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Complexities of Builder's Risk Insurance Claims: Ownership of Policy, Amount and Type of Coverage

Evaluation of Policies Based on Pricing Considerations, Location, Environmental Factors, Type of Construction

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Who Buys the Builders Risk Insurance for a Construction Project?

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SUMMARY:

There is no definitive right or wrong answer as to whether the owner or contractor should purchase the builders risk insurance for a construction project. The determination is best made on a project-by-project basis, taking into consideration such factors as:

- the type of project (i.e., new construction or renovation of an existing structure),
- type of contract (cost plus or stipulated sum),
- financing/lender's requirements (owner may want to "bundle" soft costs and loss of income coverage with the builders risk policy to avoid claim delays and argument among insurers over coverage),
- the presence of a master property program (owner or contractor),
- location of project,
- the parties' relative economic leverage to negotiate the most favorable premium and coverage,
- the contractor's level of sophistication, and
- the owner's desire to participate in project-specific risk management.

Owners generally feel that they should control the builders risk insurance purchase because they ultimately pay for the insurance (whether directly or as a pass-through). Owners' concern over prompt, adequate claim payment, as well as keeping project lenders' wishes or requirements satisfied, is often a reason provided for owner-purchased builders risk coverage.

Contractors, on the other hand, often argue that owner-purchased coverage is inadequate, and that contractors are in a better position to leverage volume discounts and coverages.

Brief overview of builders risk insurance:

Builders risk insurance is property insurance, not liability insurance. It is purchased by an owner (or, if required by the owner in the construction contract, a contractor) to cover an interest in a building under construction, alteration, or repair. Under general contract principles, when a contractor contracts to erect a building for a certain price, it is not discharged from performance until the building is complete. If the building is damaged or destroyed by fire, windstorm, hail, rain, vandalism, etc. before construction is complete, the contractor must rebuild at its expense in order to satisfy the contract. Absent agreement to the contrary, the risk of loss does not pass from the contractor to the owner until completion. This risk of loss during construction, the "builder's risk," is covered by the builders risk policy. Builders risk insurance may be thought of as the predecessor to the property damage insurance most owners will obtain upon taking possession of the building.

Anyone who has an insurable interest in a building or in labor being put into a building under construction may be covered as an insured under a builders risk policy, including the owner, a mortgagee, subcontractors of all tiers, or anyone else who would either profit or gain some advantage by the building's continued existence, or suffer loss or disadvantage by its destruction.

In evaluating builders risk insurance, it is helpful to keep in mind the following goals of the owner:

- Complete the project on time without unnecessary delay and within budget.
- Keep insurance costs reasonable; prevent such costs from being a profit center for contractor and subcontractors of all tiers.
- Ensure that foreseeable risks are properly insured.
- Properly allocate risks to those in the best position to control them.

OWNER-PURCHASED BUILDERS RISK:

Advantages to Owner:

- Permits the owner to control the costs of insurance (i.e., no marked-up pass throughs)
  - Larger deductible will keep costs down, but if too large, contractors will have a better argument to avoid paying the deductible when negotiating construction contract)
- Security - permits owner to ensure that the proper amount and type of coverage is in place
  - may choose proper form and endorsements (i.e., named peril vs. all-risk, replacement cost vs. actual cash value)
  - can ensure that level of coverage is appropriate and project is properly valued
  - can ensure that premiums are paid
  - can ensure that insurance will not be cancelled without Owner's knowledge
  - can ensure that all lender's requirements for builders risk insurance are satisfied
- Permits the owner to ensure that lender, contractor and all tiers of subs are included to the extent their respective interests are insurable (keeps overall costs down – avoids duplication of similar or identical coverage and makes subs more comfortable that subrogation suits will not be filed against them)
- Reduces the opportunity for insurance proceeds to be improperly used
- Owner can control claims (will know if and when claims are filed) and can participate in claims adjustment (in a position to demand prompt and adequate claims resolution)
  - also permits owner to participate in replacement cost value determination
- Most lenders prefer, or may require, that owners purchase builders risk directly
- If the project involves renovation work or otherwise may impact adjacent properties, it is much better to have coverage and claims coordinated through owner-controlled policies, and it may be cheaper to add the builders risk coverage to the owner's existing property policy as an "installation floater."
- "Soft costs" coverage and "loss of income" endorsements are often required due to financing or lender requirements. The complexity of resolving claims that impact the builders risk policy and an owner's soft cost or lost income claims make it prudent to have all coverage under one policy and the owner in control of that policy.
- Can include coverage for a project under a master policy for better pricing
- If using a cost-plus contract arrangement, better for owner to purchase so the owner can ensure no mark-up or premiums on insurance costs

Disadvantages to Owner:

- Higher volume of smaller claims more likely -- contractors and subcontractors are less likely to consider loss experience, resulting in more claims (so owners should require contractors and subs to pay deductibles on claims to militate this concern)
- Contractors may insist on "difference in coverage" insurance if they deem the owner-procured builders risk insurance inadequate, thereby raising costs
- Increases contractor concern over unpaid/improperly paid/delayed claims
- May result in duplication of coverages (especially at the subcontractor level), resulting in higher overall project costs and potential delay when insurance companies argue over priority of coverage before paying
- Owner must participate in filing, adjusting and resolving claims made by contractor and subs. This may be advantageous because owner knows what claims are filed, but unfavorable because of increased administrative costs and burden.
- Owner's administrative efforts are increased to ensure that it is not being charged by contractor and/or subs for overlapping or duplicate coverage and/or in calculating the costs of insurance that contractors or subs have built into their fees
- Owner is disincentivized to make claims in order to keep "loss experience" to a minimum; this may foster bad feelings with contractor and subcontractors who want to make a claim but feel pressured to refrain from doing so

CONTRACTOR-PURCHASED BUILDERS RISK:

Advantages to Owner:

- Contractors (especially the major players) may in a better position to obtain a volume discount
    - may include the project in an existing blanket policy
    - may bundle with other coverages (materials in storage or transit, equipment and tools used on project, etc.)
- Reduces the volume of minor claims made
- Reduces owner's administrative burden to process and administer contractor and subcontractor claims (i.e., takes owner out of the middle of claims)
- If using a stipulated sum contract, may be better to let contractor purchase builders risk, as owner is less concerned about the cost of individual items such as insurance.
- If contractor is required to purchase boiler and machinery insurance for new construction, contractor can get an endorsement to its builders risk insurance that covers testing of boiler and machinery equipment. It is likely cheaper in the long run to combine these coverages at the outset.

Disadvantages to Owner:

- Cannot control claims or timely payment thereof, which(may lead to further delays because contractor and subcontractors will not want to correct damage until the insurance company pays the claim
- Contractors have little incentive to keep builders risk coverage costs down because they (and subcontractors of all tiers) pass the costs through to the owner
- More minor claims because contractor will not want to eat labor and material costs already paid once by owner
- Contractor will make claims directly (many times without owner's knowledge) and will be paid directly; owner loses some control over the proper allocation of the insurance proceeds to subs, etc. This may result in more project delays and claims/liens filed against owner.

Contractors' reasons for wanting to purchase:

- Many contractors feel that the risk of loss has been passed to them until the project is complete, so they should have the right to manage that risk, including the negotiation and purchase of builders risk coverage
- If owner-purchased, contractors have increased concern that some of their profit may be negotiated away by the owner when resolving claims (owner's incentive is to get enough money to cover materials and, to some extent, labor, but not overhead and profit)
- Contractors want to bundle builders risk coverage with equipment and tools coverage, many have blanket or master policies
- Contractors like to control claims to ensure they are properly resolved so that contractor can complete the project on time and avoid delay damages