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Insuring Against Construction Risk

By **Kenneth M. Block**

And **Craig K. Barnet**

Construction projects are inherently dangerous activities, and the owners of such projects are exposed to a variety of risks that change daily as the project progresses. These risks include injury to the contractor's employees, injury to third parties, physical damage to the project during and after construction, damage to adjacent property, damage to the contractor's equipment and damage caused by construction defects. It is therefore critical that owners recognize and properly allocate these risks among the owner and contractor and contractually require that such risks be properly insured. This article will address insuring against these risks.

Transfer of Risk

Ideally, the entity that is best suited to control a particular risk should be the entity that is contractually responsible for such risk. In most cases, the owner is not in a position to control risks on a construction site, and should therefore transfer the risk to the contractor and require it to maintain insurance for such risk. The transfer of risk is accomplished in the contract's indemnification clause in which the contractor (or subcontractor) agrees to assume responsibility for certain judgments resulting from third-party claims against the owner. In such arrangements, the owner benefits from a broader indemnification clause. The transfer of risk, however, is of little consequence if the contractor lacks the proper insurance coverage (or the financial ability) to support the obligations.

From the onset, it is important to recognize that the owner is ultimately paying for the contractor's policy, either transparently as a line item for the cost of the work, or invisibly as part of the contract price in a lump sum contract. Owners should be aware that just as contractual insurance policy requirements that "underinsure" the contractor could expose the owner to liabilities, contractual policy requirements that "overinsure" for the identified risks can increase the contract price or price otherwise abled contractors out of the project.

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At the core of the contractor's insurance program is the commercial general liability policy (CGL policy). The CGL policy provides coverage for legal liability and defense costs if such liability arises out of an accidental occurrence that causes bodily injury or property damage during the performance of the work. The term "occurrence" is often defined in such policies as "an accident, including continuous or repeated exposure to conditions, which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured."

In addition to bodily injury and property damage, CGL policies also typically cover personal injury (in insurance-speak, this means libel, slander and false arrest), advertising injury (i.e., damage caused by advertising, including copyright and trade mark infringement), and medical payments.

To take full advantage of the contractor's CGL policy, the owner should (1) require the contractor to name the owner as an additional insured under the policy and (2) require the contractor's insurance policy to waive its right of subrogation against the owner. The additional-insured status allows the owner to enjoy the benefits of being insured under the insurance policy, even though it was purchased by the contractor. The waiver of subrogation precludes the insurance carrier from seeking to recover contribution from the owner in the event it pays out on a claim.

Policy Exclusions

Although the language of the CGL policy gives the impression that the coverage is broad (i.e., an occurrence of bodily injury or property damage during the performance of the work), the coverage is narrowed significantly by numerous exclusions in the policies and subsequent interpretations by the courts. These carve-outs create wide gaps in coverage and subject the owner (and the contractor) to significant exposure. The owner must therefore insure these risks through other policies or contractual provisions.

For instance, it is (somewhat) well settled that CGL policies do not cover construction defects that arise during construction. The "damage to property" exclusion found in most policies specifically excludes the "particular part of real property" in which the contractor or its subcontractors "are performing operations." Courts that have upheld this exclusion have reasoned that faulty construction is a "business risk" and not to be used as a contractor's "warranty" or "performance bond." However, in certain instances the damage may fall within the "products-completed operations hazard" which provides coverage for damage arising from work the contractor completes and turns over to the owner. Such damages may be classified as an exception to the "damage to property" exclusion.

Of course, the story does not end there. Although the "products-completed operations hazard" provision may reinstitute coverage for certain claims, CGL policies also typically con-

KENNETH M. BLOCK *is a member of Tannenbaum Helpern Syracuse & Hirschtritt.* CRAIG K. BARNET *is a licensed insurance consultant and principal of MSG Consulting.* JOSHUA M. LEVY, *an associate at Tannenbaum, assisted in the preparation of this article.*

tain what is known as the "damage to your work exclusion" which eliminates coverage for "property damage" to "your work" and specifically excludes from coverage damages that fall within the "products-completed operations hazard" provision (an exception to the exception to the exclusion). The "damage to property exclusion," coupled with the "damage to your work exclusion," appears to close all doors to coverage for property damage to the contractor's work arising out of the contractor's operations. Except that, there is also an exception to the "damage to your work exclusion" in cases in which the damage to the work arises from work that was actually performed by a subcontractor.

Another important exclusion that is customary in CGL policies is one that excludes coverage from claims alleging bodily injury to the contractor's employees. Contractors are immunized from paying to its injured employees an amount beyond the statutory limits declared in the state's workers' compensation policy (unless, in New York, such injury qualifies as a "grave injury"). An injured worker's only recourse against the employer is for payment under the workers' compensation policy. Therefore, it is not unusual for the injured worker to sue the owner for its workplace injuries in order to obtain compensation above that provided by its employer's workers' compensation policy.

In such cases, the owner's remedy is to invoke its properly crafted indemnification provision to bounce the ball back to the contractor. Depending on the nature of the claim, coverage may be afforded under the contractual liability section of the contractor's commercial liability policy or liability section of its employers' liability policy. At the end of the story, this "third-party-over action" ultimately obligates the contractor's CGL policy or employers' liability policy to pay for the claim asserted against the owner.

It did not take carriers long to recognize this exposure and it is not unusual now to find an "action-over" exclusion in contractors' policies. The elimination of coverage for these type of claims presents a major gap in coverage and owners should require that such limitations be removed from its general contractor's policies. Owners should also be aware that it is now common for insurance policies purchased by the owner to also include this type of exclusion.

One final issue that should be noted with liability policies is the concept of horizontal exhaustion. Horizontal exhaustion is a concept where all the policies in a single layer must be exhausted before the next level of insurance policies begin providing coverage. In other words, if the contractor's CGL policy is exhausted, the coverage obligation would fall to the owner's CGL policy before coverage under the contractor's excess policy would be triggered.

Whether all primary, or "first layer," insurance must be exhausted before any excess, or "second layer" coverage is available has been litigated more frequently, with courts in some states applying the horizontal exhaustion doctrine and courts in other states refusing to do so. Although a recent case in Delaware concluded that in New York horizontal exhaustion governs the primary and umbrella policies but not excess coverage, the Delaware court's opinion is merely persuasive and should not be relied upon when assessing the risk. See, *Viking Pumps, Inc. and Warren Pumps v. Century Indemnity Co.*, 2 A3d 76, 89 [Del Ch 2009].

In order to best protect itself, the owner must obtain and review the contractor's (and the subcontractor's) insuring agreements. An understanding of the contractor's policy, its exclusions, the exceptions to the exclusions, and the exceptions to the exceptions to the exclusions is critical for the owner to protect itself from gaps of coverage and potential exposure. A thorough understanding of these risks will allow the owner to properly assess its risks and procure (or require the contractor to procure) the insurance necessary to fill the gaps left by its contractor's policies.

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Insurance for the Owner

Because of the potential gaps in coverage discussed above, it is critical for the owner to procure its own CGL policy in the event the contractor's policy does not respond to a claim. Gaps could arise not only because of the exclusions in the contractor's policy, but also if the contractor's policy is cancelled, a claim is filed alleging sole negligence on the part of the owner, or the contractor provides late notice of the claim to the carrier. If the owner can represent to its insurer that the appropriate contractual risk methods are in place and that the policy would be "contingent" on the contractor's policy's failure to respond to the claim, the owner could obtain premium concessions from its carrier.

One of the other important policies for the owner to obtain is builder's risks insurance which insures the building and the materials stored on site while the building is under construction. Builder's risk forms are not standardized and coverage varies greatly from one insurance company to another. The policy can cover perils such as wind, fire, theft and vandalism but will typically exclude damages that result from earthquakes, water damage and to an extent, collapse. If the owner is not a frequent developer, it could buy a project specific policy for a single project, or a "rolling" policy on a reporting form basis which insures many projects and allows new locations to be added midterm with greater ease.

In the event of a loss, most builder's risk policies cover the property on the basis of either actual cash value or replacement value. Although with new construction there should be little difference between the two valuation mechanisms, the actual cash value basis requires an additional burden of proof on the policy holder to determine the value of the destroyed property.

Although builder's risk policies cover materials and supplies used for construction, the policies typically require that in the event of a loss, such materials and supplies must have been intended to be permanently located in the building or within 100 feet of the premises. It is therefore incumbent on the owner to review the policy to be sure that the "premises" is properly defined.

Builder's risk policies do not cover equipment such as hoists, cranes or other machinery that is not part of the completed project. In addition, the coverage only extends to "your" (i.e., the owner's) building materials and equipment. The owner must therefore be certain in the construction contract that ownership of the material is transferred to the owner at the time of delivery to the project site.

Finally, owners engaged in "phased" projects with staggered commencement and completion dates must obtain a manuscript endorsement so that the coverage does not prematurely terminate. Coverage ceases when, among other things, the property is accepted by the owner. If the owner accepts and occupies a portion of the property before the remainder of the project is complete, the owner could be without coverage during subsequent phases of the project.

Reviewing the Policies

The take home message to this article is that the owner must read the contractor's and the owner's policies in order to determine the risks associated with the particular project. Although not a substitute for a professional review, a beneficial aid for a quick review of the contractor's policies is the new ACORD form—Addendum 855—that can be included with the ACORD 25 general liability certificate for New York contractors.

It is a two-page addendum requiring responses to a series of questions concerning the contractor's liability policy and identifies specific information concerning the policy. The form should be requested from contractors (and subcontractors) in addition to the general liability certificate of insurance. Nonetheless, a careful review of the policies themselves by the owner's insurance professional or legal team is the most effective way for an owner to maintain confidence in the assessment of its risks.