

SECTION II, Chapter 08

Insurance Carrier Claims Services



Introduction

Chapter 07 discussed a variety of issues about how contractors deal with customer service and claims management issues within their own organizations. The focus in that Chapter was on the contractor's operations as they relate to service requests, complaints and some types of formal claims for construction defects in new residential homes.

This chapter focuses on the contractor's relationship with its liability insurance carrier when problems arise as a part of the construction process. This includes the problems that contractors have with the claims management services provided by both their own and their subcontractors' insurance carriers.

The balance of this chapter discusses the following major subjects:

- 8.01 Claims resistance
- 8.02 Subrogation
- 8.03 Deductibles vs. Self-Insured Retention (SIR)
- 8.04 Subcontractors victimized by Additional Insured (AI) endorsements
- 8.05 Inflated claims reserves and their impact on premiums
- 8.06 Conclusion
- 8.07 Resources

8.01 Claims resistance



Unfortunately, insurance companies sometimes inherently resist claims from their insureds. This resistance may take any one of a number of forms, including:

- (a) Reserving certain rights. Sometimes carriers will consent to initial defense, yet reserve the right to deny the claim or further defense at any point in time. This is typical in construction defect claims and is a clear indicator of the potential for further resistance later in the claims management process.
- (b) Denying coverage as a routine response for the first time in answering any claim, citing “coverage reasons.” The obvious response in such cases is to resubmit the claim, insisting on specific information on whether there is any specific exclusion and/or whether the absence of such exclusion means that coverage does in fact exist.
- (c) Denying coverage “based on the policy.” This denial may not be factual, but rather based on the assumption that the insured either cannot interpret policy language and/or will not take the time to do so.
- (d) Ignoring the claim and generally being nonresponsive.
- (e) Denying coverage based on some other argument such as errors of omission or commission on the original application for insurance. One such basis would be the misrepresentation of facts on the application. If the application is a warranted statement* that affects coverage and/or is included as part of the policy, then the burden of proof shifts heavily to the consumer and the denial might be upheld. By contrast, if there is misunderstanding, misrepresentation or omission, the insurance carrier must prove that such actions are materially relevant to its handling of the specific claim.

* A warranted statement is specifically acknowledged by the insured as true and complete.

In all such cases above, denial does not necessarily mean that the insurance carrier is not liable. Obviously a knowledgeable person, such as an experienced insurance agent, can be of considerable assistance in countering insurance carrier efforts to resist claims. Ultimately, the contractor has two choices of action: press the issue of whether coverage exists and/or determine immediately what action to take in case there is no coverage.

8.02 Subrogation



In the insurance industry, subrogation is a method of financial recovery used by insurance carriers who are obligated to pay their insureds for property damage or casualty losses which the insureds have sustained. In those situations in which the damages have been caused by the negligence or fault of a third party, the carrier may invoke subrogation provisions to pursue claims against that third party and recover all or part of the monies already paid out.

In the construction industry, application of the principle of subrogation may occur when fault rests with a subcontractor or other third party such as a buyer, supplier or manufacturer of some component of the structure. Typically, the insurance carrier's policy with the general contractor contains a provision in which the carrier reaffirms its right to seek redress from such a third party in the event that party is wholly or partially negligent for a construction defect.

An example will help illustrate the use (and meaning) of subrogation. Six months after occupancy of a new home, a plumbing failure occurs while the home owners are gone for the week, with the resultant flood of water destroying hardwood floors, rugs and other contents. The homeowner files suit against the general contractor. In this case, the general contractor's insurance company will subrogate against the plumber and the plumber's insurance company. Subrogation occurs when the first party's insurance carrier (usually the insurance carrier of the general contractor) settles the claim with the homeowner and seeks reimbursement from the plumber and the plumber's insurance company. (There is an alternative strategy which is that the general contractor bypasses his/her own insurance company and tenders the suit directly to the subcontractor. As noted below, this subject will be addressed more fully in the following chapter which discusses transfer of risk.)

The subjects of subrogation and transfer of risk are not only complicated but also vary from one state to another. Hence, certain aspects will be addressed in considerably more detail in the next

chapter of this education program. For the purposes of this chapter on claims management, the most important point is that the contractor needs to ensure that his/her contracts with both the homebuyer and subcontractors or other third parties address subrogation in a balanced manner that properly protects all concerned.

8.03 Deductibles vs. Self-Insured Retention



An additional problem in dealing with insurance carriers' claim services involves misunderstandings and/or lack of knowledge about two liability insurance contract provisions which have significant differences: deductibles and Self-Insured Retention (SIR). An explanation of the difference between these two provisions is as follows:

- (a) Deductibles. Most people are familiar with the use of deductibles in their personal lines insurance such as home and auto policies ---- that is, it is the portion of the claim which the insured is required to pay while the insurance carrier steps in and covers the balance of the claim. The same principle applies on commercial liability insurance policies but with several important variations.
1. The first variation is that typically the insurance carrier settles the claim and bills the contractor for the deductible portion after the claim has been settled. In short, the insurance carrier fronts the money. In contrast, in a personal lines situation such as one involving damage to the auto, the insured party may pay the deductible directly to the repair facility and then that repair facility submits the balance to the insurance carrier for payment.
 2. The second variation is that in some commercial liability insurance policies, deductibles apply against the cost of claims processing. In such cases, the deductible would apply against both the actual cost of the damages and the cost of determining those damages. For example, the general contractor might face a claim for \$30,000 in damages with a \$5,000 deductible, but the insurance carrier incurred \$15,000 in legal costs in fighting a claim which is then dismissed with no award against the contractor. Thus the contractor owes the insurance carrier for

the \$5,000 deductible portion of the claims expense, even though there was no award for damages.

3. The third variation is that commercial liability policies contain, or should contain, a provision that addresses whether the deductible applies on a per-claim basis as opposed to a per-occurrence basis. The difference between “per-claim” and “per-occurrence” is an extremely important one, as will be illustrated in the following example. Let’s assume that a contractor installs a water well with 10 customer hook-ups that becomes contaminated because a back flow valve fails to operate properly. The contractor is still responsible for the installation and operation of the back flow valve because the common area property has not been turned over to the homeowners’ association. If the insurance policy covered the contractor on a per-claim basis, the deductible would apply to each of the 10 claims made by the customers. If the insurance policy covered the contractor on a per-occurrence basis, the deductible would likely apply on only one of the 10 claims and the insurance carrier would be liable for the remainder. Obviously, the “per-occurrence” language is more favorable to the contractor.

(b) Self-Insured Retention (SIR). In contrast, under an insurance policy with an SIR provision, the general contractor fronts the money instead of the insurance carrier, as in a deductible situation. That is, the general contractor agrees to pay a certain sum of money that typically covers both a portion of the claim and the cost of processing that claim. In the following example, let’s assume that the insurance policy contained an SIR provision providing that the general contractor would pay the first \$7,500 of the total claim including processing costs. Obviously, the \$7,500 payment *could* be considerably more favorable than a \$10,000 deductible contract. However, here again there are certain other factors to consider which may make an SIR contract something less than a “sure thing.”

The SIR clause in the contract may contain a provision that the cost of processing is subject to certain limitations and/or approval by the insurance carrier. Specifically, the insurance carrier might allow a \$150 per hour rate for attorney services, whereas the contractor’s attorney and/or the going rate is twice that amount in the locale in which the claim is filed. Additionally, the contractor has to pay SIR costs up front. In contrast, a deductible is not due until a claim closes and that could be years later.

In cases where there are specified limitations, there are two possible solutions which the contractor should consider as part of his/her claims management plan.

1. The first is the use of a third-party adjuster in which the fee for the adjuster’s services would be paid by the contractor. Thus, the adjuster would negotiate a total settlement including processing cost for legal fees and other expenses (*e.g.*, engineers and other technical experts). The contractor would pay the agreed upon “up front” money and the insurance carrier would be responsible for the balance without regard to whether those costs were part of the damage claim or processing portions of the settlement.
2. The second is that the SIR provision provides for “first dollar coverage” --- that is, upon receipt of a claim, the contractor simply sends the insurance carrier the amount

of the SIR and the carrier is required to resolve the claim. Typically, the carrier would return any portion if the expense settlement was less than the SIR payment.

8.04 Subcontractors victimized by Additional Insured Endorsements



The subject of Additional Insureds (called “AI” in the insurance trade) is extensive and complicated. Hence it will be discussed at far greater length in Chapter 09 of this education program entitled “Risk Transfers and Additional Insureds.” However, a brief discussion of AI coverage is relevant here because of the focus of this section on problems in dealing with insurance carriers.

When the general contractor and subcontractor are negotiating a contract for performance of work on a given project, both parties should agree on (1) what parties should be included in the AI endorsement on the subcontractor’s insurance policy and (2) what the responsibilities of the general and sub are for performance of the work involved. The contract between the general and sub triggers the AI endorsement coverage for the general contractor.

What, then, is an AI endorsement? It is a liability contract provision in which the general contractor requires the subcontractor to include in the subcontractor’s insurance policy the name of the general contractor as an Additional Insured under the subcontractor’s policy. Thus, if the subcontractor is sued, or alleged at fault by the general, the general contractor can be protected by the subcontractor’s insurance carrier.

While there are many problems associated with the AI endorsement, for our purposes in this chapter, a problem arises when too much coverage is granted to the general contractor and hence the subject needs to be included, even if briefly, in this chapter on claims management. The two most typical problems are:

- (a) The use of an AI endorsement in an “action-over” situation. For example, the employee of a plumber in a construction project falls through an opening in the floor and is injured. Responsibility for allowing an unsafe condition (*i.e.*, the hole in the floor not properly blocked off) allegedly rests with the job superintendent employed by the general contractor. The plumber’s employee files suit against the general contractor for damages above and beyond,

or in lieu of, those covered by any workers' compensation plan available in the state where the accident occurred.

The general contractor refers the claim back to the subcontractor (the plumber) because the AI endorsement typically requires that the plumber's liability insurance plan defend and settle this claim. Thus the plumber winds up with (1) a claim against his/her policy and (2) the deductible or SIR expense out of the plumber's pocket for the damages which were not the plumber's fault.

To avoid such potentially unfair claims, the subcontractor clearly needs to avoid hold harmless indemnification language in cases where the general contractor is at fault. This limits the scope of the AI endorsement and hence the amount of coverage required. It is worth noting that many policies being written in today's marketplace exclude this type of "action-over" claim. This exclusion may result in an unfunded claim or discourage pursuit of the claim, depending upon the circumstances involved.

(b) The second major problem occurs when the AI endorsement provides "completed operations" coverage to the general contractor. Typically, Completed Operations provisions cover the installation of a number of construction products to create a new product (in this case, a home) and responsibility that the new product will perform as intended. Completed Operations contemplates coverage after operations at the job site are finished. Completed Operations coverage is over and above the liability insurance provisions that cover a variety of personal injury situations such as the plumbing example cited above. AI endorsements on insurance liability policies in residential construction are difficult to obtain, yet more prevalent in commercial situations.

One example of the difficulties of an AI endorsement is as follows: in a situation where a construction defect problem emerged several years later and the HVAC was involved but not the cause of the problem, the heating subcontractor with an AI endorsement in place may be forced to defend the general contractor regardless of fault. By granting the AI endorsement, subcontractors could incur claims for which they are not at fault, but which are triggered by the AI and Completed Operations provisions in their insurance plans.

To minimize this type of issue, the subcontractor should determine whether the general contractor's policy contains a Completed Operations provision and, if so, attempt to place some "fences" to limit the subcontractor's exposure. One example would be only allowing for claims where the general contractor can prove the subcontractor is at fault. Some states, like California and Colorado, prohibit general contractors from using language that imposes liability on a subcontractor without determination of fault or contributory negligence.

8.05 Inflated claims reserves and their impact on premiums



Many of the concepts and problems discussed above can contribute to inflated claims reserves and to the increases in premium required to fund those reserves. For both general contractors and subcontractors, the key fact of insurance life is that for every dollar paid for a claim as shown on the contractor's loss history, the premium is elevated by two to four dollars upon renewal. In addition, the number of claims submitted also has an impact.

For example, let's compare hypothetical Contractor A with one claim of \$20,000 during a five-year period and hence an average of \$4,000 per year with Contractor B with five claims of \$4,000 each, again a total of \$20,000. In the case of Contractor A, the underwriter for the insurance carrier uses a multiplier of 3 and raises the premium by \$12,000 (three times the average claim of \$4,000).

In the case of Contractor B, the underwriter may use a higher multiplier of 5 because of the increased likelihood of another claim based on the loss history of greater frequency and raise the premium by \$20,000 (five times the average claim of \$4,000).

While both contractors had a total loss of \$20,000 over a five-year period and hence both received an increase in premium, Contractor B received a substantially greater increase because of increased frequency of claims. In insurance theory and practice, numerous small claims inevitably lead to an eventual big claim and hence the higher multiplier.

Another factor impacting the underwriter's decision in this regard is the presence of open claims --- that is, claims that have not yet been resolved and fully paid. Since the underwriter does not know the size of the ultimate settlement (or even when it may occur), the natural tendency is to seek a higher premium as protection against the unknown future. This contingency approach to open claims can hold true even if the insurance carriers are different from year to year.

There are several courses of action open to contractors to reduce the impact of present claims on claims reserves and future premiums. The first is simply to pay any small claims without submitting them to the insurance carrier. All too often when faced with a claim, a contractor

insists “that is what I have insurance for” without knowledge of the multipliers used by underwriters and hence without evaluating the impact of the claim on future premiums. If the claim is relatively small and not able to be increased at a later date, the best course of action may be simply to pay without submission to the carrier. In any case, contractors should consult both their insurance agent and attorney for an evaluation of such decisions.

Another step is to push the insurance carrier to settle any open claim prior to the time for policy renewal. While it is bad enough to have a loss history of any length, it is worse yet to have open claims as a part of that history. Organizing the documentation of an open claim, spelling out its status, and outlining the likely disposition may help when shopping the renewal with competing carriers.

While some contractors may balk at that type of action, the reality is that insurance is designed to protect the contractor against catastrophic claims that could put the contractor out of business. In such instances, insurance is the proper method of transferring the risk to another party, and insurance companies are a highly efficient means of doing so. However, insurance companies are not designed as a bank upon which to draw funds to pay off small claims that do not threaten the existence of the contractor. Banks are designed for cash flow assistance, rather than absorbing large insurance losses.

8.06 Conclusion

Chapter 08 discusses five major factors that can make a significant financial impact on a contractor trying to settle a construction defect claim with his/her insurance carrier. Terms like “subrogation,” “self-insured retention” and “additional insured” are not words in the everyday vocabulary of most contractors, but they describe concepts of great value, either positive or negative, and hence are important to contractors.

Given the availability of outside professionals, the contractor should take the steps necessary to protect himself/herself in claims situations. At a minimum, the chapter is designed to help the contractor raise the right issues and ask the right questions as a part of the process of entering into and carrying out a building project of any size.

8.07 Resources

Most of the concepts, explanations and conclusions presented in this chapter are original material based on the training and experience of the officers and shareholders of the NWCA. Therefore, there are few specific resources available for outside review by members.

If members wish further information and/or explanations of the material contained herein, the NWCA recommends that those persons contact their insurance agent, especially those well versed in commercial liability insurance. Through those agents, members also may be able to obtain information published by organizations such as the International Risk Management Institute.



CHAPTER 08 – INSURANCE “CARRIER CLAIMS SERVICES”

1. Claims resistance, when met with denial of liability by the insurance carrier, can be resolved by...
 - a) Denying payment to the general contractor
 - b) Walking the agent through the insured structure to note damage
 - c) Pressing the issue of coverage and determining immediately what action to take in case there is no coverage
 - d) Calling the contractor repeatedly
2. In the insurance industry, subrogation is...
 - a) Placing the concerns of the homebuyer below the concerns of the contractor in level of importance
 - b) The act of billing the homebuyer for any claims as a first step in financial recovery
 - c) Appealing to the courts for a time extension
 - d) A method of financial recovery used by insurance carriers for any loss sustained by the insureds even when caused by a third party
3. In the construction industry, application of the principle of subrogation may occur when...
 - a) Fault rests with a subcontractor or other third party and the contractor uses a provision in his/her own policy to seek redress
 - b) The courts kick back a claims decision and the homeowner suffers
 - c) The contractor does not address a claim to the homeowner's satisfaction
 - d) The insurance agency pays the claim without the contractor's permission
4. A warranted statement is...
 - a) A falsehood perpetrated by the agency wishing to sell a policy
 - b) Specifically acknowledged by the insured as true and complete
 - c) Denies coverage based on some other arguments such as error of omission.
 - d) Proof that the insurance carrier handled the claim correctly
5. Deductibles in a commercial liability insurance contract
 - a) Are similar in nature to deductibles in personal home and auto policies
 - b) Differ greatly from personal home and auto policies
 - c) Are so complex that a third party insurance adjuster should be hired
 - d) Never cover the cost of claims processing
6. The difference between “per claim” and “per occurrence” deductible in a commercial liability policy is...
 - a) Relatively unimportant
 - b) Determined by the homebuyer
 - c) Very important and related to whether the contractor must pay on a group of claims or a single “occurrence” claim
 - d) Payment and distribution of monies to subcontractors



7. Self-Insured Retention (SIR) is...
 - a) When the insurance carrier fronts the money for any payment of claim
 - b) When the general contractor fronts the money for any payment of claim
 - c) When the homeowner pays the money for any payment of claim
 - d) When a subcontractor pays the money for any payment of claim

8. Problems typically associated with “Additional Insureds” endorsements are...
 - a) Their use in an “action-over” situation
 - b) Their provisions to the general contractor for completed operations
 - c) Their lack of use by carrier when processing claims
 - d) a and b

9. Open claims, claims that have not been resolved or fully paid, may cause the premiums, to increase upon renewal.
 - a) True
 - b) False

10. To reduce the impact of present claims on claims reserves and future premiums a contractor should?
 - a) Pay any small claims without submitting them to the insurance carrier
 - b) Push the carrier to settle the claim prior to policy renewal
 - c) None of the above
 - d) Both a and b