

# Builders Risk Insurance: Is It Always Necessary?

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"Le bon Dieu est dans le detail." (God is in the details.)

*~Generally attributed to Gustave Flaubert (1821–1880)*

*"The devil is in the details" is a variant of the proverb referring to a catch hidden in the details.*

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When building construction occurs as either ground-up new or renovation of an existing structure, most risk management professionals assume that the exposure requires a builders risk policy. Is this assumption correct? It depends on the details—the information necessary for the risk management professional to decide whether the construction exposure needs a builders risk insurance policy or another property policy that can or does provide same, similar, or better coverage than a builders risk insurance policy. The devil is in the details as the correct insurance response to the construction exposure may not be obvious. The exposure review starts with the insurable interest of the various parties to the construction contract to build the new building.

## Insurable Interest

The first step to determine the appropriate first-party (property) insurance policy for an individual or organization is to establish the party's insurable interest. Insurable interest is the legal concept that an insured (i.e., first named insured and any other insured) on a property insurance policy must have a financial interest in an object (building) and will suffer some degree of financial loss if the object is damaged or destroyed. The named insured may be one or more parties depending on how construction will be conducted such as the owner, the owner's general contractor ("GC") when the owner does not act as GC itself, and any subcontractor(s) ("sub") hired by the owner or GC. The construction contract will identify the various parties involved in the building construction.

The owner that builds for itself will have an insurable interest throughout the course of construction. The GC will likely have an insurable interest from beginning of construction until final acceptance and payment by the owner. Subs, when hired to do portions of construction, will have a period of insurable interest from inception of their work for the GC until final payment and acceptance of the work by the GC. How can these three unrelated interests all have an insurable interest in the same building? The owner has a direct damage exposure during the time of construction equal to (1) its funds expended for any of its own labor and supplies and (2) for payments made to the GC and/or subs. In turn, the GC and sub have a direct damage exposure equal to their labor, supplies, and profit. The named insured in this example may be ACME Building (ACME) as owner, ABC General Contractor as GC, and any subs hired by the owner or GC.

## New Construction: Builders Risk Policy

Let's assume that ACME does not have any other buildings, so it does not have another property insurance policy that may be considered for the new construction. What does ACME do? It has two options: (1) purchase a builders risk policy itself to cover the construction exposure; or (2) enter into a construction agreement with the GC and make the GC responsible for placement of the builders risk policy. The coverage terms, conditions, and policy limits should be the same whether coverage is obtained by the owner or the GC.

Is direct damage the only exposure for ACME? Likely not. There may be other costs that need to be insured. If the building will produce an income stream quickly after it's completed and put to its intended use (rental space), it may have a business income exposure during construction (loss of rents). The owner may have other costs, such as architectural, engineering, financing, and legal fees (soft costs) that may be incurred if the building is damaged during construction. Soft costs can be insured but may need to be added by a specific endorsement to whatever property insurance policy is used to insure the builders risk exposure.

In either option 1 or option 2, the named insured will be the same: each party's interest will need to be identified, such as ACME Building (owner), ABC General Contractor ("GC"), and any subcontractor thereof. Does it matter which interest is the first named insured? It can, as the first named insured in the policy will receive notice of cancellation and/or nonrenewal, can make changes to the policy (increase or decrease coverage), can receive return premiums, and is solely responsible for any deductible. The first named insured issue should be reviewed carefully by both ACME and the GC to ensure that various notices and responsibilities rest with the proper named insured.

The builders risk policy, whether obtained by the owner or the GC, will need to be carefully reviewed, as with any property insurance policy, to make sure that coverage terms (property insured, soft costs, etc.) and perils insured are appropriate for the exposure (i.e., special perils including flood and earthquake) and that the limit will satisfy all insurable interests including whatever is required specifically in the owner's mortgage agreement and the construction agreement between the owner and GC. Special consideration will need to be made as to amount of deductible and which party is responsible

for its cost—the owner or GC—even if the policy is obtained by the GC. The construction agreement must be clear as to the policy deductible responsibility if it will not be the sole responsibility of the first named insured.

A building owner such as ACME may be able to obtain a builders risk policy on its own but may find that the GC is able to secure the policy with better coverage terms and a more competitive premium. A GC should not be overlooked as having the potential to obtain a better builders risk policy for an owner. The minimum coverage requirements for the builders risk policy do not change based on which party procures it—the owner or GC—as the policy must address all exposures and satisfy all insurance requirements in mortgage and construction agreements.

## Other Commercial Property Insurance

In our first example, ACME was having a building constructed and did not have any other property insurance policy(ies) to consider for the construction exposure. Let's change the scenario, and now ACME will construct a fourth building and has a commercial property policy in effect for its other three buildings. What options are available to ACME as the owner?

ACME may be able to use its existing building and personal property coverage form for the construction exposure instead of a separate builders risk policy. Deciding which policy to use—builders risk or the existing building and personal property policy—will require scrutiny to ensure that both options provide necessary coverage terms and conditions. This review can become complex as many property insurers use independently filed policy forms for builders risk and building/personal property policies. These policies may also be different from Insurance Services Office, Inc. (ISO), filed forms. Some property policy forms easily provide coverage for a builders risk exposure equal to that which may be provided by a builders risk policy. The devil is in the details to ensure that the most appropriate policy is chosen for the construction exposure.

There are some new construction issues to consider when comparing building and personal property coverage, whether as a monoline policy or coverage within a package policy (businessowners or other) to a builders risk policy. Remember, even if the boilerplate policy has some construction coverage, the underwriter may not be comfortable with the actual exposure when notified and may not provide coverage beyond any stated coverage terms.

- Does the definition of "building" include new construction as "covered property"?
- If there is a sublimit for "newly constructed buildings," will the property insurer provide a sufficient building limit for the period of construction?
- Is the automatic coverage for "newly constructed buildings" conditioned to a time limit that is not only the policy expiration date but also for a finite coverage period, such as 30 days?
- Will the property insurer provide coverage for the builders risk exposure when notified coverage is desired beyond the automatic coverage period?
- If the property insurer will not continue coverage after the automatic coverage period, will a builders risk insurer be willing to insure new construction that has already begun?
- How are materials destined for the new building covered, and are there any distance limitations on storage sites that may overly restrict coverage?
- Will the property insurer provide time element coverage (loss of rents) as well as "soft costs" if requested by the owner as named insured?
- Will the property insurer provide competitive coverage terms for deductible and premium when compared to a builders risk insurer?
- Will the property insurer add the interests of GC and sub(s) as additional insureds or simply as loss payees for their construction exposures?
- Does the insurer have the technical ability to provide specific loss control services for new construction, such as plan review?

It seems that many property insurers will provide some level of "builders risk" coverage in their building and personal property forms for new construction. The policy intent may be more for incidental exposures, such as low limit and short coverage periods for "newly constructed" buildings. It is better to discuss the planned construction exposure with the property insurer well before any construction is begun to ensure that appropriate coverage can be provided as needed. This is important as builders risk insurers want time to underwrite the exposure and are often reluctant to provide coverage to a structure that is already under construction. Builders risk due diligence requires not only the policy review and comparison process but also dialogue with each prospective insurer.

## Renovation: Other Commercial Property Insurance

Let's consider policy and coverage issues if ACME as owner decides to *renovate* and/or *expand* one of its existing buildings *instead* of constructing a new building. Will this form of construction require a builders risk policy? Probably not, as most property insurance policies readily cover this exposure without any sublimit or time limitation other than policy expiration. In addition, it would be difficult for one insurer to insure the owner's building structure that is not undergoing renovation while another insurer is to solely cover the owner's renovations.

We get an idea of coverage intent, as an example, from how ISO filed forms address this exposure. ISO defines "building" in its building and personal property coverage form CP 00 10 06 07 as "... If not covered by other insurance: additions under construction, alterations and repairs to the building or structure; materials, equipment, supplies and temporary structures on or within 100 feet of the described premises, used for making additions, alterations or repairs to the building or structure."

Even though the property policy may provide coverage for the building renovation, the risk management professional will need to consider exposure and coverage issues, such as the following:

- Consider an increase in the building value to reflect the increased value in order to alleviate possible coinsurance penalties.
- Will the material supply storage as provided by the policy adequately address the exposures created by the renovation, or are policy changes needed?
- Will the property insurer provide time element coverage (loss of income, loss of rents) as well as "soft costs" if requested?
- Will the property insurer modify the named insured to include not only the owner but also the GC and subs, and restrict named insured status to the GC and subs to only their interest in the newly constructed building?

## Installation Floater

Is it possible for certain insurable interests to seek insurance for construction exposures outside of the builders risk policy? Yes, subcontractors such as electricians, plumbers, and heating, ventilating, and air-conditioning (HVAC) installers may decide to separately insure their exposures outside of an owner- or GC-provided builders risk policy by use of an installation floater. This approach is not recommended when the builders risk policy provided by the owner or GC can include all interests including all subs. Why? Duplicate coverage may exist that may complicate loss settlement and, at the same time, add duplicate insurance cost. If the subs maintain separate installation floaters, then they will include this cost of insurance when bidding a job, thereby increasing their proposed cost, and may create an uncompetitive bidding situation for them and the GC. Separate installation floaters will also mean that the cost of this insurance will be billed to the GC and, in turn, to the owner (ACME), thereby needlessly adding cost to the overall construction budget.

Are there ever sound reasons for a contractor, subcontractor, or other party to use an installation floater? Yes, whenever the contractor is building or installing something of value (electric wiring, HVAC equipment, data/fiber-optic cable) and there is no builders risk policy that can be used to insure its exposure. In these cases, the contractor can obtain an annual policy with limits set on average and/or maximum installation exposures at any one site to cover its exposures until accepted by and/or paid by the owner or GC.

The installation floater, like the builders risk policy, will need to be reviewed carefully, like any property policy, to make sure that coverage terms for property and perils insured (i.e., special perils including flood and earthquake) are subject to a limit to satisfy actual exposure at each installation site and a deductible that is cost effective.

## Conclusion

Buildings are constructed new and are renovated to become modernized or assume new occupancies. The risk management professional has to consider the construction exposure from various interests, such as owner, GC, and sub, to ensure that each has appropriate coverage for its exposures. Insurers have different means of covering the exposures, depending on insurable interest presented and its underwriting ability. Existing policies may provide required coverage either within boilerplate policy language or by specific endorsement. Specific policies may be required (i.e., builders risk policy or installation floater) to provide necessary coverage for the interests to be insured. It is key to understand the exposures, coverage treatment options, and the insurer's underwriting posture before construction occurs.

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