



2020 CLM Construction Conference
September 30 - October 2
Chicago, IL

Builder's Risk: Navigating the Creative Coverage Argument

- I. A Principled Approach to Builder's Risk Policies
 - a. Introduction and Takeaways of the Course
 - I. Builder's Risk insurance is unique first-party property insurance that is often misunderstood.
 - b. Defining purposes of Builder's Risk
 - I. Builder's Risk property insurance is designed to protect a construction project, including the structure under construction, the materials and equipment used in the construction, and the removal of debris of covered property damaged by a covered loss. Typically, the policy is a contract requirement and purchased by the general contractor or the owner. In some areas, this type of policy is called a "Course of Construction" coverage as it is only intended to apply during the course of construction, erection, and fabrication of a structure of appurtenances until the construction is considered complete. Coverage typically starts at the project start date and ends when the work is completed on the project, and would be considered to be on an "all risk basis" that covers direct physical loss from all causes except those that are specifically excluded in the policy.
 - II. Identifying the need for Builder's Risk for a construction project's potential exposure may be necessary to protect the interests of owners, contractors, subcontractors, and others involved in the construction project. While contractors and subcontractors are typically covered, it is a good idea for them and any other interested party to be named insureds on the policy. This coverage is limited and typically a liability policy is needed to cover damage to third parties, like passersby that become injured or killed by the construction or for damage to adjoining properties.
 - III. Typical exclusions of a Builder's Risk policy include defective design or construction as compared to professional liability or general liability insurance. Insurance carriers strongly contest coverage and argue that design flaws should be covered by professional liability insurance, as well as present defenses including faulty workmanship if applicable.
 - IV. As part of the project award and early on in the award of the contract, encouraging the project's owner and contractors to perform a proper exposure evaluation and/or the need to provide adequate insurance coverage for the restoration of the work in progress and to ensure a timely completion of a project.

- c. Pros and Cons of Builder's Risk
 - 1. Pros: Project work and associated materials can be effectively managed to minimize possible damage and cost exposure with Builder's Risk policy to the owner, the contractors, and other interested parties.
 - 2. Cons: Improper placement or inadequate limits of Builder's Risk can create cost increases and delays to projects as well as the coverage can be misunderstood resulting in creative coverage arguments. These creative coverage arguments can lead to contract disputes and cost overruns as well as project delays that may have potential contractual liquidated damages.
- II. Case Studies with Builder's Risk at the core; The Good, the Bad, and the Ugly (15 minutes)
 - a. A "Pessimistic" view of Builder's Risk
 - I. Coverage and cost limitations including Design-Build project challenges.
 - b. High Profile
 - I. Good – Cost of Making Good: the costs that would have been incurred to rectify a loss or damage of the project that is covered by the risk.
 - II. Bad – Security of Construction Sites: owners and contractors need to adequately secure their construction site to ensure the Builder's Risk policy is not breached for failure to do so. This security can include Protective Safeguards such as high fencing around the entire jobsite, locks on all gates during non-working hours, security cameras, and illuminating the jobsite from sunset to sunrise.
 - III. Ugly – Ensuing Loss: typically, if a component has a defective design, the insurer will not pay the cost for correcting the error. However, if a design defect causes the failure of the structure, collapse or partial collapse of a structure, substantial movement or other similar peril, the resulting damages are considered to be "ensuing loss or damage" and are not excluded under Builder's Risk.
 - c. Everyday Examples
 - I. Design changes mid-construction absent of sufficient review from design and construction team can be problematic. It is important to review any changes to ensure that they will not lead to accidents, deficiencies, or property losses. For instance, an owner or contractor may try to cut costs by using non-professionals for review of submittal documents that can lead to unexpected problems with the project.
 - II. Inferred decisions by contractor absent of timely notification or notification at all to the design team. The contractor may make decisions to reduce costs and time by not following the designer's recommendations or not reporting differing site conditions that can result in the structure not being built properly and non-compliant with the design and associated applicable building codes. The successful completion of the project is based on transparency between the design and construction teams, but this is not always the case. Design professionals can make minor changes, but does not make necessary changes to the means, methods of products used in the project, and similarly, the contractor can make the same minor changes as well that can impact the project. A simpler and common-sense form either side, design or construction, is inference. The design professional inferred the contractor would make the

proper modifications to make the change(s) work; while the contractor inferred the design professional reviewed the change(s), and given the lack of questions or protests, inferred the change(s) were acceptable.

- III. Substitution of building materials without proper review. Similarly, situations as described above can result in a disaster for the project due to perceived minor substitutions such as substituting OSB for plywood can cause loss of functionality and/or value.
- IV. Inadequate construction site security requirements may risk potential denial of insurance coverage. As noted previously, the need to provide adequate security of the entire jobsite may not always be possible due to the conditions at the project, but appropriate steps are necessary to ensure that the contractors' work is free from trespassers and the project materials and equipment on site are safeguarded from losses such as theft and vandalism. Technical improvements with security cameras, motion detectors, and lighting can all contribute to ensuring the Builder's Risk policy requirements are satisfied and not result in a loss of coverage.

III. Foresight versus Hindsight – Lessons Learned & Applied to the Future (30 minutes)

- a. Think "Good, Better, Best" to get most out of Builder's Risk: Hindsight is in the past while foresight is in the future. Specifically, hindsight is the understanding of a situation or event only after it has happened, developed, or been identified in some way. Foresight is the ability to predict what may happen or be needed in the future. Together, hindsight and foresight aid in the "lessons learned" approach for any project. In evaluating Builder's Risk and possible issue, the lessons learned should target the good, better, and/or best outcome.
- b. Exploring what can be done to prevent losses, mitigate risk, and avoid liability are key steps in a project from beginning to end.
 - I. Learn from the past; i.e. hindsight. The history of Builder's Risk coverage presents issues that need to be dealt with for a project to minimize property losses, accidents, and in turn, insurance claims and litigation. In order to apply the lessons learned approach, a review of these types of property losses, claims and litigation can assist in the reduction of same.
 - II. Project to the future; i.e. foresight. Having foresight in the decision-making process is key to successes in a successful project. With organized and methodical efforts, the study of alternative design concepts, means and methods, and scheduling effects can be effective tools in successfully managing changes in the project. In construction, successful risk reduction is accomplished through open and meaningful discussions between the owner, developer, contractors, and design teams. Ensuring the full group is part of critical decisions will ensure there are limited negative downstream effects on the design, construction, and/or building function.
- c. Technology; an Emerging Asset: Across all industries, there is a growing demand to do more with less. An emerging asset to accomplish this is through embracing technology. Technological advancements with product development have entered nearly all sectors; whether product development, material manufacturing, or predictive design. Using

predictive design as an example, within the past 5, 20, and 40 years, structural engineering design has evolved entirely. Presently, software developers created programs to aide (and direct) structural engineers in their designs. Through “machine learning,” the program’s algorithms essentially do the work. Going back 20 years, software existed to supplement an engineer’s design calculations. Going back further, 40 years, computer software was in its infancy and was not relied upon the way it is today; work was completed by hand. Looking to the future, predictive design is an area of cost savings on a project; however, the cost-benefit analysis will be required.

Beyond predictive design, there are many possibilities with using emerging technologies in construction and operation. It has been shown that construction technology solutions and the data captured by them are proving useful on the front end of projects for increased operational efficiency and risk reduction, and on the back end of projects (i.e. post-loss) with more effective claims resolution and assignment of liability. By increasing interconnectivity of projects with devices and better utilization of data and analytics will help reduce risk and accidents. For example, smart construction projects tout potentially fewer workplace accidents by separating the humans from the hazards with automation and robotics. Embedded sensors on a connected worksite create opportunities for collecting and managing data on safety, material performance, and operational workflow, just to name a few. Smart devices and wearable technology, as well as sensors and on-site cameras can be tied into various systems aiding risk professionals in loss prevention efforts and liability professionals on the back end. Builder’s Risk evaluations through the implementation of technology is another cost-benefit in making the construction site safer and reducing the potential for an accident, injury, litigation, etc.

- I. Design, Construction Defects
- II. Accountability and Assessment of Liability
- III. Site Security
- IV. Safety and Loss Prevention

- d. Negligence/Errors and Omissions: There are duties and obligations created by the courts applying common law which introduces the discussion of negligence; which is alleged in the breach of contract litigation. Applicable in this discussion is whether changes made during a construction project would be defined as negligence or Errors and Omissions (E&O) [Professional Liability] – and where the negligence lands (i.e. who is responsible?).

Negligence is a legally defined term; negligence is a cause of action in Tort that must consist of specific elements including the following:

- I. one person owes a duty to take reasonable care to another;
- II. the duty of care has been breached;
- III. the breach of duty caused injury or damage to another; and,
- IV. the loss sustained was not too remote a consequence of the breach of duty

- e. Breaking down who is *Ultimately Responsible* using case law as examples. The courts have looked at some of these cases differently perhaps, but the question remains as to

who is potentially liable for injuries/damages arising from defects caused by a project's design or the contractor's workmanship depends on several factors.

Using California as an example, a review of an article written by Murtaugh Law revealed that under California Law, the question of who is potentially liable for injuries/damages arising from defects caused by a project's design depends on several factors. The article notes that, "*California has a number of cases in which Courts have held that contractors that follow a project's plans and specifications without deviation are not liable for any damages caused by design defects.*" For example, in *Barnthouse v. California Steel Buildings Co.* (1963) 215 Cal.App.2d 72, the Court found that a grandstand was built by the general contractor in accordance with the plans and specifications that the general contractor was bound to follow because of their contractual obligation..." This discussion can serve as a reminder for contractors to construct what is specified, seek answers when something is not clear, and to avoid inference.

i. Ensuing Loss

1. *Blaine Construction Corporation v. Insurance Company of North America* (171 F.3d 343 (6th Cir. 1999)). The insured asserted a claim for the cost of replacing ceiling insulation that was ruined by water that condensed with the insulation cavity after a subcontractor failed to install a vapor barrier properly. The district court dismissed the insured's claims against the insurer who denied coverage under the "faulty workmanship or faulty materials" exclusion. The Sixth Circuit Court, applying Tennessee law, ultimately held that the ensuing loss to the ceiling insulation was covered under the policy. The Court further noted that here – the vapor barrier edge tabs that were incorrectly installed were not damaged – it was the adjacent material. As such, coverage existed, and the appellate court reversed the lower court's dismissal.
2. *Batram, LLC v. Landmark Am. Ins. Co.*, 864 F. Supp. 2d 1229, 1235 (N.D. Fla. 2012). Similarly, this court found that water damage to other property caused by faulty workmanship on the construction site is covered under the "ensuing loss" provision.
3. *Selective Way Ins. Co. v. Nat'l Fire Ins. Co.* 988 F.Supp. 2d at 530. The plaintiff filed a motion for summary judgement on its claims for coverage of "ensuing loss" damages under a Builder's Risk policy. In this case, a water supply line leaked during construction of a new building which resulted in extensive water damage to three floors of the construction project. The claims investigator determined that the cause of the water pipe fitting coming loose was either from a defective manufacture or defective installation. Under the assumption that the fitting came loose due to faulty installation, the U.S. District Court for the District of Maryland

held that the plaintiff was still entitled to coverage under the “ensuing loss” clause in the Builder’s Risk policy.

ii. Defeating Summary Judgement with Competing Experts

1. Central Weber Sewer Imp. Dist. V. Fire Underwriters, Inc. Co., Case No. 1:12-cv-166TS, 2014 LEXIS 16839, *33-34 (N.D. Utah February 6, 2014). The plaintiff sought to recover under a Builder’s Risk policy for construction involving the modernization of a wastewater treatment facility. The project required a shored excavation with a temporary metal sheet pile wall to retain the excavation until it could be backfilled. A series of problems occurred at the jobsite including the sheet pile wall shifted and damaged the dewatering well, electrical equipment and gravity discharge line. After the sheet pile wall was repaired, voids formed and water sprang up feeding water into the excavated area, and after this was fixed and the slab poured, there was excessive shifting of the foundation preventing it from functioning as intended. Plaintiffs sought coverage under the Builder’s Risk policy for each of these three events, but the insurer denied all three claims citing the exclusion language for faulty, inadequate or effective design, specifications, workmanship, repair, construction, renovation, remodeling, grading, compaction, and materials used in repair, construction renovation or remodeling. The parties filed cross motions for summary judgement and attached their respective expert reports in support of their positions. For the plaintiff’s breach of contract claim. The Court ultimately found that a fact issue was presented by the competing expert reports. The Court denied defendant’s summary judgement holding that a “triable issue of fact exists as to the cause of the sheet pile wall failure, and in turn, the cause of the slab settlement and the formation of the voids.
2. Harbor Communities, LLC v. Landmark Am. Ins. Co., Case No. 07-14336-CIV-MOORE/LYNCH, 2008 U.S. Dist. LEXIS 59179, *19 (S.D. Fla. August 4, 2008).

iii. Subrogation Issues in Builder’s Risk

1. How to Avoid Subrogation Suits Against Design Professionals
2. Who is the Insured and Against Whom Contractual Waivers Can Be Enforced, e.g. Additional Named Insureds?
 - a. Dyson & C. v. Flood engineers, Architects, Planners, Inc. 523 So. 2d 756 (Fla. App. 1988). The City of Pensacola contracted with Flood Engineers to design and engineer the specifications for the construction of a sewage treatment plant. Dyson was required to maintain Builder’s Risk insurance on the project to protect the interests of Dyson, the City, and Flood Engineers from various hazards to the work. Dyson obtained a Builder’s

Risk policy, but only named Dyson and its subcontractors as insureds, leaving the interest of Flood Engineers and the City unprotected. After a fire at the plant, Dyson was paid out of the Builder's Risk insurance policy for the damages sustained by fire. The Builder's Risk insurer then filed a subrogation action against Flood Engineers alleging that it negligently caused the fire. The Florida Court of Appeals found that Dyson had breached its contractual obligations to name Flood Engineers as an additional named insured, and therefore, Dyson's insurer had no subrogation rights against Flood Engineers so long as Flood Engineers has an insurable interest in the property destroyed in the fire. The Court also held that the project engineer had an insurable interest, which could be protected under the Builder's Risk policy, and barred the property insurer's subrogation claim against the project engineer.

- b. *Koken v. Auburn Mft.*, 2004 U.S. Dist. LEXIS 205 (D. Me. Jan. 8, 2004). For this case, a fire broke out and steps taken to extinguish it damaged a construction project. While cleaning up the debris from the fire, a welding blanket that was intended to prevent the fire was discarded by the employees of a subcontractor. The liquidator representing the insurance company pursued subrogation through a products liability suit against the presumed manufacturer of the welding blanket. The liquidator recited tort and contract claims against the general contractor and its subcontractors on the grounds that they allegedly destroyed the products liability claim by discarding the welding blanket after the fire. The general contractor and subcontractor filed motions for summary judgement. The U.S. District Court in Maine recognized that a duty to preserve evidence could be assumed through contract. However, in the insurance contract, the insurance company expressly waived subrogation between the general contractor and all subcontractors. Therefore, no duty to preserve the evidence was created and the Court concluded summary judgement be granted against the liquidator.
- c. *Fire Insurance Exchange v. Thunderbird Masonry, Inc.* 868 P.2d 948 (Ariz. Ct. App. 1993). The Arizona Appellate Court held that an insured could not pursue a subrogation claim against a subcontractor on the project. The owner's Builder's Risk policy designated the mortgagee, the bank lending money for the project, as the loss payee. When a fire occurred on the insured premises, the insurer paid the mortgagee the amount of the outstanding indebtedness on the project. The insurer then claimed it was subrogated to the mortgagee's rights against the

subcontractors. The Court held that the mortgagee had a right to receive the insurance proceeds only because of the loan agreement with the project owner. Therefore, the insurer could not only pursue a claim on behalf of the owner. However, the owner waived its rights against the general contractor and subcontractors to the extent that any damage was covered by insurance, and the insurer was bound by this waiver.

- d. *Aetna Casualty & Surety Co. v. Canam Steel Corp.* 794 P.2d 1077 (Colo. Ct. App. 1990). In comparison, the Colorado Appellate Court held that a material man whose only duty was to deliver materials to the jobsite, did not qualify as a “subcontractor” and thus could be sued in a subrogation action. The Court held that merely delivering materials to the site did not constitute “performing work” under the construction contract to be considered a subcontractor.

IV. Communication Matters – Lessons Learned (5 minutes)

- a. **Transparency and Timely Reporting.** Risk management techniques and strategies are designed to identify risks and consider how best to protect against risks. Concepts like contract integration and ensuring appropriate commercial insurance policies are in place like Builder’s Risk are often key components of comprehensive risk management plans and systems. However, many companies fail to identify areas of high frequency exposure, high severity exposure, and address them proactively, or to consistently review or audit claims that do arise. This means they’re not understanding the “big picture” for the company. For instance, a large majority of Builder’s Risk cases can be interpreted through the lens of a lack of comprehensive risk management and inadequate/improper engineering and communication. This underscores the need to have open discussions across a project team; specifically, with an owner/developer who is making monetary decisions, the design professionals that are responsible for implementing prescriptive and/or performance requirements, the contractors the install and construct, and the end-user who has anticipated usage requirements.
- b. **Reducing the Shades of Gray (making things blacker and whiter).** Understanding some of the subtle and not-so subtle nuances with Builder’s Risk as a whole is invaluable for any individuals that are involved in claims and litigation; specifically, the contractors and subcontractors as well as the design professionals where Professional Liability is asserted. Knowing what questions to ask insureds, claimants, and others can quickly identify where the breakdown in a project occurred resulting in the claim. When the breakdown can be confidently understood, vetted, and confirmed, the root cause and responsible parties is clearer for all interested parties. This transparency subsequently eliminates the gray areas, while determining black and white; in other words, conjecture vs. facts. This provides support to the claims and litigation process and helps eliminate problems that arise downstream between, insurers, insureds, and third-party risk transfer associated with Builder’s Risk insurance.