Insurance in Construction contracts: A few things to know

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February 2014

There are many risks in any construction project. The majority of these risks are usually assumed (and priced) by the contractor during the construction phase, who typically covers this exposure by taking out various insurance policies.

Insurance in construction contracts can be complicated and the purpose of this article is to provide an overview of some key issues to be aware of in this intricate area.

Types of Insurance

The most common forms of insurance under a construction contract in the Middle East, include:

- All risks insurance – This insures against physical damage to the works (and usually materials on site). All risks insurance typically covers the full reinstatement value of the works plus a mark up for any ancillary costs (such as consultancy and professional fees) that are incurred.

As contractors generally have "global" all risks insurance policies that cover all its projects, it is generally more cost effective for contractors to maintain this insurance. Once taken over, the risk in the works passes to the employer, who needs to ensure that the works are adequately insured.

Although defects are usually excluded from all risks insurance policies, wording can be purchased that provides cover for damage that a defect causes to other parts of the works. For this insurance to be meaningful, the different components of the works must be carefully and clearly delineated. This insurance is only generally available if the works are being undertaken in accordance with well established (rather than evolving) construction techniques.

- Professional indemnity insurance – This insures contractors with design responsibility (i.e. under design and build contracts) against liability arising out of professional negligence and will respond if, for example, designs do not comply with the requirements of the underlying construction contract (although it is not uncommon for professional indemnity insurance to exclude cover for "fitness for purpose" warranties).

Professional indemnity insurance is made on "a claims made basis" (rather than when the breach of professional duty actually occurs). This means that professional indemnity insurance is generally required to remain in place until any limitation period ends (which, in the UAE, is 10 years). The amount of professional indemnity insurance cover the contractor is required to have in place is generally determined on a case by case basis, depending on the extent and the complexity of the design works in question.

Professional indemnity insurance is also the most important insurance policy that design consultants (such as architects and engineers) are required to have in place.

- Public liability insurance – This provides cover for liability arising out of death or personal injury to third parties (but not the contractor's employees, who should be covered by worker's compensation insurance) or damage to property belonging to third parties (but not the works,

which is covered by the all risks insurance) prior to the works being taken over.
- Workers' compensation insurance – This insures the contractor against liability for the death or personal injury to its employees (usually on site) when performing the works.

If an employee of a contractor causes the death of a third party, the Sharia law applied in many Middle Eastern countries allow diyah or "blood money" to be claimed by the victim's heirs from the individual who caused the fatality. The level of compensation in the UAE, for example, is currently set at AED 200,000 per make. Contractors sometimes purchase additional insurance against this liability.

- Decennial liability insurance – Under Articles 880 to 883 of the UAE Civil Code the contractor (and supervising architect) are jointly liable to the employer for a period of 10 years (from the date the works are taken over) for any defect that threatens the safety or stability of the building or if the building suffers a total or partial collapse. Decennial liability cannot be contractually excluded and contractors often take out insurance against this liability. Similar decennial liability regimes apply in most other Middle Eastern jurisdictions.
- Delay in start-up insurance (DSU) – Unless the contractor is entitled to relief under the contract, contractors are customarily required to pay liquidated damages to the employer if the works are not taken over by the date for completion or, depending on the nature of the works, fail to satisfy specified output criteria.

However, liquidated damages are customarily capped at 10% of the contract price. Caps of this nature may mean that the employer is not fully compensated for any loss suffered and even though caps on delay damages can sometimes be set aside (and damages reassessed so that they correspond with the actual loss suffered), this can be a slow, uncertain and expensive process.

For this reason, employers sometimes (especially if the works are project financed) take out DSU insurance which provides compensation for losses (including loss of revenue and other consequential losses) arising out of late completion as well as other forms of delay (such as force majeure).

Key provisions

Apart from the basic requirement to take out and maintain insurance policies, other important ancillary issues regarding insurance include:

- Joint names – Certain insurance policies (especially public liability insurance) are generally taken out in the joint names of the employer and the contractor (as well as a funder) so that, for instance, the employer is insured against any liability (vicariously) incurred by reason of a breach by the contractor. As a matter of good order, co-insured parties should obtain copies of the policy that they are insured under so they know exactly what they are covered for.

Generally speaking, a party named under an insurance policy can make claims under that policy and it is also common for insurers to be required to waive their rights of subrogation against co-insured parties. This means that the insurer agrees not to seek to recover against a co-insured party (i.e. the employer) even if the insurer paid out on account of the actions of the employer.

It is important that, if two or more parties are insured under the same policy, the policy provides that no act or omission of a co-insured party (i.e. misrepresentation, non disclosure or failure to notify) will vitiate the policy or otherwise prejudice the cover of the other co-insured (and non-breaching) parties under the policy.

- Cross liability – It is usual for contracts that are in joint names to contain a cross liability clause. A cross liability clause essentially means that each party is insured in its own right as if a separate policy had been issued and, as such, the policy will respond to liability incurred by one co-insured

party to another co-insured party.
- Interest noted on a policy – It is important to distinguish between insurance being taken out in joint names and a party's interest being simply noted on a policy. Although a party whose name is noted on a policy has the right to share in insurance proceeds, party does not have any direct right to claim under the policy. Furthermore the insurer generally will not waive its rights of subrogation against a party whose interest is noted on the policy.

Per occurrence or in the aggregate – It is important to check if insurance cover is provided on a per occurrence or on an aggregate basis. For the employer, cover on a per occurrence basis is obviously advantageous as, if insurance is provided on an aggregate basis, a previous claim could severely impact on (and even completely exhaust) the amount of available insurance. This point is made all the more relevant if the insurance is not project specific, as a claim from one project could mean that no cover is available for any other projects.

- Deductibles – Employers should carefully assess the level of the deductible under an insurance policy to ensure that the deductible is reasonable and not prohibitively high. Excessive deductibles could lead to a risk being effectively uninsured.
- Exclusions – Insurance policies are normally subject to exclusions that may restrict the amount of available cover (i.e. some insurance policies exclude cover for guarantees and liability for delay damages while "fitness for purpose" warranties are also a relatively common exclusion). It is therefore important for employers and contractors to review the extent of cover to assess the suitability of a policy in light of the risks that are likely to occur under the contract.
- Lender's interests – As part of their security package, a lender may require an assignment of the borrower's rights under insurance policies and may also wish to be named as the loss payee of the insurance proceeds.

Additionally, lenders may prefer to use insurance proceeds to pay off the loan instead of reinstating the project if the project is destroyed or badly damaged. If lenders require this ability, care needs to be taken to ensure that this right is accommodated by the underlying insurance policy.

- Identity of insurers – Employers usually impose minimum requirements regarding the creditworthiness of insurers to reduce the risk of insurers defaulting on their payment obligations.
- Caps on liability – It is a common misconception in the construction industry that a contractor's liability for a particular risk (especially for breach of professional duty or negligence) is implicitly capped at the amount of insurance that the contractor is required to have for that risk.

This is not the case. If, for example, the contractor is required to have professional indemnity insurance of USD 5 million per claim, the contractor's liability, for say a defective design, is not automatically capped at USD 5 million per claim and the employer may seek to recover from the contractor's assets (or any additional insurance policy that the contractor has in place) for any loss incurred that exceeds USD 5 million.

Express wording is required for a contractor's liability to be limited and, even then, local laws (such as the UAE Civil Code (i.e. Article 390(2)) can be invoked upon to reassess and adjust pre-agreed caps on liability so that the injured party can only recover damages to compensate it for the actual loss sustained arising out of the breach.

Final note

The drafting of insurance clauses usually requires a contractors to "warrant" (or, in other words, guarantee) that it has satisfied all the requirements imposed by the construction contract. As such, these requirements cannot be taken lightly and may result in an inadvertent (and serious) breach of contract if they are not adhered to. It is therefore important that, prior to executing a contract, each party:

- ensures that it understands the extent of its insurance obligations;
- makes sure that the insurance requirements are reviewed by its legal advisor to ensure that they are consistent with the underlying obligations under the contract and confirm with market norms;
- confirms with its insurance advisor that the insurance requirements under the contract can be accommodated by the relevant insurance policies (and also determines any cost implications); and
- checks that any necessary amendments are made to the relevant insurance policies to ensure that the contractually agreed insurance requirements are adequately reflected.