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Reviewing Construction Contracts—Never Forget to Address the Issue of Builders Risk

We have entered one of the most uncertain economic climates in history. As professional surety agents we have an obligation to advise our clients who participate in both public and private construction projects regarding the insurance requirements contained in the contract. There is a considerable effort by awarding authorities and owners to shift more and more of the responsibility to the general contractor for virtually anything that could go wrong.

In 2004 through 2006, one of more remarkable examples of a construction failure was directly related to the omission of a proper builders risk policy. The situation involved an $8 million addition and rehabilitation of an existing Middle School. The awarding authority is one of the most difficult to deal with in the State and the architect did not create the best set of plans. With that as a backdrop, I think we can all benefit from learning what transpired.

The project was bid in early March of 2004. All of the bids were in line and the bonds were provided by a Class A Surety. For purposes of this illustration we will not utilize the names of three contractors involved, two of which are no longer in business as a direct result of what occurred.

Contractor One had been in business for over 15 years and focused primarily on public construction. They were awarded the project and proceeded to begin renovations to the existing building and prepare the site work for the new addition. Approximately four months into the project, Contractor One commenced the erection of steel at a critical point where the new building joined the existing building. While installing the roof joist a welder apparently generated slag, which caused a fire to start in the interior wall of the existing building even though there was a fire watch in place.

Despite the best efforts of the local fire department, the building was significantly damaged. It is important to note that this project had a very difficult construction schedule and the school committee of the local town was actively involved in decisions related to completion of the facility.

Initially Contractor One notified his insurance carrier who immediately began an investigation of the claim. As it turned out, the builders risk which was purchased by the contractor specifically excluded renovations to existing buildings and only provided coverage for new construction. Counsel for Contractor One requested if the town had made arrangements to schedule the existing building on their policy. As it turns out, their carrier also discovered that the existing building was not covered.

The town immediately notified Contractor One and its surety that they demanded the project continue due to the tight schedule. They also expected Contractor One to immediately proceed with repairs to the damaged building. After advice from counsel they decided to comply with the request under protest while attempting to negotiate reimbursement for their cost. After struggling for two and one half months to bring the project under control, Contractor One notified the surety and the awarding authority that they were unable to complete this project, along with several others, and they discontinued operations.

Since the project was well along, the surety elected to negotiate with one of their preferred clients in order to complete the school as expeditiously as possible. Enter Contractor Two. This company had been in business for nearly 100 years and enjoyed an impeccable reputation. Although Contractor Two had vast experience in all types of construction, they were a relatively new entrant to the public school market. Since time was of the essence they signed a lump sum contract with the surety and ratified almost all of

the subcontractors on the project.

Contractor Two apparently did not realize that the completion contract, which they signed, did have a pay when paid clause. At this point, the project had been floundering for several weeks and the owner was not happy. Contractor Two put its best resources on the project in an attempt to make up the schedule. The most critical aspect of the project, at this point in time, was repairing what was left of the fire damage and completing the rehabilitation of the existing building. This is when they encountered major problem number two. The electrical sub on the project certified that they had completed 75 percent of the contract for the entire project. As Contractor Two began the demo and rehab on the existing building they discovered, among other things, that the electrical contract was only 25 percent complete.

Contractor Two approached the surety and the town in an attempt to negotiate change orders for the additional work and were flatly denied. At the same time they were informed that the three requisitions that were pending in excess of $1 million would not be paid until they completed the repair work. The surety informed Contractor Two that they had signed a completion contract with a pay when paid clause; therefore, they would be forced to complete the school with their own resources and negotiate for payment at a later date. Shortly after receiving this decision, Contractor Two advised the surety that they would be unable to continue their operation without payment and were forced to cease operations.

The town was infuriated by this development and everyone started to speak through lawyers. Needless to say, this project was generating a tremendous amount of publicity, including negative publicity for the surety industry. Enter Contract Number Three. The surety decided that it was in their best interest to negotiate with a completion contractor who they did not represent but was able to provide a bond for the roughly $2 million of work yet to be completed. A deal was worked out in four days. Contractor Three refused to sign the completion contract rendered by the surety. After eliminating all of the onerous conditions including the pay when paid clause they stepped in and completed the project within ten weeks.

The post mortem on this little project involved substantial litigation and the demise of two very capable contractors. An intelligent decision was made by someone in the mix as the entire matter involving the dispute between the owner, the surety, and both contractors, who defaulted, was settled before it was fully adjudicated.

This case illustrates what can happen if the insurance requirements, particularly when dealing with the renovation and addition to an existing building are not properly addressed. Not only do we have to be cognizant of who is responsible for providing builders risk, we must be clear on the exposure and make certain that the coverage complies. This is indeed a challenge because there are so many manuscript forms being utilized by carriers whose coverage can be substantially different depending on the carrier. To view a form Durkin & DeVries Insurance Agency uses to help identify exposure associated with builders risk, visit the NASBP Risk Management & Insurance Committees resource web page by clicking here.

This is the fifth in a series of articles on Risk Management and Insurance coordinated by the NASBP Risk Management and Insurance Committee. The author of this article is Risk Management and Insurance Committee Member Thomas P. Durkin who is Managing Partner of Durkin & DeVries Insurance Agency of Burlington, Massachusetts.

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