ADJUSTING TODAY®
Adjusters International Disaster Recovery Consulting

Soft Cost or Delay in Opening: Insure for the Potential Exposure

EDITOR'S NOTE

To address the all-important topic of soft cost or delay in start-up coverage, we welcome first-time Adjusting Today *author, Tony D'Amico. A veteran public adjuster, Mr. D'Amico has more than 30 years of experience in the insurance industry and in this in-depth feature article, he brings his specialized expertise to bear on what is today considered a highly important, but often overlooked, facet of coverage.*

In addition to discussing the evolution of builders risk coverage over the years and examining some of the factors responsible for its transformation, Mr. D'Amico focuses attention on soft cost exposure, also known in the industry as delay in opening or start-up coverage.

By sharing his personal experiences over the past three decades, the author's intent is to help readers avoid many of the adjustment issues that can arise in a builders risk loss from policies that fail to include a comprehensive scope of coverage.

Soft cost coverage is a topic that can be controversial and confusing, but Mr. D'Amico has wisely broken it down into consumable pieces that, taken together, convey a simple message: many potentially thorny issues can be headed off by proper underwriting of risk.

I hope that you find the information presented here of benefit in your day-to-day operations or interactions with clients and that we have provided you with a useful resource.

— Sheila E. Salvatore, Editor

By Tony D'Amico, SPPA

Over the past 30 years, we have witnessed the evolution of builders risk coverage from a basic sticks and bricks policy to a very complex mechanism for insuring a multitude of risks to which a construction project may be exposed. The focus of this article will be on the soft cost exposure or what is commonly referred to as delay in opening or start up.

Soft cost coverage evolved in response to the increasing number of projects with construction time frames in excess of one to two years. Moreover, as large projects are often supported by very complex financing arrangements, lenders look to this type of coverage to protect their interests particularly from the standpoint of the income expected to be generated by the project. When a catastrophic loss delays the completion of the project, the resulting income loss and additional carrying costs can be enormous. Hence, the development of soft cost coverage and the need to

Years of experience have indicated that the vast majority of the adjustment issues encountered in a builders risk loss arise from policies that are woefully deficient in terms of the scope of coverage.

indemnify the owner, contractor or subcontractors, and lender for losses as a result of a delay in the completion of the project.

However, despite the development and enhancements in the delay in start up coverage, it is surprising how frequently we encounter policies that are extremely deficient in terms of the coverage relative to the exposure of the project. Years of experience have indicated that the vast majority of the adjustment issues encountered in a builders risk loss arise from policies that are woefully deficient in terms of the scope of coverage. The million dollar question and sometimes the multi-million dollar question is, "Why?"

First, it is important to understand exactly what soft costs are within the context of a builders risk exposure. In the developer/contractor world, soft costs are those costs incurred to perfect a construction project other than labor and material (which are commonly referred to as hard costs). Examples of such soft costs are architect and engineering fees, permits and certain general conditions. In the context of builders risk insurance, soft costs are related to those costs arising from a delay in the completion of the project.

While the type of soft costs incurred in connection with the construction of the project may correspond to a certain extent to the types of costs that will be incurred as a result of a delay in the completion of the project, there is a significant distinction between the two for purposes of writing a comprehensive builders risk policy. This distinction is often misunderstood by risk managers, agents and brokers, and this translates into policies that do not adequately indemnify against the loss associated with the delay of the project. Again, the question is, "Why?" And the answer is that the risk manager or broker often perceives these soft costs to be covered under the property damage policy, or what is commonly referred to as "hard costs," and thus fails to insure these costs against the risk of delay in the completion of the project.

To the extent that the contractor/developer costs are incurred directly in connection with the restoration of the physical damage, such costs are properly covered under the property damage element of the coverage. However, in the event of a loss, the contractor/developer will in most cases be on the project for an additional period of time. That additional time period may affect the anticipated completion date, thus necessitating the need for soft cost coverage. If repairs take an additional 10 months, the anticipated completion date is typically set back by at least the equivalent period of time. During the

In the context of builders risk insurance, soft costs are related to those costs arising from a delay in the completion of the project.

delay period, there are many costs that will continue to be incurred that would have otherwise ceased had the project been completed on schedule.

Examples of these costs are: interest on loans, real estate taxes, builders risk insurance, legal and accounting fees, contractors' general conditions, developers' fees, inspection fees, and consulting and marketing fees. The key to writing a comprehensive builders risk policy is to identify these potential costs and the extent to which they will continue during a potential delay. Additionally, there is the matter of lost income from operations and/or rental value. These exposures are typically part of delay in opening coverage and we will deal with such exposures separately in the latter portion of this article.

Understand Project Economics

So, how does one go about the task of writing comprehensive soft cost coverage so that it will not be the source of adjustment problems in the event of an insured loss? First, it is imperative to fully understand the economics of the project. Typically, the potential exposure could be assessed by reviewing development and operational budgets that were established for the project. Such budgets or *pro forma* statements will provide a snapshot of the type of costs expected to be incurred as well as the amount of such costs over a given period of time. Having identified the scope of such costs, an assessment must then be made as to which expenses would continue in the event of a delay and to what extent.

The type of expenses that are typically incorporated into the basic soft cost endorsement are: real estate taxes, interest, insurance premiums, legal, accounting, architect and engineering fees. However, will this basic scope of soft cost expense cover the full exposure of costs that will be incurred during a delay period? Usually not. As a matter of fact, we have seen many soft cost endorsements that are limited to taxes and interest, or one or two other items. This begs the question as to why soft cost endorsements, more often than not, fail to come even close to covering the full range of the exposure.

With soft cost coverage, what you see is what you get. In other words, the soft cost endorsement will apply only to those items that are specified in the body of the policy. Quite often you will see a provision added to a very short list of soft costs that reads: "and others as accepted by the company." This is often mistakenly interpreted to give a blanket catch-all for all other types of delay expenses that are not listed or specified. This misunderstanding can create very contentious issues following a loss. Many policies contain fine print that states these "other costs" must be delineated in the policy or declarations and often there is no additional coverages delineated. In the absence of such language, the company adjuster may interpret this provision to mean that the insurer has the sole discretion as to whether or not there is coverage for a given cost.

With soft cost coverage, what you see is what you get. The soft cost endorsement will apply only to those items that are specified in the body of the policy.

The lesson is to be certain that the entire range of potential delay expenses should be specified in the soft cost endorsement. It is not advisable to leave the question of whether or not an expense is covered to the sole discretion of the insurance company. Having said this, what are examples of soft cost items that are frequently overlooked and that lead to significant gaps in the coverage?

Contractors' extended general conditions or additional contractors' costs and developers' fees top the list. If a project is delayed for 10 months, as an example, the contractor will be on that project for an equivalent period of time or longer and will be incurring essentially the same general conditions for that period of time. The extended general conditions can only be covered if they are so itemized in the soft cost endorsement. The same situation applies to a developer. The developer continues to incur costs such as office overhead, salaries, travel and other related developmental "soft costs." Again, these costs can be substantial and will be covered if and only if it is specified in the soft cost endorsement.

With respect to the scope of potential delay exposures, an illustration of such exposures is as follows:

- ***Real Estate Taxes***
- ***Interest***
- ***Legal, Accounting and Consulting***
- ***Marketing and Advertising***
- ***Insurance***
- ***Architectural and Engineering***
- ***Refinance Charges***
- ***Leasing Fees***
- ***Contractors' Overhead and General Conditions***
- ***Developers' Overhead***
- ***Equipment Rental***
- ***Tax Credits***

Compensable Amount is Limited

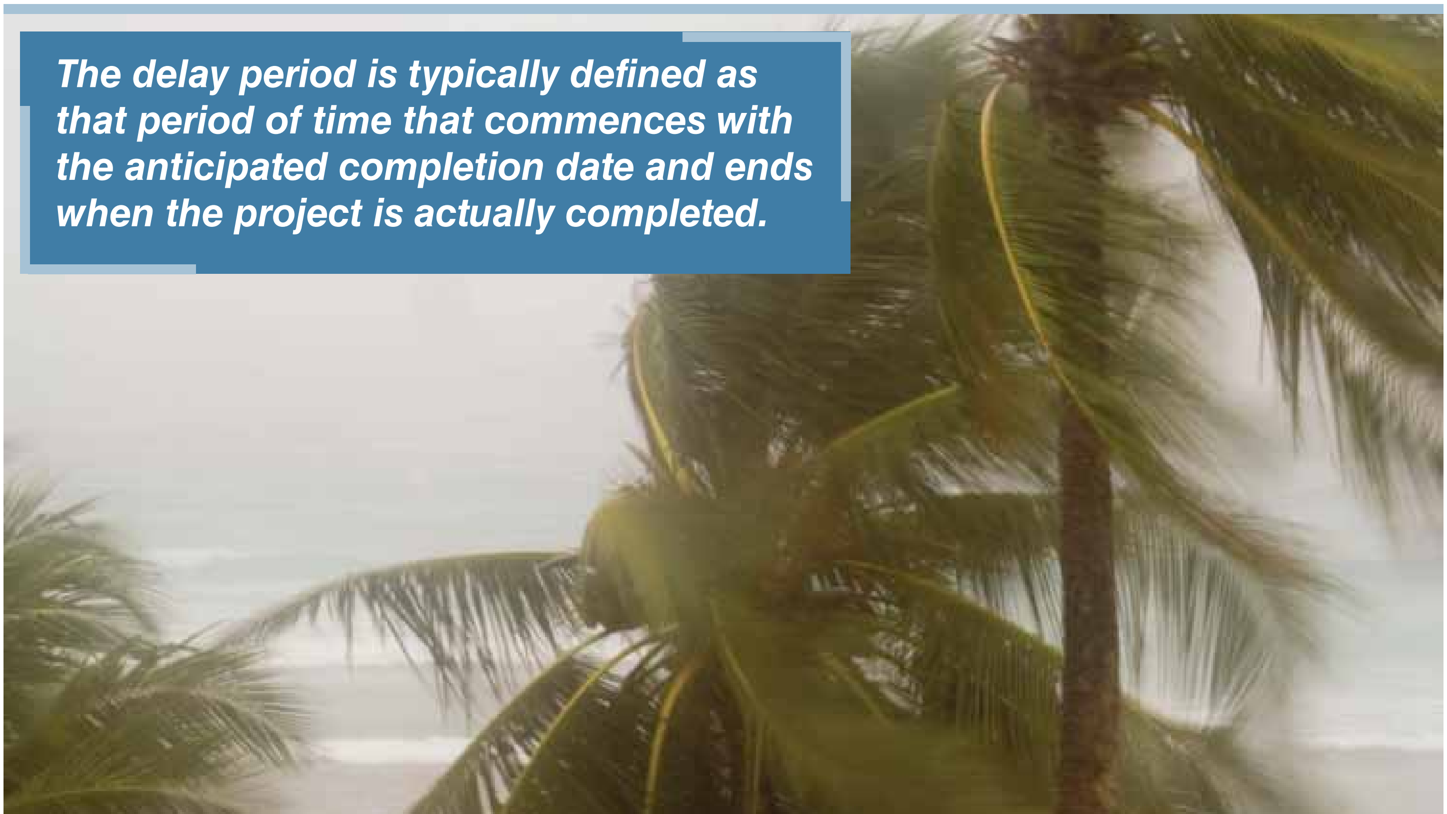
One might counter with the argument that these costs are part of the property damage and thus should be compensable in conjunction with the repairs to the sticks and bricks. There is an element of accuracy to this, however the amount compensable under the property damage coverage is limited to the amount of general conditions or developers' costs that can be allocated to the repair of the physical damage and not to any costs which are a result of the delay in completing the project. Again, it is important not to lose sight of the distinction between the costs to perfect the repairs and the costs incurred as a result of the delay in completing the project. Failure to recognize this distinction is the leading cause of significant deficiencies in the builders risk program, not to mention problems in the adjustment process.

There may be other potential exposures based on the nature of the project that may have to be contemplated. This is why developing a comprehensive understanding of the project and identifying all potential exposures that could occur in the event the project is delayed is so critical to the development of the builders risk program.

There are other key issues that must be considered when developing a comprehensive soft cost coverage program. Let's start with the duration of the project. Quite often, we will encounter soft cost policies that provide for a period of indemnity that is significantly shorter than the time frame for the completion of the project.

For example, a project may have a three-year construction period; however, the period of indemnity for purposes of the delay coverage is limited to 12 months. So what happens when a project that takes almost three years to complete is destroyed by fire a month before its anticipated completion date? Needless to say, there will be significant uninsured losses as the time needed for the adjustment of the loss and the time to rebuild this project will go well beyond the 12-month limit.

The delay period is typically defined as that period of time that commences with the anticipated completion date and ends when the project is actually completed.



Other factors related to the loss may arise and contribute to the delay in the actual completion of the project. Examples of such factors are change in sequencing of contractors and subcontractors, material and labor availability and seasonal/weather conditions.

Clearly, a crucial component of these losses is the period of indemnity; thus a sufficient time frame based on at least the planned duration of the construction should be considered.

Under a builders risk policy, the soft costs that are specified in the declarations are covered during the "delay" period. The delay period is typically defined as that period of time that commences with the anticipated completion date and ends when the project is actually completed. Often, there is a time deductible of, say, 14 or 30 days that attaches to the anticipated completion date and represents the commencement of the covered delay period.

Where due diligence is exercised and there are no other factors giving rise to the delay, the delay period is usually equivalent to the restoration period. In many cases however, other factors related to the loss may arise and contribute to the delay in the actual completion of the project. Examples of such factors are: change in sequencing of contractors and subcontractors, material and labor availability, seasonal/weather conditions, etc. In other words, the period of indemnity does not necessarily end when the damage caused by the loss is repaired or restored. Rather, the period of indemnity will end when the project is completed providing that factors not related to the loss or within the control of the insured contributed to the delay. Many inexperienced adjusters will often approach a delay loss in the same manner that they would approach the determination of the period of indemnity for a loss in connection with a completed building under a property policy. This often leads to contentious adjustment problems and/or an incomplete recovery for the sustained losses.

Often, the insurer will contend that the project wasn't on schedule or there were other factors not loss-related that contributed to the delay in the actual completion of the project. We can hypothesize about how to deal with this, but the important lesson is to provide for an adequate period

The risk manager, insured, or broker should closely monitor the construction progress and report any changes in the anticipated completion date to the insurance company.

of indemnity when setting up and procuring the policy. In addition, it is prudent to be proactive in dealing with other circumstances that may delay the project following a loss occurrence so as to eliminate or mitigate loss adjustment issues arising from the need to separate loss-related factors from non-loss related factors.

Throughout the course of this article, we have referred to the "anticipated completion date." What does this mean and what implications does it have in the evaluation and adjustment of a builders risk loss?

The anticipated completion date is typically the date set forth in the construction contract for the completion of such project. Typically, the policy will reflect this date as being the anticipated completion date against which any subsequent delay will be measured. This date is a very significant factor, however, it is often overlooked or not given due consideration. Insomuch that coverage commences at the anticipated completion date, careful attention must be given to scheduling changes that may occur throughout the term of the project. All such changes should be reported and the policy modified accordingly.

Most readers will opine that construction projects are typically behind schedule and that is just a reality of life. In some cases, on the other hand, projects are actually finished ahead of schedule. Take, for example, a project with an anticipated completion date of June 30 which is specified in the policy. Due to acceleration efforts implemented by the contractor, the completion date is moved up to March 1. For purposes of this illustration, assume further that a major fire occurred in February and as a result of the damage, the period of indemnity and delay is 10 months.

Based on the policy language, coverage would not commence until June 30, which is the stated anticipated completion date. As indicated, the project was on course to be completed March 1, if not for the loss. In the absence of the anticipated completion date being modified, coverage would not commence until June 30, thus leaving a four-month gap for which the delay costs will not be compensable.

The point here is that the risk manager, insured, or broker should closely monitor the construction progress and report any changes in the anticipated completion date to the insurance company. This will avoid what could be significant shortfalls in the amount of the loss that is recoverable.

Thus far, we have discussed the need to identify, quantify and specify the total soft cost exposures in the policy. We have discussed other germane issues such as the meaning of the delay period and how the period of indemnity is determined. All of these issues could have a very significant impact on the evaluation and adjustment of a loss and ultimately the extent of the recovery by the insured. This, however, does not necessarily cover the complete exposure.

An additional critical element of delay coverage is business income and rental value. This coverage is intended to compensate the insured for income losses sustained as a result of the delay in the completion of the project. When discussing this coverage, one of the first questions frequently asked is: "If you have soft cost coverage, why is income or rental value coverage needed or vice versa?" We believe that a soft cost endorsement is incomplete without income or rental value coverage. These coverages are not mutually exclusive and neither one will individually provide comprehensive coverage for a loss arising from a delay in opening.

Prior to analyzing the rationale for including both rental value/business income in a soft cost coverage program, we would strongly recommend that the loss determination clause include language providing that the loss will be measured based on the planned level of occupancy or the anticipated level of operations at stabilization. The reason for this is to completely eliminate any issue as to how the loss will be measured.

Insured Made Whole

With respect to a building under construction, operations obviously have not yet commenced. Therefore, when a loss occurs that delays the anticipated completion date, the loss measurement should be based on full practical occupancy or planned level of operations; if not, the insured will not be made whole.

For example, consider an apartment project. Had the project been completed and occupancy commenced, there would have been a ramp-up to stabilization over some period of time. In the event of a loss that caused a delay in the completion, a measurement of the rental value loss based on the experience of the business (had no loss occurred), would not take into account the revenue generated at stabilization or full practical occupancy. However, when the repairs and subsequently the project is completed and the apartments begin to lease up, the owner/insured would experience a second ramp-up and thus would sustain an uncompensated loss or in other words, not be made whole.

In policies that do not include language providing for the planned level of occupancy, we believe that the insured is nevertheless entitled to the income that would have been generated on the basis of planned level of occupancy or operations based on the concept of actual loss sustained. However, this can be a contentious issue and in the interest of avoiding problems, a proactive underwriting approach that formulates the loss determination clause to correspond to a builders risk exposure will eliminate many of the loss measurement problems and facilitate the adjustment process.

Back to Business Income vs. Soft Costs — Are they mutually exclusive?

A comprehensive builders risk program should include soft costs *and* business income/rental value. While there may be some overlap between the two coverages, such overlap is typically very limited and can be dealt with in the adjustment of the loss. On the other hand, the exposure created by not combining soft cost coverage with business income/rental value can give rise to significant uninsured losses.

One of the explanations or theories for not combining soft cost coverage with business income coverage is that many of the "soft costs" covered by the policy represent expenses that would be earned by the operations of the business. For example, real estate taxes and interest are common soft cost coverages, however, they are also operational type expenses that would be covered as continuing expenses under the income coverage. Other examples are: advertising, legal, accounting and insurance. If one were to claim these as a continuing expense and as soft costs, theoretically there could be duplication in the claim.

Delineate Soft Costs

However, there are many expenses that could be incurred as a result of the delay that are development/construction in nature as opposed to operational expenses. Examples of these types of expenses are contractors' general conditions, office and administrative overhead of the contractor, the developers' fee, equipment rental and other additional contractors' costs all of which can be very substantial. Therefore, as these types of expenses would not be covered under the business income coverage, complete indemnification for these expenses will require placement of soft cost coverage as well. Keep in mind that it is imperative to delineate in the delay in opening endorsement all soft costs for which there is an exposure, such as the aforementioned items.

Furthermore, operational type expenses that are not specified in the declarations of the delay in start-up endorsement would not be compensable under soft cost coverage, thus resulting in uninsured losses in the event that income coverage is not provided. Typical examples of such operational expenses are: salaries and wages, utilities, maintenance, entertainment and medical insurance, etc. These types of expenses will often be incurred during a delay period, especially if the loss occurred at the later stages of construction and the owner was gearing up to commence operations. In the absence of income/rental value coverage, net income that was expected to be generated from the project would not be covered as well.

In regard to operating profit, many owners or developers do not perceive the need for income coverage as they may not expect the project to achieve any degree of profit at the beginning of operations. However, given that income potential is measured on the planned level of occupancy/earnings, the insured would be entitled to recover any lost income as well as the continuing operational expenses based on the experience of the business at a planned or stabilized level of operations.

A comprehensive builders risk program should include soft costs and business income/rental value.

To summarize, it is imperative that the full scope of the project's soft costs be quantified and specified in the soft cost endorsement of the policy. In addition, the projected earnings or rental value at planned levels of occupancy or operations must be incorporated into

Another critical element when developing a comprehensive insurance program is to be certain that the interests of all parties involved in the project be contemplated and incorporated into the policy.

the income coverage at full value. By doing so, the named insured(s) will, in the event of a major loss, have a comprehensive insurance program in place that will minimize if not eliminate the risk of uninsured losses.

In addition to providing the appropriate soft cost and income coverage, and allowing for a sufficient period of indemnity, another critical element when developing a comprehensive insurance program is to be certain that the interests of all parties involved in the project be contemplated and incorporated into the policy. Typically, either the owner or the contractor will procure the builders risk policy. What happens frequently is that the party procuring the insurance usually obtains coverage based on its interests. As a result, the interests of other parties are often overlooked or not sufficiently addressed.

Identifying the interests of the parties to the policy and the construction contract is an absolute prerequisite to developing a proper and comprehensive insurance program. Failing to cover the interests of all parties will leave gaps in the coverage and most certainly lead to disputes between the parties. Adjusting builders risk losses is difficult enough without interjecting feuds between the various insured parties.

What happens frequently is that the party procuring the insurance usually obtains coverage based on its interests and the interests of other parties are often overlooked or not sufficiently addressed.

For example, in a real life situation, a policy procured by the owner/developer of a major office project included coverage for rental value to protect its interests in the rental income from tenant occupancy. Rental value is typically defined in the policy as "anticipated income from tenant occupancy plus continuing normal operating expenses including the amount of charges and expenses that would be the legal obligation of the tenant but would otherwise be the owner's obligation..."

It does not include any other type of earnings. Therefore, what about the interests of the contractor? The contractor is a named insured on the policy and as such is entitled to all of the benefits provided by that policy. Although the contractor does not

have an interest in the operation of the completed project, he does have an interest in the expected earnings from building the project for the owner. In this loss scenario, the construction contract required the contractor to affect all repairs and assume the cost for same, all of which would not necessarily be reimbursable under the builders risk policy.

In this example, there were many uninsured costs during the delay period, the most substantial being the contractor's extended general conditions. So how could the contractor's interests have been protected? One method, of course, would have been to include general conditions in the soft cost coverage; or the policy could have been written to include gross earnings coverage in addition to the rental value coverage. To the extent that the contractor incurred extra costs that were not insured under the policy, the profit margin that would have otherwise been earned was reduced. This reduction or margin erosion may have been compensable under a gross earnings coverage form had it been included in or in conjunction with the delay coverage.

In today's world, there are many substantial mixed-use projects being developed that entail office space, residential, retail, or condo components. In many cases, the owner/developer will operate a business that is part of the development. Under these circumstances, the owner's interest in the project is not limited to rental income but also includes earnings from the operation of the business. The contractor also has an interest in the earnings that they expect to generate. In view of this, gross earnings coverage should be contemplated along with rental value in the development of the builders risk policy to cover all exposures for all parties to the contract.

By properly quantifying the full scope of the losses that could be incurred as a result of a delay in the completion of the project due to a fire, collapse or some other peril, one might think that all of the bases are covered. There is yet another potential gap in coverage that is often overlooked mainly because of a misunderstanding in the application of soft cost coverage.

The coverage period for soft costs commences with the anticipated completion date subject to a waiting period that is typically 14 or 30 days. For example, a major loss occurs to a building at a time when it is approximately 50% complete and a year away from its anticipated completion date. A significant delay in the completion date is expected and there will be a substantial loss associated with soft costs incurred during the delay period. However, as in many cases, the owner and/or contractor begins to incur many expenses immediately after the loss. The typical expenses are for emergency services, clean up and protection of property.

The insured will also incur architectural and engineering expenses to evaluate the damage, make recommendations for stabilizing the project and prepare plans for the rebuild. There should not be a coverage problem in connection with these expenses as they relate to the restoration and repair of the physical damage. Therefore, the coverage for the property damage also known as "hard costs" should respond and indemnify the insured for such costs.

However, there may be other costs that are incurred immediately after the loss, such as marketing, public relations, legal and accounting services that are required, but not necessarily related to the costs of the restoration of the damaged property. Insomuch that these types of expenses do not relate to the replacement or repair of the damaged property, they do not fall within the purview of the property damage coverage or hard costs.

Moreover, as the delay period does not commence until the anticipated completion date, these expenses may not be indemnified as a soft cost either, since technically they are not a function of delay and were not incurred in the delay period. Hence, a potentially significant gap in coverage exists.

Phased Projects

A similar situation exists where a project is being completed in phases and permission to occupy is granted under the policy. Take, for example, a situation where tenants take possession of a completed phase of a project while the balance of the project is still under construction and a loss occurs causing the occupied space to be untenable. How would the ensuing income or extra expense losses be covered? Or would they under a builders risk policy?

Probably not, although, the placement of a property policy carrying business income and extra expense coverage would fill the gap, as such coverage would commence at the date and time that the loss occurred. All resulting income losses and expenses covered by the policy would be compensable, thus making the insured whole.

It is important to keep in mind that where business income is written into the builders risk policy, as an element of the delay in opening endorsement, it too will be subject to the terms of the delay in opening endorsement. Thus, as indicated, coverage for the income loss will not commence by definition until the anticipated completion date; subject to the applicable time deductible. Hence, the need for a permanent property policy with time element coverage to fill the potential coverage gap resulting from a situation where an income exposure may exist before the entire project is completed.

In the absence of a property policy, the aforementioned gap can be minimized by utilizing the expense to reduce the loss coverage which most builders risk policies contain. This provision will provide coverage for extra expenses that are incurred post-loss; however, the amount payable for these expenses will be limited by the amount to which such expenses actually reduce the soft cost and/or income loss that would otherwise have been incurred as a result of a delay in the completion of the project. This is obviously more restrictive than "pure" extra expense coverage, however, such coverage will apply to expenses incurred immediately following the occurrence and may reduce otherwise uninsured losses in part if not in whole. It is necessary under this type of scenario to calculate a *pro forma* loss exposure to establish the recovery limit for such expenses.

Another common coverage found in most builders risk policies is expediting expense, which must be distinguished from extra expense. The typical language is as follows:

Expediting costs and additional cost of construction materials and labor:

1) We will pay for the following costs made necessary by a covered cause of loss to covered property at the "job site;"

(a) Your costs to expedite repair of covered property; or

(b) Your increased cost of construction materials and labor.

2) The most we will pay under this additional coverage is the least of:

(a) 5% of the applicable "basic limit of insurance;" or

(b) $100,000

This coverage will indemnify the insured for costs that are incurred to accelerate the repairs and reduce the delay period. The benefit of this coverage is that it does not require the insured to demonstrate that there was a reduction in the amount of loss that would otherwise have been payable. The drawback is that underwriters typically do not offer much in the way of limits for this type of coverage. It is usually $50,000 or $100,000 and occasionally $250,000.

Because accelerating the completion of a project post-loss relates not only to the damage repairs but also to the completion of the project as well, it does not take long to exhaust this coverage when construction crews are working extra shifts, weekends and holidays. Accordingly, it is advisable to have a gross earnings and/or expense coverage in place to eliminate potential uninsured losses. With this, the last of the typical and frequent gaps in coverage have been minimized if not eliminated.

Conclusion

Builders risk coverage has been, and most likely will continue to be, the source of much controversy and confusion. Many of the issues that result in uncompensated losses and/or litigation could be minimized if not eliminated by proper underwriting of the risk.

Having the proper builders risk coverage in place should provide some peace of mind in knowing that your policy will provide the necessary foundation for recovery and minimize the financial impact of uninsured losses.

Tony D'Amico, SPPA
Adjusters International

ADJUSTERS INTERNATIONAL

CORPORATE OFFICE
126 Business Park Drive
Utica, New York 13502

800.382.2468
Outside U.S. 315.797.3035
FAX: 315.272.2054

editor@adjustingtoday.com

PUBLISHER
Ronald A. Cuccaro, SPPA

EDITOR
Sheila E. Salvatore

WEB ADDRESSES
www.adjustersinternational.com
www.adjustingtoday.com

ADJUSTING TODAY

ADJUSTING TODAY is published as a public service by Adjusters International, Inc. It is provided for general information and is not intended to replace professional insurance, legal and/or financial advice for specific cases.

AT08-2 3034