

# BUILDERS VS. MOTHER EARTH

## COASTAL CONSTRUCTION GROWTH PROMISES MORE BUILDERS CLAIMS FOR NATURAL CATASTROPHE DAMAGE.

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According to the Insurance Information Institute, 2016 insured natural disasters in the United States accounted for more than \$23.8 billion in damages. Worldwide, the total estimated damages attributable to natural disasters was \$175 billion. Last year marked the end of a four-year downward trend in damages from natural disasters since Hurricane Sandy in 2012.

In 2012, the storm—officially named “Super-storm” Sandy—generated losses in excess of \$70 billion in the New York and New Jersey area, causing damage to more than 650,000 housing units. Insured losses amounted to \$25.85 billion either through private insurance or the National Flood Insurance Program. Accordingly, less than 40% of the cost of damages sustained were covered by insurance.

Similarly, in 2005, Hurricane Katrina caused more than \$108 billion in damages. Private insurance paid claims in excess of \$41 billion, while the National Flood Insurance Program paid an additional \$16.3 billion in claims. Overall, 53% of the damage caused had insurance coverage.

While natural disasters can strike in any part of the country at any time, according to census data and the National Oceanographic and Atmospheric Administration more than 50% of the country’s population now lives in coastal watershed counties. These counties are generally defined by NOAA as counties with at least 15% of the total land area located within the coastal watershed. NOAA estimates that this population will grow by an additional 8% by 2020.

With growth of the coastal population, it would stand to reason that much of the nation’s construction and development will continue to occur in coastal areas. Housing, infrastructure and business will inevitably expand to accommodate the influx in residents and visitors.

Review of this demographic shift serves as a perfect segue to examine the types of losses that may occur during the course of this growth and development. While the majority of the losses which will

occur will impact completed homes, businesses or infrastructure, projects that are under construction will not be immune and, in fact, may be more susceptible.

To aid in our examination of potential exposures, let’s look at a hypothetical mixed-use retail and residential construction project known as The Oscar located in the town of Glenn Falls. The Oscar is situated on a river, approximately a mile from the Gulf of Mexico and consists of two five-story mixed-use buildings containing 35 residential units situated above seven commercial/retail units. The Oscar was to be completed in two primary phases, Oscar East (Phase I) and Oscar West (Phase II). The builder maintained six trailers on site located on the lower elevation of Phase II, which stored materials needed for the project, including windows, interior doors, batting insulation, sheetrock, millwork and custom cabinetry.

In the fall of 2016, the project sustained significant wind, rain and storm surge damage when Hurricane Julianna, a Category 4 hurricane, made landfall. At the time of the storm, Oscar East was 95% complete, with four of the seven retail properties occupied and open and only punch list items remaining in the upper, residential portion. Oscar West was recently started and not planned to open for another six to nine months. While the lower-level retail spaces of Oscar West had windows and doors installed, installation of the windows and exterior cladding in the upper residential floors had not been completed.

Hurricane Julianna caused substantial roof and façade damage to Oscar East due to wind, which resulted in rain/water damage to all 35 residential units. Moreover, the seven lower retail units were damaged due to storm surge flooding that resulted on the site. The river had flooded on previous occasions but never to the level that resulted from the hurricane storm surge.

Framing of the upper three floors of Oscar West was destroyed as a result of wind, and the storm surge caused the building’s foundation to shift and crack, resulting in

irreparable damage. Further, the six storage trailers on site were partially submerged in water for nearly one week, leading to a complete loss of all stored materials.

### Coverage and Claims for Site Losses

In the context of completed projects or existing structures, the primary area for coverage is generally through property and casualty insurance. In some instances, additional claims or coverage may exist under general liability or professional liability policies where a property owner brings claims against a builder, architect or engineer for defects in the structure that allowed further damage. For ongoing projects, however, the primary area of coverage is through builders risk insurance.

In nearly all construction projects, including The Oscar, builders obtain builders risk insurance to protect their project from losses which may be incurred during the construction phase. These policies cover the structures and/or buildings being built, as well as on-site materials, fixtures, supplies, machinery and other equipment to be incorporated into a project. Builders risk policies typically exclude coverage for existing structures on the site, tools and equipment used by the contractors, and the actual land upon which the project is being built. Moreover, materials and equipment in storage awaiting delivery, such as the items stored on site in the flooded trailers, and property in transit are very likely not covered under the builders risk policy.

Unlike property and casualty policies, builders risk insurance is intended to terminate when the work has been completed and the property is ready for use or occupancy, although some minor finishing work might remain. Because a precise project completion date is difficult to predict, the language contained in the policy, as well as the contract documents, is critical. Builders risk policies will usually terminate coverage when any of the following events occur: (a) the policy expires or is cancelled; (b) the insured's insurable interest in the property ceases; (c) the named insured abandons the project and does not

intend to complete it; or (d) the project is accepted by the owner/purchaser.

Under The Oscar's fact pattern, a significant preliminary question to consider is whether the builders risk policy would cover damage to the retail spaces at Oscar East given that the shops are already being used and would have a certificate of occupancy issued.

In most situations, builders risk policies are designed to protect the project from events leading to damage that are outside of the builder's control. These policies are typically written on two bases: (a) "named peril"; and (b) "all-risk". Natural events like earth movement and floods are almost universally listed as exceptions to builders risk policies, affording no protection unless the builder obtains supplemental coverage.

"Named peril" policies provide coverage for losses which arise from specific causes delineated in the policy. For instance, the ISO short form identifies 11 covered perils: fire; lightning; explosion; windstorm or hail; smoke; aircraft or vehicles; riot or civil commotion; vandalism; sprinkler leakage; sinkhole collapse; and volcanic action. In order for coverage to be triggered under these policies, the insured builder must demonstrate that the loss was the result of one of the covered perils.

Conversely, "all-risk" policies are broader and provide coverage for losses not specifically excluded or limited by the policy. In this instance, the insured builder bears the initial burden of demonstrating coverage is triggered, thereafter shifting the burden to the insurer to demonstrate that exclusion or ambiguity is applicable. Yet, even where a loss is covered, particular attention must be paid to exclusions and limitations on coverage in the policy, particularly as they relate to catastrophic property damage due to natural or storm-related disasters. For example, the manner in which a policy defines the term "storm surge" could significantly impact the availability of coverage on the loss for the retail properties at Oscar East and the structural foundation damage at Oscar West. Some policies include storm surge as a windstorm peril, while others define storm surge under flood. In the

former, coverage will likely exist under most builders risk policies, while in the latter, coverage will very likely be denied. Moreover, builders risk policies that specifically cover hurricanes, or "named storm" events, may limit the coverage available by imposing sublimit coverage and/or including a higher deductible. Thus, though coverage may exist for these occurrences, the full limit of coverage might not.

These policies may also contain concurrent causation exclusions which precludes coverage for concurrent causes of a loss (one covered and one not covered) regardless of what they are or how they contribute to the loss. The inclusion of concurrent causation exclusions in builders risk policies could negate loss coverage that would otherwise exist if it were not for the contributing secondary cause.

In the Oscar project hypothetical, the type of builders risk policy obtained by the builder will significantly impact the coverage analysis for this loss. For instance, the inclusion of a concurrent causation exclusion to the policy could materially alter the available coverage for damage sustained to Oscar East residential units that was the result of windstorm (covered) and rain (not covered). Similarly, if the policy defines storm surge to fall under flood rather than windstorm, our builder could face a significant coverage shortfall for damages to both buildings and its stored materials, particularly if he did not obtain supplemental flood insurance.

Clearly, changing the variables to the hypothetical scenario will alter the outcome. Such is true in real life, where failing to ensure that proper coverage is secured may result in the natural catastrophe for the physical project becoming a financial catastrophe for builders and owners.

### Liability for A&E Design Flaws

In addition to the builders risk coverage questions for the general contractor and owner, there may be exposure questions to consider for the architects and engineers on the project. Where gaps in coverage exist under the builders risk policy, a builder/owner could turn to the

architect or engineers if the damage can be attributable to an omission by the design professionals. For instance, if the architect selected windows or surfaces with inappropriate wind and storm ratings or the engineer failed to consider the flood history or storm surge potentials when designing levees, berms or seawalls, risk shifting may be a possibility. Referring back to The Oscar, the window-system or cladding failure may be attributable to improper selection of materials attributable to the architect, while failing to take into account the prior flood history at the site may be a claim properly asserted against the engineer.

Builders risk policies exclude coverage for professional liability of its insureds and would not include architects and engineers as named insureds on the policy. In some instances, design professionals may be listed as additional insureds on a builders risk policy; however, most claims against an architect or engineer for the provision of professional services are covered by the design professional's own errors and omissions policy. The design E&O policy will not offer coverage to other parties on site, nor will it provide coverage for damage to property on site unless the damage specifically arises from a "wrongful act" or the "negligent" provision of professional services, depending on the policy language.

As with the builders risk policy, E&O professional policies have a number of exclusions that limit coverage which may vary from carrier to carrier and state to state. They generally include willful/reckless acts, liquidated damages or general conditions, faulty work by the contractor, pollution, and contractual liability based on risk transfer that does not arise from the provision of professional services. Importantly, E&O policies often have eroding coverage, meaning that the policy limits include both the defense costs and expenses paid on a claim.

In the context of The Oscar, the primary area of concern would relate to flooding and whether the engineers properly considered the flood history, including any code or ordinance requirements. Similar exposures can be found nationwide in re-

sponding to known hazards of the region. In addition to hurricane concerns in the Southeast and on the East Coast, exposures may include earthquake-resistance building codes on the West Coast, codes related to snow loads or blizzards in the Northeast or hazards related to project-specific issues, such as water treatment and pollution discharge in fracking operations. In most situations, the risk that the designer has to respond to is a "known" hazard, and the mere fact that the known hazard is not responded to adequately usually does not affect coverage.

### Permitting and Code Changes

Another issue that may impact incomplete construction projects damaged by natural catastrophes is code changes. Normally, code changes do not occur so quickly as to change mid-project; however, it is not unheard of for regulations to arise during construction, especially in response to catastrophic events. Although Phase I and II of The Oscar were planned to be completed in 2016 and 2017 respectively, planning, design, plan approval, and permitting for the project likely began several years earlier. If Glenn Falls adopted a later edition of the International Building Code or updated environmental regulations went into effect, then the builder could be required to meet those codes prior to the issuance of any reconstruction approval or certificates of occupancy.

In response to natural disasters such as Hurricane Julianna, cities and counties regularly address or update portions of building codes to prevent similar issues from occurring in the future. An example may be the storm rating of windows or exterior doors. If The Oscar were not completed prior to the code changes going into effect, whether all windows and exterior doors in the project would have to be replaced would depend largely on the decision of the locality. If there are windows that were not damaged due to the storm, then a builders risk policy will not normally cover their replacement due to a code change during the course of the project.

With regard to the completed por-

tions of The Oscar, the question will likely be whether the structure is being "rebuilt" or "repaired." In situations where repairs are merely being made, such as in Oscar East, then there may not be a requirement to adhere to a later code, depending on the scope of the repair. Conversely, Oscar West will likely require complete reconstruction and thus may be subject to applicable changes or updates in the code. Some carriers offer coverage to rebuild to upgraded codes under either builders risk or property and casualty policies, but it is not a standard coverage.

A final aspect to consider in regard to code standards involves LEED-certified structures. With significant tax benefits, incentives or credits offered to new construction that attains various LEED levels, maintaining that certification can be vitally important to a project on an economic basis. In the context of The Oscar, its LEED status could be downgraded or lost altogether due to having to demolish or replace parts of the work, depending on how those sections are reconstructed. As with permitting issues, none of the referenced insurance types will cover remedial or additional efforts to maintain a desired LEED certification; however, several carriers offer separate policies that will provide coverage for these additional costs or expenses as well as time delays related to the same.

Clearly, a construction project impacted by a natural disaster will create a host of issues for builders and owners, inevitably delaying the project and increasing costs. While the disaster itself is unpredictable, and dealing with delays may be unavoidable, ensuring that a project is adequately insured may be the best way for project builders and owners to mitigate potential losses they may face. When handling natural catastrophe claims for builders, the exceptions may define the rules. ■

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