

## CONSTRUCTION

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#### About Navigant

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## INSURANCE COVERAGE FOR CONSTRUCTION DEFECTS

There are a variety of insurance policies aimed at construction industry to protect against construction defect claims, including before, during, and after the project. Managing a company's risk concerning construction defect claims and lawsuits almost always involves the company having all of the appropriate insurance coverage in place **before** performing any work on the project. Further, it is important to know the level of risk the company is willing to accept as this will affect your policy, its coverage and its cost. In addition, Insurance policies may vary depending upon the location and the type of project. The company must understand this and how these two factors will affect the insurance coverage for the project under consideration.

While the specifics of coverage can vary from carrier to carrier, the general underlying principles affording coverage for construction defects is the same. The coverage needed will depend on what kind of business the company has, what type of project and the perceived risk associated with such business.

## PROJECTS UNDER CONSTRUCTION

### Business Owners Policy

During construction, there are typically three types of insurance policies that can provide protection. The first type of coverage is available to property owners under their existing Business Owners Policy ("BOP") or Commercial Property Policy ("CPP"). Often, both of these provide coverage for remodeling or expanding an existing building already insured under the policy. An all-risk version of these policies covers all risks except those specifically excluded and typically provides the broadest coverage for buildings under construction.

**Practical Example:** A foundry is being refit in stages to improve production. As part of the refit, subcontractors working under the direction of the general contractor replace all duct work leading to a blower critical to the production process. At the appointed time, the foundry restarts the blower to test it. Scrap and trash material left in the ductwork by the subcontractor are sucked into the blower, damaging it. The foundry files a claim with its commercial property insurer for the damaged blower and related loss of income.

## Builders Risk Policy

Builders Risk (or Builders Risk/All Risk) insurance can be purchased by both the contractor and the property owner. Typically, Builders Risk insurance protects the project under construction against damages caused by specific perils such as wind, fire, or theft. The purchaser should also be certain that resulting damage due to faulty workmanship or design error is specifically covered. Builders Risk coverage spans the period beginning when materials are delivered and ending when the work is completed and the project has been completed and transfer of care, custody and control of the project accomplished.

**Practical Example:** Hotel ABC is under construction. A windstorm hits the area, causing damage to the structure. The damage weakened the building's infrastructure requiring previously completed work be demoed and repaired before scheduled construction can be resumed. The contractor files a claim with its carrier for the cost to repair the damages including demo work, replacement materials, labor, and subcontractor work.

In addition, Builders Risk coverage can be extended to include coverage for Soft Costs and/or Delayed Startup/Completion. Soft Cost coverage typically provides reimbursement for the non-construction costs incurred during the repair period for a covered loss. Covered soft costs may include engineering, professional fees, general and administrative costs, and permit fees among other costs should there be a lengthy delay between the time the defect is discovered and when is remedied and the contractor can return to the project to complete the work. Delayed Startup (also known as Delayed Completion) coverage indemnifies the insured for expenses incurred as a result of the original completion date not being met due to a covered loss. Typical Delayed Startup costs can include property taxes and interest. If a delay in completion could potentially lead to a loss of income for the project owner, it is important to be sure that either the Builders Risk policy itself or additional coverage options such as the Delayed Startup provide for loss of income in the event of a covered loss.

**Practical Example:** As a result of a windstorm and subsequent repairs, Hotel ABC's completion will be delayed for three months. As a result, Hotel ABC, which is located in a popular tourist area, will miss the summer season. The owners of Hotel ABC file a claim for soft costs including such items as engineering fees incurred for the rework and additional inspection fees incurred to certify the repairs. They also file a claim for expenses incurred due to the delayed startup such as additional property taxes and interest incurred on their construction loans. In addition, Hotel ABC's owners file a claim for the loss of income they suffered as a result of missing the peak summer season.

## Performance Bond

Performance Bonds are purchased to guarantee that a contractor will satisfactorily complete a project. Not only does this insure against defects in workmanship or failing to construct to specifications, it also protects against unforeseen events such as contractor bankruptcy. All construction contracts issued by the federal government, for example, must be backed by a Performance Bond.

**Practical Example:** A contractor is hired to replace a bridge. The government required the contractor to obtain a performance bond as a condition of winning the bid. The government has been paying the contractor based on the percentage of work complete. When the job is 75% complete, the contractor defaults on the project due to bankruptcy. The government finds a new contractor and files a claim with the performance bond carrier to cover the increased costs of finishing the job.

## AFTER CONSTRUCTION

Exposure to claims of construction defects continues beyond the completion of the construction project. There are several types of insurance policies available that can respond to construction defects claims post construction. Applicable coverage is determined by the circumstances of loss and it is possible for more than one coverage to be responsive.

### Business Owners Policy

The first policy type that could be responsive is the BOP or CPP discussed previously. Property owners could file claims with their own carriers for damages resulting from a construction defect. Since a typical BOP includes general liability coverage in addition to property coverage, some smaller, lower-risk contractors may have BOP coverage as their first line of defense in the event a client notifies them of a construction defect.

**Practical Example:** A contractor is hired to replace the roof for a business office. The roof installation is defective leading to water leaking into the building damaging ceilings, walls, floor coverings and office equipment. The property owner would be in a position to file a claim with their own BOP insurer for the resulting damage and the loss of income incurred while the equipment was being replaced. The BOP insurer could then subrogate against the roofing contractor who in turn may file a claim with their own BOP insurer.

### Product Liability

Product Liability coverage protects against construction defects causing bodily injury for companies that manufacture, distribute, or retail products.

**Practical Example:** A contractor who manufactures and installs custom windows installs a set of windows for a homeowner. Approximately six months after the installation, the homeowner is attempting to clean one of the windows by tipping it in according to the instructions given by the contractor. The window falls out of the frame, landing on the homeowner's foot resulting in an emergency room visit. The homeowner notifies and files a claim against the manufacturer of the defective window for costs resulting from this injury. The manufacturer, in turn, could notify and file a claim with their own Property Liability insurer.

### Contractors Professional Liability

This specialized coverage protects design/build contactors from construction defects resulting from their design errors or omissions. This type of insurance coverage is relatively new to the construction defect insurance repertoire and arose in response to the increasing number of contractors who are doing design/build work, thus increasing their resultant design liability exposure which would not be covered by typical errors and omissions insurance for a design professional or a contractor acting as a design professional.

**Practical Example:** A contractor designs an addition to a building. The contractor's crew also builds the addition. It is discovered that a design flaw has resulted in water intrusion causing damage not only at the site of the intrusion, but to the overall structure. Since the damage is a result of the design and not the construction, the contractor files a claim with their Contractors Professional liability carrier.

### Commercial General Liability

The last type of policy that may respond to construction defects is the Commercial General Liability ("CGL") policy. CGL policies provide coverage for bodily injury and property damage claims made by a third party. In the case of construction defects, it is the coverage most contended by insurers. Originally, policies provided coverage for damage caused by an accident. Over time the word "accident" changed to "occurrence" giving rise to disputes surrounding what constitutes an occurrence. Without an occurrence trigger, the insurance companies can deny coverage under the CGL policy. Specifically, the areas continuing to be debated in the courts in various States concern whether:

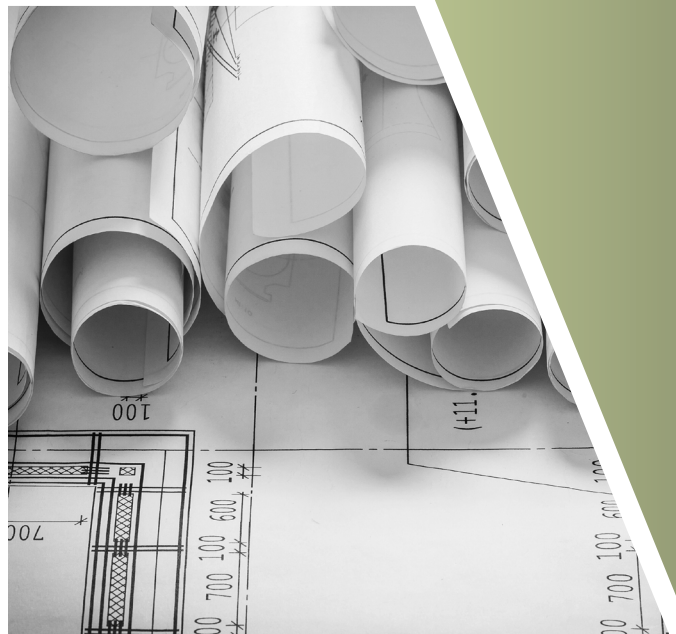
- Construction defects are an occurrence;
- Resulting damage to other work is an occurrence; and
- Resulting damage to third-party property is an occurrence.

While the recent court decisions demonstrate a lack of consistency from State to State leaving an uncertainty about what coverage might actually exist, there are some steps that can be taken by contractors to manage the unpredictability of CGL coverage. Before purchasing a CGL policy, various policies should be vetted and researched. Advice from competent legal counsel in each area should be sought. Some carriers have updated CGL forms designed for contractors resulting in specific coverage for construction defects. Other carriers allow construction defect coverage to be added by endorsement. Regardless of the carrier, it is important to know if the policy being considered:

- Specifies an occurrence trigger;
- Contains no a prior work exclusions; and
- Includes a subcontractor exception to the “damage to your work” exclusion.<sup>1</sup>

## CONCLUSION

While it can be tricky to navigate insuring for construction defects, there is coverage available that can and will respond. Do your research, seek out the advice of professionals, and know what you are buying (and what you aren't).



## ABOUT THE AUTHOR

**Jodi L. Hatherly, CPA, CFF, CGMA, CPIW** is an Associate Director based in Columbus, Ohio. She has more than 20 years of insurance claims, litigation support and other economic damage consulting experience. Ms. Hatherly has worked with several national retail chains, numerous steel manufacturers with various types of production facilities, and mid-stream natural gas companies as well as manufacturing, energy, mining, healthcare, hospitality, construction, and other types of industries. Her experience includes providing business interruption, property damage, construction contract, fidelity, and insurable value related services including the quantification of damages and expert reports in support of litigation.

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1. Typically, CGL policies do not cover damages for a contractor's "own" work. The subcontractor exception specifically acknowledges that subcontractor work is not the contractor's "own" work and would therefore be covered.