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Managing modern construction risks

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THROUGH THE LENS AT CARILLION

"Recklessness, hubris and greed"

As a company, Carillion did practically everything wrong, yet its sudden demise has sent shockwaves through the business community. As regulators trawls through thousands of documents with a view to taking disciplinary action, the inevitable result is an intense scrutiny of directors and officers liability and transparency

As successive inquiries uncover evidence of, in the words of the damning parliamentary inquiry into its collapse, the "recklessness, hubris and greed" that led to the fall of Carillion, the post-mortems are turning into a case study on how not to run a company.

And the investigations are widening all the time, bringing in every entity involved – auditors, executives, directors, consultants and even government bodies accused of failing to act soon enough.

The mis-management cited by the parliamentary inquiry was of such a scale that it may yet lead to further action against executives and directors. The inquiry recommended that the Insolvency Service investigation into the conduct of former directors "includes careful consideration of potential breaches of duties under the Companies Act, as part of their assessment of whether to take action for those breaches or to recommend to the Secretary of State action for disqualification as a director".

As revelations continue to emerge, they make an inarguable case for directors and officers and other forms of boardroom insurance, even for exemplary directors, as shareholders become more distrustful and more aggressive.

The Association of British Insurers said in a statement: "These types of products, such as professional liability, have always been important for anyone in a senior position in a business."

Regulators are on the case

Evidence of the failures within Carillion is being told in millions of words. A team at the Financial Reporting Council (FRC) is still sifting through tens of thousands of documents – audit files, KPMG's and Carillion's emails and company papers – as well as interviewing KPMG and Carillion employees, as it trawls through the final four years of the company's accelerating decline.

If the FRC's executive council determines it has enough evidence to clear the legal threshold and bring disciplinary actions, it will do so. The FRC's main focus is on two former finance directors.

> **"We now intend to enhance our focus on the audits of companies, which appear to be in danger, and should like this to be combined with an ability to call out what we find."**
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> Financial Reporting Council

The Insolvency Service, Financial Conduct Authority and Pensions Regulator (TPR) are also on the case. For instance, the Competition and Markets Authority is looking at the audit market to see whether new regulations would reduce the long-standing monopoly of the Big Four.

Stung by criticism levelled in the parliamentary report, the FRC also wants to have its say over audits. The body has expressed a wish to be enabled to issue its own assessments in future on the audits of those companies that are deemed to be on the brink. "We now intend to enhance our focus on the audits of companies that appear to be in danger, and should like this to be combined with an ability to call out what we find," the FRC has said.

Demanding better stewardship

Taken as a whole, the Carillion collapse has unleashed a fury of forensic analysis that will inevitably lead to a much brighter spotlight being shone on the boardrooms of major companies and will put directors under considerably more pressure.

A probably inevitable consequence of all this activity will be reform of the Stewardship Code. As soon as the FRC has finished a review of the Corporate Governance Code, it will start on the issue of better stewardship. The main purpose is to look at whether the code is sufficiently effective, but also whether companies and investors can engage more

constructively with each other. One possible outcome is the obligatory appointment of a class of go-betweens – intermediaries who act as proxy agents between board and investors' representatives.

Carillion's shareholders say they had little idea what was really going on – and the FRC wants this to change. "Statements by companies in the annual report about their governance can fail to provide real insight, and investors can find them hard to challenge," the organisation pointed out in July in an update of its progress on the Carillion investigation. As a result, the FRC wants more powers, including the right to undertake a report into the quality of governance in systemically important companies.

Another influential organisation to strike a blow for better corporate governance is the Chartered Institute of Internal Auditors (CIAA), which in September urged the FRC to toughen its proposed principles for large private companies "by more closely mirroring measures contained within the UK Corporate Governance Code for publicly listed firms". It also wants the regulator to "take charge of monitoring the application of the principles".

The CIIA was referring specifically to the collapse of BHS, but the failure of Carillion only serves to strengthen its case. "The collapse of both BHS and Carillion highlighted a number of corporate governance shortfalls," Gavin Hayes, the institute's head of policy and external affairs, told *StrategicRISK*, pointing

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THOUGHT LEADERSHIP

Bernadette Hackett, global relationship leader, Zurich

George Melides, global underwriting manager for management liability

The past two years have been turbulent for the construction industry. Two high-profile cases – the demise of Carillion and the tragic fire which tore down the 24-storey Grenfell Tower in west London, UK – have elicited lengthy investigations, bringing into question the involvement of all those involved along the chain of command. As revelations continue to unravel and no clear lines of accountability have been drawn, there are more questions than answers. But what is clear, is the very significance of directors' and officers' (D&O) and professional indemnity (PI) insurance.

Directors' and Officers' Insurance

Under the Companies Act 2006, directors must act in 'good faith' to promote the success of the company. They must also exercise reasonable care, skill and diligence. But in a fast-evolving business world, where business models are constantly changing, and risks are growing in complexity, how can directors keep their finger on the pulse and ensure they are fully compliant with their obligations? When do they need to act to protect their company's assets, shareholders and creditors; and how well are they protected should they come under investigation?

Through close collaboration, brokers and insurers can help risk managers glean greater understanding of their changing risk profile and match this against appropriate and adequate protection. It is important to understand that D&O insurance is varied and, in complex cases, like that of Carillon and Grenfell, standard D&O insurance may not be adequate. Specialised products, such as side A difference-in-conditions policies, may be required to provide wider indemnity to individuals.

Professional Indemnity Insurance

PI is an important risk transfer vehicle for the construction industry and provides insurance against claims of negligence. However, insurance policies and can easily be misunderstood.

In single project PI, the main contractor would buy insurance on behalf of subtractors and stakeholders involved in the delivery of a project. These policies generally run for 10 to 12 years, or for the duration of the project. But because of the nature of the cover and its extended period, contractors believe that they own the policy. This creates a misunderstanding over who the indemnity is for and what the different obligations are. This policy is about indemnifying the named insured for their obligation to a third party – and the owner is the third party to whom they have those obligation.

Contractual obligations are a minefield but there are specialist insurers and brokers who can provide extensive advice and help companies navigate through complex contract wordings.

Collaboration

In any complex risk situation, regular collaboration between insurers, brokers and risk managers can make the difference to your company's survival. We spend a lot of time looking backwards to predict what will come at us in the future. The question is how can we help you futureproof your business from threats that are coming from behind and in front? We want to challenge our products and consider if they are fit for purpose. We are partners to our clients and endeavour to foster a proactive relationship so that in an event of a new risk, we can come to a commercial decision together as to whether to insure it or build a bespoke solution around it. That's a more robust relationship.

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out how that the failure of both companies had a catastrophic impact on their workforce, customers, suppliers and the wider economy. "That's why, going forward, it's fundamental that we ensure we have a strong corporate governance framework in place that promotes greater transparency and accountability."

Hurtling to failure

Meantime the parliamentary report should be compulsory reading for risk managers and anybody who holds a position of responsibility in a big company. As the report tells it, Carillion did practically everything wrong over a period of years as it hurtled towards an inevitable failure.

"Its business model was a relentless dash for cash, driven by acquisitions, rising debt, expansion into new markets and exploitation of suppliers," the report summarises. "It presented accounts that misrepresented the reality of the business, and increased its dividend every year, come what may."

If that wasn't bad enough, the report accuses the board of increasing and protecting "generous executive bonuses" while Carillion was beginning to unravel. Conclusion: "Carillion was unsustainable."

Yet Carillion was a company that prided itself on corporate governance and saw no need for mandatory external reviews. In 2010, on the occasion of a general review of the UK code, the board wrote to the corporate governance unit of the FRC to point out that it was "among the first [publicly listed companies] to adopt a policy of detailed and rigorous board evaluation in 2002, and has used the process to adapt board process, procedure and governance" ever since. The company did not consider mandatory external reviews to be "necessary or appropriate".

The Carillion board also opposed annual re-election of directors because "it could place in jeopardy the level of continuity essential to the management of a complex business" as well as "threaten the independence of thinking necessary to achieve effective collective responsibility". At that time, Carillion may already have been running into trouble – it had tripled in size between 2002 and 2010.

A litany of errors

Few are coming out well from the post-mortems in what is turning into a general indictment of big business, causing long-lasting reputational damage by default. The entire system of checks and balances in the economic system has been brought into question by the parliamentary inquiry because they manifestly failed to work in the interests of investors. It's clear that UK's biggest resources company, responsible for building everything from roads and hospitals to providing school meals and defence accommodation, had been spiralling out of control for a long time.

Among other deficiencies, the inquiry cites:

- Failures by non-executive directors to challenge or scrutinise reckless executives.

- Systematic manipulation of the accounts "in defiance of internal controls".

- KPMG's "complacent signing off" of the accounts over a period of 19 years as auditor; Deloitte's failures in its role of risk management and financial control as internal auditor; and EY's "six months of failed turnaround advice."

- The key regulators – the FRC and TPR – also come in for a hammering for their "feebleness and timidity" in failing to follow up and use their powers after concerns were raised. Both organisations were described as "chronically passive" and requiring "cultural change". (In its defence, the FRC reminded the inquiry that following the July profits warning it was already investigating Carillion with a view to taking enforcement action when it collapsed.)

The Carillion post-mortems are still under way, but they're all pointing in the same direction. And that is much tougher oversight of the boardroom. **SR**

STATISTICS OF A COLLAPSE

Carillion toppled in early 2018 after giving every appearance of being in good health until a year earlier. Here are the milestones that led to its decline.

MARCH 2017

Carillion paid a record dividend of **£79m** including fat performance bonuses to senior executives. Of this, £55m was disbursed as late as June 2017.

JULY 2017

Exactly a month after handing out the remaining £55m, and four months after publishing the 2016/2017 accounts, it announced in a general profit warning a reduction of **£845m** in the value of its contracts.

SEPTEMBER

The reduction was increased to **£1,045m**, shocking the markets. As the parliamentary inquiry points out, this sum was equivalent to Carillion's *entire profits* in the previous seven years.

JANUARY 2018

The company went into liquidation with previously unheralded liabilities of **£7bn**. Its total cash pile was £29m. Carillion's pension liability is about £2.6bn and it owed some **£2bn** to 30,000 suppliers and other short-term creditors.

GRENFELL TOWER CASE STUDY

In the wake of Grenfell…

Tougher codes and penalties are putting pressure on the building industry's insurance cover, while raising questions over how far down the line liability should go

The series of inquiries that followed the Grenfell tower disaster have greatly widened the insurance implications relating to high-rise residential accommodation, affecting just about all those responsible for the design, construction, maintenance, management and ownership of tower blocks of all kinds.

As a result of the findings to date, building codes are being rewritten, enforcement tightened and penalties for breaches increased. In short, commercial entities all along the chain of command are in the firing line in the event of any failure to meet considerably broadened legal responsibilities.

In the UK, tighter enforcement, tougher penalties and more closely scrutinised accountability will result from the independent review of the building and fire safety regulations issued in mid-May 2018.

Applying to residential buildings of 10 or more stories, among other recommendations the review urges clearer responsibilities and accountability be imposed on "duty holders" – those in designated positions of oversight. Additionally, new enforcement powers will be given to a Joint Competent Authority composed of the health and safety executive, fire and rescue authorities, and local authority.

Under these imminent new laws, law firm Clyde & Co notes, duty holders will likely be in the firing line for up to twice as long as currently. And the time limit for taking action "should increase from two

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years to five to six years from the time of the offence".

In theory, a number of organisations could face ongoing legal action. In the case of Grenfell, that could be the tenant management association, companies involved in the refurbishment work, suppliers, and designers and manufacturers of any materials deemed to be suspect.

We must all learn something

The lessons being learned – and the inquiries are far from complete – have spilled across international borders. In the wake of the tragedy, other countries are taking a long hard look at the safety of high-rise accommodation, particularly but not exclusively in terms of aluminium composite cladding, which has become one of the most debated issues.

As far away as Australia, for instance, state governments are drawing up laws that have significant downstream implications for liability. As a result, Australian companies involved in construction are re-examining their cover in terms of professional indemnity, directors and officers, and corporate manslaughter (see box, opposite, for more on this).

In the UK, the debate continues about who pays for the removal of cladding deemed to be at risk, another important insurance matter. Following a ruling in the London's First Tier Tribunal involving the Citiscape block in Croydon in early 2018, the onus seems to have fallen on the leaseholder.

However, liability is likely to go further down the line. As Victoria Dacie-Lombardo,

"The key is to obtain cover for the entity because D&O often has limits in terms of legal costs. Not everybody has a spare half million to two million pounds lying around to cover their legal expenses."

Martin Bridges, British Insurance Brokers Association managing associate at law firm Mischcon de Reya, pointed out in a report in May: "Many leaseholders will therefore look to recover these costs elsewhere," citing a string of likely targets that include landlords, developers, building contractors and engineers, local authorities as well as the government.

Spreading the net further, the report adds to this: "Another potential target could be home construction warranty and insurance providers such as the National House-Building Council. In each case circumstances are unlikely to be clear-cut and leaseholders will need to establish a claim in either negligence or breach of contract."

Rather than risk damage to their reputations, some construction companies may simply decide it's more prudent to do the work anyway, as Barratt Developments has promised in the case of the Citiscape block. Although Barratt pointed out the building conformed with the regulations current at the time of construction in 2001, it will undertake retrospective and future safety measures at a cost of several millions of pounds.

Indemnity has its limits

In such open-ended cases as Grenfell, with so many inquiries still taking place, there is considerable uncertainty about the extent of indemnity. "There is often a concern as to whether there are sufficient limits in place," explains EC3 Legal in a prescient report. "If not, then insureds will be looking for other policies that might pick up some of the losses, or other deep pockets to offload blame and liability."

Without adequate cover though, directors could face financial ruin. "D&O cover for individuals and entities is important, especially for smaller companies with limited liability as well as for smaller PLCs," Martin Bridges, technical services manager for the British Insurance Brokers Association, told *StrategicRISK*. "The key is to obtain cover for the entity [because] D&O often has limits in terms of legal costs. Not everybody has a spare half million to two million pounds lying around to cover their legal expenses."

EC3 Legal agrees, particularly given the possibility of criminal investigations. "In our experience, companies historically have not bought sufficient limits of such cover," says EC3 Legal, pointing out that investigations and representation in criminal proceedings or tribunals can be expensive. Some insurers limit cover, for example, to £5m. But that normally provides for legal costs and not fines.

Convictions do happen

Charges of corporate manslaughter present potentially catastrophic financial and reputational risks. As data provided by Protector Insurance shows, citing statistics from the UK Health and Safety Executive, the construction industry accounted in 2017–2018 for the highest number of fatal injuries as well as having the highest annual average for 2013–2014. Construction was followed by agriculture, manufacturing, transportation and storage.

Although convictions for corporate manslaughter have been far from common in Britain since the appropriate laws were passed in 2007, they do occur. Construction firm Martinisation was convicted of the corporate manslaughter of two workers who died in a fall from a first-floor balcony in London in 2014 while trying to hoist by ropes a sofa from the pavement. The court ruled the deaths to result from a substantial breach of duty.

Charges of corporate manslaughter present catastrophic financial and reputational risks. The construction industry accounted in 2017–2018 for the highest number of fatal injuries.

"There must be a breach of duty by the company," Protector Insurance risk engineer Donal O'Hanlon told *StrategicRISK*. "And the way in which the business's activities are managed must be considered to be a substantial element of the breach."

Deaths can however happen in seemingly unlikely industries, such as finance. That's why O'Hanlon suggests: "I would say that corporate manslaughter cover is important across all sectors and industries." **SR**

AUSTRALIA: LITIGATION ON THE RISE

Stirred into action by Grenfell and their own high-rise fires, Australian authorities are piling more responsibility on the construction industry.

In mid-May, a year-long inquiry in Queensland found that flammable cladding may have been used on as many as 12,000 buildings in the state. Nearly 50 buildings are under investigation, including several hospitals. In Victoria, an audit of 170 buildings established that 51% of high-rise buildings failed to comply with the building code. In New South Wales, 58 high-rise residential buildings with aluminium cladding are also under investigation.

As a result of these sweeping audits, legal reforms are being introduced that are putting pressure on builders and owners, reports law firm Gilchrist Connell, an insurance specialist. In New South Wales, for instance, new laws empower the government to order rectification work at owners' expense and impose penalties. Further, considerably more onus is placed on owners of clad buildings in other ways, for instance to produce reports confirming the cladding used does not present any risks.

As in the UK, the findings increase the exposure of landlords, owners and other responsible parties to claims and penalties. "Insurers will have seen, and can continue to expect to see, an increase in claims for investigation and representation expenses," warns Gilchrist Connell's report. "There has been a spike in litigation against engineers, architects, builders, surveyors, valuers and certifiers where minimum [building code] standards have not been met."

At the same time, insurance premiums for owners of non-compliant buildings have shot up, with some buildings deemed effectively uninsurable. As a consequence, underwriters in Australia have started to write exclusion clauses relating to combustible cladding. "Brokers will no doubt now arrange more vigilant inspections and investigations of buildings owned by large insureds," predicts the firm.