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Seminar 9

Are We Covered? Construction Insurance, Indemnity and Risk Management Strategies for Retail Projects

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Retail construction and development projects are as varied as the risk management options available to the project participants. In an ideal project both landlord and tenant complete their respective design and construction responsibilities on time, under budget and without claims or governmental authority complications. The business of risk management and mitigation continues to grow increasingly complex. Landlord and tenants, as well as their respective development teams and risk managers are challenged to better anticipate project risks from the outset and implement strategies to ensure timely and cost-effective deliverables.

I. Construction Risks and Project-Specific Considerations

The initial inquiry for effective risk management of any construction project is to identify each risk and quantify its consequences. Project risks generally arise from three areas: 1) scope of work or services; 2) project participants; and/or 3) the functional environment.

First, a project's scope risk typically involves construction means & methods and likely includes coordination efforts between landlord and tenant work. Project participants should take proactive measures and meet early to identify and acknowledge respective roles in undertaking these risks. Once identified, these project risks can be dealt with and assigned between landlord and tenant. Some often-encountered scope risks include:

- Hidden and/or subsurface conditions

- Material cost and availability
- Labor force adequacy
- Governmental authority involvement
- Sufficiency of plans & specifications
- Acts of God
- Schedule challenges

Second, project participants each may have risk based on their level of participation and expertise. Apart from landlords and tenants, other important participants may include design professionals, contractors, material suppliers, lenders and government agencies.

Third, a construction overall project's functional environment poses its own inherent risks and potential pitfalls. These include statutory rules & regulations, climate and weather constraints, as well as natural and man-made complexities such as contaminated site conditions, co-tenancy considerations, global health emergencies and any resulting workforce disruption.

Effective risk management of a construction project is accomplished through early and frequent collaborative (and sometimes contentious) communication by landlord and tenant teams. Although parties to retail renovation and development projects often focus on their own silos of project scope, the most successful projects reach across the lines of project participants to properly identify risks and agree upon which party is best equipped to manage and mitigate them.

A. Landlord Concerns

As parties identify construction project risk, time and effort should be spent on controlling, mitigating, allocating and insuring each risk. This effort is typically performed in three phases: 1) loss control; 2) loss mitigation and 3) risk allocation.

The initial concept of "loss control" involves affirmative efforts to prevent a defined set of losses from occurring. Landlords and tenants should be diligent and informed on the selection of the design team. Loss control on the design team usually involves selection of local architects and engineers who have worked extensively in the municipality, know the local subcontractor community and (ideally) also have experience working with the tenant or landlord on similar projects. Likewise, establishing safety regulations and engaging a contractor team that can meet the site-specific safety requirements throughout the project is a critical loss control measure. For example, contractors who were able to implement site safety protocols and immediately demonstrate adherence to CDC guidelines in response to the recent COVID-19 pandemic benefitted by continuing to work seamlessly on projects and meet schedule and budgetary needs.

Second, “loss mitigation” involves actively decreasing the negative effects of a loss once it occurs. Project participants and risk managers should develop an emergency response plan to address accidental losses through contractual provisions in leases and construction contracts that dictate insurance programmatic requirements. Some of the key concepts that should be addressed in a loss mitigation plan include:

- Communication protocols between project participants
- Primary and secondary responsibilities for loss mitigation efforts
- Identification of primary property damage mitigation companies
- Identification of primary medical care facilities and protocols

Third, “risk allocation” involves landlord and tenant teams negotiating and allocating responsibilities for project risks based on the parties’ respective roles. Contractual risk allocation through leases and construction contracts is typically viewed as the most direct way to allocate these risks. However, risk allocation by contract can only be successful as long as the obligated party takes appropriate measures to understand the scope, can bear the financial burden and effectively manage the risk (either through internal means or the insurance market). Although many landlords and tenants hasten to delegate risk downstream to subcontractors or suppliers, these project participants sometimes do not have the financial or management capabilities to take on these risks in the event of a significant loss. As such, parties should carefully consider indemnity and insurance requirements to ensure that the parties who bear these risks is financially capable of underwriting and handling them. Insurance and indemnity provisions should especially be reviewed and commented on by insurance brokers, counsel and construction managers for both landlords and tenants.

In addition to the considerations above, a major portion of risk managers’ roles involve development of an insurance program that provides comprehensive and cost-effective protections for landlord’s interests. The “traditional” structure of insurance procurement employs layers of indemnifications and general liability “Additional Insured” endorsements from downstream contractors to insulate landlord and its construction team from construction liability risk. However, the traditional insurance structure presents the following potential challenges:

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

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

B. Tenant Concerns

Risk management for commercial tenants is also fraught with perils that need to be properly delineated and carefully managed in advance of construction commencement. Typically, commercial letters of intent and lease provisions are the first area of contractual leverage that place a large risk burden from landlords onto tenants. In these scenarios, tenants' risk managers need to have a detailed understanding of landlords' design and construction obligations so that a meaningful and fact-based negotiation of risk allocation can be fairly completed.

As landlords and tenants debate letters of intent and specific lease terms, debate over several insurance-related concerns predominate. The coverage obligations focus on identifying what liabilities should be covered, who should insure over those liabilities and what amounts of coverage is appropriate. Many times, these coverage concerns focus on key concepts that are central to lease negotiations and flow directly to design and construction contracts, including:

- What types of insurance should be procured?
- How will layers of insurance be stacked?
- Who will be named as an additional insured?
- Who will be the "loss payee"?
- What are lender requirements for coverage?
- What are the amounts of coverage (actual cash value vs. replacement cost)?
- What are the parties' respective subrogation rights?

While answers to all these questions often do not come easily or quickly in landlord-tenant lease negotiations, they are crucial to the completion of tenant's risk management efforts and its interface with its design and development teams before construction contracts are executed.

The distinction between an insurance deductible and self-insured retention is important in determining when coverage is triggered. In commercial insurance scenarios, insurers typically pay the full amount of a covered claim and then subsequently seek reimbursement of a deductible from the insured. In contrast, a self-insured retention creates the primary responsibility upon the insured to actually expend funds before the insurers'

obligations are triggered. A policy holder's satisfaction of its self-insured retention obligation is a condition precedent to an insurer's coverage obligation.

For publicly-traded or otherwise well-capitalized tenants, landlords should consider the propriety of requesting specific deductibles or self-insured retention limits. In the event that a self-insurance is negotiated as part of a lease or construction project, landlords often consider and vary their demands for self-insurance limits based on the tenant's overall net worth. As a corollary landlords also include lease provisions that allow for the landlord to request continued financial assurances to cover self-insured retentions in certain periodic or situational scenarios such as store closures or other weakened financial conditions.

C. Builder's Risk Insurance

Builder's Risk Insurance ("BRI") is a form of first party coverage intended to protect 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. BRI 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 landlord/developer. This exposure can be insured and specific limits of liability purchased. Finally, the landlord/developer needs to evaluate the risk of earthquake and flood and purchase appropriate limits.

In the BRI context, an "all risk" policy is the most common. All risk protects against all causes of physical loss or damage to covered property, unless specifically excluded, limited or resulting from misconduct or fraud. The most typical form of all risk insurance provision can be found in the standard American Institute of Architects ("AIA") contract forms that require coverage for at lease the perils of fire, theft, vandalism, malicious mischief, collapse, earthquake flood and windstorm. In contrast, "named perils" builders risk insurance policies provide coverage only for specific perils, risks and losses. Named perils policies and costs vary widely but typically include risks such as fire, explosion, smoke, wind, hurricane, wind-driven rain, hail, snow, sleet, vandalism and rioting.

Although it may sound all-encompassing, all risk policies continue to be limited by insurers by continuously growing list of exclusions and limitations. Some all risk policies now provide exclusions for land, existing structures, pollution, asbestos, earth movement, collapse, erosion, settling, mud slide, wear & tear, governmental ordinance and consequential losses. As such, all such policies must be reviewed in detail based on

the project-specific risks each landlord and tenant faces. Likewise, these BRI coverages must be carefully coordinated between other insurance policies and other project participants. For example, in certain parts of the country, developers and landlords may specify in their lease and construction contracts that specific perils not be covered (i.e. flood or earthquake) because the cost of coverage does not make economic sense. In these scenarios, construction contracts must be fine-tuned so as to manage these risks downstream.

D. Commercial General Liability

The commercial general liability insurance policy ("CGL") covers and pays the amounts that the named insured and the additional insured are legally obligated to pay due to bodily injury or property damage caused by an accident. The CGL policy also covers personal injuries due to libel, slander, advertising injury and false imprisonment. The CGL insurer makes payments on behalf of the insured and the insurer is required to provide for a defense, the cost of which is paid in addition to the policy limits. The CGL insurer's duty to defend ends when the policy limit or aggregate limits have been exhausted. Policy limits are framed in terms of "per occurrence" limits, which is the total amount the insurer is required to pay for a single insured incident as well as "general aggregate limits", which identify the total amount the insurer will pay as an annual limit. CGL insurance is typically written on an occurrence basis, which allows for coverage of incidents/accidents that occur during the policy period.

To properly appreciate CGL coverage, one must also study an ever-growing list of policy exclusions. Interpretation of these exclusions vary widely throughout the country and have been the subject to countless litigation, seminars and articles. Typical CGL exclusions include:

- Expected or intended injuries
- Property in the "care custody and control" of a contractor (the "own work" exclusion)
- Faulty or defective work by a contractor
- Catastrophic losses
- Losses better addressed by other insurance policies
- Contractual liability

Some courts have interpreted CGL policies to include coverage for defective work, including work specifically performed by subcontractors while court is other jurisdictions have ruled the exact opposite way. Similarly, some courts have interpreted the exceptions to the "own work" exclusion to allow for coverage related to all repairs caused by the correction of defective work, including the work itself, if performed by a subcontractor.

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.

E. Umbrella and Excess Coverage

Umbrella and excess insurance policies are intended to "sit on top" of primary insurance. These policies are typically not triggered until the underlying primary limits have been exhausted. The amounts coverage, stacking and complexities are as vast as one's imagination. Apart from worker's compensation coverage (which is typically dictated by statutory rules and requirements) umbrella and excess insurance applies in above general liability, automobile liability and employer liability coverages. These additional polices may be written with its own defined coverage terms (known as an "umbrella form") or in a way that follows the form of coverage afforded by the primary insurance policy. Both excess and umbrella coverage would typically drop down to provide coverage for losses in excess of prescribed limits in the event that primary policy is exhausted. Notably, all umbrella and excess insurance policies are expressly conditioned upon the primary insurance coverage being in full force and effect at the inception of the additional coverages they provide.

There are some scenarios where insurance policies may be procured on a specific project basis. In some larger commercial development projects or in design-build projects, landlords and/or tenants may agree to manage insurance costs by collectively procuring a specific collection of coverages. In theory, the administrative cost as well as legal defense costs of finger-pointing would be limited or eliminated by having one single structured insurance program that covers landlord, tenant and various contractors' risks. However, these considerations are significantly time consuming and likely are only justifiable in the large and complex projects. In these scenarios, involvement of highly specialized insurance brokers and attorneys are instrumental to properly underwrite and manage these risks.

F. Professional Liability

In any construction project, there is a possibility for claims to arise from errors or omissions of design professionals, including architects, engineers and surveyors. Claims against these design team members may arise during the course of construction, or in some scenarios, years after the project is complete. Claims against design professionals that may be covered by insurance are not limited to those bodily injury and property damage categories typically offered by CGL policies. Professional liability policies oftentimes include loss of use and other consequential damages as a result of design errors. As such, landlord and tenants.

Typically design professionals are allowed to carry a "practice policy" that covers any number of projects that a professional services firm is working on. However, some owners on larger or more numerous

projects may consider requiring its design team members to carry a "project-specific" policy endorsement with its own dedicated limits to the owner's project. All professional liability policies are written on a claims-made basis and are subject to annual renewal and policy aggregate limits. If a design team only carries $1 - $2 million in professional liability insurance and is extremely active or performs services for several large projects in a given year, landlords and tenants may find themselves with a worthless insurance policy if several moderate claims or one significant claim is made against a practice policy.

Both landlords and tenants 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.

Notably, a professional liability policy does not typically provide coverage for acts or omissions of subconsultants. As such, landlords and tenants' risk managers and counsel must ensure that all subconsultants carry sufficient insurance to provide cover for losses as a direct result of the subconsultants' errors, omissions and/or design deficiencies. Also, almost all professional liability policies include a deductible or self-insured retention that must be satisfied before the insurance is required to respond to the claim. These scenarios are particularly problematic when a smaller design firm only carries $1 million in professional liability insurance but also has a $100,000 deductible. In the event of insolvency or an inability for the design firm to pay the required deductible, the insurer's coverage is negated until the deductible is satisfied.

G. Wrap-Up Policies and Alternatives

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 and landlords 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

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 • Owner designs coverage terms • Owner selects liability limits • Owner directs claims, litigation, settlement • Owner understands true underwriting premium charged by insurer • Insurance stays with project if owner disengages contractor	• Contractor-controlled • GC designs coverage terms • GC selects liability limits • GC directs claims, litigation, settlement • GC sets price: premium + mark-up • 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
- Ability to direct claims process, litigation and settlement
- No dependence on others for critical liability coverage
- Streamlined claims resolution
- Cost-effective risk transfer

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' compensation 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' compensation

program. Rather, developers require each contractor to procure its own workers' compensation coverage, and the developer incurs the cost as a fixed line item in the bid.

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:

- **Pre-Construction**
  - Assemble team of trusted advisors
  - Define your activities, assets, loss history, exposures
  - Assess current insurance market conditions for anticipated pricing, terms and conditions
  - Review operating agreements and key contracts, including GC and architect
  - Catalog contractual obligations regarding insurance and indemnity
  - Develop clear insurance exhibit defining anticipated roles and responsibilities
  - Evaluate risk appetite and financial ability to retain risk
- **Program Design**
  - Model out all available program structures
  - Produce cost/benefit analysis of viable options
  - Evaluate alternative risk financing structures
  - Identify potential coverage gaps and seek transfer or mitigation solutions
- **Marketing**
  - Provide to markets an attractive, intelligible underwriting presentation that delivers a relevant, complete and accurate picture of the risk
  - Leverage relationships, broker market clout, future project opportunities to secure the best product and price
  - Identify ancillary costs or services required (administration, loss control, peer review)
- **Implementation**
  - Communicate coverage terms, conditions and limits to project participants
  - Educate insurance program participants on coverages, obligations and resources
  - Engage OCIP enrollment administrator, safety and loss control consultants
  - Build it!

While OCIP, CCIP or other wrap-up insurance policies are not universally feasible for all commercial development types, Landlords should closely consider these risk management tools as part of their risk management assessment activities on larger and more complex projects.

H. New Insurance Products and Coverages

Business Interruption

Since the beginning of the COVID-19 pandemic, the issues of business interruption coverage and its applicability to global health emergencies has been tested in courts throughout the country. This focus on the claim viability also highlights the need for a detailed understanding of the availability of coverage and any particular limitations and exclusions that have been drafted into policies. Typically, business interruption is procured as part of property damage coverage, which addresses the damage to the physical structure of a property. However, the correlated damage or threat of damage as a result of disruption to business operations is oftentimes significantly more costly. Business interruption coverage has historically also provided coverage for losses due to civil authority orders that prevent access to an owner's property.

There are several computational methods to determine business interruption losses, including "lost business income" and "loss of rental value." However, since COVID-19's impact in 2020, insurance underwriting has undergone significant modification, scrutiny and review. When seeking to place coverage, landlords and tenants should closely evaluate how coverages have been modified and how and when certain covered losses are reimbursed.

Cyber Liability Coverage

Retailers, landlords, tenants, contractors and design professionals are all prone to cybersecurity breaches and attacks. The interconnectivity of our lives and reliance on electronic communication has only our dependence and risk profiles. The ever-increasing ransomware attacks provide daily evidence that cybersecurity insurance should be a necessary part of all landlord and tenant insurance programs.

Typically, smaller companies with less robust IT department have become the Trojan Horse that allowed cybercriminals to access large corporate networks. For example, an HVAC contractor was the reason for the 2013 Target breach that affected 41 million consumers. Because contractors and design teams c collect an increasing amount of sensitive and propriety information from landlord and tenants on construction projects, personally identifiable information, payment information, architectural plans, and even insight into a client's internal network become vulnerable.

Although costs for cybersecurity coverage have increased in the last several years, the business interruption, reputational and privacy costs to landlords and tenants requires that these coverages be explored and procured as a necessary busines practice.

Contractor's Pollution Liability Coverage

The only way to obtain coverage for mold is through a Contractor's Pollution Liability (CPL) policy. The typical CPL policy pays for clean-up cost as well as for liability resulting from third party bodily injury and property damage claims arising from a new pollutant release or exacerbation of existing pollution conditions when caused by construction activities. Notably, first-party coverage is typically not automatically available to contractors but may be purchased separately as part of its "pollution legal liability" coverage Although occurrence-based forms are available, mold coverage will be limited to a claims-made policy form.

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 coverage protocol.

Although contractors often purchase a CPL policy as a matter of sound business practices, they often do not purchase limits to fund their full liability limits on a construction project. As such, landlords and tenants are best served by making specific requests for CPL coverage from their general contractors and demanding that flown-down insurance provisions are adhered to.

Subcontractor Default Insurance

Subcontractor default insurance ("SDI") (often referred to as "SubGuard") is a high deductible insurance policy that aims to replace surety bonds. Some of the benefits of such a program are typically seen as flexible coverage and less administrative hurdles that surety bonds sometimes include. However, to properly implement an SDI program, risk managers must be extremely well versed in the financial viability of the subject subcontractors. As such, the use of SDI is typically relegated to large projects that involve large, highly sophisticated general contractors with a cadre of similar large and sophisticated subcontractors.

II. Payment and Performance Bonds

Owners and large landlords 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.

A. Key Considerations

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.

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.

B. Performance Bonds

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:

- modifications to the project;
- additions or deletions in the scope of the project;
- changes or alterations to the contract, including change orders;
- changes in the method or timing of payments under the contract; and
- 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.

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. Therefore, the owner should consider making the indemnity language as specific as possible to allow recovery of these damages.

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."

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.

C. Payment Bonds

Similar to the format of a performance bond, a payment bond guarantees payment to the principal's downstream labor and material suppliers. Payment bonds are intended to protect unpaid third-party subcontractors, laborers and material suppliers. Typically, a surety's obligations are rendered null and void upon a principals payment of all sums due. However, there are certain preconditions to a surety bond's obligations. First, a claimant must provide notice of claim, claim documentation, and commence suit as per bond's specific terms and any applicable statute. The claimant must also prove entitlement to recovery within the terms of the bond. Payment bonds also typically have extremely stringent claim notice requirements and also significantly restrict the costs covered by the bond. For example, insurance premiums loans, lost profits, delay damage and other consequential losses are not covered by a payment bond.

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.

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.

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.

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.

III. 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.

A. Rights and Responsibilities

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.

1. Insured Notice Obligations

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.

2. Insurer 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.

3. Insurer Duty to Provide Independent Counsel

With increasing frequency, insurers accept defense of a claim under a "reservation of rights," (""ROR") which amounts to non-committal communication providing that an insurer may or may not be required to pay for the defense of the claim and any settlement or judgment. While not as lengthy and convoluted as the insurance policy itself, the ROR letter is typically a dense and esoteric analysis of policy

definitions, provisions and exclusions. However, the punch line usually involves a combination of positions that allows the insurer the greatest latitude in relating to any potentially covered claim:

- Defense of the claim may or may not be covered
- Any ultimate judgment or settlement may or may not be covered
- The insurer may or may not withdraw its payment of defense costs
- The insured may or may not be asked to reimburse the insurer for defense costs
- The insured may or may not be asked to reimburse the insurer for any settlement payments

Fortunately for insureds, the law in nearly every state provides protection the insured from the insurance company's non-commitment when issuing an ROR. However, many insureds are unaware of this protection and fail to take advantage of it. Courts have recognized that an attorney appointed by the insurer has a conflict of interest in and the insured has the ability to appoint its own counsel and control the defense of the claim being litigated – both as a named insured and as an additional insured.

Landlord and tenants alike are best served by consulting with their internal risk management teams and seeking trusted counsel once a claim comes in and an insurer issues a cryptic or lengthy ROR in response.

B. Coverage Determinations and Exclusions

1. 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.

2. Additional Insureds: Complications and Considerations

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.

C. Recoverable Damages

1. 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.

2. Considerations Based on Consequential and Liquidated Damages Claims

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.

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.

Builder's Risk Policies

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.