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# COURSE OF CONSTRUCTION INSURANCE: SOME IMPORTANT CONSIDERATIONS

The many risks inherent in a construction project, whether a large or moderate undertaking, require that insurance coverage be selected with the utmost care.

Generally, the builders risk (or course of construction) exposure may be insured under either a commercial property or an inland marine policy. Forms and rates associated with *commercial property* builders risk coverage ordinarily are filed with state insurance regulators. Forms and rates of *inland marine* builders risk policies, however, are not subject to filing requirements and thus are referred to as “nonfiled” forms. Insurers have more flexibility in underwriting nonfiled classes because they can create their own coverage provisions and rates, which

can be tailored to the particular risk exposure. The subject of this article is the more preferred nonfiled inland marine builders risk coverage, including the factors that must be considered in properly writing this insurance.

*Picture a typical construction project—perhaps a school, an apartment building, or an office building—and consider the parties involved in the planning and execution of the project, the general layout of the site, the building materials and construction equipment needed to complete the project, and the work force required.*

Builders risk insurance is designed to insure construction projects, and it covers buildings and other structures while being built, including building materials

and equipment intended to become part of the building or structure. Coverage applies to property while at the job site, off site in storage, and in transit. (Coverage for construction equipment, i.e., forklifts, bulldozers, mobile tools, and so on, would be provided by contractors equipment insurance.)

Typical parties to a construction contract include:

- Project owner - party that owns building or is having building constructed

- Architect/engineers
- General

contractor/contractors/  
subcontractors

- Lenders
- The construction contract itself, while not a party, is a crucial element of a construction project

## Factors to consider

1. Different parties, as identified above, have insurable interests in the overall construction project.

2. Materials and equipment can be on or off the job site, and



at different times may belong to the owner, general contractor (GC), or subcontractors. Some materials and equipment may be owned by suppliers (aka materialmen), but these individuals or entities are not considered to be subcontractors. Their interests therefore seldom are covered by course of construction policies, unless they are specifically added.

3. To facilitate the purchase of insurance and avoid potential gaps in coverage, one of the parties to the contract usually assumes responsibility for insuring the project on behalf of all parties.

4. Responsibilities, including responsibility for obtaining insurance, are generally described in the construction contract.

### Construction contract requirements

Construction projects often involve standard documents published by organizations such as the American Institute of Architects (AIA) or the Associated General Contractors (AGC), to name two. However, some project owners may manuscript their own documents, using a combination of standard and other forms. Both AIA and AGC documents require project owners to furnish builders risk insurance covering the interests of all those involved in the project. Generally, the policy must provide:

1. "all-risk" or comparable coverage;
2. coverage for material stored off site and in transit;
3. coverage for all parties to the contract: owner, contractors, subcontractors;
4. permission for waivers of subrogation among the parties; and
5. coverage for the duration of the project.

The project owner may add the construction project to its regular commercial property policy, making sure there is compliance with the above five criteria, or purchase separate builders risk coverage.

The advantage of the builders risk approach is that the coverage is considerably broader than that provided in standard commercial property insurance. For example, many builders risk policies cover flood, earthquake, and testing, and provide broader transit and off-premises coverage. Builders risk policies also usually contain fewer exclusions.

A potential problem with a separate builders risk policy, however, is getting permanent coverage in place when the builders risk policy expires. Builders risk policies contain a provision stating when coverage will end, but the

provisions vary by policy. This can cause problems if the permanent commercial property insurance is not placed in a timely manner.

The owner also has the option not to purchase builders risk coverage, but rather delegate the responsibility for obtaining insurance to the GC. This is fairly common with larger contractors because the latter may be more familiar with the needed coverage and market and prefer to have some control over who the insurer of the project will be.

It is important to note (in the AIA document, for example) that if the owner does not intend to purchase the builders risk insurance, it must inform the GC in writing prior to the start of the project. The contractor may then obtain the necessary insurance, including protecting the interests of all parties, and charge the cost to the owner.

If the GC sustains a loss because the owner fails to obtain or maintain coverage, without notifying the GC, the owner will be responsible for all reasonable damages sustained by the GC.

To meet the contract requirements regarding insurance, the insurance consultant may need to negotiate changes in coverage to comply with the contract. In some instances it may not be possible to obtain specific coverage, such as flood or earthquake, and a change in the construction contract may be necessary to delete such a requirement.

### Coverages unique to builders risk/course of construction insurance

AAIS believes the following coverages, which may or may not be available in builders risk policies, are most important, and that every effort should be made to obtain them. (AAIS builders risk forms include these coverages, either in the main form or by endorsement.)

1. **Fraud or deceit** - fraudulently inducing an insured to part with covered property (aka trick or device).

2. **Contract penalty** - penalty for noncompletion of the contract assessed against the insured. Insured's inability to complete the contract according to its terms must be the direct result of a loss by a covered peril.

3. **Expediting expenses** - pays expenses incurred by the insured to expedite repairs, such as additional labor or overtime, transportation costs to rush delivery of needed parts, and expenses to rent additional equipment.

4. **Ordinance or law** - insureds need coverage for the demolition of

undamaged parts of buildings as well as for the increased cost to repair and the cost to demolish and clear the site.

5. **Testing** - covers loss to the building or structure caused by a covered peril that results from testing of materials, machinery, or equipment that will become a permanent part of the building or structure. New machinery and equipment (air conditioning, heating equipment, etc.) must be tested to make sure it works properly. Testing includes startup, performance, stress, pressure, or overload testing.

6. **Soft costs** - the term refers to coverage for additional expenses incurred by the insured when construction is delayed by a loss caused by a covered peril. These are costs "over and above" normal costs that would have been incurred had there been no delay. Examples include **additional advertising expenses, attorney's or accountant's fees, additional interest payments** with respect to construction loans, **additional architectural and engineering fees, additional insurance premiums**, and so on.

7. **Property in transit** - during the project, property used in construction may be owned by various parties and may be in transit, on the premises, or in storage. The transit exposure needs to be covered in the builders risk form.

8. **Falsework** - is a temporary structure, often made of wood, but also of other materials, that serves as a support for a part of the permanent structure. A stone or brick archway is an example. Once the archway is strong enough to support itself, the falsework is removed. (This coverage is usually available in most builders risk forms.)

AAIS has developed four builders risk forms, providing varying levels of coverage. Two of the forms are on a scheduled location basis and two are on a blanket basis. One form combines builders risk and installation floater coverage. All four forms are written on an all-risk or open perils basis. (Tables showing coverages and exclusions in three of the AAIS forms are displayed on pages 48 and 49. These forms are included in the AAIS *Inland Marine Guide*.)

### Potential coverage issues/deficiencies

1. **Negligence of contractors/waiver of subrogation**. Damage caused by the negligence of a contractor can lead to claims or lawsuits between parties involved in the construction project. A

## Builders Risk Blanket and Scheduled Coverage From the AAIS Inland Marine Guide

The table below does not list all the additional coverages provided by the forms, and there are some variations in insured perils and other policy provisions.

### Builders Risk

Builders risk is the class that insures contractors and builders for their ownership interest in property under construction.

FORM	BLANKET FORM	SCHEDULED FORM (BROAD)	SCHEDULE (LIMITED)
<b>Property Covered</b>			
Buildings in the course of construction	Blanket coverage on all locations	Scheduled coverage per location	Scheduled coverage per location
Contingent coverage*	Covered	Not covered	Not covered
DIC coverage**	"	"	"
<b>Add'l Coverages</b>			
Debris removal	\$5,000	\$5,000	\$5,000
Pollutant cleanup	\$25,000	\$25,000	\$10,000
Fraud or deceit	\$50,000	\$50,000	Avail. by endorsement
Contract penalty	\$10,000	\$10,000	"
Expediting expense	"	"	"
Ordinance-law Demolition	Covered	Covered	"
Ordinance-law Increased cost	\$50,000	\$50,000	"
Sewer backup	"	"	"
Testing	"	"	Avail. by endorsement
Transit	\$10,000	\$10,000	\$10,000
Waterborne property	\$10,000	\$10,000	Not covered
Sewer backup, subsurface water	\$10,000	\$10,000	Avail. by endorsement
Trees, shrubs, & plants	\$10,000	\$10,000	"
Soft costs, extra expense, rental income	Avail. by endorsement	Avail. by endorsement	Avail. by endorsement

\* Contingent coverage provides protection for a contractor when the building owner fails to obtain or maintain insurance required by the construction contract, and the contractor is unable to collect its interest in the property in the event of a loss.

\*\*Difference in Conditions coverage expands or supplements the insured's coverages but, with the widespread use of "all-risk" policies available today, is less frequently offered.

comprehensive builders risk policy, including provisions for waivers of subrogation, would reduce or eliminate the potential for such claims or lawsuits. In other words, first-party coverage would be available to all parties, if named as insureds under the policy, and pressing a liability claim would not be necessary.

Although it seems that a clear waiver of subrogation provision in the policy would be sufficient to block subrogation by the insurer, this is not necessarily the case. Builders risk insurers have been successful in subrogating against negligent contractors, even when the policy contained a waiver of subrogation provision. One precaution recommended is to add a specific

waiver of subrogation endorsement in favor of all contractors and subcontractors<sup>1</sup>.

**2. All-risk coverage vs. named perils.** Recall that all-risk coverage is required by AIA and AGC documents. All-risk or "open perils" builders risk coverage is usually available and is the preferred form of coverage.

**3. Replacement cost vs. actual cash value.** AIA and AGC documents also require replacement cost coverage. The term "actual cash value" usually is not defined in the policy and may be subject to various meanings, depending on the state in which the loss occurs. Replacement cost coverage should be sought whenever possible.

Keep in mind also that sub-limits

are ordinarily imposed on many of the additional or supplemental coverages provided in builders risk forms, such as testing, ordinance or law, transit, etc. When sub-limits apply, the requirement of full replacement cost coverage is not met. It may be necessary, under such circumstances, to amend the AIA or AGC document to change this requirement.

**4. Earthquake, flood, collapse.** Builders risk insurers will occasionally provide earthquake and flood coverage for an additional premium, and with substantially higher deductibles than those applying to other coverages in the policy. The each-occurrence limit may be considerably less than the general policy limit. It may not be possible to obtain earthquake

## AAIS Builders Risk Exclusions

Exclusions (Limited)	Blanket Form	Scheduled Form (Broad)	Scheduled Form
<b>Excluded Perils</b> Concurrent Causation	—Civil Authority —Earth Movement* —Flood* —Nuclear Hazard —Ordinance or Law —War  * does not apply if limit is indicated on the schedule of coverages	—Civil Authority —Earth Movement* —Flood* —Nuclear Hazard —Ordinance or Law —War  * does not apply if limit is indicated on the schedule of coverages	—Civil Authority —Earth Movement* —Flood* —Nuclear Hazard —Ordinance or Law —War —Penalties —Sewer Backup* * does not apply if limit is indicated on the schedule of coverages
<b>Excluded Perils</b> Excluded If Caused by One or More of the Following	—Criminal, Fraudulent or Dishonest Act —Explosion, Rupture or Bursting —Loss of Use —Missing Property —Pollutants	—Criminal, Fraudulent or Dishonest Act —Explosion, Rupture or Bursting —Loss of Use —Missing Property —Pollutants	—Criminal, Fraudulent or Dishonest Act —Explosion, Rupture or Bursting —Loss of Use —Missing Property —Pollutants —Contamination or Deterioration —Freezing —Materials and Workmanship —Rain, Snow, Ice or Sleet —Settling, Cracking, Shrinking, Bulging or Expanding —Temperature and Humidity —Voluntary Parting —Wear and Tear
<b>Excluded Perils</b> Resulting Loss by Covered Peril	—Electrical Currents * —Mechanical Breakdown** —Defects, Errors and Omissions —Contamination or Deterioration —Temperature/ Humidity —Wear and Tear  * does not apply to loss resulting from testing **can be covered by endorsement	—Electrical Currents * —Mechanical Breakdown** —Defects, Errors and Omissions —Contamination or Deterioration —Temperature/ Humidity —Wear and Tear  * does not apply to loss resulting from testing **can be covered by endorsement	—Electrical Currents —Mechanical Breakdown —Defects, Errors and Omissions

insurance for the full replacement cost of the project. In certain areas, like California, coverage will be extremely expensive, if available at all.

If a project is located in a flood-prone area, flood insurance may not be available through private insurers, but some protection may be

available from the National Flood Insurance Program.

Collapse coverage availability, including the scope of coverage, will vary among insurers. The AIA and AGC documents require collapse coverage. Some forms include sub-limits for collapse coverage, so

complying with AIA and AGC requirements for full replacement cost may require negotiations with the insurer or special amendments to the documents. Exposure to loss by collapse is greater with a building or structure in the course of construction than a completed building or structure.

Faulty construction or windstorm could lead to a collapse loss of a partially completed building or structure.

**5. Debris removal.** Builders risk policies usually cover debris removal but may exclude pollution cleanup. Both should be covered in the builders risk form. Again, sub-limits usually apply.

**6. Loss of income coverage.** Loss of revenue, loss of rents, and extra expense coverage, separate from soft costs coverage for delayed opening, may be needed by the insured. Such coverage is sometimes available as an endorsement for an additional premium charge. Insurance consultants or advisors should be familiar with the endorsements available with a particular builders risk policy. It is also noteworthy that as a matter of practice, some insurance practitioners view *soft costs* as including loss of income. It is imperative that the particular endorsement in use be carefully reviewed to determine if that is the case.

**7. Exception to faulty work, or defects, errors, and omissions exclusion.** Faulty work is typically excluded in builders risk policies, but some policies will provide coverage for ensuing loss, or certain types of losses resulting from faulty work. The covered perils may be broad or limited, but it is important that some coverage for ensuing loss be provided.

**8. Change orders.** Changes that increase contract construction costs need to be reflected in policies written on a *completed value* basis. To avoid or at least reduce the chances that the policy limit will be insufficient to cover a loss, the person responsible for the insurance and risk management role should: assume that contract changes that increase values are likely; and require that notice of changes in contract value be in writing with the warning that failure to do so may result in a coverage deficit.<sup>2</sup> This problem is less likely to occur with coverage written on a reporting basis, unless change orders are overlooked.

## Conclusion

Obtaining sufficient builders risk insurance is no simple matter. Insurance consultants must be familiar with the construction contract, particularly the responsibility for procuring required insurance. Because this is a nonfiled class, coverage may vary significantly among insurers. It is incumbent on consultants to know not only what coverages are required by

the construction contract, but also what coverages are available in the marketplace, so that their insureds have the necessary protection to meet the many exposures they will face.

For more information about the AAIS *Inland Marine Guide*, contact Robert Schnoll, AAIS marketing manager, at bobs@aaisonline.com or (800) 564-AAIS (2247), Ext. 222. ■

## The author

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