

DISCLAIMER

Electronic versions of the exhibits in these minutes may not be complete.

This information is supplied as an informational service only and should not be relied upon as an official record.

Original exhibits are on file at the Legislative Counsel Bureau Research Library in Carson City.

Contact the Library at (775) 684-6827 or library@lcb.state.nv.us.

AGC WHITE PAPER
ON
CONSOLIDATED INSURANCE PROGRAMS
(SENATE BILL 44)

INTRODUCTION

Consolidated insurance programs, e.g., owner-controlled insurance programs, are also referred to as wrap-ups because such programs enable the party sponsoring the construction to purchase workers' compensation and general liability insurance policies for all the contractors and subcontractors participating in their building project. A rolling wrap-up is a consolidated insurance program that encompasses construction projects at several sites.

According to the Insurance Information Institute, construction project owners can profit from making insurance coverage centrally available for their contractors, rather than having to indirectly pay for it when built into the cost of contracts. Companies are motivated to offer wrap-ups by other factors, too, such as the ability to centralize claims handling and centrally manage safety programs.

According to George D Dale, president of D&H Resources, Inc., a Los Angeles – based risk management consultant, “wrap-ups can be very profitable.” As a result, “there is a gold-rush stampede to get into this business,” and “more brokers and insurers are getting into it.”

As a result, brokers and insurers are the principal and, usually, the only proponents of consolidated insurance programs or wrap-ups.

While opponents of wrap-ups, including the AGC and AFL-CIO, agree that wrap-ups can be very profitable for brokers and insurers and, occasionally, project owners, we must ask at whose expense.

ECONOMIC INTERESTS AND PUBLIC POLICY CONSIDERATIONS

Wrap-ups are a form of construction insurance program first seen in the 1970s. Conceptually, the project owner or general contractor purchases an insurance policy covering all contractors and subcontractors of every tier working on the specific project. The policy period normally includes the term of the project plus a stated number of years after completion known as the “tail” period. The tail is normally five to seven years but can extend beyond fifteen years. The coverages included in a wrap-up are normally workers' compensation, general liability, and property. Other special coverage types may be included but normally eighty percent (80%) or more of program premium is derived from workers' compensation insurance.

The purported benefits of a wrap-up must be evaluated in comparison to the traditional approach to construction insurance, wherein contractors of every tier cover their employees and their liability by means of their own insurance programs. The perceived benefits must also be weighed against the harm caused to individual

contractors in terms of disruption of existing insurance agreements and safety programs. Finally, the economics of wrap-ups must be analyzed in order to clearly understand who benefits financially, who loses financially and what types of uncertainty are present.

OVERVIEW OF LEGISLATIVE SCHEMES

Throughout the United States debate over wrap-ups has been contentious for the past thirty years and continues today. There should be no mistake as to the interests and parties to the issue. On one side, large insurance brokers, a few large insurance companies, very large general contractors and project owners press for wrap-ups. On the other side, local business groups, subcontractors, construction trade associations, regional insurance companies, and labor groups resist wrap-ups. Legislatively the states have split along similar lines. The federal government has not allowed wrap-ups on federal projects. Furthermore, the General Accounting Office has been tasked to investigate the "savings" in wrap-ups, where federal funds are utilized and the Department of Justice has initiated prosecutions on various state and local construction projects using wrap-ups.

As of 1997, some twenty states did not allow wrap-ups of any form. These states follow the Nebraska model. Generally, they are states with a small to medium population base. Economic activity is concentrated in one or two population centers. A significant amount of construction is in the public works sector. The legislative history of wrap-ups indicates that such programs were promoted at some point but rejected, because the legislatures: 1) were not persuaded of the savings of wrap-ups, particularly on public works; and, 2) did not believe that the interests of "big insurance" justified the negative impact on their local economies. Additionally, there is evidence that the notion of local business being "force fed" someone else's insurance coverage ran contrary to the spirit of self-determination in these states.

At the same time, other states adopted a policy of "laissez faire" concerning construction insurance. In these jurisdictions, numbering about fifteen, project owners are free to control insurance under most circumstances. This includes both public and private works. Some of these states have very large populations and enormous amounts of both commercial and residential construction under way at any moment. In very populous states an underlying rationale is that, even if a contractor's insurance agreements are disrupted on the one wrap-up on which the contractor is working, he/she probably has many other sizable jobs going at the same time. Therefore, the premium and control lost under the wrap-up is only a small part of the contractor's overall, annual insurance budget. California has adopted this model.

Another group of states, numbering some fifteen as of the mid-1990s, has adopted a middle ground policy on wrap-ups. These states do allow wrap-ups. However, the legislative intent appears to be acknowledgment of the disruptive effect of wrap-ups on local economies and a resultant limitation on the use of wrap-ups. This model includes New York, where wrap-ups on public works projects and geographical limits are circumscribed.

These categories are of course general. A review of the statutory and regulatory framework of all fifty states, including the legislative history of debate on various wrap-up schemes is beyond the scope of this paper. Each state has its own nuances, which reflect both its own economy and the relative political power of big insurance versus local contractor interests.

ECONOMICS OF LARGE, PRIVATE WRAP-UP PROGRAMS

Large insurance entities, particularly brokers, have a clear, financial incentive to promote wrap-ups. Insurance budgets on wrap-ups typically run two to five percent of construction value (labor and materials excluding land value and the cost of financing, permits, etc.). On a \$500 million project that amounts to one to two and one-half million dollars. First, it is critical to keep in mind that unless the contractors and subcontractors were coerced to accept the wrap-up coverage, as a condition to bid, the insurance company and the broker running the wrap-up would never see any, or at best a small fraction, of this money. The economic impact of these dollars would be infused throughout the local economy, rather than concentrated in one or two entities. There is no argument as to who these entities are: only a handful of insurance companies will underwrite wrap-ups and only a handful of brokers will manage wrap-ups, most of whom are based outside the State of Nevada.

From the standpoint of the local business community this is a net loss. Under a traditional insurance program, perhaps 100 contractors and subcontractors would work on such a project over a two-year period. These 100 local businesses each have a local insurance agent and use their own insurer. In many cases, the insurer is domiciled in the home state of the contractor or is a regional company with strong ties to the locale. Therefore, the project insurance budget is not highly concentrated but may be disbursed through ten, twenty or more local agents and a large number of insurers. The contractor's local safety consultant, agent and insurer are, however, out of the funding loop on a wrap-up. While these entities will be required to assist the contractor in filling out documents, reconciling premium audits, and handling reports of claims in the "gray area" between what the wrap-up does and does not cover, they will not be compensated through the project insurance budget. The incentive that the contractor has for being safe is reduced because any retrospective incentives for keeping losses down, such as retrospective premium adjustments and dividends, accrue to the owner. Overall, the contractor and his insurance team lose both the funding and the incentive to maintain their normal insurance and safety programs.

From the owner's view the wrap-up is a net gain, provided that the broker's projections materialize. The broker normally forecasts what the losses will be on the project. The broker also estimates what the owner would pay, if the contractors furnish their own insurance. If the broker did not project that: 1) the contractor's insurance is more expensive than the broker's program will cost; and, 2) that the expected losses will

be low due to the brokers wonderful claims management and safety programs, then the broker is not going to sell many wrap-ups. In practice, an independent, licensed actuary seldom prepares loss-cost estimates.

Second, the contractors are never afforded the opportunity to talk directly to the owner and negotiate the insurance costs passed on to the project. This disreputable practice impacts self-insured contractors with low insurance costs the most. The safe contractor may be able to offer the owner an insurance burden of say \$50,000 for the contractor's piece of the project. The contractor may further be able to offer this on a "guaranteed" cost basis (i.e., regardless of the contractor's claims he/she guarantees that the owner will not pay more than the \$50,000 maximum). The contractor might even be willing to negotiate a lower, guaranteed cost for his insurance, if given the chance. In practice, however, the owner may be paying the wrap-up up to \$75,000 to cover this contractor when in fact the contractor was willing to cover himself for less than \$50,000.

If the losses balloon beyond the broker's forecasts, the owner pays an additional "penalty premium" on the back-end of the project, where the insurance was written on a "retrospective rating formula." No one, not the wrap-up broker, not the wrap-up insurance company, not the wrap-up owner, knows what the final bill will be for insurance until the wrap-up retro closes. No one knows either what the cost would have been, if the contractors had furnished their own insurance, because no one ever gave them the opportunity to negotiate directly with the owner.

This notwithstanding, there can be net savings for the owner on a very large, private project compared to a traditional insurance approach. There can also be net losses. The tale is not told until years after the project is completed and the losses develop.

The bottom line is that it's the owner's money. If he wants to enrich a particular broker or insurance company it's more or less his business. The local economy suffers a net loss in jobs and diversity but under a laissez-faire system adopted by some states, the price local economies pay for private wrap-ups is deemed to be justified by the benefit of an owner risking millions in capital to build his project. In essence, it's a private citizen's money and a private citizen's risk. Contractors and owners would merely benefit from a bid process that allows safe contractors to provide the owner directly with real figures, rather than via a "middle-man", whose financial interest lies in selling wrap-ups.

ECONOMICS OF SMALL, PRIVATE WRAP-UPS

Operationally and conceptually a wrap-up works the same on either a billion-dollar project or a one hundred million dollar project if both are located on a single site. The definition of "site" is critical and varied throughout the nation. The economics are, however, extremely sensitive to scale. Simply put a large project generates more premium and thus higher broker fees. This allows for a relatively large pool of funds to

absorb losses. It also creates higher broker revenues, allowing more resources (hopefully) to be dedicated to site safety and project claims management.

There is an economic point of diminishing returns for the wrap-up owner and wrap-up insurer. Many insurance companies will not touch a wrap-up generating less than \$200 million in construction value. They know how badly claims forecasts can blow up. Unfortunately, to generate bottom line income some insurers will write wrap-ups on lower value projects. Recall that 80% of wrap-up premium derives from workers' compensation. California is littered with the corpses of insurance companies, who under priced workers' compensation coverage to generate premium revenue that didn't cover claims and expenses.

From a broker's view it does not really matter, because the broker generally has no direct, financial stake in the ultimate losses. In the industry parlance the broker has no "skin in the game." Therefore, it's not unusual to have a wrap-up vigorously promoted on a marginal project of \$100 million or less.

Thus there are relatively few projects, where it makes any economic sense to use a wrap-up. However, wrap-ups are very profitable for big brokers. To get around the real limitation on the number of wrap-ups that can be sold in a given year, big insurance conceived the "rolling wrap-up." Essentially, to meet that \$200-250 million threshold, where a wrap-up will even be considered, the broker proposes to stretch the geographic and time horizons of a regular wrap-up. If an owner will not generate \$250 million in construction value on one project over the next two years, let's give him twenty different sites over the next 10 years to add up the critical mass. That's the concept.

On private works the most frequent use of rolling wrap-ups, where they are legal, is in residential homebuilding. For example, a single, \$100,000 home cannot qualify for a wrap-up." It only generates enough payroll and revenue exposure to yield approximately \$2,500 in premium. On one hand the insurer has a net loss, if one accident results in say a \$10,000 workers compensation claim. On the other hand, the broker would only be paid about \$300 in commissions. There is not sufficient funding to justify putting a safety officer on site and dedicating a claims adjuster to the project.

The notion is to combine a large number of these \$100,000 houses. Each tract in a development is covered under the rolling wrap-up. And, all the houses in all the other developments the owner ever builds may be added later. The rolling wrap-up in theory can extend ad infinitum.

The economics of such an arrangement, as well as the operational problems, are manifest. The developer has to pay a minimum premium at the inception of the policy. The wrap-up may contemplate covering 10,000 homes over a 10 year period. But the developer may go out of business 3 years into the deal. The promised economics (adding up a number of covered units to reach the \$200 million threshold) never materializes. Brokers also tend to push toward the lower end of the threshold. Many residential wrap-

ups target large projects of \$250 million, \$500 million and more. Again, you have fewer resources to do the job.

Operationally, rolling wrap-ups can be a nightmare. They are distinct from a \$250 million hospital, or casino or office tower with a footprint measured in a few blocks and extending over a couple of years. These programs have sites spread out over miles, perhaps going simultaneously in different areas of an entire county. They also run for years or even decades. The safety resources cannot and are not concentrated. Staffing changes over time. Management practices vary from site to site, year to year. In order to properly fund operational resources, premiums are relatively higher. Potential savings are therefore lower.

The disruption and economic impact on locales, in particular contractors and subcontractors, is magnified on rolling wrap-ups for private work. In the case of a single, large project the contractor suffers a loss to his insurance program and may be deprived of winning the bid against a less safe rival. But, the degree of damage is limited. The contractor has other work. Under a rolling wrap-up, a residential contractor or subcontractor may find his entire insurance program gutted. If he does work for one or two large developers who force him to work under a wrap-up, his own program is a shell. He does not pay sufficient premium to qualify for major incentives and rate reductions. His agent, insurer and safety consultant have no revenue from which to draw to provide resources.

In effect, the owner's broker and carrier become the contractor's broker and carrier by default. By contract these owe a duty to the owner, not the contractor. They are not looking out for the contractor and in the event of a conflict, have a fiduciary obligation to protect their principal.

In essence, a rolling wrap up is the combination of several little projects that would never have been wrapped on their own merit. You are asked to believe that the sum of the parts is greater than the whole. Contractors, mainly small and medium residential subs, are forced to pay for this theory. The price is the virtual dismantling of many firms insurance and risk management programs. Once these assets are gone, the contractor cannot rebuild them easily or cheaply. This lack of internal safety and insurance resources puts him at a real disadvantage in future bidding for non-wrap-up work. Larger contractors who manage not to have their own programs gutted by rolling wrap-ups will be able to compete against him using the lower rates they have earned from their own carriers and the safety resources they bring to the table.

PUBLIC WORKS WRAP-UPS

All of the elements of a private wrap-up inure to a wrap-up on public works projects. Except in this case the "owner" is the government and the funding source is the local taxpayer.

The economies of scale do not change. Large projects on a single, geographical footprint completed in a relatively short period of time (1-2 years) have the best chance of generating real cost savings, compared to traditional insurance approaches. Thus, a wrap-up on a \$500 million municipal stadium or courthouse complex stands more chance of working than a wrap-up on 50,000 meters of pipeline or 16 different county road-improvement jobs spanning 60 months.

The element of "risk" and who is taking it are extremely different in public works wrap-ups. Again, the purported "savings" of any wrap-up are based upon loss-cost projections. The projections are normally prepared by the same parties trying to sell the wrap-up. These parties will also profit, whether the projections are met or not. Not only is there no independence of judgment from licensed actuaries, but there is no requirement that an independent actuary be consulted. Furthermore, there is no requirement that a second-opinion be solicited and that each and every meeting, forecast, and study be subject to open meeting requirements. There is an inherent conflict of interest, which is not addressed.

If losses go beyond projections, the taxpayer foots the bill. If a self-insured contractor could have covered his own insurance costs for less than the wrap-up rates, the taxpayer never hears about it. Meetings between brokers and public sector risk managers and finance staff are not subject to open meeting requirements. In addition, the selection of insurance brokers and carriers by public entities is not subject to public bid laws. The public may not even be getting the lowest, qualified bid for wrap-up insurance, let alone the best deal-which often comes from a safe contractor using his/her own coverage.

In addition, insurance companies are covered by the state guarantee fund. This is significant because wrap-ups are inherently large and risky undertakings. A company insolvency due to inadequate rates on one or more wrap-ups will be paid for by the guarantee fund. The guarantee fund in turn assesses all other insurance companies for the shortfall. The increase in rates will ultimately be passed on to the insurance buying public.

Finally, there are numerous examples of public works wrap-ups gone wrong. Due to "tail" exposures stretching out more than 10 years in some cases, the public and local government elected officials may not know if a wrap-up saved money for a decade after project completion. The incidence of malfeasance is significant as well. To cite two contemporary examples, the wrap-ups covering the Metro Transit Project in California and the Boston Tunnel Project in Massachusetts have both spawned debacles, including investigations by the FBI, United States Justice Department and Congress's General Accounting Office. GAO is mounting a study to attempt to determine if purported savings on wrap-ups are real or illusory. These were both projects, where the local governments were assured of large savings, good safety and loss control and a fair selection process.

At this juncture, it is important to note that on January 10, 2000 the Employers Insurance Company of Nevada was forced to bring suit against The Resort at Summerlin, Inc. for \$1,171,200 for unpaid insurance premiums for the wrap-up that the parties had entered into on January 20, 1998.

SPECIFIC CONCERNS

Wrap-ups discriminate against contractors with good safety programs and records

In a wrap-up, a project owner buys workers' compensation, general liability and builders' risk insurance on behalf of all contractors and subcontractors bidding the project. Contractors must then deduct insurance costs from their bids.

Since workers' compensation is the greater of the insurance costs deducted, those contractors with the lowest workers' compensation costs lose their competitive advantage when bidding. These lower workers' compensation costs are, of course, the product of a good safety program and record.

Wrap-ups, therefore eliminate any competitive bidding advantage a contractor with a good safety record may have over a contractor with a poor safety record. **Wrap-ups, by their very nature, therefore negate one of the primary inducements traditionally used by the Nevada State Legislative to encourage companies to establish and maintain viable safety programs, i.e., workers' compensation costs.**

Injury rates on wrap-ups are three times the national average

While there has been no nationwide study completed, it must be noted that an independent report, the Fluor Daniel/Kellogg Report, on the \$2.4 billion Los Angeles Metro Rail Subway Construction Project concluded that the recordable incident rate of 45.48 per 200,000 man-hours worked on the project was three times the national average of 14.3, while the lost-time incident rate of 19.36 per 200,000 man-hours was about triple the national average of 6.8.

As a result of the Fluor Daniel/Kellogg Report, the Los Angeles County Transportation Commission which was formed to direct the subway building project, replaced the project's consolidated insurance administrator, Sedgwick James of California, Inc. The insurance administrator had not reported 50 percent of the accidents occurring on the project.

While there are no comparable safety statistics available for construction projects with consolidated insurance programs in Nevada, it must be noted that in 1999, four (4) of the seven (7) construction related fatalities reported in 1999 for Southern Nevada

occurred on projects with consolidated insurance programs. **The following is a list of construction related fatalities in Southern Nevada in 1999. Those fatalities highlighted on this list which was provided by the Occupational Safety and Health Enforcement Section occurred on projects with a wrap-up:**

1) **February 8, 1999**: Masonry block fell 45 feet and hit the employee in the face resulting in his death;

2) **March 4, 1999**: Employee was checking fire/smoke dampers inside an air duct on the 2nd floor when he fell approximately 31 feet to his death;

3) **June 11, 1999**: The deceased was knocked down by the bucket and ran over by a front articulating loader;

4) **September 16, 1999**: An employee installing a pipe in a 13-14 feet deep trench was buried by a cave-in;

5) **November 9, 1999**: While attempting to cross from one portion of a roof to another, an employee fell 27 feet to his death when one of the scaffolding planks moved;

6) **November 10, 1999**: Employee fell 24 feet to his death while working on a roof; and,

7) **December 14, 1999**: Employee died after being struck by a falling section of pre-cast concrete.

Safety requirements for wrap-ups in Nevada are inadequate

NRS 616B.725 requires that only one safety coordinator be assigned to a construction site covered by a wrap-up. By comparison, there is a staff of eight assigned to oversee safety and claims administration on the \$2.4 billion ongoing construction project at the San Francisco International Airport. Workers' compensation coverage for the airport wrap-up is underwritten by the Menlo Park, California – based Argonaut Insurance Company.

There is no regulatory oversight of wrap-ups in Nevada

According to the Insurance Information Institute, a key factor in realizing potential cost savings from a wrap-up is the institution of a rigorous safety program with incentives and penalties for contractors and subcontractors pegged to an agreed upon accident incident rate. Unfortunately, there is no provision for such rigorous safety programs under Nevada law and, as a result, no such rigorous safety programs have been instituted for any of the wrap-ups approved to date by the Department of Insurance.

More significantly, discussions with the staff at the Department of Insurance indicate that they believe that their role is to approve or disapprove wrap-ups, not to regulate them.

Rolling wrap-ups will add to the complexity of wrap-up safety administration and oversight by introducing the need to manage several locations

Section 11 of chapter 582, Statutes of Nevada 1999 will permit rolling wrap-ups beginning October 1, 2001. A rolling wrap-up is a consolidated insurance program that encompasses construction projects at several sites.

Although NRS 616B.725 requires the private company, public entity or utility with a wrap-up to "ensure that the primary or alternate coordinator for safety for the construction project is physically present at the site of the construction project whenever activity related to construction is taking place at the site," there is no way to enforce this requirement for rolling wrap-ups which cover numerous construction projects at different sites. Furthermore, there is no provision for the rigorous safety programs recommended by the Insurance Information Institute for either wrap-ups or rolling wrap-ups.

Rolling wrap-ups will add to the complexity of claims administration and impose an even more significant administrative and economic burden on local contractors than do wrap-ups

Consolidated insurance programs covering more than one construction project, i.e., rolling wrap-ups, could, theoretically, involve a number of different owners. In any event, a separate construction contract will be required for each project thereby involving a multitude of contractors and subcontractors. The resulting administrative requirements will increase not only the cost of the consolidated projects; but, more significantly, the administrative costs of the many contractors and subcontractors on each of the consolidated projects. These administrative costs include, for example: 1) additional accounting costs to segregate the hours worked by each employee on each project to track insurance coverage and calculate insurance costs; 2) the reapportionment of the costs of a company's safety staff and safety vehicles which are excluded from payment on a wrap-up; 3) additional premium audits; and, 4) handling claims in the "gray area" between what the wrap-up does and does not cover.

In addition, we must note that each time a contractor or subcontractor is employed on a project covered by a wrap-up, his industrial insurance coverage is disrupted. The result has already been an increase in industrial insurance rates. This increased cost will be magnified by the inclusion in a rolling wrap-up of numerous smaller projects that do not individually meet the dollar threshold for a wrap-up.

RECOMMENDATIONS

The specific concerns enumerated in this white paper are reflected in Senate Bill 44 which proposes to further define and limit wrap-ups in the State of Nevada by:

- 1) Increasing the threshold amount that the estimated total cost of a construction project must be equal to or greater than before a wrap-up may be established from \$150 million to \$250 million;
- 2) Redefining the "estimated total cost" of a construction project to include only those construction related costs covered by a wrap-up;
- 3) Defining a construction project; and,
- 4) Eliminating rolling wrap-ups by requiring that each consolidated insurance program cover no more than one construction project.

While it may be possible by statute to require that a rigorous safety program be instituted for each new wrap-up, neither the Department of Insurance nor the Department of Industrial Relations is staffed to provide the regulatory oversight needed to enforce the additional safety requirements needed for a wrap-up. And, unfortunately, the imposition of additional safety requirements does not address all of the concerns expressed by local business groups, contractors, subcontractors, construction trade associations, regional insurance companies, and labor groups.

The opponents of wrap-ups have, therefore, concluded that the best solution to the problems exemplified in this white paper is to further limit wrap-ups and eliminate the provision for rolling wrap-ups which will greatly add to the complexity of wrap-up administration and oversight.

While Nevada (like Nebraska and other states that have banned wrap-ups) is a large state with a relatively small population, we do not purpose to eliminate wrap-ups on single construction sites. Mega-projects are important to the economy but relatively rare in comparison to home building, public works and the other "meat and potatoes" of the Nevada contractor's livelihood. Contractors may reluctantly embrace being coerced into taking wrap-up coverage on one or two mega-projects per year. However, rolling wrap-ups, particularly in residential construction and public works would gut the internal insurance and safety resources of most contractors. This would reduce their ability to manage risk, which in turn drives up rates due to losses. In the end, Nevada contractors would have difficulty finding and maintaining competitive insurance and risk management services. Wrap-ups would then become increasingly attractive to fill the gap, which wrap-ups created. In a state with Nevada's demographics, we could find

ourselves in five years with most construction projects being insured under wrap-ups by a few out-of-state brokers and carriers. The organic insurance market and related service industry would then cease to be a local economic force.