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The Intersection of Builders Risk, Commercial General Liability, Contractors Professional Liability and Subcontractor Default Coverage - What Covers What?

A. OVERVIEW.

The construction industry has a broad range of insurance products available to ensure a multitude of risks that arise in large commercial or public improvement construction projects. Builders Risk provides first-party property protection during construction and typically expires upon project completion. Commercial General Liability (“CGL”) coverage provides protection against third-party bodily injury and property damage claims both during construction and after completion. CGL protection may be written with separate policies for the general contractor and subcontractors, or on a “WRAP” policy acquired by the owner (“OCIP”) or the general contractor (“CCIP”).

Professional Liability coverage is generally required from all design professionals. With the expansion of Design-Build contracts as a more common project delivery method, general contractors can purchase Contractors Professional Liability (“CPL”) insurance, which includes both third-party and first-party coverages. The first-party coverage is known as “Protective” and “Rectification” coverage.

Further, to streamline potential delays and the increased cost arising from traditional performance and payment bonds, private projects that do not carry mandatory bond requirements often protect the risk of subcontractor default with the purchase of a Subcontractor Default Insurance (“SDI”) policy rather than traditional bonds.

While these different coverages all serve a valuable risk protection role, claims and litigation often arise that potentially trigger many or all these coverage forms. Formulation of a global resolution strategy requires an understanding of the scope of coverages as well as the subrogation rights that may remain potentially jeopardizing the goal of global resolution.

This presentation is designed to provide an overview of the scope of protection provided by the different coverages, identify common issues arising in a complex construction claim/litigation context, and examine a hypothetical for discussion of coverage application and issues.

B. THE BASIC SCOPE OF COVERAGE PROVIDED BY BUILDERS RISK, CGL, CONTRACTORS PROFESSIONAL LIABILITY AND SUBCONTRACTOR DEFAULT INSURANCE.

1. Builders Risk.

Builders Risk is a kind of property insurance, providing first-party coverage for fortuitous loss during construction. Builders Risk typically covers the building under construction and the materials, fixtures, supplies, machinery, tools, and equipment to be used in construction of the project.

Typically, either the owner or the general contractor is designated in the prime contract as responsible for arranging this coverage. The named insured under the policy is typically the party procuring the coverage. If the general contractor obtains the policy, it would be the named insured while the owner and the subcontractors of all tiers can be added as additional insureds. As a rule, suppliers of material and design professionals are not insureds under the Builders Risk coverage as the Builders Risk carriers want to preserve their subrogation rights against those parties.

Usually, both the prime contract and the policy will contain waivers of subrogation language reflecting a mutual intent to place the covered risks with the Builders Risk insurer with no right for indemnity or subrogation between any insured party. It is best to for the owner, general contractor, and subcontractors of all tiers to be insureds, coupled with waivers of subrogation, to eliminate the prospect of subrogation by the Builders Risk insurer. Despite these protections, some Builders Risk insurers still try to find avenues to subrogate. Fortunately for the insureds under the policy, those efforts typically fail when there are waivers of subrogation and/or insured status under the policy.

Unlike CGL coverage, the Builders Risk coverage is often written on manuscript forms rather than standardized policy forms; thus, it is critical to review and understand the scope of protection afforded. Regardless of the form used, the Builders Risk policy is typically written on either an "all-risk" or a "named peril" form. All-risk policies, the most common form used, insure against all risks of "direct physical loss" except for risks specifically excluded.

The enumerated perils insured against, typically include fire, lightning, windstorm, hail, explosion, aircraft, smoke, strikes, vandalism, and malicious mischief.

The policies often contain exclusions that apply to different causes or types of damages. Excluded causes of damage often include faulty design, specification or workmanship, earthquake, earth movement, government action, nuclear hazard, flood, and war/military action. However, some Builders Risk forms provide coverage for ensuing damage caused by the faulty design, workmanship, or product. Excluded types of damage will often include delay/loss of use, wear, and tear, and settling or cracking. Delay in Completion/Delay in Startup coverage can be purchased for an additional premium.

Typically, the contract and policy contain "anti-subrogation" provisions that confirm the contractual intent that losses paid under the Builders Risk coverage rest with the insurer and are not to be spread to the other parties. This waiver does not usually extend to product manufacturers/suppliers or design professionals responsible for architect or engineering errors.

2. CGL Coverage.

Generally, CGL coverage provides protection for bodily injury, property damage, and any other designated forms of accidental damage caused to other people or property. Accordingly, a CGL policy is considered "third-party" insurance.

The essence of coverage under a CGL policy will require a three-part analysis: (1) is the insuring agreement triggered, i.e., has there been an "occurrence" resulting in "bodily injury" or "property damage" during the policy term(s); (2) if so, does an exclusion apply; and (3) if an exclusion applies, is there an exception to the exclusion.

CGL coverage is written on an "occurrence" form that requires that the bodily injury or property damage take place during the policy term and not be an intended or expected event. In construction cases, issues often arise concerning whether the deficiency constitutes "property damage," or does there need to be consequential damage to other non-defective components of construction.

The CGL coverage is frequently written on standard ISO policy forms. These forms contain several exclusionary provisions that attempt to limit or eliminate coverage for damage to "your work" or that part of the project being worked on by the contractor or subcontractor.

Specifically, exclusion "l" eliminates coverage for losses arising from a contractor's poor workmanship. Importantly, this exclusion contains a critical exception if the work that is damaged or that causes the damage was done on behalf of the insured by a subcontractor.

Exclusions j (1), (5), and (6) target damage and faulty workmanship to that component being worked on by the contractor or subcontractor (ongoing construction activity).

The goal of these “business risk” exclusions is to eliminate coverage for the cost of remediation of defective workmanship during construction; however, the limitations on these exclusions provide potential coverage concurrent with Builders Risk coverage to the extent that both policies provide potential coverage for “ensuing loss” or “consequential damage” to non-deficient components.

3. Professional Liability for Contractors as Well as Protective and Rectification Coverages.

“Design-Build” contracts are becoming a more common project delivery method on many large projects. With a Design-Build contract between the owner and the general contractor, the general contractor assumes responsibility for both design and construction of major building components.

The general contractor will either retain an architect, who then retains other designers with specific scopes of work or will retain separate architects and engineers to execute the design requirements of the project. The contracts between the general contractor and the design professionals will certainly contain a requirement for minimum limits of professional liability coverage; however, these limits will often be less than the cost of remediation and other damages that flow from significant design errors.

In addition to the third-party design exposure, the general contractor will also face circumstances where prompt rectification of a design deficiency will potentially limit additional damage from delay and disruption. To address these design liabilities and challenges, professional liability insurance for contractors has evolved into a coverage form that contains three components. First, a standard professional liability limit to provide protection against claims by third parties for design deficiencies. Second, a Contractors Rectification coverage, which enables a contractor to submit a first party claim to gain access to funds to “rectify” design deficiencies identified during construction to limit damage and delay problems and to avoid potential future Professional Liability claims. Third, Contractors Protective coverage serves as first-party coverage whereby a contractor seeks recovery for a design loss in excess of the limits provided by the design professional’s own insurance to insure a source of recovery in excess of the design professional’s limit.

The “Rectification” and “Protective Loss” coverages usually contain a Self-Insured Retention (“SIR”) that must be satisfied. Similarly, these policies often contain a requirement that the design professionals carry a designated Minimum Insurance Requirement (“MIR”). These policies will often contain provisions that limit or require insurer approval of so-called “limitation of liability” provisions in the contract between the general contractor and the design professionals. In contrast to CGL coverage, professional liability coverage is written on a claims-made basis and defense costs are usually included within the policy limits so that protracted litigation will reduce limits available for resolution. Finally, the professional liability coverage will

usually contain a right of subrogation that raises the prospect of continued litigation unless these insurers' subrogation rights are extinguished as part of the case resolution.

4. Subcontractor Default Insurance.

SDI is an alternative to traditional performance and payment bonds. SDI is not available for public work projects as bonds are statutorily mandated. SDI is acquired by the general contractor to provide protection against subcontractor default. SDI does not provide protection to subcontractors or their subs for potential payment or performance breaches by the owner or the general contractor.

SDI coverage is attractive to larger general contractors because it is generally less expensive than traditional bonds and the processing of a claim is more streamlined. If a claim is made under a traditional bond, the administration of the claim is undertaken by the bonding company, which independently determines whether there has been a "default" and then administers the completion and/or remediation effort.

Under the SDI, the contractor makes the determination as to whether there has been a default and payment is then due within a fairly short time frame from the submission of a proof of loss form. Also, the general contractor then assumes responsibility for execution of the completion or repair effort.

Unlike a traditional bond, the SDI product contains a shared risk component through rather high deductibles with additional co-pay requirements that shift a significant cost of the risk to the contractor. Many deductibles are in excess of \$500,000 and those deductibles are coupled with a co-pay percentage in the 10% - 20% range up to a designated per project limit.

Just as a bond contains a right of reimbursement from the principal on the surety bond, the SDI contains similar rights of subrogation from the responsible subcontractor. Thus, in formulating a resolution strategy, the potential subrogation rights of the SDI insurer must be factored into the equation.

Finally, the SDI insurance likely contains an excess "other insurance" provision making that coverage excess to other available coverage, such as Builders Risk, Professional Liability and CGL.

C. COMMON COVERAGE ISSUES THAT ARISE IN THE HANDLING OF COMPLEX COMMERCIAL AND PUBLIC BUILDING IMPROVEMENT PROJECTS UNDER THE VARIOUS COVERAGES.

1. Builders Risk.

In a claim that may involve a combination of defect, delay and disruption damages incurred both during and after completion of construction, the builders risk coverage may be triggered. Some common issues that arise include the following:

- Does the claim satisfy the requirement for “direct physical loss” or “direct physical damage” to the insured property? If the claim is limited to the cost of remediation of defective workmanship or design, the insurer will likely raise a coverage defense concerning the absence of physical loss or damage.
- The physical damage must occur during the policy term, which will likely equate to project completion or occupancy.
- Potential application of exclusion for faulty design, specification, workmanship, and materials.
- Potential application of the “ensuing loss” provision whereby coverage potentially provided when an excluded loss (defective design/workmanship) causes a loss or damage to other non-deficient building components caused by a covered event such as collapse or fire.
- Loss of use and delay/disruption damages may be excluded or subject to a separate sublimit.
- Most contracts contain a waiver of subrogation provision whereby the parties agree to leave the risk with the insurer and waive subrogation rights against each other, as well as the subcontractors. The subrogation waiver likely does not extend to design professional and product suppliers.

2. CGL.

Common issues that arise concerning potential application of CGL coverage include the following:

- Does defective construction qualify as an “occurrence” or is it deemed not accidental or fortuitous? Many states have concluded that construction deficiencies may qualify as an “occurrence.”
- How many “occurrences” are involved?

- Does the cost of remediation of a component deficiently constructed or designed qualify as “property damage?”
- The potential application of the “your work” exclusion (Exclusion “I”) eliminates coverage for losses arising from poor workmanship in a “completed operations” context. Does the policy contain the standard exception from the exclusion for work done by subcontractors?
- Concerning ongoing operations, do the “Damage to Property” exclusions found at j (1), (5), (6) apply? Is there damage caused to other non-defective components that would not fall within the parameters of these ongoing operations exclusions?
- Is the contractor’s exposure a combination of workmanship and design exposure thereby triggering potential application of the design exclusion in the CGL policy?
- Does the claim raise the potential for “stacking” of primary limits and do the policies contain anti-stacking provisions?
- What is the extent and scope of AI coverage afforded to various entities?
- What is the priority of coverage as between Builders Risk, Wrap, PL and CGL (primary and excess) coverages?

3. Contractors Professional Liability Including Protective and Rectification.

As many projects involve Design-Build agreements, claims against the general contractor will often trigger both CGL and Professional Liability exposure. The Contractors Professional Liability policies contain both third-party professional liability coverage as well as first-party protection under the Protective and Rectification coverages.

The issues that arise under these coverages include the following:

- For Protective and Professional coverages, was the claim made and reported during the policy period?
- What are contractually mandated limits for the design professional retained by the general contractor to perform the design in question?
- What are the remaining limits on the design professional coverage?
- What is the amount of the Self-Insured Retention (“SIR”) under the policy?
- Are there Minimum Insurance Requirements required of the design professional and how do those limits potentially impact the SIR?

- Are there limitations of liability provisions in the contract between the design professional and the general contractor and how do those impact the contractor's professional liability coverage?
- Does it make business sense to make a rectification claim to keep the project on schedule or limit the schedule impact of a design error?
- What is the scope of indemnity afforded by the rectification claim, i.e., general contractor overhead and profit?
- Should the general contractor make a "protective" claim against the sub consultant/design profession and what must be established to trigger an obligation for payment by the insurer to the contractor?
- What subrogation rights potentially remain that will need to be dealt with as part of a global resolution effort?

4. Subcontractor Default Insurance.

The issues that may arise concerning application of the Subcontractor Default Insurance include:

- Do the facts support the general contractor declaring that the subcontractor is in default?
- Does the nature of the claim justify deductible and co-pay that are likely required under the policy?
- If the Policy is written on a policy period and not a project specific basis, what are the remaining limits?
- What potential impact on business relationships if policy contains a prohibition on granting additional work during default?
- Is there a sublimit for "Indirect Cost" such as liquidated damages, job acceleration and extended overhead?
- What is the potential impact on case resolution given the indemnity rights of the insurer against the subcontractor?
- Will the SDI coverage be excess to all other applicable insurance?