Builder’s Risk: Common Misunderstandings (Defects and Delays)

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Meet your presenters...

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Agenda

I. Introduction to Builder’s Risk
   ▪ Overview
   ▪ How it works

II. Defects / Cost of Making Good
   ▪ London Engineering Group (LEG) introduction
   ▪ LEG 1, 2, and 3 definitions
   ▪ DE 1 to 5 overview
   ▪ Extended maintenance
   ▪ Loss scenarios

III. Delay In Start-Up (DSU) vs. Soft Costs
   ▪ Comparing definitions and time dependence
   ▪ Time-element, Period of Indemnity and Waiting Period
   ▪ Trigger dates and scheduled completion
   ▪ Loss scenarios
I. Introduction to Builder’s Risk
I. Introduction to Builder’s Risk Overview

- What is Builder’s Risk and who is it meant for?
- As a Builder’s Risk underwriter or any underwriter, what is our mission, job?
- Who should purchase the Policy?
  - Owner/developer, lender, contractor, sub-contractor?
  - If there is loss of revenue associated with the Project, does that make the decision easier?
- Simply put; it is Property Insurance intended to cover physical damage and if needed and endorsed Soft Costs, Delay in Opening to property during construction.
  - For mid-rise/high-rise apartments, condominiums, offices, data centers, airports, transportation, bridges, sewer and water treatment plants, manufacturing plants, tunnels, bridges, highways, pipelines, etc.
  - An exposure while being constructed and perhaps for a specified time afterward prior to final acceptance
- May be endorsed to include certain other coverages such as: flood, earth movement (quake), soft costs, delay, tenant hold over
I. Introduction to Builder’s Risk Overview (continued)

- Delay In Start Up Coverage [Soft Costs (additional expenses), Rental Income and Revenue]
  - Time dependent exposures
  - Assists in protecting project owner’s “downstream” revenue exposures and additional expenses
  - Is Builder’s Risk Delay different than Property Business Interruption, from a...
    - Owner’s perspective
    - Contractor’s perspective
    - Policy Coverage (think about a Property Policy and when a loss occurs, when does the Business Interruption deductible trigger start? Does a Property Policy even have a separate deductible?)
    - Think about how your Builder’s Risk Policy and applicable Delay endorsements work. Do they work the same as your Company Property/Business Interruption form? Probably not. Thus, the disconnect starts.
  - Why does Builder’s Risk Delay work differently than Property Business Interruption?
I. Introduction to Builder’s Risk
How It Works

Policies start at site work and continue to intended occupancy, but many do not follow this path.

- Sometimes start occurs at vertical
- Sometimes Policies go to final completion, what exposure do we have from substantial completion to final completion – how/when does this go from Builder’s Risk to Property?

Insurance should include reimbursement to owner or builder for the cost of the project materials suffering accidental damage at a work site, including general conditions and profit.

Common Coverage Extensions:

- Debris Removal
- Materials in Transit to or from jobsite
- Temporary Storage not at jobsite
- Fire department service charges
- Extra and Expediting Expense and depending upon the broker/agent or lender a myriad of other coverage extensions.
- Flood, Earthquake, Windstorm & Hail

**Question for Discussion:** What does ALL Risk mean?
Section 1 Questions?

**Poll One:** The basis of indemnification is that any of the insured parties cannot get in a better (financial) position than before the loss. Should the GC be reimbursed for any “profit” (percentage) they claim on top of all the repair works? [https://api.cvent.com/polling/v1/api/polls/sp-h8jtcu](https://api.cvent.com/polling/v1/api/polls/sp-h8jtcu)
II. Defects / Cost of Making Good
II. Defects / Cost of Making Good: London Engineering Group (LEG) Introduction

https://www.londonengineeringgroup.com/

LEG Association objectives include:

- Identify and discuss issues
- Provide education on issues
- Provide a forum for presentations
- Facilitate the distribution of information
- Establish and oversee subgroups to review, assess, development or comment upon policy wordings, clauses, papers or matters of interest
- Organize and sponsor conferences and seminars
- Provide a forum for the exchange of views and information
II. Defects / Cost of Making Good:
LEG 1, 2, and 3 Definitions

LEG 1/96, Outright Defects Exclusion:
“The Insurer(s) shall not be liable for:
Loss or damage due to defects of material workmanship, design, plan, or specification.”

LEG 2/96, Consequences Defects Wording:
“The Insurer(s) shall not be liable for:
All costs rendered necessary by defects of material workmanship, design, plan, specification, and should damage occur to any portion of the Insured Property containing any of the said defects, the cost of replacement or rectification which is hereby excluded is that cost which would have been incurred if replacement or rectification of the Insured Property had been put in hand immediately prior to the said damage.

For the purpose of this policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship, design, plan, or specification.”
II. Defects / Cost of Making Good: LEG 1, 2, and 3 Definitions (continued)

LEG 3/96, Improvement Defects Wording: “The Insurer(s) shall not be liable for:
All costs rendered necessary by defects of material workmanship, design, plan, specification, and should damage occur to any portion of the Insured Property containing any of the said defects, the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship, design, plan, or specification.

For the purpose of this policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect or material workmanship, design, plan, or specification.”

LEG 3/06, Improvement Defects Wording: “The Insurer(s) shall not be liable for:
All costs rendered necessary by defects of material workmanship design plan or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property) occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification.

For the purpose of the policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship design plan or specification.”
II. Defects / Cost of Making Good: LEG 1, 2, and 3 Definitions (continued)

LEG 3/96 revision to LEG 3/06:

- White paper available to explain “why” LEG 3/06 was drafted
- Summarizes 2005 US Court of Appeal case of Skanska Construction Ltd. Vs. Egger (Borony) Ltd.
- Case arose regarding building contract dispute, not insurance policy dispute
- Legal evaluation and resultant LEG 3/06 issuance recapped

II. Defects / Cost of Making Good: Defect Exclusion (DE) 1 to 5 Overview

History: Established by London-based insurers in 1985 and revised in 1995 to limit indemnity

Note: DE 1 to 5 is seldom used in the United States

- DE1 is a total exclusion of all loss or damage.
- DE2 excludes property that is defective and property which relies for its support on property which is defective, but gives cover for other insured property which is free of defect.
- DE3 excludes property which is defective, but gives cover for other property which is free of defect and is damaged by defective property.
- DE4 is similar to DE3 but restricts the exclusion to any 'component part or individual item' which is defective.
  Note - DE4 was generally intended for machinery erection risks where an individual component could be identified in a machine as defective.
- DE5 provides full cover for both defective and non-defective property provided there is actual damage (even if only to the defective part). Cover is not given for the existence of defects. The costs of redesigning are excluded.

II. Defects / Cost of Making Good: Extended Maintenance

*Does it make sense to enhance the Builder’s Risk policy with this specific extension of coverage?*

- Types of Maintenance:
  - Visit Maintenance
  - Extended Maintenance
  - Guarantee Maintenance
- External perils are not considered (such as natural catastrophe)
- Sometimes a sub-limit is introduced
- Deductible applications may be higher
- Is there duplication in cover with the General Liability (GL) cover for completed operations?
- Is there duplication in cover with a First Party Property Cover?
- Loss example:
  - *Sprinkler breaks due to freeze... who pays?*
- Claims challenges
II. Defects / Cost of Making Good: Loss Scenario no. 1

Coverage elected: LEG 2/96 with $100,000 deductible (with no option for LEG 3)

Loss scenario:

- A new bridge is under construction
- Steel girders are bolted together and put on top of the piers
- Before the decks are installed on top of the steel girders, all of the girders collapse. There is no damage to the piers.
- All girders are damaged and have to be replaced

Cause of the collapse: Bolts are too small and could not support the stress on the joints of the girders.

Replacement costs: $5,050,000 = $5,000,000 girders + $50,000 bolts

Question: How much can the Insured get reimbursed from the loss scenario?
II. Defects / Cost of Making Good: Loss Scenario no. 2

**Coverage elected:** LEG 2/96 with $25,000 deductible (with no option for LEG 3)

**Loss scenario:**
- A house has been built with a floor and 4 walls and a roof
- Floor has a faulty design (not enough reinforcement)
- The floor, 4 walls, and roof collapse resulting in a total loss

**Cause of the collapse:** Insufficient reinforcement of structure

**Replacement costs:** $525,000 = $25,000 floor + $100,000 per wall + $100,000 roof

**Question:** How much can the Insured get reimbursed from the loss scenario?
II. Defects / Cost of Making Good: Loss Scenario no. 3

Coverage elected: LEG 2/96 with $25,000 deductible and LEG 3 option with $75,000 deductible

Loss scenario:
- A house has been built with a floor and 4 walls and a roof
- Floor has a faulty design (not enough reinforcement)
- The floor, 4 walls, and roof collapse resulting in a total loss

Cause of the collapse: Insufficient reinforcement of structure

Replacement costs: $525,000 = $25,000 floor + $100,000 per wall + $100,000 roof

*Question:* How much can the Insured get reimbursed from the loss scenario?
II. Defects / Cost of Making Good: Recap

Key Concepts to Remember:

1. There must be covered physical loss
2. Exclusion of coverage or coverage grant?
3. Is LEG 3 with additional premium and typically higher deductible than All Other Perils (AOP) worth it?
4. Are there differences in US Defect wordings vs. LEG wordings
5. Improvements/betterments are always excluded under any scenario

Great reference for future reading:

https://www.imua.org/Files/reports/An_Underwriting_Review_of_Construction_All_Risks_and_Erection_All_Risks.html
Section II Questions?...

Poll Two: Why could the definition “Cost of Making Good” be “misleading”?

a. Because it implies that any repaired is covered, even for non-physical damage claims
b. Because it implies that any repaired is covered, even for betterments (enhancements)
c. Both of the above
d. None of the above

https://api.cvent.com/polling/v1/api/polls/sp-pg8ipn
III. Delay In Startup (DSU) including Soft Costs
III. Delay in Start-Up (DSU) including Soft Costs Comparing Definitions and Time Dependence

Delay in Start-Up
- Also known as “Delay In Opening”, “Delayed Completion”, or “Advance Loss of Profits (ALoP)
- IRMI defines as “… [insuring] against income loss or specified additional expenses (such as additional interest charges and advertising expenses) that result from a delay in the completion of a construction project beyond the expected completion date as a result of covered property damage.”
- Rental and business income values defined over a specific period of time with a monthly pro-forma

Soft Costs
- Part of DSU cost definition, not driven by income
- Intangible costs incurred as additional expenses in the event of a loss resulting in physical damage
- Value basis may be 100% or broker/client loss estimate

Examples of Time Dependent and Non-Time Dependent

<table>
<thead>
<tr>
<th>Time Dependent</th>
<th>Non-Time Dependent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction loan interest</td>
<td>License and permit fees</td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>Advertising and marketing fees</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>Legal and accounting fees</td>
</tr>
</tbody>
</table>
III. Delay in Start-Up (DSU) including Soft Costs
Builder’s Risk DSU vs. Property BI

**Builder’s Risk Delay In Startup**

- Insured Value
- "S" curve
- Buildup of Values
- Mob to Site
- Loss Event #1
- Loss Event #2
- Substantial Completion
- Cumulative Delay
- Term

**Property Business Income**

- Policy Expiration
- No Buildup of Values
- Loss Event #1
- Loss Event #2
- Term
III. Delay in Start-Up (DSU) including Soft Costs

Standard Definitions

Insurance Agreement
Subject to all terms, conditions, limitations and exclusions of this endorsement, and of the policy to which this endorsement is attached, in the event of direct physical loss of or damage to insured property, the Company shall indemnify the Named Insured for SOFT COSTS/ADDITIONAL EXPENSES*, Loss of RENTAL INCOME* and/or Loss of GROSS EARNINGS* sustained during the PERIOD OF INDEMNITY* as a result of the DELAY* in completion of the INSURED PROJECT*, on an actual loss sustained basis.

Period of Indemnity
The number of calendar days stated in the Declarations of this Endorsement which are in excess of the DEDUCTIBLE PERIOD*. The PERIOD OF INDEMNITY* for any insured DELAY* hereunder shall not be limited or otherwise affected by the expiration, cancellation or termination of the Policy.

Delay
The period of time between the ANTICIPATED DATE OF COMPLETION* and the actual date on which commercial operations or use and occupancy can commence with the exercise of due diligence and dispatch.
III. Delay in Start-Up (DSU) including Soft Costs
Standard Definitions (continued)

Anticipated Date Of Completion
The date stated in the Declarations of this Endorsement on which the work is scheduled to be completed for commencement of commercial operations or use and occupancy.

Question: So if the actual loss date is before the ANTICIPATED DATE OF COMPLETION, WHEN DOES the DELAY TRIGGER START?
III. Delay in Start-Up (DSU) including Soft Costs Loss Scenario no. 1

Loss scenario:

- As of completion of the project the Developer/Owner is going to rent the majority of the available space out to a key anchor tenants with a 10-year lease
- As an incentive the developer/owner rents out the space for the first year for free to the tenant (rent-free)
- Year 2 the rent to be paid by the tenant is $5,000,000
- Because of the simplicity of the project the broker suggest a 30 days waiting period and a POI of 12 months
- There’s a fire and the total repair (delay) is exactly 12 months after which the anchor tenants moves in

**Question 1:** What will be paid out by the insurer?

**Question 2:** What should the broker have suggested to do to provide more protection for the Owner Developer?
III. Delay in Start-Up (DSU) including Soft Costs Loss Scenario no. 2

Loss scenario:

- **Client projects the total rental income for his project to be $9,000,000 for the first year**

- **After 6 months the projected rental income is $3,000,000 (based on 50% occupancy) and after 12 months $9,000,000 (based on 100% occupancy)**

- **During the construction the project suffers a fire and the Delay is 6 months after which the tenants can go in and start paying rent**

**Question 1: What do you think the client would/should be reimbursed for? (for this example assume there’s no time deductible)**
Module III Questions...

Poll Three: If the actual loss date is before the ANTICPATED DATE OF COMPLETION, when does the DELAY TRIGGER START?

A. Date of the loss
B. Policy Expiration Date
C. Depends upon the Policy Expiration Date
D. The ANTICPATED DATE OF COMPLETION at the time of loss

https://api.cvent.com/polling/v1/api/polls/sp-1nxrob
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