

CONSTRUCTION

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BUILDER'S RISK QUALIFICATION ISSUES

When the walls come down on a project under construction, the resulting chaos for the owners and contractors can be daunting. The appropriate property insurance can ease some of that burden from a financial standpoint.

Buildings that are under construction or renovation require a builder's risk insurance policy to insure against damages and loss of income as a result of a covered loss during construction. Builder's risk insurance is critical to limit the policy holder's exposure if he or she is looking to build a new building or renovate an existing one.

WHAT IS BUILDER'S RISK INSURANCE?

Builder's Risk insurance covers a project owner or general contractor for damages resulting from an insurable event while the project is under construction. The policy is typically an all-risks policy, meaning that all incremental costs are recoverable from the insurance company unless specifically excluded within the policy. A builder's risk policy covers the physical damage to the project, extra expenses, expediting expenses, soft costs and in many cases delay in startup losses due to flood, windstorm, collapse, etc. The policy may also cover, subject to exclusions and limitations, third party acts and negligence.

Some examples of covered property:

- Building material and supplies used for construction
- Curbing, paving, fences and outdoor fixtures
- Trees, shrubs, plants and lawns installed by you or on your behalf
- Property belonging to another for which you are liable

Some examples of property not covered:

- Existing buildings or structures
- Land or water
- Contractor's tools and equipment
- Automobiles
- Faulty workmanship

Similar to traditional business interruption wording, delay in startup coverage may be defined as follows:

“‘Loss of Rental Income’ and/or ‘Loss of Gross Earnings’ which, but for the ‘Delay Period’, would have been derived from the ‘Insured Project’ during the ‘Delay Period’. ‘Loss of Rental Income’ and/or ‘Loss of Gross Earnings’ shall be adjusted, as may be necessary, to provide for market trends or special circumstances. The amount thus adjusted shall represent as near as may be reasonably practicable the ‘Loss of Rental Income’ and/or ‘Loss of Gross Earnings.’”¹

Loss of gross earnings and rental income are typically defined as revenue less all non-continuing expenses either including or excluding ordinary payroll. Essentially, the policy covers what the lost revenue or profit would have been but for the insured loss event.

Conceptually, builder’s risk claims are similar to traditional property damage and business interruption claims. Loss of materials, repair or rebuild labor and equipment charges all have to be quantified. In some cases there is a business interruption or delay in startup component. However, this coverage does depend on the nature of the project being built (i.e., apartment building, manufacturing facility, etc.), and it covers the loss of revenue to the owner as a result of not completing the facility by the original completion date. The sticks and bricks of the operation, any temporary work and all the repair labor costs still apply. The policy holder is typically insured for replacement cost unless they make a decision not to rebuild. In that case, then, the policy holder will most likely receive the actual cash value of the asset or property lost.

Under delay in startup coverage, loss of revenue and extra expenses should be quantified in a manner similar to a traditional business interruption loss as defined and noted above. Coverage for physical damage usually begins at the time of the event. For delay in startup, coverage begins at the original scheduled date of completion of the project – the date when the policy holder was expected to become a viable operation and generating revenue. This is also the date at which the waiting period deductibles begin. The delay in startup measurement is the period from the original completion date to the new forecasted completion date less any applicable deductibles or sub limits. This is typically referred to as the period of indemnity.

As mentioned above, delay in startup coverage is normally the expected gross earnings less any expenses which do not normally continue during the period of indemnity. Since in many cases there are no historical operating results, many of the delay in startup losses are calculated based on budgets or forecasts derived from similar businesses or possibly other facilities operated by the policy holder.

Deductibles for physical damage under a builder’s risk policy are typically a specific dollar amount, same as with a traditional property policy. Deductibles under delay in startup are typically 30, 60 or 90 day waiting period deductibles. It is unusual to find deductibles based on a percent of insurable value or an average daily value.

There are distinct coverages in builder’s risk policies that are not included in a traditional property policy. In the following paragraphs, we will discuss some of the unique quantification issues that could arise as a result of these coverage items.

QUANTIFICATION ISSUES

As mentioned, delay in startup losses are conceptually the same as a traditional business interruption claim. Quantifying the loss of revenue associated with the delay and calculating the saved (variable) expenses are the core of either calculation. However, there are several unique coverage categories in a delay in startup claim that will be found in a builder’s risk form that will not be found in a business interruption form. We will cover those categories in detail below.

EXTENDED GENERAL CONDITIONS

Extended general conditions are comprised of the following:

- Labor and benefits
- Supervision
- Equipment rentals
- Overhead expenses: trailers, office personnel, etc.
- Contractor profit

After a loss which causes a significant delay in the construction timeline, contractors and subcontractors will be on site longer than originally anticipated. All of the aforementioned costs are now being incurred over and above the normal scope of the project. Any costs incurred beyond the original contract work estimate are considered extended general conditions and covered under the builder’s risk policy and not a typical property policy.

1. Ironshore Specialty Insurance Company Delay in Completion Endorsement http://www.ironshore.com/pdfs/general/Delay_in_Completion_Endorsement.pdf

On every construction site, a contractor has a trailer, office personnel, labor, supervision labor, equipment and tools. To the extent that the contractor is extended on the project, as a result of a covered loss, any incremental equipment rentals, trailers or office personnel will likely be covered under general conditions.

Supervision labor and direct labor, to the extent the scope of work is increased, will typically be covered under the revised repair or rebuild contract. However, mobilization and demobilization costs, as well as others, outside of the contract can be claimed under extended general conditions. In addition, any contractual hourly rate increases would also be incorporated into the aforementioned projects or costs.

Also included under extended general conditions is an item called home office overhead. Typically, a contractor will charge a certain percentage for overhead on every job. That percentage can be anywhere from 10-25%. The overhead charged in many cases covers the contractor's home office costs. Contractors charge this percentage generally to cover payroll, billing, labor and other costs that are not directly chargeable to the project.

In a delay in startup situation, many contractors claim additional home office overhead on the incremental scope of work. The quantification issue is: Exactly how is it calculated? One of the more talked about methods is the Eichleay formula. The definition of the formula is total contract billings of the contractor divided by the total contract billings for the performance period multiplied by the total overhead for the performance period. This is the amount of home office overhead allocable to the project. The home office overhead allocable to the project is then divided by the number of days in the performance period to arrive at the daily contract overhead rate. Utilizing the daily contract overhead rate and multiplying by the number of delay days provides the amount of home office overhead attributable to the delay.²

The shortcomings of this method include: 1) it is an estimation, 2) home office overhead costs may include costs that are not variable with respect to the increase in the scope of the project, 3) some courts don't recognize it, 4) the resultant delay may not cause an incremental increase to home office overhead costs and 5) the base period utilized in the formula may not be representative of the current project.

There are other methods available for calculating home office overhead, such as a fixed percentage or an analysis of the contractor's profit and loss statements. The final result doesn't have to be exact, but the resultant figure should be representative of the actual loss sustained due to the delay of the project.

SOFT COSTS³

Soft costs are comprised of the following:

- Interest on money to finance contract work
- Realty taxes
- Advertising and promotional expenses
- Costs of additional commissions incurred renegotiating leases
- Architects, engineers and consultant fees
- Project administration fees
- Insurance premiums
- Other similar costs you incur over and above normal in course of construction

As noted above with respect to extended general conditions, many of the costs categories above are a result of the project timeline extending beyond the original scope of the contract work. Interest is discussed further below, but additional costs over and above normal such as advertising expenses, engineering fees, project fees and insurance premiums are all covered expenses under a builder's risk policy.

Typically, soft costs are additional coverages that are separate from the delay in startup and extended general conditions. However, we have noticed that some builder's risk policies include soft costs within delay and startup. This can create certain coverage questions. Specifically, if soft costs are within the delay in startup coverage section, even though a project may be extended, coverage may not begin until the estimated date of completion. In addition, soft costs would then be subject to the applicable deductibles and sub-limits under delay in startup.

2. ConstructionClasses.com: <http://www.constructionguy.com/litigation/eichleay.htm#basic>

3. Builder's Risk Policy

Interest

Interest is part of the Soft Cost coverage listed above, but it warrants its own discussion. Interest is rarely considered in a traditional business interruption claim. Policy limits are normally limited to one year so there isn't a time value of money concern. However, for builder's risk claims, interest can be a significant component of the overall claim.

Interest and loan payments do not cease if there is a significant loss impacting the construction schedule; they will continue and payments will have to be made for a longer period than was originally anticipated. There can also be additional interest on construction loans that are converted to long term loans due to the varying nature of interest rates. Lastly, lines of credit can be affected. Assume a contractor has a line of credit that he has borrowed from to finance construction costs. If a loss extends the timeline of the project, the contractor will pay additional interest on the construction related financing for a longer period of time.

Similarly, there may be an instance where interest mitigates the claim. For example, assume the construction loan outstanding has a fixed interest rate. Starting around 2008, the Federal Funds Rate has decreased to .25% from approximately 5% up until the recent rate hike at the end of 2015.⁴ It is conceivable that at the end of the delay claim interest rates could be lower on the long term loan. In this case, the reduction in the interest rate could represent an offset to the claim.

Cessation of work exclusion

The definition of cessation of work is as follows:

"Cessation of work, whether total or partial. Cessation of work as used herein shall not mean any period of time during which operations would not normally have been conducted such as Saturday's, Sundays or holidays, nor shall it mean seasonal inactivity planned in advance, schedule delays due to weather, labor actions beyond the insured's control or suspension of project activity which has been occasioned by loss or damage covered under this policy provided the 'Insured Project' is maintained and protected against loss during such inactivity."⁵

Coverage for losses sustained by the policy holder can be found under cessation of work if it is for costs such as show-up time or idle labor due to inefficiency delays, created by the loss, while waiting for other contractors to clear an area. For example, the workers show up to work on a day that is overcast with severe storms forecast. Shortly after they start their work, the storms move into the area and the job site is closed. Typically under the union contract, it is mandatory to pay the workers two hours show up time. The policy holder should look for coverage under cessation of work. Any delays due to weather beyond the contractual show up time would likely not be covered since it is specifically excluded by the definition.

HOT TESTING

Hot testing is defined as "any start-up, commissioning or other form of testing making use of any feedstock, including operational tests and performance tests performed in conjunction with 'hot testing.' Hot testing includes the examination, experiment or trial of Covered Property such as ovens, boilers, turbines, generators, pumps, process equipment or equipment of a similar nature to prove their ability or function." Hot testing usually excludes things such as plumbing, HVAC units, sprinkler systems and elevators and escalators.⁵

Hot testing is an agreed upon period of time shown in the Declarations of the builder's risk policy. Hot testing is the period of time in which a project is first brought online until the time it reaches its full capacity safely and without incident. During this time, projects are typically ramped up slowly in an attempt to avoid catastrophic failures in the event that there are defects or the project doesn't function correctly. For example, assume the builder's risk coverage applies to a cogeneration facility where there are two combustion turbines and one steam turbine. During this testing phase, the combustion turbines are ramped up slowly and are monitored for vibration, gaseous levels and other items that may signify failure through various levels of rpms before reaching their full capacity. Subject to any exclusions or limitations, hot testing is designed to cover the policy holder for losses incurred during instances such as this.

4. Federal Reserve Economic Data <https://research.stlouisfed.org/fred2/series/FEDFUNDS>

5. Ironshore Specialty Insurance Company, Builder's Risk Policy (Specimen)

CHANGES IN MARKET CONDITIONS

Changes in market conditions are typically exclusions within the builder's risk policy. The exclusion language will be similar to the following: "Delay, loss of use or occupancy, loss of market, liquidated damages, performance penalties, penalties for non-completion, delay in completion or non-compliance with contract conditions or any other consequential loss, damage or expense."⁵ In this example, let's assume the facility is a condominium project. In January 2015, the project was to be completed and accepted by the owner; however, a major loss event delayed the completion of the project until January 2016. In all likelihood the owner had secured buyers for the property who expected the property to be tenantable in January 2015. Also, it was likely that the owner had expectations of many more unit sales once the building opened. Assuming no other changes in the market or other areas that would impact unit sales, the property owner would be entitled to recover all his lost profits, excluding any exclusions or sub limits.

As we now know, if this property is located in Texas, January 2016 may paint a much different picture with oil prices flirting with \$20 per barrel. It might now be that projections were excessive. If the language above is present, insurers will look to limit recovery under the delay in startup claim.

Assume the opposite is now true. In January 2015 oil was trading at \$20 per barrel and now in January 2016 it is trading for \$100 per barrel. It is possible that the unit sales will be greater than anticipated. In this instance, any incremental unit sales may be taken as an offset to the delay in startup claim.

CLOSING

We recommend consulting with a policy expert, your broker or an attorney prior to any loss situation to understand specific coverages within the policy. Builder's risk and delay in startup claims are, in general, subjective by nature since there is no history to compare to, only projections. However, by understanding some of the coverage pitfalls and quantification issues, a policy holder can have a claim that runs smoother and minimizes general disputed coverage issues. In the end, this will expedite the adjustment, settlement and payment of the claim.

ABOUT THE AUTHORS

Brad Murlick is a Managing Director in the Global Construction practice and practice leader of the Insurance Claims Accounting and Consulting (ICAC) team. He advises clients worldwide on the preparation, negotiation, and settlement of claims associated with catastrophic or other triggering events. During his career, he has assisted thousands of policyholders with the recovery of billions of dollars in connection with: property and business interruption; product recall; fidelity/employee dishonesty; political risk; and construction/builder's risk, among others. In addition to event-driven claim consulting, he proactively performs property and business interruption value analyses for his clients. He also assists numerous insurance brokerage clients in the defense of error and omission (E&O) matters involving property and casualty disputes and litigation and has testified both at arbitration and federal court.

Jason Scholler is an Associate Director based in Houston and has more than fifteen years of insurance claims, litigation support and consulting experience within a wide variety of industries, including refining, petrochemical, power generation, retail, service, hospitality, construction and manufacturing. His experience includes the preparation of claims for business interruption, property damage, extra expense, delay-in-startup, expediting expenses and builder's risk, as well as the quantification of damages in support of litigation. Mr. Scholler has assisted in providing consulting services for matters involving damages to real property in the context of litigation and insurance claims. In addition, he has extensive builder's risk experience where he was responsible for reviewing and determining the amounts for property damage, extra expense and soft cost claims, in addition to the day-to-day accounting issues.