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THE ROLE OF INSURANCE AND COST REDUCTION IN EPC CONTRACTS

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KEY ROLE OF INSURANCE IN EPC CONTRACTS

- To optimise the total cost of risk for your project
- That total cost needs to include for the cost of insurance itself
- No concept of ‘one size fits all’ in the international EPC insurance market
- There are many variables to consider

OPTIMISING THE TOTAL COST OF RISK AND INSURANCE FOR YOUR PROJECT

- Issues to consider include:
  - **Insurance type** - there are many different types of insurance available for construction risks
  - **Risk transfer mechanism** - insurance is simply a mechanism for transferring risk to a third party risk bearer (insurer) for a cost (premium)
  - **Cost** - the total cost of the insurance can often represent a significant proportion of total project costs
  - **The small print** - it is imperative that policyholders understand they are getting and the limitations of different insurance policies.

OPTIMISING THE TOTAL COST OF RISK AND INSURANCE FOR YOUR PROJECT (CONT)

- The cost of insurance can be reduced by:
  - good risk management;
  - structuring the insurance programme;
  - careful drafting of the insurance provisions to ensure that there is no duplication of the cost of insurance or gaps in coverage

SIGNIFICANT INSURANCE CHALLENGES

- **Choice** - All insurance products are not created equal
- **Market Conditions** - e.g. 'mega' projects may exceed market capacity
- **Issues Affecting Availability** - e.g.
  - Duration of project – may be up to 5 + years
  - Experience of contractors/EPC and quality assurance issues
  - New technology and scale-up of existing technology
  - Lenders' expectations e.g limits/deductibles, scope of coverage and non-vitiation
- **Geographic/Geopolitical issues**

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UTILIZING ALTERNATIVE RISK TRANSFER PRODUCTS

- Types of insurance policies:
  - third party liability insurances:
    - e.g. EL, PL, PI
    - triggered by a claim and stand behind the insured and indemnify it in relation to liability to a third party
  - material damage policies:
    - ‘first party’ coverage
    - triggered by an occurrence of physical damage
    - e.g. insurance of the risk of physical damage to the works during construction
  - consequential loss policies:
    - e.g. delayed start up (DSU) insurance

UTILIZING ALTERNATIVE RISK TRANSFER PRODUCTS (CONT)

- A number of these policies can be taken out as either:
  - insurance for a specific project a “single project” policy (e.g. single project PI) or
  - for a number of projects (a “block” or “floater” policy)

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INSURANCE OF THE WORKS - CONTRACTOR'S ALL RISKS POLICIES

- **No fault** - a ‘no fault’ policy that covers the risk of physical loss or damage to the works during construction
- **Joint names** - taken out in the Joint Names of the Employer/Owner and Contractor
- **End date** - full cover under the policy generally ceases on completion or takeover
- **Risk transfer:**
  - risk usually transfers to the Employer's property insurance at completion/takeover
  - although the CAR policy will continue to provide more limited cover for Contractor on a liability basis for damage to the works while undertaking corrective work during the defects liability or guarantee period

ALL RISKS EXCLUSIONS

- Do CAR Policies actually cover all risks? - generally no
- Typical approach is to <u>start</u> with a general coverage of 'all risks' of physical damage to the works and then <u>exclude</u> various matters
- Exclusions under a typical onshore CAR policy are retained by the insured and need to be addressed under the EPC contract - coverage likely to vary significantly for onshore and offshore construction work
- Typical exclusions include:
  - war, hostilities, civil commotion, riot or strike
  - terrorism
  - radioactive contamination etc.

ALL RISKS EXCLUSIONS (CONT)

- Typical exclusions (cont.):
  - wilful, intentional, careless, fraudulent, criminal actions or omissions of insured or their representatives
  - defects in design, plans or specifications
  - defects in workmanship
  - liquidated damages, penalties and consequential financial loss
  - Wear, tear, corrosion or other gradual deterioration
- Under FIDIC (sub-clause 17.3) these matters that typically excluded under the CAR are “Employer’s Risks”

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COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES

- ***Common Coverage Issue No. 1: What is damage?***
  - what is damage? Can be difficult to tell
  - a common area of dispute with insurers is whether physical damage has actually occurred or the extent of coverage
  - case law distinction between works which are defective at the moment of their creation and works which suffer physical damage
  - *Pilkington UK v. CGU Insurance [2004] All ER (D) 272:*
    - Glass panels in the canopy at Eurostar International terminal which were prone to fracture because of an impurity in the glass
    - Insured's claim in relation to the panels failed
    - Held: *"damage requires some altered state, the relevant alteration being harmful in the commercial context"*

COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- ***Common Coverage Issue No. 1: What is damage?***
  - latent defect or physical damage?
  - *Seele Austria GnbH & Co. v. Tokio Marine Europe Insurance Ltd [2007] BLR 337*
    - applied the test in *Pilkington v. CGU* and held there had not been any physical alteration in the insured property
    - Judge Field decided:

      "*damage means here not a defect in the works but an adverse physical effect on the state of the physical state of the works as a result of the defect …there is no damaging within the insuring clause and therefore no cover under an unbespoke Contractor's All Risks policy for the cost of rectification where a defect is discovered which has not yet physically affected the insured property but will do so unless it is rectified.*"

COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- Tip to maximise coverage and potentially reduce overall cost:
  - understand the distinction between the defect itself and physical damage; and
  - make sure claims are submitted where appropriate for accidental physical damage (even if caused by the EPC Contractor’s error or omission etc.)

COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- ***Common Coverage Issue No. 2: 'Other Assured'***
  - a key consideration in relation to CAR on major projects with many different parties and subcontractors at various tiers
  - typically CAR policies will identify the principal assured by name and list “Other Assureds” by category – e.g. “subcontractors of any tier”
  - this is a complex area of the law
  - the conventional position is that a joint assured is not liable to another assured or, by way of subrogation, to the insurers
  - however, under English law, Other Assureds may only have the benefit of the insurance to the extent made available in the underlying contract (see, for example, *National Oilwell (UK) Ltd v. Davey Offshore Ltd* [1993] 2 Lloyds Rep 582

COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- *Hopewell Project Management Ltd v. Ewbank Preece* [1998] 1 Lloyd's Rep 448
  - power station in the Philippines
  - during commissioning, damage occurred to two gas turbines
  - alleged to have been caused by the negligence of Ewbank Preece who were the engineers
  - Ewbank Preece argued they were an “Other Assured” under the category of “subcontractor” and the claim (which was a subrogated claim brought by CAR Insurers) could not be brought against them
  - held: EP were a “subconsultant” not a “subcontractor” and therefore were not insured under the CAR policy

COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- *Gard Marine & Energy Limited v. China National Chartering Co Ltd and another* [2017] UKSC 35
  - A vessel (the 'Ocean Victory') ran aground while attempting to leave a port in Kashima, Japan
  - The vessel owner had chartered the vessel to a charterer who sub-chartered
  - The charter contained a 'safe port' warranty
  - Insurers paid out and attempted to bring a subrogated claim against the sub-charterers for breach of the warranty
  - The Supreme Court decided by a majority that the insurance provisions in the charter precluded a claim between co-insured so the insurer could not bring a subrogated claim against the sub-charterers

COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- Tips to maximise coverage and potentially reduce overall cost:
  - Consider the definition of ‘Other Insured’ or ‘Additional Insured’ under your CAR policy
  - If you are a party to a major project and are not listed as an insured or afforded the full benefit of the CAR policy in your contract, insurers may seek to shift the burden of meeting a claim on to you.
  - If you are an EPC Contractor you may require express acknowledgement in the contract that the EPC Contractor and its subcontractors are named as other insureds under the CAR policy and that insurers have waived rights of subrogation.

COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- ***Common Coverage Issue no. 3: What is an '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 and there is an excess or deductible for each occurrence
  - this can lead to disputes over what constituted the "occurrence" and insurers typically seek to argue that there are multiple occurrences in order to apply multiple deductibles

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COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- See, for example, *Mitsubishi Electric v. Royal London Insurance* [1994] 2 Lloyds Rep 249 and claims for toilet cubicles!
  - 94 identical toilet modules attached to a cementitious board which was defective, causing damage to the tiles in each of the modules
  - deductible under the CAR policy was *"the first £250,000 of each and every loss in respect of any component part which is defective in design, materials or workmanship"*
  - insurers attempted to argue that the defective component was the module and 94 deductibles applied
  - Court of Appeal rejected this argument and held that the defective component was the cementitious board; therefore only one deductible applied

COMMON INSURANCE COVERAGE ISSUES UNDER CAR POLICIES (CONT.)

- Tips to maximise coverage and potentially reduce overall project cost:
  - Consider the definition of ‘occurrence’ in your CAR policy;
  - Make sure it is properly tracked through to any equivalent provision in the EPC contract providing allowing the EPC Contractor additional time or money for an insured occurrence;

OTHER TYPES OF COVERAGE – TRANSIT AND MARINE CARGO INSURANCE

- Other forms of insurance which can be obtained either as an extension to the CAR cover or as 'stand alone' additional coverages:
  - Transit and marine cargo insurance
  - Delay in Start Up insurance
  - Contractor’s Plant and Equipment Insurance
- **Transit and marine cargo insurance**:
  - common on major international projects where parts are transported from overseas
  - covers the risk of loss or damage to goods in transit
  - need to ensure complete coverage on a 'warehouse-to-warehouse' basis
  - check the definition of delivery to the Site and coordinate supply contract provisions to avoid coverage gaps and/or duplication

OTHER TYPES OF COVERAGE – DELAY IN START UP COVERAGE

- **Delay in Start Up Insurance:**
  - covers the ‘soft cost’ of the CAR insurance caused by delays
  - often triggered by a claim under the CAR policy
  - parties with an insurable interest in the project revenue stream will be named as insured
  - the claim can often only be considered on completion, once the impact of the event can be properly assessed

PROFESSIONAL INDEMNITY COVER FOR CONSULTANTS AND DESIGN AND BUILDING/ EPC CONTRACTORS

- Typical insuring clause:

  “The insurers will indemnify the insured in respect of any legal liability to a third party incurred in the course of professional services carried on by the insured”

- In this example the trigger is ‘legal liability’ rather than ‘a negligent act, error or omission’
- Limit of indemnity may be ‘each and every claim’ or ‘in the aggregate’
- Watch out for big claims in the first year that could ‘wipe out’ future cover

CONTRACTOR'S PI POLICIES

- A Contractor's PI policy will usually include a detailed list of the activities covered – e.g.
  - feasibility studies
  - surveying
  - Procurement
  - design or specification
  - project or construction management
  - supervision or inspection (by an architect, engineer, etc employed by the Contractor)
- Can be a 'grey area' as to what amounts to a 'professional activity' by a contractor

PI POLICIES

- Typical exclusions common to all PI policies:
  - fitness for purpose obligations
  - dishonest, malicious or fraudulent acts
  - liability outside geographical limits
  - pollution and contamination
  - liability arising out of an agreement to pay liquidated damages “except to the extent that such liability would have attached in the absence of such an agreement”
- Other considerations:
  - notification provisions will be interpreted strictly as conditions precedent to cover & don’t assume that one notification will be sufficient
  - insured typically required to notify “circumstances likely to give rise to a claim” - “likely to give rise” has been held to mean “a better than even chance of a claim”

SINGLE PROJECT PI INSURANCE

- Taken out by the Employer or owner for a specific project
- Covers all professional duties performed by any insured over a fixed period including a ‘run-off’ period of up to 12 years post-completion
- Will usually cover any consultants, contractors, subcontractors and suppliers on a project
- Insurers waive rights of subrogation against any insured
- Advantages:
  - Continuity of cover
  - Increased control
  - Increased limits of indemnity
- Main disadvantage is cost

SINGLE PROJECT PI (CONT.)

- May only be cost-effective on major projects
- Owners Protective Professional Indemnity Insured (“**OPPI**”) is a variant of Single Project PI
- OPPI is a form of excess liability insurance which ‘sits above’ all of the design team’s annual insurance programmes and is triggered if any of these policy limits are inadequate

TIPS FOR DRAFTING INSURANCE PROVISIONS

- A well drafted EPC contract should have insurance, risk allocation and liability provisions that mesh seamlessly with the coverage provided by the CAR policy and other insurance policies
- Key provisions are:
  - obligation to insure
  - indemnity regime
  - insurance provisions including deductibles
  - provisions for extension of time for an occurrence of physical damage and
  - limitations and caps on liability

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OBLIGATIONS TO INSURE

- The EPC Contract will usually include obligations both the Owner and EPC Contractor to take out and maintain particular policies (including periods for maintaining cover, minimum limits of indemnity etc.)
- Parties need to consider the most cost-effective insurance programme for the whole project avoiding unnecessary overlapping coverage
- CAR can be taken out by the Owner or the EPC Contractor
- Consider who can purchase the best coverage at the lowest cost;
- An international EPC Contractor will be familiar with the insurance market and will often have insurance for its risks on multiple projects
- However, the Owner might equally be a multi-national with its own brokers and insurance programme

OBLIGATIONS TO INSURE (CTD.)

- EPC Contractors may agree the basic minimum CAR insurance cover and then seek to place the insurance at the lowest premium to increase their margin;
- The Owner may require transparency as to the cost of insurance;
- In a competitive bid situation, Owners may require bids to be priced exclusive of specific insurance costs;
- Who bears the additional CAR premiums if the project duration is in delay?
  - If the Owner insures, the Owner may want to consider if the delay liquidated damages allow for additional premiums
  - Equally, if the EPC Contractor insures, the EPC Contractor should check that the relevant overhead percentages for insurance, bonds etc. for pricing Changes allow for this?

INDEMNITY PROVISIONS

- The indemnity regime in an EPC contract is a way of allocating specific risks between the parties and the indemnity provisions should properly allocate those risks
- Take care:
  - not to create overlapping indemnities for the same risk between the indemnifying party under the contract and the insurer
  - to ensure that the policy of insurance taken out in the joint names of the parties has a waiver of subrogation clause, to avoid the insurer subrogating to the non-indemnifying party's right and seeking to recover from the indemnifying party
  - to check coverage – no all-risks policy insures all risks

SETTING THE DEDUCTIBLES AT THE CORRECT LEVEL

- Major projects usually have high deductibles:
  - can be more cost effective in terms of the CAR policy premium for the parties to carry these lower level risks of physical damage to the works
  - <u>but</u> if the deductible is set too high and passed to the EPC contractor it will have to insure this risk, which will defeats the object of reducing the overall cost of insurance
- Can lead to negotiation as to who bears responsibility for the risks of damage within the uninsured layer or deductible
- Recognise the distinction between the deductible under the CAR policy and the allocation of liability for the deductible under the contract

SETTING DEDUCTIBLES (CONT.)

- It is more common to allocate liability for deductibles on a fault basis
- This is reflected for example in the standard NEC clause 85.4:

  "Any amount not recovered from an insurer is borne by the Employer for events which are at his risk and by the Contractor for events which are at his risk."

- The EPC contractor may also:
  - require express acknowledgement in the contract that the EPC Contractor and its subcontractors are named as other insureds under the CAR policy and that insurers have waived rights of subrogation
  - want to be sure of the coverage provided by the CAR policy during the defects liability or guarantee period
  - need to be clear that he is covered for post-takeover on-site defect rectification - most CAR policies provide more limited liability coverage for damage to the permanent works while the Contractor is undertaking defects rectification works during this period

EXTENSIONS OF TIME AND ASSOCIATED COST FOR OCCURRENCES

- Another potentially problematic area that it is worth paying particular attention to in drafting and negotiating the EPC contract.
- If the Employer is the insuring party - the CAR may pay out to the Employer and the Contractor may be entitled to a Change
- EPC Contractors may seek to include in the EPC contract an express entitlement to an extension of time (but not necessarily cost) in relation to an occurrence
- Because CAR is a ‘no fault’ policy the neutral position adopted in many EPC contracts is:
  - the EPC contractor is paid for the cost of repairing the physical damage caused by the occurrence (but not the defect that may have caused the occurrence);
  - the EPC contractor receives an extension of time (and therefore relief from liability for LDs) but not its delay costs

LIMITATIONS ON LIABILITY

- **Contract caps** – caps on liability should take into account the insurance arrangements and limits of indemnity under the insurance policies
- *Trustees of Ampleforth Abbey Trust v. Turner & Townsend Management Limited* [2012] EWHC 2137 (TCC) - an aggregate cap on liability was held to be unenforceable because it was in conflict with a further clause requiring the insuring party to hold professional liability insurance at a much higher level
- **Aggregate caps** - should make it clear whether or not the proceeds of particular insurance policies counts towards the cap

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FINAL TIPS

- Know what coverage you are taking out and tailor the insurance and contractual indemnity regimes in the most efficient manner at the most advantageous overall cost
- Make sure your insurance programme is aligned with your contractual arrangements
- Discuss with your broker how to negotiate your policy
- Be aware of local issues – e.g. decennial liability risks under the Civil Code and try to mitigate these risks
- Avoid over insurance
- Consider establishing claims protocols on major projects
- Carry out regular checks to ensure that the required levels of insurance are being maintained
- Seek advice – prevention is always better than cure