MASONS THELEN REID LLP

OCAJI Construction Seminar

CONTRACTORS' ALL RISK INSURANCE POLICIES- AN ADDITIONAL SOURCE OF REVENUE ON CONSTRUCTION PROJECTS

Global Infrastructure Lawyers℠

www.masonsthelenreid.com

Introduction

- Construction is a high risk industry. Accidents happen all the time, and these accidents cost the Contractor money.
- Many times these accidents are or could be covered under the Contractor's All Risk ("CAR") policy.
- With proper management, which includes identifying covered or potentially covered claims and properly documenting the claims, CAR policies can provide an additional source of income for the sophisticated Contractor.

What is CAR Insurance?

- CAR policies insure against physical loss or damage to works, plant, equipment and materials during the course of construction. They are therefore sometimes called "Course of Construction," Builder's Risk" or "All Risk" policies.
- The key characteristic is that, unlike other classes of insurance, the insurance clause is not limited by reference to specified perils – in other words everything is covered unless it is excluded (expressly or by implication).
- CAR insurance is usually combined with (but must be distinguished from) Public Liability Policies.

The Six Rules for CAR Insurance When Negotiating Contracts

- Insurance is something that most Contractors pay scant attention to at the Contracting phase. Typically the only thing the Contractor will do is to send the insurance section of the Contract Documents to his insurance broker to get a price for the insurance required to be provided by the Contractor so the Contractor can include this price in his estimate.

- If CAR policies are going to be a source of revenue down the line, the first step in the process is to ensure that a CAR policy is in place that contains the proper terms and conditions.

- If problems with the CAR policy are identified PRIOR to the Contract between the Contractor and the Employer, the parties can negotiate the risks, including reducing the CAR excess or removing some exclusions in exchange for payment of a slight additional premium.

- The terms of the CAR policy are, like the terms of a Prime Contract, subject to negotiation.

The Six Rules for CAR Insurance When Negotiating Contracts (continued)

Make sure that:

1. The project includes a CAR policy
2. The Contractor inspects a copy or specimen of the policy
3. The policy names the Contractor and the Employer as insureds
4. The excesses/deductibles are reasonable
5. There are no unusual exclusions from coverage
6. There are no unusual limitations on the measure of damages

Typical Policy Wording

- Policies bearing the title "Contractor's All Risks Insurance" vary considerably in their terms. Nevertheless such policies have a number of common features.

- The central provision is the indemnity clause. A typical example from a CAR policy is as follows:

> *The Insurers will indemnify the Insured in respect of physical loss or damage to the Insured Property described in the Schedule arising FROM ANY CAUSE except as hereinafter provided.*

- In this example all the features of CAR insurance can be found. It is an <u>indemnity</u> policy against <u>physical loss or damage</u> to identified <u>property</u> from <u>all causes</u> except those identified.

ELEMENTS OF THE INSURING CLAUSE

The Insured

- This usually includes the Employer, Contractor, Sub contractors/suppliers and (more unusually) consultants.

- Under ALL internationally accepted forms of construction contracts, the Contractor will have care of the Works until completion and will own the equipment and materials.

- In other words, it is the Contractor who will be contractually responsible for any accidental damage to the Works, the very risk that CAR policies are issued to cover.

- As a result, as between the Employer and the Contractor, it is the Contractor who should be more keenly aware of the terms and conditions of the CAR policy. And therefore it is incumbent on the Contractor to ensure that a proper CAR policy is in place.

OCCURRENCE

- Typically the CAR policy will stipulate that there is a limit of liability for each "occurrence."
- Generally, an "occurrence" is physical loss or damage to the Works.
- Generally, there is an excess or deductible for each occurrence.
- This can lead to disputes over what constituted the "Occurrence."

OCCURRENCE

Occurrence Case Study: Philippine Bridge Typhoon Case

- Severe Damage was caused to a public works bridge project in the Philippines by typhoons which struck the Philippines on 14-15 and 22-24 October 1998. The damage was caused by flooding from waters released from the Magat Dam Reservoir.
- Damage was sustained by two bridges and approach structures during both typhoons. A substantial portion of the damage consisted of damage to temporary works and structures, including temporary construction bridges.
- The deductible for "Acts of God" under the CAR policy was quite high, P15,000,000 (about US$400,000) per occurrence.

OCCURRENCE

Case Study: Philippine Bridge Typhoon Case, Continued

- An endorsement to the CAR policy essentially provided that "any loss or damage to insured property arising during any one period of 72 consecutive hours, caused by storm, tempest, flood or earthquake, shall be deemed as a single event and therefore to constitute one occurrence with regard to the Excesses provided for herein."
- While this clause did not say that if the period exceeded 72 hours, it was deemed to be two occurrences, there is a strong inference that this is what was intended.
- As a result, the case was settled based on two deductibles, which reduced the recovery by an additional $400,000. Certainly this high deductible, or the 72 hour endorsement, are things which the contractor could have attempted to negotiate prior to the issuance of the policy and the execution of the Prime Contract.

Consequential loss

- The meaning varies according to the context, but generally "consequential loss" refers to loss beyond the normal measure and includes such things as loss of profits and expenses caused indirectly by the event.
- In a typical CAR claim, there will be 3 damage components: the direct loss (the costs to repair); the prolongation costs to the Employer; and the prolongation costs to the Contractor and Sub-contractors.
- CAR policies are NOT consistent in their treatment of prolongation costs, which may be considered consequential losses.
- Because prolongation costs arising out of a loss covered by a CAR policy are so significant, it is a good practice to review the CAR policy to determine whether such costs are covered, and to even pay more policy premium to ensure that prolongation costs arising out of a covered claim are covered under the CAR policy.

Consequential Loss Case Study: Philippine Bridge Typhoon Case

- The subject policy contained an exclusion that stated that the Insurers shall not be liable for "consequential loss of any kind or description whatsoever including penalties, losses due to delay, lack of performance, loss of contract."
- In essence, this clause meant that the CAR policy did not provide coverage for delays to the work resulting from the "occurrence" and resulting damage.
- In the case of the flood claim, no delay damages or prolongation costs were paid to the Contractor, even though the flood, and resulting repair work, caused considerable delay to the Project.

INSURED PROPERTY

- This will be defined in the policy. It will include primarily the Works but is also likely to include temporary works, equipment and material provided that it is on site or in transit intended for incorporation in the works.
- For larger projects where materials may be produced off site, a wider geographical limit may be used.
- The property will be expressly or impliedly limited to that which is owned by the Insured or for which they are responsible.

Insured Property/Temporary Works Case Study: Philippine Bridge Flood Case

- Another aspect of the Philippine Bridge Flood Case were the various exclusions in the policy regarding temporary works and materials.
  - The Depreciation Structure Endorsement effectively required that the Insurer depreciate the value of any temporary facilities or structures in determining the amount of payment.
  - The Formworks, Scaffolds Endorsement required that the Insurer depreciate the value of any formworks, scaffolds and supporting structures in determining the amount of payment. Special rules apply to steel/metal scaffolds and forms, which are treated as construction equipment.
- As a result of these provisions, the Contractor faced substantial discounts for the temporary works (temporary bridges and scaffolding) that were effectively washed away as the result of the flood/typhoon.

Insured Property/Temporary Works Case Study: Philippine Bridge Flood Case

- Fortunately, the Contract between the Contractor and the Philippine Government basically provided that the government was responsible for damages to the permanent works resulting from acts of *force majeure*, to the extent not covered by the CAR policy.

- The Contractor appealed to both the CAR insurer and the Employer for reimbursement for the temporary bridges and scaffolding, which formed a great part of the claim, on the grounds that the temporary bridges and scaffolding were not "temporary works" or, alternatively, that they were in the nature of permanent works.

- This is a good example of the interplay between the CAR policy and the terms of the Prime Contract.

IMPLIED AND EXPRESS EXCEPTIONS

EXCLUSIONS – IN GENERAL

- The simplicity of CAR policies - they cover physical loss or damage unless excluded - is eliminated because a typical CAR policy has many exclusions to coverage that can make the analysis of whether coverage exists in a given case very complicated.

- There are not only exclusions, but exceptions to exclusions, and even exclusions to exceptions to exclusions.

- Below we briefly touch on express and implied exclusions, and provide some case examples of how exclusions operated to cause certain CAR claims to be covered or uncovered.

IMPLIED AND EXPRESS EXCEPTIONS (continued)

IMPLIED EXCLUSIONS

- As with building contracts there are certain requirements which are always implied into the policy and which limit the cover. One of these has already been considered, that the policy will frequently not cover consequential loss.
- The other important implied exclusion is that the loss must be fortuitous.
- Loss will not be fortuitous where (a) it was inevitable from the commencement of the cover; or (b) it was caused by the wilful misconduct of the Insured. In these cases the loss is excluded by implication.

IMPLIED AND EXPRESS EXCEPTIONS (continued)

EXPRESS EXCLUSIONS

- These may be implied exclusions given express form. Wear and tear, obsolescence and deterioration, rust and mildew are not risks as such because they are inevitably occurring events but it is nevertheless usual to find express exclusions confirming the position.
- An example is: *"Any repairs or replacements necessitated solely by wasting wearing away or wearing out caused by or naturally resulting from ordinary use of works, rusting, corrosion or gradual deterioration of any part of an item of Insured Property, but this exclusion shall not apply to damage resulting from such causes to other Insured Property by this policy.'"*

Defective design and workmanship exclusion

- One of the most important exclusions is for defective design and workmanship.

- An example wording of such an exclusion could be to exclude liability in respect of:

  "loss or damage due to fault, defect, error or omission in design, plan or specification, failure of design, defective materials or workmanship"

- The impact is that if the damage was caused by defective construction, the loss is excluded from coverage.

- One method that has been used to avoid the impact of this exclusion is to characterize Contractor error as defective "means and methods" rather than defective "workmanship."

Defective Construction Exclusion Case Study: Singapore Plant Building Poured In Place Concrete Collapse Case

- This CAR claim arose out of the temporary formwork collapse at a chemical plant building on a project in Singapore.

- In essence, the concrete second floor of a building, 14 meters in the air, collapsed while the concrete was being poured.

- This necessitated the rebuilding of the collapsed portion of the building, at substantial additional cost.


West View


North View


Close-up

Defective Construction Exclusion Case Study: Singapore Plant Building Poured In Place Concrete Collapse Case, Continued

- **The Key Policy Exclusion.** The "Exceptions" section of the policy provided in part as follows:

  Exceptions

  No liability shall attach hereunder for

  1) loss or damage due to fault, defect, error or omission in design, plan or specification …

  2) the cost of rectifying defects of material or workmanship but this exclusion shall not apply to the cost of making good accidental damage to the Contract Works which occurs during the Period of Insurance … as a result of such defects.

- The critical issue was whether the collapse was the result of ["due to"] fault/defect/error in "design [or] failure of design." If this was the predominant or proximate cause, then liability was excluded under the policy.

Defective Construction Exclusion Case Study: Singapore Plant Building Poured In Place Concrete Collapse Case, Continued

- **Causation.** This collapse was taken very seriously by the Employer and the Singapore Government, who demanded that a formal report on the cause of the collapse be compiled.
- The Project Manager for the main contractor hired an engineer to prepare the report, which predictably assigned fault to inadequate design by the shoring engineer retained to design the shoring (some beams were under designed by over 20%) and to inspect it to ensure that it was properly erected.
- The Project Manager was obviously reluctant to assign blame to his construction team.
- The CAR insurer denied the claim based on the defective design exclusion.
- At this point the Contractor retained counsel to assist with prosecuting the claim.

Defective Construction Exclusion Case Study: Singapore Plant Building Poured In Place Concrete Collapse Case, Continued

- **Bleak Outlook.** Counsel quickly identified the fact that the policy DID cover defective construction. Recall that the exclusion quoted above excluded defective construction, but went on to state that the exclusion did not apply to the cost of making good damage to the Works which occurs as a result of such defects. The bulk of the damage in this case was damage to the Works due to the collapse.
- Thus, the policy covered all damage to the Works, but excluded damage caused by defective construction, but then had an exception to the exclusion for defective construction.
- Another report was prepared that concluded that the collapse was caused by defective construction.
- A lawsuit was filed, and the case settled on the day before trial for 60% of the claimed amount, which allowed the Contractor to essentially break even on the costs of the claim.

- And the CAR policy in this case DID cover prolongation costs.

PERIOD OF COVER

- CAR policies are claims occurring policies. The applicable policy is that which was in force when the event occurred that caused the "occurrence."

- Generally the time will be expressly identified and should coincide with the period when the Contractor is on site. It will therefore end either when the Employer takes possession of the Works or when the Contractor leaves site.

- Some limited coverage will also usually extend to the period when the Contractor is remedying defective works in particular during the defects Liability period.

Strategy for Claims Against CAR Policies

Claims Against the Employer

- On construction projects, the Contractor will assert claims against the Employer seeking additional compensation.

- These claims will take a variety of forms: strong, weak and mediocre claims.

- The Contractor asserts this variety of claims because he wants to negotiate a settlement where he receives most of the money on the strong claims, some money on the mediocre claims, and little money on the weak claims.

- Sometimes the Contractor will hesitate to pursue many claims against the Employer, because the Contractor wants to maintain a good relationship with the Employer, does not want to be seen as a "claim" contractor or because of cultural reasons, such as is frequently the case with Japanese contractors, who are reluctant to pursue claims against Employers because such claims are not pursued on construction projects in Japan.

Strategy for Claims Against CAR Policies (Continued)

Claims Against the CAR Carrier

- The strategy of pursuing strong, mediocre and weak claims should also be pursued in claims against the CAR policy.

- Frequently Contractors do not assert the small, weak or mediocre claims against the CAR policy, instead only pursuing major claims that are obviously covered.

- This is bad policy. The Contractor must be creative in attempting to identify and pursue claims that are POTENTIALLY covered under the CAR policy.

- Note that asserting claims against the CAR carrier will not cause the Employer to take a negative attitude toward the Contractor, so asserting claims against the CAR carrier is actually a better practice than asserting claims against the Employer.

Strategy for Claims Against CAR Policies (Continued)

Managing the Claims

- Before submitting a claim on the CAR policy, particularly a major claim, legal advice should be obtained.
- Counsel will review the claim before it is submitted and ensure that the claim is not structured in a way that causes the claim to fall within an exclusion.
- Counsel can also assist in structuring the damages portion of the claim.
- For example, if the CAR policy excluded prolongation costs, and the claim caused a substantial delay to the project, in order to obtain enough money from the CAR carrier to reimburse the Contractor for all costs arising out of the claim, counsel and the Contractor may need to be creative in expanding the amount of damages sought under the CAR claim.

Strategy for Claims Against CAR Policies (Continued)

Managing the Claims

- Some of the Case Studies provided above were given to illustrate the importance of CAR claim management.

- Despite all of the problems on the Philippine Bridge Flood CAR claim – two deductibles, a high deductible, no cover for prolongation costs and reductions for depreciation, the case ultimately settled, and the Contractor made a substantial profit on the claim, because the claim was prepared by a professional who had identified these problems and took them into account BEFORE the claim was filed, and the negotiations were well-managed.

- And even in the case with the Singapore plant formwork collapse, where the Contractor had commissioned a report that placed the cause of the claim squarely in an exclusion, counsel was able to identify an exception to an exclusion and to make arguments in favour of coverage that eventually led to a satisfactory settlement.

Strategy for Claims Against CAR Policies (Continued)

Documenting Damages

- CAR Insurers, like any project Employer, will be naturally inclined to attempt to reduce the amount of damages arising out of a claim against the CAR policy.
  - They will attack prolongation costs
  - They will assert the maximum excesses allowed under the policy
  - They will attack markup for overhead and profit
- And the CAR carriers will not pay on claims unless and until proper documentation is provided.
- Assistance by experienced counsel or consultants at the damages preparation stage is critical.

Conclusion

- Japanese Contractors need to change their perceptions about claims against CAR policies.

- CAR policies are a source of additional revenue, period.

  - While the CAR policies may be issued by Japanese companies, there are non-Japanese reinsurance companies standing behind the Japanese companies, known as reinsurers, and the reinsurance companies will bear the majority of the cost of the claim. So there is nothing anti-Japanese about aggressively pursuing claims against the CAR policy.

- Maximize this source of additional revenue by:

(1) Identifying and pursuing all covered and <u>potentially</u> covered claims.

(2) Working through the logic of the claim through <u>before</u> asserting the claim, to avoid going down a path that will ultimately lead to no coverage.

(3) Creatively documenting the damages for the claim.

MASONS THELEN REID LLP

Global Legal Infrastructure Services from Masons and Thelen Reid & Priest LLP

LONDON
T +44 (0) 20 7490 6230
F +44 (0) 20 7490 6676

SAN FRANCISCO
T +415 371 1200
F +415 371 1211

SHANGHAI
T +86 21 6321 1166
F +86 21 6329 2696

MADRID
T +34 91 436 33 25
F +34 91 436 33 29

NEW YORK
T +212 603 2000
F +212 603 2001

HONG KONG
T +852 2521 5621
F +852 2845 2956

EDINBURGH
T +44 (0) 131 225 0000
F +44 (0) 131 225 0099

WASHINGTON, DC
T +202 508 4000
F +202 508 4321

Global Infrastructure Lawyers[SM]

www.masonsthelenreid.com

SF#838008