



**ECRI Risk Group Meeting
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Risk Sharing and Insurance

Introduction

I should apologise at the outset for using both the term "employer" and "owner" which I hope will not cause confusion. The reason for this is that the model form of contract to which I will be referring uses the term "employer" whereas in insurance parlance we tend to use the term "owner" as in Owner Controlled insurance.

Where I use the term "contractors" I am generally including sub-contractors, engineers and other contracting parties.

Construction risks commonly involve many contractors and sub-contractors whose interests need to be considered alongside those of suppliers, designers, other professionals, the employer or owner and in many cases banks and other lending institutions.

Insurable risks may be protected under a single insurance policy covering all interests in a project under an Owner Controlled Insurance Programme ("OCIP"), or under individual insurance policies covering only the work in which the insured party has an interest.

Today I will be concentrating on material damage insurance (Construction All Risks insurance and Marine Cargo insurance) and financial consequential loss insurance (Delay in Start-Up insurance). There are many other types of insurance to be considered, for example Third Party Liability insurance and Professional Indemnity insurance, which I will also touch upon.

Relationships between the parties are usually governed by standard conditions of contract. As a benchmark I will be using the FIDIC Conditions of Contract for EPC/Turnkey Projects First Edition 1999 (the "Silver Book"). Some of the provisions within this Contract that have the greatest bearing on insurance are:

- Employer's Risks
- Consequences of Employer's Risks
- Definition of Force Majeure
- Consequences of Force Majeure
- Time for Completion
- Extension of Time for Completion
- Delay Damages

Owner Controlled or Contractor Controlled insurance?

The great majority of large construction projects are insured by the owner, rather than by the contractor. Under an OCIP the project owners purchase and control the insurance with the cover extended to the benefit of the owner, contractors and sub-contractors, as well as lenders and other interested parties.

There are arguments for and against OCIPs depending on "which hat you are wearing". Contractors will argue that if they have risk of loss for the contract works then they should insure the contract works. Owners will argue that if they have risk of loss for delay in completion then they should insure the financial consequences of such a delay (Delay in Start-Up insurance). The latter cannot be insured without the former so who should have control?

OCIPs have come about for a number of reasons some of which are more legitimate than others. Insurance brokers have pushed heavily for OCIPs as a means of generating business where they do not have contractors as their clients. Many owners have pushed equally heavily where for whatever reason they want to see as much insurance business as possible passing through their own risk management and insurance departments and through their own books.



In my opinion the most compelling arguments in favour of OCIPs are as follows:

- Where a project is financed by debt and the interests of lenders have to be met.
- Where the owner lets multiple contracts and no single contractor has overall responsibility for the works.
- Where there is phased start-up of a project.
- Where the owner and/or lenders wish to purchase Delay in Start-Up insurance.

From a contractor's viewpoint it is important that an OCIP provides at least the equivalent cover that would otherwise have been available to the contractor had the contractor been responsible for arranging his own insurance. Alternatively the contractor should be permitted to arrange his own insurance that protects him for any difference in cover, the cost of which should be admissible in his contract price.

A further consideration for contractors is the extent to which they can benefit, directly or indirectly, from Delay in Start-Up insurance purchased by an owner.

What does an OCIP cover?

OCIPs are usually tailor made to suit the particular needs of a project but typically they provide the following cover:

- Construction All Risks insurance

Covering physical loss of or damage to the permanent and temporary works until completion of the project as a whole.

- Marine Cargo insurance

Covering loss of or damage to any property to be incorporated into the works during transit from supplier's / manufacturer's warehouse to the project site.

- Delay in Start-Up insurance

Covering the owner's financial loss, such as the fixed costs of his business, caused by a delay in completion of the project where the delay is caused by loss or damage indemnifiable under the Construction All Risks insurance and/or the Marine Cargo insurance.

- Third Party Liability insurance

Covering each of the insureds' legal liability to provide indemnity for damages and claimants' costs and expenses arising out of damage to third party property and injury to third party people.

Sometimes contractors are asked to arrange their own primary insurance with the OCIP providing contractors with cover in excess of their primary insurance.

- Professional Indemnity insurance

It is rare for owners to purchase project specific Professional Indemnity insurance. In cases where it is purchased it may provide contractors, or their design sub-contractors, only with cover in excess of their own primary insurance similarly to Third Party Liability insurance.

- Other insurance

Contractors usually arrange their own insurance for their constructional plant and equipment and their own Employers' Liability, Motor and other statutory insurance. The owner will do the same for his own employees, vehicles and so on.



Timing is everything

In order for contractors to best protect their interests **do not leave risk sharing and insurance to the last minute**. It is far more difficult to successfully negotiate the risk sharing and insurance provisions in a contract retrospectively than at the outset of contract negotiations.

One of the difficulties often faced by owners is that at the time of early contract negotiations the scope of work, the work methods, time schedules and other material information for insurance might not have been fully defined. As a consequence it is not always possible for owners to fully define all of the terms and conditions of their OCIP until some later date. In these circumstances it is essential that insurance negotiations are ongoing between the contractor and owner until the OCIP becomes fully defined.

Transparency and collaboration between owners, contractors and their respective insurance advisors is the best medicine.

How does the negotiating process work?

Some owners have global OCIP facilities that cover all of their projects at fixed terms and conditions. It is difficult to adjust or amend these programme to meet any specific needs of contractors where such needs are at variance to the global OCIP. In these circumstances the contractor can arrange "Difference in Conditions/Difference in Deductibles" cover either by way of a project specific policy or on the back of any annual programme they have in place. This is not a cost effective solution.

Most OCIPs are arranged on a project specific basis which allows for collaboration between the owner and the contractor to develop a programme that meets both their needs. It is not unusual for contractors to seek broader cover than owners are prepared to pay for. In these circumstances the owner can offer the broader cover at the cost of the contractor. Examples of this are:

- Guarantee Maintenance cover versus Extended Maintenance cover
- Full Defects cover versus Limited Defects cover (e.g. LEG3 versus LEG2)
- Lower deductibles versus higher deductibles

What can Contractors Negotiate?

On the basis that "there is a price for everything" there is much that contractors can negotiate in terms of transferring risk to owners or to their insurers. However, if one applies industry norms and commercial reality it is hard to deviate very far from the provisions in a standard form of contract unless the contractor is in a very strong negotiating position. Typically the contractor will have "risk of loss" in respect of the contract works, perhaps with certain exclusions in some contract documents.

Some measures contractors can seek to negotiate are:

- Employer's Risks and the Consequences

Employer's Risks (under the "Silver Book") are broadly defined as war, terrorism, riot, radioactive contamination and pressure waves.

The consequences are that the contractor is entitled to an extension of time for completion and the employer will pay for the cost of repairing or reinstating any loss or damage.

It is in a contractor's interest to broaden the definition of Employer's Risks to encompass all risks that are insurable under an OCIP. This is not common practice although I have seen this done on some occasions in the USA.

Note 1 – There is a difference between "insurable risks" and "those risks for which indemnity is provided by insurance".

Note 2 – Not all Employer's Risks are insurable or easily insurable. For example, War risks are not covered under a Construction All Risks policy but may be covered under a Marine Cargo policy.



- Force Majeure and the Consequences

Force Majeure is broadly defined as exceptional circumstances (events beyond the control of the parties and unavoidable events) and exceptional events (Employer's Risks and natural catastrophes).

The consequences are that the contractor is entitled to an extension of time for completion and the employer will pay for the cost of repairing or reinstating any loss or damage due to Employer's Risks and natural catastrophes.

As with Employer's Risks it is in the interest of contractors to broaden the definition of Force Majeure to encompass insurable risks.

Note – In essence the consequences of Employer's Risks and of Force Majeure are the same. There are procedural differences.

- Delay in Start-Up Insurance

Before considering who has an interest in Delay in Start-Up ("DSU") insurance it is perhaps worth looking at the relationship between what triggers this insurance and the Force Majeure and Extension of Time provisions in a contract. DSU insurance is triggered by an insured event of physical loss or damage. The definition of Force Majeure includes many of these insured events including natural catastrophes. Following a Force Majeure event the contractor is entitled to an extension of time and is therefore not liable to pay liquidated damages for late completion. This is one important factor that drives the need for or desirability of DSU insurance.

The primary beneficiary of Delay in Start-Up insurance is the employer. Contractors may have an insurable interest which is usually limited to their liability to pay liquidated damages for late completion. Unless otherwise agreed, which is usual, DSU insurers will be entitled to rights of recovery against contractors to mitigate losses paid under the policy, i.e. to seek payment of liquidated damages for late completion.

Some insurers will agree to waive such rights of subrogation or they will agree to make DSU insurance primary to any liquidated damages for late completion. Because some insurers will not agree to this it is important that contractors raise this issue before an owner becomes committed to a "dissenting" insurer.

- Limitation of Liability

In circumstances where contractors are working on or near an owner's existing property they should seek to limit their liability for damage they cause to such existing property. Owners can in turn protect themselves against this through a combination of cover under their Property insurance and cover under their OCIP. The latter is done through an "Owner's Existing Property" extension to the Construction All Risks insurance.

- Surrounding Third Party Property

Where there is a contractual or commercial relationship between an owner and the owner of an adjoining or surrounding property mutual hold harmless agreements between these parties and their respective insurers can be obtained. This should be achievable at a neutral cost.

By way of example the owner of a power plant project may have an offtake agreement with an adjoining refinery. The power plant owner, the refinery owner and their respective insurers could enter into a mutual hold harmless agreement for damage one causes to the other's property. Contractors and their insurers could in turn enter into this agreement.

- First Party Property

On a more general note I would always advocate that where possible property should be treated as "first party" property rather than "third party" property whereby the insurers of the property provide indemnity to the owner without recourse to the party causing the damage. This is a cost effective insurance solution and it avoids potentially time consuming and expensive litigation between the parties with subsequent delays in repairing or reinstating property.



Debt financed projects

Non-recourse project finance debt brings with it a whole raft of additional insurance considerations including general insurance obligations, lenders' minimum insurance requirements, loss payable provisions and insurance conditions precedent to financial close.

The insurance agreement between the borrower (the project owner) and lenders is what I would describe as the "insurance bible" from which all other insurance agreements between the other contracting parties should flow. I say this because without agreement between the borrower and lenders and without meeting the insurance conditions precedent to financial close and first drawdown there is no project. A contractor might of course argue that without agreement between the owner and the contractor there is no construction contract and therefore still no project. Contractors are probably more easy to find today than lenders!

The development of an insurance programme for a project financed by debt tends to start by way of general minimum insurance requirements agreed between the borrower, the lender and their respective insurance advisors. If you like a "heads of agreement". It is at this stage that a contractor ideally becomes involved in the insurance negotiating process before things are cast in stone.

The scope of insurance for a project financed by debt is essentially the same as for any other project. The differences lie mainly in the procedures that have to be followed and how insurance claims proceeds are dealt with.

Note: These notes have been prepared by Lockton Companies International Limited as a basic guide only. They are not necessarily a complete description of risk or insurance, and are not a substitute for a thorough analysis of risk.

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