Friday, October 26, 2018
10:30 – 11:45 AM

Seminar 17

How to Avoid Out-Kicking Your Coverage: Construction Insurance and Risk Management Strategies for Retail Developments

Presented to

2018 U.S. Shopping Center Law Conference
JW Marriott Orlando Grande Lakes
Orlando, FL
October 24-27, 2018

by:

Anthony Meagher
Partner
DLA Piper LLP
The Marbury Building
6225 Smith Avenue
Baltimore, Maryland 21209-3600
Anthony.meagher@dlapiper.com

William S. (Trip) Thomas III
Area Senior Vice President
Arthur J. Gallagher Risk Management Services, Inc.
505 N. Brand Blvd., Suite 600
Glendale, CA 91203
Trip.thomas@ajg.com

Bill Toliopoulos
Partner
Laurie & Brennan LLP
Two North Riverside Plaza
Suite 1750
Chicago, Illinois 60606
BT@lauriebrennan.com

KEY ISSUES AND CONSIDERATIONS FOR INSURANCE COVERAGE

I. Understanding Common Liability Program Structures

A. “Traditional” Structure

As illustrated below, the “Traditional” approach employs layers of indemnifications and GL “Additional Insured” endorsements from downstream contractors to insulate owners and GC’s from construction liability risk.

Traditional structure presents the following potential challenges:

- Inconsistent coverage terms
- Shared or diluted policy limits
- Dependency on contractors
- “Nightmare” claims resolution
- Cost inefficiency

B. OCIP or CCIP Structure

Most residential and increasingly more commercial construction projects are being insured via Owner- or Contractor-Controlled Insurance Programs (OCIPs, CCIPs or Wrap-Ups). By including all parties to the project within a single portfolio of insurance, developers have found a number of cost, coverage and administrative benefits.

These include:

- Dedicated limits for the life of the project
- Primary coverage for all participating contractors
- Uniform coverage terms and conditions
- Unified defense and coverage response to claims
- Streamlined project administration
- Products/Completed Operations coverage extends to statute of repose

C. Other Options

Other liability insurance products used on construction risks include Owner’s Protective and Project-Specific GL programs. While useful in certain instances, these insurance mechanisms provide liability coverage for the developer’s interest only. The Project-Specific GL policy can include both “Premises-Operations” and a 10-year tail for “Products/Completed Operations.” The Owner’s Protective Liability form only insures against loss during the construction period.

II. OCIP vs. CCIP Comparison

While OCIP and CCIP program structures may seem nearly identical in nature, owner/developers should consider several key differentiators when evaluating options.

OCIP	CCIP
• Owner-controlled	• Contractor-controlled
• Owner designs coverage terms	• GC designs coverage terms
• Owner selects liability limits	• GC selects liability limits
• Owner directs claims, litigation, settlement	• GC directs claims, litigation, settlement
• Owner understands true underwriting	• GC sets price: premium + mark-up

premium charged by insurer • Insurance stays with project if owner disengages contractor	• Insurance follows the contractor, so project becomes uninsured if contractor is replaced

In summary, key benefits of the OCIP for owner/developers include:

- Opportunity to design coverage terms, conditions and limits to meet project needs and suit risk appetite
- Ability to direct claims process, litigation and settlement
- No dependence on others for critical liability coverage
- Streamlined claims resolution
- Cost-effective risk transfer

III. Recent Trends

A. Risk Management

Amid a frenzy of new construction starts, insurance purchasing trends are pointing towards a shift in risk management perspective. OCIPs and CCIPs are finding favor with strictly commercial developers that once relied exclusively on downstream contractors for GL protection – largely due to the efficiency and control these program structures provide.

Workers' Comp. claim costs continue to climb across much of the nation, and future loss development is extremely unpredictable. To bring greater certainty to their bottom line, multifamily and commercial developers are implementing General Liability-only OCIPs with greater frequency. Once utilized solely for "high hazard" residential projects such as condos and tract homes, GL-only OCIPs provide developers with the certainty of owner-controlled GL insurance without the highly-unpredictable costs of a loss sensitive Workers' Comp. program. Rather, developers require each contractor to procure its own Workers' Comp. coverage, and the developer incurs the cost as a fixed line item in the bid.

IV. Successful Strategies for Implementing OCIP and CCIP

Understanding risk exposures and available products for transfer or mitigation is important, but successful implementation depends upon careful planning, close coordination and strategic vision. Following is segmented overview of key risk management tactics and milestones on the path toward groundbreaking:

A. **Pre-Construction**
1. Assemble team of trusted advisors
2. Define your activities, assets, loss history, exposures
3. Assess current insurance market conditions for anticipated pricing, terms and conditions
4. Review operating agreements and key contracts, including GC and architect
5. Catalog contractual obligations regarding insurance and indemnity
6. Develop clear insurance exhibit defining anticipated roles and responsibilities
7. Evaluate risk appetite and financial ability to retain risk

B. **Program Design**
1. Model out all available program structures
2. Produce cost/benefit analysis of viable options
3. Evaluate alternative risk financing structures
4. Identify potential coverage gaps and seek transfer or mitigation solutions

C. **Marketing**
1. Provide to markets an attractive, intelligible underwriting presentation that delivers a relevant, complete and accurate picture of the risk
2. Leverage relationships, broker market clout, future project opportunities to secure the best product and price
3. Identify ancillary costs or services required (administration, loss control, peer review)

D. **Implementation**

1. Communicate coverage terms, conditions and limits to project participants
2. Educate insurance program participants on coverages, obligations and resources
3. Engage OCIP enrollment administrator, safety and loss control consultants
4. Build it!

V. <u>Other Considerations</u>

The essential coverages, in addition to the OCIP or CGL-only Wrap-Up, are listed below with an explanation of benefits, options, or alternate methods to deal with the exposures:

A. **Builder's Risk**

This first party coverage protects the developer, contractor and all subcontractors in the event of physical damage or loss to the project during construction. The policy insures to the full contract value of the project plus enhancements such as off-site storage, transit and similar exposures. Policies are written on an all-risk basis, but care must be taken to negotiate broad terms and conditions since each underwriter's policy language can differ significantly. Subsidence coverage is critical, as is the right to partial occupancy. These are just two areas that need to be carefully manuscripted. Insurable Soft Costs should be closely calculated to ensure adequacy without duplication. Also important, any delays in the project completion will result in significant lost revenues to the developer. This exposure can be insured and specific limits of liability purchased. Finally, the developer needs to evaluate the risk of earthquake and flood and purchase appropriate limits.

B. **Mold/Pollution**

The only way to obtain coverage for mold is through a Contractor's Pollution Liability (CPL) policy. The CPL policy should be in force during construction and for ten years thereafter. Neither the Builder's Risk nor Pollution Legal Liability policy will provide coverage for mold damage to the project itself during construction. This exposure should be handled contractually with the general contractor and through the use of a project-specific mold protocol.

C. **Architects & Engineers**

The developer should evaluate the contractual obligations and insurance requirements of the lead architect and their subcontractors. Since design professionals purchase *claims made* policies on an annual basis, and policy limits are depleted by defense costs, the developer must decide what risks they are willing to take. The design professionals' E&O coverage provides protection for losses arising from their professional errors, whether bodily injury or property damage or economic loss (i.e., the project is delayed or costs escalate because of design errors). The OCIP traditionally does not provide this coverage, although the CGL-only underwriters are offering "limited professional" by including coverage for bodily injury or property damage for enrolled contractors. Another solution for the developer may be an Owner's Protective Professional Indemnity (OPPI) policy, which acts as an excess policy over each and every design professional's policy. Coverage is purchased as a *claims made* policy with the retro date back to first design. Coverage is then extended after project completion with an extended reporting period of up to ten years. The policy limits are dedicated to the project and coverage terms and conditions mirror those typically provided by the design professionals.

KEY ISSUES FOR PAYMENT AND PERFORMANCE BONDS

Construction owners often require payment and performance bonds on construction projects to protect them from default by the general contractor. Performance bonds guarantee the performance of the contractor under the construction contract. Payment bonds provide protection to the owner in the event that the contractor fails to pay subcontractors and suppliers, because any unpaid vendors may claim against the payment bond, as opposed to having to file a lien against the owner's property.

Owners frequently simply accept the "industry standard" payment and performance bonds offered by the general contractor. Unfortunately, many owners later find that the bonds do not cover various damages suffered as a result of default by the general contractor. Some owners also encounter a claim by the surety that it has been "discharged" from liability because of some act or omission on the part of the owner.

In preparing, approving or negotiating payment and performance bonds, a construction owner should make sure that it obtains adequate coverage, and that the bonds limit claims of discharge by sureties confronted with a default by their principal.

I. PAYMENT BOND ISSUES

A**.** **PAYMENT BOND AND PERFORMANCE BONDS SHOULD BE ISSUED ON SEPARATE FORMS.**

Payment and performance bonds usually are issued in the amount of the contract price (referred to in the bonds as the "penal sum"). If separate bonds are issued, the owner or contractor has coverage in the amount of the full bond amount for payment problems and separate coverage in the full bond amount for performance problems. A single bond guaranteeing performance and payment offers only half of the protection of separate bonds. Accordingly, owners should insist upon separate performance and payment bonds in the full contract amount.

B**.** **THE PAYMENT BOND SHOULD REFLECT THE POTENTIAL LIABILITY OF THE OWNER UNDER THE LIEN STATUTE OF THE STATE IN WHICH THE PROJECT IS LOCATED.**

Many payment bonds only cover subcontractors and suppliers who have a direct contract with the principal on the bond (typically the general contractor), as opposed to lower tier subcontractors and suppliers. In most states, lien statutes extend protection to a larger class of claimants than those who have privity of contract with the general contractor. Because the owner may be subject to liability for any liens that are filed, the payment bond should cover the full spectrum of potential lien claimants.

In addition, the notice requirements in a payment bond should not be shorter than those contained in the applicable lien statute. For example, many payment bonds provide that subcontractors and suppliers who do not have a contract with the general contractor must give 90 days' notice in the event of a claim, or the claim is waived. In some states, the time for filing a lien may extend to as much as four or six months.

If the notice period in the payment bond is shorter than the notice period in the lien statute, a claimant may well wait until the only remedy it has is filing a lien, in which case the owner loses the protection of the payment bond. The owner's primary goal in this regard is to encourage claimants to pursue remedies under the payment bond, rather than a lien claim against the owner's property.

C. **PAYMENT AND PERFORMANCE BONDS SHOULD CONTAIN AN UNCONDITIONAL WAIVER OF NOTICE OF CHANGES TO THE CONTRACT BY THE SURETY.**

Although many standard form bonds contain a "waiver of notice" provision, owners and contractors should verify that the waiver includes every type of occurrence for which the surety could claim discharge for lack of notice. At a minimum, the surety should waive notice of the following:

1) modifications to the project;

2) additions or deletions in the scope of the project;

3) changes or alterations to the contract, including change orders;

4) changes in the method or timing of payments under the contract; and

5) changes in the schedule or time for performance under the contract.

The waiver of notice clause, if broadly drafted, will prevent claims of discharge by the surety where the basis for the discharge is purely technical.

D. **PERFORMANCE BONDS SHOULD INDEMNIFY THE OWNER FROM ALL LOSS DUE TO THE DEFAULT OF THE CONTRACTOR AND GUARANTEE COMPLETION OF THE WORK.**

When a general contractor defaults, the owner is exposed to many different kinds of damages. These damages include delay damages, claims by unpaid subcontractors and suppliers, legal fees necessary to defend claims and pursue remedies against the general contractor and its surety, and the assessment of liquidated damages, penalties or claims by third parties. A performance bond that simply guarantees completion of the work by the surety does not cover any of these damages. Therefore, a construction owner should make sure that the performance bond contains language indemnifying the owner from all loss or damage, including attorney's fees, incurred as a result of a default by the principal on the bond.

Also, under the law of some states, delay damages cannot be recovered unless they are clearly referenced as recoverable damages in the bond. See, e.g., American Home Assurance Company v. Larkin General Hospital, Ltd., 593 So.2d 195 (Fla. 1992). Therefore, the owner should consider making the indemnity language as specific as possible to allow recovery of these damages.

E. A PERFORMANCE BOND SHOULD NOT SPECIFY A NUMBER OF DAYS WITHIN WHICH THE SURETY MUST RESPOND TO A DEFAULT OF THE PRINCIPAL.

In some standard form performance bonds, a surety will include a specific duration for its response to a demand from the construction owner that the surety perform under the bond. A specified response time, particularly a lengthy one, is an invitation for the surety to delay in responding to the claim. Instead, the performance bond should provide that the surety shall "promptly remedy the default of the principal."

If circumstances warrant, an owner or contractor should be able to demand that the surety begin curing the default within days or weeks, instead of waiting for a stated time period to expire. Once the surety is put on notice that significant damages may occur if the surety does not step in and perform quickly, the surety is far more likely to be responsive if it cannot point to stated time limits.

F. A PERFORMANCE BOND SHOULD NOT CONTAIN A LIMITATION ON THE TIME FOR FILING A LAWSUIT UNDER THE BOND.

Performance bonds often of put time limits (i.e., statutes of limitation) on the time for making a claim under the bond. These time limits often are far shorter than the limitations under applicable law. While it may be a simple enough matter for a construction owner to sue a non-performing surety within a year or two after the default of the general contractor, a strict limitations period in the bond can significantly impinge on the owner’s ability to have recourse against the surety for liabilities arising after project completion, such as liability for defective work or liability for latent defects. Because most states have a contract statute of limitations of three years or longer, which typically run from discovery of the defect, an owner may give up extremely valuable protection for latent defects by agreeing to a statute of limitations in the bond.

G. AN OWNER SHOULD BE WARY OF ACCEPTING SUBCONTRACTOR BONDS AS A COMPLETE SUBSTITUTE FOR BONDS FROM THE GENERAL CONTRACTOR.

General contractors unable to obtain bonding on a particular project, or who have reached their bonding capacity on other projects, often ask an owner to accept subcontractor bonds as a substitute. The reason subcontractor bonds are not an adequate substitute for a bond from the general contractor is that they do not guarantee performance by the general contractor – only the subcontractor providing the bond.

So, for example, if the contractor receives payment from the owner and then fails to pay its subcontractors, the subcontractor bonds will not cover this default by the general contractor. Similarly, if the general contractor mismanages the work of its subcontractors, causing substantial delay damages, and then declares bankruptcy, the subcontractor bonds offer no protection for this default either. If the subcontractors have not defaulted, their sureties will not be liable on the surety bonds. Accordingly, owners should be careful when accepting subcontractor bonds in place of a bond from the general contractor.

H. A DUAL OBLIGEE RIDER IS A RELATIVELY SIMPLE MEANS OF OBTAINING EXTRA PROTECTION.

Despite that a construction owner may not want to accept subcontractor bonds as complete substitutes for bonds from the general contractor, there are instances in which bonds from subcontractors may very well play an important role on the project. For example, specialty subcontractors providing difficult, complex or relatively new systems and components should provide bonds guaranteeing their performance.

By obtaining bonds from these specialty contractors, the contractor and owner both obtain some assurance that the subcontractor is competent (since the surety is willing to bond that subcontractor), and that there will be a solvent party to call upon if the specialty work is not successful. If bonds are obtained from subcontractors on a project, the owner should require that those bonds include a "dual obligee rider," naming the owner as a beneficiary of the bond. A dual obligee rider allows the construction owner to make direct claims against the subcontractor's surety in the event of default. In most cases, this extra level of protection does not increase the bond premium.

I. VERIFY THE FINANCIAL STRENGTH AND REPUTATION OF THE SURETY

A surety bond is merely a contract and the security it provides is only as strong as the financial strength of the surety providing the bonds. Construction owners should take care to verify the financial strength of the surety before accepting a bond. The Federal Government has a list of approved sureties; if the proposed surety is not on that list, it is a good idea to check with the state insurance office and other sources of information to verify the solvency and good standing of the surety.

II. AVOIDING DISCHARGE OF A SURETY'S BOND OBLIGATIONS

Even if a construction owner undertakes to prepare comprehensive and effective payment and performance bonds, the greatest danger for any construction owner lies in taking some action that will discharge the surety's obligations under the payment and performance bonds. Although the issue of the surety's discharge is primarily a concern in the performance bond context, the issue also arises under the payment bond.

By issuing a performance bond, a surety guarantees the contractor's performance of the construction contract with the owner in exchange for a payment of specified premium. If a claim situation occurs, a surety will frequently seek discharge from its responsibilities under the bond by arguing that something has changed since the bond was issued that has increased the surety's risk without its consent.

The contract may have changed; the contractor performing the work may have changed; the time period for performing the work may have changed; or, the payment terms may have changed. Such changes may, in some instances, allow a surety to successfully claim discharge of its responsibilities under the bonds.

Because no owner or contractor will ever notify a surety of every conceivable change on a construction project, as a precautionary measure, the owner needs to be aware of the primary ways that the actions of the owner can create a potential discharge of the surety. There are four major bases for claims of discharge.

1. *Change in the Contract Terms.* Case law still exists in the suretyship area to the effect that if the owner and the contractor change material terms of the construction contract without the surety's consent, the surety is discharged. See, e.g., Reeder v. Ramsey, 458 N.E.2d 682 (Ind. Ct. App. 1984). Although many of the more recent decisions require that a surety demonstrate it has suffered actual prejudice by the change, cases can still be found where the simple change itself resulted in a discharge, regardless of prejudice. See, e.g., Allied Fidelity Insurance Co. v. Pico, 99 Nev. 15, 656 P.2d 849 (1983); Detroit Fidelity & Surety Co. v. Bushong, 96 Ind. App. 352, 175 N.E. 683 (1931).

When it comes to simple changes to a construction contract, like a minor change order or minor change in the completion date, the construction owner can most effectively eliminate the possibility of discharge by including a provision in the performance bond under which the surety waives notice of changes to the construction contract. However, such a provision may not be effective to prevent discharge in the face of a substantial change, known as a "cardinal" change in the contract. A cardinal change is a change that substantially expands the basic scope of the contract.

Most discharge cases are decided on the basis of whether a particular change or event increased the risk of the surety without the surety's consent. In undertaking its suretyship obligations, the surety obviously takes certain risks, for which the surety charges a premium. If the owner materially increases the risk of the surety in some manner, without the surety's knowledge or consent, the surety likely will argue that it has been discharged from its obligations under the performance bond, and case law will support the surety's arguments. See, e.g., Brunswick Nursery & Convalescent Center, Inc. v. Great American Insurance Co., 308 F. Supp. 297 (S. D. Ga. 1970). Therefore, all substantial changes to the contract, including change orders, must be evaluated in light of the discharge issue.

2. *Overpayment and Underpayment*. One of the more frequent issues raised by sureties seeking discharge under a performance bond is the issue of whether the contractor was underpaid or overpaid. If the contractor has not been paid all that it is legally due under the contract, the surety will take the position that the owner has improperly increased its risk under the bond. In fact, the surety might even take the position that its principal, the contractor, is not in default (no matter what the contractor has failed to do), because the owner has not met its payment obligations under the contract. If the owner has breached the contract, the contractor may not be liable for its default, and the surety may therefore not be liable under the bond. See, e.g., State v. Massachusetts Bonding & Insurance Co., 117 P.2d 80 (1941).

On the other hand, if the owner advances funds to the contractor before they are due, the surety will also claim discharge on the basis that the owner has altered the contract without its consent and increased its risk by releasing funds otherwise available to the surety to cure the contractor's default. See, e.g., Airtrol Engineering Co. v. U.S. Fidelity & Guaranty Co., 345 So.2d 1271 (La. Ct. App. 1977). Therefore, the owner must be careful in meeting its payment obligations under the contract. Contractors often seek to bill for as much of the work as possible, as soon as possible. If the owner pays a greater percentage of the contract amount than the actual percentage of the work completed, the surety may be discharged to the extent of the overpayment.

Decisions about payment require the owner to determine the risks and liabilities presented in making requested payments. If there are serious problems with the quality of the work, or there are numerous claims from subcontractors and suppliers, the owner should consider notifying the surety of the problem, even if the owner is not ready to terminate the contractor or even declare a default. Once the surety is involved, the owner may be able to obtain the surety's consent to a particular payment and avoid a subsequent claim of discharge.

3. *Extensions of Time.* A third area that may lead to a discharge claim occurs when an owner extends the time for completion of the project without the consent of the surety. In these cases, the surety is likely to claim that it evaluated its risk on the basis of the original period of time contained in the contract, and that the extension of time has increased its risk under the performance bond. See, e.g., Keene Corp. v. International Fidelity Insurance Co., 736 F.2d 388 (7th Cir. 1984). Most sureties receive regular reports on the financial strength of the contractors they bond, and they may claim that they would not have agreed to an extension of time given the downward trend of a particular contractor's financial position.

Once again, minor extensions of the contract time can adequately be addressed in the performance bond's waiver of notice clause. However, if the extension of time is substantial, the owner should consider notifying the surety and obtaining the surety's consent before granting the extension. In many cases, the owner may be requesting the extension for reasons having nothing to do with the contractor, such as suspending construction on a retail establishment during the Christmas selling season. In these instances, the contractor will have no objection to the owner contacting the surety to obtain the surety's consent to the extension. If an extension of time is allowed because of failures on the part of the contractor (which it typically would not be), the owner may still want to notify the surety and obtain consent because those failures could continue and ultimately result in the contractor's default.

4. *Change in the Contracting Entities*. Although it does not happen often, in some cases the contracting entities on a given construction project may change. In some cases, the owner makes such changes for business reasons or because of financing requirements. In other cases, the contractor's organization changes, either in terms of the partners involved in a joint venture, or because of a corporate acquisition. In some cases, the owner will agree to allow a contractor to use another contracting entity to complete all of the work on a project, even though the contract is nominally in the name of the non-performing contractor. This may be done in order to obtain payment and performance bonds.

Each of these changes could lead to a claim of discharge by the surety. See, e.g., Bianco v. Fireman's Fund Indemnity Co., 232 P.2d 386 (1951); Mead Samuel & Co., Inc. v. U.S. Fidelity & Guaranty Co., 611 P.2d 112 (1980). A surety may claim that it issued the bonds because of the financial strength of the original owner. This argument could easily arise if the subsequent owner does not pay the contractor's draw requests on time, and the contractor later defaults. Similarly, a surety may claim that it only bonded the original contractor, and not a new joint venture or other contractor performing the work on behalf of the original contractor.

In of these circumstances, the owner should endeavor to obtain the consent of the surety. If there are no real concerns involved in the change of contracting entities, the surety is likely to consent and the owner can avoid any claim of discharge on account of this change.

The issues discussed above may have an impact in the payment bond context as well. Generally speaking, a payment bond allows any unpaid subcontractor or supplier to sue the surety directly on the payment bond for amounts owed for its work. In those cases, the surety is not allowed to claim discharge as to the payment bond claimant, even if a potential claim of discharge is available to the surety under the performance bond. Area Masonry Ltd. v. Dormitory Authority, 407 N.Y.S.2d 279, 64 A.D.2d 810 (1978). This rule stems from the fact that the unpaid subcontractor or supplier is not a participant in any change to the contract between the owner and the contractor.

However, once a surety has finished paying payment bond claims to subcontractors and suppliers on a project, the surety may make a claim against the owner for reimbursement of sums it has paid to subcontractors and suppliers under the payment bond. Such a claim may be based on the theory that the owner participated in an event or change that increased the surety's risk on the project. That event or change, such as not paying the contractor sufficient funds, caused the contractor financial difficulties, and the claims under the payment bond were the logical result. Although the legal issues involved in such a claim are complex, such claims are clearly not out of the question and reinforce the need for the owner to be vigilant in avoiding potential discharge claims.

III. CONCLUSION.

The issues discussed above, while not exhaustive, constitute many of the common problems faced by owners in drafting, negotiating or evaluating and approving payment and performance bonds on construction projects. By paying attention to the terms of payment and performance bonds, the construction owner can significantly enhance the likelihood that the surety will actually perform under the bonds in the event of a default by the contractor.

Given all of the possible claims of discharge on the part of sureties, every construction owner needs to carefully evaluate each substantial change or event during a construction project for its possible effect on the surety's obligations under the bonds. Given the consequences of a successful claim of discharge, the owner would be well-advised to err on the side of caution. If the contractor begins having serious problems on a project, or if a substantial change in a project is necessary, the owner should notify the surety and take steps to avoid discharge of the surety's obligations.

CONSTRUCTION DEFECT CLAIMS AND INSURANCE CONSIDERATIONS

Construction defect claims and related disputes between parties and their respective insurers have given rise to a cottage industry of defect and insurance coverage litigation. In analyzing the availability of insurance coverage and the damages recoverable, parties to a construction contract need to be diligent regarding in enforcing their rights and meeting their obligations under relevant insurance policies.

I. RIGHTS AND RESPONSIBILITIES WHEN CONSTRUCTION DEFECT CLAIMS ARISE

A. Insured's Notice Obligation

Nearly every insurance policy requires that a notice of loss or claim be provided to the insurer. However, notice provisions vary in their required form and content depending on the insurer and type of policy. Notice provisions are generally considered separate from the insured's obligation to cooperate with the insurer in the investigation and defense of a claim or suit. An insured's breach of the duty to provide notice may serve to negate not only the insurer's defense obligation but also the duty to indemnify the insured.

Generally, courts have adhered to one of two approaches on the issue of notice under insurance policies. First, some courts adopt a "no-prejudice" rule. Under this view, an insured must strictly comply with insurance contract requirements in order to satisfy its obligations and secure coverage under the policy independent of any prejudice to the insurer. These courts construe notice provisions as requiring standards such as "reasonable notice" or "as soon as practicable." Under this view, timing of notice is subject to circumstances which might influence the reasonableness of the insured's conduct. Other courts, expressing a more modern and common view, permit an insurance carrier to disclaim coverage only if the insurance carrier can demonstrate that some prejudice has been suffered. This is generally considered the "prejudice rule."

Although timeliness of notice under an insurance policy is the typical basis for dispute, issues also exist regarding the sufficiency of notice provided the insurer. Substantively, insurance policies frequently require written notice of facts and circumstances regarding a claim or potential claims. Whether a notice must be written or may be oral largely depends upon underlying rules such as prejudice as a basis for disclaimer of coverage.

Insurer's "notice" defenses most often arise in defective work claims relating to water intrusion, mold, and settling or cracking of concrete structures. Based on the definition of "occurrence" (defined below), insurers typically argue that successive incidents such as water intrusion over a period can be viewed as one occurrence that triggers an insured's notice obligation at the first instance and will attempt to provide coverage as it relates to one occurrence.

B. Insurer's Decisions: Accept, Reserve or Disclaim

Equally as important as the insured's notice obligation is the insurer's obligation to timely provide a determination of coverage relating to defective work claims. An insurer's failure to timely respond to a claim may have devastating consequences even if valid defenses to coverage exist. Such consequences are also based upon fiduciary obligations, policy considerations, or fundamental considerations of fairness. Most jurisdictions not only require timely responses from insurers but also require that an insurer provide its basis for disclaiming coverage. Failure of the insurer to adhere to these principles exposes the insurer to an insured's claims of waiver, estoppel and bad faith.

In light of these strict obligations in an increasing number of states, insurers typically address defective work claims by providing a "Reservation of Rights" letter to an insured, detailing the basis for their coverage position as well as the following:

- Identification of applicable policies
- Identification of applicable occurrence or occurrences;
- Identification of policy provisions upon which the insurer relies in support of its coverage position
- Appointment of counsel to represent the insured
- Reference to the underlying complaint and allegations supporting the insurer's coverage position
- Reiteration of the insured's obligation to cooperate
- Statement of the insured's right to obtain independent counsel

In some scenarios, insurers may choose to disclaim coverage altogether or seek to rescind an insurance policy. While these two "nuclear" options are much rarer, insurers in some jurisdictions are increasingly more willing to seek a judicial declaration supporting their position of no coverage. From a legal perspective, an insurer's basis for disclaiming coverage will be largely defined by the reasons set forth in the declination letter provided to the insured. Principles of waiver and estoppel are likely to preclude the insurance carrier from invoking additional later-discovered justifications for disclaimer if it chooses to issue a declination letter. Equally important, a declination letter may release the insured from any obligations to cooperate with the insurer in defense of the claim and invites the insured to pursue independent avenues for defense of the claim, including settlement. Therefore, declination letters may have the practical effect of ceding control of the defense and settlement of claims to the insured. Thus, declination letters are rarely the first avenue of defense by insurance carriers in the context of coverage disputes and are typically preceded by reservation of rights letters.

Alternatively, insurers make seek to rescind the operative insurance policy in response to construction defect claims. Rescission is typically invoked by an insurer in the event of fraud or misrepresentation in applications of insurance, or interviews conducted as part of the underwriting process. Rescission occurs more predominantly in first party insurance contracts since first party coverage typically involves a more rigorous underwriting process with detailed applications and more information provided by the insured. Rescission is less typical in CGL or third-party policies where underwriting is less dependent upon application information or related disclosures by the insured. Notably, an insurer's allegation of fraud or misrepresentation by its insured may impose substantial burdens of proof upon the insurer regarding the underlying allegations. Such burdens may be mitigated by the terms of the policy or applications which characterize the nature of the insured's disclosure and the basis of the insurer's reliance upon such information. Finally, the insurer's right of rescission may be restricted by specific statutory provisions that provide a very narrow roadmap for an insurer to demonstrate materiality in the context of insurance applications.

II. INSURER'S COVERAGE DETERMINATIONS AND EXCLUSIONS

A. Does the Defective Work Constitute "Property Damage"?

A key consideration for most CGL carriers is whether the claim for "defective work" qualifies as "property damage" under the policy and whether any of the myriad of exclusions apply. Under most standard CGL policies, coverage is granted only where there is "property damage" caused by an "occurrence" during the policy period. "Occurrence" and "property damage" are terms which are both defined in the policy. The terms "occurrence" and "property damage" are defined by the standard CGL Coverage Form, as follows:

- **"Occurrence"** is defined as: **"**An accident, including continuous or repeated exposure to substantially the same general harmful conditions.
- **"Property damage"** is defined as: (a) Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or (b) Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

Even assuming the defective construction work qualifies as both an "occurrence" and "property damage" under an insurance policy, insurers are keen to rely on the broad "your work" exclusion to deny coverage. Typically known as "Exclusion (l)" of the standard CGL policy, the "your work" exclusion bars coverage for "property damage to 'your work' arising out of it or any part of it and included within the products-completed operations hazard." The "your work" exclusion serves to preclude coverage where the application of coverage is based on defective or faulty workmanship. The determination of whether there is an occurrence under the policy, therefore, will depend upon the actual components of the construction defect claim and the type of property damage alleged. Notably, the property damage must be to property owned by a third party.

In determining whether coverage applies in a particular case, analysis must be conducted as to whether the defect claim at issue seeks "property damage" as it is defined by the standard CGL policy. As noted above, CGL policies generally define property damage as "physical injury to tangible property." The definition of property damage under the standard CGL policy distinguishes between actual injury to tangible property and intangible loss, such as economic loss. The general contention among courts is that construction defect claims based on defective or faulty workmanship do not constitute property damage, insofar as property damage implies injury to tangible property.[11] However, where a claim of faulty workmanship causes damage to other parts of a project, courts may consider the resulting damage "property damage" that is covered under the policy.[12] In such cases, whereas the resulting injury to tangible property is covered, economic loss will remain uncovered under most if not all policies.

B. **Additional Insured Complications and Considerations**

1. *Additional Insured Status Under CGL Policies*

Construction contracts frequently require a general contractor to procure CGL coverage naming the owner as an additional insured and, as a result, often flow down to subcontractors, who are typically also required name the owner and the general contractor in their policies. While insurance agreements vary in their requirements, significant legal implications and practical consequences flow from the additional insured policy language.

The distinction between a "named insured" and an "additional insured" under an insurance policy is important on many levels. Typically, a "named insured" under the CGL policy typically includes: partners or members where the named insured is a partnership or joint venture; executive officers and directors where the named insured is an organization other than a partnership; and employees of the named insured. Coverage for a "named insured" is often limited to acts or conduct within the scope of employment and is also limited to specific categories of property (i.e. property owned, occupied or used by the named insured).

In contrast, additional insured endorsements are the typical procedure for extending coverage under a CGL to those outside the ambit of "named insured" under a CGL policy. Additional insured endorsements also vary in their terms and provisions. Typically, an additional insured endorsement extends the coverage to a third party in exchange for an additional premium. In deciding whether to be named an additional insured under a CGL policy, requesting parties should consider the following trade-offs:

- An additional insured obtains direct rights under the policy rather than simply indemnity rights under the contract provisions;
- Additional insured status provides additional security for indemnity rights under the contract terms;
- Additional insured status precludes subrogation by the insurer against the additional insured;
- Additional insured status may protect the additional insured's loss experience under its own liability insurance program.

Typically, additional insured endorsements can be found in two types of Insurance Services Organization ("ISO") forms. They are as follows:

- **CG 20-10**: Amends the definition of who is an insured under the CGL to include the designated additional insured and limits coverage to liability arising out of ongoing operations performed by the named insured for the additional insured.
- **CG 20-09**: Provides coverage for liability arising from the ongoing operations of the named insured but contains exclusions such as coverage for bodily injury or property damage arising from acts or omissions of the additional insured "other than general supervision" of the named insured's work.

In light of the critical trade-offs detailed above and the various types of policy forms available relating to additional insured coverage, parties are best served spending some time with a risk manager to critically analyze the comparative benefits and detriments that these options provide.

2. *Additional Insured Under Professional Liability Policies*

Oftentimes, parties seek to leverage the additional insured status onto professional liability policies issued to construction professionals, such as architects, engineers, surveyors or design/build contractors. Although the request may sound reasonable, it is rarely, if ever, successful. First. professional liability errors & omissions insurance policies most frequently preclude coverage for entities which are not furnishing professional services (i.e. owners, general contractors). Second, professional liability policies provide specific exclusions for claims between two insured entities. These cross-liability exclusions provided in professional liability policies effectively negate the coverage which an additional insured is seeking to obtain.

III. TYPES OF DAMAGES RECOVERABLE

A. Economic Loss vs. Property Damage

Damage to intangible property is often considered economic loss and thus, not covered under a standard CGL policy. Insurers often argue that the cost of repairing or replacing defective construction work is merely an economic loss rather than "actual injury to tangible property" and thus, such costs are not covered. As a corollary to the question of whether "property damage" has occurred, parties to an insuring agreement should also analyze whether the damages being claimed are simply economic losses. It then follows that the existence of economic loss in a particular case depends upon an initial assessment of whether there is in fact "property damage," or actual injury to tangible property. Only after making such a determination is it then appropriate to discuss the potential existence of injury to intangibles, which includes economic loss.

B. **Considerations Based on Consequential and Liquidated Damages Claims**

1. CGL Policies

As detailed above, the typical CGL policy provides broad protection for insureds for legal liability due to bodily injury or property damage to which the insurance applies. In the context of construction defect claims, property damage that results in the loss of use will likely allow for coverage as long as the alleged loss of use is causally related to the property damage itself. Examples of these types of claims include loss of rents from a building that was unable to open on time as a result of a liability claim, additional costs related to a delay in a project caused by a property damage claim, and even to some liquidated damages. A variety of cases speak to consequential and liquidated damages and many support the idea of coverage for those which can be shown to arise from a covered property damage claim.

2. Professional Liability Policies

In the context of professional liability policies, the increase of design/build construction projects has caused an increase in consequential damages and LD claims against E&O carriers. As is typical in design-build work, construction contracts have pushed more construction management and schedule risk to contractors. Likewise, more sophisticated technologies in construction, which increase their professional responsibilities.

By definition, a professional liability loss can arise without direct physical loss to tangible property. Therefore, many of the indirect losses that could be considered consequential could fall into the definition of damages under professional policies. Examples include schedule delays resulting in additional costs arising from design errors, such as a faulty electrical system design that causes an investment company to not close a series of transactions which resulted in lost profits; a change order to fix an issue with a foundation design that caused additional costs for storage of materials; and an owner claimed lost profits for a job due to a scheduling error arising from a professional service. Each of these has aspects of consequential losses as they resulted indirectly from a professional liability claim.

Regarding liquidated damages, many professional underwriters are either silent on the subject or try to limit their coverage to the extent of actual damages arising from a professional claim. Two leading underwriters specifically address liquidated damages in their forms by specifically indicating that they will only pay the actual damages that the contractor is responsible for up to the limit of the liquidated damage amount. This is different from just paying the LD amount.

3. <u>Builder's Risk Policies</u>

In the context of Builder's Risk policies, the assessment of coverage is even more complicated. Typically, Builder's Risk provides first-party insurance coverage that seeks to address most property damage during the course of construction for most project participants. Since it is not a liability-based coverage, construction project participants expect a smoother claim process for damage to the work during construction. However, coverage for Builder's Risk is not that simply. First, this coverage has wide flexibility when being placed. Different underwriters have different attitudes toward coverage; no standard policy can be pointed to as definitive on coverage interpretation. Second, the coverage one would expect to address consequential loss must be carefully worded and added to the Builder's Risk policy. This coverage often is referred to as "soft costs" and pays for indirect losses, such as re-doing drawings, paying additional interest on construction loans due to project delay from a covered loss, or in some cases the owner's loss of rents or income as the project did not open on time due to a covered direct loss. Each of these have elements of consequential losses. Some underwriters use "Delayed Start Up" coverage to address similar additional costs for delay, particularly on engineered projects where an output from the facility is expected upon completion.

In most cases these coverages address, or are intended to address, actual damages arising from a covered loss in the policy and typically liquidated damages are specifically excluded.