ZURICH®

insights

CONSTRUCTION

CHALLENGES AND TRENDS IN THE CONSTRUCTION INDUSTRY

IN THIS ISSUE

Welcome

to this issue of Insights focusing on construction.

In this issue we share views and ideas discussed at a Zurich workshop held in Paris for construction customers and industry experts.

Attention focused on a number of topical areas:

- Concern is growing over potential financial losses from inadequate professional indemnity cover. This highlights the importance of checking there are no gaps in your policies.
- Contractual default and non-performance of critical subcontractors often expose main contractors and project owners to uninsured risks. You can read how different thinking in this area is shaping new types of protection.
- During periods of economic uncertainty companies must ensure they are protected against contractor performance, especially as the volume and frequency of claims rises. The workshop looked at various options.
- We also welcomed a thought-provoking perspective on insurance and the law offered by Paul Reed, QC.

After such a well-received event we plan to continue the dialogue. Bringing together people from the construction industry who share similar risks and concerns enables us all to gain greater insights into current challenges and how we can tackle them together.

We trust that you find this issue of Insights useful. Please contact us if you would like more information on the topics discussed or if you would like to be part of one of our regional Customer Construction Communities.

Nathan Espe
Head of Engineering Lines
General Insurance Europe, Middle East & Africa

PROTECT PROJECTS

AGAINST EXPOSURE TO PROFESSIONAL RISKS

Benoît Combarel
Head of Professional Indemnity, Financial Lines
Zurich Global Corporate France

Construction companies are more exposed than ever to financial losses due to gaps in cover. New types of professional indemnity product can increase protection.

There is a growing trend in the insurance market for construction industry professionals, particularly architects and engineers, to rely on inadequate professional indemnity cover. As building projects around the world increase in complexity and the volume of professional liability claims rises, owners and contractors need to understand how they might be affected by possible gaps so they can put in place the right levels of cover.

CHALLENGES FACING CONTRACTORS AND OWNERS

Liability for damages can arise from errors, omissions or negligent acts when firms provide or fail to provide professional services. These services are architectural, acoustic, chemical, civil, electrical, soil testing or structural.

The problem is partly due to the fact that professional indemnity (PI) policies traditionally set low limits and are generally taken on an annual basis so they can quickly be exhausted by claims made on other projects. There are also issues around sublimited policies that restrict the cover available on certain types of loss.

The separation between PI and general liability is not always clear and can cause confusion, gaps or overlays in cover. Co-ordinating PI with general liability and erection all risks insurance can be complex and challenging but is critical to avoid disputes between insurers and clients if a claim is made.

INCREASED RISK EXPOSURE

Owners and contractors may mistakenly believe their design professionals have policies that will provide funds to cover problems arising in the early stages of a construction project. But we are seeing an increase in exposures that are beyond the scope of standard professional liability insurance.

For example, construction contracts are setting elevated standards of care that are more than will be met by conventional professional liability cover. This means the insurer will not agree to cover a contract in case a claim is made that is related to this elevated standard of care.

Contractors who take on both the design and build phases are particularly vulnerable to gaps in their professional liability insurance. The situation is exacerbated if large projects go over budget or fall behind schedule, which increases the likelihood of arbitration or litigation.

NEW THINKING ON COVER

Insurance products need to keep pace with these changing circumstances.

Three relatively new products in the construction sector are challenging conventional thinking. Traditionally, the industry has been slow to adopt new types of insurance but demand is gradually growing for more comprehensive cover that provides greater certainty with fewer delays or financial losses in the event of a claim.

LONG-TERM FINANCIAL PROTECTION

Construction sector professional liability claims often take years to settle and it may be much further down the line that owners or contractors discover their professional liability insurance is not sufficient to cover the full amount of the cost.

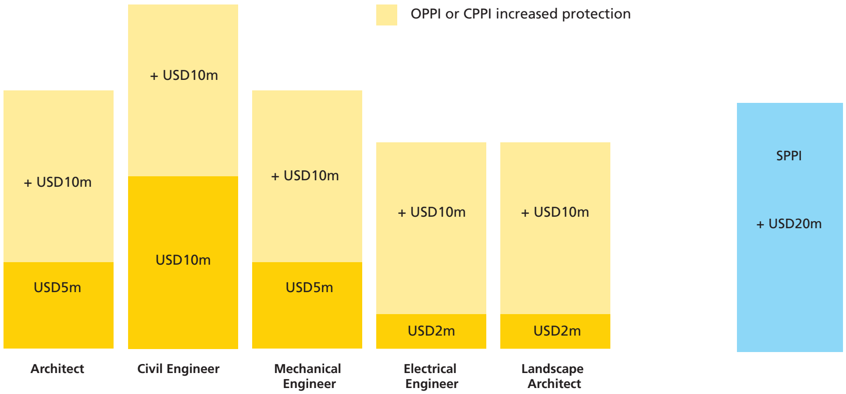
Owners protective professional indemnity coverage (OPPI), contractors protective professional indemnity coverage (CPPI) and single project professional indemnity coverage (SPPI) all aim to ensure there are no surprises and capacity will be available to protect project contractors and owners against financial losses.

OPPI, CPPI AND SPPI AT A GLANCE

OPPI **Owner's protective professional indemnity coverage**
Protects construction project owner's assets and provides additional cover on top of their contracted design team's annual practice policy. OPPI indemnifies owners for first-party losses resulting from a design professional's negligence that causes economic loss – for example, delays, redesigns or reworking.

CPPI **Contractor's protective professional indemnity coverage**
Protects contractor's assets and provides additional cover on top of their subcontracted design team's annual practice policy. CPPI is aimed at contractors, construction managers and design-build firms. It includes third-party claims against the contractor and first-party losses for subcontracted professional services.

SPPI **Single project professional indemnity coverage**
Provides primary cover for the design team 'from the ground up' for initial professional services during design through to build and completion. This long-term cover protects against negligence in professional services and avoids reliance on design teams having insufficient cover.



For illustration only.

INCREASING PROTECTION FOR CONTRACTORS AND OWNERS

OPPI and CPPI provide an additional layer of insurance protection that sits above professional service PI policies taken out by individual firms involved in the design.

SPPI provides primary 'ground up' cover for the duration of the project (design, build and completion).

SELECT INSURANCE TO COVER YOUR SPECIFIC NEEDS

Owners	Monitor design team members and contractors' policies **OR** write your own OPPI or SPPI.
Contractors	Write your own CPPI or SPPI **AND** check specific legal requirements for overseas projects.
Design teams	Check limits on your annual professional indemnity policies.

Nick Wildgoose
Global Supply Chain Product Leader
Zurich Global Corporate

SUPPLY CHAIN RISK
MITIGATION FOR MAIN CONTRACTORS

Main contractors who rely heavily on subcontractors could expose their businesses to potentially huge and probably uninsured risks should things go wrong. Managing subcontractor performance before, during and after a project is essential.

An increasing number of contractors depend on a key subcontractor or supply chain partner for goods and services that are critical to complete construction projects. The failure to perform is a default risk that can be disruptive, expensive and threatens delivery of your project on time, on budget and to the quality required.

Subcontractor default is probably a main contractor's single biggest uninsured exposure. As a consequence, companies that sign multi-million contracts carrying penalties for delayed completion may face huge uninsured losses if their subcontractors fail.

It is often difficult to quantify the scale of this threat because in Europe the risk is rarely insured, and as such few businesses accurately track the cost of remedying a subcontractor default. Consequently supply chain default costs are frequently lost amongst a whole host of other expenses and contingencies. However, these costs can be significant. It is unlikely that major contractors will escape a year without a subcontractor default and whilst an experienced contractor with advanced supply chain risk mitigation procedures can sometimes avoid or mitigate a major loss, an untimely default of a subcontractor that disturbs the critical path is frequently a costly problem.

The cost of remedying a subcontractor or supply chain default issue frequently amounts to the subcontract value. Even greater losses can be sustained if the subcontractor defaults when active on several construction project sites.

WHY RELY ON SUBCONTRACTORS?

The trend among large construction companies in the last few decades has been away from performance of physical construction trades. In the past, main contractors employed a multi-disciplined manual workforce. That meant the employer controlled the quality of work and ensured that 'self-performed' works were completed on time and on budget.

Nowadays, much of the construction activity risk is assigned to subcontractors. This increases the need for robust pre-qualification and supply chain procedures by the main contractor. When work is scarce and margins are thin the need for vigilance is even greater.

INSURERS ARE WARY

Unsurprisingly, some insurers are reluctant to provide cover for such potentially large losses. Insurers have always been cautious about underwriting areas such as quality, design, workmanship and insolvency, which are the most frequent underlying causes of default.

ACTIONS FOR MAIN CONTRACTORS

Managing supply chain risk can be mitigated with a diligent pre-qualification process while ongoing management and post-project analysis are equally important. Attention should focus on reducing avoidable subcontractor defaults during a construction project.

BEFORE ENGAGING A SUBCONTRACTOR

- Focus on the subcontractor's three Cs: character, capacity and capital.
- Assess their financial liquidity, safety record and quality controls.
- Check their insurance, and whether they have an unusual history of previous disputes, claims or uncompleted works.
- Use pre-qualification questionnaires to gather information about their operations, organizational structure, annual sales volumes, completed projects, relevant experience, references, and whether they currently or in the recent past have faced litigation.
- Check for risks further along the supply chain and extend due diligence work to include the supply chain of subcontractors, particularly their ability to perform and their liquidity. Many construction projects include pre-fabrication elements, so risk is spread beyond the subcontractor.
- Share information across your organization. Subcontractors often work at multiple locations.
- Discuss subcontractor and supply chain risk with your insurer to check cover matches requirements.

DURING THE PROJECT

- Establish a robust and diligent process of checks to verify all subcontracted work is carried out according to your design and specification and quality requirements at every stage of construction.
- Include photographs and documents as part of the quality checking process.
- Keep an eye on health and safety at construction sites and record and engage those that fail to meet site standards.
- Keep sharing information.

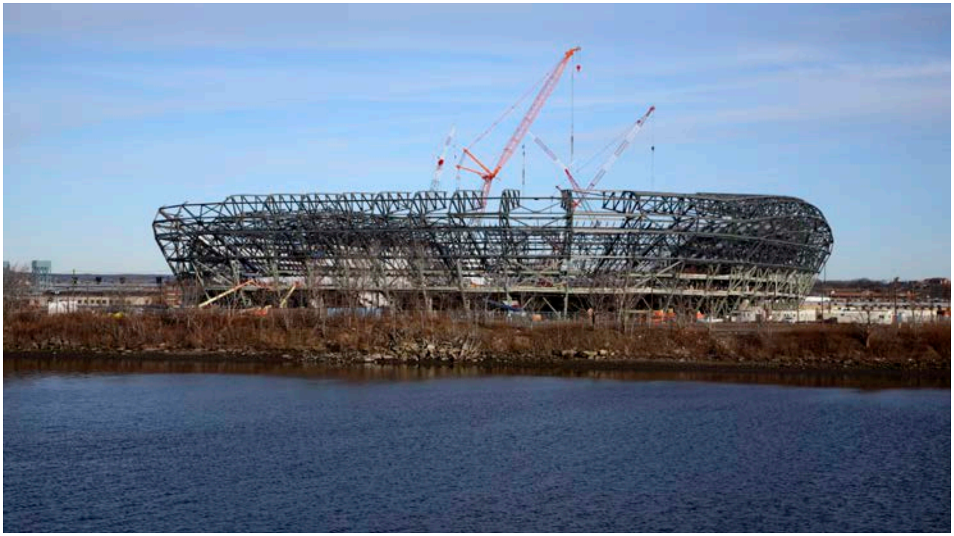
AFTER THE PROJECT IS COMPLETED

- Use a scoring system to assess performance in key areas – for example, the timely submission of designs and documents such as compliance with health, safety and quality issues.
- Review the subcontractor's complete performance. For example, they may perform poorly on one project or in one region but not in others.
- Ensure the records are stored and shared appropriately with all in your organization who have responsibility for or contact with your supply chain.

ROLE OF INSURANCE

Subcontractor default insurance for example, brings with it a heightened appreciation of controls and methodology that helps companies reduce the risk of 'avoidable losses', manage default events when they occur and enable non-confrontational claims resolution. The risk management processes that are the foundation for coverage also generate valuable best practice information to help avoid or mitigate the risk of defaults in projects. Subcontractor default insurance has been available in North America since 1995 and has benefitted from the associated supply chain improvements promoted by default insurers. With the prospect of cover being made more widely available in Europe, it is hoped that these supply chain disciplines will increasingly form part of European contractors risk management processes.

Richard White
Credit Surety & Political Risk
Zurich General Insurance



SURETY SECURITY COVERS CONTRACTOR PERFORMANCE

Surety bonds issued by banks and insurers provide an essential guarantee of contractor performance for employers, investors and funders. We examine the latest trends.

For construction groups, securing new contracts in tough, uncertain economic conditions is a challenge and a company's ability to obtain performance guarantees is a critical factor.

Contractor insolvency is a significant concern for project owners. For example, a half-completed project that needs to be finished by a replacement contractor will inevitably cost more than the original contract price.

It is therefore in the interest of project owners/employers and their funders to use surety bonds to mitigate these risks – and contractors who are able to provide surety support for their contractual commitments will be able to compete more effectively for new contract awards.

ECONOMIC IMPACT

In the current economic climate the construction sector has borne much of the brunt of government cuts in public spending and infrastructure investment. With fewer public and private projects available and tighter cash flow, balance sheets have been weakened for many companies. This hampers their ability to secure and pay for surety protection. Insolvencies in the sector have caused performance guarantee providers to review their risk appetite and criteria for extending surety credit.

On top of this, the financial sector faces challenges of its own, which affect overall capacity to issue performance bonds, including stringent regulatory and compliance requirements. Banks are lending more cautiously to meet capital liquidity and resilience requirements.

Unsurprisingly, there is little appetite to lend to heavily leveraged companies and risk increased exposure. A growing trend is for banks to share the risks of performance bonds with other surety providers in syndication arrangements.

The Catch-22 situation some construction companies face is that they may struggle to demonstrate sufficient financial strength to

obtain surety support, without which they may be restricted in the volume or types of work they can bid for. Smaller companies with weaker financial profiles may face a significant increase in the cost of obtaining surety credit if it is available at all.

Currently, the outlook in the US construction sector appears brighter than the Eurozone, fuelled partly by increasing housing prices and rising demand for new builds. The US also underwent a more radical write-down and write-off of bad debts, whereas European banks have carried ailing loans for longer. Nevertheless, we expect to see a modest short-term rise in US construction sector losses in the SME smaller corporate sector as construction insolvencies often occur at the end of recessionary periods as recovery begins.

100% FOCUS

In the US, bonds are generally written for 100% of the contract value, which means that the surety stands fully behind the entire project. Outside the US, bonds tend to be insured for lower amounts, typically 10% of the contract value, which is considered to be a reasonable margin to cover unexpected cost overruns needed to complete a project.

In the US this means surety providers tend to work more intensively with owners/ employers to ensure projects are completed and will in many instances appoint their own contractors to ensure completion as opposed to simply making cash payments. However, this means premiums may be higher in the US compared with other countries.

GLOBAL PROGRESS

Increasing demand for performance guarantees is driven by globalization. A growing challenge for construction companies is finding surety support in the countries where they are looking to expand. Large-scale infrastructure projects are attracting big construction corporations – for example, we are seeing more European-based contractors seeking business in the Asia Pacific and Latin American regions. These projects need large surety bonds but there are few sureties with the capability to provide facilities that enable bonds to be issued in all these locations, and contractors prefer to avoid utilizing important bank credit lines for large and often relatively long-term surety commitments.

The surety industry needs to be able to respond to these global requirements, which requires detailed local knowledge to support international construction clients.

ON-DEMAND DIMENSION

Requirements for on-demand bonds, which are common in many countries outside the US and differ very materially from surety bonds, pose a major challenge for contractors. Payment is made ‘on-demand’ up to the agreed limit of the bond when a written demand in the form specified by the bond is made. The effect of this is that the surety must pay regardless of the underlying contractual position or any dispute. On-demand bonds originated in

Increasing demand for performance guarantees is driven by globalization. A growing challenge for construction companies is finding surety support in the countries where they are looking to expand.

the banking sector as banks attempted to avoid lengthy disputes or Court action by issuing bonds that operated in the same way as letters of credit. The bank will simply pay the amount demanded, debit the contractor's account and treat its credit line as reduced commensurately. Insurers are concerned about the risk of unfair calling that instruments of this type create.

There are, however, different forms of on-demand bond ranging from the simple or 'unconditional on-demand' bond which requires nothing more than a written demand for payment of a fixed amount to a 'conditional on-demand' bond where, although a compliant written demand in the correct form will still create an immediate payment obligation, the bond requires that written demand to incorporate a statement or certificate confirming that the principal or contractor is in default (and possibly requiring particulars of the specific breach or default to be listed). A conditional on-demand bond will afford some limited protection against unfair calling because a director or responsible officer of the beneficiary must sign a statement confirming that a breach has occurred and will be reluctant to do so unless there are reasonable grounds for so doing.

An experienced surety will be able to review bond wordings to ensure that they meet the requirements of the parties and balance their reasonable commercial interests (assurance and certainty of payment for the beneficiary where a default occurs and protection for the principal/contractor against unfair or oppressive calling). In some cases amendments and revisions can be proposed by the surety for review by principals and their legal advisers.

BEWARE OF INCREASED LIABILITIES

Another trend is the development of increasingly sophisticated and often onerous forms of bond – for example, bespoke wordings that may appear superficially to comprise surety instruments but which operate in law as on-demand bonds. Bonds of this type can create more onerous liabilities than those assumed by the contractor under the bonded contract, which through the contractor's recourse/indemnity obligations to the surety will increase the contractor's exposure to risk. Contractors therefore need to be aware of the exact nature of the agreements they enter into.

PRIVATE FINANCE INITIATIVE/PRIVATE PUBLIC PARTNERSHIP INFLUENCE

The growing use of Private Finance Initiative (PFI)/Public Private Partnership (PPP) structures for large-scale public sector construction projects means demand for credit support including surety bonds is rising. The payback for lenders is totally dependent on a project being completed as they are only repaid from the operating income derived from the completed asset bespoke/structured performance bonds. Guarantees provide the essential backup they need in case a PFI fails or is delayed, and if provided by strongly rated institutions these will enhance the project credit rating.

WHAT'S NEXT?

Since the start of the downturn in 2008 the surety market has remained fairly steady. This is because major contractors with substantial order backlogs were able to maintain revenues as contracts entered into for longer-term projects were executed whilst adjusting their resources and structures to adapt to difficult market conditions. Smaller generalist contractors without specialist skills were far more susceptible to distress and default. This can be explained by the traditional lag in the construction industry to complete projects. As global economies begin to come out of adverse cycles, construction companies with weak balance sheets and poor cash flow may struggle to attract the level of surety bond protection they need to compete for and win projects in a healthier market.

Nathan Espe
Head of Engineering Lines
General Insurance Europe, Middle East & Africa

TRENDS IN CONSTRUCTION CLAIMS

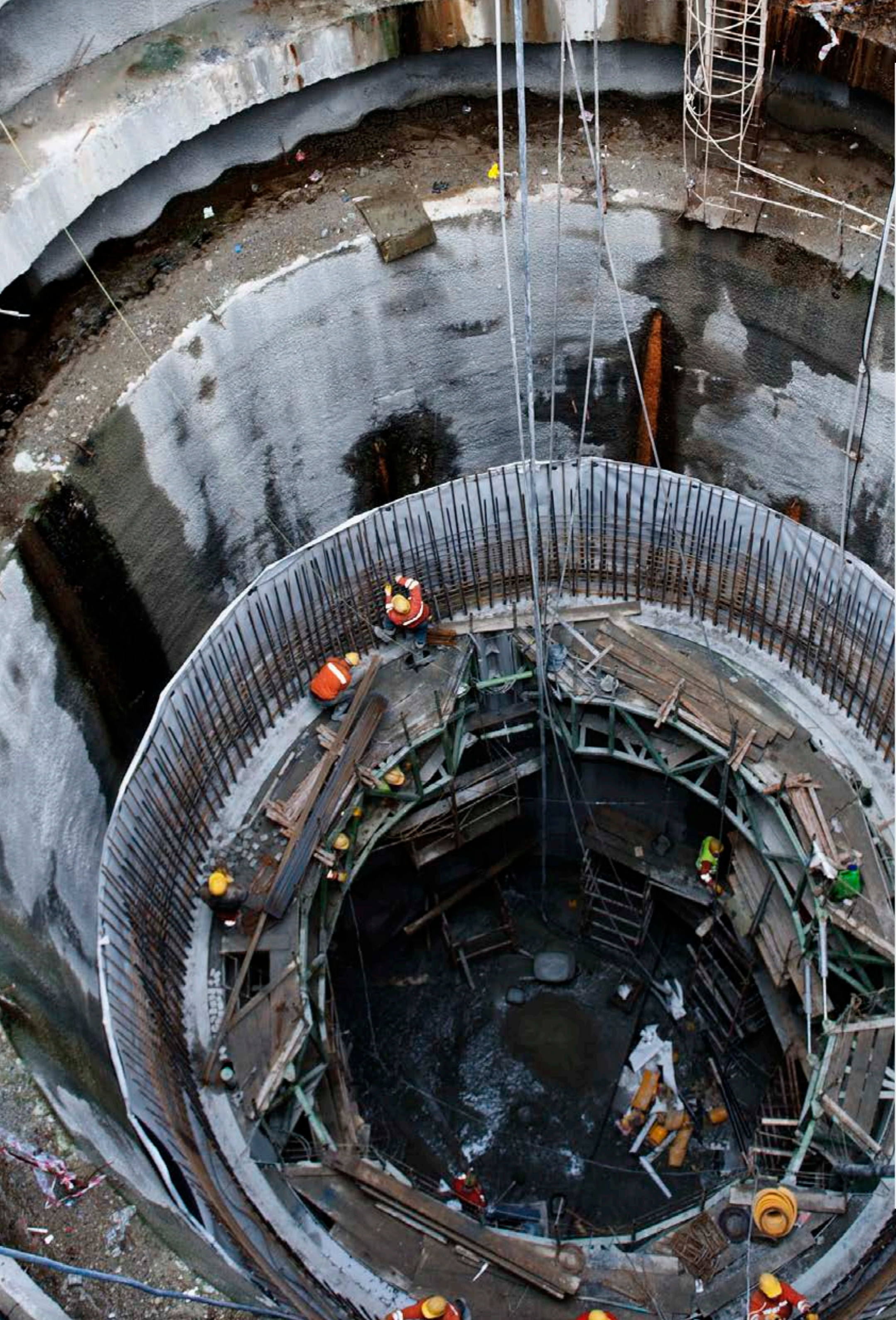
Claims are becoming more severe, more frequent and on a global scale with expansion in emerging markets bringing new challenges for construction companies to manage their losses and reduce risks.

Risks in the construction industry are changing rapidly and constantly. Construction spending statistics show that in 2000 almost half the spend was in Europe but by the end of 2012 it was less than one third, with rapid expansion in emerging markets.

In the next decade we will see a continuing shift to Latin America, Middle East/Africa and Asia where expansion in the construction sector is being driven by economic growth and rapid urbanisation. This changing environment creates new and different challenges and risks for global construction companies and their insurers.

Rapid infrastructure expansion requires faster project delivery and favours the use of low-cost production materials and techniques, for example, in steel, plumbing fixtures and drywall. Competition from local companies based in emerging markets exposes significant differences in attitudes and approaches to corporate responsibility as well as health and safety issues.

As a consequence of the changing risk landscape and types of exposure, historical lines of responsibility and liability within companies are altering. This poses challenges to construction companies in the way they manage their risks and cope with losses.



Industry views

Comments from members of Zurich's Construction Community.

"In developing countries, local contractors bring in unskilled labour with little construction experience and then provide inadequate training."

"We are involved in projects where we have to cover preliminary works completed by construction companies who apply less rigour in their quality and safety practices."

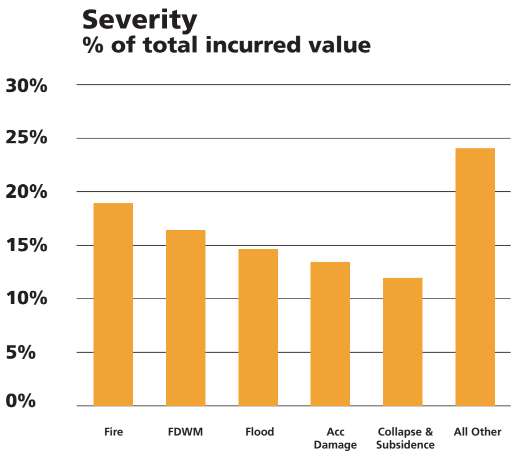
"Unexpected excessive rains that cause flooding are being given as the reason for losses but this happens every year so you can't really call it unexpected."

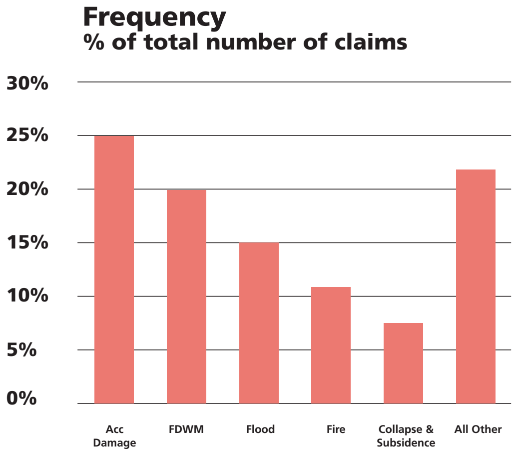
"It is difficult to using modelling for flood risk especially as weather patterns are changing. The risks are higher than we thought they would be."

"A fire may be well controlled but you can suffer from smoke damage. We find we cannot be sure of the guarantee of fire protection materials. We try to discuss this with constructors but they won't change and insurers won't assist unless there has been an actual claim."

TOP FIVE LOSSES BY SEVERITY AND FREQUENCY

Zurich's database of large losses covers more than 225 claims valued at over $300 million across 16 major categories of types of loss. The analysis shows that the causes of both frequency and severity are the same: fire, flood, collapse and subsidence, accidental damage and faulty design, workmanship and material (FDWM).



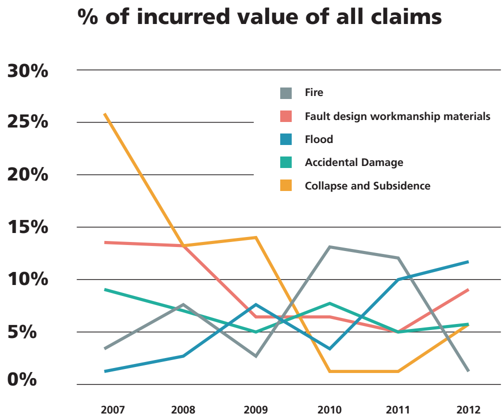


Source: Zurich

TRENDS IN TOTAL INCURRED VALUE OF TOP LOSSES

There has been a significant drop in losses caused by collapse and subsidence in the last five years. It seems likely this is linked to the introduction of tougher building regulations and industry practices – for example, the Tunneling Joint Code of Practice, which establishes a defined practices – for identification and allocation of risks for the construction of underground structures between various parties to a contract and their insurers. An increase in flooding during this period might be linked to climate change, while FDWM claims have increased steadily and are now the second main area of losses in terms of value of claims.

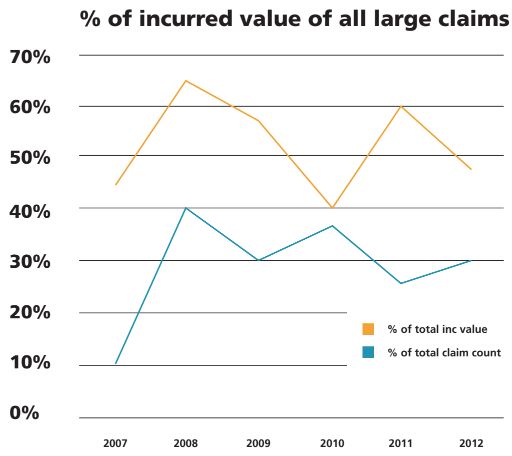
Although the trend for fire losses has reduced, they tend to be large and severe. In many cases they are preventable – for example, people failing to follow fire protection protocols.



Source: Zurich

THE RISE OF FLOODS IN NATURAL PERILS LOSSES

Flood losses are driving a rise in natural catastrophe perils. As an industry, we need to look at what we can improve and how we can communicate more on this issue – for example, developing and distributing better flood mapping tools, providing more information about protection against flash flooding and the impact of building in high-risk areas. With the increasing prominence of flood risk losses in construction, perhaps more attention should be focused here than other natural catastrophe risks.



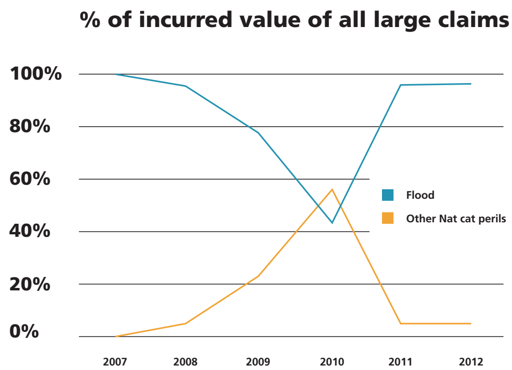
Source: Zurich

* For purposes of this analysis, we have used the Dow Jones definition of emerging markets

LOSSES IN EMERGING MARKETS

We are seeing more losses coming from emerging markets. This disproportionate rise in certain countries could be due to a number of reasons:

- Less knowledge of geo-technical conditions in developing countries – for example, exposure to risks such as flooding.
- Relying on local joint venture partners and subcontractors who may be less qualified and experienced.
- Less rigid building rules and regulations in developing countries.
- Different standards in building materials leading to defects.



* includes all GI Europe Engineering Lines NAT CAT claims between 2007 - 2012 with Total Incurred Value > $500,000

Source: Zurich

FOCUS ON IMPROVING RISK MANAGEMENT

The nature of risk management in the construction industry is changing. There is an increased need for better quality assurance and quality control (QA/QC) programs on projects. For example, many supplies and materials would traditionally be sourced from developed, industrial markets, where there were reliable manufacturing standards and robust QA/QC programs. Now, more material and supplies are being procured from developing and emerging markets where testing and QA/QC processes are less robust and under-regulated.

If company purchasing departments are focused on sourcing from the cheapest suppliers then this adds to the risk. A problem with one supplier can affect more than one project so a claim at one site can quickly escalate to involve multiple sites.

Concern is also growing about the low skill and experience levels of construction industry workforces adding to risks on projects, especially in developing countries.

Stronger risk management will help construction companies to tackle the main loss trends:

- **More frequent, more severe losses from natural perils, especially floods.**
- **Increased severity damage caused by fire.**
- **Rise in faulty or defective design or workmanship claims.**

Rupert Travis Sc ACII FCILA
Chief Executive
Cunningham Lindsey International Ltd

IMPROVING THE WAY CLAIMS ARE SETTLED

"Greater transparency, more trust and clearer guidance will benefit both insureds and insurers," says Rupert Travis, Head of Global Construction, Cunningham Lindsey.

SHARED EXPERIENCE: DIFFERENT VIEWS

INSUREDS SAY...

"Claims take too long to settle, insurers lack transparency and don't communicate enough with us. We feel insurers sometimes deliberately take an adversarial stance. Claims handlers don't always understand our business and there is a lack of co-operation between co-insurers. When lawyers become involved it slows the process down even further."

INSURERS SAY...

"Customers take too long to provide us with information or notify us of claims. They often hold unrealistic expectations about what is recoverable, give artificial arguments to recover non-recoverable costs and ask us to pay for poor workmanship. Sometimes over-ambitious quantity surveyors see claims as a way of turning around projects that are in financial difficulty."

A question insurers constantly ask is 'How can we improve the way claims are settled?' Disputes and decisions take too long to resolve, which means there is a lack of certainty about the possible outcomes and this frustrates their customers. What concerns construction companies most in these situations is the impact on their cash flow, so there are real business benefits to be gained from improving the claims handling process.

Insurers need to develop a stronger rapport with customers by talking the same language, understanding their business and being willing to co-operate with them. This means they need to be more pro-active in managing claims and resolving problems. Loss adjusters need to be out in the field, giving advice and not leaving the work to a claims person sitting behind a desk.

TIMING ISSUES

For construction companies, similar changes in attitude and approach would help reduce the time it takes to settle claims. For example, late notification is a main underlying reason for the length of time it takes to settle a claim. A company can have hundreds of sites and will often attempt to rectify a defect itself. However, the defect can grow before a site reports a loss and the full extent of the problem is revealed. This also raises the issue that the company may continue with a project despite knowing there was a problem.

"Anything that helps us to reduce areas of contention has to be welcomed. Zurich aims for a tri-partite level of liaison between us, customers and their brokers where communication is the key. Resolving claims as early as possible is common sense and would be helped by the insurance industry adopting a more formalised approach."

NATHAN ESPE, HEAD OF ENGINEERING LINES, GENERAL INSURANCE EUROPE, MIDDLE EAST & AFRICA

A PROTOCOL FOR CLAIMS

The industry needs swifter action dealing with claims to give customers more confidence with greater ownership of the claims handling process and decision-making by both insured and insurer. A protocol or code of practice by agreement between the broker and underwriter at the placing stage to deal with claims would be a significant voluntary step. **This should be based on three core principles:**

Transparency

eg. notifying claims as soon as possible, sharing relevant information.

Management

eg. loss adjusters and insurers being more pro-active, sharing reports, creating greater certainty and working to deadlines to reach resolutions.

Guidance

eg. learning from experience and sharing best practice to avoid problems in the future.

A protocol would provide:

- a Code of Practice referenced in the insurance policy
- a claims resolution code for brokers and insurers
- a pre-agreed adjudication panel referenced in the policy
- claims advocates from insured and insurers
- mediation in the event of a dispute
- the joint appointment of Counsel, should the need arise.

LEGAL EYE
ON CONTRACTOR POLICIES

Paul Reed, QC, Construction and Insurance Barrister, Hardwicke, offers his legal perspective on contentious insurance policy questions about who is insured, what is excluded and how you define defects.

WHO IS INSURED UNDER A CONSTRUCTION PROJECT POLICY?

Contractors all risks (CAR) policies name multiple parties as the insured, usually including employers, funders, the main contractors and subcontractors. If the actions of any of the parties cause property damage then it must be determined whether this is insured under the policy.

However, there is a great deal of confusion about what appears to be a straightforward issue. Companies often name the wrong person in their policies – for example, if a parent company has a number of small subsidiaries carrying out the work. If a party is not specifically identified by name or by a definitive description then there may be an issue about whether the policy intended to include it.

CAR AND PROFESSIONAL INDEMNITY COVER

The position of professional service providers can further complicate the situation. The relationship between professional indemnity (PI) and CAR insurance can be complex on construction projects. For contractors, there is an issue about who provides the service – for example, if a main contractor subcontracts professional services, services may not be covered under a CAR policy unless it specifically says so, in which case more PI may be required to cover gaps in cover.

Another area of confusion is that professionals won't usually be covered under a CAR policy for activities they would normally undertake off-site but which they carried out on the site. So although a policy may be described as 'All Risks', in order to be an insured party under a CAR policy, you need to demonstrate the contractual rights contained in the policy have been conferred on to you. Unsurprisingly, insurers commonly seek to limit the number of parties covered under a policy in order to limit their risks.

TAKE CARE WITH THE 'SUPPLIERS OF ANY TIER' CLAUSES

A CAR policy will typically refer to classes such as subcontractors or 'Suppliers of any tier' who sit several tiers removed from the

works taking place on a site. 'Suppliers of any tier' is often included in the list of insureds in CAR policies, which could imply that suppliers of every type of component would be covered.

A key consideration here is what was the intention of the main insured and their insurers and whether they really wanted a particular party to be covered. An excessive literal interpretation of 'Supplier of any tier' would fail to appreciate the differences between contractors and suppliers.

Example: The blade on turbine in a power station comes off and causes extensive damage. The blade was held on by bolts, which failed. The power station owner is insured and wants to make a claim against the nut and bolt supplier, who says it is a 'Supplier of any tier' and therefore covered. The problem for a Court is that this reduces the idea of any tier to a ridiculous extreme if it includes every component used to construct the power station.

CHECK IF INTERESTED PARTIES ARE ONLY 'NOTED IN THE POLICY'

Insurance policies often include arcane wording, such as 'Noted in policy' that can be unclear and confusing. Policies do not always make it clear what the term means or what is its intended scope.

An entity that is named in a policy – for example, funders – would expect to have the right to step in if they have concerns about a project. But having the interests of – for example, a bank, noted in a policy as opposed to being included in the list of insureds appears to have a limited legal effect.

Example: If a bank is not named as an insured and only 'Noted in the policy' then it is unlikely that the bank would be able to assume a contractual position, as it is not a contracting party in the construction contracts. It is therefore unclear whether it would be able to derive any benefit under the insurance policy or take a share in the proceeds.

Case law: When is a party a contractor?

This question often comes before the Courts. Hopewell Project Management Ltd and Hopewell Energy (Philippines) Corpn v Ewbank Preece Ltd, a case involving CAR and advance loss of profit policies, suggests that only those engaged in the core work of construction should be covered by the phrase and not providers of professional services. The situation is complicated if a contractor or subcontractor also carries out professional work, such as design services. The Hopewell case found it would be most unusual for the terms contractor or subcontractor in CAR policy to include a firm providing professional services.

LEGAL EYE
ON CONTRACTOR POLICIES

EXCLUSIONS CAN MAKE OR BREAK A CLAIM

Exclusion clauses are often treated as an afterthought and given less attention than other areas of insurance but this is a mistake, especially for CAR policies. They are important because they precisely define the extent of cover provided. The proper interpretation of exclusion clauses is vital to operating the policy, and in many cases, could make or break a claim.

When a claim is made, the burden is on the insurer to prove that the loss falls within one of the exclusions. As a result, many standard exclusions commonly appear in policies in order to reduce the risk of ambiguity.

Example: To avoid uncertainty some CAR policies expressly exclude matters that may, in any event, have been excluded as a matter of law – for example, wear and tear and inherent vice. The benefit of doing this is that if a loss results from two concurrent events where only one falls within a specific exclusion then the loss is not recoverable under the policy.

The use of standard exclusions can cause disharmony between contractors and insurers and the Courts often find that CAR policies include meaningless exclusions.

GENERAL EXCLUSIONS

CAR policies can include several exclusions that deal with risks that are not specific to construction. Instead, they cover risks that are either uninsurable or which would need to be priced separately in a tailored policy. The usual forms of general exclusions relate to natural events, conflicts, nuclear material, consequential loss and the requirement to take reasonable precautions.

Another key general exclusion relates to 'non-risk' events. One of the most common 'non-risk' events is inherent vice, which is excluded from policies on the principle that insurance covers risks and not certainties.

Many of the cases considering the circumstances in which an insurer can rely on this exclusion arise in the context of marine insurance – for example, from questions about the cause of damage to goods during transit.

WEAR AND TEAR, CORROSION, GRADUAL DETERIORATION

As with inherent vice, these exclusions would not normally be covered in a damages policy. Wear and tear exclusions commonly include a number of natural processes – for example, rust, corrosion, fungus, decay, wet or dry rot and gradual deterioration. The aim is to exclude cover where the cause of the loss results from the processes of nature. But corrosion can be caused by other means – for example, chemicals – and there have been cases where both types of corrosion have been excluded.

- Wear and tear is usually defined as 'the ordinary and natural deterioration or abrasion that an object experiences by its expected contacts during its natural life expectancy'.
- Corrosion definitions typically refer to a chemical reaction that results in the breaking down or destruction of a solid material, especially metal. In a typical CAR policy, the corrosion exclusion often appears in the term that also excludes cover for wear, tear and gradual deterioration. Where the exclusion clause refers to wear and tear, corrosion and gradual deterioration, it is usually argued that the only corrosion intended to be covered by the exclusion is gradual corrosion, which is similar to gradual deterioration.
- Gradual deterioration is usually defined as meaning deterioration that is progressive by degrees, as opposed to sudden and catastrophic.


Wear and tear


Corrosion


Deterioration

Case law: The Inchmaree clause

In an important case that helped clarify the position on exclusions, the House of Lords held that breakage of machinery on a ship was not recoverable as a peril of the sea. This led to a clause being formulated to provide cover for breakages and other damage caused by internal failings, including latent defects. When named perils are involved (as opposed to all risks policies) insurance against damage due to a defect should be secured by including the Inchmaree clause provision.

LEGAL EYE
ON CONTRACTOR POLICIES

Example: Design exclusion clauses

A steel frame building with roof completed, cladding partially completed and dwarf brick wall completed. The nuts and bolts used in construction of the steel framework proved to be inadequate and the whole structure collapsed, damaging everything.

The various defects exclusions would limit indemnity as follows:

DE1: all the damage would be excluded.

DE2: all damaged items excluded except the dwarf brick wall.

DE3: steel framework excluded; roof, cladding and dwarf brick walls paid for.

DE4: only nuts and bolts excluded.

DE5: all damage paid for but improvement costs excluded.

However, even this example has created confusion with DE3 and DE4. Since the fault was with the nuts and bolts, why should the steel framework be treated as being defective?

What is a defect?

A 'defect' is usually defined as any quality of an item that makes it less valuable or less fit for its purpose than is intended. A thing is in 'defective condition' where it suffers from such a quality.

COVER FOR DEFECTS AND CONSEQUENT DAMAGE

Contractors are often concerned that a relatively minor defect in some part of a construction project can result in an incident, such as a fire, explosion or collapse that has catastrophic consequences. For example, a faulty piece of electrical wiring could start a fire that destroys the entire works.

Defective workmanship is not uncommon as mistakes that result in damage to the works can occur even in well-managed projects. Although one might be more circumspect about extending a claim to inherently faulty design or specification, contractors have been able to argue that the responsibility will usually lie with an architect or consulting engineer.

There is market demand for, and a willingness by insurers to provide, cover for accidental damage that is brought about by defects in the design or build of the insured property. This has led to the introduction of standards and exclusions in insurance policies to help the market understand what will be covered in a policy.

DEVELOPMENT OF EXCLUSION CLAUSES

Since 1985, a suite of five standard form Design Exclusion (DE) clauses drafted by a committee of leading insurers has been available. These provide different levels of cover thought to adequately define the various degrees of cover that insurers are prepared to offer.

Each provides progressively wider forms of cover for the consequences of defects and they have been widely adopted in the CAR market:

DE1 Outright defect exclusions

DE2 Extended defective condition exclusion

DE3 Limited defective condition exclusion

DE4 Defective part exclusion

DE5 Design improvement exclusions.

A revised set of DE clauses was drawn up in the 1990s to reproduce the levels of cover prescribed by the original clauses, whilst clarifying their meaning in certain respects.

The way the Courts interpret the clauses means they will not apparently seek to construe a particular DE clause in the light of the others. For example, the fact that DE4 excludes damage to the defective 'component part' will not assist in interpreting the scope of the phrase 'property... in a defective condition' in DE3.

LEG CLAUSES

A similar suite of three 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. Since first being drafted in 1996, LEG 1 and LEG 2 remain unchanged while LEG 3 was amended in 2006 to avoid confusion over the meaning of the word 'damage'.

Like the DE clauses, the LEG clauses broadly distinguish between the costs of simply putting right a defect (excluded), and consequential damage (covered, except under LEG 1).

DROP DOWN CLAUSES

It is common to find alternative DE3 and DE5, or LEG 2 and LEG 3 defects exclusion wording in one policy with a higher deductible for DE5 and LEG 3 exclusions in each case. These arrangements are known as drop down clauses. The purpose of including different exclusions in one policy is to permit the insured, if it does not want to take advantage of the more limited exclusion in DE5 and LEG 3, to claim under DE3 or LEG 2 and attract a lower deductible.

Case law: Distinguishing between defective and non-defective property

Two main cases consider this distinction. In Blackwell v Gerling, the Court was concerned that a broad interpretation of an exclusion under DE3 would allow an insurer to *escape liability by finding some defect remote from the damage and entirely unconnected with its cause*. In construction projects, the challenge is identifying what is the *insured property* what is *other property* when a claim is made.

Seele Austria GmbH & Co KG v Tokio Marine Europe Insurance Ltd is an attempt to find a workable approach to distinguishing the difference. A set of windows installed during construction leaked water when tested. For the purpose of the DE3 wording, it was necessary to show that damage was caused to other parts of the building when water penetrated plasterboard ceilings, rather than just the window units themselves. A key question here is whether the defect is contained in an area that can be treated as a distinct package, or stage, of the works.

John Scott
Chief Risk Officer
Zurich Global Corporate

SETTING HIGH STANDARDS OF CORPORATE RESPONSIBILITY

Stakeholder expectations of companies are rarely black and white, but there is mounting pressure on construction companies and their insurers to play their part in developing a sustainable society.

Being a responsible company, abiding by codes of conduct and conforming to environmental and social standards is a tough call for multinational construction businesses. The demand to contribute to society's long-term sustainable development has to be matched not only with immediate commercial realities but also the practical challenge of managing activities in countries with very different regulatory, political, economic, environmental and social standards.

Even within a single country, stakeholder views can vary according to income, education, religion, ethnicity, age and gender, which makes it harder to reach consensus on what is the best course of action. This is magnified at regional and global scales, where the effectiveness of governance processes vary considerably.

A good example of this is the difficulty with implementing the landmark Kyoto Protocol on climate change. Although signed by world governments in 1997, we are still a long way from achieving a binding global agreement on greenhouse gas emissions.

What can be achieved at a corporate level, however, is for companies to identify and address the key issues within their spheres of influence, working with employees, suppliers and partners. Participation in the Global Compact (www.unglobalcompact.org) is a widely visible commitment to the implementation, disclosure, and promotion of its 10 universally accepted principles in the areas of human rights, labour, environment and anti-corruption.

SPOTLIGHT ON LABOUR AND HUMAN RIGHTS

The plight of low-cost workers in developing countries who manufacture products for consumers in high-income markets highlights the inter-connected global nature of employee rights.

High suicide rates among workforces assembling smartphones in Asia and a tragic building collapse in Bangladesh that killed a large number of people making clothing destined for retail markets in high-income countries have again highlighted the problem.

Media campaigns and consumer pressure are beginning to force global companies and brands to take greater responsibility – for example, a number of leading UK retailers provided financial support to families affected by the Bangladesh incident.

ANTI-CORRUPTION CHALLENGE

The construction industry is no stranger to the types of payment often described as facilitation or arrangement fees that are made without much clarity on what level of service is actually provided in return. In commercial negotiations these can be grey areas, particularly in regions where views on what constitutes a bribe or corruption may differ from international conventions. The challenge for global companies operating within global standards of corporate responsibility is to challenge and create clarity and transparency in these payments.

The UN Global Compact's anti-corruption principle calls on businesses to 'work against corruption in all its forms, including extortion and bribery'. Legislative measures have been introduced to combat corruption, particularly the Foreign and Corrupt Practices Act in the US and the UK's Bribery Act. These are wide-ranging and far-reaching pieces of legislation as they affect the employees of companies that have significant operations in the US or the UK, even if those employees are not British or US nationals and are operating in other jurisdictions. This places clear legal responsibilities on global businesses to act responsibly with regard to anti-corruption principles.

The UK Bribery Act is currently being reviewed with a particular focus on so-called 'facilitation payments'. Such payments involve officials being paid bribes to speed up an otherwise lawful act, such as a customs check or border crossing. Payments that do not simply speed up an otherwise lawful process or do not protect 'liberty or limb' are prohibited under the UK Bribery Act. This is the main difference between UK legislation and the US Foreign Corrupt Practices Act.

INSURERS ARE NOT ENFORCERS

Insurers have a role to play by advising and influencing commercial decisions made by their customers. We must act as insurers not policemen. It is the responsibility of insurers to work with their customers to share information and best practice on doing business with companies or in countries who have a poor record in relation to the UN Global Compact.

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