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A Construction Lender's Nightmare—No Wrap Insurance and We Foreclosed

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The insurance coverage issues faced by construction lenders dealing with broken residential development projects pose potential liabilities that must be evaluated before a lender takes control of a project, whether by foreclosure or a deed-in-lieu. The same issues and considerations also confront a receiver appointed to complete construction of a project. It is vital to thoroughly review the status and coverage of construction insurance in place for a distressed project. The high number of construction defect claims filed in California, combined with the inclination of judges and juries in this State to afford innocent homeowners and homeowner associations a remedy, are a trap for lenders or receivers who are not thoroughly knowledgeable about potential construction claims and the issues attendant thereto.

Lenders should understand the implications of the California construction claims statute, known as "SB800", which governs the procedures and process for the handling of potential construction defect claims and the insurance obtained to insure against such claims. SB800 prescribes both the construction standards and warranties applicable to new residential projects, and the grievance procedures and dispute resolution procedures for resolving construction defect claims. Under SB800, developers have the option of establishing their own procedures for resolution of claims and disputes rather than having to strictly comply with the statutory protocols. If such election to use alternate procedures is not made, the developer and its successors are subjected to the onerous statutory obligations and rigid time frames of SB800 in order to be able to benefit from the right-to-repair provisions of SB800.

Lenders who become owners by foreclosing and who perform any work of improvement to the project to complete construction, or respond to requests of owners or buyers to fix project improvements, may very likely have exposed themselves to liability for potential construction defect claims which could extend for a period of up to ten years. As projects took much longer to complete and cost overruns started to plague projects, the likelihood of construction defect litigation in failed projects is almost a certainty for the following reasons: (i) the high probability that substandard materials may have been used, (ii) the use of shortcuts and substandard construction practices by developers, contractors and subcontractors in light their economic difficulties and (iii) the non payment of monies owed for work performed. More often than not, with problem projects, it is not always what you can see that will be the source of the future problems and claims. The fact that there may not be insurance to make claims against and the fact that lenders may be perceived as the only means of recovery, particularly where developers and contractors are no longer viable targets or insolvent, should be of significant concern to lenders who are considering foreclosing on projects.

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Ideally, potential construction defect claims are adequately addressed by wrap construction insurance. Most insurance policies do not cover SB800 claims since they are deemed "warranty issues". However, construction insurance is a complex matter where all assumptions should be avoided regarding: adequacy of coverage, whether or not coverage requirements have been satisfied, and the enforceability a developer's successors (such as a lender or by a receiver). The prior action or inaction of the developer, its contractor and/or subcontractors may give rise to a denial of coverage by the insurer. In this economic environment, insurers are **very** alert and aggressive to the opportunities to deny coverage.

The risk of claims is especially high with respect to condominium projects due to the fact that numerous attached residences may be affected by a single structural issue, a roof, water intrusion problems, or the use of inadequate noise attenuation measures and protocols, and the existence of a homeowners association that have the specific right to use association funds to fund litigation. In the past decade, most of the insurance policies issued for such multi-family buildings have been "wrap insurance policies," also referred to as "OCIP" or "CCIP," which cover the builder and all of the qualified enrolled subcontractors under one policy. Wrap policies became necessary because the multiplicity of applicable policies became unwieldy to manage and insurance became increasingly more expensive to procure, particularly for subcontractors involved in condominium construction. Under a wrap policy, a subcontractor will typically pay a share of the premium and will self-insure for the deductible portion for claims arising from the subcontractor's work. Wrap policies, however, do not necessarily simplify coverage issues for the insured and/or their successors.

It is important to note that just because a developer had a wrap insurance policy it does not mean that it is still in effect, or that it will cover the lender or receiver. If the wrap insurance is still in effect it does not necessarily mean that there is adequate insurance. A borrower/developer may have secured wrap insurance that covered multiple projects and the amount of insurance left to cover a particular project may be woefully insufficient. Many developers left the responsibility to secure wrap insurance coverage to their long time general insurance agent. Not all agents are equal nor are there many agents that are well versed in the complexities of wrap insurance. More importantly, very few developers ever read the wrap insurance policy to assure themselves that they had received the desired and intended benefits of such insurance. Sadly, we are finding that most developers did not have the wrap insurance coverage that they thought they had. Regrettably, lenders and receivers are now becoming all too aware of the issues and problems caused by that lack of understanding and diligence.

There are also typically two types of insurance: (a) "on-going operations" which covers claims which may arise during construction; and, (b) "completed operations" which covers construction defect claims arising after a Notice of Completion has been filed on a project. Lenders should not assume that had the developer acquired both, nor should lenders assume that had the developer acquired both, that the lender had been added as an additional insured. Other likely

potential issues include a failure by cash-strapped developers to keep their premium payments current.

It is also important to note that most wrap policies require that the legal fees and defense costs incurred by the insurer be applied against the principal amount of the coverage, thereby reducing the dollar amount that will be available to satisfy potential claims. These policies are typically referred to as "defense within limits". This subtle issue of insurance coverage is often missed by less sophisticated insurance brokers and developers, leaving them with the false belief that they have the full amount of the policy to address the construction problems.

The intent of this article is to raise the awareness of lenders and receivers to risks associated with the likely specter of construction defect claims and the problems being encountered to adequately and safely defend against them, the existence of viable and adequate insurance coverage being the most important. Once you know that these complex issues exist, you will be in a better position to evaluate your options.

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