SURETY TODAY PRESENTATION

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Understanding Builder's Risk Insurance as a Salvage or Loss Mitigation Tool

Today we are discussing the Builder's Risk Insurance policy. Builder's Risk is a very common policy on construction projects and having some familiarity with it can be useful in a variety of circumstances. A funny story - I decided on this topic because I recently wrote a 22 page article with like 80 footnotes for an upcoming construction insurance monograph that will be provided in connection with the 2018 ABA Mid-Winter program. I submitted the draft to the editors on the deadline and later got an e-mail back apologizing and saying that they were only looking for something shorter and more basic. So, I don't want my work to go to waste and I will send a copy of the full article to those on this call later for your edification.

BUILDER'S RISK INSURANCE - GENERALLY

Builder's risk insurance covers a building *during construction*, before it becomes insurable as a completed structure, while the materials and components are being moved on-site, assembled, and put in place. Builder's risk Insurance is a type of "first-party" property insurance that protects those with an insurable interest from accidental losses, damages, or destruction to buildings under construction, repair or renovation, as well as materials, property and equipment at a construction project.

Addressing the nature and purpose of builders risk insurance, the Florida Supreme Court observed that "[b]uilder's risk insurance is a type of property insurance coverage, not liability insurance or warranty coverage. The purpose of this type of insurance is to provide protection for fortuitous loss sustained during the construction of the building."[1]

(A) First-Party Insurance

As I mentioned, builder's risk insurance is a type of "first-party" property insurance policy; it does not indemnify third parties. The Maryland Court of Appeals noted "[p]roperly cast, the [builder's risk] Policy's coverage is for damage to the subject property directly caused by a covered loss, not to indemnify a third party for damage to the third party's property caused by an insured tortfeasor. The focus in this first-party insurance is loss to insured property, not whether someone else ought to be held liable for that loss." *Id.* (clarification added). In essence, first party coverage is a promise by the insurer to pay its own insured, rather than a promise to its insured to pay some third party.

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[1] *Swire Pac. Holdings, Inc.*, 845 So. 2d at 165; *U.S. Fire Ins. Co. v. Sovran Const. Co.*, 854 So. 2d 221, 222–23 (Fla. Dist. Ct. App. 2003).

(B) Types of Coverage Forms

The policy forms for builder's risk coverage have historically been divided into "all-risks" and "named perils" categories. The "named perils" policies provide coverage only for the specific risks enumerated in the policy and exclude all other risks. "All-risk" policies, on the other hand, provide coverage for all risks unless the specific risk is excluded. Although characterized as an "all-risks" coverage, the policy does not actually cover *all risks* because of the exclusions that are in every policy. This has led some courts to observe that the name "all-risk" is a "misnomer." Indeed, the name "all-risks" has been described as a "misleading and dangerous term." Nevertheless, all-risks policies typically provide insureds with the broadest available coverage compared to named perils policies because all-risk policies generally provide coverage for all causes of loss except those that are specifically excluded or limited by the policy's terms. All-risk coverage is the most prevalent form of builder's risk coverage found in the market.

The Insurance Services Office ("ISO") has drafted a number of standard-form builder's risk policies, however, most insurance companies issue builder's risk insurance on their own manuscript forms. Accordingly, there can be significant variation from policy to policy in the coverages and exclusions. Because of these variations in policy forms one must be careful to read the specific policy language and be aware that case law may not always have precedential value because of the variations in policy language.

WHO IS TYPICALLY COVERED

The named insured under a builder's risk policy will typically be either the owner or general contractor that is purchasing the policy. However, builder's risk policies usually include coverage for the owner, general contractor, and subcontractors at any tier. Contracts such as the AIA A-201 expressly require that the builder's risk policy insure the "interests of the Owner, the Contractor, Subcontractors and Sub-subcontractors in the Project." Claims will only be paid if the covered loss involves a party that has an "insurable interest."

(A) Insurable Interest

So what is an "insurable interest"? Insurable interest has been defined as "an actual, lawful, and substantial economic interest in the safety or preservation of the subject of the insurance against loss, destruction, or pecuniary damage or impairment to the property." Generally, an insurable interest exists where the person can suffer a loss if the property at issue is damaged. A party does not need to have an absolute right, title or ownership interest in the property. The key is that the party must suffer some loss if the property is destroyed. Thus, contractors, subcontractors, and materialmen all potentially have an insurable interest in a construction project.

In *Dyson & Co. v. Flood Engineers, Architects, Planners, Inc.*, 523 So.2d 756, 759 (Fla. Dist. Ct. App. 1988), the Florida appellate court held that an architectural firm had an insurable interest because they "had a substantial interest in being held free from any liability arising out of its participation in the project." In contrast, the court in *J.J. Altman & Co. v. Illinois*, No. 78–CC–1656, 1984 WL 589452, at *1–2 (Ill.Ct.Cl. Jul. 2, 1984) held that a construction manager

had no insurable interest under a builder's risk policy because it suffered no loss due to water damage and was not responsible for damage resulting from the actions of an independent subcontractor.

1. WHAT RISKS ARE COVERED

The typical builder's risk policy covers the structure being constructed, building materials, supplies, equipment, and machinery intended to become a permanent part of the covered building or structure. Coverage generally is provided in some manner for temporary structures constructed and used on the job site, including construction forms, scaffolding and false work. Coverage is also generally extended to materials in transit and in temporary storage away from the job site.

In addition to insuring the structure itself, builder's risk policies also typically include coverage for building materials, machinery, and equipment on the premises that are awaiting installation. The covered "machinery and equipment" is different from a contractor's machinery and equipment that is used in the construction process, such as a back-hoe or crane. The type of machinery and equipment intended to fall under the definition of "covered property" in a builder's risk policy is that which will become a permanent part of the structure - this includes materials such as elevators, doors, windows, electrical equipment, HVAC units, water pumps and the like.

(A) Declarations Page

The declarations page of the builder's risk policy should be the starting point when evaluating the extent of coverage under the policy. The declarations page is where the details of the policy coverage are summarized such as: identification of the named insureds and any additional insureds, the property insured, the coverage period of the policy, the limits of insurance, any deductibles, and the endorsements. In contrast to liability coverage like a CGL policy, a builder's risk policy will have "limits of insurance" with respect to the property covered. Thus, each individual covered property category may have specific limits and deductibles. For example, a builder's risk policy might have an overall limit of coverage of $1 million, but the limit of coverage for collapse might be $100,000, scaffolding and temporary structures may be $50,000, debris removal $20,000 and property in transit $30,000. Thus, if a particular loss is covered, the amount of that coverage will be limited to the amount shown in the declaration page.

(B) Direct Physical Loss

The coverage grant of the typical builder's risk policy is limited to "direct physical loss." The "physical loss" requirement is intended to eliminate coverage for economic losses or diminution in value. In *Couch on Insurance* it is stated:

> The requirement that the loss be 'physical,' given the ordinary definition of that term, is widely held to exclude alleged losses that are intangible or incorporeal, and thereby, to preclude any claim against the property insurer when the insured

> merely suffers a detrimental economic impact unaccompanied by a distinct, demonstrable, physical alteration of the property.

10 COUCH ON INSURANCE § 148:46 (3d ed.).

Accordingly, it is generally held that "physical loss" requires some physical change in the condition of the covered property. In *AFLAC Inc. v. Chubb & Sons, Inc.*, 260 Ga. App. 306, 581 S.E.2d 317 (2003), addressing a builder's risk policy, the court noted that the "direct physical loss" requirement of the policy contemplates "an actual change in insured property, then in a satisfactory state, occasioned by accident or other fortuitous event directly upon the property causing it to become unsatisfactory for future use or requiring that repairs be made to make it so." *Id.* Thus, physical loss or damage does not encompass faulty initial construction.

The mere fact that defects exist in one's property is generally insufficient, in and of itself, to trigger coverage. As the court in *State Farm Fire & Casualty Co. v. Superior Court*, 215 Cal. App. 3d 1435, 1445, 264 Cal. Rptr. 269 (4th Dist. 1989) observed, "the defect that caused loss of value to building was not covered as '[n]either diminution in value nor the cost of repair or replacement are active physical forces - they are not the cause of the damage to the structures, they are the measure of the loss or damage.'"

(C) Fortuitous Loss

In addition to the requirement of the presence of a physical loss in order to recover under the typical builder's risk policy, the loss must also be "fortuitous." A fortuitous loss is a loss which so far as the parties are aware is dependent on chance. It may be beyond the power of any person to bring the event to pass; it may be within the control of third persons; it may even be a past event, provided that the fact is unknown to the parties. "Fortuitous" can be thought of as a synonym for the word "accident." To determine if a loss was fortuitous courts will look to the time that the policy was issued to determine if *subjectively* the parties could reasonably have foreseen the loss. This subjective test standard will look to what the insured actually knew or believed as to the probability of loss at the time the policy was issued. The fortuity requirement exists as a matter of public policy, because it would encourage fraud to permit recovery on an insurance loss which is certain to occur.

2. WHAT RISKS ARE GENERALLY EXCLUDED

As I mentioned, the all-risks form of builder's risk insurance begins with a broad grant of coverage and then limits the scope of coverage, in part, through exclusions. Accordingly, all builder's risk policies exclude certain losses from coverage. Some of the more typical exclusions found in a builder's risk policy form include:

i. Delays caused by adverse weather
ii. Liquidated damages
iii. Governmental actions
iv. Earth Movement
v. Water
vi. Corrosion, rust, dampness, mold
vii. Defective work/design

viii. Wear, tear, gradual deterioration
ix. Settling, cracking, shrinking or expanding
x. Collapse from defective materials

As with any insurance policy, exclusions are generally to be construed narrowly and any exception to a policy exclusion is to be interpreted broadly. Ambiguity will typically be construed against the insurer who drafted the policy and in favor of coverage. Moreover, the burden is on the insurer to prove that an exclusion applies.

(A) Defective Work Exclusion

One of the more common exclusions in builder's risk policies is the "defective workmanship" exclusion. One commentator has observed that as a general rule an all-risks policy will be interpreted to include faulty workmanship or negligent conduct as a covered peril or cause of loss subject to elimination or restriction by exclusion. This is because of the all-risks policy form's broad grant of coverage. However, while the initial grant of coverage may be broad enough to encompass defective work, most builder's risk policies contain a "faulty or defective workmanship" exclusion which usually excludes losses arising from faulty or inadequate work.

A defective workmanship exclusion is applicable when the insured's loss is attributable to the quality of the constructed property and arises from defects in the materials or process used by the insured or its agents to construct the property. Thus, in order for an insurer to deny coverage based on a defective workmanship exclusion, a court must be able to attribute the acts or omissions giving rise to the stated loss to the insured or its agents.

(B) Ensuing or Resulting Loss Provision

Most builder's risk policy forms contain an "ensuing loss provision." A typical ensuing loss provision provides as follows:

> We will not pay for a "loss" caused by or resulting from any of the following. *But if "loss" by a covered cause of loss results, we will pay for that "resulting loss"* …

Ensuing loss clauses act as exceptions to exclusions and operate to provide coverage when, as a result of an excluded peril, a covered peril arises and causes damage. Judicial interpretation of ensuing loss provisions is not consistent and is highly fact-intensive. A basic example can help to illustrate how the ensuing loss provision operates - Suppose a contractor defectively installs a building's electrical system, resulting in a fire and significant damage to the building. Further suppose that the builder's risk policy excludes losses caused by faulty workmanship, but the exclusion contains an ensuing loss clause. In this situation, the ensuing loss clause would preserve coverage for damages caused by the fire because loss due to fire is an otherwise covered loss. But, it would not cover losses caused by the defective wiring that the policy otherwise excludes. Nor would the ensuing loss clause provide coverage for the cost of correcting the faulty wiring.

Generally speaking, an ensuing loss provision does not cover loss directly caused by the excluded peril, *i.e.*, repair of the faulty work itself, rather it operates to cover loss caused to other property wholly separate from the defective property itself. Once an insured triggers an exclusion, courts generally interpret "ensuing loss" clause as restoring coverage to the insured only when an independent and covered loss occurs subsequent to the excluded acts or omissions giving rise to loss. But, it is important to recognize that an exception to an exclusion does not create coverage where none otherwise exists.

Under the majority view, to be an ensuing loss, the loss must occur subsequent in time to the initial excluded conduct, and that loss cannot be excluded by any other provision in the policy. These courts hold that the ensuing loss exception is applicable when the loss is the result of an independent or superseding cause that is covered under the terms of the policy.

Some examples can help with understanding this clause. In *Selective Way Insurance Co. v. National Fire Insurance Co. of Hartford*, 988 F.Supp.2d 530, 538 (D. Md. 2013), a plumber defectively installed a water line fitting. The fitting failed and water flooded the building. The court concluded that while the cost of replacing the faulty installation of the water line fitting was excluded under the workmanship exclusion, the ensuing damage to the building from the flow of water was an ensuing loss covered under the policy.

The Ninth Circuit in *Costco Wholesale Corp. v. Commonwealth Insurance Co.* addressed an ensuing loss provision and its relationship to a faulty workmanship exclusion arising from a settling foundation. Costco was building a new warehouse when damage was sustained as a result of differential settlement in the building's foundation. Costco's insurance policy contained a "faulty workmanship" exclusion, but movement of the earth was a risk the policy insured against. The Ninth Circuit concluded that coverage existed due to the "ensuing loss" exception. The court reasoned that movement of the earth was a risk insured against, movement of the earth caused Costco's loss, movement of the earth is distinct from the defective design and the loss did ensue from the defective design. Thus, damage to the foundation from the movement of the earth was not an excluded peril.

In *Laquila Construction, Inc. v. Travelers Indemnity Company of Illinois*, 66 F. Supp. 2d 543 (S.D.N.Y. 1999), aff'd memo, 216 F.3d 1072 (2d Cir. N.Y. 2000), the insured contracted with a construction company to provide concrete for its construction of a new building. The contract required the concrete to be a certain minimum strength. The strength of the concrete that was delivered did not meet the specification. The defective concrete had to be replaced using a process, which required "shoring" of the building, and the HVAC ductwork, electrical fixtures, and plumbing units had to be removed and reinstalled. The insured submitted the loss to its insurer requesting coverage for the defective concrete, as well as costs for shoring, removing and reinstalling the above items. The insurer denied the claim on the basis that the plaintiff was seeking the costs of making good faulty or defective workmanship or material.

The court found that the insured's claim fell "squarely into the exclusion clause simply as a cost incurred to make good the defective concrete." In doing so, the court rejected the insured's argument that the mere incorporation of the defective slab into the building caused the building, as a whole, property damage. The Court noted that the defective concrete caused no damage to any other portion of the structure or property. The sole claim was for the cost of correcting the

deficiencies in the concrete. Had the wall, as a result of the deficiencies in the concrete, collapsed and caused damage to some other portion of the work, the court noted it would be a different case.

The court added that "Laquila's claim for coverage here is no more than an attempt to recover for the excluded costs of making good its faulty or defective workmanship any other interpretation would result in coverage for nearly every instance of defective workmanship.

In Re Chinese Manufactured Drywall Products Liability Litigation, 759 F.Supp.2d 822, at 850 (E.D.La.2010), the court found that because the insured's losses resulting from odors emitted by defectively built Chinese drywall were a direct and continuous result of the drywall's defect, the ensuing loss exception was not applicable to restore coverage.

3. DUTY TO DEFEND

The standard ISO builder's risk form does not typically include an express duty to defend or reserve to the insurer the right to control litigation against the insured. While a duty to defend exists in third party liability insurance, such as CGL policies, as noted above, the builder's risk coverage is "first-party" insurance that insures the property not third parties. This means that, in contrast to liability policies builder's risk coverage does not require that a claim or suit be brought against the insured in order to trigger coverage. Because builder's risk insurance is first-party coverage it has been held that there is no duty to defend under such policies.[2]

However, given the varying terms among builder's risk policies, it is possible that some of the manuscript policies may provide a duty to defend or an endorsement may introduce such a duty. In such circumstances the standard obligations of the insurer in complying with such a duty will apply. In some cases, the builder's risk policy will reserve to the insurer an "option to defend." When such option language has been present in a builder's risk policy arguments have been made that the insurer has a duty to defend. However, the majority of courts that have considered such provisions have held that a mere "option to defend" does not give rise to a "duty to defend."[3] In *Dryden Oil Co. of New England v. Travelers Indem. Co.*, 91 F.3d 278, 289 (1st Cir. 1996) the property insurance policy imposed no duty to *defend* in suits for physical loss or damage. But the policy did provide the insurer the *option* to defend its insured. The court held

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[2] *Nourishad v. SCPIE Indem. Co.*, No. G035218, 2006 WL 1015756, at *8 (Cal. Ct. App. Apr. 19, 2006) ("[f]irst party property insurance generally does not carry with it a duty to defend third party claims."); *Shell Oil Co., supra.*(" there is no implied duty to defend under a first-party 'all risks' policy"); *Power Eng'g Co. v. Royal Ins. Co. of Am.*, 105 F. Supp. 2d 1196, 1208 (D. Colo. 2000); *M.L. Foss, Inc. v. Liberty Mut. Ins. Co.*, 885 P.2d 284, 285 (Colo.App.1994) (concluding that no duty to defend arises under "a first-party policy [when] the underlying action ... [is] a third-party claim."); *Butler v. Clarendon Am. Ins. Co.*, 494 F. Supp. 2d 1112, 1129 (N.D. Cal. 2007), *aff'd*, 317 F. App'x 648 (9th Cir. 2009)("because the [policy] is a "first-party" coverage, it cannot legally create a duty to defend against third-party claims, as would a "third-party" coverage."); *Camp's Grocery, Inc. v. State Farm Fire & Cas. Co.*, No. 4:16-CV-0204-JEO, 2016 WL 6217161, at *6 (N.D. Ala. Oct. 25, 2016).

[3] *Omega Demolition Corp. v. Travelers Prop. Cas. of Am.*, No. 14-CV-01288, 2015 WL 3857341, at *4 (N.D. Ill. June 19, 2015); *Genaeya Corp. v. Harco Nat'l Ins. Co.*, 991 A.2d 342, 349 (Pa. Super. Ct. 2010); *Stadium Lincoln-Mercury, Inc. v. Heritage Transport*, 826 N.E.2d 332, 337 (Ohio Ct. App. 2005) ("policy language stating '[w]e may elect to defend you against suits arising from claims of owners or property' unambiguously stated that [insurer] has the right, but not the duty, to defend [insured] from suit"); *Nourishad*, 2006 WL 1015756, at *11; *M.H. Lipiner & Son, Inc. v. Hanover Ins. Co.*, 869 F.2d 685, 688 (2d Cir. 1989); *B & D Appraisals v. Gaudette Machiner Movers, Inc.*, 752 F.Supp. 554, 556 (D.R.I. 1990); *City of Peoria v. Underwriter's at Lloyd's London, Unincorporated*, 290 F.Supp. 890, 892-893 (S.D.Ill. 1968).

that an *option to defend* does not constitute the requisite agreement upon which might be predicated a *duty* to defend.

(A) Sue and Labor Clauses

As a general matter parties to a contract have a duty to mitigate damages. In builder's risk policies a provision known as the "sue and labor" clause seeks to define and limit the duty to mitigate. A sue and labor clause has been described as an ancient clause that addresses the mutual duties owed by an insured and an insurer. It has been explained as follows:

> [T]he insured has the duty of preventing a threatened insurable loss and mitigating such loss when it does occur. An insured who avoids or minimizes insurable loss acts for the benefit of the insurer. It is the benefit conferred which creates the duty on the part of the insurer to reimburse the insured for prevention and mitigation expenses.[4]

The purpose of the clause is to reimburse the insured for expenses incurred in satisfying the duty to the insurer, but there is no such duty where the policy does not afford coverage. The sue and labor clause does not operate as an enlargement of the perils insured against. Rather, the clause is simply a condition of coverage, which must be read in conjunction with the insuring agreement, any applicable exclusions, and the remaining terms of the policy.

4. WHEN DOES COVERAGE TERMINATE

Builder's risk insurance is generally limited or temporary in nature; it is designed to cover the structures, materials and equipment during the construction process. Some policies will specify a date certain for termination of the coverage. In the absence of a specified termination date or prior to the passage of that date, coverage under a builder's risk policy typically ceases when the project is considered to be "completed." The date of completion will generally be defined in the policy as being when the owner accepts the structure as complete, when a certificate of occupancy is issued by the local building authority, or when the structure is put to its intended use.

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[4] *Southern California Edison Co. v. Harbor Ins. Co.*, 83 Cal.App.3d 747, 148 Cal.Rptr. 106, 111-12 (1978); *Blasser Bros., Inc. v. Northern Pan-American Line*, 628 F.2d 376, 386 (5th Cir. 1980); *Continental Food Products, Inc. v. Insurance Co. of N. Am.*, 544 F.2d 834, 837 & n. 1 (5th Cir. 1977).