

The Use of Controlled Insurance Programs as a Risk Management Alternative on Construction Projects

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This paper discusses the use of controlled insurance programs as a risk management alternative for insuring construction projects. Controlled insurance programs, commonly referred to as “wrap-ups”, are insurance policies for construction projects purchased by a single entity. The traditional method of insuring projects is examined and comparisons are made between the two approaches to risk management. Not all projects are candidates for controlled insurance programs as the project cost may be too low or the additional administrative burden for the policy sponsor may be too great. The positives and negatives of controlled insurance programs are researched throughout this paper as well as some guidelines for determining the feasibility of a controlled insurance program. The decision is ultimately up to the potential sponsor, or purchaser of the policy. The entity should be well informed and well educated about controlled insurance programs before undertaking one. Examining controlled insurance programs provides insight into an insurance alternative that may not have been previously considered for a project.

Key Words: Insurance, Controlled Insurance Program, Builder’s Risk, Commercial General Liability, CIP Sponsor

Introduction

Large construction projects are subject to a multitude of risks and it is the responsibility of each party involved to have a clear understanding of the project in order for it to be a success. The individual parties are responsible for identifying their associated risks and finding ways to best mitigate these risks. An important first step is to recognize which party is best equipped to handle the particular risk in question. Some risks are mutual among all parties involved, while others may be exclusive to a single entity. Certain entities are better equipped to manage risk than others. The language of construction contracts often dictates to which party the risk is allocated because that party is best equipped to manage the particular risk (Gibson, 2006). Controlled insurance programs are being used more frequently for construction projects and their popularity is expected to grow in the future as an alternative to traditional insurance methods (Lew & Overholt, 1999).

Traditional Insurance Approach

The traditional approach to insuring construction projects involves each individual party purchasing their own insurance policies required for the job. Each party purchases liability, workers compensation, and other job specific lines of insurance for the project. Owners, general contractors, and subcontractors purchase insurance specific to the project to protect themselves and their workers (Grenier, 2001). Under this approach, the general contractor shoulders the majority of the risk on the project, specifically pertaining to property damage and personal injury. The general contractor is responsible for hiring subcontractors for the project and must make sure they are insured as well, or face the risk of being held accountable for an uninsured loss (Gibson, 2006). There are many positive attributes to using traditional insurance methods for insuring projects, but there are drawbacks as well. A glaring problem is the inherent inefficiencies that exist due to the numerous parties bringing their individual policies to the project. It is the responsibility of the general contractor to track each individual subcontractor’s certificate of insurance. This can be a burden for the contractor along with making sure each subcontractor has adequate coverage limits for the project which can lead to gaps in coverage. The owner of the project can be affected by these gaps in

coverage, raising the cost of the project and exposing them to risk that could have been alleviated. The various parties involved with the project can make handling claims a difficult process as well (Grenier, 2001).

Builders Risk Insurance

Builders risk insurance covers the physical structure during construction. The policy does not cover the project before construction starts or after completion. Construction must be on going in order for coverage to exist. This policy covers loss from fire, acts of vandalism, and wind damage. Any materials or supplies on the job are also covered under this policy umbrella from damage or theft. While the standard documents issued by the American Institute of Architects (AIA, specifically A201) indicate that the owner should provide the builder's risk policy, this policy can be purchased by the owner or general contractor depending on which party can acquire the best available market rates. Additional coverage, such as earthquake, flood, and terrorism coverage, can be added to the policy depending on the needs of the owner or general contractor. Another additional measure that can be taken under a builder's risk policy is coverage for materials in transit or materials stored offsite. The contractor's tools and equipment should be added to the policy if they are not already covered. Basic builder's risk policies only cover materials at the construction site and would not cover an unexpected loss off the jobsite. The size of the policy needed depends on the size of the project and scope of work.

The type of building and intended use has an impact on how much coverage should be purchased. If taking on a renovation project, the purchaser of the policy needs to be aware of the policy he or she is purchasing. It is important for the policy to insure both the existing structure as well as the new construction. The problem is that often builder's risk policies do not cover the replacement cost of an existing structure. In the event of a catastrophic event such as a tornado, the purchaser would not be covered for the full replacement cost of the building. This can have a detrimental impact on the cash position of the contractor or owner and ultimately cause the project to fail. The construction contract will dictate the structure of the builder's risk policy. Typically, the owner and general contractor are insured on a single policy with coverage extending to the subcontractors as well. Having a builder's risk policy with broad coverage significantly reduces the liability exposure of the owner and general contractor (Gibson, 2006).

Commercial General Liability

The contractor also carries a commercial general liability policy, or CGL policy. This policy insures that the purchaser is protected from claims of bodily injury or property damage resulting from the purchaser's work. In order for the policy to respond, the property damage or bodily injury must be caused by incident or occurrence that happens during the policy period. It is important for the purchaser of the policy to be aware of exclusions built into the policy. Without knowing the exclusions, the purchaser may be exposed to an uninsured loss. Understanding which additional coverages should be purchased mitigates the risk with a CGL policy. The policy does not cover intended instances, such as an employee intentionally causing property damage. Pollution is also often excluded from the standard commercial general liability policy. If injury is caused to a party outside the premise of the jobsite from the release of pollutants, the standard CGL policy typically will not cover it. For example, a tank filled with a hazardous gas leaks and causes a neighboring building to be affected. The CGL policy does not cover the contractor should the contractor be held liable for the leak and subsequent harm to the neighboring building. These are just a few examples of exclusions the policy purchaser should be aware of when buying coverage. It is important for the purchaser to understand the basics in order to be protected (Stanovich, 2010).

Workers Compensation

The contractor carries workers compensation insurance to protect its workers. This is legally required and is necessary due to the hazardous nature of construction work and the potential for injury it entails. Workers compensation insurance provides medical coverage for injured employees. By accepting workers compensation coverage, the injured employee no longer has the right to sue the employer. The insurance quote the contractor received is based on the companies experience modifier rate, or EMR for short. The insurance companies quote rates to the contractors that are competitive in the market, but at the same time the quoted premium must be able to cover an insured loss. Insurance companies do their homework on companies to determine the proper premium they should be quoted. The insurance company takes into account accidents that the contractor has had on jobs to determine if they are a risky investment. The contractor's experience modifier rate is based on accident history.

Fewer at fault accidents for the contractor mean a lower experience modifier rate. The lower the experience modifier rate, the lower the quoted premium. Jobsite safety is crucial not only for the workers, but also for the contractor to acquire insurance at a reasonable premium (Chan et al., 2008).

Controlled Insurance Programs

Controlled insurance programs, also known as wrap-ups, have been utilized as far back as World War II. The Chase Manhattan Bank headquarters was the first documented project to use a controlled insurance program. The United Nations building in New York also used a wrap up as opposed to traditional insurance. Both of these projects were built in the 1950's and were two of the more notable projects to first utilize wrap up policies. Controlled insurance programs are becoming increasingly popular for private owners, general contractors, public entities, and for government projects (Gibson, 2006).

A noticeable difference between a controlled insurance program and traditional insurance methods is who purchases the policy. Under a controlled insurance program, a single party purchases insurance for all parties involved on the project. Claims are handled by the purchaser's policy, regardless of which party was at fault. The policy can be purchased by the owner, known as an OCIP, or can be purchased by the contractor, known as a CCIP. The purchasing party is commonly referred to as the CIP Sponsor (Gibson, 2006). A controlled insurance program offers the sponsor a unified risk management solution for insuring a project and can potentially save the purchasing party money if managed properly. Additional safety measures can lead to fewer accidents on the job under a CIP. Claims are handled more efficiently and loss control is monitored more closely to provide the sponsor with an effective risk management approach to the project (Yahn, 2009). Claims handling is more efficient due to the insurance for the project being under a single policy (Lew & Overholt, 1999). Some subcontractors may have previously not been able to bid on jobs due to failing to meet the insurance requirements. Under a controlled insurance program, this problem is avoided because of the uniform coverage limits provided to each individual subcontractor (Gibson, 2006).

It is the responsibility of the sponsor's risk manager to determine how much liability coverage should be purchased for the project (Lenckus, 2008). The main drivers for determining the feasibility of a controlled insurance program are based on hard construction cost and payroll percentage. Schools of thought differ on the minimum hard dollar cost needed for a controlled insurance program to be feasible. Other variables taken into account include the type of project, geographic location, type of workers, and loss history (Ciccone & Traver, 1994). Location is a key factor because workers compensation rates differ from state to state and this can have an effect on the feasibility of the project. A concrete structure such as a parking deck may be more feasible for a controlled insurance program at a lower cost due to the high workers comp rates for the workers on the project. Whereas, a hospital would need to have a higher construction cost in order for a CIP to be feasible because of lower workers comp rates. Often, CIPs are used where construction costs are relatively high due to the increased overhead and administrative expense required to administer one of these programs. One opinion states that hard construction costs need to be a minimum of \$100 million in order for the CIP to be feasible (Ceniceros, 1999). This number tends to vary, and other experts contend that construction costs need to be closer to \$150 million (Gibson, 2006). Greg Bundschuh, an attorney with risk management firm Ames & Gough, recommends that controlled insurance programs should be considered for projects with construction costs of \$70 million (Staff, 2007). It is most important for the sponsor to understand how these programs work and what is required for their success when choosing to employ a controlled insurance program (Ferraro, 1996). Smaller projects can be insured under these programs by being "rolled in" to an already existing program. These programs are known as rolling wrap-ups and consist of multiple projects over multiple years. For example, several \$25 million projects can be rolled in to a single program to make the CIP a feasible alternative (Gibson, 2006).

Potential Cost Savings

A major draw to using controlled insurance programs is the money that can be potentially saved on the project. The potential cost savings are based on a number of variables, most importantly hard dollar project cost and payroll percentage. Using an owner controlled insurance program, for example, savings can range from 1% to 3% depending on loss. Savings of greater than 1% should never be assumed without conducting a feasibility study on the front end of the project (Gibson, 2006). However, others opine that savings between 1.5% and 4% can be

realized by using a controlled insurance program (Cicccone & Traver, 1994). Savings are derived from comparing the cost of the controlled insurance program to the insurance each contractor would contribute to the project.

Public Sector Usage

Owner controlled insurance programs are often utilized on large public sector projects. The Secaucus rail transfer project for the New Jersey Transit Authority saw significant savings by the use of an owner controlled insurance program. The project had an estimated cost of \$450 million and the New Jersey Transit Authority projects \$15 million in insurance cost savings on the project. The city of Austin in Texas built a new airport with an estimated cost of \$400 million. By utilizing an OCIP, the city of Austin estimates \$11.6 million in savings for the project. An opinion on the topic from Stephen Kirkman gives a different view. He states that these programs involve innovative team building skills and are different from traditional business models; therefore they are a difficult sell in the public sector (ENR, 1995). Another public sector job that realized cost savings from the use of an owner controlled insurance program was the rebuilding of Interstate 15 in Salt Lake City, Utah. The savings, which were certified by a consultant, totaled \$30 million. The Suncoast Parkway Project in Florida reportedly saved 2% of construction costs. This is just another example of the public sector successfully implementing an owner controlled program (Schexnayder, et al, 2004). The Orlando Utility Commission chose to implement an owner controlled project on a \$550 million project. The project finished on time and under budget and was viewed as a success by all those involved. The director of risk management for the commission, Ray Scullian, was pleased with the outcome of the project and would choose to use an owner controlled program again given the opportunity (Atkinson, 2002, p.45). While saving money is always the objective when utilizing a controlled insurance program, this does not always work out if there are higher than anticipated losses, higher administrative costs, or unexpected costs of another type. This was the case with the Fort Washington Way project in Cincinnati. As a result of additional costs levied on the owner, the cost savings did not materialize; but the owner still felt the benefits of a safer jobsite outweighed the added cost.

Benefits of a Controlled Insurance Program

While cost savings are the goal for every controlled insurance program, other incentives can be realized by the implementation of these programs. A few of these include: reduced litigation, uniform coverage limits for subcontractors, efficient claims handling, comprehensive safety regulations, improved productivity, and solutions for insurance availability issues (Gibson, 2006). These large dollar insurance placements provide tremendous leverage in the marketplace and consequently lower premium rates are obtained (Ferraro, 1996). A single insurance carrier and having fewer parties involved with the insurance policy leads to reduced litigation costs, cost savings, and time savings (Lew & Overholt, 1999). The single insurance carrier on the project also leads to the reduction of cross liability lawsuits. The majority of these lawsuits arise from workers on the project alleging that a safe work environment was not provided. An aggressive safety plan and coordination among all parties on the project can ensure a safe work environment as well as reducing the potential for legal claims. Under most circumstances, the controlled insurance program will cover the payout if a claim were to arise (Gibson, 2006).

Another benefit of controlled insurance programs is the broader and more comprehensive coverage limits provided by the program. Under an OCIP, contractors and subcontractors are typically able to obtain higher coverage limits than they could potentially acquire individually. These increased coverage limits benefit women owned, minority owned, or other DBE status firms that may not have been able to bid the job previously (ENR, 1995). Since each contractor on the job is given the same uniform limits, it allows for more competition even among the smaller contractors. The public sector often employs these programs with a goal in mind of increasing participation from DBE firms (Ceniceros, 1999). These programs also help mitigate the risk of design flaws by the architect. On large projects, losses can exceed the architect's professional liability coverage and the sponsor of the program is left to deal with the loss unless architect has a lot of capital (Andre, 2008). The use of a controlled insurance program also promotes a safe work environment. The general contractor on the job will already have a well managed safety plan on the job adhering to OSHA requirements. Under an owner controlled program, further guidelines will be added to the already existing safety program. The project has an extra set of eyes so to speak. This promotes a safer and efficient work environment for all parties involved (Gibson, 2006). Table 1 highlights the advantages and disadvantages often seen with controlled insurance programs.

Drawbacks of a Controlled Insurance Program

Though controlled insurance programs offer numerous benefits, the drawbacks should be looked at as well. If the CIP is not managed correctly it can place a large administrative burden on the sponsor and the potential for increased cost may not be worth it to some entities (Grenier, 2001). The increased administrative burden also leads to the presumption that liability will increase on the sponsor as well. This is another risk some are not willing to take. An owner, for example, may not like the increased responsibility for ensuring the safety program is properly administered. Most would rather let the general contractor handle their firm specific safety program (Grenier, 2001). Potential sponsors may not like going against the traditional way they insure projects. They are comfortable with their current insurance provider because of a long standing relationship. The controlled insurance program may also cost more than the traditional insurance they are accustomed to buying (Ciccione & Traver, 1994). A contractor may be able to acquire limits higher than those provided by the controlled insurance program. This may lead to the contractor not buying in completely to the program. The contractor may also have less incentive to control losses due to having no financial involvement in the insurance portion of the project (Gibson, 2006). When the owner is sponsoring the program, contractors submit bids with the insurance cost they would normally include in the bid and also without it (Grenier, 2001). The contractor can also face delays in receiving loss data for claims occurring on the project. These delays by the CIP administrator can directly affect the contractors experience modifier rate (Gibson, 2006).

Controlled Insurance Programs	
Advantages	Disadvantages
Overall cost savings	Only available for large projects
Insures that all contractors are in compliance with insurance requirements	Additional administrative tasks
Claims handling and disputes – reduced litigation and efficient claims handling in case of litigation	Contractor may prefer to have higher insurance limits than selected by an Owner
Eliminates gaps in insurance coverage	Often are not dealing with your regular insurance provider (agent)
Eliminates overlaps in insurance coverage	May prevent subcontractors from choosing to participate (e.g., if they cannot maintain insurance on their other projects outside of the CIP)
Uniform coverage limits for subcontractors	Safety program overview/oversight by insurer (some contractors prefer not to have someone else involved with their safety program)
Comprehensive safety regulations – enhanced safety programs are typical	
Opens up opportunities for subcontractors that otherwise would not be able to obtain insurance required for a particular project (MBE/WBE/small contractor advantage)	
Levels the playing field (competitive bidding) of subcontractors as related to their EMR (this is either a benefit if your EMR is high or a disadvantage if your EMR is low)	

Table 1. Advantages and Disadvantages of Controlled Insurance Program

Feasibility Study

When considering whether to purchase a controlled insurance program for a project, a proper first step is to conduct an in depth feasibility study. The individuals conducting the study should have vast knowledge of construction risk management and insurance, as well as wrap-up insurance. These studies are generally conducted by the sponsors in house risk management staff, or third party brokers and consultants. Brokers and consultants generally have specialists on staff with extensive knowledge of the construction industry and a long history of implementing these programs. A problem that can occur with using a third party administrator is the bias the firm may have towards controlled insurance programs. The firm performing the study would like to be retained to administer the controlled insurance program and therefore may have motives to skew the study. Forming a team made up of individuals not from a single entity can mitigate bias that may arise during the feasibility study (Gibson, 2006).

Certain steps need to be followed when conducting a feasibility study on the front end of a project. Legal requirements need to be looked at because insurance policies differ from state to state. States have different requirements when it comes to controlled insurance programs and certain states do not even allow them at all. The next step that needs to be taken is determining whether the project is large enough to warrant a CIP. It is important to make sure only hard construction cost is evaluated and not the overall cost of the project. This can lead to overestimating the payroll and therefore not accurately assessing the feasibility of the project. The number of contractors on the job should also be considered. In order for a controlled insurance program to be feasible, at least ten contractors should be involved (Yahn, 2009). The potential for savings is greater by combining each contractor's insurance coverage into a uniform policy. Duration of the project is also to be considered. This is important in order for the CIP to be properly planned and coordinated. All parties must be on board in order for the program to be successful. The contractor in charge is responsible for enforcing safety and health regulations, payroll reports, and other requirements for the CIP to be effective. Safety constructability reviews should also be conducted along with the regular design reviews. During this process, the project should be looked at from the point of view of whether it can be built safely. Site security is also an issue that should be taken into account as well as support for risk control. The owner and contractor need to have complete buy-in for the project to be successful. Incentives for safe behavior and promoting a return-to-work program lead to a safe jobsite and ultimately cost savings (Gibson, 2006). Figure 1 shown below represents a financial pro forma comparing the cost of a traditional insurance policy and an owner controlled insurance policy. The final cost calculated is based on zero jobsite loss. As it is not reasonable to assume a zero loss, Figure 2 takes the information from Figure 1 and adds in potential losses. The table shows the potential savings that can occur at different levels of losses when buying an OCIP versus traditional insurance. In this example, loss ratios in excess of 50% are not shown as this is where the cost avoidance no longer occurs. Note that the cost of the owner controlled policy increases based on jobsite loss whereas the traditional insurance policy remains constant.

One of the most difficult tasks in the feasibility study is accurately predicting the level of losses that are expected to occur on a particular project. The analysis must take into account the accident history of the company on similar projects as well as projections of the insurance company. In the example illustrated in Figures 1 and 2, if the insurable loss on the project approaches \$600,000 (loss ratio of 15%) the owner still achieves an overall cost savings of 29% on their insurance. However, if the insurable losses approach \$2,000,000 the owner would be at a breakeven point. At any loss level above this, the owner would have been wise to choose a traditional insurance approach instead of a CIP.

Conclusion

Controlled insurance programs are advantageous to traditional insurance programs in a number of ways. These programs also have drawbacks. Before taking on the burden of administering one of these programs, it is important for the sponsor to understand every detail of the program. The potential sponsor needs to evaluate the pros and cons of undertaking a CIP versus using a traditional insurance approach. Not every project is feasible for a controlled insurance program and therefore a feasibility study needs to be conducted on the front end of the project. Each project should be carefully evaluated based on the needs of the sponsor and whether a controlled insurance program suits the particular project. Complete buy-in by all parties must occur in order for the program to be a success. Failure to have all parties on board can lead to the failure of the CIP program, potentially losing money, and the

development of poor working relationships. Controlled insurance programs, if administered properly, can save sponsor's money and provide a unified approach to risk management.

Program Exposure Basis		
Estimated Hard Costs		\$150,000,000
Labor		\$37,500,000
Fixed Insurance Costs		
	<u>Traditional</u>	<u>OCIP</u>
WC Basic Premium	\$4,500,000	\$1,125,000
GL/Umbrella Premium	\$1,950,000	\$1,968,750
Insurance Cost	\$6,450,000	\$3,093,750
Overhead Costs		
	<u>Traditional</u>	<u>OCIP</u>
Administration	N/A	\$750,000
Contractor Markup	\$100,000	N/A
Loss Control	N/A	\$90,000
Carrier Fee	N/A	\$50,000
Total Fixed Costs	\$6,550,000	\$3,983,750

Figure 1 – Sample Financial Pro-Forma

Loss Ratio	Paid Losses	LCF (8 % of losses)	OCIP Costs	Trad. Costs	Cost Avoidance	Cost Avoidance %
0%	0	\$0	\$3,983,750	\$6,550,000	\$2,566,250	39%
5%	\$199,188	\$15,935	\$4,198,873	\$6,550,000	\$2,351,128	36%
10%	\$398,375	\$31,870	\$4,413,995	\$6,550,000	\$2,136,005	33%
15%	\$597,563	\$47,805	\$4,629,118	\$6,550,000	\$1,920,883	29%
20%	\$796,750	\$63,740	\$4,844,240	\$6,550,000	\$1,705,760	26%
25%	\$995,938	\$79,675	\$5,059,363	\$6,550,000	\$1,490,638	23%
30%	\$1,195,125	\$95,610	\$5,274,485	\$6,550,000	\$1,275,515	19%
35%	\$1,394,313	\$111,545	\$5,489,608	\$6,550,000	\$1,060,393	16%
40%	\$1,593,500	\$127,480	\$5,704,730	\$6,550,000	\$845,270	13%
45%	\$1,792,688	\$143,415	\$5,919,853	\$6,550,000	\$630,148	10%
50%	\$1,991,875	\$159,350	\$6,134,975	\$6,550,000	\$415,025	6%

Figure 2 – Cost Savings Based on Loss

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