

All change

Is it the end of the line for professional indemnity and construction all risk insurance?

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Risk, the need to reform construction insurance, Integrated Project Insurance and the Insurance Act 2015

- ▶ Change in profile of construction risk
- ▶ Insurance Act 2015
- ▶ Integrated Project Insurance in place of
 - Professional Indemnity (PI) and
 - Construction All Risks Insurance (CAR)
- ▶ Reforming Insurance Market Wordings.

Domestic Claims



- ▶ The Gherkin
- ▶ The Cheese Grater
- ▶ Heron Tower
- ▶ The Shard
- ▶ The Walkie Talkie

Large Policy Claims



Professional Indemnity and CAR

- ▶ Major Insurers are no longer prepared to provide insurance cover for construction industry professionals.
- ▶ Construction industry professionals, particularly architects and engineers, are more willing to rely on inadequate professional indemnity cover.

Professional Indemnity and CAR

In 2014 several leading insurers announced their withdrawal from Architects and Design and Build Insurance.

"As part of our strategy to improve the business performance of the Group we are sharpening our focus on target markets and segments where we can deliver sustainable returns and growth".

New forms of Construction

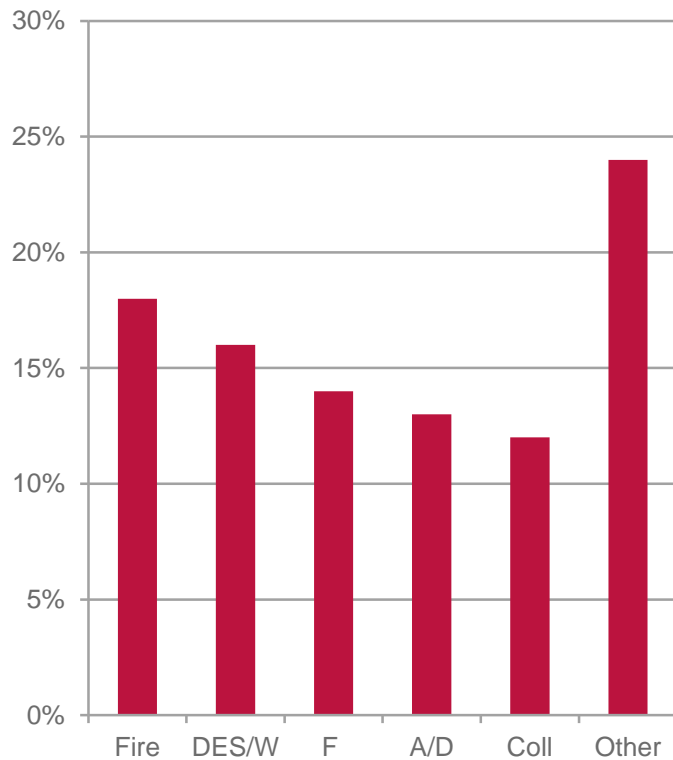


Innovative Design

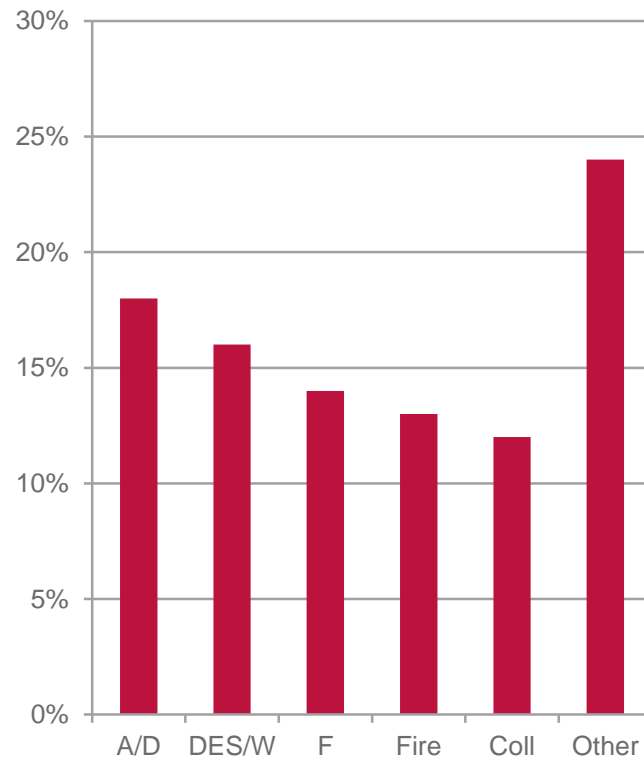


Largest Losses by Severity

Severity % of total incurred value



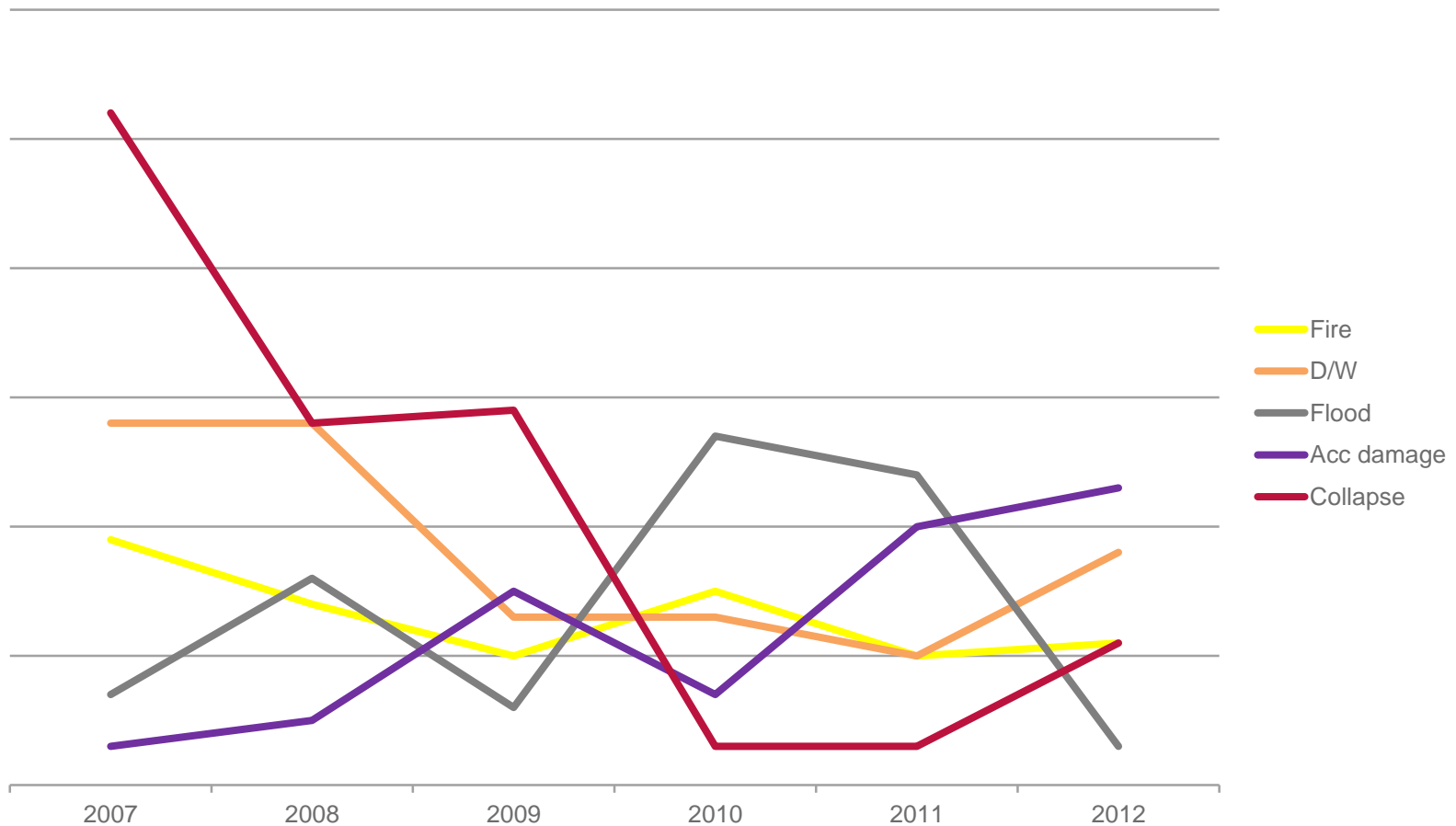
Frequency % of total incurred value



Analysis

- ▶ 225 claims over \$300m
- ▶ 16 major categories
- ▶ Frequency and severity similar.
- ▶ Design and workmanship the second most frequent and severe.

Trends in Total Incurred Value of Top Losses



Analysis

- ▶ A significant drop in losses caused by collapse and subsidence.
- ▶ Linked to improvement in building regulations and practices.
- ▶ Increase in flooding due to climate change.
- ▶ Increase in design and workmanship – now second area of loss.
- ▶ Fire losses are large and usually preventable.

Frequency of National Category Perils

Growing concern regarding frequency of national category perils.

- ▶ Earthquake
- ▶ Hurricane/typhoon
- ▶ Flood

Flood



Causes

Failure to identify risk

- ▶ Flooding due to hurricane/typhoon
- ▶ Mould in humid climates
- ▶ Inadequate supply of quality materials

Causes

Failure to manage risk

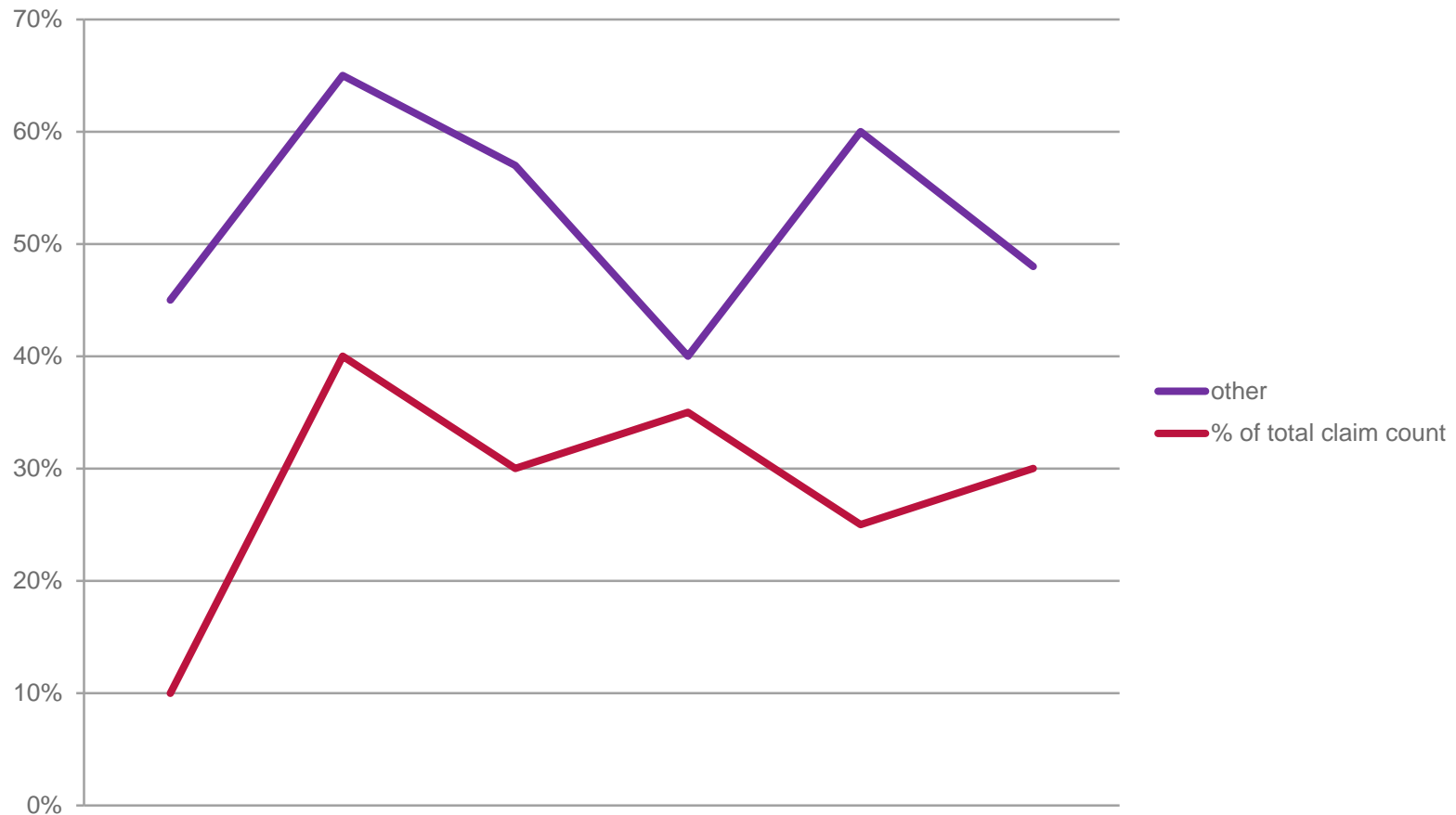
Lack of knowledge of local conditions:

- ▶ Site location and layout
- ▶ Project design
- ▶ Construction sequencing

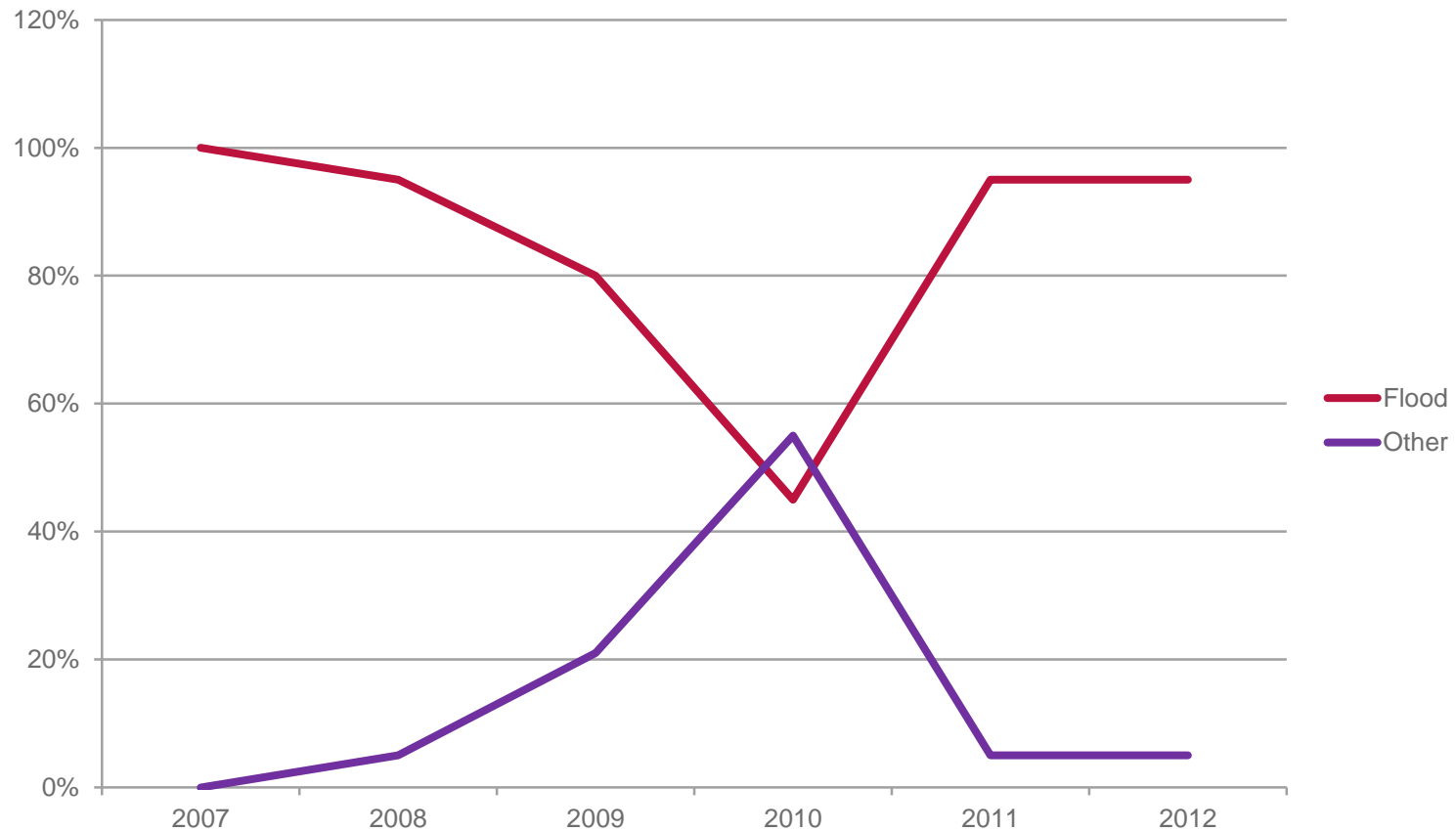
Causes

- ▶ Working with unfamiliar Joint Venture partners
- ▶ Working with unfamiliar major subcontractors

Rise of Flood as a Natural Peril



Losses in Emerging Markets



Causes

Disproportionate rise

- ▶ Less knowledge of geo technical conditions
- ▶ Reliance of local joint venturers
- ▶ Less rigid building regulations
- ▶ Different standard of materials

Domestic Claims

- ▶ Fire
- ▶ Design
- ▶ Value Engineering
- ▶ Flood

Allocating Risk

- ▶ More risk placed on Owner
- ▶ Caps, exclusions, deductibles for professionals
- ▶ Fewer Insurers, possible increase in premiums

Integrated Project Insurance

- ▶ Part of Government Construction Strategy
- ▶ Published July 2014 by Cabinet Office

“The Government Construction Strategy (2011) set out to achieve savings in construction procurement of up to 20%. Reforming procurement practices to effect behavioural and cultural change underpins this effort.”

Objective

“The proposition is that IPI will cost no more than traditional project insurances, but the real benefits are from collaborating as a “virtual company” to eliminate process and procedural waste and deliver improved project performance and efficiency savings which achieve the expectations of Government Strategies.”

Framework for IPI

- ▶ The IPI model requires the creation of an Alliance or “Virtual Company”
- ▶ Each practice or firm has a seat on the Board which collectively appoints an Alliance Manager.
- ▶ Staff are seconded to form an Integrated Project Team reporting to the Alliance Manager and Board.
- ▶ IPI is the “crucial enabler” for this model.

The Alliance Contract

- ▶ A flat structure of the client and other alliance members that brings together key parties.
- ▶ Free flows of information, including costing and payment (through a project bank account).
- ▶ The IPI policy which insures cost overrun above a shared deductible.

Capped Financial Exposure

- ▶ The “pain-share” is the excess under the financial loss section of the IPI policy.
- ▶ The Alliance members financial exposure is capped at their agreed share of the total pain-share.

Insured Outcomes

IPI covers project outcomes and not individual liabilities:

- ▶ IPI pays the cost overrun beyond the excess subject to minimal exceptions.
- ▶ cover for incidents during design and construction, such as physical damage and third party claims.
- ▶ “no fault” latent defects insurance for 12 years.

Conditions

- ▶ IPI is only available as part of the IPI Model.
- ▶ Insurers agree a wider range of cover than under traditional project policies.
- ▶ Expected to recognise and fund overspends promptly after they have been identified and verified.

Study for the Office of Government Commerce

- ▶ The combined premium cost of traditional construction all risks, public liability and professional indemnity insurances on a commercial development throughout the supply chain amounted to 2.5%.

- ▶ The cost of IPI fixed at 2.5% of the project cost.

Cover

- ▶ Section 1: Construction All Risks (including Terrorism Extension)
- ▶ Section 2: Third Party Liability (including Non-Negligent Liability)
- ▶ Section 3: Delay in Completion (resulting from damage under Section 1)
- ▶ Section 4: Financial Loss cover
- ▶ Latent Defects cover (for 12 years) – a “no fault” commercial latent defects insurance policy.

Insurance Act 2015

The Act addresses perceived current imbalance in the law in favour of insurers in the following areas:

- ▶ Disclosure and misrepresentation in business insurance contracts
- ▶ Insurance warranties
- ▶ Insurers' remedies for fraudulent acts

Insurance Act 2015

- ▶ Amends the Third Parties (Rights Against Insurers) Act 2010 so it can be brought into force.
- ▶ The 2010 Act simplifies the procedure for third parties to seek compensation from an insurer in circumstances where the insured has become insolvent or ceased to exist.

Insurance Act 2015

- ▶ Correcting defects in the 2010 Act
- ▶ The 2010 Act failed to deal with all categories of insolvent or defunct entities.

Fair Presentation of the Risk

- ▶ The insured has a duty to make a “fair presentation of the risk” to the insurer.
- ▶ The duty applies to pre-inception disclosure as well as variations of non-consumer insurance contracts.

The Duty of Fair Presentation Comprises of Three Elements

The insured's duty of disclosure

- ▶ The insured must either:
 - disclose every material circumstance which it knows or ought to know, or
 - failing that, give the insurer sufficient information to put a prudent insurer on notice that it needs to make further enquiries for the purpose of revealing those material circumstances.

The First Limb Misrepresentation

- ▶ The duty includes the duty not to make misrepresentations (section 20 of the 1906 Act).
- ▶ The insured is not required to disclose material circumstances which the insurer knows, ought to know or is presumed to know.

The First Limb

- ▶ A business insured is taken to “know” what is known to the insured’s senior management and individuals responsible for the insured’s insurance.
- ▶ An insured “ought to know” what would have been revealed by a reasonable search of information available to the insured.

The Second Limb

- ▶ Changes the existing law
- ▶ It is intended to address the risk of an insurer taking a passive role in the disclosure process and only asking questions when the insured makes a claim under the policy.
- ▶ Requires the insured to make the disclosure in a manner which would be reasonably clear and accessible to a prudent insurer.

Knowledge

- ▶ **“knows”**: What is known to the individuals involved in that particular underwriting decision.
- ▶ **“ought to know”**: Information which is readily available to the underwriters or is known by an employee or agent of the insurer who ought reasonably to have passed it on.
- ▶ **“presumed to know”**: Matters it ought to know in the ordinary course of its business, such as industry knowledge.

Proportionate Remedies

- ▶ The new Act provides for a range of proportionate remedies.
- ▶ Unless the breach is deliberate or reckless (in which case the remedy of avoidance is still be available), the onus is on the insurer to show what it would have done had it received a fair presentation of the risk.

Proportionate Remedies

- ▶ Insurers will still be entitled to avoid the policy if they can show that had they received a fair presentation of the risk, they would not have entered into the contract.
- ▶ Will Insurers now introduce additional warranties or exclusions which affect the recoverability of claims?

Duty of Good Faith

- ▶ The duty of good faith remains as a interpretative principle.
- ▶ A breach of the duty no longer automatically entitles the insurer to avoid the policy and will instead be subject to proportionate remedies.

Warranties

Under the 1906 Act, a breach of warranty discharges the insurer's liability under the contract in its entirety, even if the breach was trivial or did not relate to the insured's loss.

Warranties

- ▶ Under the new Act, a breach of warranty will no longer automatically take the insurer off risk.
- ▶ The Act makes warranties “suspensive conditions”.
- ▶ The insurer’s liability will be suspended while the insured is in breach of a warranty but can be restored if the breach is subsequently remedied.

Basis of the Contract Clauses

- ▶ Clauses, which operate to turn the insured's pre-contractual representations (including answers to questions on a proposal form) into warranties are known as 'basis of contract' clauses.
- ▶ These clauses have been abolished.

Terms to Reduce Particular Risks

- ▶ An insurer may not rely on the insured's breach of a term to avoid paying a claim if the breach could not have increased the risk of the loss.
- ▶ Applies to breaches of warranties and other terms which tend to reduce risk of loss of a particular kind or at a particular location or time.
- ▶ It does not apply to terms which define the risk as a whole.

Insurers' Remedies for Fraudulent Claims

An insurer:

- ▶ is not be liable to pay fraudulent claims.
- ▶ can elect to terminate the contract and refuse to pay claims relating to losses suffered after the fraud.
- ▶ will remain liable for all legitimate losses suffered before the fraud.

Contracting Out

Parties to non-consumer insurance contracts may contract out (with the exception of the prohibition on “basis of the contract” clauses) as long as any “disadvantageous term” (which puts an insured in a worse position than that under the default regime) meets transparency requirements.

Transparency

- ▶ An insurer must take sufficient steps to draw the disadvantageous term to the insured's attention before the contract is entered into or the variation agreed; and
- ▶ the disadvantageous term must be clear and unambiguous as to its effect.

Reforming Standard Insurance Market Wordings

“All Risks” CAR Insurance

Is not insurance for “all risks”

All Risks

- ▶ Does not explain that all risks are not covered.
- ▶ Does not provide an explanation that all risks cover is not a guarantee of good condition or of good working order.

Example of a Standard Exclusion

Wear and tear, corrosion and
gradual deterioration

“Normal making good, wear, tear or the cost involved in rectifying normal wasting, wearing away, corrosion or gradual deterioration”

Wear and Tear, Corrosion and Gradual Deterioration

Wear and tear

The ordinary and natural deterioration or abrasion that an object experiences by its expected contacts during its natural life expectancy.

Defect Exclusions

Since 1985 a suite of standard form defect exclusion clauses, drafted by a committee of leading insurers, has been available to the market.

DE Clauses

The clauses, labelled “DE1” to “DE5” by the original drafting committee, provide five different levels of cover thought to adequately define the various degrees of cover that insurers were prepared to offer.

“LEG 1” to “LEG 3”

A similar suite of standard form defect exclusions clauses was introduced in 1996 by a consultative group of engineering insurers known as the London Engineering Group (“LEG”) for engineering class risk.

DE5

This policy excludes:

- ▶ The cost necessary to replace, repair or rectify any Property insured which is defective in design plan specification materials or workmanship;
- ▶ Loss or damage to the Property insured caused to enable replacement, repair or rectification of such defective Property insured.
 - But should damage to the Property insured (other than damage as defined in (ii) above) result from such a defect, this Exclusion shall be limited to the costs of additional work resulting from and the additional costs of improvement to the original design plan specification materials or workmanship...

The Issues

The DE clauses use different terms without explanation

- ▶ So that they exclude the cost of repairing or replacing property which is lost or damaged “*due to defective design plan specification materials or workmanship*” (DE1)
- ▶ or in “*defective condition due to a defect in design plan specification materials or workmanship*” (DE2, DE3)
- ▶ or is “*defective in design plan specification materials or workmanship*” (DE4, DE5).

DE 1 – Lack of Clarity

An outright exclusion for damage **caused** by a defect

- ▶ Is “*defective ... workmanship*” limited to defective workmanship **built** into the insured property, as would be defective “design”?
- ▶ Was the intention to exclude damage to the building inflicted directly by a mistake in the method of working?

DE 1 – Anomalous

- ▶ It is phrased so as to apply only where the damage is caused by (“due to”) a defect.

- ▶ It is anomalous that the other DE clauses contain no such requirement.

DE 2 – Inconsistent Interpretation

- ▶ JCT requires the minimum level of cover that must be obtained in an all risks policy with a defects exclusion clause akin to DE2.
- ▶ However the minimum level of cover does not fully correspond to DE2 in one important respect.
- ▶ Requires cover where a defective part, and any structure supported by it, is damaged by a peril other than the defect itself, the standard DE2 wording exclude cover in this situation.

DE 3 – May not provide wider cover than DE1

- ▶ To apply the Insurers does not have to show a causal link between defect and damage as required by DE1, but merely that the property “is in defective condition”
- ▶ Provided the insurer can show that the property was in a defective condition the exclusion applies

DE 3 – Requires Divisibility

- ▶ The exclusion hinges on the distinction between “*Property ... which is in defective condition*” and “*other Property insured which is free of the defective condition*”.
- ▶ *Blackwell v Gerling*, “[t]his suggests, and indeed requires, divisibility.”

Dividing the Indivisible

No clear indication as to how to distinguish between defective and non-defective parts.

Possible tests for *“property ... in defective condition”*

- ▶ whether the material or item in question is rendered less useful or valuable by reason of the defect.
- ▶ whether the item was likely to be damaged if the defect materialised.
- ▶ whether the item is distinct in “commercial” or “construction” terms from the defect.

DE 3 – Dividing the Indivisible

Tuckey L.J. in *Blackwell (Contractors) Ltd v Gerling*

the “*property insured*” excluded by the clause must be “*restricted to that part of the works which has suffered damage. If that part is wholly or partly defective the exclusion applies*”.

But the assured can only claim an indemnity for “*loss or damage*” so the real question is how the works should notionally be divided into parts for these purposes.

DE 3 – Dividing the Indivisible

Moore-Bick L.J. in *Seele v Tokio Marine* considered that the clause was intended to preserve cover in respect of “*parts of the work which in commercial terms are to be regarded as separate and distinct from that part in which the defect exists*”

It appears that one asks the question: is the defect contained within an area which the participants would treat as being a distinct package, or stage, of the works

DE 4 – Defective Part Exclusion

Like DE3, it distinguishes between defective and non-defective parts of the insured property, but identifies the excluded property with the narrower phrase

“component part or individual item”.

But what constitutes the component part?

DE 5 – Design Improvement Exclusion

- ▶ DE5 preserves the most generous scope of cover for consequential damage.
- ▶ If the defect causes damage to the property over and above the defect itself, the assured is entitled to the costs of re-instating all of the damaged property, including to the defective part, less the additional costs (if any) of improving the original design, materials etc.

DE 5 – Design Improvement Exclusion

- ▶ The basic exclusion for the cost of remedying the defective property applies whether or not the damage is caused by the defect.
- ▶ The write-back for loss of or damage to the defective property is limited to the situation where damage “*result[s] from such a defect*”.
- ▶ Accordingly, at least if the clause is to be read literally, it has the opposite effect to DE1.

DE 5 – Design Improvement Exclusion

The policy will indemnify for damage to defective property where it is damaged as a result of the defect, but not where damage to the defective property is caused by an unrelated peril.

DE 5 Design improvement exclusion

It would have been possible to make a distinction in DE5 between improvements to the original design of the Property insured which is carried out voluntarily and betterment that is the unavoidable consequence of carrying out remedial works.

DE Clauses: General

It has been held that the Report of the Insurance Institute of London, which describes the background market developments is:

“[I]nstructive about the purpose of defect exclusion clauses and how they have evolved ... [b]ut ... cannot be used as an aid to construction of the clause in question which must be construed according to its terms.”

Reform

- ▶ There is a natural tension in using standard wording in bespoke policies.
- ▶ Exclusion clauses ought to be capable of being easily understood and applied.
- ▶ There is no rational basis for not using simple plain English and to provide accompanying guidance notes.

Any questions?

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