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Measure Once, Cuss Twice: Navigating the Faulty Workmanship Exclusion to Maximize Builder's Risk Recovery

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Measure Once, Cuss Twice: Navigating the Faulty Workmanship Exclusion to Maximize Builder's Risk Recovery

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Introduction

No construction project is without its risks, and as such, any owner or contractor involved in an ongoing project must take steps to protect their investment. When it comes to insuring against the risks that arise during the course of construction itself, the most valuable means available is the builder's risk policy. While most standard property policies cover the finished product, builder's risk provides much-needed coverage for damages or losses that occur during construction.

Builder's risk is attractive to owners and contractors alike for its flexibility and broad range of coverage. However, it is not uncommon for a policyholder to make a claim only for its insurer to deny coverage, citing an exclusion in the policy. More often than not, the "Faulty Workmanship Exclusion," and its common "Ensuing Loss Exception," are at the heart of these disputes. The typical builder's risk claim scenario often involves a contractor who completes faulty or defective work on a covered project that results in further loss or damage to the project caused by another event. The Faulty Workmanship Exclusion will preclude any coverage for the defective work itself, but where an Ensuing Loss Exception provision is present in the policy, coverage is available for the resulting damages if they are caused by an otherwise covered peril. The policyholder is thus entitled to indemnification for the cost to repair the "ensuing" damage, but not for the cost to repair or fix the faulty construction work itself.

Determining what damages are covered can be challenging, and issues undoubtedly arise in proving that a loss resulted from a covered peril and not defective workmanship. The best way to approach these claims is to have an understanding of how builder's risk claims operate in real life. Practical knowledge of when the Faulty Workmanship Exclusion and the Ensuing Loss Exception apply can provide useful insight into effectively preparing and submitting builder's risk claims. Implementing best practices in obtaining and recording claim information can ensure efficiency in the claims process and maximized recovery under your builder's risk policy.

I. The Basics: Risk Transfer and Builder's Risk

In a high-stakes business like construction, adequate risk transfer is essential. A common form of risk transfer for construction projects is the builder's risk policy. Builder's risk is a first-party property insurance policy specifically designed to cover risks related to construction operations. It is also referred to as "course of construction coverage" because its intended purpose is to protect the insured against loss or damage that occurs when the property is under construction. While other first-party policies only protect the finished product, builder's risk protects ongoing projects by covering the cost to repair or replace physical damage that occurs to the work or other covered property during the course of construction, as well as additional expenses related to delays caused by a covered loss. In other words, builder's risk provides insurance coverage for a property before it becomes an insurable building. Since it is a first-party policy, this coverage is triggered by a non-excluded "direct physical" loss to the construction project and does not require a claim or

suit against the insured. However, the loss must be within the scope of coverage provided by the policy.

The scope of builder's risk coverage available will vary based on the specific language of each policy. While insurance coverage will often follow standard forms such as those developed by the Insurance Services Office (ISO), builder's risk policies are usually written on a manuscript specific to the carrier rather than a standard industry-wide form. As such, a builder's risk policy may be written to cover "all-risk" or just "named-perils." An all-risk policy will typically provide coverage that insures against all risks of loss or damage to the construction project except those that have been explicitly excluded. A named-peril policy provides coverage for damage or loss caused only by those certain risks specifically identified in the policy. All-risk policies are generally preferred amongst policyholders for their broader scope of coverage; however, they can be more cost prohibitive, as they tend to command higher premiums than the more limited named-peril policy alternatives.

Typically, builder's risk policies are purchased by general contractors, real estate developers and owners. However, any party with a financial interest in the project may wish to purchase the policy to ensure sufficient coverage. Construction contracts often require all trade contractors working on the project to be an "Insured" under the purchased builder's risk policy, and all parties with an "insurable interest" in the project, materials, and equipment may be included as additional insureds on the builder's risk policy.

Builder's risk provides these insureds with something that standard property insurance policies cannot by allowing them to protect their investments while their projects are still under construction. The flexibility of the policy provides coverage for risks not covered under other policies and is therefore crucial to preventing gaps in coverage and safeguarding the project. However, no policy provides absolute protection, and issues often arise interpreting and applying policy exclusions. The "Faulty Workmanship Exclusion" in particular is at the center of the most significant and frequent issues impacting builder's risk coverage.

II. The Faulty Workmanship Exclusion and Ensuing Loss Exception

The interpretation and application of the Faulty Workmanship Exclusion is perhaps the most commonly disputed, and therefore litigated, provision in builder's risk insurance policies. It is frequently relied upon by carriers to limit or deny coverage for builder's risk claims. This exclusion puts the cost of repairing the faulty or defective workmanship itself outside of coverage. In other words, looking at the exclusion in a vacuum without consideration to its typical coverage carve-out, the builder's risk policy will not provide coverage when a loss or damage is not the result of an insured peril, but rather, the result of defective workmanship, supplies, or materials in the construction process. The language of this exclusion, and its built-in exception, often resembles something similar to the following:

***Faulty Workmanship
Exclusion:***

We will not pay for “loss” caused by or resulting from any of the following:

Faulty, inadequate or defective:

- (3) Planning, zoning, development, surveying, siting;
- (3) Design, specifications, workmanship, repair, construction, renovation, remodeling, grading, compaction; or
- (3) Materials used in repair, construction, renovation or remodeling.

***Ensuing Loss
Exception:***

But if an excluded cause of loss listed above results in a covered cause of loss, we will pay for the resulting “loss” caused by that covered cause of loss only.

As with any builder’s risk claim, the Faulty Workmanship Exclusion requires the insured first prove that a loss—i.e., physical damage to the covered construction project—occurred. If the insured can demonstrate the loss, the burden then shifts to the insurer to prove that the loss resulted from inadequate or defective construction work, thereby triggering the exclusionary language in the Faulty Workmanship Exclusion to bar or limit coverage for the claim. If the insurer is successful, the burden shifts back to the insured to prove that an exception to the exclusion in the policy applies to bring back coverage for all or part of the claim.

To that end, most Faulty Workmanship Exclusions contain a significant carveout via the “Ensuing Loss Exception.” Following the language of the Faulty Workmanship Exclusion, the policy may read something like “unless direct physical loss or damage by an insured peril ensues, and then this policy will cover for such ensuing loss or damage only.” This Ensuing Loss Exception allows coverage for the resulting damage when faulty or defective work results in a covered cause of loss, which often are significant. Then, the only damages left uncovered are the costs to repair or replace the faulty or defective construction work itself.

Courts across the country have interpreted and applied such Faulty Workmanship Exclusions with Ensuing Loss Exceptions in insurance coverage disputes under both first- and third-party policies. For instance, the case *Auto-Owners Ins. Co. v. Pozzi Window Co.*, 984 So. 2d 1241 (Fla. 2008), out of Florida, is instructive as a prime example of how the Faulty Workmanship Exclusion and the Ensuing Loss Exception are reconciled to determine coverage. Pozzi Window Company (“Pozzi”) supplied windows to a builder for the construction of a home. After the subcontractor installed the windows, the homeowners noticed water leakage around the windows and brought a claim against Pozzi and the other parties involved. As the insured contractor’s assignee, Pozzi sued the commercial general liability (CGL) insurer, Auto-Owners Insurance Company (“Auto-Owners”), for denying coverage under the Faulty Workmanship Exclusion in the Auto-Owners’ policy. Pozzi

claimed that the windows they provided were not defective but that the subcontractor negligently installed them and, as such, the water damage is an otherwise covered loss. Auto-Owners argued that the policy excluded coverage because the damages resulted from defective workmanship on behalf of Pozzi. The Florida Supreme Court held that “property damage” under a CGL policy does not include defective work. Still, it may consist of consequential damages to other tangible property that occur as a result of the defective work. This holding is a clear adoption of the interplay between the Faulty Workmanship Exclusion and the carveout that prevents it from applying to an ensuing covered loss.

Another case that illustrates how the Faulty Workmanship Exclusion and the Ensuing Loss Exception are meant to be read together is *Sel. Way Ins. Co. v. Natl. Fire Ins. Co.* of Hartford, 988 F. Supp. 2d 530 (D. Md. 2013). In this Maryland case, a contractor hired to construct a new building at Towson University obtained a builder’s risk policy from National Fire Insurance Co. (“National Fire”). While the construction project was in progress, a subcontractor responsible for the plumbing work installed a water supply line in the building that leaked, resulting in water damage. The subcontractor filed a claim under its CGL policy with Selective Way Insurance Co. (“Selective”), who settled with the contractor and obtained the right to bring a claim under the builder’s risk policy. Selective brought suit against National Fire, seeking reimbursement for the loss caused by the water damage. National Fire argued that such loss from defective installation was excluded by the policy, specifically the Faulty Workmanship Exclusion. In its analysis, the court pointed to the Ensuing Loss Exception as a means for providing coverage. The court reasoned that it is logical to find that the ensuing loss provision is intended to provide coverage for a covered cause of loss, such as water damage, that results from an excluded cause of loss, like faulty workmanship. Thus, while the cost to fix the defectively installed water line was excluded under the Faulty Workmanship Exclusion in the builder’s risk policy, the water damage to the building which resulted from the faulty water line installation was covered by applying the Ensuing Loss Exception.

Finally, *Blaine Const. Corp. v. Ins. Co. of N.A.*, 171 F.3d 343 (6th Cir. 1999), is another classic example of a Faulty Workmanship Exclusion and Ensuing Loss Exception operating within a builder’s risk policy. In this case, a construction company brought a claim for property damage against its insurance company under a builder’s risk policy. The construction company asserted that the insurer was liable for the cost of replacing ceiling insulation that was damaged by water that condensed within the insulation after a subcontractor improperly installed a vapor barrier. In its defense, the insurance company argued that the faulty workmanship provision excluded coverage and that the damage did not occur because of any further accident. The court referred to the Ensuing Loss Exception and found that the damage the insured sought coverage for was not the incorrectly installed vapor barrier excluded via the Faulty Workmanship Exclusion, but rather the damage to the adjacent and non-defective material which ensued as a result. Therefore, coverage still existed under the policy via the Ensuing Loss Exception.

III. Real-World Application and Practical Tips for Preparing Claims

In navigating what can sometimes be a blurry line between damages attributed to faulty workmanship and damages caused by an ensuing loss, there are several proactive measures that insureds can take to efficiently and effectively prepare and present their claims. These

best practices can help insureds obtain maximum recovery and streamline the claim adjustment process.

First, know the policy. It is important to know what coverage is available in relation to the loss in order to maximize potential recovery. This is where an ounce of prevention is worth a pound of cure. If insureds are uncertain of their coverage or the scope of their damages, consulting with or hiring a knowledgeable professional early on, such as the insured's broker, a forensic accountant, or a coverage attorney, can make a world of difference. The fees for many professionals, such as forensic accountants, are often even a covered expense under the policy. Be aware that anything said or submitted to the insurer early on may be utilized throughout the claim to deny or minimize a loss. Therefore, properly identifying how the cause(s) of loss and associated damages fit within the policy early on can significantly minimize issues later and streamline the claim process. While these professionals can still be helpful throughout the adjustment process and even post denial, they are often most effective if utilized from the beginning. Guidance from someone who appreciates the nuances of the policy and potential hurdles to coverage can prevent the insured from having to rehabilitate a messy claim or reconcile information that had previously been presented to the insurer unclearly or unfavorably, which can be a lengthy and costly process that could have been avoided.

Second, communication is key. It is important for insureds to know the notice requirements for their policies, and to provide notice as soon as possible. Even general notice to the insurer advising that a potential loss or claim is being investigated is helpful. This avoids the insured having to commit to a position or coverage narrative before it has fully investigated the situation and is prepared to do so while still ensuring compliance with any notice requirements under the policy and allowing the insurer to start participating in the investigation if desired. Timely and clear communication is critical to any claim, and keeping the insurer involved and informed of any mitigation or repair efforts can negate any defenses an insurer may raise regarding notice, consent, or reasonableness to disclaim coverage.

Third, consistent and accurate record-keeping is crucial. Throughout the project, it is best practice to take photos, mark floor plans, and document the progress of construction and any delays or activities that could impact the projected date of completion. In documenting a loss, it is important to keep separate logs breaking out the costs to repair or replace the faulty work as well as the costs to address any covered ensuing loss. Understanding the different costs will allow insureds to clearly define which costs align with the broadest coverage under the policy and present them in a way that maximizes potential coverage.

Depending on the loss and types of damages involved it may also be necessary to keep track of the associated soft costs. These are indirect or intangible expenses such as realty taxes, permit fees, consulting costs, loan interest and financing, etc. If the builder's risk policy covers delay damages, it is crucial to have a detailed log of all expenses that exceed what would have been incurred if not for the delay period.

And finally, fourth, identify and utilize the right experts. There are various types of experts that may be utilized for builder's risk claims, including but not limited to scheduling experts, market experts, and construction experts.

When submitting a claim for soft costs associated with a delay, it is not only prudent to hire an expert, but often necessary. As delay damages can require some educated speculation, they are frequently and heavily disputed. Common disputes include the length of the delay, the appropriate analysis for determining the period of delay and associated damages, whether there were uncovered events or occurrences that impacted the construction schedule, what soft costs are covered, and the reasonableness of the same. These issues can be further complicated where a project is to be completed in phases. In that scenario, there may be a dispute regarding when delay damages are triggered, i.e. whether the insured is entitled to damages associated with the delay of a phase or if delay damages only apply to a delay for total completion of the project.

Unless the policy identifies a specific methodology for determining delay damages, a skilled expert should be able to assess the loss and determine the best credible methodology to utilize that will favor the insured. They can also help identify areas of the claim that require further development and support to minimize insurer scrutiny and defend against attack. Obtaining expert testimony can help legitimize the claim and tie speculative damages to tangible facts.

Construction experts may also be used for builder's risk claims in various capacities. This may include opining on the cause of damage, the resulting impact of any faulty workmanship, the projected completion date, and the reasonableness of repair costs or strategy. In certain circumstances, an insured on a builder's risk policy may even seek to act as their own expert witness on these issues for the adjustment process and even during any ensuing litigation.

A contractor or other insured on the policy who is a party to a lawsuit against its insurance carrier is not precluded from qualifying as an expert witness in the case. However, doing so must be handled delicately and strategically by both the insured and their attorney. Any testimony presented by the insured as a "hybrid" fact and expert witness must be carefully and clearly defined, and the line between attorney client privilege may become blurred. The insured will need to make sure the appropriate expert designations are being made during litigation and consider what privileged information may now be subject to disclosure based on those designations. The decision to have the insured act as a hybrid witness must be made carefully. While the insured may have the knowledge, experience, and be readily available, it may be a safer choice to hire an outside expert to avoid any concerns of waiving privilege.

Conclusion

Builder's risk insurance is crucial for anyone looking to protect a project from the various risks associated with construction. However, to fully benefit from this coverage, the Faulty Workmanship Exclusion and its Ensuing Loss Exception necessitate proper claim management. It is important to understand the coverage provided and determine what

damages are from faulty or defective work versus from an ensuing covered cause of loss, as accurately categorizing and distinguishing such damages in the repair work can significantly impact the scope of coverage. Proper claim preparation, including timely notice, detailed record keeping, and the use of expert witnesses, can help the claims process run smoothly and effectively, minimizing insurer disputes and streamlining resolution, while maximizing recovery of covered damages under the policy.

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