



A Guide to Understanding Construction Insurance

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A Guide to Understanding Construction Insurance

Construction project managers, contractors and subcontractors need to understand some of the issues involved in small and large construction projects from risk-management points-of-view. Any business that works on construction projects must address these issues to mitigate risk. Companies deal with risk in one of three ways.

- Eliminate the risk. Safety systems and impact and environmental analyses help control risks, but some risks prove impossible to manage.
- Live with the risk. Professional managers make solid efforts to mitigate risks, but some risks seem too remote to take seriously. Companies might decide to risk covering certain types of losses from their own resources.
- Transfer the risk. Insurance products help to transfer risks from one party to another. Contractual arrangements could require subcontractors and vendors to carry insurance to spread the costs and risks.

Major Types of Construction Insurance

Insurance falls into two basic types: first-party and third-party policies. First party policies indemnify the insured against losses of materials and worker injuries. Third-party insurance involves indemnifying companies against claims from clients or bystanders due to injuries or damages caused during construction.

Construction projects often involve multiple contractors, natural disaster risks, injuries to workers and bystanders, security problems, quality assurance and dealing with environmental damages. Construction teams include engineers, contractors, architects, subcontractors and the vendors that deliver materials to job sites. Mitigating risks proves complex and challenging because conditions change and risks evolve throughout the construction process.

The major types of insurance coverage that most managers need to consider include the following:

Builders Risk Insurance

Builders risk policies include insured contractors, building owners, subcontractors and vendors, protecting them against accidental losses of materials due to vandalism, theft, destruction of property, lightning, water intrusion, fire and high winds. Insurance claims apply to the building under construction, building supplies and materials used during the building process.

Typically, policies only cover materials up to the value of the policy. The insurance does not cover the completed value of property but only those material losses actually sustained during an unfortunate event. Policies do not cover losses before the start of construction projects or those that occur after they end. Construction must be currently in progress before these policies will pay damage claims.

- Flood and earthquake coverage usually involves adding separate riders because different regions have higher risks of experiencing these disasters.
- Builders risk policies do not include contractor's tools and equipment, which builders need to insure under private business policies.
- Soft costs, such as marketing expenses, interest, legal fees, accounting expenses and losses of income, are not covered under builders risk policies.

Insured contractors must study the exclusions and limitations of their policies carefully, so an experienced insurance broker could prove critical to project success. For example, many policies limit water-intrusion coverage. A \$5 million policy might have water-intrusion limits of \$15,000, so contract details could prove devastating. Some policies require that each subcontractor sign indemnity agreements. Failure to obtain these endorsements could result in limited or no coverage for certain events.

Premiums also depend on the type of project as defined by the Insurance Services Office. Project types fall into six categories for underwriting purposes.

Class 1—Frame. These buildings have combustible interior walls, floors, roofs or exterior walls.

Class 2—Joisted Masonry. These buildings resist fire damage for up to one hour.

Class 3—Noncombustible. Metal buildings

and slow-burning construction materials fall into this category.

Class 4—Masonry Noncombustible. Buildings that have exterior walls, floors and roofs made of materials that resist fire damage longer than one hour qualify for this rating.

Class 5—Modified Fire Resistive. These exterior walls, roofs and floors have construction materials that resist fires between one and two hours.

Class 6—Fire Resistive. Exterior walls, roofs and floors resist fires for two hours or more.

General Liability Insurance

Lawsuits have become commonplace, and lawyers advertise to encourage people to file suits for real or imagined injuries. People file these suits due to high potential settlements and the abilities to get legal representation on contingency bases. General liability for contractors proves essential to cover bystanders injured around construction projects. In many jurisdictions, contractors can bid projects without general liability protection, but they cannot perform the work without obtaining coverage.

All liability products offer different levels of protection, so good advice helps managers choose the best limits, deductibles and products for their needs. Some policies will not cover faulty work of subcontractors. The costs of liability insurance depend on the liability limits—usually in \$1 million dollar increments.

The type of work also affects premiums, and insurance companies analyze total receipts, credit ratings, payroll expenses and other factors to determine rates.

- Testing coverage often involves obtaining separate policies or contract riders. Contractors need to test key systems such as air conditioning and heating equipment, and malfunctioning machines could cause fires, explosions or injuries.
- Insurance companies get rated like bond companies, and some have stronger ratings. Contractors should check prospective insurers' ratings when getting price quotes.
- Some jurisdictions require insurance companies be "admitted" in their states or countries because some regions have different consumer laws and protections.

Railroad Protective Insurance

Standard liability policies exclude liabilities for demolition or construction projects that take place near railroad lines and property. Railroad protective insurance offers added protection for specific circumstances that relate to railroads for limited times. The policies do not offer general liability protection but only apply under narrow sets of conditions. Premiums depend on type of project, duration and liability limits, but there are no deductibles.

Self-Insured Retention

Deductibles and self-insured retention limits both represent insured contributions to

liabilities, but SIRs differ in two key ways. SIR limits add to the total policy limit because policy holders agree to pay certain amounts beyond policy limits. Deductibles get subtracted from coverage limits, and insurance companies collect these funds from insured clients directly. The insurance companies bear no responsibility for paying these SIR amounts, and insured clients pay claimants directly.

Contractors Pollution Liability (CPL) Endorsements

This coverage adds protection for damages caused by pollution, noise, mold, environmental damage, liquid spills and toxic cleanups. Unfortunately, declining revenues and increased environmental-advocacy efforts hit small contractors hard financially. These policies help decrease SIR costs from settlements and litigation scenarios. Coverage extends to include damages to natural resources, and insured clients get help with legal costs due to construction defects, property damages, environmental lawsuits and water intrusions.

Vehicle Insurance

Commercial builders operate boom trucks, cement mixers, cranes, backhoes, pickup trucks and other vehicles that could cause injuries and property damages. These kinds of equipment usually need separate policies, depending on the terms of existing liability and builders risk policies. Vehicular mishaps could easily generate extraordinary liabilities that would cause many contractors to go out of business. Even small

subcontractors might need vehicle insurance because regular automobile policies exclude vehicle incidents caused by using vehicles in work situations.

Workers Compensation Insurance

Workers compensation laws vary among states, and some states provide this coverage. Contractors who qualify for state protection in one state might need to get state-approved policies if working in other states. Workers comp policies protect employees while working, and general liability coverage extends protection when workers are off the clock.

Most private insurers cover workers in all states except those that have monopolistic regulations. These states do not allow private insurance companies to compete with state-run workers compensation plans. In some cases, general liability policies will cover incidental injuries that occur during travel or while working on out-of-state building projects. Qualified insurance brokers help contractors understand their obligations under confusing state laws and

Most states require contractors to bear responsibility for subcontractors' workers. If subcontractors fail to contract adequate insurance, then insurance companies can add subcontractors' payrolls to contractors' audits. Unlike most insurance, workers comp premiums adjust after the coverage period depending on actual payroll figures. The insured companies pay premiums based on estimates, which insurers adjust in annual audits.

- Workers compensation rates rely heavily on contractors' accident histories to determine premium rates.
- Insurance companies study accident records for four previous years to determine premium rates.
- Contractors can choose workers compensation plans insurance with high deductibles, join guaranteed-cost policy plans, make dividend-plan arrangements that rebate premiums when accident rates drop and implement retrospective programs that require companies to pay certain losses directly. These tactics help manage insurance costs.
- Superior claims-management techniques help to promote best practices that reduce injuries and lower premiums.

Professional Liability or Errors and Omissions

This coverage is called malpractice insurance when applied to lawyers and doctors. Contractors who help to design buildings and projects could be held liable for errors, omissions and incidental damages. More contractors have expanded their duties to include both designing and building services, so they face the kind of liabilities that other professionals must insure against.

Some policies combine errors and omissions coverage with protection against environmental damage. These policies eliminate multiple payments and reduce coverage gaps.

Other Types of Insurance Coverage

Contractors could benefit by contracting various types of coverage to mitigate certain risks.

Wrap-up Insurance

Owners and general contractors buy this type of insurance for large projects. The coverage extends across multiple policies and applies to everyone involved in projects. Contractors might choose to divide insurance expenses among other consultants and subcontractors.

Project Insurance

This insurance covers all aspects of single construction projects to protect against material damages and third-party liabilities.

Property Insurance

This coverage protects business and buildings.

Miscellaneous Coverage for Contractors

- Electronic Data Loss
- Employee Tools
- Loss of Business Income
- Accounts Receivable Protection
- Leased, Rented or Borrowed Equipment

Commercial umbrella insurance could help to cover any gaps in protection. Insurance coverage has become more expensive and challenging for contractors and project managers, especially in the wake of the September 11th terrorist attacks. Policies cover losses from fraud, deceit, employee theft, and bringing existing buildings up to code. Insurance brokers help small contractors navigate the minefields of risks that litigious consumers and lawyers plant for unwary building professionals.

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