RISK & INSURANCE IN CONSTRUCTION

1. Introduction - The need for Construction Insurance

1.1 The construction contract has four significant characteristics that separate it from any other contract. Firstly, in all construction contracts there will be an express or implied undertaking that, except in certain specified circumstances, the contractor will complete the works and the project as a whole.

1.2 Secondly, owing to the grand scale of many major building and civil engineering projects, there are vast sums involved. Sums that require the involvement of financial institutions, banks and governments to raise the capital for the execution of the project. Logic therefore states that there have to be guarantees in place regarding the safety of the finance expended in the construction of the project(s).

1.3 Thirdly, a construction project is a unique artefact that is not comparable to a manufactured product. Every building and every civil engineering project is a unique creation that has its own individual characteristics. There are many parties involved in the construction project, from planners, to designers, to contractors to the final user. It necessarily involved the use of different materials, with different manufacturers of those different materials. The period of construction can be long, extending over many seasons in some cases, and as such, many seasonal changes can occur. Furthermore, and perhaps most significantly, a prospective purchaser can view and examine a
manufactured product before deciding whether to buy it. If the product does not live up to expectations, if it is not as promised, or indeed if it is defective, it can be sent back and the purchaser reimbursed. You cannot do that with a construction project – built into the ground and immovable.

1.4 Finally, there are so many hazards and risks involved in a construction project, for all of these reasons. The risks and hazards happen the moment a decision is taken to initiate a project and continue to grow in number and intensity the further along a project develops. Therefore, it is essential to be prepared for such occurrences and to forestall their undesirable effects through good management and foresight.

1.5 The construction contract therefore is unique in that it seeks to provide for a specific remedy in the event of any breach of the terms and conditions within its framework and/or for a contractual entitlement in respect of specified events or perceived risks should they eventuate. Comparatively viewed against other types of contract, the wording of a construction contract is therefore more extensive, as it has to provide for and deal with detailed conditions in respect of the risks that might eventuate during the construction period and beyond.

2. The Risks in Construction

2.1 Once a party initiates the process of procurement of a project, it forms a spectrum of risk matrices connected with that project. These risks obviously belong to that party until it seeks to re-define, re-allocate or re-allocate them to others. Thus, the genesis and development of the various standard forms of construction contract, were and remain to be based on that party’s need to define and apportion the risks that are attached to it through the operation of the applicable law or the Contract Conditions. This process is in accord with the legal concept that the purpose of a contract is to identify and apportion the rights and obligations of the parties; since these rights and obligations stem from the allocation of the risks to which the execution of the contract is exposed, a principle which is particularly true in construction contracts.

2.2 If and when such risks eventuate, the parties to the contract would have certain
remedies against each other or against insurers with whom they had contracted. However, it must be borne in mind, whether the remedy sought is in respect of a breach of a term of the contract or as a result of an occurrence of a specified event, most construction contracts place an obligation on the party who wishes to avail of that remedy to follow a set procedure, generally referred to as “the claims procedure”, which is then expected to be strictly managed and adhered to.

3. **The Assessment of those Risks**

3.1 Once the risks to which the project is exposed are identified, a decision has to be made by the employer on whether or not they are acceptable and if not, whether they can be eliminated or their effect can be mitigated. The risks may be classified in many ways, but the most appropriate is a chronological classification, which divides the risks into pre-construction; construction; and post-construction phases. Each of these phases can be further sub-divided into sections and sub-sections on the same basis of chronology of the procurement process.

3.2 Thus, the risks can be identified for the whole of the procurement process through which the project must pass from the feasibility stage to the design (along with its own various stages) to tendering and then to execution and completion followed by the post-construction stage.

4. **The Management and Allocation of Risks**

4.1 The next stage is for the employer to decide on whether these risks should be retained by him or spread to other parties, such as the contractor or insurers. The process by which risk allocation is carried through is part of the process of Risk Management.

4.2 In construction contracts, most of the risks are allocated using the concept of **control** of the risk and/or its consequences, but essentially there are three other criteria by which allocation should be accomplished, as will be discussed within Section 5 below. Risk management also includes the mitigation of those risks, which derive from any unavoidable hazards by specifying warning and safety devices and risk control
procedures that have to be planned and implemented, such as contingency and emergency action plans.

4.3 At this point, it is important to emphasise that the risks to which a construction contract is exposed are spread throughout the whole of its general conditions and provisions. Whatever the rules or the reasons for allocation of risks, the responsibility and liability attaching to those risks, if and when a risk eventuates, follow and flow from that allocation. Accordingly, the simplicity and clarity of the wording where such allocation is made could be of paramount importance.

4.4 Furthermore, there should be harmony between what is written in one part of the contract conditions, including any concept adopted therein, and any other part. This harmony means that the contractual arrangements, the legal rules of the governing law of the contract between the parties, and the technical documentation, including the specifications and drawings, must be clearly and, as far as possible, explicitly stated so that they can be fully understood. This is indeed one of the risks attached to the employer that generally cannot be shifted to another party, as it remains with him throughout the various stages of the contract. However, there may be exceptions to that general rule, where for example, liability for errors in a document like the “Employer’s Requirements” is shifted from the employer to the contractor.

4.5 Once liabilities are allocated and assigned through the contract, the parties involved have a number of options to adopt in order to safeguard the project but also themselves; and furthermore, have various options to finance the consequences of risks should they eventuate. These options are as follows:

(a) To retain the responsibility for financing the costs of any loss or damage or injury that may result from an eventuating risk by providing any one or a combination of the following arrangements:
(i) a portion of their cash flow;
(ii) reserves created specifically for the purpose;
(iii) funds specially assigned; and
(iv) creating captive societies.¹

(b) To transfer the responsibility for financing the costs of such loss or damage or injury or non-performance to:
   (i) another party to the contract by agreement, thus creating a sharing of risks;
   (ii) an insurer through an insurance contract which would in turn becomes transferred to reinsurers through reinsurance arrangements. An insurer may impose his own risk management conditions, thus creating another cycle of transfer.

4.6 This second cycle of transfer which is enforced through either an incentive in premium reductions or conditions attached to the insurance policies may result in:
   • the insured having to take measures to eliminate or mitigate a certain risk;
   • the insured having to retain part of the responsibility by the imposition of a deductible or excess at the lower end of the scale, or a limitation of the part insured at the upper end of the scale;
   • the insured having to retain certain risks through exclusion clauses in the insurance policy; or
   • the insured having to seek another insurance cover from a different insurer.

4.7 Of course, in general terms, liabilities arising from the duties and obligations of the parties to a contract should be covered by indemnities given by one party to the other, or provided in one form or another, including the provision of insurance policies. Thus, the logical sequence that emerges in any construction contract is the flow of Risk to Responsibility to Liability to Indemnity to Insurance. If such logical sequence is not complied with in the contract conditions, the rationale of insurance would be lost and the user could become confused as to the purpose of what has been arranged in the contract.

5. **The criteria of allocation of Risk**

5.1 The allocation of risks to the various parties in a contract has a significant impact on the

¹ A captive society may be created by a group of professionals of the same discipline or by a group of members
type of contract form that one might appropriately use. In this connection, it is worth mentioning that if the Risks are not clearly allocated in the contract or the remedy is held to be shared, then it is the arbitrator, if an arbitration clause exists or if no arbitration clause or agreement is in existence, then the court would take on that task of allocation and in doing so, they would use one of four established criteria for such an allocation, as discussed below.

5.2 The hypothesis of risk allocation in construction has been the topic of debate for many years. It is common ground that the principles of risk allocation are intended to set out the ground rules for a fair and equitable allocation of the risks surrounding construction projects. An examination of leading construction decisions will ultimately lead us to the conclusion that there are four criteria that will determine the allocation of risk in a dispute, be it construction or otherwise:

- Which Party can best control the risk and/or its associated consequences? (*McCook v. Lobo & Others*[^2] and *Yarm Road Ltd & Anor v Hewden Tower Cranes Ltd*[^3])
- Which Party can best foresee the risk? (*Eckersley & Others v. Binnie & Others*[^4] and *Sandhu Menswear Company Ltd v Woolworths plc*[^5])
- Which Party can best bear that risk? (*Eckersley & Others v. Binnie & Others*[^6]) and
- Which Party ultimately most benefits or suffers when the risk eventuates? (*Davis v. Fareham UCD*)[^7]

[Please refer to the diagrams at the end of the paper]

6. **Construction Insurance**

6.1 Any insurance contract, regardless of whether it be in respect of construction activity or any other type of insurance policy, is a contract of indemnity and bears the same characteristics, namely:

[^2]: McCook v. Lobo & Others [2003] 1 ICR 89
• **The duty of utmost good faith**
  
  A contract of insurance is in effect a contract for the purchase of goods. However, unlike an ordinary contract for the purchase of goods, where there is no obligation to give any information to the seller, as a purchaser of insurance, there is an absolute obligation to furnish the insurance company (the seller) with all and any information that it requests, in addition to any other information that relate to the risks in respect of which insurance cover is being sought. This concept is best described as follows:

  “the proposer is expected to divulge to the seller all available knowledge regarding the perils and the risks involved. The insurer relies on the information provided to him to assess the level of risks involved and to determine the premium and the conditions which may have to be attached to the insurance policy.”

• **No financial profit on claims made**
  
  As a contract of indemnity, an insurance policy is intended to place the insured, after a loss event covered by it, in the same financial position as that which existed immediately prior to the event. Therefore, as a general rule, profit is not allowed as a result of an insured event.

• **Insurance interest**
  
  There must be an established interest between the insured and the item that is to be insured.

• **Subrogation**
  
  Where a claim is covered by an insurance policy and where the insurer has paid out for the loss arising from the claim, the insurer has the right to subrogate, i.e. step into the shoes of the insured (hypothetically speaking) and avail itself of all the rights and remedies permitted by that position, against any blameworthy party.

• **Contribution**
  
  Where a risk eventuates and results in a loss that is covered by more than one

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insurance policy, the insured cannot recover from more than one insurance policy. In that event, an insurer, having paid out for a claim, can seek a contribution from other insurers liable for the same loss to contribute to the payment made.

6.2 Generally speaking, there are essentially two types of insurance policies required in a construction project. Firstly, there is property insurance for protection to the works as well as any material equipment and machinery connected to it. This type of policy is what is generally referred to as ‘Contractor’s All Risks’. Don’t be deceived by its title however, there are a number of excluded risks and a long list of conditions that must be met to ensure the validity of the policy. Generally speaking however, unless a risk is specifically excluded from the policy, it is considered to be included in the cover provided.9

6.3 Secondly, there is liability insurance, which is intended to provide protection to the insured party against specific legal liabilities to which he may become exposed as a result of activities culminating in bodily injury and/or damage to property. Generally, such liabilities arise as a result of negligence and a lack of care. These legal liabilities may be owed to employees (where Employer’s Liability Insurance would be necessary) or to third parties (in which case Third Party Liability Insurance would apply).

6.4 Construction insurance will more often than not involve the issue of a number of insurance policies for the benefit of each of the parties involved in the particular project under construction. Therefore, there is likely to be more than one insurance company involved. Where design professionals are involved, legal liabilities incurred in the course of the conduct of professional work would be covered under the terms of a Professional Indemnity Insurance policy.

6.5 It is important to bear in mind however, that whilst most legal liabilities may attach where there has been negligence and a lack of care, there are circumstances where liability may arise even where there has been no negligence. Strict liability implies

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therefore, that it is not sufficient that reasonable care has been taken for a party to absolve itself from liability. To deal with such a scenario, Non-Negligence Insurance cover would be necessary.

6.6 Another type of insurance policy, which is important to consider is Decennial Insurance. This type of insurance will cover the liability of those involved in construction for latent defects in the stability of the structure and for major defects in the weather shield for a period of ten years.

6.7 Below are some other examples of the types of insurances available:

• Insurance against damage to Machinery & Hired Plant used in construction of project
• Insurance against loss or damage to Materials and Plant whilst in storage or in transit
• Air freight cover for urgent repairs
• Insurance for Motor vehicles
• Group Personal Accident, Travel, Medical and Life Assurance
• Decennial insurance
• Credit risk insurance
• Insurance against unfair termination of the Contract
• Insurance against unfair call on any surety or bond with special attention to on-demand bond;
• Delay risk insurance
• Currency risks insurance
• Insurance against Manufacturers’ Risks of defective material, defective workmanship and defective design
• Insurance against confiscation of plant & Machinery
• Insurance against expropriation of overseas assets risk; &
• Insurance against Special Risks connected with:
  - the type of contract undertaken; or
  - the locality of the contract such as war risk or earthquake; or
  - inability to obtain construction materials following political events.
7. **Construction Insurance**

7.1 As noted within paragraph 1.4 above, the risks associated with construction are extensive and come into existence with the decision to initiate a project. They grow along with the development and progress of the construction work and only begin to diminish following completion of the works, but they never cease. Hazards can eventuate into occurrences and the unexpected can happen. *Murphy’s Law* will always creep into the issue of risk and insurance in construction:

- Noting is ever as easy as it looks;
- Everything takes longer than expected;
- Anything that can go wrong, will go wrong and at the worst possible moment.

7.2 Perhaps my own personal favourite – *‘If everything seems to be going well, you have no idea what is going on’*\(^{10}\). When the unexpected does happen, the most effective and the safest way of meeting this eventuality and forestalling its effects is through insurance. It is imperative however to remember that the insurance will only be of assistance if it is arranged properly, i.e., the cover required and the party responsible for obtaining and maintaining the policies of insurance is properly stipulated within the construction contract.

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