

Questions And Answers About Builder's Risk Policies



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The better you know the policy, the better you can plan litigation—or avoid it.

WHEN A BUILDING under construction is damaged or destroyed by fire or collapse or is otherwise the site of a property damage event, there are a number of potential sources of recovery under tort or contract theories. Among the potential contractual sources of recovery are insurance policies, and within that subset of potential recovery sources there are property policies and liability policies. Within each of those “sub-subsets” of recovery sources there are various types of policies. On the property side, the two types of policies typically at issue are: (1) Blanket all-risk property insurance policies that cover an insured’s real and personal property at one or more locations; and (2) Builder’s Risk policies that are location-specific or project-specific.

This article discusses the basic scope of coverage provided by Builder’s Risk policies, as well as some standard exclusions and limitations on coverage. Following that background discussion, we consider the rights of mortgagees and loss payees to collect policy proceeds and how those rights may be affected in the event an insured fails to fulfill a condition precedent to coverage or otherwise breaches a Builder’s Risk policy.

As discussed below, property damage at a construction site will not always fall within the scope of Builder’s Risk coverage. Similarly, such losses may or may not be

covered under a general liability policy or professional liability policy. When a loss is covered by a Builder's Risk policy, there may be an opportunity for the property insurer to step into the shoes of the insured and pursue a tort claim in subrogation against a negligent third party.

BUILDER'S RISK BASICS • Buildings that are under construction or undergoing substantial remodeling present different risks than occupied residential property or operating commercial buildings. Linda G. Robinson & Jack P. Gibson, *Int'l Risk Mgmt. Inst., Commercial Property Insurance*, at IX.J.1 (2001). Generally the risks are greater and present different underwriting issues to the insurer. *Id.* As a result, with certain limited exceptions, commercial property insurance policies and homeowner's policies typically exclude buildings under construction. Builder's Risk policies provide coverage for these buildings.

Builder's Risk coverage is recognized as a species of "inland marine" property coverage. *Id.* Historically, property insurers have offered ocean marine coverage for property in transit on the open seas. Inland marine policies were modeled after those policies and provide coverage for property in inland transit, by water or land. Similarly, Builder's Risk policies essentially protect property that is "in transit." The materials that ultimately will be incorporated into the building may be in transit to a storage site, in transit from the storage site, on hand at the construction site, or in place during construction at the site. Until the project is complete and the structure becomes subject to a standard homeowner's or commercial property policy, the materials remain in some sense "in transit" on their way to becoming part of the completed building. See *Village of Kiryas Joel Local Dev. Corp. v. Ins. Co. of N. Am.*, 996 F.2d 1390, 1392 (2d Cir. 1993).

Despite the unique nature and history of Builder's Risk coverage, it is still a creature of property insurance and is similar in form and function to a standard property policy. Stephen A. Cozen ed., *In-*

uring Real Property, at 6-3 (Matthew Bender 2006). A homeowner's policy and a Builder's Risk policy for a residential project will provide somewhat similar coverages, exclusions, and conditions. The same is true of commercial property policies and Builder's Risk policies for commercial construction projects. Despite the similarities, however, construction projects involve different risks and additional interested parties, and construction losses can present a different set of questions regarding what is covered, who is entitled to policy proceeds, and how the facts of a given event may impact the rights of the various parties.

Who Are The Insureds (And Who Is Entitled To Policy Proceeds)?

A Builder's Risk policy is typically purchased by the property owner or the general contractor, and the question of who is responsible for the acquisition of this coverage is often specified in the contract documents. 11 *Couch on Insurance* §155:42 (Thomson West, supp. 2005). The insureds under such a policy will usually include the owner, the contractor, and the project subcontractors. In addition, a Builder's Risk policy may designate a lender that has a financial interest in the property as an additional insured or mortgagee. Similarly, a lender may be identified as a loss payee or assignee of policy proceeds. This sort of designation will entitle the lender to all or a portion of the policy proceeds if a loss occurs, but with important limitations discussed below.

What Property Is Covered And What Property Is Excluded?

Builder's Risk policies insure buildings and structures during the course of construction, but other types of property may also be included. For example, a policy may include buildings that are under "repair" or "reconstruction," in addition to buildings in the initial construction phase. *Insuring Real Property*, supra, at 6-8 to 6-10. Temporary

structures and scaffolding on the job site may also be identified as covered property, as may equipment that is intended to become a permanent part of the completed building. *Robinson & Gibson, supra*, at IX.J.3. Covered property may include materials and supplies on site, or within a certain distance from the building or structure being constructed. *Insuring Real Property, supra*, at 6-8 to 6-10. Materials and supplies in transit to the site, or in storage awaiting delivery to the site, may also be defined as covered property. *Id.* What is included within the scope of coverage is entirely dependent on the precise language of the policy.

Property policies usually include within “covered property” the personal property owned by an insured, or within the care, custody, and control of an insured. Builder’s Risk policies may include such language, and, therefore, a contractor’s or subcontractor’s tools and equipment could fall within the scope of coverage if not otherwise expressly excluded. *Id.* at 6-17 to 6-18. In fact, Builder’s Risk policies often do exclude the contractors’ and subcontractors’ equipment and vehicles on site, limiting the scope of covered property to the materials and equipment to be incorporated into the structure. *Robinson & Gibson, supra*, at IX.J.5.

What Are The Effective Dates Of Coverage?

Since the essential “covered property” under a Builder’s Risk policy is a building in the course of construction, it is obviously important to define when the course of construction begins and when it ends, since this will determine the inception and termination of coverage under the policy.

In establishing the effective dates of coverage, there is a noteworthy distinction between Builder’s Risk policies on one hand and all-risk commercial property policies and homeowner’s policies on the other. Homeowner’s policies and commercial property policies typically identify a specific commencement date and specific end date (such as January 1,

2008 to December 31, 2008). However, although construction projects typically have an identified schedule that includes a project start date and a project end date, anyone who has ever hired a contractor understands that construction projects do not always begin and end precisely on schedule. Moreover, it can be difficult to define what is meant by the terms “start date” and “end date” in a construction project.

Identifying the start date—or at least determining whether a loss took place after “construction” had begun—creates relatively few potential coverage issues. If some of the construction materials are on site and they are destroyed by a covered peril as the contractor is just beginning site preparation, an argument by the insurer that the loss did not occur during the course of construction will likely be rejected. *Ira S. Bushey & Sons v. American Ins. Co.*, 142 N.E. 340, 341 (N.Y. 1923). Similarly, if the covered property is being remodeled, and the structure is destroyed while the contractor is only performing preparatory work on site, courts will likely find that this initial phase still constitutes the “course of construction.” *Patton v. Aetna Ins. Co.*, 595 F. Supp. 533, 534-35 (N.D. Miss. 1984). However, if no work has begun on a structure, there can be no coverage. *Insuring Real Property, supra*, at 6-23.

Determining the date on which Builder’s Risk coverage terminates is more complicated. If the project will certainly be completed within a given time frame, the policy may identify a specific end date that is far enough into the future as to make certain that it will post-date project completion. If, however, a loss occurs during construction but after the specified policy termination date, there will be no coverage. *Hosp. Serv. Dist. No. 1 v. Delta Gas, Inc.*, 141 So. 2d 925, 926-27 (La. Ct. App. 1962). A Builder’s Risk policy on an extended project may simply carry annual premiums with annual renewal requirements so that the insureds can extend the coverage as needed until the project is completed.

A Builder's Risk policy may also specify an event that constitutes the end date of coverage, such as occupancy of the building, or the owner's acceptance of the building from the contractor, or upon project completion. A policy may also state that the policy ends on a given calendar date or upon the happening of an identified event.

The policy may attempt to define what is meant by "completion," but if it does not or if the definition is not clear when applied to the facts at hand, courts may look to such issues as whether all construction activity had ceased, whether the only remaining work consisted of de minimis items, whether the owner had begun to occupy the structure, whether the building was ready for occupancy or for its intended use, or any other indicators that the building was no longer under construction but instead was occupied or ready for occupancy or use. *Insuring Real Property*, supra, at 6-24 to 6-25.

Similarly, if the policy identifies "occupancy" as triggering the termination of coverage, it may not be clear what constitutes occupancy. Courts may look to the extent and purpose of the occupancy that preceded a loss, whether there had been a permanent occupancy or only a temporary use of the structure, and whether construction was continuing at the time of the occupancy or use in question. *Id.* at 6-26 to 6-27. If the structure was fully occupied for the permanent purpose for which the building was intended, a court will likely find that coverage terminated. Conversely, if the occupancy was temporary, or partial, or for a different purpose than the intended ultimate use, a court will likely find that coverage had not terminated. Some policies address this potential uncertainty by stating that coverage terminates if the building is wholly or partially occupied. *Am. & Foreign Ins. Co. v. Allied Plumbing & Heating Co.*, 194 N.W.2d 158, 161 (Mich. Ct. App. 1971).

Whatever the approach taken, it is obviously critical that the insured have in place a property insurance policy as of the date on which the Builder's

Risk coverage terminates. However, if an overlap might exist between the termination of the Builder's Risk policy and the inception of the property policy that follows, there can still be a dispute between the respective insurance carriers.

What Are The Covered Perils And Excluded Perils?

As with other property policies, most Builder's Risk policies are "all-risk" policies, insuring against all perils except those that are specifically excluded by the policy terms. Robinson & Gibson, supra, at IX.J.6. A Builder's Risk policy may also be a "Named Peril" policy, in which only those perils that are specifically named in the policy are covered perils. In either case, however, the doctrine of fortuity applies, meaning that the loss must result from a chance event rather than an event that is known or certain to occur, or which is within the control of the insured. *Avis v. Hartford Fire Ins. Co.*, 195 S.E.2d 545, 548-49 (N.C. 1973). Loss resulting from the deliberate act of the insured which will inevitably lead to the loss will not be considered fortuitous, nor will losses resulting from the insured's fraud or intentional misconduct. *Id.*

Among the excluded perils commonly noted in Builder's Risk policies are those dealing with faulty workmanship, faulty materials, design defects, and ordinary wear and tear. If, for example, the owner or contractor learns that a faulty material has been installed and must be removed, that cost will not be covered by a typical Builder's Risk policy. *Insuring Real Property*, supra, at 6-34. If the faulty material causes other damage, however—such as a collapse—there may be coverage for the ensuing property damage, depending on the precise language of the exclusion. Robinson & Gibson, supra, at IX.J.10. For example, some faulty workmanship exclusions state that they only apply to the cost of making good any faulty workmanship and not to any ensuing loss that is not otherwise excluded. This language may provide coverage for an ensu-

ing collapse, but not for the cost of replacing the faulty material itself.

If the faulty material, workmanship, or design requires extensive removal and replacement costs—such as replacing a wall or column—the insured may argue that the repair work was done to prevent a covered loss. Courts have generally held that such costs are excluded, but the insured may be able to establish that the costs are covered under a “sue and labor” provision, depending on the wording of such provision. *Insuring Real Property*, supra, at 6-47. Some sue and labor provisions only provide coverage for costs incurred to mitigate ongoing property damage losses; others arguably provide coverage for costs incurred to prevent an “imminent” loss.

Some Builder's Risk policies exclude the perils of flood and/or “earth movement,” including earthquakes, landslides, and sinking or shifting of the earth. *Id.* at 6-42 to 6-43. Courts may limit the scope of such exclusions so that, for example, in the event of a fortuitous earth movement resulting from non-natural causes (such as excavation work or a broken water line), there will be coverage for the resulting loss. *Winters v. Charter Oak Fire Ins. Co.*, 4 F. Supp. 2d 1288, 1291 (D.N.M. 1998). In addition, an insured may obtain flood or earth movement coverage for a construction project through an endorsement, for an additional premium and perhaps with a specified sublimit. Robinson & Gibson, supra, at IX.J.12.

A related issue is the requirement of “physical loss or damage” to covered property, which is a standard prerequisite for any claim under a property insurance policy. If the insured cannot demonstrate that an insured peril caused “physical loss or damage” to the covered property, there can be no insured loss.

How Is Valuation Calculated?

Builder's Risk policies provide coverage for the cost to replace the damaged property or the actual cash value of the property. *Id.* at IX.J.13. A

Builder's Risk policy for a commercial construction project may also cover the insured's “time element” losses, involving construction “soft costs” and delayed opening costs. *Id.* at IX.J.20. Soft costs refer to the costs beyond labor and materials (such as architectural and engineering fees, financing costs, and permitting or inspection fees). Delayed opening costs are items such as lost rental income or lost profits that would have been generated if there had been no property damage and the project had been constructed on time.

THE RIGHTS OF A LENDER TO RECOVER POLICY PROCEEDS •

As stated above, several entities can be protected by a Builder's Risk insurance policy, including the owner, the contractor, the project subcontractors, and the lender. This section examines lender's rights to recover Builder's Risk policy proceeds, discussing how those rights are determined and the effects such a determination has on the lender's rights to recover a policy's proceeds. There are few cases which discuss this issue in the context of a Builder's Risk insurance policy. The cases we cite and discuss are predominantly in the context of other types of property insurance policies. However, as we discussed earlier, Builder's Risk coverage is a type of property insurance, and issues which arise in the context of other types of property insurance are applicable to Builder's Risk coverage.

Individuals constructing homes or commercial buildings typically finance construction. These individuals obtain financing by giving a lender a mortgage in consideration for the construction price. As such, lenders often have a financial interest in property covered by Builder's Risk policies. Obviously, the borrower, or mortgagor, has an insurable interest which can be insured by Builder's Risk insurance. However, the lender's, or mortgagee's, financial interest in the property under construction also gives the lender an insurable interest, allowing it to require the mortgagor to insure the property for its benefit. *See* 4 Couch, supra, at §65:1. “[O]ften,

the mortgagee or lender, who also has an insurable interest in the property securing the loan, may seek to impose an obligation to insure that property for its benefit.” *Id.*

How Are A Lender’s Rights To Policy Proceeds Determined?

It is important to note that the lender’s status as a mortgagee does not by itself give the mortgagee a right to the proceeds of the Builder’s Risk policy obtained by the mortgagor. *Id.* at § 65:2. While there are varying ways that a mortgagor can grant the lender rights to the proceeds of a Builder’s Risk insurance policy, the type of arrangement granting those rights can drastically affect the lender’s rights to recover a Builder’s Risk policy’s proceeds once a loss has occurred.

A lender can be designated as an insured along with the policy’s other insureds. In such an arrangement, a lender becomes an “additional insured” or mortgagee under a Builder’s Risk policy. Robert E. Keeton & Alan I. Widiss, *Insurance Law: A Guide to Fundamental Principles, Legal Doctrines & Commercial Practices* 291-92 (Practitioner’s ed., West 1988). A lender is granted rights to the proceeds of a Builder’s Risk policy as a mortgagee through a standard mortgage clause (also known as a union mortgage clause) in the mortgagor’s insurance policy. *Id.* at 294-95. Traditionally, such a clause states that a mortgagee’s rights “shall not be invalidated by any act or neglect of the mortgagor or owner of the within described property.” John W. Steinmetz, et al., *The Standard Mortgage Clause in Property Insurance Policies*, 33 Tort & Ins. L.J. 81, 83 n.14 (1997) (citing *Burritt Mut. Sav. Bank v. Transamerica Ins. Co.*, 428 A.2d 333, 336 n.4 (Conn. 1980)).

In a second type of arrangement, the mortgagor arranges for the mortgagee to receive payment of the Builder’s Risk’s policy’s proceeds through a loss payable clause in his or her Builder’s Risk policy. Under such a clause, the lender becomes a beneficiary of the insurance proceeds, or a loss payee,

and is not treated as an additional insured. Keeton & Widiss, *supra*, at 289-91. Rather, the lender is an appointee, entitled to the insurance proceeds to the extent of its interest. See *Chrysler First Commercial Corp. v. State Farm Ins. Co.*, 646 N.E.2d 647, 649 (Ill. App. Ct. 1995); *In re Rose Investments, Inc. v. Star Ins. Co.*, 1996 WL 596328, at *9 (Bankr. N.D. Ill. September 16, 1996); 4 Couch, *supra*, at §65:15. A lender becomes a loss payee through an open mortgage clause (also known as a simple loss-payable clause). Steinmetz, *supra*, at 81-82; 4 Couch, *supra*, at §65:9. Such clauses typically state: “Loss or damage, if any, under this policy, shall be payable as interest may appear to lender.” Neil J. Lehto, *The Standard Mortgage Clause Under Attack: The Lender’s Insurance Claim When a Borrower Commits Arson*, 66 U. Det. L. Rev. 603, 603 n.2 (1989).

In another type of loss payable arrangement, the mortgagor can transfer his or her rights to the Builder’s Risk policy’s proceeds through an assignment of a chose in action. Keeton & Widiss, *supra*, at 290-91. Once the lender has been assigned the right to receive the policy’s proceeds, sometimes by documents that are not a part of the Builder’s Risk policy, it is not treated as an additional insured but rather, as in other loss payable arrangements, a loss payee.

What Rights Does A Mortgagee Or Additional Insured Have To Recover Builder’s Risk Policy Proceeds?

The standard or union mortgage clause provides a mortgagee, or additional insured, greater protection than a loss payable clause provides a loss payee. The standard mortgage clause, it has been held, creates an independent contract between the lender and the insurer. *E.g.*, *Fireman’s Fund Ins. Co. v. Rogers*, 712 S.W.2d 311, 313 (Ark. Ct. App. 1986); *Iowa Nat’l Mut. Ins. Co. v. Cent. Mortgage & Inv. Co.*, 708 P.2d 480, 483 (Colo. Ct. App. 1985); *Ideal Fin. Servs., Inc. v. Zichelle*, 750 N.E.2d 508, 514 (Mass. App. Ct. 2001). See also 4 Couch, *supra*, at §65:32

and numerous cases cited therein. As such, “the mortgagee does not stand or fall with the mortgagor and acquires rights which give it independent and distinct protection.” *Grange Mut. Cas. Co. v. Cent. Trust Co.*, 774 S.W.2d 838, 840 (Ky. Ct. App. 1989). Essentially, the insurer cannot assert against the mortgagee defenses it has against the mortgagor. *Fortson v. Cotton State Mut. Ins. Co.*, 308 S.E.2d 382, 383 (Ga. Ct. App. 1983); *see also Hartford Fire Ins. Co. v. Assoc. Capital Corp.*, 313 So.2d 404, 407 (Miss. 1975). In practice, this means that the mortgagee is protected if the mortgagor breaches the insurance contract or commits bad acts, such as arson, fraud, or misrepresentation, which would void coverage. While the insurance contract between the mortgagor and the insurer would be void in such cases, the mortgagee’s contract with the insurer would remain valid. The mortgagee would maintain its rights to the proceeds of the Builder’s Risk policy’s proceeds.

Additionally, a mortgagee maintains its rights to a Builder’s Risk policy’s proceeds if a covered loss follows foreclosure. Normally a change in the ownership of a covered property is prohibited by insurance policies; however, “a foreclosure sale is not deemed a ‘change in ownership’ unless someone other than the mortgagee purchases the property.” Mark E. Cohen & Brooks V.B. Powers, *What Real Estate Lawyers Need to Know About Insurance Coverage* 9-10 (citing *Nationwide Mut. Fire Ins. Co. v. Wilborn*, 279 So.2d 460 (Ala. 1973)); *see also* 4 Couch, *supra*, at §65:59. “[T]he mortgagor’s, but not the mortgagee’s, rights are cut off by the institution of foreclosure proceedings.” *Id.* (citing *Altshuler v. New Brunswick Fire Ins. Co.*, 176 A.359 (N.J. 1935)). As such, the mortgagee retains its rights to the insurance proceeds even after foreclosure.

What Rights Does A Loss Payee And Assignee Have To Recover Builder’s Risk Policy Proceeds?

A loss payee or assignee, in contrast, is afforded much less protection as “[t]he rights of a loss

payee are derivative of the insured’s rights. There is no independent contract between a loss payee and the insurer.” Cohen & Powers, *supra*, at 10; *see also Rushing v. Dairyland Ins. Co.*, 456 So.2d 599, 602 (La. 1984). As such, when a mortgagor breaches the Builder’s Risk insurance policy and voids the contract, the mortgagee loses its rights to the proceeds of the policy. Additionally, a mortgagee may lose its rights to a Builder’s Risk policy’s proceeds if a covered loss follows foreclosure. *Id.* “[W]here a foreclosure sale occurs before a loss, the loss payee loses its right to the proceeds, unless it specifically notifies the insurer of the foreclosure.” *Id.*

Cases Illustrating Mortgagees’ And Loss Payees’ Rights

Cases in which the insured has breached an insurance policy by committing arson, fraud, or misrepresentation, or failing to fulfill a condition precedent, illustrate the importance of the arrangement by which a lender obtains its rights to insurance proceeds.

In *Whitney National Bank v. State Farm & Casualty Co.*, 518 F. Supp. 359, 361 (E.D. La. 1981), the court discussed whether the arson of the property by the insured (President of the company located on the property) barred claims by Whitney National Bank (protected under the mortgagee clause of the insurance policy). The court found that the determinative factor in resolving the dispute was whether Whitney was entitled to protection under a standard or union mortgage clause or an open mortgage clause. *Id.* at 361-62. The court stated that “where there are loss payees in a policy of insurance pursuant to an open mortgage clause, i.e. without inclusion of a standard or union mortgage clause, their right to recover is contingent upon, and purely derivative of the right of the mortgagor to recover from the insurer.” *Id.* at 362. However, if the clause at issue was a standard mortgage clause it would essentially create a new contract between the mortgagee and the insurer which could only be

breached by the mortgagee itself, not by the actions of the mortgagor. *Id.* at 362 n.2 (citing 5A Appleman, *Insurance Law and Practice* § 3401 (West 1970)).

The court held that the policy provision at issue in *Whitney National Bank* was an open mortgage clause, and therefore, the claim by Whitney was barred because arson constituted not only a valid defense against the insured, but also against the loss payee whose rights were derived from the insured. *Id.* at 363.

The distinction between the rights of loss payees and mortgagees is also exemplified in cases in which the mortgagor breaches by committing fraud on the insurance policy. In *Old Colony Co-Operative Bank v. Nationwide Mutual Fire Insurance Co.*, 332 A.2d 434, 435 (R.I. 1975), the mortgagor failed to disclose his criminal and financial records accurately. The fraud voided the insurance policy between the mortgagor and the insurer. *Id.* The court reviewed the common law and held that under a standard mortgage clause (as opposed to an open mortgage clause) two contracts are created, one between the mortgagor and insurer and one between the mortgagee and insurer. *Id.* at 435-36. The court further held that the clause at issue in the case was a standard mortgage clause because it required notice to the mortgagee before cancellation of the contract. *Id.* at 436. Therefore, if two contracts were created, “then where only one is voided the other will remain intact.” *Id.* The court concluded that the insurance policy was not void as between the mortgagee and insurer, and the mortgagee could still make a claim under it. *See id.*

Courts have not been as consistent when ruling on the effect of the insured’s failure to fulfill a condition precedent. In *Germania Fire Insurance Co. v. Bally*, 173 P. 1052, 1054 (Ariz. 1918), the insurer argued that the insurance policy had not followed the title to the property when the property was transferred from the original property owner to the subsequent owner, due to mistakes made during transfer. Therefore, the insurer contended, since

the insurance policy had not transferred to the current owner, neither the current owner nor the mortgagee could make claims under the insurance policy. *Id.* The Supreme Court of Arizona rejected this argument and decided that under a standard mortgage clause a mortgagee “is justified in assuming that the insurance company has satisfied itself that the policy is valid and free from impeachment for any conduct or act of the assured at its inception or prior to the attachment of the mortgage clause.” *Id.* at 1054-55. The court reasoned that because the standard mortgage clause created an independent contract between the mortgagee and the insurer, “the mortgagee is impliedly or expressly relieved from doing the things ordinarily required of the mortgagor, and likewise exempted from the penalties for neglect or omission.” *Id.* at 1055. The court’s decision indicates that a mortgagee can make a claim under a standard mortgage clause even if the policy is void due to the failure of the mortgagor to fulfill a condition precedent.

Not all courts agree with the Supreme Court of Arizona regarding the rights of mortgagees in situations in which the mortgagor has failed to fulfill a condition precedent. In *Young Men’s Lyceum v. National Ben Franklin Fire Insurance Co.*, 163 N.Y.S. 226, 227 (N.Y. App. Div. 1917), the court considered the issue of whether a warranty in the insurance policy requiring a fire hydrant to be placed not less than 500 feet from the property was binding upon not only the mortgagor, but the mortgagee as well. The court decided that breach of the protective warranty did not fall within the protection of the standard mortgage clause (which said the policy “shall not be invalidated by any act or neglect of the mortgagor”) because the warranty was not “an act or neglect,” but a condition upon which the validity of the policy depended. *Id.* at 230. The court concluded that the mortgage clause “must be read in connection with the rest of the policy, of which it is made a part, and all conditions that are consistent with it, and not exempted by it, must be deemed

to be incorporated into it.” *Id.* at 232. Therefore, the protective warranty was applicable against the mortgagee as a condition precedent to the validity of the insurance policy (so long as it was determined that the protective warranty was included on the policy before it was issued). *Id.* at 232-33.

CONCLUSION • In understanding a lender’s potential right of recovery under a Builder’s Risk

policy—whether one is advising a party at the time the various contracts are being negotiated or advising a party after a loss—it is essential to understand not just the scope of coverage and the applicability of any conditions, exclusions, or limits, but also the policy language pursuant to which the lender will seek recovery. Focusing on that language at the outset will help avoid litigation later, and focusing on it after a loss will inform one’s litigation strategy.

PRACTICE CHECKLIST FOR Questions And Answers About Builder’s Risk Policies

- Who are the insureds (and who is entitled to policy proceeds)? The insureds under such a policy will usually include the owner, the general contractor, and the project subcontractors. In addition, a Builder’s Risk policy may designate a lender that has a financial interest in the property as an additional insured or mortgagee.
- What property is covered and what property is excluded? Builder’s Risk policies insure buildings and structures during the course of construction and can include other types of property such as:
 - ___ Buildings that are under “repair” or “reconstruction”;
 - ___ Buildings in the initial construction phase;
 - ___ Temporary structures and scaffolding;
 - ___ Materials and supplies on site, or within a certain distance from the building or structure being constructed;
 - ___ Materials and supplies in transit to the site or in storage awaiting delivery to the site;
 - ___ The personal property owned by an insured or within the care, custody, and control of an insured.
- What are the effective dates of coverage? The commencement of coverage depends on when the course of construction begins and when it ends. The date on which coverage ends can be a date certain or a date tied to construction completion or occupancy. This inquiry will depend on the precise policy language and the facts of the case.
- What are the covered perils and excluded perils? Most Builder’s Risk policies are “all-risk” policies, insuring against all perils except those that are specifically excluded by the policy terms. However, some are “Named Peril” policies, in which only those perils that are specifically named in the policy are covered. Among the excluded perils commonly noted in Builder’s Risk policies are those dealing with:
 - ___ Faulty workmanship;
 - ___ Faulty materials;
 - ___ Design defects; and
 - ___ Ordinary wear and tear.
- How is valuation calculated? Builder’s Risk policies provide coverage for the cost to replace the damaged property or the actual cash value of the property.

- How is a lender's right to policy proceeds determined? The lender's status as a mortgagee does not by itself give the mortgagee a right to the proceeds of the Builder's Risk policy:
 - ___ A lender can be designated as an insured along with the policy's other insureds;
 - ___ In a second type of arrangement, the mortgagor arranges for the mortgagee to receive payment of the Builder's Risk's policy's proceeds through a loss payable clause in his or her Builder's Risk policy. Under such a clause, the lender becomes a beneficiary of the insurance proceeds, or a loss payee, and is not treated as an additional insured;
 - ___ In another type of loss payable arrangement, the mortgagor can transfer his or her rights to the Builder's Risk policy's proceeds through an assignment of a chose in action.
- What rights does a mortgagee or additional insured have to recover Builder's Risk policy proceeds? The standard or union mortgage clause provides a mortgagee, or additional insured, greater protection than a loss payable clause provides a loss payee. Additionally, a mortgagee maintains its rights to a Builder's Risk policy's proceeds if a covered loss follows foreclosure.
- What rights does a loss payee or assignee have to recover Builder's Risk policy proceeds? A loss payee is afforded much less protection, so if a mortgagor breaches a Builder's Risk policy, a mortgagee designated as a loss payee or assignee loses its rights to the proceeds of the policy. Such a mortgagee may also lose its rights to a Builder's Risk policy's proceeds if a covered loss follows foreclosure.

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