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Essential Issues in Builders Risk: Examining the Critical Modern Strategies That Drive a Successful Product

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Essential Issues in Builders Risk: Examining the Critical Modern Strategies That Drive a Successful Product

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Biographical Information

Greg Podolak is a Partner in SDV's Southeast office. He has spent his entire career advocating on behalf of corporate policyholders, navigating issues involving all lines of coverage, with a wealth of experience strategizing risk transfer/financing. In addition, Greg assists clients in all manner of concerns from coverage placement and drafting contracts to complex litigation.

Additionally, Greg's litigation and appellate practice includes successful arguments in multiple jurisdictions, including a $40 million builder's risk claim in a Maryland Federal Court case, related to previously unsettled issues of law involving coverage for construction scheduling impact costs, and a multi-million-dollar bridge collapse builders risk lawsuit in Florida bankruptcy court. Greg has also represented clients on countless residential and commercial construction defect claims throughout the country. Further, Greg has also successfully advocated multiple seminal state supreme court decisions.

Further, Greg routinely reviews insurance program placements for his clients, advising on critical litigation trends that influence contracting strategy. Greg also leads the firm's Cyber Risk team, which focuses on advising clients in all industries on their unique risk and insurance recovery.

In addition to his active law practice, Greg frequently collaborates with national insurance brokerage firms. He has been named a Super Lawyers Rising Star for 10 consecutive years (2012 – 2021) and was a recipient of the 2015 Connecticut Law Tribune New Leaders in the Law award.

As a Senior Vice President at NHG Specialty, **James Moye** will leverage his construction knowledge and experience to assist our clients in analyzing, understanding, and lowering their costs of risks. James spent almost a decade as legal counsel within some of the construction industries' largest household names. During this time, his ability to negotiate large complex contracts (Prime Contracts, Subcontracts, JV Agreements, Lender Agreements, etc.), manage litigation, strategize and manage corporate structures, and support companies' risk management departments has been recognized across the State of Florida and Southeast United States.

Andrea Nelson serves as vice president for Manhattan Construction Group, a national civil and general building service company. Andrea is part of the team that makes decisions as to risk management issues that directly impact the strategic direction of the company. As part of that team, Andrea is charged with providing risk solutions that will help optimize operations. Her duties include overseeing a department of 4 risk professionals that manage our various Contractor Controlled Insurance Programs, Subcontractor Default Insurance Program and Subcontractor Compliance. She is also responsible for the purchase of our insurance programs and managing relationships with our various insurers and sureties.

Alex Stephens is a Claims Director for Turner Construction Company. For some of the highest severity and most complex claims at Turner and its sister companies, he is responsible for advising internal clients, coverage and litigation strategy, risk transfer, and ultimate resolution. Alex primarily handles construction defect, builder's risk, professional liability, and pollution liability claims. In doing so, he employs best practices, creative solutions, and strong advocacy to protect enterprise earnings. Alex's experience includes practicing attorney in Chicago, construction defect claims specialist for a major carrier in New York, and claims director for a national contractor in Boston.

Overview

Builder's Risk insurance offers policies that cover damage to property during construction. Builder's Risk policies are like property insurance policies for existing property; however, Builder's Risk usually provides broader coverage than a property insurance policy. Builder's Risk has fewer exclusions, greater coverage for materials off-site and in transit, and may offer coverage for earthquakes, flood, and testing coverage.

The purpose of obtaining a Builder's Risk policy is to protect against financial and economic losses due to damage and resulting losses to work during construction.

Builder's Risk provides coverage for physical damage, typically on an all-risk basis, to first-party insured property at the insured project site or insured property while in transit or offsite storage. Additionally, Builder's Risk policies provide extensions of coverage to rectify damaged work, including but not limited to expenses related to debris removal, extra and/or expediting expense, and claims preparation. Builder's Risk does not typically cover personal property unless scheduled to the policy and does not respond to property unrelated to the project. Builder's Risk does not provide coverage for increased cost of construction unrelated to physical damage. Nevertheless, Builder's Risk policies are flexible, so a policyholder can typically buy coverage to include otherwise excluded perils.

With this background in mind, the following commentary explores certain of the "hot button" issues of the day.

I. Critical Language Negotiations – *Know the Game and Stay Ahead*

The most relied upon and controversial exclusion in a Builder's Risk policy is the Faulty Workmanship Exclusion. The traditional American Faulty Workmanship Exclusion is as follows:

> Perils Excluded… Cost of Making Good Faulty or defective workmanship, supplies, or materials… unless direct physical loss or damage by an insured peril ensures and then this policy will cover for such ensuing loss or damage only.

This exclusion creates a burden-shifting framework. First, the burden is on the insured to prove that a loss occurred. Second, the burden is on the insurer to prove that the loss was due to faulty or defective workmanship. If the insurer meets the burden, then, thirdly, the insured must prove that the resulting damage is covered by the policy.

The most common modern take on faulty workmanship is known as a "LEG" endorsement. London Engineering Group, also known as LEG, is a consultative body for insurers of engineering class risks providing a forum for discussion and education. LEG published three variations of defects exclusions, known as LEG 1, LEG 2 and LEG 3, with increasing levels of coverage for defective construction. While initially available through London markets, these endorsements, or similar "cost of making good" endorsements, are increasingly available in the United States.

LEG 1 Endorsements are the most restrictive for the insured. They generally exclude coverage for all

> *"Loss or damage due to defects of material workmanship design plan or specification"*

whether damage to other property has occurred or not. There is no exception for resulting damage, and all effects of the faulty work may be excluded.

LEG 2 endorsement offer a middle-of the road approach, excluding:

> *[a]ll costs rendered necessary by defects of material workmanship design plan specification and should damage occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost which would have been incurred if replacement or rectification of the Insured Property had been put in hand immediately prior to the said damage….*

This means that a policyholder will have to pay for what it would have cost to replace the defective work prior to the damage, but the ensuing damage to property itself is covered.

LEG 3 is the most policyholder-friendly of the LEG endorsements. This endorsement excludes coverage for:

> *defects of material workmanship, design plan or specification and should damage … occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification.*

but provides broader coverage for insured property damaged by the defect by limiting the exclusion to the cost "incurred to improve the original material workmanship, design plan or specification." This means that, under this exclusion, the costs to remedy the defective work are covered.

When available, Insureds should strive for LEG 2 or 3 language over other faulty workmanship exclusionary language. Under both, the scope of exclusion is substantially narrowed, and the burden remains squarely on the insurer.

Until September of 2023, only Canadian caselaw was available to interpret LEG exclusions. The Court in *Acconia Infrastructure Canada Inc., v. Allianz Global Risks US Ins. Co.*, 2015 BCCA 347 (CanLII), analyzed a LEG 2 exclusion and held that "the excluded costs are only those costs that would have remedied or rectified the defect immediately before any consequential or resulting damage occurred, but the exclusion does not extend to exclude the cost of rectifying or replacing the damaged property itself; the excluded costs crystallize immediately prior to the damage occurring and are thus limited to those costs that would have prevented the damage from happening." The court's decision weighed in favor of the insured because after the insured makes a prima facia showing that coverage existed, the burden was then on the insurer to prove that the costs sought were crystalized before the damage or for the replacement of the faulty workmanship itself.

In *South Capitol Bridgebuilders v. Lexington*, 2023 WL 6388974, 21-cv-1436 (RCL), a Federal District Court in Washington, D.C. issued an opinion interpreting LEG 3, as discussed below. *South Capital* is a win for policyholders, meaning that insureds now have favorable American jurisprudence to support arguments when a LEG 3 exclusion is contested.

II. Anticipating Emerging Legal Strategies That May Undermine Coverage

Presently, insurers make two common arguments concerning defective workmanship:

1. Defective construction is not a triggering "physical" loss; and

2. Consequences stemming from defective construction are faulty workmanship excluded from coverage, even with favorable LEG 3 or similar language.

The insurers premise their first argument, that defective construction is not a triggering physical loss, on the notion that property that was never in a so-called "satisfactory state" cannot then be in a damaged state. Under this theory, the insured would be unable to show that there was a triggering physical loss. Insurers attempt to support this argument using the language in the issued Builder's Risk policies. However, to date, there is no statute or case law that supports this contention.

The "Satisfactory state" language first appeared in *Trinity Industries, Inc. v. Insurance Co. of North America*, 916 F.2d 267 (5th Cir. 1990), where the Court discussed the physical loss requirement. The Court states that "[t]he language 'physical loss or damage' strongly implies that there was an initial satisfactory state that was changed by some external event into an unsatisfactory state—for example, the car was undamaged before the collision dented the bumper. It would not ordinarily be thought to encompass faulty initial construction." Insurers have taken this language and ran with it, despite diminishing support for their argument.

In *AFLAC, Inc. v. Chubb & Sons, Inc.*, 260 Ga. App. 306, 581 S.E.2d 317 (2003) the Court denied coverage without analyzing the "initial satisfactory state" of the covered property (although the insurance policy at issue was not a Builder's Risk policy). However, the court used "satisfactory state" language that insurers have since continued to rely on, stating that the phrase "direct physical loss or damage" contemplated "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."

Recently, in a Southern District of Florida case, *Mama Jo's Inc. v. Sparta Ins. Co.*, 823 F. App'x 868 (11th Cir. 2020) (Petition for writ of certiorari denied), where the Plaintiff sought indemnification for cleanup costs due to construction dust and debris from construction occurring outside a restaurant, the court cited to the "satisfactory state" language in its opinion. The court found that the Plaintiff lacked expert testimony to show that the dust and debris caused a direct physical loss and that cleanup costs did not constitute a direct physical loss. Notably, the restaurant's state prior to the dust and debris was not decisive. As such, we can surmise that the initial state of the property is dispositive so long as physical damage occurs.

The "satisfactory state" argument again cropped up in the District of Columbia Federal District Court (applying Illinois law), where the court refused the argument. On September 29, 2023, in *South Capitol Bridgebuilders v. Lexington*, *supra*. the Plaintiff showed that the structural integrity of the Federick Douglass Memorial Bridge was compromised when the concrete honeycombed and voided, decreasing the strength of the bridge support structures due to inadequate vibrations. The insurers claimed that there was no physical damage because the bridge was never in a "satisfactory state." The court held that there was physical damage to the bridge because the inadequate vibration caused a decrease in the weightbearing capacity and "[a] decreased weightbearing capacity is surely an injury, or at the very least a bad effect, on the bridge and its support structures."

In that same case, the Court interpreted the LEG 3 exclusion. The Court recognized the ambiguity in the exclusion, calling it "internally inconsistent" and "incomprehensible." The court rejected the insurers "invitation to ignore the unclear and error-riddled language of the Extension, which [the insurer] drafted, signed, and now seeks to rely on to deny coverage." The court also recognized that in the context of the extension, an improvement made things "better than it would have been it were not for the defective work," so fixing the concrete was not an improvement, but merely a remedial measure when the bridge's weight bearing capacity was diminished due to the defective construction. This indicates that LEG 3 does not require covered property to be in a "satisfactory state" prior to the occurrence of physical damage for coverage.

Ultimately, the LEG 3 exclusion was construed in favor of coverage, irrespective of the state of the property prior to physical damage. However, insurers are likely to bring up variations of the "satisfactory state" argument in future litigation. As such, knowledgeable policyholders can now point to American jurisprudence to help secure coverage.

III. Navigating Hard Market Conditions – *Act Early!*

Favorable language in Builder's Risk policies, like that in the LEG 3 exclusion, is more costly and less frequently sold in hard market conditions. Being aware of these market conditions, planning ahead, and leveraging relationships is becoming more and more critical.

At least one insurance company has indicated that lead times are increasing, meaning it is taking longer to obtain a Builder's Risk policy than before. This, coupled with the fact that Builder's Risk underwriting requires substantial documentation, means that the insureds must plan to secure coverage well ahead of time. Moreover, for an initial policy quote made months before a bid is submitted, rate increases can be expected as high as 20 to 30% by the time the bid comes to fruition. Checking in periodically with the broker and carrier partners for market updates is important, as is getting a final quote before submitting a bid or signing a contract.

Since 2021, the construction industry has seen consistent supply chain challenges, causing requests to extend Builder's Risk policies beyond the anticipated period. Under the terms of a run-of-the-mill Builder's Risk insurance policy, the insurer does not have to extend the policy term, even if the project's completion is delayed. Even when extensions are granted, the original premium is not guaranteed, and costs could increase because of high loss ratios. In one recent civil project, the project has gone bare, meaning it lacks coverage for the final phase of construction due to the cost increase of extensions. Another recent project with two open claims managed to convince the insurer to extend the policy, but at an exorbitant cost. Critically assessing the time for completion and providing sufficient leeway to deal with supply chain issues will help avoid price increases associated with policy extensions.

Lastly, premiums and deductibles are all rising. Builder's Risk premiums are usually calculated based on a project's estimated costs. Supply chain issues, rising interest rates, and an uptick in labor costs means that the average project's estimated costs are rising. This rise leads to higher insurance costs, making it harder to get "bang for your buck." Moreover, in certain specific circumstances, an insurance company may adjust the final premium based on the costs they incur related to the project if there is a Retrospective Premium Endorsement. These costs are typically hard to negotiate as insuring projects is critical. However, making well-founded time and expense estimates well ahead of the project's inception helps budget for insurance and avoid the extra insurance costs associated with an over-budget project.

IV. Proactively Preparing Claims to Achieve Maximum Recovery

When providing an initial notice of a claim, it is important to communicate early and often with an insurer. In fact, most policies require an insured to timely notify the carrier of a loss. The Eleventh Circuit in *Equitable Life Assurance Soc'y v. Studenic*, 77 F.3d 412, 415 (11th Cir.1996) held that "timely notice to the insurer of a claim or occurrence is a condition precedent to the insurer's duty to defend or pay." A best practice is to notify the insurer within 24 hours of a claim. If an Additional Insured on an Owner's policy becomes aware of a claim, the Additional Insured should notify the insurance carrier directly instead of waiting for the Owner to give notice. Transparency leads to better outcomes in the long run, so if the loss is major, consider calling the carrier leadership. Do not downplay the loss; instead, be realistic and show that the policyholder is taking proactive steps to mitigate the damage and recover the project and schedule.

Likewise, most insurance policies contain a cooperation clause, meaning that the policyholder must cooperate with an insurer to obtain or maintain coverage. To fulfill the duty to cooperate, the policyholders must provide the insurer with supporting documentation regarding the claim. The policyholder may need to allow access to the project site so that the carrier can investigate the claim; if further damage is found at a later date, invite the insurer to re-inspect the site. It is also a good idea to have weekly or bi-weekly meetings with TPA/carrier and weekly or bi-weekly meetings with the project team.

When preparing a claim, it is important to implement good record-keeping habits. Taking photos, marking floor plans and using an industrial hygienist are all good habits. Keeping separate logs with the costs incurred for remedial work, work done as a result of faulty workmanship, and the costs incurred during the normal course of business is also important. Having a good understanding of your costs will allow you to "bucket" costs to align with your policies broadest coverage. For example, if your policy offers broader coverage for physical damage than for debris removal, understanding your costs can help you categorize more expenses as "physical damage," leading to coverage for a greater part of the claim. A ROM (Rough Order of Magnitude) should be produced to the carrier within a week of the loss; this ROM should overestimate the cost of the loss by 20%. An internal claim manager or risk manager should prepare the cost packages reviewed and produced to the insurer.

The importance of proper claim preparation is exemplified in *6 W. Apartments, LLC v. Ohio Cas. Ins. Co.*, No. 1:20-CV-02243-RBJ, 2021 WL 4949154, at *6 (D. Colo. Oct.

25, 2021), where the insurer alleged that the policy holder did not timely notify the insurer of damage because the policyholder continuously "discovered" new damage. The insurers also said the policyholder did not properly document damage because they did not photograph all damage and did not allow an inspection before conducting repairs. If the insurer's allegations were true, then the policyholder would have breached the Timley Notice Provision and the Cooperation Clause, and the policyholder would have been unable to recover the damage. However, the policyholder was able to delineate the dates on which the damage occurred and when notice was given, providing a reasonable explanation for the time it took the policyholder to notify the insurer. Likewise, the court held that the policyholder did not clearly violate the Cooperation Clause because the insurer was not able to prove prejudice or that the policyholder's actions were unreasonable in light that taking photographs was difficult due to the location of the damage and that the insurers were allowed to inspect the damage when subsequent damage was discovered. As such, the policyholder survived a Motion for Summary judgment. Note that the policyholder was able to do so with sufficient documentation of the timeline of the events, the damage, actions it took, and other crucial details due to good, thorough record keeping.

If the Builder's Risk includes language such as, "The necessary and reasonable costs relating to the construction, erection, or fabrication of a covered 'building or structure' that are over and above those costs that would have been incurred had there been no 'delay period,'" then keeping detailed logs of the soft costs incurred is crucial. Soft costs are indirect or intangible expenses and may include, but are not limited to, expenses consisting of Architectural, Interior design, and/or engineering design, supervisory services, and consulting costs or fees; commissions or fees for the renegotiation of leases; fees for licenses and permits; interest and financing on the construction loan; realty taxes and other assessments; and development fees. In such cases, tracking staff time and confirming current work schedules is important.

Consider hiring an expert when submitting a soft cost claim. The expert can help provide evidence as to the delay period for loss of profits and projecting earnings. Common areas of dispute in soft cost claims include the length of delay, overhead costs, and expediting expenses.

Lastly, consider negotiating a lump-sum settlement for future delay or acceleration, rather than letting the claim drag out for months. Settling the claim means you'll have the money in your pocket sooner.

Understanding the information needed to resolve a claim will help expedite the claims process. Consider the documentation that would support your position in, for example, LEG 3 exclusion litigation as discussed above. Documentation that shows physical damage to covered property, resulting damage, and remedial measured can make or break the claim.