



PERSPECTIVES

Builder's Risk: Complexities in Insuring Existing Property

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INTRODUCTION

Property insurance for projects under construction can be significantly complex. Insuring renovation projects under a builder's risk policy will often require more care in crafting a policy that provides adequate protection. This paper is intended to highlight the myriad complexities of insuring a renovation project under a builder's risk policy.

To illustrate the unique issues found in insuring renovation projects, it is helpful to review the following hypothetical project.

HYPOTHETICAL PROJECT AND LOSS

A developer acquires a historic property in the center of a large city. The property contains a 100-year-old five-story limestone building. The developer purchased the land and building for \$5 million two years prior to the anticipated construction start date and acquired zoning approvals for the renovation of the existing building, plus an addition of five floors. When completed, the project will be mixed-use office and retail. The project will include tax credits for investors.

The following are pertinent facts:

1. The purchase price is \$5 million (80% or \$4 million allocated to the existing historic structure).
2. The design and construction costs are as follows:
 - a. \$137.5 million for renovation and the construction contract.
 - b. \$7 million in design fees.
3. The requested property coverage is \$148.5 million (the sum of the portion of the purchase price allocated to the existing structure, construction cost, and design fees).
4. The requested tax credit coverage is \$25 million.
5. The construction period will last two years.

The policy will also include sub-limits for extra expense and expediting expense. In addition, the developer's lending agreement requires delay coverage, composed of soft costs and loss of revenue. The insured also

requests coverage for loss of tax credits.

The project commences as planned. Within one week after the notice to proceed, demolition activities at the interior of the historic structure have commenced. Demolition activities including use of welding equipment cause a fire which destroys the existing structure.

The complexities and potential coverage gaps created by the hypothetical fact pattern are highlighted below. Coverage problems and potential solutions are noted as follows.

ISSUE 1: WHAT IS THE REPLACEMENT COST OF THE EXISTING STRUCTURE, AND WHAT CONSIDERATIONS SHOULD BE GIVEN TO INSURING SUCH STRUCTURES?

Where the builder's risk policy does not exclude coverage for existing property, the acquisition cost, representing the developer/owner's investment in the property, is often considered. If a catastrophic loss occurred based on the hypothetical scenario, the owner would make a claim for the cost to repair or replace the property. However, in the hypothetical example, it is undisputed that such values are not included in the amount of property coverage. If, however, a catastrophic loss occurred at the end of the project, the amount of coverage would likely be insufficient to cover the cost to replace the entire project.

POTENTIAL SOLUTIONS FOR ISSUE 1

Likely the most expedient method for determining the amount of coverage is to evaluate the replacement cost value (RCV) of the existing structure and either

include it as part of the building limit or as a separate sub-limit. However, this can be problematic to the extent that existing structures often have contributory economic value to a project that is less than (or at least different than) replacement cost. Thus, insuring such structures at RCV potentially creates a moral hazard.

Absent a determination of the RCV of existing structures, some policies are written subject to an existing structure's sub-limit. This is another expedient method for dealing with such property but may not represent coverage that is sufficient if the existing property is destroyed. Such sub-limits may also exceed the economic value that the structure contributes to the completed project.

Existing structures are sometimes written at actual cash value (ACV) or may be subject to a stated sub-limit. With respect to existing structures, recognizing that the property may not have contributory market value equal to its replacement cost, ACV clauses may present significant difficulties in the adjustment of a claim. This is primarily due to a lack of jurisdictional consistency in the application of ACV. For example, if the hypothetical loss occurred in California, a state which restricts ACV to the cost of repair or replacement minus depreciation of material cost only, the ACV loss would likely be far greater than the acquisition cost. By contrast, in New York, which follows the broad evidence rule, the loss evaluation in most circumstances (if ACV was not defined in the policy) would allow consideration of the acquisition cost or market value of the structure at the time of loss. For these reasons, ACV coverage for existing property under most circumstances is not advised, unless the policy were to include a definition of ACV that limits the insurer's obligation to an amount not to exceed the contributory economic value of the existing property at the time of loss.

Perhaps the most compelling solution to the existing structure issue would be to determine a sub-limit, or agreed amount, based on certain criteria. In this scenario, the most important question for the policyholder will be, "At what cost would repair or replacement of the existing structure become unlikely?" In the event of a catastrophic loss, an insured (and its lenders) will certainly re-evaluate the feasibility and resultant market value of the project. If the resultant value (and additional time) becomes insufficient to support the anticipated economic

value at the end of the project, the developer might decide to forego the development and dispose of the property.

From an insurer's perspective, in the event the insured chose not to repair and complete the project post-loss, then the valuation of the existing structure should arguably be the lesser of the acquisition cost of the building (segregated from the land value) or the owner's adjusted tax basis in the existing property. The adjusted tax basis is an accounting calculation that uses the cost of an asset which is reduced by depreciation or increased by capital expenditures. To the extent that the latter method is the standard by which uninsured losses are allowed to be deducted by the Internal Revenue Service in the United States, this recognizes that reimbursement for a catastrophic loss will likely result in indemnity, i.e., the lesser of language plus demolition would make an insured whole to the extent that their investment would be protected by insurance.

The most reasonable solution could be to sub-limit existing property for its resultant contribution to the overall market value of a project at completion, but not more than its replacement cost. This information is typically available to the developer and lenders pre-construction, since it is key to understanding project feasibility. The following is an example based on the hypothetical:

1. Requested property coverage is \$148.5 million (as noted above, the sum of the acquisition cost, construction, and design costs).
2. Existing structure RCV is \$12.5 million.
3. The market value at completion is \$155 million.

If the completed project had a market value in excess of the acquisition cost of the existing structure plus construction and design costs, then the amount of the economic contribution to the completed value could be established as a sub-limit. If a project were abandoned/sold post-loss, the "lesser of" language noted herein is likely the most reasonable and equitable solution. Therefore, at the time of placement, it is important for the risk manager, broker, and underwriter to fully understand the consequences and likelihood of rebuilding in the event of a catastrophic loss to an existing structure.

ISSUE 2: WHAT ARE THE COMPLICATIONS IN DETERMINING THE PERIODS OF RESTORATION AND DELAY IN THE EVENT OF A SUBSTANTIAL LOSS TO AN EXISTING STRUCTURE?

A builder's risk policy is designed to commence when construction activities begin and expire when the project is put into service for its intended use. The anticipated length of the construction project contemplated in the establishment of a policy's start and end dates should always match the project's schedule as determined by the general contractor or construction manager.

After a loss, the measurement of covered delay losses typically begins on the date the project would have been completed had no loss occurred and ends when the project is completed post-loss (assuming of course that there are no other non-loss related delays). The complexities associated with having to determine the period of restoration (time to repair or replace) and its impact on the date of completion require a significant level of study. The following are just some of the many questions that must be answered:

- How long will it take to restore the existing structure?
- Are there any concurrent delays that are excluded and/or unrelated to the loss?
- Will the ability to commence work be affected by zoning, law/ordinance, permitting, or code issues that extend the period of restoration?
- Is the repair/replacement of the existing structure in the critical path of the project, and will the project suffer a day-for-day delay equal to the time to repair or replace the existing structure?
- Is the post-loss project economically feasible?
- In a variable interest rate environment what risks are inherent in the cost of project financing and project feasibility, and how will they be affected by the loss?

- Does the loss affect the ability to obtain the tax credits for the investors?

The above questions and others give rise to a complex set of issues that should be studied and given consideration prior to the issuance of a policy. On one hand, the developer and lenders will be seeking coverage, in most instances, for the potential losses that might occur from catastrophic damages presented in the hypothetical. On the other hand, underwriters may be unwilling to take on the risk of the uncertainties presented in the hypothetical.

POTENTIAL SOLUTIONS FOR ISSUE 2

From the standpoint of a policyholder (and additional insureds such as lenders), decisions regarding what actions will be taken to continue with the project as planned will almost always be driven by the feasibility of the post-loss project. Proper diligence will require new feasibility and market analyses showing the potentially changed post-loss economic assumptions. A decision to "re-imagine" and execute the project will be driven by profitability and the resultant post completion market value of the project.

If existing property has contributory market value less than its replacement cost, it is incumbent upon the risk manager, the broker, and the underwriter to understand the potential ramifications of a catastrophic loss.

Time element coverages should be crafted with a view toward the potential gaps in coverage that may be created by a delay period that exceeds the anticipated project schedule at the time of binding. Recognition of the following can reduce coverage ambiguities post-loss:

- Prior to placing coverage, the risk manager and broker should determine the effect of a catastrophic loss on the project's construction period.
- Prior to placing coverage, the risk manager and broker should be aware of whether a project's post-loss timeline might result in the project being changed or abandoned.
- If tax credits are reduced or eliminated because of

a catastrophic loss, would this change the project's feasibility? If so, how should the tax credits be insured? Note that tax credit coverage is often embedded in delay coverage sections of policies. Because loss of tax credits may not be dependent on delay, embedding coverage for "time element" in delay endorsements is inappropriate. To the extent that the credits are either lost/delayed or not, having coverage subject to a waiting period is also an inappropriate way to deal with tax credit losses.

- Brokers and underwriters must work to craft appropriate delay coverage language and limits that provide protection at a level that insurers are willing to accept.
- Brokers and underwriters should limit coverage to provide protection to the insured that is sufficient for completion of an economically feasible project.
- If a project is abandoned or sold, underwriters should craft time element policies that relieve them of any claims for all potential delay in opening expenses and/or lost income for the hypothetical post-loss delay period.
- If a catastrophic loss to existing property results in a project being abandoned or sold, risk managers, brokers, and underwriters should seek to determine whether coverage for post-loss expenses during a defined period might be reimbursable. For example, if lenders had advanced a portion of the acquisition costs in the hypothetical example, the developer/owner may be liable for ongoing interest and other costs between the date of loss and date when the property is abandoned or sold. If this occurred, the risk manager and broker may wish to seek coverage for such post-loss expenses during a defined period, in recognition that other anticipated delays in opening and income losses would not be considered by the insurer.

CONCLUSION

Builder's risk policies and time element coverages for renovation projects can be more complex than new construction projects. The myriad factors created by each unique renovation project require exceptional care, outside-the-box thinking, and carefully tailored language to insure an appropriate level of protection. Risk managers, brokers, and underwriters need to be

mindful of these early on in the process in order to avoid confusion and contention following a loss.

***Disclaimer:** We at J.S. Held do not interpret, underwrite, or place policies. The intent of this article is to offer our expertise regarding complex situations such as those hypothetically described within.*

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