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Forum on Construction Industry

The Future of Construction Insurance and Bonding

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Abraham Lincoln is quoted as saying, "you cannot escape the responsibility of tomorrow by evading it today." Instead of dwelling in the past, let us look into the future to better understand what the construction and insurance worlds will look like. This paper, and the related presentation at the ABA Forum on the Construction Industry's 2023 Annual Meeting, attempts not to dwell on the past but instead focus on the future through discussion of the ever-changing landscape of the construction industry for insurers, insureds, and lawyers alike. The Forum has gathered two industry leading experts to guide this discussion and assist us in looking into the future. Those two leaders are:

> **Gary L. Smith, CPCU AAAI, Director Construction Group**, Insurance Office of America, Tallahassee, FL, who will focus his discussion on current insurance trends amidst a market that has not before been seen; and
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> **Samantha Ip, Esq., Partner, Clark Wilson,** Vancouver, BC, who will focus her discussion on the future of construction and insurance in general, but also with a Canadian perspective.

While none of us can precisely predict what the future holds, our two distinguished panelists have utilized their combined industry and legal experience to address how the construction and insurance industries have changed and will continue to change into the future. This includes (i) managing losses caused by delays and price escalations from unforeseen events, such as supply chain issues, (ii) climate change, and (iii) global inflation. Supply chain issues have become a growing concern in the shadows of the COVID-19 Pandemic. Coupled with the increasingly strong and more frequent severe weather events, including most recently Hurricane Ian, the related insurance risks and contracting issues abound. Add the political unrest throughout the globe that is creating challenges for suppliers meeting contractual deadlines, and we have a perfect storm of novel real-world issues that require conscientious review of contracts and insurance policies before the storm arrives. We will also be exploring how the construction defect coverage afforded by general liability policies has transitioned over the past several years, what factors have led to these changes, and what we can expect in the future.

This paper embarks on several real-world trends and events that are disrupting the insurance and construction industries as we currently know them, including:

1. Supply chain delays. Following the Pandemic, current trends have caused massive delays and procurement issues for construction materials;

2. Severe Weather Events. The increasing frequency of severe storm events is causing premium increases and some carriers to leave certain markets. Hurricane Ian is a recent example of what challenges these severe weather storms will cause for carriers and insureds alike;

3. Global Inflation. The rising costs of consumer goods is being felt throughout the world, but perhaps none larger than in the construction industry. Rising construction costs for raw materials, such as timber, are creating real issues in guaranteeing pricing and supplies; and,

4. Changes to CGL Policies. Carriers are looking at ways to minimize risk, which includes revisions to typical commercial general liability policies, in part by defining "hazards and perils" on a policy-by-policy basis.

First, let us look at some real-world implications that are driving the future of the insurance and construction industry.

I. REAL-WORLD IMPLICATIONS

Real-world implications can throw a wrench in an otherwise seemingly problem-free project. Predicting weather events and health pandemics is difficult at best, but predicting the negative cost impacts these events have on the construction industry is not. In this section we will discuss the real-world implications that weather events and pandemics can cause, as well as tools to help you prepare.

A. Inflation Impacts on the Construction Industry

Regardless of whether a project is impacted by a severe weather event or a global pandemic, inflation plays a key role. According to the 2023 Doge Construction Outlook, the forecast predicts that total U.S. construction starts will be unchanged in 2023 at $1.08 trillion. However, when adjusted for inflation, total construction starts will dip by 3%. Some key takeaways from the 2023 Doge Construction Outlook are:

- The dollar value of single-family starts will be down 5% when adjusted for inflation;

- The multi-family sector, which has experienced record low vacancy rates due to the current affordability of single-family homes, will be down 7% when adjusted for inflation;

- Commercial starts, such as retail, office, warehouse, and hotel projects, are estimated to fall 13% in 2023 when adjusted for inflation, led in large part by pullbacks in the warehouse and office sectors;

- Institutional starts, such as schools, are estimated to fall by only 1% when taking into account inflation. Healthcare starts are expected to be the engine of growth for this sector; and,

- Manufacturing starts are one sector that has seen growth in the pandemic. EV battery plants and other large facilities are breaking ground and while starts are expected to decrease in 2023, the starts nearly tripled in 2022.[i]

With the exception of manufacturing starts, it is clear that the negative impacts of inflation are being felt throughout most sectors of construction.

While material costs are likely to fluctuate into the future and impact construction starts, so too should we expect the costs of construction to fluctuate. Many projects take several years to complete and the costs of materials can drastically change from project inception to project completion. One trend is parties moving away from Guaranteed Maximum Price (GMP) type contracts and instead moving toward cost-plus type contracts that allow for adjustment of the contract price based on fluctuations in materials, equipment, and labor costs. There are a multitude of hybrid approaches being utilized as well in which certain price-volatile materials or equipment are carved out of what is otherwise a lump sum or GMP contract that are separately covered in allowances or tied to market prices.

Another consideration is that higher interest rates are only expected to exacerbate the already growing problem of the rise of construction costs. On December 21, 2022, the Federal Reserve raised its benchmark interest rate to the highest level in 15 years.[ii] The Federal Open Market Committee voted to boost the overnight borrowing rate by half a percentage point. What this means for the construction industry is simple: if you plan to borrow money, expect to pay more. This too may be a reason parties move towards more cost-plus type contracts or hybrid agreements, instead of GMP contracts.

B. Supply Chain Issues and Catastrophic Storms

If you drive a car, shop at a grocery store, or use a cell phone, you have been impacted by the recent supply chain challenges. Whether a consumer is paying more for the same product that was cheaper pre-pandemic, or a consumer is waiting an extended period of time for a particular product, the impacts have been felt far and wide.

Construction-related supply chain issues, while they have improved somewhat recently, continue to be one of the causes of increasing insurance premiums. These increased premiums have resulted in developers and contractors moving to less expensive and less protective insurance products to reduce overall project costs and maximize profit. In the face of this cost-cutting, owners, developers, and lenders need to carefully review and confirm that a contractor's insurance satisfies their respective requirements and adequately protects project participants. One current trend is that Developers are becoming more interested in pricing and obtaining Owner Controlled Insurance Policies (OCIPs) due to increased concerns about contractor provided insurance coverage and costs, either for traditional contractor-provided policies and coverages or for Contractor Controlled Insurance Policies (CCIPs). Practically speaking, continued market restrictions and the limited number of insurers and products in the market prevent any substantial coverage or cost negotiations. Carriers are starting to take less and less of a share in each risk, thereby causing even more market restriction. The end result is often either more contentious developer and contractor negotiations concerning project insurance, or in an effort by contractors to remain competitive with their respective bids, increased attempts to recoup additional insurance costs and project risk after project commencement through the change order process.

Builder's Risk insurance costs are also rising dramatically. This is due in large part to supply chain problems increasing costs and underwriters being willing to take on smaller percentages of overall project risk on large projects due to the increasing loss history on these policies. Increased restrictions on coverage for water intrusion and increasing deductibles are also trends in Builder's Risk insurance.

In 2022, Hurricane Ian proved how fast and far the costs of a catastrophic event have risen. These costs have risen due to a number of factors. Increasing population densities in coastal areas where tropical storms make landfall have increased the number of structures subject to damage in any given storm. The costs of repairing or replacing these structures has also increased because modern houses are becoming larger, stretched supply chains have caused the cost of materials to rise, and severe labor shortages have made it increasingly difficult to find and retain workers to rebuild. Material and labor costs have always fluctuated, but downward fluctuations are now limited by overall inflationary pressures.

Commercial property lines were among the most affected by recent inflationary trends.[iii] The extent of such increases depends on (i) whether the property is subject to a catastrophic loss and (ii) loss history. Through mid-2022, primary insurance premium increases on properties not subject to catastrophic losses and a good loss history have ranged from flat to 10%. Adding catastrophic loss exposure resulted in increased premiums of 10-15%. Combining catastrophic loss exposure and a poor loss history resulted in primary carriers increasing premiums by about 20%.[iv]

In 2022, the market was relatively stable outside the catastrophic category. The reinsurance market, however, was driving premiums up for properties subject to catastrophic loss. Even before Hurricane Ian made landfall, both primary and reinsurance carriers were reducing their exposures in coastal areas, resulting in a loss of capacity. The remaining reinsurance capacity became even more expensive, with rates increasing 15-25%.[v] These reinsurance rate increases flowed down into primary insurance rates.

Looking forward, expectations are that reinsurance costs in coastal areas will surge in 2023 as many reinsurers have reduced capacity for more losses and need to adjust premiums to reflect the risks. Catastrophe reinsurance rates were already predicted to increase 20-25% in 2023, but after Hurricane Ian, they will most likely rise even further.[vi] As a result, primary insurance rates, which were predicted to rise 10% are likely to rise at twice that rate.[vii] These costs will be reflected in primary policy premiums. It is expected that carriers will reduce risks in other ways, for example, by increasing deductibles for named windstorms and providing credits for hurricane resistant construction.

While this discussion has focused on losses in coastal areas from named storms, such storms are not the only source of catastrophic losses. Such losses can also come from other events like wildfires, earthquakes, and mudslides. Owners hoping to insure their properties and to limit their premiums should consider such catastrophic risks when establishing design criteria or remodeling their properties. For example, it may be advisable to replace a roof before it becomes absolutely necessary because some carriers are limiting replacement value on roof damage to newer roofs built to higher standards. So, what can be done about this and the resulting price escalations?

C. Contract Considerations for Changes in Material Pricing

When facing material price escalations, contracting parties have several resources at their disposal. One starting point is the AIA A201-2017 form contract, specifically Section 3.8, discussing Allowances, which provides some language to contemplate when contracting for unanticipated price escalations in materials. Best practice is to include something akin to the language in Section 3.8 but outlining the specific concerns and procedure if or when price escalation occurs.

In addition to the AIA contracts, ConsensusDocs is another resource to consult when considering price escalation issues when drafting contracts. ConsensusDocs addresses the issue in Section 200.1 of its form contract labeled: Potentially Time and Price-Impacted Materials. Specifically, section 200.1 discusses not only price increases, but also price decreases and provides an owner and contractor a baseline price and calculation method for potential adjustments to material prices. Currently, people often only tend to think about the price of construction materials as increasing; however, this is not always the case. The possibility of price decreases must also be considered, especially from a supplier’s perspective or for any company that has entered into a requirements contract. Artful drafting remains the key.

Another less often utilized resource is the Federal Acquisition Regulation (FAR). While FAR provisions apply only to federal procurement contracts, they are nonetheless another tool for consideration when drafting contracts to address material price fluctuation. FAR 48 CFR § 16.203-2-4 allows for material price escalation when there is market volatility, but the FAR language can be used as form language to be inserted into any contract. FAR 48 CFR § 16.203-2, permits material price escalations when two specific contingencies are met: (1) there is serious doubt concerning the stability of market or labor conditions that will exist during an extended period of time, or (2) contingencies that would otherwise be included in the contract price can be identified and covered separately in the contract. One need not look any further than the ongoing war in Ukraine to surmise when or why such clauses are important.

D. Insuring Against Impacts of Natural Disasters to Property and Businesses

As the global environment is ever-changing, the costs and impacts from unforeseen events is a consideration for all insurers. In September 2022, Hurricane Ian made landfall on Florida's West Coast in the Fort Myers area creating an estimated $66-$75 billion in damage. This damage includes property damage, impacts to businesses and their ability to serve customers and clients, and potential third-party liability for the manner in which companies and insurance companies respond to such disasters. So, what can be done to help plan for when a future unforeseen event occurs?

When evaluating personal property coverage, one simple solution is instead of using an all-risk type policy that will provide very broad coverage, insurers are likely to start implementing policies that contain specifically covered enumerated perils. This would be akin to an a la carte menu at your favorite fine dining restaurant. You are able to insure as many perils as you would like, but each is going to include its own price and terms. Doing away with the old, one-size-fits-all approach will benefit both the carrier and insured alike. The carrier will be able to better set reserves and determine its potential risk exposure. The insured will be able to specifically target the perils he or she wants to insure. This will enable an owner to shop *a la carte* for the coverage that best fits his or her needs and to narrowly focus on the perils that create the biggest risk to the property at issue. Some inevitable pitfalls will be insureds not paying close enough attention to their policy exclusions or otherwise not fully appreciating what the policy does, and does not, cover. Consider for a moment a hurricane. An owner in Florida would expect wind damage and some rain, but perhaps will not consider the impact of storm surge if the property is located in a coastal environment. However, a property owner in California is not worried about hurricanes but instead will be concerned about potential wildfires. The bottom line is that you must be vigilant in determining the perils that are at issue for you and securing the proper coverage for your geographic area. The day may very soon come where we select our homeowner's insurance coverage the same way we select our auto insurance in that we will have options to select the coverage we want and do not want by simply clicking through an enrollment screen on a computer.

Businesses are equally impacted by natural disasters, albeit in a different way. Whether there is a hurricane, flash flood, a wildfire, or some other weather event, natural disasters can be fatal to a business if adequate coverage is not secured beforehand. One-step in the right direction is for businesses to secure a business interruption policy that will assist in keeping a business functioning and potentially assist with getting it back on its feet after the event. Despite many employers now allowing employees to work from home, the potential disruption cannot be avoided. A business with interruption coverage can plan for the loss of employee incomes and earnings during the immediate loss, in addition to covering the lost income to the business and assisting to restore the business to its status quo pre-loss. Employee losses are only one aspect a business needs to consider.

For a business that rents or leases either residential or commercial property, consideration should be given to ingress and egress coverage that will cover a loss due to a tenant's inability to access or exit a building during a peril. Another consideration for businesses is to secure coverage for any possible service interruptions, such as disruptions to the necessary utilities, the internet, and waste management. If a business has a service interruption policy, it will help alleviate expenses incurred from the loss of service or from the expenditure of more resources due to the peril, such as drinking water or needing to utilize roaming services instead of WiFi service. If a business does not want to absorb the costs associated with natural disasters alone, policies such as business interruption or an ingress and egress policy should be contemplated.

Whether insuring a home or a business, it is important to note that states have different requirements in order to establish causation for a loss. The majority rule, which is followed in states such as Alabama, California, New Jersey, and Florida, concludes that if one cause of loss is covered, damage to a non-covered or excluded cause of loss is also covered.[viii] The minority rule, followed in states such as Texas and Iowa, is that damage is only recoverable if the covered peril is the "efficient proximate cause" of the loss.[ix] In order to deal with the differences that exist from state to state, insurance companies are responding by issuing policies that contain language that addresses, and in some instances omits, concurrent causation. A typical clause will confirm that if a loss is due to a natural disaster that is excluded under the policy as the cause of the loss, there is not any coverage. How each state chooses to interpret and enforce these clauses is ongoing, but looking ahead it is expected that states will continue to take varying approaches.

II. FUTURE TRENDS LOOKING AT INSURANCE

A. Insurance Policy Changes and Carrier Responses to Market Trends

Once upon a time there was a policy called a General Liability Policy, that was endorsed to provide broad form property damage coverage for contractors for defective construction, after a project was completed. After several varying positions regarding this coverage, some key court cases affirmed that a construction defect could be considered an occurrence and coverage was afforded if the completed work was performed for the contractor by a subcontractor.[x] While many are familiar with Commercial General Liability (CGL) policies, the reality is today's insurance market is not for the faint of heart. In fact, some carriers have entirely withdrawn some or all coverages in certain counties or states, such as Florida and California, due to losses. Other carriers are attempting to introduce new policy forms in these regions that limit coverages to deal with the increasing construction defect litigation. Some have also imposed underwriting restrictions on tract housing or multi-family dwellings. In further efforts to reduce exposure by insurers, some states have implemented legislation to reduce the applicable statute of repose limiting the time a contractor or developer (and its insurer) may be exposed to claims for construction defect claims.

General Liability premiums continued to rise steadily, increasing 10-20% Year-over-Year by the end of 2021, and continuing at that same pace by the middle of 2022.[xi] While new carriers have entered the marketplace, it has not prevented premiums from continuing their upward march. These rate increases have been concentrated in high-exposure sectors, of which construction is certainly one.

Primary drivers of increased premiums include "social inflation" that accounts for costs associated with social trends that increase the frequency and costs of litigation, such as plaintiff-friendly legal decisions and large jury awards, reportedly resulting in a 300% increase in the median value of jury awards.[xii] As a result, it is becoming increasingly difficult and expensive to build a tower of excess insurance to cover high-dollar verdicts. Fortunately, contractors can greatly reduce their premiums through a relentless focus on safety and quality control.

Quality Control is important because CGL polices will often cover damage caused by defective work, even though they do not cover the costs of repairing the defect. For example, CGL policies will not pay to fix a defective roof, but they may pay to repair water damage resulting from the defect. Strict quality controls can reduce claims by preventing the loss in the first place. Additionally thorough documentation of the quality control efforts undertaken can often reduce or eliminate liability.

In Florida, the legislature has also implemented Fla. Stat. Ch. 558, which mandates notice before a claim is filed or the Court may stay the action until a claimant has complied. Regardless, the withdrawal of certain carriers, types of policies, and coverages in certain markets has resulted in increased pricing for those insurance products that remain available in a market, which attracted non-admitted markets into the marketplace.[xiii] In some of these markets insurers have also introduced variable warranty and exclusive remedy CGL forms to limit developer and contractor liability in the face of increased claims and litigation.

New insurers continue to enter the marketplace to replace carriers that have departed. Enough additional market capacity and capital still exists to attract new players to replace the carriers and programs that exited the market due to underwriting losses. Whether the new players and insurance products will endure is unknown. These new products must survive court scrutiny or else the new strategies to reduce underwriting losses will be ineffective. Even with an emphasis on quality control requirements, such as plan review, on-site inspections, and water intrusion and other loss control programs, the rate of construction defect exposure and losses continues to mount. That is not to say that bad buildings do not exist. Some buildings are built with defective roofs, windows, stucco, plumbing, waterproofing, and so on and so forth. Large national builders and developers are moving into larger deductibles, retentions, and captives to try to mitigate their respective losses due to increased litigation. It is also worth noting that just because a carrier left the market does not mean the underwriters are new to that specific market. When new carriers enter the market, it is not abnormal for the underwriters to come from a carrier that has exited that market due to losses or unprofitable books of business. The experience that these underwriters bring with them lends to increased pricing, stricter underwriting, and reduced terms and conditions that further harden an already tough market.

As premiums continue to rise, capable companies increase deductibles and retentions to limit premium increases. Some companies have begun coordinating captives such as 831b small captives to gain more control over their risk.[xiv] In some instances, deductibles that were once $25,000 are being increased by as much as 200%. Lenders, some of which may not be familiar with the changing market conditions and have been demanding unattainable coverages or limits are engaging insurance consultants to educate and assist them with new coverage restrictions.

While the insurance industry has attempted to adjust to increased loss exposure, underwriting losses in certain markets continue to mount. Markets are now requiring severe restrictions in coverage and the number of parties who are insured, especially when considering habitational risk. For example, condominium wrap policies have seen prices increase by a factor of four or five times as the cost for the same policy for the same project just two years ago. In some instances, carrier capacity in jurisdictions has been reduced to only one primary carrier, creating a monopoly effect on pricing that leaves the consumer with only one choice. Frontline underwriters are losing authority requiring submissions to insurance home offices requiring actuary approval. When frontline underwriters lose underwriting authority and discretion, this requires more and more management authority requirements.

B. Expected Impact Wrap Policies Will Have on Future Projects, Including Pricing

The truth is that while premiums for insurance products increase, the increases have not offset underwriting losses. Continued construction defect litigation and court decisions have frustrated attempts by the insurance industry to limit coverage for defects. Insurance Services Office (ISO) and non-ISO general liability forms are being introduced to address the rising costs due to increased construction defect litigation. This is a trend anticipated to continue. In new general liability endorsements, the use of non-ISO forms, as well as warranty products and formalized loss control and quantity control programs, are being introduced to help blunt rising losses suffered by insurers. Of course, these rising costs are being passed through to owners and developers.

One trend to offset the rising owner and developer costs are the utilization of Contractor CCIPs and OCIPs, or other project specific policies to attempt to gain control over coverage limitations and increasing premiums. As a result of the current insurance market, carefully crafted CCIPs are increasingly being used by contractors to attempt to maintain adequate coverages and limits while also controlling costs. While CCIPs have a place in the market, developers and owners need to be aware of certain risks when they cede control over project insurance to the contractor. There have been recent examples of contractors simply “walking-off” projects in cases where their contracts do not adequately address material or labor price escalations. In these circumstances, when the contractor leaves the project, oftentimes so does the contractor’s CCIP insurance covering all project participants. That leaves the developer behind to hold the proverbial bag with an unfinished project and needing to secure insurance to finish construction.

The market volatility and changes in market trends make for a moving target in terms of trying to hit the bullseye on mitigating risk while balancing cost considerations. Having knowledge of your current market allows you to have a more all-encompassing approach to navigate risks and a more consultative relationship with an insurance broker. Proactive assistance in developing a construction defect claim litigation strategy can also pay dividends when faced with a lawsuit.

So how can one survive the storm? Implementing larger deductibles and retentions offers an insured more control over a construction defect claim, taking on more frontline risk, and coordination with the captive. Warrantying new best practice strategies may not get dramatic price relief but should assist in gaining access to more competitive markets. Some pragmatic solutions to take into consideration are:

- Proactively establish a claim and litigation plan. This will obviously work best with a high retention; however, this may also be something to consider in conjunction with your general liability carrier at lower retention levels;

- Identify your experts before a claim happens. The best experts are not the ones who tell you what you want to hear. The best experts are the ones who tell you the truth. Having an expert you know and trust is worth its weight in gold to determine the validity and exposure of claims; and,

- Establishing claim and litigation protocols *before* a loss occurs. Similar to a life raft, protocols are only helpful if they exist before the storm arrives.

While the current market may feel like a bunch of sharks eating sharks, knowing your market, and utilizing some of the above solutions should help navigate the insurance landscape, minimize risk, and ultimately save money in the long run.

C. The Time to Plan is Before the Storm, Not After

Most, if not all of us, are familiar with the tragic condominium collapse of the Champaign Towers. What most of us may not be familiar with are pre-crisis preparation steps that should be taken to mitigate risk, maximize safety, and protect a party’s interests.

First, a company should have a written plan that is stored online and accessible by all employees. The plan should include the identity of key personnel with current contact information (e.g., CEO, CFO, regional and district managers, etc.), a list of key outsiders with contact information (e.g., outside counsel, public relation firms, first responder information, etc.), and a game plan for certain events (e.g., an active shooter, natural disasters, etc.). These simple and basic first steps will go a long way in preparing for a crisis. Additionally, designating multiple persons to call first responders is recommended because, more often than not, people fail to call first responders thinking that someone else has already done so. Unfortunately, this has occurred repeatedly following a disaster. Of course, the steps taken are only effective if all employees are aware of a company's disaster protocols. It is recommended that both employee handbooks and personnel onboarding policies include an acknowledgement form for the employee to sign confirming that he or she has read and received a copy of the disaster protocols. The disaster protocols can also be included in an employee's contract. Regardless of the source of the information, a company should implement a policy and educate each employee on its emergency procedures.

D. What are the Impacts on Construction Defect Coverage?

The options available for insuring against losses and damages flowing from a loss at or to a construction project are plentiful. One such option most are likely familiar with is a builder's risk policy. A builder's risk policy will cover the physical damage to the work under construction and may also contain extensions that cover other costs, such as delay-related damages and damages due to changes in the law. Business interruption coverage is available to make up for a company's lost revenue. Professional error and omission coverages are available if a designer, engineer, or other professional causes the loss event, and may also trigger a professional liability policy.

While the policies available vary, one constant is that these policies are likely to change as construction defect losses continue to grow. For instance, a builder's risk policy may no longer contain extensions to cover other losses and may become so costly that owners will bargain for the cost of the policy in the contract amount. Business interruption policies may soon be so narrowly tailored that unless a specific event is expressly listed, coverage will not apply. Professional E&O policies may soon contain language that is more akin to a CGL policy that contains a "your work" type exclusion. These "your work" type exclusions provide coverage, so long as the insured's work itself did not cause or contribute to the loss. This becomes counter intuitive because the purpose of securing an E&O policy is to protect the design professional against poor decisions or errors made during the performance of the design professional's work. If E&O policies soon contain "your work" type exclusions, the carriers will undoubtedly rely on these endorsements as a basis for denying coverage.

While these are just some of the changes that may soon occur, insurance companies are continuing to evolve their policies to better reflect the world that we live in today. Contracting parties must pay close attention to what is and is not being insured under their policies at the time of contracting. As Benjamin Franklin wisely said, "by failing to prepare, you are preparing to fail."

III. CONSTRUCTION CONTRACT PROVISIONS IMPACTING RISK AND INSURANCE COVERAGES

There are a number of key risk mitigation provisions to consider when entering into a construction contract. Force Majeure clauses, "no damage for delay" clauses, and the doctrine of frustration of purpose, are just some of the legal and contractual tools parties utilize to address unexpected occurrences on a project. This section will discuss each of these and provide some helpful considerations in applying each doctrine to your unique circumstance.

A. Force Majeure

A force majeure clause relieves parties from performing their contractual obligations when certain circumstances beyond their control make performance impossible, commercially impracticable, or illegal. Historically, force majeure clauses have been as boilerplate legal language to excuse strict contractual performance in the face of unforeseen events. As a general matter, force majeure clauses are typically narrowly construed by the courts and their utility has been somewhat limited.[xv] However, the importance of a well-tailored force majeure clause and focus on negotiating these clauses and enforcing them is now in the forefront with the recent Pandemic and related global supply chain issues.

An event that is foreseeable at the time of contracting generally will fall outside the coverage of a force majeure provision and thus will not excuse a party's contractual performance. For example, freezing temperatures between November and January is a foreseeable event in Minnesota; thus, such temperatures would not typically fall within the definition of a force majeure event.[xvi] So what is unforeseeable? Generally, unforeseeable events would be unpredictable weather events that are outside the norm, such as a flash flood, hurricane, or wildfire.[xvii] Many are attempting to offset losses incurred by citing to force majeure clauses due to the COVID-19 Pandemic and severe weather events. The law continues to evolve in this area. However, at least one jurisdiction found the outbreak of Porcine Reproduction and Respiratory Syndrome (PRRS) in hogs frustrates contractual performance of a contract to supply hogs and constituted a force majeure event. [xviii]

When facing supply chain delays, it is best practice for the party invoking the clause to set forth in detail the specific event that resulted in the loss. As a practical matter, if there was damage to materials or equipment in transit that resulted in a delay or loss, supplying dates, photographs, especially before and after photographs, and the steps taken to mitigate a loss are helpful in establishing and satisfying one's burden to prove that a certain event or occurrence constitutes a force majeure event. That said, to know whether a specific event may trigger a force majeure clause one must read the underlying contract. Some contracts explicitly state what to do when facing a project delay or non-performance by a supplier as a force majeure event.[xix] The standard AIA A201-2017 form contract does not expressly identify supply chain issues as a basis for excusing performance. Therefore, if you are using an AIA form you will want to consider thoughtful revisions and additions to protect your interests. As a practical matter, the mere occurrence of a force majeure event generally does not serve as an adequate basis to excuse performance. A party invoking a force majeure event should always provide notice and review the underlying contract for any specific notice requirements, or it is possible the party may waive its ability to rely upon a force majeure clause.

The impact a force majeure event has on parties' contractual obligations is also important because, typically, a contract is not automatically void. If using the standard AIA A201-2017 contract, the force majeure event will only excuse performance until a later time when performance is possible. These are just some of the force majeure considerations to keep in mind when navigating today's ever-changing challenges regarding unexpected events.

B. Frustration of Purpose

Similar to a force majeure clause, the frustration of purpose doctrine is another arrow in the quiver of a party seeking to avoid liability due to circumstances beyond their control. The doctrine of frustration of purpose states that frustration occurs when an unforeseen event renders performance of a contract impossible or radically different from that originally contemplated by the parties. No party is considered at fault. If a contract is found to be frustrated, it is automatically terminated. All future obligations of the parties to the contract are discharged.

When considering whether this doctrine may apply to your particular situation, there are a few things to consider. First, when this doctrine has been successfully applied in the past, there has typically been nothing in the contract that discusses what happens if there is an unexpected event, such as a force majeure clause. If the contract specifically sets forth what happens in an unexpected event, the contract language will apply, and not the doctrine, even if there is a legitimate frustration of purpose.

Second, the doctrine only applies as long as the unexpected event frustrates the purpose of the contract. For example, if we look to the facts of *Taylor v. Caldwell*—the original British Common Law case that established the principle back in the 1800's—and we assume that the rental of the concert hall at issue was for an entire year rather than simply for a single event that had to be canceled due to a fire, the doctrine of frustration of purpose would only last until the music hall was rebuilt. This is true because once the music hall was again available to hold concerts, the purpose of the contract would no longer be frustrated.

Lastly, in order for this doctrine to succeed, the entire purpose of the contract must be frustrated. If the contract provides for a number of things, but only a few of them are frustrated, this doctrine may not apply. Or, if the contract is just hampered or hindered (such as if the arrangement can continue but is no longer as profitable to one of the parties) the doctrine may not apply to excuse performance. In other words, the doctrine is most applicable when the entire contract simply cannot be performed or no longer makes any sense.

For all these reasons, the frustration of purpose doctrine has limited utility.[xx] When relying upon the frustration of purpose doctrine the focus should be on the parties' primary purpose at the time of contracting. The argument follows that if the primary purpose when contracting is frustrated by the event, and the non-occurrence of the event was a basic assumption of the parties at the time of contracting, the doctrine may be applicable to excuse the parties from performance.[xxi] While it may seem obvious, the key to a party's ability to use the frustration of purpose doctrine as a defense to contractual performance is the extent to which the purpose of the parties performance obligations is made clear in the contract itself.

An interesting case decided by the Supreme Court of Connecticut pertained to a restaurant business owner-lessee arguing that the COVID-19 pandemic executive order closing "on premises dining with bar service" frustrated the purpose of its lease rendering the lease valueless.[xxii] The plaintiff-landlord contended that the executive orders did not frustrate the purpose of the lease agreement because a legal use for the premises remained available to the restaurant owner-lessee. Namely, the restaurant could still serve food and beverages for off-premises consumption—like many restaurants were doing during the recent Pandemic. The Court agreed with the landlord and rejected a frustration of purpose argument by the lessee. Had the lease stated the exclusive purpose to be serving food to patrons on the premises, perhaps the Court would have ruled differently.

C. No Damage for Delay

Most, if not all, practitioners have experienced the impacts of project delays. The risks resulting from delays must be taken into account when preparing a contract because the damages can be significant. One clause to consider that can, at least in part, shift risk and potential damages in a delay situation is a "no damage for delay" clause. Most are familiar with these clauses because they are widely used in the construction industry by owners, developers, and contractors as a defense to claims by lower-tier parties in the contract chain who claim that they are entitled to additional payment or damages to cover the added job site and extended project overhead costs that result in delays for which they are not responsible. Typically, a "no damage for delay" clause affords a defense to an owner/developer against their general contractor, and will then flow downstream to offer the same defense from a general contractor to its subcontractors. These clauses are typically invoked when unforeseen events cause project delay and they shift the financial risk for delays onto the contractor and/or its subcontractors. A detailed critical path schedule agreed upon at the time of contracting can assist in mitigating delay, assist in understanding the risks being taken, and the proper steps to take to mitigate or insure a specific risk.

While "no damage for delay" clauses are simple in theory, challenges can emerge in application. For example, let us assume a project is delayed and the underlying contract contains a "no damage for delay" clause. Let us further assume that the delay at issue precluded a contractor or subcontractor's delayed performance due to an unforeseen event beyond his or her control. The keystone to the argument is proving who was responsible for the delay, a task that usually involves a detailed factual investigation involving lots of moving pieces and oftentimes multiple parties. A sage contractor will know this before a project starts and focus on the sequencing of work, including whether and when one trade can start its work before a subsequent trade is complete, or whether or when a trade can start its work before all needed materials have arrived at the project. The result in either scenario—a trade failing to finish its work that is required for a subsequent trade to start its work or needed materials not being onsite at the time a trade is supposed to start its work—should be discussed before a project commences.

Considerable time and resources can be saved if the contracting parties narrow down and establish who is responsible for a given delay and under what circumstances. One simple solution is to require contractors to procure their own building materials and necessary equipment and that any incurred delays are their responsibility alone.

Anyone who has spent even a single day working in the construction field can appreciate that project delays are inevitable. Amidst supply chain issues and labor shortages, contemplating delays before a project begins has become more important than ever. If you intend to use a "no damage for delay" clause, best practice is to give thoughtful consideration to the underlying contract language and the needed burden of proving who or what caused the delay at issue.

Whether a party's performance is impossible, frustrated, or delayed, the careful drafting of the underlying contract is paramount. Ensuring appropriate and project specific contractual terms are included in the underlying contract are needed when taking into account all the unknowns that a party faces in today's ever changing construction landscape.

D. Risk Analysis Checklist

Aside from the specific contract provisions already discussed, below is a robust Risk Analysis Checklist. The checklist is intended to address additional issues and considerations to be mindful of at the time of contracting. Using this checklist in conjunction with some of the pointers already discussed should enable a party to be proactive in analyzing and transferring risk at the time of contracting.

<u>1. Delay</u>:

- Determine reasonable notice requirements;
- Consider inclusion of "No Damage for Delay" clauses;
- Consider inclusion of reasonable time and price adjustments for delay not due to contractor's fault or neglect;
- Implement reasonable liquidated damages provision; and
- Determine control of project schedule and updates.

2. Indemnification:

- Limit to personal injury and property damage (excluding damage to work);
- Limit to extent caused by fault or neglect of contractor; and
- If broader, make expressly subject to other contract terms.

3. Consequential Damages:

- Either get mutual waiver or reasonable cumulative cap; and
- Consider reasonable exceptions from waiver acceptable (e.g., insurance proceeds, damages due to contractor's gross negligence or willful misconduct).

4. Insurance:

- Consider Builder's Risk with "All Risk" coverage, normal exclusions, reasonable deductibles and standard AIA "No-Fault" terms; and
- Consider OCIP subject to terms reasonably acceptable prior to work starting at the project with completed operations extension at least equal to the statute of repose in the jurisdiction.

5. Payment:

- Implement a reasonable payment cycle;
- Ensure Owner's obligation to timely pay all undisputed amounts;
- Implement late payment interest;
- Consider right to stop work if not paid undisputed amounts;
- Consider proof of funding (especially for an SPE owner or developer);
- Use lien waivers only to the extent of payment reviewed; and
- Reasonable contingency provisions for GMP contracts.

6. Changes:

- Use reasonable and practical notice and change order procedures;
- Consider no obligation to proceed with change in work without appropriate authorization and Owner's obligation to pay for change work as it is performed;
- Consider reasonable restrictions on amount of force account change work;
- Require Owner obtaining necessary lender prior approvals;
- Implement terms for contract to have a reasonable changed and concealed conditions clause; and
- Implement terms for contract to have a reasonable change in law clause.

7. Claims/Dispute Resolution:

- Implement reasonable notice and claim procedures;
- Include language for prompt review and resolution; and
- Consider ADR steps, including stepped negotiation, followed by mediation, followed by litigation.

8. Hazardous Materials:

• Consider a co liability for pre-existing (or migrating) conditions clause;
• Consider responsibility for removal and remediation of pre-existing hazardous material conditions; and
• Consider Owner indemnification for all pre-existing hazardous material conditions.

9. Design Liability:
• Consider clause for no design liability for design review and comments as contractor or construction manager;
• Implement contract terms that all design delegation must be expressly identified in the contract with responsible subcontractor carrying appropriate professional liability insurance; and
• In all design-build contracts, design liability must be capped at amount of professional liability insurance proceeds.

10. Completion:
• Ensure no subjective standards or impractical conditions precedent to achieving substantial and final completion;
• Implement a reasonably sufficient time between substantial and final completion;
• Require the Punch List is fixed and released at substantial completion;
• Require warranties to start at substantial completion. All extended warranties priced with subcontractors and included in contract price; and
• Require retainage to be released at substantial completion (unless contrary to applicable law).

11. Special Drafting Issues:
• Eliminate or avoid ambiguous, inconsistent and duplicative contract terms;
• Make sure scope of work is clear as to what is in and what is out and do not use subjective standards like “best,” “highest” or “state of the art”; and
• Add controlling employer provisions to all contracts.

IV. SUBCONTRACTOR DEFAULT INSURANCE AND BONDS

Many of us are familiar with bonds. Performance bonds protect the general contractor and owner from risk if the contractor or subcontractor are unable to fulfill their contractual obligations. Payment bonds ensure that subcontractors and suppliers are paid for their work. What some practitioners may not be as familiar with is Subcontractor Default Insurance (SDI), which is another way to a general contractor can mitigate risk for non-performing subcontractors.

A. Introduction to SDI and Bonding

The larger the project, the more subcontractors are typically involved. So, what are a general contractor's options in dealing with subcontractors who do not complete their work? Historically, bonds mitigate the risk in event of a subcontractor's failure to perform. A newer development in the insurance world is SDI. Instead of general contractors securing performance/payment bonds, a growing trend is to use SDI.

In the event of a subcontractor default on a project, SDI transfers that risk from the general contractor to an insurance company. Some key things to keep in mind about an SDI policy are as follows:

- Generally speaking, general contractors with revenues of $50,000,000 or more can take advantage of an SDI policy;
- Covers all chosen subcontractors on a given project or on an annual basis for all projects combined. There is no individual policy for each subcontractor;
- Covers indirect losses due to subcontractor default including liquidated damages, contingencies, etc.;
- Targets private projects as opposed to publicly bid projects;
- Pricing is negotiable, but the rate is rising due to fewer players in this market and increased losses;
- Policy term is usually 3-5 years;
- Deductibles are required and have become larger due to increased claim activity in this space;
- Limit of liability is determined by general contractor, which can be the total dollar amount of subcontracts on a project basis or on an annual basis; and
- Most common claim types can include: construction defect after a project is complete, unpaid amounts due by subcontractor, solvency issues from other jobs.[xxiii]

B. Differences Between SDI and Bonds

There are several differences between SDI and performance and payment bonds (PPB), which begins at the pre-qualification process. For PPB, the pre-qualification process is carried out by the surety, where the subcontractor submits financial documents to ensure that subcontractor is capable of performing the work. Compared to SDI, the pre-qualification process is managed by the policy holder.[xxiv] In practice, the pre-qualification process for bonds is more thorough compared to SDI, and PPBs cover the subcontractors and suppliers. Such is not the case for SDI because the subcontractor or supplier cannot file a direct claim with the insurer.[xxv]

Another key distinction is who controls the process. If a party files a claim using SDI, the general contractor is the one who manages the default. In a PPB situation, the surety decides the merits of the default as an independent party. If the surety determines that a contract violation has occurred, it will then arrange for the contract to be completed, up to the amount of the bond.[xxvi] Additionally, SDI policies generally are not provided on public projects.

C. SDI Policies in Practice

To provide an example, let us assume a general contractor is building a commercial project and has an SDI policy covering all of its projects. ABC Plumbing is providing the plumbing work for this project and the subcontract is worth $2 million. Now let us assume that halfway through completion of the plumbing work ABC Plumbing starts to fall on hard times and is experiencing significant cash flow problems. This results in ABC Plumbing being unable to pay their vendors and employees. Consequently, the laborers performing the plumbing work walk off the job because they have not been paid, and thus, bringing all plumbing work to a screeching halt. Having realized this problem, the general contractor makes a claim with its insurance carrier under its SDI policy. The general contractor is now forced to hire XYZ Plumbing to finish the project at a cost of $1.2 million. The general contractor has a deductible of $750,000 on its SDI policy, so the total claim payout is $450,000. The $450,000 is paid to the general contractor as the cost for XYZ Plumbing to finish the work ($1.2 million), minus the general contractor's deductible ($750,000). The $750,000 deductible is shown as a loss on the project.[xxvii]

So why are all general contractors not securing SDI policies? The answer is that most are not building projects that qualify. For example, one large insurer has a minimum of $200,000,000 in subcontractor contracts that must be covered under the policy.[xxviii] Ty Moffett, Bond Department Manager at A.G. Sadowski Company, has said that this minimum puts SDI coverage out of reach for most contractors: "It's not available to small contractors at all," he says. "Even a lot of contractors you would consider to be quite large don't make the grade."[xxix] Looking into the future, it seems more likely than not that large general contractors building mega projects will turn to SDI policies instead of bonds simply because of the control it affords them. Instead of the surety being in the driver's seat, SDI coverage puts the general contractor behind the wheel.

V. A CANADIAN PERSPECTIVE

As counsel specializing in construction and insurance law, I highlight in this Canadian segment of our paper on the Future of Construction Insurance and Bonding some issues which have been prevalent in recent years, and which will provide insight on what we can expect in the future years.

A. Physical Damage in Canada

All types of policies in play at a construction site – course of construction or builders risk policies ("COC"), commercial property policies, wrap up policies ("Wrap Up") and commercial general liability policies ("CGL") – require there be "damage" to trigger coverage. A COC policy, which is a first-party property policy, typically requires there be "direct physical loss or damage to" property. In contrast, liability policies, such as Wrap Up and CGL policies, usually define "damage" to include both physical injury to property, as well as loss of use of property without physical injury.

One frequently-encountered issue, and an area we are likely to see future coverage disputes arise from in the future, is the concept of "damage," and what constitutes "damage." During the pandemic years, in particular, when projects were significantly impacted by COVID-related restrictions, project parties sought to cushion the economic blow by seeking coverage on their project COC's for coverage related to delay, or delayed start up ("DSU") coverage, and other time-element coverages which may be available.

Coverage disputes revolving around the meaning of "damage" were not limited to the construction insurance context. We have seen an increase in claims focused on the meaning of "damage" in all manner of property policies as businesses tried to access business interruption coverage for business closures during the pandemic. In Canada, and in other parts of the world (in the UK the Financial Conduct Authority ran a business interruption test case based on different policy wordings), courts considered the issue of what exactly constitutes "damage" or the related concept of "physical loss" in the context of various species of policies. Can infiltration of the COVID virus on the project site satisfy the "damage" requirement in a policy's insuring agreement?

To appreciate the recent Canadian cases that consider the meaning of "damage," a leading Canadian case on what property damage is in Canada is *Progressive Homes Ltd. v. Lombard General Insurance Co of Canada*, 2010 SCC 33. There, the Supreme Court of Canada considered whether a CGL insurer was required to defend the insured general contractor, who was sued for damages related to alleged defects. The insurer denied a duty to defend on the basis that property damage had to occur to property other than the alleged defects themselves. In disagreement with the insurer, the Supreme Court of Canada held that defects themselves *may* be property damage depending on the facts of a given case. With respect to the physical component of property damage, the Supreme Court of Canada held that physical injury denotes harm to the property in the sense that it is visible or apparent.

More recently, notable cases have shaped the way in which Canadian insurers are required to determine if there has been physical damage to property. A leading decision in the COC realm is a British Columbia Court of Appeal decision in *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Co.*, 2015 BCCA 347. The claim in *Acciona* was for recovery of losses that occurred during a hospital's course of construction. Concrete slabs cracked and over deflected as a result of faulty design and workmanship of the concrete formwork. The Court of Appeal upheld the trial court's decision that the over deflection and cracking were "physical damage" to the slabs. With respect to the physical component, the Court of Appeal held that physical damage denotes an alteration in the appearance, shape, color, or other material dimension of the property insured. While the Court in *Acciona* somewhat expanded on what *Progressive Homes* said about physical damage, it is still essentially visible or apparent damage.

The British Columbia Court of Appeal provided further clarity on property damage recently in *Prosperity Electric v. Aviva Insurance Company of Canada*, 2021 BCCA 237, referring to both *Progressive Homes* and *Acciona*. *Prosperity Electric* involved a commercial property policy. That policy contained the same sort of insuring language as found in a COC, as it required there to be "direct physical loss of or damage" to insured property. In *Prosperity Electric*, smoke and soot entered the insured's premises from a fire in an adjacent hallway. A small amount of chloride contamination was deposited on lighting fixtures that comprised the business' stock of merchandise. Therefore, the Court of Appeal had to determine if the chloride contamination was physical damage to the property. Relying on *Acciona*, which set out that physical damage was an alteration in the appearance, shape, color or other material dimension of property, the British Columbia Court of Appeal clarified that it had to be a harmful alteration. Ultimately, whether a harmful alteration in a material dimension has occurred will likely be a fact specific to each case.

The *Prosperity Electric* decision came out a few months before the Ontario Court of Appeal decision of *MDS Inc. v. Factory Mutual Insurance Company*, 2021 ONCA 594. The decision of the lower court, which found in favor of coverage, would have changed the Canadian insurance industry's understanding of the concept of "damage," and how time element coverage could be accessed on a construction site.

MDS involved a large nuclear reactor which was essentially made up of various compartments. Water caused corrosion of a compartment's wall; however, the water did not cause any other "physical damage." Corrosion was excluded under the policy, except for any resultant physical damage. The trial judge had held that the loss of use of the reactor constituted resultant physical damage, and therefore there was coverage for the construction-related losses. The policy in *MDS* did not define "damage" in the applicable section of the policy, and so the trial judge looked to case law for guidance.

The Ontario Court of Appeal disagreed with the trial judge. The Court of Appeal reviewed Canadian, American, and English authorities and found that loss of use or economic loss was <u>not</u> physical damage. Therefore, the Court of Appeal confirmed that physical damage requires some tangible damage, which is in line with the decisions of *Progressive Homes, Acciona* and *Prosperity Electric*.

The lower court's decision in *MDS* sent a shockwave through the construction and insurance industries in Canada and worldwide, with insureds citing MDS as a way to access business interruption or time element coverage on property policies. In the context of significant COVID-related shut downs, insureds all over the world attempted to rely on the *MDS* trial decision to claim that business or construction project shut downs involving "loss of use" were sufficient to trigger coverage under a property policy. When the Ontario Court of Appeal reversed the lower court's decision, restoring Canadian law to its precedential path, one could hear the collective sigh of relief in the Canadian insurance industry.

Had the trial decision in *MDS* been upheld, Canadian coverage law would have provided additional fodder for those seeking coverage in Canada and worldwide. The Court of Appeal's decision in *MDS* would have certainly been appealed to Canada's highest court – the Supreme Court of Canada. The implications from the decision are significant. Beyond remediating damaged property, policies may provide coverage for economic losses flowing from such damage. For example, COC policies often provide for time element coverage such as delay start up coverage and soft cost coverage. The business interruption losses from the presence of the COVID virus, resulting in "damage," would have caused notable impact on indemnity paid out.

In Canada today, there must be "property damage" in order to trigger coverage in property policies. If the insuring agreement's requirements are not satisfied, none of the time-element coverages such as DSU, soft costs, and extra expense, are triggered. While economic losses were claimed due to COVID-19, in order for a policy to be triggered, most property policies required that there had to be covered property damage. As a caveat, there are some extensions of coverage which have wording that do not necessarily require property damage for time-element coverage. Thus, the question was whether COVID-19 resulted in physical loss or damage to insured property.

On the whole, the insurance industry in Canada took the view that COVID-19 did not cause physical loss and damage. While many class actions have been and are challenging this position, there have been no cases deciding the issue until recently. In *Sir Corp. v. Aviva*, 2022 ONSC 6929, the court was asked to determine whether there was coverage for business loss as a result of business closures due to COVID-19. The insured relied on various extensions and endorsements, claiming that physical loss or damage was not required to trigger them. In other words, the insured tried to bypass the requirement for physical damage. However, the court found that the extensions and endorsements were to be interpreted with reference to whether there was a covered peril, which required direct physical loss or damage. As there was no direct physical loss or damage, the extensions and endorsements were not triggered and coverage was denied. While the court did not go into an in-depth analysis of whether COVID-19 was physical loss or damage to property, the court's conclusion indicates that it accepted that COVID-19 did not cause physical loss or damage.

Similar challenges will continue in Canada on what constitutes "damage". What may constitute an alteration in the appearance, shape, color, or other material dimension of the property insured that is harmful? Those parameters leave a fair bit of room for construction and insurance lawyers to be creative. If an application is designed and constructed with excessively large gaps, such that it is unable to function as intended, would that satisfy the requirement? Maybe.

B. Risk Management—Interplay Between Construction Policies

Construction and insurance counsel are often asked to advise on the interplay of the various policies available and which may be triggered by a loss on a construction site, including the COC, the Wrap up, and the CGL. When a construction loss occurs, understanding how the COC, Wrap Up and CGL interact is important in order for parties to manage the risk. And during the pandemic years when construction projects were significantly challenged, such risk management has certainly been front and center in Canada.

While it ultimately depends on the wording of a particular policy, the policies are meant to work in conjunction with each other, but the policy coverage is not intended to overlap. As with any coverage issue, the intention of underwriters is not always how policies are interpreted. The mechanisms used to delineate between which policy is triggered are typically exclusions and Other Insurance provisions.

The COC policy and the Wrap Up policy are project specific policies. The COC policy is meant to cover damage that occurs during the course of construction, whereas the Wrap Up policy is meant to cover losses that occur during the completed operations hazard. The completed operation hazard typically commences after substantial completion. When the COC is supposed to terminate, the Wrap Up commences. The CGL Policy, on the other hand, is not a project specific policy, and is generally meant to cover what the COC and Wrap Up do not.

When a loss occurs, the starting point is usually the COC, which expressly covers property damage that occurs during the course of construction, but terminates at the completion of construction or project. In order to avoid the Wrap Up policy operating at the same time as the COC policy, it will typically include an exclusion which sets out that there is no coverage with respect to damages to the project insured until the Completed Operation Hazard period. The

Other Insurance provision may also set out that the Wrap Up operates in excess of a COC, to ensure that there not be any overlap in coverage, and the Wrap would not be primary.

With respect to the CGL, it usually does not apply during the course of construction because of exclusions with respect to property damage to property that occurs when the insured is working on it. However, those exclusions often do not exclude resulting damage, and therefore the CGL policy *could* apply to damage that occurs during the course of construction. In any event, even if the CGL does apply to property damage during the course of construction, ultimately coverage may not be triggered if the COC covers the damage. This is because the CGL will often include an Other Insurance provision, which will render the CGL excess to other triggered policies. Therefore, if the COC covers all the damage, then there will be nothing left to sue over; thus, the CGL will not be triggered. However, it is possible that the COC will not cover all of the damage, and therefore the CGL will also be triggered.

With respect to the interplay between a CGL and a Wrap Up, the answer is usually found in the Other Insurance provisions of both policies. In more recent cases, the Other Insurance language operates with the apparent intention that the CGL is excess over a Wrap Up. However, careful review of the interplay between the Other Insurance wording in the two policies is required because sometimes they can cancel each other out, rendering both policies primary, or sometimes, whether the policy is primary or excess will depend on specific circumstances. For example, for one insured under a Wrap Up, the Wrap Up may be primary based on the wording of that Insured's CGL, but for another insured the Wrap Up may be excess because the other Insured's CGL has different wording. Further, the Other Insurance language can also factor in various circumstances outside of the policies themselves in determining which policy is primary and excess. In a recent case, there was language in the Wrap Up policy that made it excess;

however, that excess language did not apply if the construction contract required the Wrap Up policy to be primary. Therefore, at the end of the day, in order to determine which policy is triggered for any given loss, a close review of the wording of the policy and the application of that wording is necessary.

C. Other Recent Issues of Interest in Canada

In addition to whether there is physical property damage, there are other unique issues that can arise when considering coverage in the construction context.

<u>Insured Property</u> – In order to find coverage, the property that suffers damage must be insured property. Both the COC and the Wrap Up are project specific, and the property must be in some way related to the project. Often the property that is damaged is a man-made structure, and therefore likely to be insured property if it is part of the project.

However, a more unique circumstance is where damage occurs to natural objects, such as soil. Soil exists at a construction site before construction begins; however, it often has to be manipulated, such as dewatered, in order to facilitate excavation work. If the dewatering is not done correctly, and the soil caves in as a result, is there coverage for remediating the soil which requires the soil to be property insured?

A recent case from Saskatchewan, *Kelly Panteluk Construction Ltd. v Lloyd's Underwriters*, 2022 SKKB 227, indicates that soil can be property insured if it forms part of the project property. In *Panteluk*, the soil was part of the project because it was part of an earth embankment the insured had built to construct a railway crossing. While *Panteluk* involved a Wrap Up policy, the analysis of whether soil is property may nonetheless be applicable to COC policies as well. Ultimately, whether the damaged property was part of the construction project will be fact specific to any given case.

Who is an Insured – Usually, COC policies set out the named insureds and also explicitly set out categories of additional insureds, which include contractors and subcontractors. However, there are times when the policies do not set out these categories of additional insureds, and therefore the question is whether they are also insured under the policy. To make this determination, the intention of COC policies should be considered. As noted by the Supreme Court of Canada in *Commonwealth Construction Co Ltd v Imperial Oil Ltd et al*, 1976 CanLII 138 (SCC), a COC policy is by nature intended to cover multiple parties and to provide broad coverage for construction projects as a whole, rather than to specific Insureds. The Supreme Court of Canada found that the description of the property insured was sufficient to cover all subcontractors working on site. Various cases have followed *Commonwealth*.

Commonwealth described the additional insureds, as opposed to not mentioning them at all. However, there is likely a strong argument that even if a COC policy does not mention additional insureds at all, contractors and subcontractors will be insureds because it will be difficult to overcome the fact that the case law that has found subcontractors as insureds is based on the function of the COC policy generally and the way such policies describe the property insured, which will likely exist regardless of whether additional insureds are mentioned in the policy or not.

LEG and DE Exclusions – COC Policies usually include exclusions for faulty design or workmanship. However, the scope of those exclusions can vary widely. Recently, Canadian policies have been using variations of these types of exclusions developed in the London insurance market, namely the London Market Defect Exclusions (“DE”) and the London Engineering Group exclusions (“LEG”). These two London market types of exclusion often accomplish the same thing, though there are five levels of DE exclusions and three levels of LEG exclusions. Essentially, the broadest exclusion excludes all damage caused by the defect, the middle ground exclusion only excludes the cost to repair or remediate the defect before the damage occurred, and the narrowest exclusion only excludes the cost to improve the original design or workmanship.

There are few Canadian cases that have applied these London market exclusions. *Acciona*, *supra*, applied the middle ground exclusion, and in particular LEG2. In that case, only the cost of redoing the faulty formwork was excluded, as redoing this work would have remediated the defect before the damage to the slabs occurred. As the cost of redoing the faulty formwork was essentially nil, while the exclusion was triggered, it effectively excluded nothing. In other words, the Court of Appeal found that the exclusion did not exclude any damage from defective design or workmanship. Instead, the Court found that the damage was covered, and the exclusion only operated in a fashion whereby the Court calculated the cost of what it would have been to remedy the defective design or workmanship before the damage, in order to subtract that cost from the covered amount. While it is not entirely clear how the Canadian courts will interpret the other versions of the exclusion, we expect for the narrowest exclusion, a court would also cover the damage from the design and workmanship, and then only subtract the cost to improve the original design or workmanship.

As a practical concern, one thing to note is that usually the narrower exclusion comes with a higher deductible. Therefore, whether engaging the narrower exclusion is worthwhile for an insured will be fact dependent. Moreover, whether an insured will even have the option of which version of the exclusion to engage will depend on the policy itself.

D. Trends to Look Out For

The notion that clarity in policy wording is required to achieve underwriting intent is not a new concept. Yet policies are continually challenged and pushed to their four-corner limits with new situations in which an insured may claim for coverage. Canadian courts continually balance the reasonable expectations of parties, a concept gaining traction in Canadian policy interpretation, with the words on the piece of paper. Plain meaning carries the day for an insurer only when a court finds the meaning to be self-evident. All too often the risks inherent in any litigation are magnified when a judge, not well versed in construction insurance or policy interpretation, is asked to decipher what was meant to be covered. Thinking of the infinite ways that project works may go wrong is enough to inspire excitement in any construction or insurance lawyer.

V. CONCLUSION

The future for insurance and bonding in construction is likely to look different than it does today. From tougher underwriting standards, to increased premiums, to newly created insurance products to face the unforeseeable challenges, and beyond, expect the insurance landscape to evolve. The inevitably challenges will be to lower the costs of insurance and bonding while maintaining an appropriate level of insurance to protect the interests of an owner and contractor.

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[iii] Q2 P/C Markey Survey 2022, The Council of Insurance Agents & Brokers, https://www.ciab.com/resources/q2-pc-survey-2022/.

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[v] *Id.*

[vi] Gavin Souter, Property Insurers Set to Raise Rates Further, https://www.businessinsurance.com/article/20221102/NEWS06/912353319/Property-insurers-set-to-raise-rates-further.

[vii] *Id.*

[viii] *State Farm Fire & Cas. Co .v. Slade*, 747 So.2d 293 (Ala.1999); *Garvey v. State Farm Fire & Cas. Co.*,48 Cal.3d 395 (Cal.1989); *Julian v. Hartford Underwriters Ins. Co.*, 35 Cal.4th 747 (Cal. 2005); *Flomerfelt v. Cardiello*, 202 N.J. 432 (N.J. 2010); *Wallach v. Rosenberg*, 527 So.2d 1386 (Fla. 3d DCA 1988).

[ix] *Travelers Indem. Co. v. McKillip*, 469 S.W.2d 160 (Tex. 1971); *Amish Connection, Inc. v. State Farm Fire & Cas. Co.*, 861 N.W.2d 230 (Iowa 2015).

[x] *U.S. Fire Ins. Co. v. J.S.U.B., Inc.*, 979 So.2d 871, 885 (Fla. 2007).

[xi] USI, 2022 Commercial Property & Casualty Market Outlook Mid-year Addendum, https://info.usi.com/rs/121-VCO-807/images/2022_P%26C_Mid-Year_Market_Outlook.pdf?mkt_tok=MTIxLVZDTy04MDcAAAGH_aYccW3FQGxPSmSyhciw4zRjEhH12BXUMSU8vBymfmEH-yNSK2i_X2bxySuZphV7KRxcI73-HU6cSp0TdhHrcnjmcX4zsaRZswEMUkyuId0-Z5mD.

[xii] ECOMP NOW! Insurance Services, 2022 General Liability Insurance Market Outlook, https://ecompnow.com/2022-general-liability-insurance-market-outlook/ -:~:text=The%20general%20liability%20market%20has%20consistently%20underperformed%20for,standards%2C%20deploying%20less%20capacity%20and%20seeking%20rate%20increases.

[xiii] An “admitted carrier” will have met the Department of Insurance (DOI) regulations, such as filing rates and forms. A “non-admitted carrier” will not have met all DOI regulations, such as filing of rates but are approved to do business in that particular state.

[xiv] An 831b captive is a captive that takes the 831(b) election and is then taxed under the internal revenue code S831(b).

[xv] *JN Contemp. Art LLC v. Phillips Auctioneers, LLC*, 29 F.4th 118, 124 (2d Cir. 2022) (interpreting New York state law).

[xvi] *Matter of Licensing Order Issues to Gaffney Constr. LLC*, A21-0441, 2022 WL 433305, at *5 (Minn. St. App. Feb. 14, 2022).

[xvii] *Matter of Welfare of Child of J.H.*, 968 N.W.2d 593, 605 (Minn. Ct. App. 2021) *review denied* (December 6, 2021).

[xviii] *SNB Farms, Inv. v. Swift & Co.*, C01-2077, 2003 WL 22232881, at *10 (N.D. Iowa Feb 7, 2003).

[xix] *InterPetrol Bermuda Ltd. v. Kaiser Aluminum Int’l Corp*., 719 F.2d 992, 1001 (9th Cir. 1983).

[xx] *See AGW Sono Partners, LLC v. Downtown Soho, LLC*, 343 Conn. 309, 273 A. 3d 186 (2022).

[xxi] Nat’l Recruiters, Inc. v. Toro Co., 343 N.W. 2d 704, 707 (Minn. Ct. App. 1984).

[xxii] *See AGW Sono Partners, LLC v. Downtown Soho, LLC*, 343 Conn. 309, 273 A. 3d 186, 202 (2022).

[xxiii] Scott Haris, M3 Insurance, Subcontract Default Insurance (SDI): An Alternative for General Contractors, July 2, 2020, https://m3ins.com/subcontractor-default-insurance-sdi-an-alternative-for-general-contractors/.

[xxiv] Surety Bond Professionals, Surety Bonds vs. Subcontract Default Insurance, https://www.suretybondprofessionals.com/surety-bonds-vs-subcontractor-default-insurance/.

[xxv] *Id.*

[xxvi] *Id.*

[xxvii] Dawn Killough, Subcontract Default Insurance: Pros & Cons for General Contractors, https://www.levelset.com/blog/subcontractor-default-insurance/.
[xxviii] *Id.*
[xxix] *Id.*