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EDITOR'S NOTE

Moving into a newly constructed or renovated building is an exciting time. It's the culmination of a complex undertaking, involving a spectrum of activity from land acquisition to architectural drawings, the first shovel full of earth to rolling out the fresh carpet. The final product is a major investment, certain to be protected with a well-designed insurance program.

Too often lost in the process, however, is consideration of the risks to which the project will be exposed while construction is underway. Fire, theft, vandalism, wind, lightning and other hazards are as much a threat to the project and construction site while work is in-progress as they will be to the finished structure.

Builder's risk insurance provides this valuable protection. But it is a specialized coverage that can be unfamiliar to even experienced insurance professionals. In this issue of Adjusting Today, expert Donald Malecki discusses the key aspects of builder's risk insurance, including who and what can be covered, the policies and options available, and questions that must be addressed in putting the right coverage into effect.

—Sheila E. Salvatore, Editor

Builder's Risk Insurance: Specialized Coverage for Construction Projects

By Donald S. Malecki, CPCU

Builder's risk insurance can be defined as coverage that protects a person's or organization's insurable interest in materials, fixtures and/or equipment being used in the construction or renovation of a building or structure should those items sustain physical loss or damage from a covered cause.

The term "builder" is misleading because insureds can include not only the contractor(s) performing the work, but the ultimate owner, lending institution and others. Suppliers of materials, although having an insurable interest in the property being used in the construction, are not normally candidates for builder's risk insurance.

Many options are available under builder's risk coverage. They depend on the policy's provisions, including the causes of loss or perils being insured against. While these should be studied before the construction contract is drawn, they seldom are. The builder's risk policy is often purchased after the contract has been signed and without regard to what it specifies or what the exposures of the construction project are. As a result, coverage problems can arise — to the detriment of most parties, including the insurance representative.

Contrary to general belief, the provisions of builder's risk policies do not follow those of the Insurance Services Office (ISO). ISO's builder's risk policy is limited to site-specific coverage. More commonly required, however, is broader coverage encompassing materials and equipment in storage awaiting transit to the job site, as well as coverage for such property while it is in transit. To obtain coverage that includes these exposures, it is necessary to purchase an inland marine type of builder's risk policy.

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The builder's risk forms of the American Association of Insurance Services (AAIS) are a good benchmark here and are used by many insurers. AAIS is an organization similar to ISO in that it drafts language for builder's risk and other inland marine policies. Unlike ISO, however, AAIS offers several builder's risk forms to meet the various needs of those confronted with course-of-construction loss exposures.

It is important to note that an inland marine builder's risk policy is not necessarily broad in scope. Therefore, there are many types of such policies available. Rather than focus on one particular type, this article takes into account a variety of such policies and discusses how careful consideration of the exposures of the project is essential to selecting the right one.

Policy Provisions

The types of property covered under builder's risk policies vary. All of these policies, of course, are meant to cover what goes into constructing the final product. Insurers differ, however, in how they address the subject.

One common approach is for the insurer to refer to covered property as "buildings or structures in the

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course of construction, erection or fabrication." When a policy follows this approach, one has to remember that although a building is a structure, not all structures are buildings (a building is generally considered to be a structure that will be occupied).

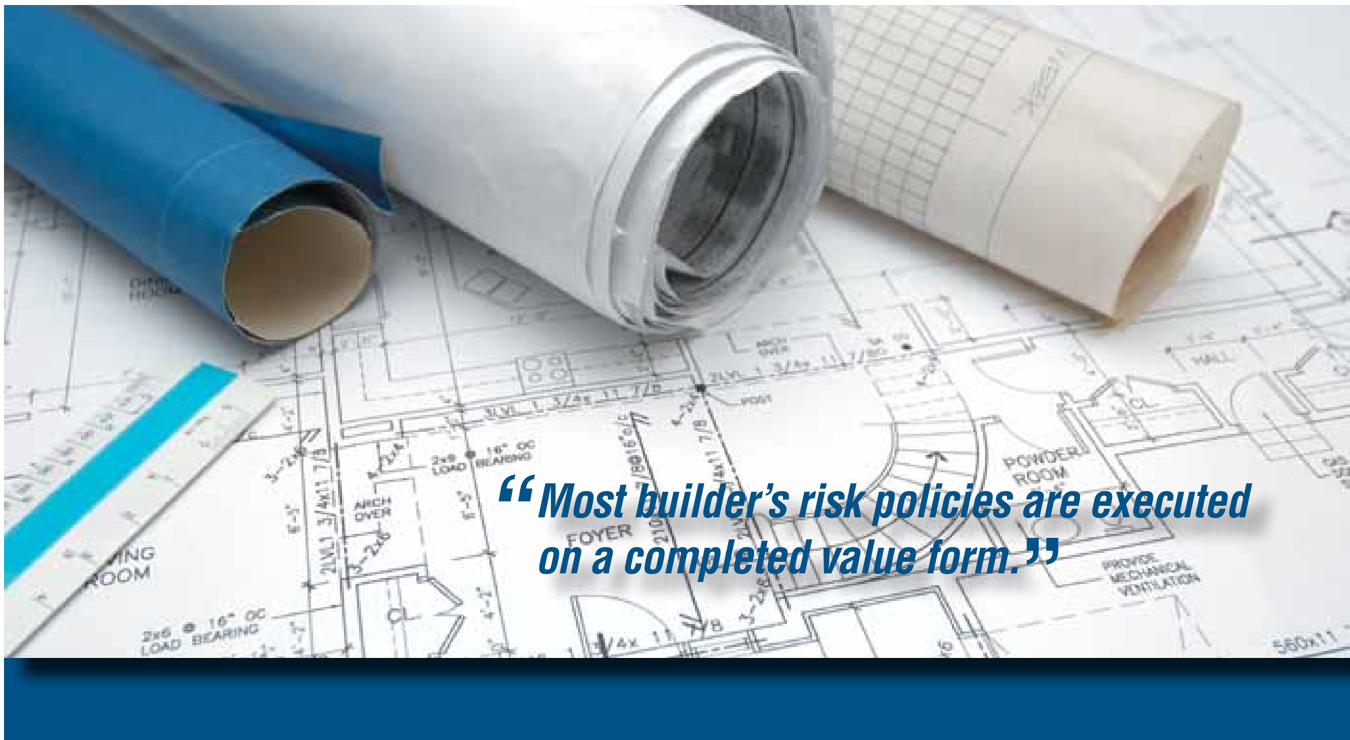
So if the construction project involves a *structure*, care should be exercised that it is identified and declared — and that the provisions of the policy follow through with the structure in mind. For example, if the builder's risk policy limits collapse coverage to a building and a *structure* is being built, there could be a coverage gap.

Some builder's risk policies take a broader approach to covered property by stating that coverage applies to property of every kind and description intended to become a permanent part of the construction, installation or erection of the project.

It is quite common for a builder's risk policy to include coverage for scaffolding, temporary structures, construction forms and cribbing. Some insurers will include these automatically, others will subject them to a sublimit, and still others will require that their values be added to the policy limit. In the majority of cases, the contractor's equipment — other than the aforementioned items — is not covered. Examples include bulldozers and ditch diggers. For such property, unless the insurer makes an exception, a contractor's equipment floater is recommended.

Depending on the terms of the construction contract, the builder's risk coverage may be purchased by either the contractor or the project owner. In either case, all parties to the project who may have an insurable interest in the construction should be named. As a general rule, however, suppliers of materials are not commonly named, nor are architects or engineers.

It is not necessary to list everyone by name on the policy. It might be easier to list the project owner's name and then note that included as named insureds are contractors for all tiers. No name is necessary because insurance is only paid if the covered loss involves a party that has an insurable interest.



By no means should anyone be shown as a loss payee, not even a financial institution. When it comes to covering a financial institution’s insurable interest, the proper language is *mortgagee,* on a separate mortgagee provision; or *designation of mortgagee,* on a lender’s loss payee endorsement.

Most builder’s risk policies are executed on a completed value form. The exception is a reporting form when a contractor is involved in more than one project at a time. The determination of which form will be used is usually an option left to the underwriter.

Completed Value Form

Under the completed value form the insurance limit is set at the expected completed value of the project, sometimes with a coinsurance clause. If, as is frequently the case the actual cost of the project exceeds the initial estimate, the limit should be increased as soon as this is discovered.

Care must be taken when determining the insurance limit to be applied. Common errors include:

1) Using the amount of the construction loan as the limit of insurance without taking into consideration change orders. As changes are required and permitted by the owner or architect, they invariably will result in additional costs. If the insurance limit is not adjusted to reflect these changes, the amount of insurance will fall below the completed value.

In one case, involving the collapse of a large free-standing sign being constructed for a hotel, there were three change orders before construction began. With the policy subject to a coinsurance clause, the insurance limit was grossly inadequate even before work on the project started. The project owner did not learn about the significance of change orders until after the loss, which amounted to thousands of dollars.

2) Failing to determine whether overhead and profit — commonly figured at 10 percent each — have been included in the completed value. Some builder’s risk policies specifically mention these items as being covered, but many policies do not. Some builders choose to leave these items out when

determining a project's completed value. In the event of a loss, doing so can be a critical mistake. Because these items can commonly represent up to 20 percent of the completed values, omitting them sets the limit at only a portion of the completed value, especially when a coinsurance penalty is also applicable.

3) Leaving out other insurable values, resulting in inadequate insurance.

4) Including items *excluded* from coverage. Land value is a major item excluded. What should be included, however, is the added value of excavation and landscaping work. Architect's fees, which can be substantial, should also be considered. Some policies automatically include them, but never assume that this is the case.

Reporting Form

The reporting form is frequently used by contractors who have numerous jobs going on simultaneously and can be used to insure all of them under a single program of coverage. The policy can be tailored to include automatic coverage for new locations, usually requiring that they be declared within a stated number of days from the start of construction.

As noted, determining whether a reporting form will be used is a decision usually left to the underwriter's discretion. The underwriter will most likely select a limit high enough to cover the expected completed value, with the actual value of the property at risk reported to the insurer regularly.

Care must be used with this form to:

1) Submit the reports of value in the timeframe prescribed by the policy, which is usually monthly. Late reporting can result in a penalty because values continue to increase, making a loss between the report due date and the time the report is submitted likely to be underinsured.

2) Compute the monthly or quarterly values carefully and include the value of all covered property — including materials and supplies in place, in storage off-site, in transit, and on premises to be installed. Covered property of contractors, subcontractors and other parties also should be included, to the extent that these items are included in the insurance. Do not overlook the value of leased equipment on the premises for which contractors or subcontractors have responsibility, provided the policy will cover them.

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Deductibles

Some builder's risk policies are written with deductibles along with, in some cases, a catastrophe limit. It is difficult to determine the deductible ranges, since they are left to the underwriter's discretion. Depending on the insurer, a dollar deductible might apply to physical loss or damage to covered property, and separately for water damage and hot testing. For physical damage from earthquake, flood, named storms or windstorm, some insurers might apply either a dollar amount or a percentage — and sometimes both. Again, these are underwriting discretions, with some impact on reinsurance.

When a deductible is applied the insurer is obligated to pay only that part of the loss that is over the deductible amount. A catastrophe limit, on the other hand, is the most the insurer will pay in any one occurrence. This limit applies even though a loss might affect one or more buildings or structures, described locations, or any combination of the two.

Deductibles are also likely to apply to delays in opening and other soft costs, to the extent that they are covered. In this case it would not be unusual for the delay in completion coverage to be subject to a certain deductible period, with a separate deductible applying to physical damage.

Covered Causes of Loss

Most builder's risk policies are written on an all-perils basis, with the more modern term referred to as a "special causes of loss" (or perils) form. On this basis, coverage applies to physical loss or damage from any cause of loss, unless the loss is limited or caused by a peril that is specifically excluded. The fact that a policy is written with these causes of loss does not mean that coverage will be all inclusive in scope. Much will depend on what is *not considered* to be a covered cause of loss.

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One cause of loss that is not specifically mentioned but nonetheless is not covered is a loss that is "non-fortuitous" or, in other words, not accidental. Thus, if the loss is expected to happen or is intentionally caused, it is not accidental and therefore not a loss that is likely to be covered by insurance.

Exclusions/Perils Not Insured

As a general rule, the section on exclusions in a builder's risk policy is divided into two parts. These parts and what they contain will vary, but for our discussion here it is possible to address them in generalities.

The first part consists of specifically mentioned causes that directly or indirectly impact the covered property, regardless of any other cause or event that contributes concurrently or in any sequence to the loss. A concurrent loss comes about when two independent causes converge on a loss, with one covered and the other excluded.

This wording is intended to preclude coverage for concurrent causes that produce a loss, regardless of what those causes are or how they contribute to the loss. Without a concurrent causation exclusion, the entire loss caused by a covered or non-covered peril would be covered. An example of a concurrent cause is damage caused by a landslide (excluded) brought about by negligent construction (covered).

Commonly included in this part and not deemed to be covered losses are those brought about by ordinance or law, earth movement, nuclear hazard, war or military action, flood or other water source, fungus, civil authority or contamination.

The second part of the exclusions precludes coverage for physical loss or damage caused by or resulting from itemized causes, without mentioning concurrent causation. Generally included in this part and not considered to be covered are losses from criminal, fraudulent, dishonest or illegal acts; mechanical breakdown; loss of use and consequential losses; wear and tear; voluntary party; pollution and steam boiler explosion.

Steam boiler explosion is commonly covered by separate equipment breakdown insurance. This will not be needed initially, unless there is an exposure from a nearby source or the project involves extensive renovation work rather than new construction.

Earth movement and flood coverage are generally available by endorsement or in separate policies. Whatever the case, these exposures are severe enough to merit consideration, especially in areas known to have potential exposure to these hazards.

Another common exclusion is loss or damage caused by or resulting from design error, faulty workmanship or defective construction. A consideration in determining the appropriate builder's risk policy is whether this kind of an exclusion makes an exception for resulting physical loss or damage not otherwise excluded. All else being equal, the more exceptions to exclusions for covered ensuing losses it contains, the better the policy is likely to be.

When Coverage Ceases

Of particular importance in a builder's risk policy is the "when coverage ceases" provision. Unlike other property policies, the builder's risk policy is intended to terminate when the work has been completed and the property is ready for use or occupancy, even though some minor finishing work might remain.

Because a precise completion date is often difficult to predict, insurers will generally extend coverage until such a time can be determined. If occupancy is required while work is being done, coverage usually can be arranged for this exposure as well. It is important, however, that permanent insurance be arranged and in place so as to ensure a normal transition without a gap in coverage.

Typical provisions in the policy that terminate coverage are when any of the following first occurs:

- The policy expires or is cancelled;
- The project is accepted by its owner or purchaser;
- The named insured's insurable interest in the covered property ends; or
- When the named insured abandons construction with no intention to complete it.

Some policies also provide that coverage ends 90 days after construction is complete, 60 days after the project has been occupied in whole or in part, or when the property is put to its intended use.

In considering coverage termination it is important to note not only what the policy says, but also what the construction contract prescribes. If the contract were to be at odds with the policy, the owner or whoever has the obligation to purchase the builder's risk policy could be confronted with an allegation of failure to procure the proper coverage.

"Not covered by the builder's risk policy is the delay in completion and resulting loss of business income, loss of rents, extra expense, interest on loans and other consequential losses incurred after an insured property loss."

The American Institute of Architects General Conditions A201 2007 is commonly referenced by those who prepare contracts. With respect to property insurance, this document states (under Section 11.3.1) that "the insurance shall be maintained until final payment has been made or until no person or entity other than the owner has an insurable interest in the property to be covered." It is obvious that either the policy has to be amended or the contract changed for there to be no argument over when coverage is to terminate.

Builder's Risk Options

Depending on the risk, some of the optional coverages available from insurers offering builder's risk policies are:

Contingent Coverage

It's not unusual to hear of project owners neglecting to obtain builder's risk insurance. Sometimes owners are fortunate to have a commercial property policy in force at the time of loss, on which they can rely for coverage. Some of these policies may also cover the interest of contractors. If those interests are not covered, contractors could have a case against the owners, although litigating these issues can take a long time and entail considerable expense.

Instead, contractors might be able to purchase contingent coverage, designed to apply when the party who is supposed to purchase the builder's risk policy fails to do so, or obtains the coverage but fails to maintain it. If this happens and a contractor is unable to collect their interest following a covered loss, contingent coverage will apply — subject to the applicable limit and if the loss occurs during the course of construction.

Difference in Conditions

Difference in conditions or "DIC" coverage was first introduced when only named causes of loss coverage was available. Applying above a property policy on a named peril basis, the DIC form covers losses from causes not caused by a named peril and not otherwise excluded by the DIC form.

With many policies written to apply on a special causes of loss basis, including builder's risk policies, the usefulness of the DIC has diminished. To the extent that it is available, DIC coverage is generally purchased to obtain additional causes of loss coverage over a high deductible, such as flood, windstorm in high-wind prone areas, and earthquake. Sometimes insurers of a builder's risk policy will not provide DIC coverage, even when a construction contract requires it.

Soft Costs

Not covered by the basic builder's risk policy is the delay in completion and resulting loss of business income, loss of rents, extra expense, interest on loans and other consequential losses incurred after an insured property loss. Any of these, which are known in construction circles as "soft costs," can be covered by adding soft costs coverage to a builder's risk policy. With its popularity increasing in recent years, some insurers automatically include soft costs coverage, which can be activated by designating the limit on the policy declarations.

A challenge that must be overcome in providing delay in completion coverage and the other coverages that should be purchased is determining when the project will be completed. Since the exact costs of future operations of a new building or structure are not known, it might be necessary to project a worst-case scenario. In such cases, estimates should be made for the following:

- How much money would be lost and how much extra expense would be incurred if the worst imaginable loss occurred at the worst possible time?
- What benefits of occupying the completed building on schedule would be lost if completion was delayed by an insured loss? What additional expenses would be incurred to hasten completion and occupancy?

Also determine whether consequential loss coverage is available for excluded losses such as a strike, which shuts down the construction, or a loss at a key supplier that prevents or delays the delivery of needed construction materials to the site.

The answer to these questions will form the basis for estimating the amounts of the coverage to purchase.

Soft Costs CASE STUDY

"Soft Costs" are essentially extra expenses incurred as a result of a delay caused by a covered loss. Some of the more common soft costs are interest charges on project financing, realty taxes or other assessments, workers overtime, advertising and promotion, costs associated with lease renegotiations and accounting, legal, architectural, or engineering fees.

Typically these costs are not applicable on smaller projects such as individual dwellings. On commercial projects, however, these unplanned expenditures can be rather costly.

In some instances an insured may find the carrier reluctant to pay what it considers a covered soft cost. The following language, as taken directly from a basic builder's risk policy, highlights this point.

Expenditures, during the period of indemnity, which would not have been incurred by the insured if the delay had not incurred include:

A) Interest on money borrowed to finance the contract work;
B) Other as accepted by the company.

It is plain to see that during the adjustment process the language in "B" gives the carrier the discretion to include, or more importantly exclude, costs as it sees fit. When such ambiguous language exists, the insured would be wise to come to an understanding with the carrier before a loss occurs.

In the case of a delay in opening, the insured should be aware that the estimated completion date may be what triggers coverage for soft costs. The following example will help to illustrate this point.

Assume a two-year project had an estimated completion date of December 1, 20XX. It is now August 1, 20XX and the project is expected to be completed in one month, on September 1, 20XX, putting the project three months ahead of schedule. Unfortunately, a fire occurs the evening of August 1, 20XX. It is expected to take two months to effect the repairs necessitated by the fire. On October 1, 20XX, the fire repairs are completed and the final 30 days of the project can now be resumed. On November 1, 20XX, the project is completed one month ahead of the schedule instead of three.

Because the delay occurred prior to the original completion date, allowing the builder to finish the entire project before that date, the carrier will take the position that no delay has occurred. If this were the case, soft costs incurred during the two months of the fire restoration would not be covered.

Contract Options/Problems

While construction contracts vary, attorneys representing project owners or developers commonly rely on the contract documents offered by the American Institute of Architects (AIA). Other organizations whose forms can be used as references are the Associated General Contractors (AGC), ConsensesDOCS, the Engineering Joint Contract Documents Committee (EJCDC) and the Design Build Institute of America (DBIA).

The AIA documents require that if the owner does not want to obtain the builder's risk policy, it must notify the general contractor, who then has the option of purchasing a policy and charging the owner for it. What often seems to happen is that many of the provisions of these contracts are modified to suit the particular project, with the exception of the insurance requirements, which remain intact.

One of the problems with most of these contracts is that they give the party responsible for procuring the builder's risk coverage the option of obtaining a builder's risk policy or an equivalent policy form. What begs the question here is the meaning of "equivalent policy form." Actually, there is no policy form equivalent to a builder's risk policy. Consequently, based on this wording, owners rely on their existing commercial property policies for course of construction coverage instead of purchasing a builder's risk policy.

Is this a bad practice? That depends on how the insurable interests of the contractors are covered. If an owner relies on their own policy, it is not likely that contractors will be added as named insureds. To be without named insured status could invite the chance that an insurer will exercise their right of subrogation against those who are not named insureds. A waiver of subrogation also does not guarantee full protection. It might only apply to the contractor's own work and not for the physical loss of or damage to the property of others involved in the project.

This is not to say that all contractors are covered as named insureds on builder's risk policies. They should be, but this item is frequently overlooked. Of course, what hinders the need is that construction contracts such as the AIA's do not prescribe contractors as named insureds. They merely require that the interests of the parties be covered. As a result, contractors of all tiers do not enjoy the same coverages as the purchasers of the insurance. In fact, when owners rely on their own commercial property policies for coverage, some of these policies might cover contractors' interests, while others do not. It is not unusual, therefore, for owners to be confronted with legal action for failing to fulfill their contractual promises to cover contractors' interests.

As pointed out previously, it is not necessary to list all parties as named insureds on a builder's risk policy. The owner, for example, could be named and a statement included noting that named insureds also include contractors of all tiers. Considering that many commercial property policies — including builder's risk policies — limit coverage to the named insured, reference to additional insured status should be avoided.

In fact, the use of additional insured status should be limited to liability insurance only. Also, architects and engineers are not commonly added as named insureds on a builder's risk policy. Instead, they usually require a waiver of subrogation — although there is a trend among carriers providing builder's risk coverage to specifically omit architects and engineers as recipients of such waivers.

The Need For Rigging Coverage

It is not unusual for contractors to lift or move the property of others in the course of construction, erection or installation. To the extent that a builder's risk policy covers damage to property in the care, custody or control of the contractor, or for which the contractor has assumed liability, some coverage may apply for this kind of activity — if, for example, the property is dropped and thereby damaged or destroyed.

An installation floater provides similar coverage. This floater is usually purchased by contractors to cover a single specialty such as plumbing, electrical or heating work. Unlike a builder's risk policy, it encompasses all phases of the construction process.

Without this coverage for lifting and moving the property of others, a contractor would be without insurance, since a commercial general liability policy excludes personal property damage in the care, custody or control of the insured.

It is important to note that the foregoing is incidental coverage and not adequate protection for a company that is in the business of hoisting or moving property (a rigger) or in the business of hoisting or moving and installing property (a millwright). A rigger or millwright needs rigger's insurance.

AAIS offers two forms for this coverage. One covers the direct physical damage to the property of others while in the insured's care, custody or control for millwright or rigging operations, regardless of the insured's negligence. The other, which is the more common type issued by insurers, requires that the insured be legally liable for the resulting damage.

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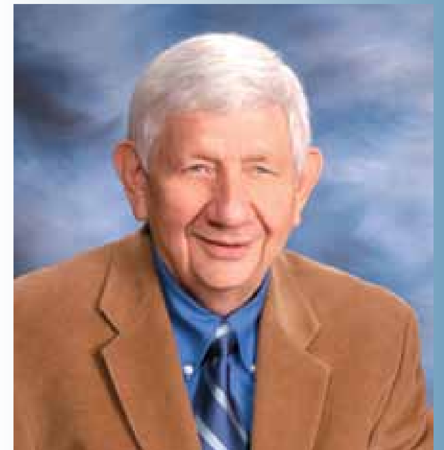

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