
Professional indemnity insurance in construction

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Important notice: This document has been prepared by way of guidance. Anyone who proposes to use it should consider the details based on their business's obligations and if necessary, take independent advice either from their own trade or professional body or insurance or legal advisers.

INTRODUCTION

Businesses which hold professional indemnity insurance (PII) will be aware that availability of cover is becoming increasingly expensive, with insurers placing limits on the amount and type of cover available.

Over the last 18 months or so, businesses have seen the cost of PII increasing hugely while, at the same time, often seeing the scope of cover reduce.

STATE OF PLAY IN CONSTRUCTION INSURANCE

The last 'hard' insurance market occurred in 2001 following the September 11 terrorist attacks which was coupled with the insolvency of one of the UK's leading independent insurers.

Since 2003, the construction insurance market has been 'softening', which had led to broad coverage and premium reductions driven by a surplus of competing insurers.

A 'soft' market is one where there is plenty of capacity, i.e., available finance, because investors see a profitable outcome.

Due to more entrants to the market increasing competition, premium rates reduce, excesses become more competitive and relatively low and wide cover on an 'each and every loss' basis is widely available. A soft market is really a buyer's market due to a surplus of supply.

The past few years has witnessed a sharp change in attitude due to the very heavy losses recently experienced (see *'The perfect storm on pages 4 & 5*).

Premium rates have increased, cover has been restricted, either to an 'in the aggregate' basis with restrictions being reinstated, or increased levels of excess. Additionally, several insurers have left the market altogether putting further strain on capacity.

One of the biggest factors influencing the availability of PII is that the primary limits of cover are being reduced and businesses will almost always need an 'excess layer' or 'top-up' in order to obtain the total level of cover they require to operate.

This means that while premiums remain somewhat the same, it is usually for a much lower limit of cover. Businesses then face the additional cost of the 'excess layer' on top of renewal of their existing PII policy.

THE PERFECT STORM

The following factors have caused a sudden and rapid hardening of the construction insurance market – and indirectly the PI market within construction insurance.

Lloyds of London

Lloyds suffered significant losses in 2017 and 2018 and a strategic review of how it was performing highlighted the fact that certain classes of insurance were very unprofitable.

The PII market was identified as one, with most syndicates paying out more in claims than they had collected in premiums by chasing market share rather than profitability.

As a result, syndicates were told

to take remedial action to tidy up their books and measurement of profitability.

This has led to several syndicates pulling out of the PII market altogether and the remaining syndicates looking for substantial increases in premium to try and write the risks at the 'technical price', i.e. the price they need to make sure that the risks actually make them money in the long term.

Technology and the evolution of construction and engineering

A downside to Building Information Modelling (BIM) and technological advances in the built-environment is that the complexity and value of the design and construction process is exponentially accelerating, which has had a direct consequence of increasing the value and size of projects to be insured.

This has led to an increase on the

potential size and complexity of claims on construction insurance products, and when something goes wrong, it has more significant repercussions for the insurance sector which is already struggling to catch-up with several 'nuclear' judiciary decisions around the world, in terms of the size of claims being awarded.

Economic overeating

Before the pandemic, the economy had been slow but steadily growing, with only moments of short-term stagnation since the recession of 2007.

Within an industry where the vast majority of businesses are SMEs, there is often a tendency to 'over-eat' and enter into contracts with a lower level

of contractual due diligence than is employed in a tougher market. Over the recent economic period, insurers are nervous that this has led to some businesses taking on higher levels of risk that will give rise to potential legacy claims for which insurers are not prepared to foot the bill.

Grenfell – fire safety

With 'design and construct' there had already been a market reaction following Grenfell in 2017, with not only the cladding industry facing increasing premiums and restricted cover but also those involved in high-rise buildings and/or fire risk.

After Grenfell, insurers have been concerned about the use of ACM panels on tall buildings, but this has been expanded to cover all combustible materials on a wider range of buildings. Furthermore, the endorsements placed in PII policies have widened in recent years. Now they do not just relate to cladding and fire claims specific to what was encountered on Grenfell, but to anything which can be related either "directly or indirectly to fire safety".

This wide definition of fire safety appears to incorporate more than just fire engineering claims and will impact numerous parties including architects, engineers, specialist contractors and large contractors, as most work undertaken on a construction project can be seen to indirectly relate to fire safety.

Widespread adoption of fire safety restrictions will result in heavily restricted PII cover in such a crucial area (not exactly in the post-Grenfell

spirit) and will potentially create difference in cover available to those working on such projects. The level of cover available has moved to aggregate cover and many businesses are finding they cannot obtain cover or have exclusions in their policies for any fire and cladding claims.

As such, the widespread adoption of fire safety restrictions has resulted in heavily restricted PII cover. It has become standard in all PII renewals to demonstrate that an audit was performed on projects to understand the level of combustible material (wider than just ACM panels) used where a business is designing, specifying, installing, inspecting or supervising the inclusion of combustible materials.

Added to the Grenfell issues is the collapse of a major bridge in Genoa and faults with several waste to energy projects. It is clear that the volume of claims is on the rise, creating a reduction in available cover by those insurers still involved in the construction market.

It is therefore anticipated that the hard market will continue for the foreseeable future.

Natural disasters globally

In addition to the factors listed above, a number of natural disasters have hit the global insurance market including fires, floods, hurricanes etc.

WHEN ARE YOU EXTENDING YOUR LIABILITY?

If a business gives advice or provides a professional service to clients, it often insures against the risk that the advice is wrong by maintaining PII.

Designing can be defined as “the realisation of an idea, or the resolution of requirements, through means of communication such as drawings, plans, specifications and models to enable items to be created or issues resolved”.

Put simply, if a business is asked to make choices about which products, specification of products, size of

product or otherwise to use or integrate, because the client is relying on their professional judgment, knowledge and experience, they are designing – whether they realise it or not.

Carrying out design – consciously or inadvertently – is delivering advice and/or a professional service. As a result, additional legal risk arises and the requirement to commonly insure against the risk of being sued, by obtaining a suitable PII policy, is usual business practice.

DO I HAVE CONTRACTUAL LIABILITY?

The next question businesses should ask is: Does my contract state I have design responsibility? Or is it silent? In which case the description of the scope of works will determine the answer to whether a business is designing. If the description of the

scope of works leaves any issue(s) to be decided by the business, then by making those decisions on behalf of a client, a business may very well be designing – even where the document does not mention ‘design’ as an actual word.

WHAT LIABILITY SHOULD I OWE?

Where the business is only designing the works, its legal duty will be to carry out that design service with “reasonable skill and care” – this is normal, industry acceptable and insurable.

Where the business is supplying, installing and designing, the law regards the person carrying out this work as “delivering a finished product” and imports a general duty that the finished works will be “fit for their intended purpose” – in the vast majority of cases this risk is uninsurable

in the UK and leads to a very high level of responsibility where fault is based on damage arising, not whether fault actually occurs.

It is therefore usual to agree a specific clause in the contract stating “goods supplied will be of satisfactory quality and the works will be carried out using reasonable skill and care” to override the presumption under general law and ensure the risk is in line with industry practice, i.e. good/professional engineering practice, and therefore an insurable risk.

WHAT IS THE NATURE OF MY COVER?

The result of the hardening of the construction insurance market is that some insurers are trying to impose aggregate (the total of claims allowed during any period of insurance) limits rather than any one claim, include defence costs within the limit (previously 'costs in addition' was readily available) and apply the excess to defence costs, rather than just the compensation part of the claim.

Businesses should therefore check the nature of cover being quoted, to ensure they have sufficient cover to carry out any projects. In one recent example, a business found that although their PII cover continued to be offered at reduced rates, the scope of cover was limited to testing and commissioning, and not the actual carrying out of the design and construction of works.

WHAT LIMIT SHOULD I CARRY?

Ultimately, the client procuring the contractor will set out in the tender and contractual documents the limit/level of each insurance package that is required, and the scope should be matched to the liability taken on within the contractual terms. But clients must also take a reasoned and responsible attitude to the risks and applying an artificial limit in the current climate helps neither the businesses holding the insurance risk or the client.

Where contractual risks/liabilities exceed insurance cover, the contractor is self-insuring against those parts of the risks that remain uninsured.

Often PII is asked for at limits of anywhere between £1m and £25m. Inevitably these values should, but often don't, reflect the actual risk as project documents are routinely rolled-out as part of an administration process without due consideration to the actual risk in hand.

It may also therefore be worth seeking clarification, from the client, that the value specified is actually what is realistically needed. If questionable or only required for a one-off project, seek clarification if the client is willing to procure the PI or bear the cost of the increased value limit.

OBLIGATIONS UNDER ANCILLARY DOCUMENTS

In many contract documents and ancillary documents, such as collateral warranties or bonds, businesses are also agreeing to an ongoing obligation to maintain PII for a given period, often either six or 12 years from the date of completion of the project as a whole.

Hopefully, this obligation is conditional, such that if PII is unobtainable you put in place

‘suitable arrangements’ at your client’s ‘reasonable cost’, where available at ‘commercially reasonable rates’.

Recently introduced limitations on PII cover may therefore be an issue to businesses who have pre-existing commitments for certain levels of cover under ancillary documents and businesses should check and review these.

WHAT CAN BE DONE? RISK MANAGEMENT

Maintaining control of the risks encountered on projects is becoming more essential if a business is to present a sustainable commercial and operating risk model ensuring the cost of insurance does not become prohibitive.

The basic principles of risk management do not vary and remain as follows:

- **Identify** risks involved in the process
- **Evaluate** the impact on the business of each risk

- **Take steps** to control the risk either physically by putting in place appropriate measures, or financially, either by transferring to insurers or taking other financial measures, such as a larger degree of self-insurance, and

- **To mitigate** future increases in premium or reduction of cover, you should advise your insurance broker or insurance company as soon as you can if you become aware of a possible claim against your policy.

NEGOTIATING WITH INSURERS

Perhaps one solution, where a corporate group has interests offshore, is to procure PII from outside of the UK, given that the hardening of the market does seem to be particularly exacerbated in the UK.

Also remember that in some instances, insurers rank brokers according to volume and sophistication and placed premiums, not only based on the risk of the insured. A value is put on the brokerage which can access rates and covers that others can't, based on the volumes of business that they transact. It may therefore be worth considering the reputation and buying ability of your broker.

The key aspect for a business is to ensure that the expertise of the broker is relevant to the contractors' specialist sector(s). This will be a good indication of their ability to access the relevant insurers and for the broker to offer suitable advice to the contractor.

The difficulties in the current market can be alleviated to some degree, at renewal for instance, or when approaching an insurer for proposed and renewed cover through proper preparation.

Given that the primary duty is on the business to fairly present the risk to the insurer (including every material circumstance the business knows or ought to have known of and sufficient information to put a prudent insurer on enquiry), up to two months before renewal date is not too early to start preparing the presentation. Make sure all information is up to date, particularly on the status and value of outstanding claims.

Full disclosure remains vital, despite the increased onus on underwriters following a fair presentation of the risk by the contractor, to ask the relevant questions, since the passing of the Insurance Act 2015.

Demonstrating that you have a solid risk management culture, robust financial resources and controls, as well as providing insurers with proof and documentation of risk mitigation, internal practices, cashflow and profit margins, will all help lower premiums. Ask your insurers what criteria they employ for risk assessing your premium, so that you can clearly demonstrate you meet their requirements.

The number and type of claims disclosed should be analysed. Scrutiny of the record over the previous three or five years may reveal a pattern of problems which could be overcome by adopting risk management techniques.

If poor management is indicated, this presents a trickier problem, but it can still be improved by employing risk management disciplines.

EVALUATION

Each risk identified will provide an idea of the likely impact on a business. Clearly, low risk areas could be dealt with by accepting a higher excess level, particularly for larger businesses able to absorb such costs. For medium to high-risk areas, any measures taken need to be cost-effective and improve overall business performance.

Control measures – due diligence

The following are the obvious areas for consideration, as integrating these disciplines within a business's management culture, systems and processes will see a return on investment:

- **Profile clients**

Enquiries should centre on previous relationships. Have there been any litigation problems? What is their financial position? What attitude has been adopted during the progress of previous projects? Are they a well-managed, quality orientated, client?

- **Benchmark yourself against sector performance**

Market conditions may dictate the need for work and keeping the workforce together. One of the factors in many claims is underbidding to secure a contract. If a business underbids it will create a strain on costs and timescales, where errors are more likely to creep in, but if your performance is in line with the market, you know you are simply working in line with the economic climate.

- **Quality control**

This is best achieved when all team members are kept informed at all stages. Each person's role must be thoroughly understood. Briefing meetings are vital and details recorded. Looking at the designs and calculations through fresh eyes can be useful, use an experienced person not connected with the actual project to review the overall picture. They may pick up some points, often overlooked by those who have prepared the design. Finally, liaison with outside specialists and sub-contractors will be valuable on some difficult technical areas.

- **Legal due diligence is a necessity not a luxury**

Never claim a standard of service which you cannot achieve in practice. Larger businesses may attract business using tender/sales promises which may make claims that are not carried out during the contract. They may then be construed as part of the contract terms. The higher the standard claimed, the more strictly the duty of care will be applied.

Do not accept any terms which may imply a wider duty than you have contracted for. Set out clearly the extent of the services you are providing under a duty of 'reasonable skill and care'.

Indemnities extend both a) the scope of your liability to any and all loss no matter how farfetched, exorbitant or tenuous, and b) the duration of your liability to six or 12 years from the date of the damage arising. This may be long after the date of the works, which is the usual date for your liability to run from. These should be resisted where possible as being 'unnecessary' given you are still liable for ordinary breach of contract without an indemnity or insurance if such is available.

Acting as your own solicitor (even if skilled as a qualified quantity surveyor) is dangerous as the specialised detailed knowledge of contract drafting is lacking, and the client will almost certainly be using a qualified legal team.

- **Management and audit trail**

Be careful to avoid cost overruns. Comprehensive record keeping is important. Discuss your brief at an early stage with the client. Where fees are substantial, the client will expect a good quality and diligent service. Problems will be highlighted if there are delays in completion or budgets exceeded.

Record keeping at all stages is therefore vital. Traditionally, this would be paper contracts, correspondence, briefs, minutes of site meetings and discussions over problem areas. In a BIM environment, electronic information is fine if it is backed up, accessible and protected.

Ensure that any decisions made by the client are fully informed decisions. The client needs to be informed at all stages. The well-informed client is less likely to claim at a later stage. Information necessary to the client will include choice of materials, quality and status of the contractor and their sub-contractors, changes to the original specification, and any cost variations. A full explanation of the latter will assist. In brief, the client should be making the decisions based on your detailed advice.

For this purpose, use the technology to maintain auditable records and facilitate decision-making, quality control, regulate safety and present a well-managed project and data backed safe risk to insurers.



Members



Further information



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