Insurance: a very risky business

by DOUG JONES

THE parties to construction projects often place a lot of faith in insurance — only to find, when it comes to the crunch, that it does not respond the way they expected or in the timeframes intended under the project's contracts.

This is particularly concerning for those who regard insurance as a primary form of project risk protection. A carefully tailored and properly drafted insurance program provides an important form of financial security to insurable risks.

But anyone who regards insurance as the ultimate "catch-all" for most project risks does so at their peril — particularly if they have not made the effort to ensure the program is carefully tailored and drafted specifically for the project.

Contractors and owners alike are voicing frustration about the uncertainty that now seems to permeate the insurance contracts they enter into. Substantial numbers of cases are now headed to the courts to resolve insurance coverage disputes.

And insurance needs are changing rapidly, entering new territory.

Increasing liabilities for extended design guarantees have significantly raised the profile of professional indemnity insurance. And owners and contractors are turning more and more to "non-traditional" forms of insurance, such as insurance for liquidated damages and *force majeure*.

These policies are complex. They are usually negotiated on a project-by-project basis, and their terms and conditions are strict, in stark contrast to the fluid and variable nature of the risks being insured. What is more, the major provider of these types of insurance prefers these policies to be subject to United Kingdom law, so Australian policy holders miss out on the protection of Australian laws such as the Insurance Contracts Act.

Insurance claim disputes are not, of course, restricted to these more unusual classes of project insurance. Contract works insurance policies, covering physical loss or damage to project works, also "enjoy" a long history of disputes about how to resolve losses caused by faulty design, workmanship and/or materials.

Similarly, the resolution of "advance loss of profit" claims, covering responsibilities for revenue losses and debt servicing, also leads to many delays in final settlement.

At present, insurance issues are often addressed only during final negotiations on finance and/or construction contract documents. In these circumstances the insurance clauses are often seen as an impediment to contract finalisation.

They also tend to be considered only in terms of catastrophe protection, rather than as cash-flow generators to facilitate the reinstatement of damaged works and assist the contractor to return to its critical path.

As a result, the clauses are often drafted in generalised terms and descriptions, with the intention of agreeing on final coverage when the policy wordings are drafted, often after works have commenced. This is far from "best practice", but it does not have to be the case.

Much of the uncertainty that now plagues construction industry insurance can be removed if all project risks and their protection alternatives are considered right from the outset, and an integrated risk apportionment and insurance protection strategy is developed during the project feasibility stage.

Project risk profiles

This strategy can then be incorporated into all the subsequent project agreements. This way, the parties can enter early project negotiations with a clear understanding of their retained project risk profiles and the cost and extent of insurance protection available.

The parties can also more accurately assess the cost of the risks they are seeking to transfer to others!

In formulating this overall strategy, it is important to recognise that:

- ☐ The project finance and construction contracts are the primary vehicles for apportioning project risks, so the extent of risk transfer or mitigation must be carefully described in these contracts.
- ☐ The insurance program can act as a financial guarantee for the apportioned risks, but it can never replace the obligations imposed by the project's contracts. The insurance program is therefore not a form of risk transfer, particularly for contractors, but simply a way of mitigating the cost of the risks that remain with the contracting party.
- ☐ All insurance programs contain conditions excluding coverage for a diverse range of physical, legal and financial risks, and therefore cannot be relied on as a "catch-all" for project risks.
- ☐ A properly arranged insurance program will, however, provide financial security for a significant number of the parties' contractual obligations.

This does not require an effort of the magnitude of "War and Peace". But as a major tool in reducing the cost of project risks, insurance deserves comprehensive consideration and attention, both at the feasibility stage and within the project contracts, in line with the importance more typically placed on penalty, indemnity, risk of loss and other risk-apportionment issues.

A formalised project risk and insurance protection strategy, translated into pro forma clauses and setting benchmarks for the risks you prefer either to transfer or to assume and manage, can be incorporated into all project agreements.

These pro forma clauses will act as a basis for negotiations and can be amended if and as required, subject to commercial considerations for each project. They may be incorporated into existing company pro-forma contracts or applied on a project-by-project basis.

As a practical example, risk management thresholds might be incorporated into existing pro-forma contracts in the following areas:

- ☐ The scope of indemnities to be provided or demanded
- ☐ Extent of *force majeure* provisions
- ☐ Sub-contractor compliance with legislative obligations
- ☐ The period and scope of design and defect guarantees
- ☐ Risk of loss and transfer of title interfaces under supply obligations
- ☐ Partial handover or construction/operation interfaces, and
- ☐ Environmental risk obligations.

The pro forma clauses should incorporate a comprehensive description of the insurance program required, with clear definitions of coverage extensions and the obligations of each party, including:

- ☐ Insurance requirements for all contracting parties
- ☐ Named insured parties under the program and their loss payee rights
- ☐ Waivers of subrogation and insurers' rights of recourse
- ☐ Non-vitiation for breaches of policy conditions
- ☐ Disclosure and material change obligations of the insured parties, and
- ☐ Policy jurisdiction and the governing law.

As another practical example, clauses on design risks might address:

- ☐ Liability policies to cover blanket contractual liabilities and financial or economic losses of third parties
- ☐ Contract works insurance to cover physical loss or damage arising from design, workmanship or materials (either including or excluding the defective works themselves, subject to your company's risk philosophy)
- ☐ Liability insurance to cover all civil liabilities and ensuring coverage for legislative obligations under the Trade Practices Act, occupational health and safety, environmental and other relevant laws
- ☐ Professional indemnity insurance limits of liability, reflecting the potential risks, premium costs, aggregate limits and the need to re-negotiate the limits in the event of loss
- ☐ Insurance periods and limits consistent with the project's contractual obligations, taking account of current and future insurance market availability

☐ *Ed.: Doug Jones AM is a construction partner of national law firm Clayton Utz, and for this article the assistance of Gregory McCoy of Clayton Utz is gratefully acknowledged.*

■ Airplan's senior airside planner at its Melbourne office, **David Cheing**, has won the 1999 Frank Magee Scholarship, which is in honour of the company's founding director. Cheing is using the scholarship to visit airports in Hong Kong, Malaysia, UK and Europe to investigate and study aircraft parking and manoeuvres and ground service equipment storage and staging.

■ **CNH, the company formed by the merger of Case Corporation and New Holland, has announced its board of directors: the former vice chairman of Citicorp and Citibank NA, Pei-yuan Chia; the former Italian agriculture minister, Alfredo Diana; the president and ceo of Brady Company, Katherine Hudson; Lipper chairman Kenneth Lipper; European Parliament member James Provan; Fiat ceo Paolo Cantarella; Fiat fiance chief Damien Clermont; with Jean-Pierre Rosso as chairman and ceo, and Umberto Quadrino as co-chair. Rosso had been chairman ceo of Case since 1994.**

■ Following the recent Transfield restructure, a new senior management team has been appointed: 25-year company man **Bruce James**, as ceo Transfield Engineering and Construction, with **Peter Watson** succeeding James as ceo Transfield Operations and Maintenance. **Peter Francis**, who successfully led the Transfield Thomson-CSF bid for Australian Defence Industries, will join the ADI board, as will **Tony Shepherd** while continuing as ceo Transfield Project Development. **David Iverach** has been appointed to the new position of ceo Transfield Group Services.

■ *Douglas Partners' Darwin office has been strengthened by the addition of geotechnical engineer **Konrad Schulz**. He commenced his engineering career with DP in Sydney in 1996 and then spent two years in the Perth office. Additional DP northern Australia senior staff include **Chris Stewart**, who manages the Cairns lab, and geotechnical engineer **Dennis Ford**, providing consultancy in Cairns, Townsville and Darwin. **Ken Boddie** has rejoined DP as senior associate and manager of the Townsville office.*

Angus McLeod moves to Ajax.

■ TAB Datafile has appointed **Jennifer Freeman** as corporate business development manager in Victoria to work exclusively with architects, interior designers and building fitout professionals. Her experience includes 10 years in managerial and marketing roles.

■ **Ajax Fasteners has appointed Angus McLeod as national sales engineer, to be based at Braeside, Vic. He has been with Connell Wagner for the past four years, and was site engineer on the Crown Casino complex.**