BUILDERS RISK INSURANCE:
Utilizing Builder's Risk Policies to Help Settle Construction Defect Cases
Finding the Oasis in the Desert

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I. What is Builder's Risk insurance?

Builder's risk insurance is a unique form of first-party property insurance that typically covers a structure under construction, the materials and equipment used in construction, and the removal of debris of covered property damaged by a covered loss. Builder's risk insurance policies are typically purchased by the project general contractor or the owner. It is sometimes called "course of construction" coverage because it is only intended to apply during the course of construction, erection, and fabrication of a structure until the construction is considered completed. Coverage typically commences on the "start date" of the project and ends when the work is completed.

i. Who is covered?

Builder's risk policies cover the interests of owners, contractors, subcontractors and others involved in the construction project. While contractors and subcontractors are typically covered, it's a good idea for contractors and subcontractors to request being named insureds on the policy. In comparison, liability insurance covers damage to third parties, such as passersby injured by construction or for damage to adjoining property.

ii. What does it cover?

Typically, it is written on an "all risks basis" and covers direct physical loss from all causes except those specifically excluded. This does not mean it covers everything, so it is important to look at the exclusions. Although it is typically limited to the construction site, an insured can request coverage for property stored off site and in-transit.

iii. Exclusions for Defective Construction

A major issue in insurance coverage is whether damages for defective design or construction are covered under builder's risk policies. Carriers will strongly contest coverage, and argue that design flaws should be covered by professional liability insurance. Carriers will also invoke other defenses, including the "faulty workmanship" exclusion. An example of such an exclusion from an insurance policy provides:

4. EXCLUSIONS

This Master Policy, its quarterly reports and Project Certificates shall not pay for loss, damage, or expense caused by, resulting from, contributed to or made worse by any of the following, whether direct or indirect, proximate or remote or in whole or in part caused by contributed to or aggravated by any physical loss or damage insured by this Policy, except as specifically allowed below:

. . .

B. Cost of Making Good

The costs that would have been incurred to rectify any of the following had such rectification been effected immediately prior to the loss or damage:

(1) Fault, defect, error, deficiency, or omission in design, plan or specification;

(2) Faulty or defective workmanship, supplies or material;

(3) Wear and tear, gradual deterioration, inherent vice, latent defect, corrosion, rust, dampness or dryness of the atmosphere;

. . .

Fortunately for design professionals and their counsel, the policy language does not stop here. Reading further, the policy allows for "ensuing loss":

However, if direct physical loss or damage by an insured peril ensues, then this Policy will cover for such ensuing loss or damage only.

For the purpose of this Policy and not merely this exclusion, Covered Property, or any portion thereof, shall not be regarded as damaged solely by virtue of the existence of any condition stated under (1), (2) or (3) above.

Several courts across the country, as discussed in detail below, have found that similar policy language only excludes costs to rectify faulty or defective design, plan or specifications, but that it covers the "ensuing losses" caused by the defective design.

II. The Oasis: Getting Coverage for "Ensuing Loss" in Design Defect Lawsuits.

In builder's risk policies, generally, if a component has a defective design, the insurer will not pay the cost of correcting the error. However, if a design defect causes the failure of a structure, collapse or partial collapse of a structure, substantial movement or other similar peril, the resulting damages are considered "ensuing loss or damage" and are not excluded.

i. Cases Granting Coverage for "Ensuing Loss"

In *Blaine Construction Corporation v. Insurance Company of North America*,[1] the insured asserted a claim for the cost of replacing ceiling insulation ruined by water that had condensed within the insulation cavity after a subcontractor failed to install a vapor barrier properly. The district court dismissed the insured's claims against its insurer who denied coverage under the "faulty workmanship or faulty materials" exclusion. The Sixth Circuit Court, applying Tennessee law, ultimately held that the ensuing loss to the ceiling insulation was covered under the policy. The court further noted that here – the vapor barrier edge tabs that were incorrectly installed were not damaged – it was the adjacent material. As such, coverage existed and the appellate court reversed the lower court's dismissal.

Other courts have also found that water damage to other property caused by faulty workmanship on the construction site is covered under the "ensuing loss" provision.[2]

In the *Selective Way Ins. Co. v. Nat'l Fire Ins. Co.,* [3] case, the plaintiff filed a motion for summary judgment on its claims for coverage of "ensuing loss" damages under a builder's risk policy. Here, a water supply line leaked during the construction of a new building which resulted in extensive water damage to three floors of the construction. The claims investigator determined that the cause of the water pipe fitting coming loose was either defective manufacture or defective installation. Under the assumption that the fitting came loose due to faulty installation, the U.S. District Court for the District of Maryland held that the plaintiff was still entitled to coverage under the "ensuing loss" clause in the builder's risk policy. The court quoted insurance treatises stating:

> Ensuing loss clauses act as exceptions to property insurance exclusions and operate to provide coverage when, as a result of an excluded peril, a covered peril arises and causes damage.
>
> and
>
> The "faulty workmanship" or "faulty design" exclusion is often drafted in such a way that loss or damage in the form of the faulty work itself is excluded, but coverage is afforded for "physical loss or damage resulting from such faulty work." . . . Generally speaking, an ensuing loss provision does not cover loss directly caused by the excluded peril (i.e., repair of the faulty work), but rather covers loss caused to other property wholly separate from the defective property itself.[4]

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[1] 171 F.3d 343 (6th Cir. 1999)
[2] 988 F.Supp. 2d 530 (D. Md. 2013); *Batram, LLC v. Landmark Am. Ins. Co.*, 864 F. Supp. 2d 1229, 1235 (N.D. Fla. 2012).
[3] *Selective Way Ins. Co.*, 988 F.Supp. 2d at 530.
[4] *Id.* at 538 (*quoting* 4 Bruner & O'Connor Construction Law § 11:211.).

Ultimately, the court granted plaintiff's motion for summary judgment on its claim for coverage and determined that the plaintiff was entitled to a judgment as a matter of law.

The U.S. District Court for the Southern District of New York in *1765 First Associates, LLC v. Continental Casualty Company*, also found coverage available to claimants despite the faulty workmanship exclusions.[5] This case involved damage to tower caused by the collapse of construction crane. Plaintiff requested a declaratory judgment that it was entitled to reimbursement for costs and losses associated with construction delays. The insurer denied coverage citing the faulty workmanship exclusion which read:

> Unless otherwise provided for and limited in Section 1.6., this Policy does not insure against physical loss or damage caused by or resulting from the following; however, if physical loss or damage from a peril not excluded herein ensues, then this policy shall cover only for such ensuing loss or damage:
>
> > a. Errors or defects in design or specification, errors in processing or manufacture, faulty workmanship or faulty materials; coverage for damage from an ensuing peril not otherwise excluded, shall apply to covered property other than the work or construction of the Insured.

The insurer argued that this exclusion precluded damages because the crane collapse was the product of faulty workmanship. The court disagreed stating that New York courts reading similar exclusions presume that "faulty workmanship" refers to work done by the insured or its agents to the property itself, not work done by the manufacturer of tools or equipment used on the premises. The court held that the exclusion, "as it is most natural read, does not apply to losses related to accidents or equipment malfunctions during construction."

ii. Distinguishing the Coverage Denials

Even in cases were coverage is ultimately denied, courts will often acknowledge that had the defective design damaged other non-defective property and that the losses to the other non-defective property would qualify as covered "ensuing losses."

In *Laquila Construction, Inc. v. Travelers, Indemnity Co. of Ill.*,[6] the contractor poured a defective slab because the concrete did not meet the specifications. The entire slab on the fifth floor of the building had to be removed and the lower floors of the building had to be shored up while the remediation occurred. The policy in this case excluded "physical damage" resulting from faulty or defective workmanship or material. The clause specifically stated:

> 1. PERILS EXCLUDED
> . . .

[5] 817 F. Supp. 2d. 374, 376-377 (S.D. NY 2011).
[6] 66 F. Supp. 2d 543, 544 (S.D.N.Y. 1999).

(b) Cost of making good faulty or defective workmanship or material, but this exclusion shall not apply to physical damage *resulting from* such fault or defective workmanship or material.

The court found that all costs were related to repair and remediation of the faulty workmanship of the defective slab. The court further noted that had the concrete slab collapsed and damaged other property at the site, those losses would be covered ensuing losses.

Likewise, the Fourth Circuit found in *Carney v. Assur. Co. of Am.,*[7] that repairs for wood siding improperly installed were excluded because it involved a repair of the property directly damaged by the faulty workmanship.

iii. Defeating Summary Judgment: Competing Experts Can Raise an Issue of Fact to Defeat the Exclusion

To the extent a court is not willing to find coverage as a matter of law, you can still create a fact issue to avoid summary judgment. The key issue is whether the damage was *part of* the defective workmanship or design, or alternatively, whether the damage *resulted* from the defective work or design. Summary judgment can be avoided by presenting competing expert reports on this very issue.

In *Central Weber Sewer Imp. Dist. v. Fire Underwriters, Ins. Co.,*[8] the plaintiff sought to recover under a builder's risk policy for construction involving the modernization of a wastewater treatment. To construct the foundation for the project, it required a shored excavation with a temporary metal sheet pile wall to retain the excavation until it could be backfilled. A series of problems occurred at the worksite. First, the sheet pile wall shifted and damaged a dewatering well, electrical equipment and a gravity discharge line. Next, after the sheet pile wall was fixed, voids formed and wells sprang up feeding water into the entire excavated area. After this was remedied and the slab was poured, there was excessive shifting of the foundation that prevented it from functioning as intended.

Plaintiff sought coverage under the builder's risk policy for each of the three events described above. Citing the exclusion for "faulty, inadequate or defective . . . design, specifications workmanship, repair, construction, renovation, remodeling, grading, compaction, and materials used in repair, construction renovation or remodeling", the insurer denied coverage.

The parties filed cross motions for summary judgment and attached their respective expert reports in support of their positions. On plaintiff's breach of contract claim, the court ultimately found that a fact issue was presented by the competing expert reports. The court denied Defendant's summary judgment holding that "a triable issue of fact exists as to the cause of the sheet-pile wall failure, and, in turn, the cause of the slab settlement and the formation of the voids."

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[7] 177 F. App'x 282 (4th Cir. 2006) (unpublished),

[8] Case No. 1:12-cv-166 TS, 2014 LEXIS 16839, *33-34 (N.D. Utah February 6, 2014); *see also Harbor Communities, LLC v. Landmark Am. Ins. Co.*, Case No. 07-14336-CIV-MOORE/LYNCH, 2008 U.S. Dist. LEXIS 59179, *19 (S.D. Fla. August 4, 2008).

III. Subrogation Issues in Builder's Risk

Recent issues that have emerged in subrogation involve builder's risk insurance and design professionals who may not always be included as an insured on a builder's risk policy. Design professionals are subject to a variety of different claims arising from their design and construction administration services. However, many design professionals are unfamiliar with subrogation claims brought by insurance companies against project architects and engineers for damages resulting from the partial or complete destruction of a structure in a construction accident.

Providing contractors and subcontractors with protection from subrogation is a crucial aspect of builder's risk coverage. Contractor, subcontractors, and even design professionals included as named insureds under a builder's risk policy in most cases are immune from subrogation brought by the builder's risk insurer. This is because an insurer generally is not permitted to subrogate against its own insureds; hence, the importance of naming all contractors, subcontractors and design professionals in a builder's risk policy.

i. How to avoid subrogation suits against design professionals

Architects or Engineers, may, under certain circumstances, be sued by the builder's risk insurer in a subrogation action after a catastrophic event occurs on a construction site. If it is determined that the accident was a due to a design error (*e.g.* such as a collapse caused by under designed structural steel, or a pipe rupture caused by an improper piping schedule), the issue is whether the builder's risk insurance company can maintain a suit against the architect, or structural engineer. It should be noted that the builder's risk insurance compliments, but typically does not overlap, the general contractor's general liability policy. The contractor's general liability policy usually covers claims for damages to all property other than to the work.

A design professional has two contractual avenues to ward off potential subrogation claims brought by property insurance companies. They include: (1) a clause indicating that the design professional is one of the insured under the builder's risk policy; and (2) a waiver of subrogation provision by which the property insurer's right to bring a lawsuit against the design professional has been waived by the owner and contractor. Basically, each party to the contract agrees to waive their right to subrogation against the other to the extent that the damage is covered by the construction policy. Such an agreement can be found in either the AGC[9] or AIA[10] standard form agreements.

In order to avoid the uncertainties of litigation, steps maybe taken during contract negotiations to maximize a design professional's protection under a builder's risk insurance policy. Typically, two written agreements govern the relationship between the design professional and the other parties; the owner-design professional agreement and the owner-general contractor agreement. If such agreements are open to negotiation, they both should reflect the parties' intent to have the design professional included among those whose interest are insured under the

[9] Associated General Contractors ("AGC")
[10] American Institute of Architects ("AIA")

builder's risk policy. For example, the design professional should insert language in its contract with the owner and in the general conditions of the owner/contractor agreement. Using standard AIA documents as examples, the following modifications to AIA Documents B-102 and A-201 should be utilized:

> (i) Add to Article 8 ("Special Terms and Conditions") of the B-102 Standard Form of Agreement Between the Owner and Architect: "All property insurance policies purchased by Owner or the Contractor in connection with the Project shall include the interest of the Architect/Engineer and the Architect/Engineer's consultant's in the Project."
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> (ii) Amend Article 11.3.1 of the A-201 Property Insurance to read: "This insurance shall include interests of the Owner, the Contractor, Subcontractors, Sub-contractors, the Architect/Engineer and the Architect/Engineer's consultants in the Project."

Both the B-102 owner-Architect/Engineer agreement and the A-201 Property Insurance should be amended to include a statement acknowledging that the Architect/Engineer has an insurable interest in the Project under the builder's risk policy.

A-201 generally includes a Waiver of Subrogation provision in Article 11.3.7, which includes an Architect and the Architect's consultants. If these modifications to the contract documents are made in conjunction with Article 11.3.7 Waiver of Subrogation, and a subrogation claim is initiated against the design engineer by the builder's risk insurer, the design professional will have a strong argument that, as a matter of law, it has an insurable interest in the project. As such, summary judgment should be available in favor of the design professional against the builder's risk insurer.

ii. Who is the insured and against whom contractual waivers can be enforced

Many recent cases in the subrogation area involve the determination of who is an insured under the policy, and against whom contractual waivers of subrogation can be enforced. This determination is important because the insurer cannot pursue a subrogation action against its own insured. Depending on the interest the insurer represents, the insurer may become bound by these waivers of liability. Below are some case examples.

In Dyson & C. v. Flood Engineers, Architects, Planners, Inc.,[11] the City of Pensacola contracted with Flood Engineers to design and engineer the specifications for the construction for a sewage treatment plant. Dyson was required to maintain builder's risk insurance on the project to the project the interest of Dyson, the City and Flood Engineers from various hazards to the work. Dyson obtained builder's risk insurance, but the policy only named Dyson and its subcontractors as insureds, leaving the interest of Flood Engineers and the City unprotected. After a fire at the plant, Dyson was paid out of the builder's risk insurance policy for the damages sustained by the

[11] 523 So. 2d 756 (Fla. App. 1988).

fire. The builder's risk insurer then filed a subrogation action against Flood Engineers alleging that it negligently caused the fire. The Florida Court of Appeals found that Dyson had breached its contractual obligations to name Flood Engineers as an additional insured, and therefore, Dyson's insurer had no subrogation rights against Flood so long as Flood has and insurable interest in the property destroyed. The court also held that the project engineer had an insurable interest, which could be protected under the builder's risk policy and barred the property insurer's subrogation claim against the project engineer. The court reasoned that Flood Engineers risked liability for damages arising out of destruction of property, and that his was a sufficient "insurable interest" in the property.

In *Koken v. Auburn Mft.*,[12] a fire broke out and steps taken to extinguish it damaged a construction project. In the course of cleaning up debris from the fire, a welding blanket that was intended to prevent the fire was discarded by the employees of a subcontractor. The liquidator representing the insurance company pursued through subrogation a products liability suit against the presumed manufacturer of the welding blanket. The liquidator recited tort and contract claims against the general contractor and its subcontractors on the ground that they allegedly "destroyed" the products liability claim by discarding the welding blanket following the fire. The general contractor and subcontractor filed motions for summary judgment. The U.S. District Court in Maine recognized that a duty to preserve evidence could be assumed through contract. However, in the insurance contract, the insurance company expressly waived subrogation between the general contractor and all subcontractors. Therefore, no duty to preserve evidence was created. The court concluded that summary judgment be granted against the liquidator.

Similarly, in *Fire Insurance Exchange v. Thunderbird Masonry, Inc.*,[13] the Arizona Appellate Court held that an insured could not pursue a subrogation claim against a subcontractor on the project. The owner's builder's risk policy designated the mortgagee, the bank lending money for the project, as the loss payee. When a fire occurred on the insured premises, the insurer paid the mortgagee the amount of the outstanding indebtedness on the project. The insurer then claimed it was subrogated to the mortgagee's rights against the subcontractors. The court held that the mortgagee had a right to receive the insurance proceeds only because of its loan agreement with the project owner. Therefore, the insurer could not only pursue a claim on behalf of the owner. However, the owner waived its rights against the general contractor and the subcontractors to the extent that any damage was covered by insurance, and the insurer was bound by this waiver.

In contrast, the Colorado Appellate Court in *Aetna Casualty & Surety Co. v. Canam Steel Corp.*,[14] held that a material man whose only duty was to deliver materials to the job site did not qualify as a "subcontractor," and thus could be sued in a subrogation action. The court held that merely delivering materials to the site did not constitute "performing work" under the construction contract so as to be considered a subcontractor.

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[12] 2004 U.S. Dist. LEXIS 205 (D. Me. Jan. 8, 2004).
[13] 868 P.2d 948 (Ariz. Ct. App. 1993).
[14] 794 P.2d 1077 (Colo. Ct. App. 1990).

The Oklahoma Supreme Court reached a similar decision in *Travelers Ins. Co. v. Dickey*,[15] when it found that a roofer was not a coinsured under the owner's builder's risk policy, and thus could be liable to the insurer in a subrogation action. Here, the contract between the roofer and the owner required the roofer to secure liability insurance coverage, listing the owner as a coinsured under its liability policy. The construction contract contained no provisions requiring the owner to list the roofer as a coinsured under its policy. Accordingly, the court held that the roofer was not coinsured under the owner's builder's risk policy.

It is important to always carefully read the language of a Builder's Risk Policy when it serves as the basis for a subrogation claim. The parties must identify who is an insured and to what extent they are protected as an insured under the policy. Further, it is also important to identify the nature of the damages as they relate to a subrogation claim against a subcontractor. A subrogation target that is neither a signatory nor a party to a contract cannot automatically rely upon the terms and conditions of that contract.

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[15] 799 P.2d 625 (Okla. 1990).