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Alternative Project Delivery Considerations: Consideration of Existing Insurance Products

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This document's purpose is meant as a guide to assist the discussion during the ABA forum and is not meant to be fully comprehensive of all of these issues associated with the consideration of these products or various contracting methods.

Most LEAN construction professionals will tell you that IPD is a method of LEAN. Similar to LEAN principles, IPD's goal is to achieve efficiency in its project delivery method. IPD is said to lead to fewer claims, more accurate cost estimates, better defined design scope, lower cost, a more efficient schedule, and overall increased communication amongst the parties. However, IPD is a good example of how innovative contracting methods do not always line up with the insurance products currently available in the market. Nonetheless, there are products that have been in the market for some time that can be solutions to the challenges of achieving the goals of alternative project delivery.

Below is a basic discussion of just some of these products, the available market, and some of the issues that may exist within the alternative project delivery realm.

Subcontractor Default Insurance

What is it?

- An alternative to traditional performance and payment bonds
- First party insurance policy that indemnifies the insured (usually a general contractor or an owner) for costs incurred as a result of a subcontractor's or supplier's default of performance

Some of the benefits:

- Two Party relationship (Insurer & Contractor/Owner) as opposed to 3 party relationship/avoid surety fights
- Control: It puts control back into the hands of the project team
- Coverage: in general provides consistent and efficient coverage with notable enhancements that do not exist with traditional surety
- Cost: a cost effective solution
- Wide Acceptability by Lenders

Who provides this type of product in the insurance market?:

Zurich – Zurich was the leader in this innovative product. They developed it in 1995. The product is commonly known as <u>Subguard.</u>

CRU (Arch Insurance) – Some of the individuals who developed Zurich's Subguard product started this competing product within Arch Insurance.

XL – A recently developed product called ConstructAssure has been backed by a team of former Zurich underwriters.

There are differences between the products bring offered by these carriers. Each product offering can be said to target a certain size of contractor, type of construction project through its coverage form offerings, capacity of limits available, and willingness to offer lower or higher deductibles. No matter what the delivery method is it is imperative that the contractor purchasing this product has an in depth understanding as to its chosen product and its applicability to the project at hand.

In the context of IPD, Subcontractor Default Insurance is a product that makes sense. Remembering the goals of IPD SDI can contribute to some of those goals:

- Efficient, cost effective, consistent coverage
- Ability to utilize a 2 party relationship in a first party insurance context for the handling of claims
- Allows to eliminate disputes during construction operations and address the issue immediately without a third party interest slowing the process
- A claim/default that can be addressed immediately results in less loss of production and mitigate any potential delays for the IPD parties.

There are some areas that may be in question with regard to use of SDI in an alternative project delivery method like IPD. No matter which product is chosen generally it is underwritten on the basis that the General Contractor as program sponsor has an in depth proficiency to prequalify subcontractors. In true IPD, the IPD parties select the subcontractors to be used. The solution would be for the IPD parties to agree to the General contractor's prequalification process as a precursor to the selection of subcontractors to work on the project. For example if 5 mechanical subs are being considered and 3 are able to make the cut in the prequalification process administered by the general contractor the IPD group would have to agree to give best value consideration to only those three. This would pass muster with the underwriter.

Should an alternative delivery method be utilized that results in a contractual relationship other than the General Contractor/subcontractor model, special underwriting consideration would need to be made to obtain coverage through subcontractor default insurance. In the situation of a joint venture again as long as the General Contractor with the SDI program is handling the

prequalification of subcontractors it is highly likely that the existing program run by the General Contractor would allow enrollment of the project. If however there is a there is a single purpose entity formed that holds the contracts the implementation of SDI becomes more difficult. Again, to get around this would require some discussion with underwriting.

SDI products are viable insurance solutions for alternative delivery methods. Of course each project, contract situation, and the parties' needs are different. However, the overall benefits to a product like Subguard tend to be consistent with the same principles that alternative project delivery seeks to achieve – innovation, efficiency, consistency, cost effectiveness, less claims & litigation, and mitigation of loss.

Builder's Risk Insurance

First and foremost we need to address what the intent of this product is and not what it has become as a result of contract negotiations. The intent of builder's risk very simply put is to protect the work/property for those who have an insurable interest irrespective of the negligence component. Those who have an insurable interest (direct or lien interest) are the Owner, the lenders, the general contractor, and the subcontractor's of all tiers. It is an insurance product that is utilized to not only protect those insurable interests, but to eliminate disputes during construction operations.

Imagine a large claim that arises during construction operations that causes significant property damage to the project that involves the potential act or omission of multiple parties. Add to that investigations and conclusions of liability being made by multiple insurance carriers, attorneys, and experts and it has all the makings for some good litigation. During construction operations this is damaging to all of those parties. If anything, builder's risk is the product that is

the first party solution to eliminate those woes. The AIA was very purposeful in their contract language drafting to mirror this intent by typically including broad waivers of subrogation for all parties. The market has been understanding of the product's intent, has priced it accordingly, and has created coverage forms that lend themselves to partnership environments that are created through some of the alternative project delivery methods.

However, there are some challenges that may be innate to a project when considering coverage for an Owner, GC and Designer when there is a heavy design aspect that could potentially cause a loss that could result in a covered claim under a builder's risk policy. Usually builder's risk underwriters do not want to find that they are providing any form of professional liability coverage for the Architect and Engineer and typically want to retain their ability to subrogate. Standard builder's risk provides coverage for the resulting damage of defective work or design, but not typically of the defect itself. This is commonly known as Leg 2 coverage. Traditional construction of a structure does not usually offer more than Leg 2 exposure. Underwriters may or may not have concern over naming the A & E as an additional insured and including them within the waiver of subrogation. This of course would be a consideration that one would want to make certain of in an alternative delivery method where a partnership environment has been created.

Industrial and power construction types create more challenges as the engineering and design have more likelihood of compounding a loss. In this space it is expected that the builders risk coverage would provide LEG 3 wording which provides coverage for the resulting damage of defective work or design as well as the defective work itself as long as the damage is not solely a result of the existence of the defect. Only the improvement to the original workmanship or design is not covered. Underwriters on these types of projects are not as willing to provide the

waiver of subrogation for the A&E as they want to assure their ability to get back to the Professional Liability policy to recover. Again, a challenge when you are considering alternative project delivery methods.

In conclusion, the original intent of builder's risk insurance lends itself well to alternative delivery methods like IPD. It is very important for the parties to understand the products intent no matter what the delivery method and to not dilute the intent by contract negotiations that begin to add back in the component of negligence or fault. During the forum we will discuss some other common modifications to standard builder risk cover that should be considered for alternative project delivery methods.

Wrap Up Insurance Programs (OCIP & CCIP)

What is wrap up insurance?

- Coordinated insurance program providing certain coverages for all Enrolled Parties performing work at the Project Site.
- These coverages are typically worker's compensation, general liability, and excess coverages

Some of the benefits:

- Broad insurance coverage
- High dedicated limits providing more comprehensive, enhanced and consistent coverage to all parties, minimizing coverage gaps

- The increased limits afford a higher band of protection over and above the typical subcontractor insurance requirements

- Wrap up programs provide one insurance solution, which aids in avoiding disputes and complex litigation issues

From the above it would appear that wrap up programs seem to mesh very well with alternative delivery methods. Again it is always dependent upon the project and the needs of the parties. Wrap up programs were not originally designed to meet some of the need of all alternative delivery methods, but can be modified to assist in meeting most of those needs.

The owner or the general contractor can be a sponsor of a program through a rolling OCIP, CCIP or stand alone insurance programs. No matter how the program is placed there are many questions that underwriters are concerned with when it comes to the implementation of a wrap program let alone in an alternative delivery method:

- Who are the named insureds?

- Submission of financials and history of exposures by all parties involved for underwriting purposes is likely required.

- In order to be cost effective it is likely that most wrap programs have an associated deductible. How will deductible responsibility be allocated? Who and how is collateral being placed or assessed?

- Will the program be a loss sensitive program and does it require a significant escrow in additional to LOC or cash collateral requirements?

- Who will be responsible for administration and enrollment processes during construction operations?

- Who will be responsible for claims management and policyholder cooperation for the tail period of the insurance policies when losses may occur several years after project completion?

- Does the alternative delivery method require the architect to be enrolled into the insurance program?

- Will the alternative delivery method require a waiver of subrogation in favor of design professionals?

The parties to the alternative delivery method have to ask these questions as well. Most of the questions involve financial considerations, assets of the various parties, and a tolerance to share in this kind of risk.

The benefits of a wrap up program in a construction project cannot be dismissed simply because of these challenges that may arise in alternative delivery methods. In fact, it is typical for parties within alternative delivery relationships to create hybrid arrangements to allow for the implementation of the wrap. It does not mean that all parties are at risk to these financial issues or share in the risk. As such, certain additional consideration that is equitable to those parties are likely to arise. These modifications will not take away from the overall partnership environment, but rather represent a component of alternative delivery method that may have to be given different consideration in favor of broad singular coverage.

The alternative to a broad singular coverage method is a project specific policy for a combined entity. This of course comes with some of the similar underwriting questions and has had a history in the market as not being cost effective.