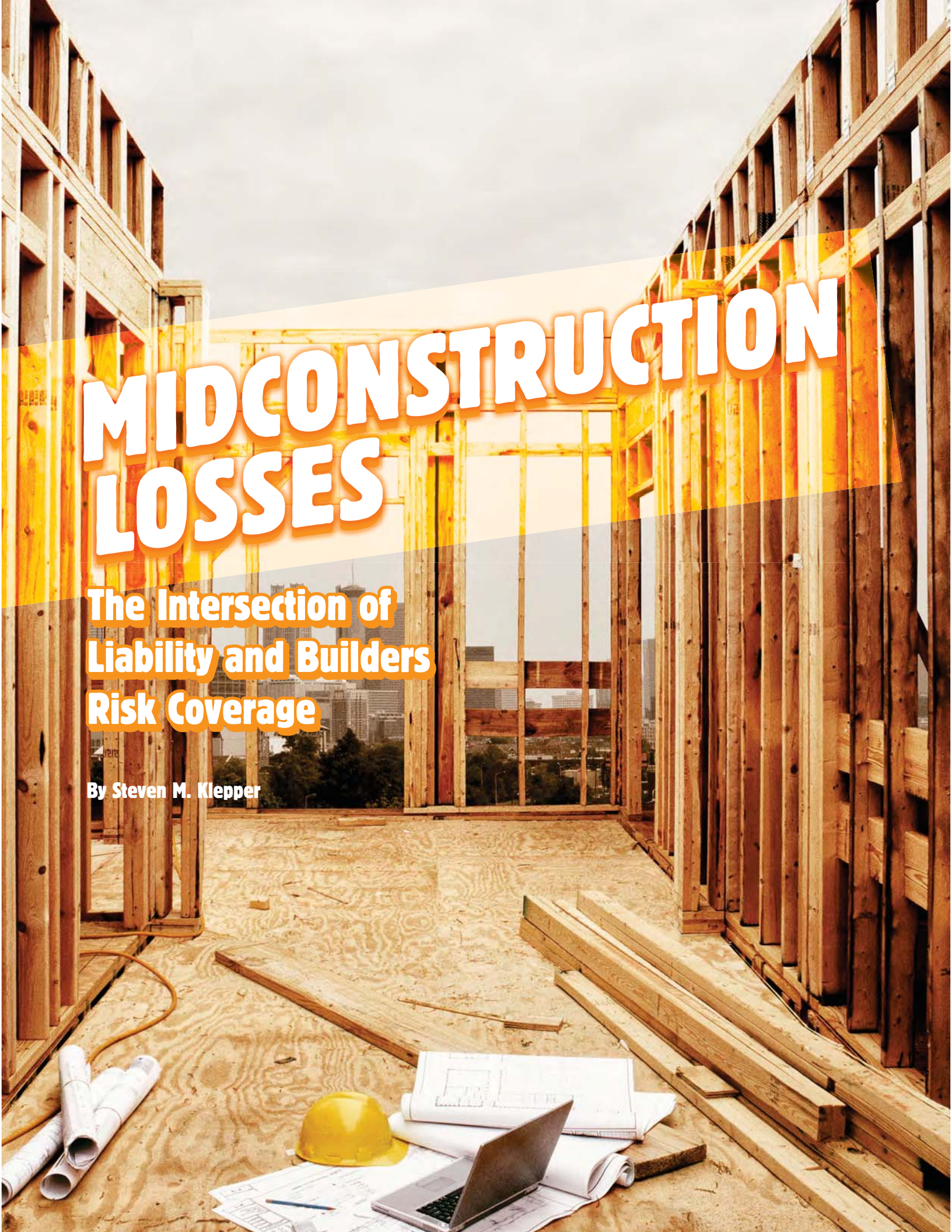

MIDCONSTRUCTION LOSSES

The Intersection of Liability and Builders Risk Coverage

By Steven M. Klepper

An insurance professional or coverage attorney may have experience in first-party coverage or third-party coverage, but often not both. When a midconstruction casualty like a fire or collapse occurs, the loss is likely to implicate both a builders risk policy—a first-party coverage usually purchased by the owner—and commercial general liability (CGL) policies purchased by the general contractor and subcontractors. The coverage picture can become a puzzle, involving potentially overlapping but not coextensive coverages. This article discusses the respective scope of coverage under builders risk and CGL policies and addresses some particular questions that arise in the interplay between the coverages.

Different Types of Applicable Coverage

Builders risk coverage. Courts have described builders risk coverage as "a unique form of property insurance that typically covers only projects under construction, renovation, or repair and insures against accidental losses, damages or destruction of property for which the insured has an insurable interest."[1] The policy pays only for damage to the construction project itself.[2] "A typical builder's risk policy provides work site insurance on a building, renovation, or construction project for property as it is brought to the site and made part of the improvements on the property."[3]

Although builders risk policies are not standardized, they are typically "all risk" policies—meaning that they cover all direct physical loss to covered property, except where exclusions apply. Builders risk policies, with varying language, typically exclude loss caused by defective workmanship, but not ensuing loss from covered causes like fire.[4]

The authority on builders risk policies is sparse, but there are at least two state supreme court decisions on the scope of the faulty workmanship exclusion. In a 2003 decision, the Florida Supreme Court addressed an exclusion for "[l]oss or damage caused by fault, defect, error or omission in design, plan or specification," with an exception for "physical loss or damage resulting from such fault, defect, error or omission in design, plan or specification."[5] When a preoccupancy inspection of a condominium revealed serious structural deficiencies, the project owner sought coverage for $4.5 million in corrective costs, claiming that the exclusion did "not exclude any costs for work that necessarily damages or destroys portions of the insured property as a result of required remediation or repair of defective property."[6] Rejecting this argument, the court held that "[n]o loss separate from, or as a result of, the design defect occurred," and thus the owner was "not entitled to recover the expenses associated with repairing the design defect. To hold otherwise would be to allow the ensuing loss provision to completely eviscerate and consume the design defect exclusion."[7]

The Washington Supreme Court, in a 2012 decision, addressed the scope of coverage for a building collapse caused by defective shoring for concrete slabs.[8] Shortly after the concrete subcontractor finished pouring the first section of the floor, "the shoring underneath the concrete gave way. The framing, rebar, and newly poured concrete came crashing down onto the lower level parking area, where the wet concrete eventually hardened. It took several weeks to clean up the debris, repair the damage, and reconstruct the collapsed floor."[9] To illustrate the scope of the faulty workmanship exclusion, the court analogized the case to one where faulty wiring work causes a fire: "the ensuing loss clause would preserve coverage for damages caused by the fire. But it would not cover losses caused by the miswiring that the policy otherwise excludes. Nor would the ensuing loss clause provide coverage for the cost of correcting the faulty wiring."[10] Because collapse was a covered peril, and because the framing, rebar, and poured concrete were not themselves defective, the court affirmed that there was coverage for the nondefective items damaged in the collapse—but not for the defective shoring.[11]

General liability coverage. In the event of a midconstruction event like a collapse or fire, the scope of coverage under a CGL policy differs from the coverage under a builders risk policy. The standard CGL insuring agreement provides that the insurer will pay "[1] those sums that the insured becomes legally obligated to pay as damages [2] because of [3] 'bodily injury' or [4] 'property damage' [5] to which [the] insurance applies."[12] Each of these five parts of the insuring agreement distinguishes a CGL policy from a builders risk policy.

First, the "legally obligated to pay as damages" requirement is central to the distinction between first- and third-party coverage. The CGL coverage is fundamentally narrower, incorporating concepts

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TIP

When a property loss occurs during construction, it is important to understand the interplay between first-party builder's risk coverage and third-party liability coverage.

of fault and legal responsibility that do not apply under first-party coverage.

Second, however, the "because of" language broadens the scope of potentially covered damages. Economic loss, standing alone, is not "property damage" under a CGL policy.[13] Nevertheless, the "because of" language means that a liable party's CGL policy may pay consequential economic damages from "property damage,"[14] which a builders risk policy does not pay.

Third, in a catastrophic event like a fire or collapse, individuals may sustain "bodily injury" within the CGL insuring agreement. A builders risk policy does not pay for such bodily injury.

Fourth, the scope of "property damage" is similar, but not identical, to the risk of direct physical loss under a builders risk policy. "Property damage" is defined, in principal part, as "[p]hysical injury to tangible property, including all resulting loss of use of that property."[15] "Physical injury to tangible property" is similar in scope to "risk of direct physical loss" under a builders risk policy.[16] Nevertheless, there is a division of authority whether "rip and tear" damage—injury to undamaged property in the course of remedying an uncovered condition—can, standing alone, constitute "property damage."[17] There is no comparable authority finding coverage for "rip and tear" under a builders risk policy. Moreover, "property damage" under a CGL policy—unlike loss under a builders risk policy—can include third-party damages, such as when a fire spreads to another property or forces nearby businesses to shut down.

Fifth, a CGL policy's ongoing operations exclusions may apply more broadly than the defective work exclusion under a builders risk policy. Exclusion J5 applies to property damage to "[t]hat particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations."[18] Exclusion J6 applies to property damage to "[t]hat particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it," but J6 "does not apply to 'property damage' included in the 'products-completed operations hazard.'"[19]

The most widely cited case on the meaning of the phrase "particular part" is *Columbia Mutual Insurance Co. v. Schauf*.[20] In that case, the Missouri Supreme Court held that exclusion J5 "denies coverage for more than just damage to the insured's work . . . by excluding from coverage damage to the particular part of property on which the insured is performing operations."[21] During the construction of a new home, a subcontractor hired to "paint, stain, or lacquer all interior and exterior surfaces" accidentally started a fire while cleaning his equipment immediately after spraying lacquer on the kitchen cabinets.[22] Exclusion J5 barred coverage under the subcontractor's policy for any damage to the kitchen cabinets, but not for the fire damage to the rest of the home.[23] Thus, the CGL ongoing operations exclusions—unlike the builders risk defective workmanship exclusion—can bar coverage for physically injured property other than the defective work itself.

When it comes to evaluating a case's settlement value, a CGL insurer faces the prospect of paying the cost of defending its policyholder in the liability action. An insurer for a subcontractor often faces a second set of defense costs—if the general contractor is named as an "additional insured" on the subcontractor's policy, the insurer may also pay a share of the general contractor's defense costs. Indeed, because many CGL policies limit "additional insured" coverage to injury arising out of the named insured's ongoing operations,[24] midconstruction damage is more likely than postcompletion damage to trigger an obligation to defend a general contractor under its subcontractors' insurance policies.

Particular Questions That Arise

"Other insurance" clauses. A CGL policy's "other insurance" clause typically states that the "insurance is excess over . . . [a]ny of the other insurance, whether primary, excess, contingent or on any other basis . . . [t]hat is Fire, Extended Coverage, Builder's Risk, Installation Risk or similar coverage for 'your work.'"[25] This clause has been held to refer "solely to first-party property coverage."[26]

It does not appear that courts have addressed the mechanics of how third-party liability coverage and first-party property coverage can be primary or excess to one another. But, as discussed in the next section, the more pressing

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question is the scope of a builders risk insurer's subrogation rights after it pays for a loss.

Subrogation. Even if a builders risk policy pays first, the builders risk insurer will then have a subrogated right to sue responsible parties. But, as a general matter, the "antisubrogation rule" precludes an insurer from asserting a subrogated claim against a person who qualifies as an insured under the policy.[27]

A builders risk policy often will provide that various persons, such as contractors and subcontractors, are additional insureds "as their interests may appear."[28] Some courts have held that this language triggers the antisubrogation rule and bars subrogated claims against all such persons.[29] The builders risk insurer can always try to seek recovery from responsible parties who do not qualify as its insureds—perhaps including architects, construction managers, engineers, suppliers, or manufacturers.

Alternative dispute resolution. Disputes may arise regarding which insured holds the power to settle a builders risk loss. The answer most likely will come from the general contract, the terms of which typically are incorporated by reference into subcontracts. Standard language promulgated by the American Institute of Architects provides:

> The Owner as fiduciary shall have power to adjust and settle a loss with insurers unless one of the parties in interest shall object in writing within five days after occurrence of loss to the Owner's exercise of this power; if such objection is made, the dispute shall be resolved in the manner selected by the Owner and Contractor as the method of binding dispute resolution in the Agreement. If the Owner and Contractor have selected arbitration as the method of binding dispute resolution, the Owner as fiduciary shall make settlement with insurers or, in the case of a dispute over distribution of insurance proceeds, in accordance with the directions of the arbitrators.[30]

Appraisers often can decide which items of claimed loss resulted from covered or excluded causes.

In some cases, it may make sense for the owner or the insurer to demand appraisal under the policy. A common policy provision states:

> If we and you disagree on the value of the property or the amount of loss, either may make written demand for an appraisal of the loss. In this event, each party will select a competent and impartial appraiser. The two appraisers will select an umpire. If they cannot agree, either may request that selection be made by a judge of a court having jurisdiction. The appraisers will state separately the value of the property and amount of loss. If they fail to agree, they will submit their differences to the umpire. A decision agreed to by any two will be binding.[31]

This language contemplates a two-party process between the insurer and "you" (i.e., the named insured). Thus, the insurer and the owner will select the two appraisers. Nevertheless, insureds other than the owner likely can submit materials to the appraisers and umpire for their consideration.[32] Although the appraisers cannot resolve questions of policy construction or conditions of coverage, they often can decide which items of claimed loss resulted from covered or excluded causes.[33]

Conclusion

Each case will present its own facts and contract provisions. In most cases, however, the builders risk insurer must pay to repair the portions of the property that have sustained direct physical loss, minus the cost of repairing the initially defective work that caused the loss. If the negligent parties are named insureds or additional insureds under the builders risk policy, the builders risk insurer is likely to face difficulty pursuing subrogated claims against them and their CGL insurers. But the CGL insurers face a broader set of risks and, if a case cannot settle quickly, the steep cost of defending their policyholders and additional insureds. A builders risk insurer often can avoid significant legal fees by demanding appraisal to resolve disputes regarding the scope and valuation of the covered loss. ■

Notes

1. Vision One, LLC v. Phila. Indem. Ins. Co., 276 P.3d 300, 303 n.1 (Wash. 2012) (quoting Fireman's Fund v. Structural Sys. Tech., Inc., 426 F. Supp. 2d 1009, 1025 (D. Neb. 2006)).
2. *Id.*
3. John V. Garaffa & Heidi Hudson Raschke, *The Valuation of Losses under Builder's Risk Policies*, Brief, Fall 2010, at 50, 50–51.
4. 4 Philip L. Bruner & Patrick J. O'Connor Jr., Bruner & O'Connor on Construction Law § 11:234 (2002 & Supp. 2014); *see, e.g.*, *Vision One*, 276 P.3d at 308.
5. Swire Pac. Holdings, Inc. v. Zurich Ins. Co., 845 So. 2d 161, 165 (Fla. 2003).
6. *Id.* at 164.

If a case cannot settle quickly, CGL insurers face the steep cost of defending their policyholders and additional insureds.

7. *Id.* at 168.
8. *Vision One*, 276 P.3d at 302.
9. *Id.*
10. *Id.* at 307.
11. *Id.* at 305, 309–10.
12. Ins. Servs. Office, Inc. (ISO), Commercial Gen. Liab. Coverage Form CG 00 01 04 13, ¶ I.A.1.a., *reprinted in* 1 Susan J. Miller, Miller's Standard Insurance Policies Annotated (7th ed. 2013) (numbering added).
13. 3 Allan D. Windt, Insurance Claims and Disputes: Representation of Insurance Companies and Insureds § 11:1 (6th ed. 2013).
14. *Id.*
15. ISO Commercial Gen. Liab. Coverage Form CG 00 01 04 13, ¶ V.17.a., *reprinted in* 1 Miller, *supra* note 12.
16. *Compare* Auto-Owners Ins. Co. v. Pozzi Window Co., 984 So. 2d 1241, 1249 (Fla. 2008), *with* Swire Pac. Holdings, Inc. v. Zurich Ins. Co., 845 So. 2d 161, 168 (Fla. 2003).
17. *Compare* Desert Mountain Props. Ltd. P'ship v. Liberty Mut. Fire Ins. Co., 236 P.3d 421 (Ariz. Ct. App. 2010), *aff'd*, 250 P.3d 196 (Ariz. 2011), *with* U.S. Metals, Inc. v. Liberty Mut. Grp., Inc., 490 S.W.3d 20, 28 (Tex. 2015).
18. ISO Commercial Gen. Liab. Coverage Form CG 00 01 04 13, ¶ I.A.2.j.(5), *reprinted in* 1 Miller, *supra* note 12.
19. *Id.* ¶ I.A.2.j.
20. 967 S.W.2d 74 (Mo. 1998).
21. *Id.* at 77.
22. *Id.* at 76.
23. *Id.* at 81. For other examples, see 4 Bruner & O'Connor, *supra* note 4, § 11:100, and 3 Windt, *supra* note 13, § 11:18A.
24. *See, e.g.*, Weitz Co. v. Mid-Century Ins. Co., 181 P.3d 309, 312 (Colo. Ct. App. 2007).
25. ISO Commercial Gen. Liab. Coverage Form CG 00 01 04 13, ¶ IV.4.b.(1)(a)(i), *reprinted in* 1 Miller, *supra* note 12.
26. Colony Ins. Co. v. Ga.-Pac., LLC, 27 So. 3d 1210, 1214 (Ala. 2009).
27. 16 Lee R. Russ & Thomas F. Segalla, Couch on Insurance § 224:1 (3d ed. 2005).
28. Dyson & Co. v. Flood Eng'rs, Architects, Planners, Inc., 523 So. 2d 756, 758 (Fla. Dist. Ct. App. 1988).
29. *Id.* at 758–59 (collecting authority on both sides of the issue); *see* 4 Bruner & O'Connor, *supra* note 4, § 11:200.
30. Am. Inst. of Architects (AIA), Gen. Conditions of the Contract for Constr., Document A201™–2007, § 11.3.10, *reprinted in* Werner Sabo, Legal Guide to AIA Documents § 4.65 (5th ed. 2008).
31. Ins. Servs. Office, Inc. (ISO), Builders Risk Coverage Form CP 00 20 06 07, ¶ E.2., *reprinted in* 1 Miller, *supra* note 12.
32. *Cf.* 15 Russ & Segalla, *supra* note 27, § 211:58 (observing that appraisal binds other interested parties, such as mortgagees, if they receive adequate notice and an opportunity to be heard).
33. State Farm Fire & Cas. Co. v. Licea, 685 So. 2d 1285, 1288 (Fla. 1996) ("[Appraisal] necessarily includes determinations as to the cost of repair or replacement and whether or not the requirement for a repair or replacement was caused by a covered peril or a cause not covered, such as normal wear and tear, dry rot, or various other designated, excluded causes.").