Builders' Risk and Other "First Party" Coverage for Construction-Related Property Damage

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I. Overview: Why Purchase Builders Risk Insurance?

No major construction project (and few "minor" projects) should be commenced without adequate coverage in place for property damage risks, including damage to the work in progress, the equipment used for the work, and the tools and materials of contractors an other business invitees who may have equipment at the site. While most contractors will carry some form of commercial general liability coverage that insures generally against bodily injury and property damage liability, as discussed in other seminar papers, such policies will not insure against property damage during the work or arising out of the "work" of a contractor. While the owner (or others) may have claims for indemnity if the damage is caused by negligence, two questions arise: (1) Can the contractor (or responsible subcontractor) pay; and (2) should the contractor pay or can the risk of damage be mitigated by insurance?

Also, what happens if the damage is not caused by a negligent act, but by the so-called "named perils" of fire, windstorm, lightening or flood? Fire and other forms of property damage insurance will protect against "first party" loss of and damage to the insured's property; but such policies may not insure against loss during construction of incomplete projects that are not occupied by the owner or otherwise ready for occupancy—whether as a dwelling or office facility or as an operational plant. A builders risk policy is needed to cover property damage occurring during the course of construction.

Builders risks policies, usually written on a "project specific" basis, will cover not only the "named perils" of loss caused by external causes, but also may cover, subject to exclusions and limitations, property damage caused by acts of third parties (theft or vandalism) and even damage caused by the negligent acts of a contractor or subcontractor. Most builders risk policies are written on an "all risk" basis, meaning that the policy will cover all risks of property damage unless the cause is specifically excluded. Such policies may be referred to as ARBR (all risk builders risk) or CAR (construction all risks policies). In addition, contractors will sometimes obtain builders risk "floater" policies that are not project specific, but that will cover, subject perhaps to lower limits than a project-specific builders risk policy, property damage at any project undertaken by the insured contractor. Such "floater" programs may fill coverage gaps not otherwise insured by the project specific builders risk program; but

floater policies usually will not provide any coverage until the limits of the project specific coverage are exhausted.

Project specific ARBR policies usually insure the full value of the completed project and may include an escalation clause that increases the coverage limits, along with a corresponding increase in the premium, if change orders or other factors increase the completed value of the project. However, unlike a "valued" policy that will provide coverage for the full limits specified, ARBR policies either provide "actual cash value" or "cost or repair" coverage that is determined at the time of the loss and capped at the project value stated in the policy.[1] In addition to this basic coverage, builders risk policies covering commercial construction also may insure against "delay in start up" losses resulting from a covered cause of loss that delays completion of the project. Such coverage may potentially offset contractual liquidated damages that might be assessed for project delay. Also, while coverage under a project-specific builders risk policy typically is limited in time—either by specific dates stated in the policy or by the date of completion of the project—some policies may include "maintenance" period coverage that insures against damage caused by post-completion maintenance work or against property damage that occurs during the specified maintenance period as a result of a pre-existing construction defect.

When an ARBR policy includes maintenance coverage, and even sometimes without such coverage, the builders risk policy and the owner's property insurance, such as a plant owner's operational property damage policy, may provide overlapping coverage. Uncertainty regarding which policy applies is possible whether the ARBR coverage extends to a specific date or to a specified event, such as "final completion and acceptance." Final completion may not always be determined by a fully objective measure; and plant operations or partial operations may sometimes commence before the owner signs off on a certificate of final completion. In the meantime, the owner and the contractor will continue to need property damage coverage. Also, the premium costs of ARBR coverage may increase significantly during the final stages of construction work. There usually is an added premium and sometimes reduced coverage for final testing and start-up of a plant, especially if the project involves high risk activities, such as a power plant, high-tech manufacturing, oil and gas or chemical operations facility.

[1] A Georgia statute provides that in the event of a "total loss" of "residential" property covered by a "standard" fire insurance policy, the stated policy limits "shall be taken conclusively to be the value of the property" (less any depreciation after the policy issued). *O.C.G.A.* §33-32-5(a). However this statute does not apply if the "completed value of a building or structure is insured under a builders' risk policy." *Id.* §5(b)(4). *See Georgia Farm Bureau Mut. Ins. Co. v. Garzone*, 523 S.E. 2d 386 (Ga. Ct. App. 1999) (rejecting builder's claim for full, stated value of a fire damage policy where, because it was construed as a builders risk policy, the policy only covered the actual cash value of the partially completed project at the time of the construction loss, not to exceed the cost of repair).

Not all of the often complex issues regarding possibly overlapping property policy and ARBR policy coverage can be addressed in a brief paper or seminar presentation. The remaining portions of this paper will address "highlights" of some of the basic, recurring issues that often arise. In addition to major treatises and resources regarding insurance, including construction coverage publications addressing this topic, the following are some general resources that may be consulted regarding coverage for construction-related property damage:

S. Coombs and D. Malecki, *The Builders Risk Book* (International Risk Management Institute, Inc. 2010)

Coverage Under Builder's Risk Insurance Policy, 97 A.L.R.3d 1270 (2010)

C. Jong, *Builders Risk Insurance Policies*, 94 A.L.R.2d 221 (2008) (superseded in part by the 2010 annotation)

E. Kneisel and B. Epps., *Pirates, Rovers, and Builders Risks: Seaborne Coverage Lessons for Shore-Based Construction Projects*, 2010 *Construction Law Update* 75 (N. Sweeney ed. 2010) (hereinafter "Pirates, Rovers").

II. Who is Covered and When Does Coverage Exist?

A. All Parties to the Construction Contract Should be Insureds

ARBR policies (whether project specific or "floater" programs) may be purchased by the project general contractor; or a project-specific program may be purchased by the owner, sometimes as part of an owner-sponsored OCIP. The requirement to obtain the coverage often is and usually should be specified in the construction contract, which should include language specifying the limits (usually full contract value of the project), the duration of coverage (including possibly post-completion maintenance) and providing that the policy should be "all risk" coverage, including coverage for "testing and start up" of the facility. The contract also should specify who must obtain the coverage (the owner or general contractor) and who should pay for it, *i.e.*, is the premium cost part of the cost of the work? Consideration also should be given to whether or not the proceeds of the insurance will be the "exclusive" remedy between the parties for damage caused by a construction-related accident.

Both the owner and the contractor have "insurable interests" in the project; therefore, it is common and usually sound practice that a builders risk policy should name the owner, the general contractor and subcontractors of every tier as insureds, as well as mortgagees and lenders who have a financial interest in the project. Naming each party to the construction contract and their subcontractors as insureds will help to minimize controversy and may be one way to minimize liability that otherwise might not be insured by a typical commercial general liability policy that excludes

coverage for damage to the insured contractor's "work." For instance, in *E.C. Long, Inc. v. Brennan's of Atlanta, Inc.*,[2] the court addressed a situation in which the negligence of a grading subcontractor caused an explosion and fire that destroyed a mansion being converted into an upscale restaurant. The owner and several carriers who had issued builders risk coverage to the owner sued the general contractor (and others) for negligence. Citing a clause of the AIA construction contract requiring the owner to purchase insurance for the "full insurable value" of the work, including the "interest of the *Owner, the Contractor,* Subcontractors and Sub-subcontractors *in the Work*…,"[3] the defendant contractor argued that this clause barred the carriers' subrogation claims. The court agreed.

The contractor also argued that the owner's claims were barred by another clause of the contract providing that the parties waived "all rights against each other for damages… *to the extent covered by insurance provided under this* [contract]…."[4] Because the contractor sustained no damage to the work then in progress, the owner argued that this clause did not bar its claims. The court disagreed, concluding that the contractor had an "insurable interest" in the damaged building because it was part of the project as a whole: "Where the subject matter of insurance is a builder's risk policy, whether for construction, alteration, or repair, the building contractor who has entered into such a contract has an insurable interest in the building."[5] The court concluded that the "waiver" clause effectively made the builders risk coverage the exclusive remedy for damage to the project caused by the construction-related negligence of the contractor.

Not every construction contract contains a clause effectively making insurance coverage the exclusive remedy for course of construction property damage; however, such clauses are a viable and potentially very acceptable way to minimize controversy and spread or shift what otherwise may be an uninsured risk to insurance. There are too many variations of clauses that may be used to accomplish this result to discuss in this paper; but such clauses should be considered in allocating construction risks and can be a very important reason to obtain ARBR coverage.

B. The Duration of Coverage

As noted above, project-specific ARBR coverage is limited in time, usually commencing on the "start date" of the project and usually ending when the project

[2] 252 S.E.2d 642 (Ga. Ct. App. 1979).
[3] *Id.* at 644 (emphasis in original). *See also Island Villa Developers, Inc. v. Bonner Roofing & Sheet Metal Co.*, 334 S.E.2d 41, 42 (Ga. App. 1985) (When an insurance waiver clause bars the owner's lawsuit "against the subcontractor, certainly the insurer in subrogation may not sue the subcontractor, since the rights of the insurer are not superior to those of the owner.").
[4] *Id.* at 645 (emphasis in original).
[5] *Id.*

work is done.[6] As noted above, sometimes, a policy will be issued and premiums determined based on the estimated completion date of the project; and for major projects, time-specific policies may be necessary as the only form of policy available. Carriers are reluctant to issue "open ended" policies for a stated premium; therefore, for longer term projects, it will be necessary for the contractor and owner to calendar policy dates to make sure that the ARBR coverage is appropriately extended to provide ongoing coverage if the project completion date is extended.[7] Conversely, to the extent the premium, especially during the "testing and start-up" phase of a major project, is measured in part by time and in part by project value, an "early" completion of the project may be a basis for terminating the coverage early, thereby reducing the premium cost.

Unfortunately, uncertainty regarding project completion often generates disputes between the owner, the contractor and insurers, especially when the project, such as a power plant project, involves testing and start-up protocols that may require several stages, including "preliminary acceptance," followed by partial operations and "final completion" that may be accomplished some weeks (or even months) later.[8] The timing of damages, whether caused by fire or explosion, especially during or shortly after final testing, can lead to disputes regarding coverage, as well as serious disputes between the owner and contractor. In these and other circumstances, the builders risk carrier may contend that its coverage ended, while the owner's property damage carrier may contend that its policy never incepted. As is the case when the owner and contractor agree up front to waive claims against each other that are covered by the project-specific ARBR policy, an agreement between the parties regarding the date of completion or partial completion and the shifting of the risk of loss between the carriers may be one way to mitigate, if not eliminate an otherwise lengthy and contentious dispute that requires one side or the other (or both) to expend resources to accomplish a repair while the competing carriers sit on the sidelines.[9]

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[6] When the policy does not specify the beginning date (incept date) for the coverage, disputes may arises regarding whether construction has "commenced," thereby limiting or barring coverage. *Cameo East Corp v. National Fire Ins. Co.*, 383 N.Y.S.2d 355 (N.Y. App. Div. 1st Dept. 1976) (denying coverage because construction had not commenced). *But see Ira S. Bushey & Sons v. Am. Ins. Co.* 142 N.E. 340 (N.Y. 1923) (destruction of shipbuilding materials by fire is covered after the materials are delivered and being shaped for construction, even though not yet incorporated as part of the construction work). *See generally Bosecker v. Westfield Ins. Co.*, 724 N.E.2d 241 (Ind. 2000) (coverage for renovation and repair of existing building measured from start date of policy rather than date of commencement of actual construction work).

[7] For instance, in *Hospital Service Dist. v. Delta Gas, Inc.*, 141 So.2d 925 (La. Ct. App. 4th Cir. 1962), the insured apparently neglected to extend the builder's risk policy to final completion; therefore, the court denied all coverage for a course-of-construction explosion that occurred several months after the policy's stated termination date.

[8] In *Philadelphia Facilities Management Corp. v. St. Paul Fire & Marine Ins. Co.*, 379 F. Supp. 780 (E.D. Pa. 1974), the court ruled that there were material issues of fact regarding the issue of whether the coverage had ended on completion of construction work (before a fire occurred) or after completion of testing and final acceptance by the owner, which had not occurred.

[9] *See* E. Kneisel and J. Leonard, *Allocation of Settlement Payments Among Self-Insured Policyholders, Insurance Carriers, and Others Having 'Interests' in Construction Industry Liability Claims*, 2000 *Construction Law Update* 39 (N. Sweeny ed. 2000).

Insurance covers uncertain risks; and unfortunately, policies covering those risks often use uncertain language. Absent clearly expressed coverage limits, such as specific dates for the commencement and end of the coverage, the outcome of disputes regarding the duration of coverage also is uncertain. Policies measuring the termination of coverage by objective criteria, such as issuance of a "certificate of occupancy" for a residential project, may not always provide the certainty necessary to eliminate disputes. And when an unfortunate, accidental fire, or explosion or other event causes major damage at or near the end of the project, it will be necessary to review carefully the policy language and governing case authority to determine what coverage is available.

For instance, carriers have argued that "substantial completion" of the work is enough to end the coverage. In *Cherokee Ins. Co. v. United States Fire Ins. Co.*,[10] the court noted that the building might have been completed for purposes of offering it for sale, but ruled against the carrier, applying policy provisions specifying that the insurance coverage did not end until the property had been accepted or occupied or the policy term had expired or been canceled, thereby extending the builders risk coverage beyond "substantial completion." On the other hand, when the owner of a fertilizer plant being constructed rented more than 40% of the partially completed structure to a third party, a court applying Arkansas law ruled that a policy proviso terminating coverage after the building had been occupied (in whole or in part) should be enforced because the parties contemplated that builders risk coverage would end when the owner made "substantial use" of the building.[11] While partial "occupancy" of the fertilizer plant being constructed in Arkansas barred coverage, a Michigan court held that partial occupancy of a few of the apartments of a project still under construction did not mean that the project was "completed" for purposes of terminating the builders risk coverage.[12]

Cases addressing "occupancy" and completion issues are many and varied and may turn on uncertain distinctions in the facts and policy wording. One of the many cases addressing this issue that raises another important question regarding the duration of coverage is *Hendrix v. New Amsterdam Casualty Co.*,[13] applying New Mexico law. After considering the fact that the period of construction had expired,

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[10] 559 S.W.2d 337 (Tenn. Ct. App. 1977). A recent module issued as part of a "floater" ARBR portion of a package property policy by the Great American Insurance Group provides that coverage ends "90 days after the structure is 'substantially completed,'" if construction work has ended. A project is deemed "substantially completed" if it is "usable for its intended purpose."

[11] *McCarty v. Maryland Cas. Co.,* 429 F. Supp. 112 (W.D. Ark. 1976). The court rejected the insured's argument that an understanding that coverage would not be affected by use of the building to store construction materials or materials used in installing plant machinery did not create an ambiguity, given that the chemicals being stored were unrelated to construction of the fertilizer plant.

[12] *American & Foreign Ins. Co. v. Allied Plumbing & Heating Co.,* 194 N.W.2d 158 (Mich. Ct. App. 1971) (holding that trial court's ruling in favor of coverage was not "clearly erroneous," but reversing on ground that coverage had been terminated by agreement).

[13] 390 F.2d 299 (10th Cir. 1968).

the Tenth Circuit noted that evidence showing that the house had been regularly occupied by renters, while not conclusive, supported the proposition that for all practical purposes, the building had been completed before the fire. The court ruled that evidence that a few "minor" items remained and that work was being done to repair defects and inferior workmanship did not extend the policy coverage.

The issue of "post-completion" coverage, whether for work done during the required warranty or "maintenance" period or for post-completion property damage caused by pre-completion construction flaws remains a matter of controversy in the United States. One solution to the widely divergent rulings regarding liability coverage for such claims under Commercial General Liability (CGL) policies would be to purchase "maintenance period" coverage for post-completion, construction-related damage. While not common in U.S. policies, many overseas insurers offer such coverage, which has now become standard in Marine Builders Risk coverage available in the U.K.[14] If a maintenance extension cannot be added to the builders risk program, coverage for damage caused by negligent maintenance work might be available under a "floater" program or through a separate ARBR policy or extension of the existing project-specific policy.

III. What Damages Are Covered and What Is Excluded?

A. The Basic Coverages

An ARBR policy is "first party" property damage coverage, even though, as noted above, such policies may be a viable means of protecting against possibly uninsured liability that otherwise might be incurred as a result of construction-related property damage. *See E.C. Long, Inc., supra.* Typically, an ARBR policy will insure against all "direct physical loss" to Covered Property, unless the cause of loss is otherwise expressly excluded or limited. Covered property will include the project property at the job-site and also should include coverage for building materials, supplies, equipment and fixtures intended to become a "permanent" part of the completed project.[15] It may be important to clarify when construction materials and the sometimes very expense equipment to be installed are covered. Is such coverage limited to equipment actually at the site, or is coverage also provided for a "lay down" location or other temporary storage location? Many ARBR policies will include "inland marine" transit coverage, which may be very important depending on the transit and custody risks involved. For instance, if expensive machinery to be supplied by the contractor is purchased FOB the factory, transit coverage needs to be arranged to supplement the sometimes more limited coverage provided by the shipper.

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[14] Maintenance covers are standard in the WELCAR form of ARBR marine policy that has replaced the "American Institute" marine builders risk form issued in the London market. *See* "Pirates, Rovers", *supra* at 94-98.

[15] The policy also may include coverage for "temporary" structures, such as a construction trailer and related facilities at the job site, subject perhaps to separately stated sublimits.

Generally, the ARBR coverage provided should fill the coverage gaps not provided by a general liability policy, as such policies normally exclude coverage for property "in the care, custody and control" of the insured. For instance, an ARBR coverage form issued by the Great American Insurance Group expressly covers "your property and property for which you are legally responsible, in your care, custody or control…" that is intended for installation at the job site. However, it is not unusual for such policies to exclude coverage for equipment being used for construction, including subcontractor tools and equipment that is not intended to be installed permanently as part of the project. Such equipment and tools should be insured by a separate property policy or perhaps by an endorsement to the ARBR form. Also, the owner/ contractor should make sure that a builders risk policy for renovation or modification of an existing structure does not exclude coverage for damage to existing buildings or structures that may be caused by the construction work. Damage to the portion of such structures that is not in the "care, custody or control" of the contractor and that is caused by negligent construction work *may* be covered by a CGL policy, *see* note 25, *infra*; but the issue of coverage for such damage is often a matter of serious dispute, not only with the owner, but also with the insurance carriers.

In addition to the "equipment and tools" or "existing structures" limitations on coverage, the ARBR policy may specify that the definition of "covered property" does not include land or water, crops, currency and other intangibles, and property while being transported by water or from overseas locations. "Inland marine" coverage, either added by endorsement to the builders risk policy or purchased separately, may be needed to fill these coverage gaps.

As noted above, the coverage limits of the ARBR policy usually will be measured by the completed value of the project. However, that does not mean that a loss will be paid on a "valued" basis. *See* note 1, *supra*. Rather, the completed value typically is stated as the maximum amount of loss that the carrier will pay. The actual amount paid will be determined by the cost to repair or replace the damaged property or equipment (replacement costs), which may or may not include contractor overhead and profit. It also is common to include specified sublimits for certain categories of loss, especially those that might have to be added by endorsement, such as coverage for flood, pollution cleanup, mold or fungus remediation (in the event of water damage), earthquake, and other specified causes of loss, whether or not the fault of a contractor or subcontractor. Also, the measure of insurance recovery might be different for certain categories of covered property, such as contractor equipment or other property for which an insured may be responsible.[16] Such property may be

[16] In *H.W. Ivey Construction Co. v. Transamerica Ins. Co.*, 168 S.E.2d 855 (Ga. Ct. App. 1969), the contractor sought coverage for damage to a leased forklift being used at the job site, invoking the policy's coverage of property "for which the assured is legally liable;" however, the court affirmed the jury's verdict that coverage was barred by the policy's exclusion for "contractor's equipment." *Id.* at 856.

insured on an actual cash value basis or if based on cost to repair, there may be a separate limitation on the amount of coverage provided.

Project value is not only important in determining the maximum coverage available, it also usually is the basis for measuring premium costs. In addition, premium costs and even coverage limits may vary depending on the stage of construction when the damage occurs. As noted above, premiums may increase or coverage may be reduced during the high-risk "testing and start-up" stage of major plant construction. Also, if the project completion date is extended, whether by change order or other cause, premiums will change and may even be measured by the partially completed value of the plant at the time of the loss. A "Completed Value Monthly Reporting Endorsement" issued by the Great American Insurance Group requires the insured to issue monthly reports specifying the estimated value of the completed work and provides for adjustments of the premium based on such reports and the applicable schedule of rates and premiums. Absent timely reporting, a "coinsurance" penalty may significantly reduce the coverage available to an amount below the actual cost of repair.

Project delays, in addition to requiring extensions of coverage and additional ARBR premiums, may subject the contractor to significant liquidated damages, as specified in the construction contract. Some ARBR carriers offer "delay in start up" coverage that may offset some or all of the contractual liquidated damages if the delay results from a covered cause of loss, such as a fire or other construction-related physical damage to the facility. While delay in start-up coverage provisions vary, they often contain "business interruption" language that may measure the available coverage in large part by the value of lost production (or rentals or revenues) experienced by the project owner. Such coverage will be similar, if not identical to the business interruption portion of the owner's property policy, which usually is measured by lost revenue, less discontinued overhead expenses saved during the period of interrupted or reduced sales. Thus, if coverage under the owner's property coverage commences before the ARBR delay in start up coverage ends, there will be overlapping coverage that may or may not generate a subrogation claim against the contractor by the owner's property damage carrier. Issues pertaining to competing coverages and the varying accounting methods used for calculating lost revenue are beyond the scope of this paper.

The Great American Insurance Group offers a coverage endorsement that expressly insures, subject to a specified sublimit, the contractor's "reasonable monetary contractual obligation to pay… the project owner…." if the completion is delayed by a covered cause of loss. Great American also offers another more extensive endorsement to developers and contractors of apartments and similar commercial projects that provides delayed completion coverage for "soft costs," "rental value" (loss of rental income or fair rental value) and mitigation costs. "Soft costs" are defined to include costs incurred in refinancing construction loans,

advertising, taxes, consulting fees, and other costs as may be specified in separate declarations issued for each project for which the coverage is provided.[17]

The language of the delay in start up provision covering expenses to "reduce loss," sometimes referred to as "extra expense" or "expediting expense" in the business interruption sections of property damage policies, is both an obligation imposed on the insured and a benefit to the insurer. In other words, when there is a "loss in progress," the costs incurred in minimizing any worsening of the loss are a necessary component of a duty to mitigate that may be implied or stated expressly as part of the obligation of the insured to protect the property. As a quid pro quo, the carrier should reimburse the costs incurred in mitigating the insured loss. This requirement, commonly specified in the "sue and labor" provisions of a marine builders' risk policy, may not be included in the body of an ARBR policy, but often can be a very valuable component of coverage, whether express or implied, that should not be overlooked.[18]

B. Common Policy Exclusions

As noted above, while delay in start up coverage is available from some ARBR carriers, ARBR policies usually expressly exclude coverage for contract liquidated damages or penalties. An exclusion for liquidated damages may be unique to builders risk coverage; but other exclusions commonly found in such policies will overlap, if not be virtually identical, to exclusions typically found in an owner's first party property damage policy. Such exclusions will bar coverage for nuclear risks (nuclear reaction or radiation or contamination); war and military action; earthquakes or earth movement (including or excluding sinkholes); volcanic action; dishonest or criminal acts; machinery breakdown; water and floods (whether wind driven or not); pollution; fungus or bacteria and mold; and enforcement of government ordinances (condemnation, for example). Fortunately, many of these exclusions can be eliminated by adding endorsements to the policy that expressly cover some or all of the excluded causes of loss. For instance, machinery breakdown (a/k/a "boiler and machinery") coverage should be added for power plant and other projects involving installation of power boilers and other expensive equipment. However, endorsements that enhance coverage should be carefully reviewed and often are subject to express,

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[17] *See RLI Ins. Co. v. Highlands on Ponce, LLC*, 635 S.E.2d 168 (Ga. Ct. App. 2006) (dispute regarding whether or not the "soft costs" and loss of business income coverage of a builders risk policy was subject to sublimits or provided additional coverage in excess of the stated "blanket policy limits" must be resolved by a jury because parol evidence did not eliminate the ambiguity in the policy wording).

[18] There should be little dispute that an obligation to mitigate (and to reimburse the costs of mitigation) is triggered after a loss has occurred and/or is in progress. *See Continental Food Prods., Inc. v. Ins. Co. of N. Am.*, 544 F.2d 834, 837 n.1 (5th Cir. 1977); however, disputes arise when a future loss is anticipated, but has not yet commenced. *See, e.g., Swire Pac. Holdings, Inc. v. Zurich Ins. Co.*, 845 So. 2d 161, 169 (Fla. 2003); *Wolstein v. Yorkshire Ins. Co.*, 985 P.2d 400, 409-10 (Wash. Ct. App. 1999). As in *Swire Pacific*, the issue of whether or not the loss is sufficiently "imminent" to trigger coverage may be outcome determinative. *See also Buczek v. Continental Cas. Ins. Co.*, 378 F.3d 284 (3d Cir. 2004) (wind damage that may occur only every 10-20 years is not an imminent risk that triggers collapse hazard coverage).

monetary sublimits or will contain other restrictions, such as being limited solely to the clean-up and remediation or pollution or mold damage.

In addition, there may be express limitations or exclusions that apply to the delay in start up coverage. For instance the Great American coverage "time element" endorsement excludes losses caused by strikes (also a common, ARBR exclusion or limitation); "irregularities" or interruptions caused by supplier problems; cancellation or lapses of permits, licenses and leases; weather conditions generally; delays caused by funding (construction loan) issues; and deficiencies in the original project construction, designs, specifications and materials. Some of these exclusions are written broadly enough to raise the issue of just what is a "covered cause of loss" that might trigger such coverage? Presumably, loss by fire or explosion would be covered—unless caused by a "construction defect." The broadly word exclusion in this coverage for construction "deficiencies" arguably is consistent with a general exclusion found in the body of the Great American policy, which bars coverage for "gradual deterioration, hidden or latent defects, *any quality in the property that causes it to damage or destroy itself*, wear and tear, depreciation, corrosion, rust, dampness or dryness, cold or heat…." (emphasis added). Because of the on-going controversy about whether or not losses caused by "construction defects," whether the damage occurs before or after completion, may be insured, the last section of this paper is devoted to this subject. This issue can and will lead to sometimes complex coverage disputes, whether under builders risk, property or CGL policies.

In addition to a clause barring coverage for workmanship or design flaws, another issue that often arises under ARBR and other property insurance policies relates to coverage or exclusions barring coverage for "collapse." For instance, while the risk of collapse is not expressly included as a "covered cause of loss" in the Great American policy, a collapse exclusion in that policy bars coverage if the collapse is caused by specified external causes, such as earth movement, flood or water seepage. The policy expressly insures against a collapse caused by underground water that leads to a "sinkhole;" and a collapse caused by the weight of rain, snow or ice. The policy also should cover a collapse caused by negligent construction; but the availability of such coverage is by no means certain, even when the builders risk policy expressly includes collapse hazard coverage.

For instance, in *Stagl v. Assuance Co. of America*,[19] the insured purchased a builders risk policy to cover the construction of a vacation home in North Georgia. The policy expressly covered "collapse of all or part of a building." The insured argued that the foundation walls had been built "using defective materials and methods, lacked strength and durability, lacked steel reinforcement in some places" and contained a "cold joint" defect.[20] However, the walls had not actually collapsed. Citing other Georgia cases allowing coverage under property damage policies, one

[19] 539 S.E.2d 173, 174 (Ga. Ct. App. 2000).
[20] *Id.*

involving an "actual collapse" and the other involving subsidence of the foundation that caused a "worsening of the structure's condition, such that a collapse was "inevitable,"[21] the court concluded that the collapse coverage could be triggered if "the structure's integrity is seriously impaired and collapse is imminent…."[22] Because the evidence in *Stagl* did not satisfy this standard, the court affirmed the denial of coverage. The court also noted that while a collapse caused by the use of "defective materials or methods in construction," would be covered, the policy expressly excluded coverage for "defective design, workmanship, or construction; or faulty, inadequate, or defective materials used in construction."[23] As a result, the court also decided that the insured's evidence merely established that the condition of the foundation "resulted from the alleged use of defective materials and poor workmanship by the contractor unaccompanied by any accident," concluding that the insured's coverage argument did not "realistically reflect the purpose of the builder's risk policy," which was to cover the "*accidental collapse* of a structure occasioned by an underlying structural defect."[24] While this portion of the opinion may be called into question in light of a recent decision of the Georgia Supreme Court holding that defective construction can trigger coverage for an "accidental" occurrence,[25] it highlights an overarching issue that arises under ARBR as well as other forms of policies insuring construction risks: Coverage for damage caused by "construction defects."

IV. When and How Can ARBR Coverage Insure Against "Construction Defects?"

Perhaps there is no more contentious area of insurance coverage law than the issue of whether or not and under what circumstances damage caused by "defective construction," *i.e.*, faulty, negligent workmanship or installation of defective components, can be insured? Carriers will vigorously contest such coverage, whether the claims arise under CGL policies, including policies that include products completed operations hazard coverage, or under builders risk policies providing all risks property damage coverage. If the damage at issue is caused by a product defect,

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[21] *See Lipsitz v. Fireman's Fund Ins. Co.*, 358 S.E.2d 624 (Ga. Ct. App. 1987); *Nationwide Ins. Co. v. Tomlin*, 352 S.E.2d 612 (Ga. Ct. App. 1986).

[22] 539 S.E.2d at 175-76. *See generally*, *What Constitutes "Collapse" of a Building Within Coverage of Property Insurance Policy*, 71 A.L.R. 3d 1072 (2012). In *Pickering Contr. Co. v. Liberty Mut. Fire Ins. Co.*, 141 S.E.2d 165 (Ga. Ct. App. 1965), there was no dispute that an actual collapse had occurred, but the court sustained a jury's verdict for the insurer based on the policy's water damage exclusion.

[23] *Id.* at 176.

[24] *Id.* at 175, 176 (emphasis in original).

[25] *American Empire Surplus Lines Ins. Co. v. Hathaway Dev. Co.*, 707 S.E.2d 369, 372 (Ga. 2011) (a subcontractor's "faulty workmanship [that] causes unforeseen or unexpected to other property" is covered by a CGL policy because "'[a] deliberate act performed negligently, is an accident if the effect is not the intended or expected result….'") (quoting *Lamar Homes Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 16 (Tex. 2007)). Coverage for construction-related property damage under the PCOH provisions of a CGL policy is addressed elsewhere in the written materials for this seminar and has been discussed in other articles by this author. *See* E. Kneisel and B. Cooke, *The Products-Completed Operations Hazard: When Coverage Exists, Just What is Covered?*, 2009 *Construction Law Update* 161 (N. Sweeney ed. 2009).

i.e., defective design, both ARBR and CGL carriers will invoke exclusions, arguing in effect that design flaws should be covered by professional liability insurance and not by CGL or ARBR policies. CGL carriers also will invoke other defenses, including the so-called "business risk" defense that damage caused by faulty workmanship should be covered by contractual warranties and that "defective," negligent; construction cannot be an insured, "accidental occurrence." As noted above, the Georgia Court of Appeals ruling in *Stagl* suggests that similar arguments can be made to bar coverage under an ARBR program; but other Georgia case authority, especially *Hathaway*, *supra* (a CGL case) and *E.C. Long*, *supra* (a builders risk case) hold otherwise, at least when construction negligence causes consequential damage to other parts of the work—such as the uprooted gas line incident in *E.C. Long* that caused an explosion that destroyed a building to be renovated.

As illustrated by the outcome in *E.C. Long*, physical property damage occurring during the course of construction that is caused by negligent construction arguably should be covered by *all* ARBR policies, but many policies contain express exclusions for "faulty workmanship." The issue of ARBR coverage for damage caused by a construction-related design flaw is even less certain and typically will be hotly contested.

Disputes regarding builders risk coverage for property damage caused by construction flaws often arise under all risk property damage policies containing exclusions for the "cost of making good faulty or defective workmanship, materials, construction or design…," but with exceptions for "damage resulting from such faulty or defective workmanship, material, construction or design." The intent of these provisions is to distinguish between the uninsured cost to repair or replace defective parts that were never in a "satisfactory state," and the insured cost incurred in repairing resulting or "ensuing loss" damage to non-defective property that is caused by the defective part.[26]

For instance, the Great American ARBR policy form mentioned above provides "all risks" coverage, but is subject to numerous exclusions that bar or limit coverage, including an exclusion for "any quality in the property that causes it to damage or destroy itself." It is uncertain whether this exclusionary language should only be construed as barring coverage for the cost of repairing the defect, while allowing coverage for consequential damage to other, non-defective property that is caused by the poor "quality," defective component.[27] Such coverage has been

[26] *See Trinity Industries, Inc. v. Ins. Co. of N. Am.*, 916 F.2d 267, 271 (5th Cir. 1990) (Marine ARBR policy covering "physical loss or damage" insures against "accidents resulting from defective design or workmanship, but not the cost of repairing the defect itself"). Policies that refer to "resulting" loss or damage are treated the same as those covering "ensuing" loss or damages. *See, e.g., Continental Cas. Co. v. Landmark Hotels, LLC*, 184 F. App'x 649, 650 (9th Cir. 2006) (resulting loss provision operated precisely like ensuing loss provision).

[27] In Vermont, the clause arguably should be interpreted to cover such damage. *See City of Barre v. New Hampshire Ins. Co.*, 396 A.2d 121, 122-23 (Vt. 1978) (builders risk policy does not "exclude coverage for

allowed by several courts, especially when the ARBR policies at issue, as many do, contain express "resulting loss" language that restores coverage for consequential damage caused by defective design or workmanship.

In *Laquila Construction, Inc. v. Traveler's Indem. Co.*,[28] the court considered the following ARBR clause:

> 1. PERILS EXCLUDED
>
> . . .
>
> (b) Cost of making good faulty or defective workmanship or material, but this exclusion shall not apply to physical damage *resulting from* such faulty or defective workmanship or material.[29]

Construction on the insured project had to halted and some of the previously completed work had to be removed and reinstalled to replace a defective concrete slab. The insured claimed the costs associated with the removal and reinstallation of the additional building materials as a "resulting loss," arguing that the defective concrete had "physically damaged the insured property (the structural slab and/or the building as a whole) because it was physically incorporated into the larger entity and could only be removed at a cost."[30] The court disagreed. Concluding that the mere removal of the defective concrete slab did not constitute "resulting" physical loss or damage, the court noted that if the defective slab had collapsed and damaged other, non-defective property, such damages would be insured as covered, "resulting" losses. This ruling is similar to the Georgia court's ruling in *Stagl, supra.*

Cases such as *Laquila* and *Stagl* establish that an insured cannot obtain coverage under an ARBR policy that contains faulty workmanship and design exclusions for the costs incurred in repairing the defective parts or workmanship, unless there is actual evidence of consequential damage that can be characterized as resulting or "ensuing" damage to other, non-defective property.[31] If the evidence

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damage caused, at least in part, by negligent practices of the contractor during the construction process. It is the quality of the product which is excluded from coverage, and not damage to the product caused by negligence ….).

[28] 66 F. Supp. 2d 543 (S.D.N.Y. 1999), *aff'd without op.*, 216 F.3d 1072 (2d Cir. 2000).

[29] *Id.* at 544 (emphasis added).

[30] *Id.* at 545.

[31] Other illustrative cases denying coverage include *Vermont Elec. Power Co. v. Hartford Steam Boiler Inspection and Ins. Co.*, 72 F. Supp. 2d 441 (D. Vt. 1999) (*VELCO*), in which the court considered a policy with an exclusion for "faulty, inadequate, or defective design, specifications, workmanship, repair, construction…" that contained an "ensuing loss" exception. The court denied coverage for damage to defective transformers, concluding that construing such damage as an "ensuing" loss would improperly "supersede Continental's exception for losses caused by design defect." *Id.* at 445. *Accord City of Burlington v. Hartford Steam Boiler Inspection and Ins. Co.*, 190 F. Supp. 2d 663, 674 (D. Vt. 2002) (following *VELCO* and denying coverage under all risk property policies because "'resulting damage' is the same as 'ensuing loss' and does not encompass the costs to repair or replace … faulty welds."). Similarly, in *Allianz Ins. Co. v. Impero*, 654 F. Supp. 16 (E.D. Wash. 1986), the court rejected a builders risk claim for repairing voids in a concrete wall because there was no evidence of "resulting,"

establishes that the defective part or faulty workmanship did damage other property, most courts will hold that the insured may recover all the costs associated with the resulting damage, including, in some cases, the "rip and tear" costs of remedying the cause of the loss.

The evidentiary and policy interpretation issues that must be considered in determining "resulting damage" coverage are illustrated by *National Fire Insurance Co. v. Valero Energy Corp.,*[32] a case considering ARBR coverage for damages "arising as a consequence" of faulty workmanship. In *Valero*¸ a citrate scrubber sustained substantial damage during the testing phase of a refinery expansion project as a result of faulty design of one of the components. The court concluded that the damage at issue could be characterized as either the use of inadequately designed components that had to be replaced to "make good" the faulty design (an excluded event) or as being "a consequence" of the faulty design that had caused insured, resulting damage to the other components of the scrubber. Adopting a reasonable construction of the language in favor of coverage, the court concluded that the loss had occurred "as a consequence of" the faulty design.

Similarly, in *Rosenberg v. First State Insurance Co.*,[33] the ARBR policy covered lost rents due to "untenantability, caused by damage to or destruction of the building…" and contained standard wording excluding coverage for "making good faulty or defective workmanship" along with the exception for "damage resulting from such faulty or defective workmanship…."[34] Damage to a subterranean parking garage had been caused by faulty foundation work, resulting in sloping, cracks, and water accumulation that had to be repaired, delaying completion. The court allowed coverage for the loss, concluding that "[b]ecause damage resulting from defective workmanship is expressly covered by the policy, the conclusion is inescapable that faulty workmanship is a covered peril."[35]

Cases addressing ARBR coverage for damage caused by faulty workmanship and design are many and varied. Court decisions considering coverage under first party property and CGL policies for resulting damage caused by faulty workmanship also are instructive and should be considered in developing strategies for coverage under an ARBR policy. Generally, when actual, "physical" damage to other, non-defective property is caused by a defective part or by faulty workmanship, the resulting loss is insured, even if the cost of repairing or replacing the defective

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consequential damage. The court ruled that when an contractor fails to complete "a structure in accordance with plans and specifications and fails to perform properly, he cannot recover under the all-risk policy for the cost of making good his faulty work." *Id.* at 18. The court noted that the outcome might have been different if the concrete wall had collapsed and damaged other work. *Id.*

[32] 777 S.W.2d 501 (Tex. App. 1989).

[33] 280 Cal. Rptr. 388 (Cal. Ct. App. 1991) (unpublished decision).

[34] *Id.* at 389.

[35] *Id.* at 392 (emphasis in original). *See also Yale University v. CIGNA Ins. Co.*, 224 F. Supp. 2d 402, 421 (D. Conn. 2002) (distinguishing *VELCO*, *supra* at n. 30, and allowing coverage under all risks property policy for "resulting contamination" caused by "flaking or chipping of lead based paint").

component itself is barred. The key issue in such cases is to identify a factual basis for distinguishing the uninsured defective workmanship or defective part from the resulting, insured consequential (or ensuing) property damage.

V. Coverage Checklist

- Builders risk coverage protects against course-of-construction property damage that otherwise may be uninsured.
- Obtain the broadest ARBR coverage available.
- The ARBR policy should cover the owner, contractor and all subcontractors and mortgagees.
- Carefully consider the required duration of coverage.
- Consider whether coverage is needed and may be obtained for maintenance/warranty work and post-completion property damage.
- Carefully review all policy language and exclusions to determine the scope of coverage being provided.
- Consider adding specific endorsements to cover identifiable risks of loss that may be unique to the project.
- When a loss occurs, develop appropriate strategies to maximize recovery, including determining causation and "resulting" damage issues.
- Consider making the proceeds of insurance the exclusive remedy for construction-related property damage losses.