

PROPERTY DEVELOPERS - PROTECTING YOUR POSITION

It is now more important than ever in the current economic climate that project owners, developers and funders fully review all of their key material damage, liability and financial risks when undertaking development projects. They should also ensure that the most comprehensive and competitive insurance protection for their development projects in respect of their key risks is in place, not only at the start of works but continuing for the full duration of the project.

INSOLVENCY OF CONTRACTORS

We continue to see every day more and more headlines about contractors and sub-contractors of all sizes becoming insolvent. Unfortunately, as a result of insolvency an additional unwelcomed consequence is that the contractors' insurances cease to provide cover for development projects from the date of insolvency.

The first priority of the project owner, developer and funder following insolvency of the contractor is to get the project back on track as quickly as possible. The first step will be to arrange to secure the site and also to arrange the immediate replacement of insurances, where insurances were arranged by the contractor. This additional insurance headache for the project owner, developer and funder of replacing the contractor's insurances following insolvency could have been avoided if the project owner, developer or funder had from the start taken control of the key insurances instead of utilising and relying upon the contractor's annual insurances.

INSURANCE PROCUREMENT

The Willis approach to insurance procurement for development projects is that we recognise the importance of addressing the key material damage,

liability and financial risks associated with development projects and we can advise upon and arrange a range of insurances that provide protection not only during the development phase but also afterwards, including an Operational Insurance Programme.

We recommend addressing the key risks of the development phase by arranging an Owner Coordinated Insurance Programme (OCIP) largely controlled and procured by the project owner, developer or funder, as opposed to leaving such insurances to other parties, to ensure that comprehensive insurance protection continues to remain in force for the duration of the development project and to meet the contractual obligations contained within Development Agreements, Finance Agreements, Building Contracts and Lease Agreements.

Within this Willis newsletter we have provided an overview of a range of insurances that can be considered for development projects and beyond. By utilising a combination of these insurances the project owners, developers and funders can have peace of mind that even in the event of contractor insolvency they have a comprehensive and competitive insurance programme already in place and therefore insurance is one less issue to deal with.

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FREQUENTLY ASKED QUESTIONS - INSOLVENCY OF THE CONTRACTOR

What if the worst scenario happens and your original contractor becomes insolvent and is unable to complete the development project?

Option A) Project Owner, Developer or Funder has arranged insurances via the original contractor's Annual Insurances.

This is a major concern for the project owner, developer and funder because unfortunately the original Contractor's Annual Insurances (typically Contractors All Risks – Contract Works, Public Liability and Employers Liability plus perhaps, Non Negligence JCT Clause 6.5.1.) will no longer provide insurance cover from the date of insolvency for the development project (includes all aspects such as partially completed works, completed works not yet handed over, ongoing works and outstanding future works and any site materials).

The project owner, developer or funder needs to take immediate action and arrange new insurances from the date of insolvency. We expand more about this in the next question.

Option B) Project Owner, Developer or Funder had previously arranged an Owner Co-ordinated Insurance Programme (OCIP).

The project owner, developer and funder are in a strong insurance position because the insurances are already under their cost and control.

The OCIP Insurers will need the following information:

- Site security arrangements
- When a new contractor will be appointed to complete the project
- If there is expected to be major delay in the works restarting and a change to the original Practical Completion date
- In due course details of the new contractor, the date project works will recommence, if there any changes to the scope of works and revised construction period/Practical Completion date

The most important point about this question we would make is that under Option B the OCIP continues to provide uninterrupted insurance cover protection with the same insurers at the same terms and conditions. There are also no additional insurance premiums incurred, other than for changes to the original scope of works or insurance cover.

What are the insurance options following insolvency of the contractor, where the project owner, developer or funder had arranged insurances via the original Contractor's Annual Insurances?

The project owner, developer or funder will urgently from the date of insolvency need to arrange replacement insurances (Contract Work, Public Liability and possibly constructional plant and equipment, scaffolding and temporary buildings and Non Negligence JCT Clause 6.5.1.), pending the appointment of a new contractor and as such will have three options:

1. Arrange temporary insurance, especially Public Liability Insurance. Please note that an existing Annual Property Owners Liability (POL) policy does not automatically provide cover to the project owner or developer; or
2. Immediately appoint another contractor and insure by means of the new Contractor's Annual Insurances; or
3. Arrange an Owner Coordinated Insurance Programme (OCIP)

The new premiums for all of these options will be additional costs to the project owner or developer, notwithstanding that the insurances will have been paid and included as part of the original contractor's costs. These replacement insurance costs may also be more expensive than usual due to insurers being requested to provide insurance cover for a partially completed ongoing project and depend upon at what stage the project is at and how much of the works have previously been completed but not yet handed over or insured elsewhere.

What are the insurance implications following re-tendering or appointing a new Contractor, if new insurance arrangements are required?

The project owner, developer and funder should be aware that:

- The new contractor's insurances will not apply until a date agreed with the new contractor, usually upon date of appointment. There may also be a need for temporary insurance cover to plug the gap in the insurance cover from the date of insolvency to the appointment date of the new contractor.
- The new contractor's insurances will be on different terms, different cost and the security of the insurers will probably be different.

- The project owner or developer will have to pay again for the new contractor's insurances, despite having already paid the original contractor's.
- The new contractors may not accept contractual responsibility or insurance responsibility for any works previously undertaken and partially completed by the original contractor including any pre-existing defects. They may also be unwilling or unable to provide collateral warranties for such works.

What insurances would Willis recommend be considered to cover the development project, following the insolvency of the contractor?

Willis recommend that the same insurances be considered for a development project after a contractor's insolvency as those prior to the start of a project, with the new insurances controlled and coordinated by the project owner, developer or funder.

The development insurances to be considered include:

- a) Legal Indemnity
- b) Owner Coordinated Insurance Programme (OCIP)
- c) Latent Defects Insurance (LDD)
- d) Environmental Impairment Insurances (EIL)
- e) Owners Protective Professional Indemnity (OPPI)

A major difference to the insurances, after a contractor's insolvency, will be that the premium costs will probably be more expensive depending upon what stage the development project is at. There may also be restrictions in the insurance cover provided such as insurers may exclude pre-existing defects in existing partial completed works.

How can Willis provide help to the project owner, developer or funder following an insolvency of a contractor?

Willis will provide assistance by reviewing your existing insurance position for your development project, in conjunction with contractual responsibilities, and will provide advice to quickly identify and arrange competitive insurances from a panel of leading insurers.

OWNER COORDINATED INSURANCE PROGRAMMES (OCIP)

An OCIP, may also be referred to as a Project Insurance and can be arranged on the basis of either:

- An annual policy to provide automatic cover for all defined projects of a certain type and size; or
- An individual policy arranged for each specific project as it arises

THE COVER

The following insurance covers can be included within an Owner Coordinated Insurance Programme (OCIP):

1. **Contract Works** – provides All Risks of Loss or Damage to the Contract Works and site materials excluding constructional plant and equipment.
2. **Existing Property** – All Risks or Specified Perils Cover to the retained, existing structures or partially completed contract works for incorporation within the works.
3. **Increased Costs of Constructing Incomplete and Unbuilt Works following damage to the works** – provides such cover arising out of damage to the Works under # 1 above.
4. **Public Liability** – cover for Legal liability of the Employer or All Contractual Parties in respect of death of or bodily injury to third party persons or damage to third party property.

5. **Non Negligence (JCT 2005 Clause 6.5.1. or similar)** – provides cover as per the clause.
6. **Advance Loss of Revenue/Income/Delay in Start Up (Loss of Rent, Profit, Interest etc.)** – provides such cover arising out of damage to the Works under #1 above.

The OCIP will always include cover for Contract Works and the other covers above are optional.

THE BENEFITS OF AN OCIP

There are numerous advantages in adopting this method of procurement, with the main benefits including:

- The ability to avoid situations where following the insolvency of a contractor their insurance programme is terminated, thereby leaving the project owner, developer or funder exposed without cover in place.
- Competitive premium rates, since an OCIP is not based upon the various activities or claims experience of the Contractors and does not include Contractor's profit or insurance overheads.
- Control of direct insurance expenditure by the project owner, developer or funder paying the insurance premiums direct.

- Purchasing broad bespoke insurance protection for the project duration covering the many diverse interests, liabilities and risks of all those contractually involved.
- Arranging an insurance programme that meets the specific insurance requirements of investors, future owners, tenants, joint venture partners and financiers.
- An opportunity to purchase key financial protection e.g. Advance Loss of Revenue/Income/Delay in Start Up for the project owner's or developer's benefit. This cover can now only be purchased in direct conjunction with the contract works cover.
- Increased insurer security.
- The provision of a more structured and co-ordinated claims reporting and handling procedure.
- Smooth transfer to Operational Insurance Programme.

LATENT OR INHERENT DEFECTS INSURANCE (LDI OR IDI)

In the current economic climate there has been an increased demand for this type of insurance cover for commercial, residential and also mixed use development projects of all sizes. This has not only been in respect of existing incomplete development projects, following insolvency of a contractor, but also from project owners, developers and funders for new projects.

Reasons for this growth in demand has included:

- The policy meets the requirements of owners, Council of Mortgage Lenders, funders, future purchasers and prospective tenants.
- More insurance protection, security and comfort is provided by a Latent Defects Insurance policy, rather than the more intangible collateral warranties provided by the professionals.
- In the event of insolvency the collateral warranties provided are effectively worthless.
- Professionals offering lower levels of Professional Indemnity Insurance, often with aggregate limits and failing to comply with their contractual obligations by not maintaining or renewing their policies.
- Wider LDI cover being available such as for Mechanical and Electrical Services.

THE COVER

The policy cover, which incepted upon practical completion of a building, is a first party material damage policy which can be in force for a period of up to 12 years from practical completion and is subsequently non-cancellable by insurers.

The insurance provides cover for:

- Structural damage
- Non-structural elements damaged as a consequence of structural damage
- Imminent threat of structural damage
- Waterproofing cover above and below ground
- Subsidence, landslip or heave (provided by Norwich Union/Aviva only)

due to defective design, materials or workmanship unknown or undiscovered at the time of practical completion.

It is important to emphasise at this point that the LDI cover is provided on a first party material damage basis and therefore there is no requirement to prove that a member of the professional team was liable or negligent. All that is required is to show that there is a Latent Defect or Damage or threat of structural damage as defined within the policy.

Optional extensions such as LDI – Business Interruption (Rent, Cost of Alternative Accommodation) can be provided.

A waiver of subrogation, which protects the contractor and design team, is also available but at an additional cost. This no fault cover offers comfort to all those signing up to a partnering agreement and can help prevent the need for potentially drawn out and expensive litigation.

There are only a limited number of insurers who will consider providing LDI cover for existing buildings, retained facades, partially completed buildings, recently completed buildings or Non-Structural elements such as Mechanical and Electrical Services but such cover will come at a premium rate.



THE COST OF LDI COVER

The most competitive premiums are provided by insurers prior to the start of construction and cover is subject to a technical control service (technical audit) to be undertaken during the construction period. There is a separate technical audit fee payable at the start of construction, which is subject to VAT. The insurance premium, which is subject to Insurance Premium Tax, is payable once the offer of LDI cover is confirmed by insurers following practical completion based on a satisfactory audit report.

A little more about the technical auditor role is that he is there to confirm to the LDI insurers that to the best of his knowledge the building does not present any known defect in design or construction. If he is unhappy with any feature he will try and resolve the problem during the construction phase so that any there are no nasty surprises upon practical completion that may prevent the LDI being given. They have also helped to identify potential problems which are corrected and thereby preventing future claims plus additional costs and inconvenience to the building owner.

In general terms the insurance rate on the rebuilding value (including professional fees) will be in the range of 0.50% to 1%. Completed buildings can attract a rate in excess of 2% because the technical auditor has not been able to carry out his role during the construction phase.

As mentioned previously there are a limited number of insurers that will consider providing cover for partially completed or recently completed development projects and this cover will come at a premium rate, especially where the original contractor is insolvent or collateral warranties from the professionals are no longer available.

THE BENEFITS OF LDI

- First party material damage cover
- Useful as a marketing aid and can act as an inducement to prospective purchasers or tenants
- Policy is freely assignable to future owners and tenants
- Reduces reliance on collateral warranties, guarantees and third party insurances provided by the professional team
- Reduces the need to resort to expensive litigation to prove a professional party was liable or responsible, which is needed before a professional indemnity insurance can respond

RESIDENTIAL AND MIXED USE DEVELOPMENTS

For a number of years residential developers have been offered little choice when it came to the procurement of home warranties and LDI cover for residential properties, with the only products being offered from NHBC and Zurich Municipal and having to be purchased via the contractors.

However this has changed in recent years, due to new insurers entering the marketplace and as a result of the increased trend of mixed use developments where residential developments are undertaken as part of larger commercial developments.

In respect of such mixed use developments it is advantageous for both the commercial and residential elements of a single project development to be covered by the same LDI insurer to avoid any gaps in cover. For these developments it is now possible for project owners, developers or funders to arrange an LDI policy cover direct from some insurers with the options of covering:

- The structure
- Non-structural
- All components within the buildings
- Land remediation (clean up costs following statutory notice upon the owner)
- Health and Safety breaches of the Building Regulations

It is also possible to obtain such a policy in respect of residential developments whereby there is no requirement on the policyholder to pursue the contractor in the first two years of cover to have the latent defects remedied.

LDI CONCLUSION

Although it is recognized that LDI is not the 'total solution' it can go some way to providing greater comfort and peace of mind not only to the project owners, developers and funders but also to future purchasers and tenants for the whole period of the LDI policy. This is particularly important in the event of an insolvency of a contractor or sub-contractor.

PROFESSIONAL INDEMNITY INSURANCE

It is common practice in the U.K. for the Employer (Project Owner or Developer) under a building contract to require the construction professionals to effect and maintain Professional Indemnity Insurance (PII) for a period of 12 years or longer after completion of the Works.

The majority of U.K. construction professionals will normally purchase PI Insurance, which:

- Is designed to protect the construction professional not his client.
- Is dependent on proof of liability.
- Is on an annual renewable claims made basis for the construction professional's whole business.
- Can be subject to aggregate or costs inclusive limits of indemnity.
- Can be compromised by professional breaches of condition and/or non-disclosure.
- Will not indemnify the Project Owner or Developer for third party claims.
- Is under the control of the construction professional
- Can be expensive.
- Will be billed to the Employer (Project Owner or Developer).

A PI Insurance policy does not include a cancellation clause and in the event of insolvency cover would continue until natural expiry. However, liquidators would seek to cancel the policy, where possible, from the date of insolvency to obtain a refund of premium for the creditors. They would not be concerned about the lack of insurance protection for future liabilities.

As a solution to the limitations of a professional's annual PI Insurance we are pleased to advise that a new insurance product, Owners' Protective Professional Indemnity (OPPI) Insurance, is available in the U.K. This OPPI does not replace the annual PI Insurance held by the professionals but rather is a policy which is under the control of and provides protection to the Project Owners, Developers and Funders.



OWNERS' PROTECTIVE PROFESSIONAL INDEMNITY (OPPI) INSURANCE

WHAT IS OPPI?

An 'umbrella' or excess insurance policy purchased by the Employer (Project Owner or Developer) for its own benefit sitting above the construction professionals' own various Professional Indemnity Insurance policy limits for development projects.

The insurance can be arranged to cover single or multiple development projects running simultaneously and can also be reviewed annually to cater for changing levels of exposure.

It is possible to arrange OPPI insurance at any point during the planning, design or construction process and even for development projects already underway.

THE COVER

OPPI Insurance cover:

- Indemnifies a named Project Owner or Developer for direct claims arising out of the professional negligence of their sub-contracted design teams, such as architects and engineers.
- Sits in excess over all of the professional's annual PI Insurance and is triggered when these policy limits are exhausted.
- Includes cover for third party claims and any legal defence costs arising out of design negligence.
- Effectively bridges any gaps resulting from inadequate insurance limits.
- Is independent of any other insurances that might apply.

THE BENEFITS OF OPPI

- Consultants and contractors will have some responsibility for their own mistakes
- The Project Owner or Developer can purchase cover in excess of all consultants' and contractors' policies up to a limit of their choosing (+/- GBP 50,000,000)
- The Project Owner or Developer can design a policy to cover any Difference in Conditions (DIC) of consultants' and contractors' own policies
- In the event that consultants and contractors are unable to renew policies as originally envisaged, this umbrella policy could drop down to ensure there are no gaps in cover
- Cover can be purchased for development project 'hot-spots'
- Claims can be resolved more quickly
- A cost effective option compared to single project cover

THE COST

Upon receipt of information Willis will negotiate competitive terms from OPPI insurers but because this product is so new to the U.K. and each development project requirements different it is not possible to indicate rates or a range of premiums. However, OPPI insurers have advised that their OPPI experience in the United States is that the cost of an OPPI is typically 25% to 50% cheaper than a single project PI cover.

OPPI CONCLUSION

OPPI gives control of this valuable insurance to the Employer (Project Owner or Developer) at a cost effective premium and provides future peace of mind.

FREQUENTLY ASKED QUESTIONS - OPPI

If the design professional's insurance does not pay by reason of exclusion, will it also be excluded under an OPPI policy?

Not necessarily, as OPPI is subject to its own terms and conditions irrespective of the underlying policies. In this particular instance, an OPPI would still respond to covered losses as if there would have been underlying insurance.

When does the OPPI policy pay a claim?

The OPPI pays a claim when:

- Liability has been established by settlement and;
- The design professional's insurance is not adequate to cover the loss.

If the design professional's insurer does not settle a claim where liability has already been established to be in excess of their policy limits, can OPPI insurers pay without settlement?

Yes. Once there is agreement on the claim value between the Insured and the OPPI insurers, then the OPPI insurers would pay as if the underlying carrier had tendered its limits.

How are disputes about the value of a claim resolved in an OPPI policy?

Establishing design liability is usually a negotiated process which can be determined by court judgement, arbitration or other agreed method of dispute resolution. To the extent that all parties (Project Owner, Developer, construction professionals and OPPI insurers) agree to mediation, expert witnesses from all sides will offer their professional opinions as to the extent of the design professional's negligence.

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LEGAL VIEWPOINT

BUILDING CONTRACT

The problem with many standard forms of building contract is that they still take a 'plain vanilla' approach to the development process, i.e. the documents are still constructed around the premise that the employer in the building contract is actually the owner of the site and end user of the building. As we all know, modern property development has long since moved on from that and has become increasingly complex with joint venture partners, shared site ownership and work being carried out for third parties. Such arrangements rarely fit into the plain vanilla category and require a fairly sophisticated matrix of legal contracts. The lawyer's job is to marry up the various rights and obligations between funding agreements, development agreements, agreements for lease and joint venture agreements and then step those down into a building contract so that the entire legal matrix works properly as a whole. If you simply try and bolt onto the end of all that a plain vanilla insurance regime (like the one provided for in most standard forms of building contract) then sooner or later you are going to come up against some serious gaps in your risk strategy and insurance regime.

Let us be under no illusions; the insurance provisions in standard form building contracts have traditionally been among the most difficult to read and understand. As a result they often do not even get read, let alone understood. Even a cursory examination of the insurance provisions in such contracts will reveal a bewildering requirement for numerous different insurance policies covering a variety of risks, all expressed in complicated legal language. It is often only the very experienced who can decipher all this.

RISK

As a grown up Developer you should be on notice that risk in the development game and the insurance of that risk is a complicated matter. It is then really beholden upon you to either understand the insurance provisions in your building contract or get someone to explain them to you. The best person to do this is your insurance broker.

Do not ever assume that you are operating in a risk free environment. How many developers fully appreciate that the contractor's public liability insurance is there for the contractor's benefit, not the developer's? How many developers actually carry their own public liability insurance to cover the risk of the claim against them? In fact, how many developers as they read this confidently know exactly what insurances they do carry?

Understanding what your risks are is the first step to deciding whether or not you want to buy insurance to cover those risks. The easiest way to take that first step is to get hold of your insurance broker and make him explain things to you.

INSURANCE

As a prudent developer you really should be carrying out an insurance audit at the very inception of your project, i.e. at the Heads of Terms stage.

Do not make the mistake of assuming that your contractor understands insurance any better than you do and do not fall into the trap of thinking he is going to be taking care of all the insurance arrangements for you, just because your project manager has ticked a number of options in 'Appendix 1' of the contract. That is a very simplistic approach to modern development schemes.

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Should you require further copies of this newsletter, wish to receive future editions by Email or notify us of any changes to your address please contact Kirstie Blyth on 020 3124 6656 or by email: blythk@willis.com

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