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CONCURRENT AFTERNOON SESSION - CONSTRUCTION INSURANCE

EIGHT CONSTRUCTION INSURANCE TRAPS EVERY PROJECT OWNER SHOULD AVOID

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Despite their potential financial significance to project stakeholders, the drafting, review, and approval of design and construction contract insurance provisions is often delegated to insurance brokers and other non-lawyer consultants.[1] Worse yet, sometimes insurance-related provisions are simply ignored and boilerplate language in construction industry forms is used without consideration or thought. As with other contract terms and conditions, parties should not accept insurance provisions in contracts without an understanding of what these contract clauses require or provide, but they often do. A lawyer called upon to draft and negotiate a construction contract who has enough knowledge regarding insurance-related provisions to raise questions and explain contractual insurance-related provisions to her client is invaluable to a project owner.

This paper focuses on eight insurance-related traps which every project owner should be wary. While we do discuss some specific contract language, we do not advocate the blind adherence to "model" or form contract clauses for insurance procurement because of the multitude of circumstances under which projects are built and project stakeholders come to the negotiating table. The benefit of a form is its weakness: even though it can be a good starting point, over-reliance by clients and lawyers on form language without asking questions and considering what it is they actually need can lead to unnecessary effects upon project cost and risk or even malpractice. When form language is appropriate, the practitioner in search of them has many options from which to choose, including IRMI's practitioners' guides.[2] In addition, if you have an interest in acquiring a deeper understanding of insurance-related provisions and what they mean and how they work the American Bar Association has an excellent resource: *Construction Insurance A Guide for Attorneys and Other Professionals*.

This paper includes a discussion of eight insurance-related provisions frequently found in construction contracts that are potential traps for a project owner. As we address each potential trap, we begin with a discussion of the provisions within many standard construction industry agreements and conclude with drafting suggestions a project owner might consider. For discussion purposes, we refer at times to the most popular construction industry form agreements for vertical construction, the American Institute of Architects or "AIA" form agreements.

1. Professional Liability Insurance

Generally, professional liability insurance in the construction context refers to insurance covering loss or damages arising from "professional services" provided by design professionals such as engineers, architects, and design-builders. Most professional liability policies have lower limits of liability than commercial general liability policies and excess insurance policies. The AIA's Standard Form of Agreement Between Owner and Architect, does not address the limits of the architect's professional liability insurance.[3] As a result, an owner seeking to require a certain or appropriate policy limit must modify the AIA form language.

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[1] This paper was prepared by Chris Dunn, Ryan Cochran, Mark Bell, and Keith Randall. All four practice law at Waller Lansden Dortch & Davis LLP in Nashville, Tennessee. Each represents clients in the construction industry with a focus on representing owners, developers, and lenders.

[2] For a list of available publications and resources, see IRMI, Risk and Insurance Publications, http://www.irmi.com/products/marketing/alphalist.aspx.

[3] § 2.5 of the AIA B101 2007 Agreement Between Owner and Architect contains a location for the parties to include professional liability limits, but does not provide guidance to the parties.

When determining whether the policy limit is acceptable, a project owner needs to know that professional liability coverage is written on a claims-made basis, and each annual policy limit can be subject to claims arising out of projects worked on or completed many years before. Policy limits in professional liability policies are also almost always "wasting," that is, reduced by defense costs. As a result, a project owner is subject to the risk that the designer's coverage is depleted by claims and legal fees arising out of the designer's work on other projects. Factors affecting whether a project owner needs to consider requiring higher policy limits include a knowledge of the complexity of the project, design professional's practice policy limits, claims history, and policy retroactive date.

2. Builders Risk (Property) Insurance - All Risk

The AIA A201 provides that "Property insurance shall be on an "all-risk" or equivalent policy form and shall include, without limitation, insurance against the perils of fire (with extended coverage) and physical loss or damage including, without duplication of coverage, theft, vandalism, malicious mischief, collapse, earthquake, flood, windstorm, falsework, testing and startup, temporary buildings and debris removal including demolition . . ."[4] Many owners review this language and assume that because the perils listed here are in a "standard" agreement, their "standard" insurance policy will cover them.[5] It is important to note that in contrast to Commercial General Liability (CGL) coverage, there is a wide variation in builders risk policy language. In fact, some carriers even offer multiple forms within their own product lines. Unfortunately, very few, if any, builders risk insurance policies actually provide full coverage for each of these perils. For example, very few policies will provide either earthquake or flood insurance without any sublimit, let alone full coverage for both. Further, even if such coverage were available, the cost to procure the insurance would be prohibitive. .

In addition, some builders risk forms contain extraneous warranties and endorsements that could bar coverage that the owner may believe it has.[6] The problem from the owner's perspective is that a contractor could successfully sue the owner for the losses it suffered by a peril the owner was "supposed to" cover. The owner then would not only be responsible for the losses it suffered because it didn't have insurance for a particular peril, but the owner could ALSO be responsible for the contractor's losses under a theory of breach of contract due to the owner's failure to obtain builders risk that covered the agreed upon perils.

Without an industry-standard-form builders risk policy, the owner must fully understand the provisions and exclusions contained in the particular builders rick form purchased by the owner. The owner should also ensure that the policy covers the risks specified in the contract and ensure that the policy does not contain extraneous warranties and endorsements that could

[4] A201 § 11.3.1.1. We use the AIA A201 2007 as our primary example because the A201 is the most commonly used agreement is the construction industry.
[5] STEPHEN D. PALLEY, CONSTRUCTION INSURANCE Ch. 2 (ABA 2011).
[6] *See generally Liberty Ins. v. Weitz*, 158 P.3d 209 (Ariz. 2007) (denying coverage in an instance where fire damage was clearly covered under the builders risk policy because the policy also contained a warranty endorsement related to supervisory oversight that the owner failed to meet).

bar coverage.[7] In our view, builders risk policies should always be read and reviewed to ensure that the owner's interests are appropriately protected.

3. Builders Risk (Property) Insurance - As their Interest May Appear

The AIA A201 provides that "This insurance shall include interests of the Owner, the Contractor, Subcontractors and Sub-subcontractors in the Project."[8] There are a host of concerns with including all Subcontractors and Sub-subcontractors in the Project. A full discussion of all of the issues is outside the scope of this paper, but it bears noting that named insureds have a number of rights available to them.[9] Named insureds can negotiate the amount of loss, be required to be named as a payee on every check, and demand an appraisal.

Further, and more importantly, conduct by named insureds can void the policy. For example, a crafty insurer may be able to use a named insured's subcontractor's fraudulent conduct to deny coverage for the entire loss. Additionally, the standard A201 language is inherently vague. Courts throughout the country have struggled to grasp what exactly this language means and no consensus has developed. Accordingly, it is difficult to know ex ante whether the owner is fulfilling the terms of the contract.[10]

Contractors and subcontractors often inaccurately assume that if their interests are included "as their interests may appear" on the builders risk policy, they will avoid subrogation. This is not accurate. Insurers often attempt to subrogate against additional named insureds and loss payees. To protect the interests of subcontractors, the owner is better served by waiving subrogation, which better ensures that the insurer cannot go after the subcontractors. (Though owners must confirm that their builders risk insurance policy allows the owner to waive subrogation).

4. Builders Risk (Property) Insurance - Fiduciary Language

The AIA A201 provides that "A loss insured under the Owner's property insurance shall be adjusted by the Owner as fiduciary and made payable to the Owner as fiduciary for the insureds . . ."[11] The term fiduciary, however, is problematic from the owner's perspective because it is a legal term of art. A fiduciary relationship imposes certain duties that vary based on the jurisdiction. A fiduciary relationship can include, among other things, a duty to act in good faith and with due regard for the interests of the other. Additionally, it often requires the fiduciary to subsume its own interests for the other's interests. It seems unlikely that any owner would intend to do this, but the clause still appears in scores of form contracts signed by owners.

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[7] To the extent the builders risk policy contains extraneous warranties and endorsements, the owner should require compliance.

[8] A201 § 11.3.1.

[9] For a more detailed discussion see Mark M. Bell, Christopher S. Dunn, James H. Costner, *Confronting Conventional Wisdom on Builders Risk: From Named-Insured Status to Concurrent Causation,* 31 CONSTRUCTION LAWYER 15 (Fall 2011).

[10] STEPHEN D. PALLEY, CONSTRUCTION INSURANCE Ch. 2 (ABA 2011).

[11] A201 § 11.3.8.

Rather than obligating the owner to act as a fiduciary, the owner should be named as the party responsible for adjusting losses. The owner can then equitably allocate proceeds. This ensures that contractors are paid what they are due, but also ensures that the owner receives all that it is entitled to receive.

5. Insurance Minimums

The AIA A201 provides minimal instruction to the parties on insurance required for the Project. It only requires the contractor procure insurance that protects the contractor from claims in eight distinct categories.[12] The only instructions relating to minimum insurance is to procure insurance that is "for not less than limits of liability specified in the Contract Documents or as required by law."[13] Because a contractor's insurance costs can often be significant, contractor's may look to squeeze more profit out of a project by procuring insurance with insufficient coverage for the Project. Without specific language in the Agreement as to required minimums, owners are in no way guaranteed that their Projects are sufficiently insured. Delegating control to the contractor over coverage minimums is inherently risky and an owner who discovers that a contractor lacks sufficient coverage is often unable to react prior to a loss.

6. Prohibited Exclusions

Similar to its lack of detail about policy limits, the AIA A201 2007 contains no discussion of prohibited policy exclusions for contractor provided insurance. Policy exclusions have the potential to subject owners to as much, if not more, risk than insurance policies with insufficient minimums. For example, CG 22 94 and CG 22 95 exclusions eliminate the "Subcontractor exception." Commercial General Liability ("CGL") policies typically do not cover damage caused to the property by defective work performed by the prime contractor, commonly referred to as the "your work" exclusion. However, historically CGL policies do cover property damage caused by defective work performed by subcontractors.[14] The insurance industry reacted in 2001 by creating an exclusion to eliminate coverage for subcontractor-based property damage.[15] Owners should carefully draft insurance-related provisions to prohibit exclusions which have the effect of sharply limiting coverage.

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[12] A201 § 11.1.1. The categories are broadly: workers' compensation; bodily injury/death/disease for employees; bodily injury/death/disease for non-employees; personal injury; property damages; automobile; bodily injury or property damages from completed operations; and injuries covered under the contractor's indemnity.

[13] A201 § 11.1.2

[14] *See Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 11-12 (Tex. 2007)(discussing history of "Subcontractor Exception".)

[15] *See* J. James Cooper, *Construction Defect Claims*, 88 MICH. B. J. 30, 33 (2009).("Importantly, because some courts have found coverage for construction defect claims based primarily on the existence of the subcontractor exception, the insurance industry has crafted two endorsements that remove the subcontractor exception to the "your work" exclusion. Forms CG 22 94 and CG 22 95 completely remove the subcontractor exception. The removal of the subcontractor exception conceivably leaves policyholders without coverage for most construction defect claims….[E]ndorsements CG 22 94 and CG 22 95 represent a dramatic shift in the industry's position because, in the past, using the subcontractor exception, the industry had made a purposeful decision to include coverage for general contractors for the defective workmanship of their subcontractors that caused damage to the project. Without the

7. **Coverage Duration**

Surprisingly to many owners, the AIA documents have little to no requirements specifying the minimum period that the contractor must maintain its insurance. Obviously, the duration of coverage is critical to owners given that most defects manifest following substantial completion. For example, within the AIA A201 2007, Section 11.1.1 requires that the contractor's CGL coverage protect from claims which may arise out of the contractor's operations and "completed operations." The inclusion of the "completed operations" phrase occurred in the AIA's 2007 edition of the A201, but as is the shown in Section 11.1.2, the "completed operations" coverage extends only to the expiration of the period for Work correction which could be as short as one year. An owner would be wise to at least pursue completed operations coverage for the period of the statute of repose.

8. **Additional Insured Status**

Most standard form industry agreements require the owner, designer, and designer's consultants to be listed as additional insureds on the contractor's CGL coverage. However, most industry forms do a poor job of clarifying the owner's status as an additional insured on other contractor policies, and the savvy owner will seek to become an additional insured on all contractor policies where that status is advantageous. Policies where inclusion is appropriate are auto liability coverage, umbrella liability coverage, and possibly pollution liability insurance. Two types of policies which would *not* be appropriate for owner inclusion as an additional insured are professional liability insurance and workers' compensation insurance for reasons which are beyond the scope of our discussion here.

It also bears noting that ISO revised the standard CGL additional insured endorsement to clarify three points: (1) coverage will not exceed that permitted by law; (2) coverage is restricted to the amount required by contract; and (3) coverage is limited to that which is required by contract.[16]

Construction contract insurance-related provisions are no more or less important than other contract clauses. Addressing these insurance-related traps - before contract documents are finalized - can save time, money, and aggravation, and avoid complex and expensive disputes if and when claims arise.

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subcontractor exception, the construction industry likely will have a more difficult challenge in overcoming the 'your work' exclusion in the standard CGL form.")

[16] *See* Mark M. Bell and Christopher S. Dunn, *An Overview of the 2013 ISO Additional Insured Endorsements and a Historical Overview: Putting the Changes into Context for the Construction Industry*, available at http://www.irmi.com/expert/landing-pages/construction/const-liability-insurance/default.aspx