

A NEW FOCUS FOR THE CONSTRUCTION PROFESSIONALS INDEX

Nearly five years has elapsed since the first Willis FINEX Construction Professionals Index, and what a five years it has been, where the construction industry has swung from one of the most successful periods of construction to a period of deep recession. The concerns about securing enough resources to fulfill the contracts has been replaced with concerns about securing contracts, albeit there are still fears that there will be a lack of resources when the market does turn.

During the last five years there has been substantial mergers & acquisitions activity, which shows no sign of abating, with a number of high profile acquisitions being announced in 2010. Also, working overseas has been an attraction for a large number of firms, whilst work in their home territory has been hard to win or obtain at reasonable margins.

Often these situations require bespoke insurance solutions, and at Willis FINEX we have recognised that we must move with our clients, and in the last few months we have brought together the UK and Ireland Mergers & Acquisitions and International divisions into one division Willis FINEX Global.

We see this as another step in providing our clients globally with the best insurance advice wherever they are operating in the world. We are in the process of enhancing our Global Construction Professionals Practice, building upon our existing network of Construction Professionals Associates in the U.K., U.S.A., Ireland, Australia and New Zealand; by identifying Associates with specialist knowledge in various European countries, Canada, Middle East, Far East and South America.

To reflect our change of focus we have decided to produce an Index with issues which are affecting Construction Professionals around the globe. We hope you find this new approach to be informative and enjoyable to read.

Michael Earp

CONSTRUCTION M&A: HOW TO AVOID POST-DEAL INDIGESTION?

The global construction market boomed and then crashed and as design and construction firms struggled, mergers or acquisitions have proliferated in both phases of the industry cycle. For most design and construction industry executives, consummating a merger or executing an acquisition is not an everyday occurrence and is undertaken with much caution and uncertainty. Anecdotal evidence indicates that the majority of design and construction industry deals fail to deliver the value that was projected during the feasibility and due diligence processes, and that many company executives must tolerate a protracted period of post-deal indigestion.

Professional services firms must also contend with the issues surrounding the real possibility of a claim being brought – after the deal is complete – for the past acts, errors or omissions of the merged or acquired firm. While the mechanics of responding to such a claim can be addressed through the deal structure (asset versus stock acquisition, run-off and tail covers, etc.), we strongly encourage clients involved in mergers and acquisitions activity to adopt an underwriting approach as they evaluate potential target companies.

An underwriting approach will help the acquirer obtain a fully rounded understanding of the risk management and loss prevention culture within the target firm and quantify the potential financial impact of an unforeseen Professional Liability/Indemnity claim. The following checklist of do's and don'ts will help you underwrite a target company.



DO	DON'T
<ul style="list-style-type: none"> - Consider three-year projected estimates of insurance premiums for the combined entity and benchmark against your peer group using accepted market data - Consider the financial impact and collateral requirements of increasing self-insured retentions and deductibles - Adopt an underwriting approach as you evaluate potential target companies - Closely review any 'change of control' clause implications of the target's insurance policies - Review twelve years' claims experience to identify any claim trends of concern – in terms of both frequency and severity - Determine the target's losses from the ground up and identify claims costs incurred by the target within its self-insured retention or deductible - Confirm that asset valuations are current to confirm the appropriateness of sums insured to prevent under-insurance - Review and quantify any contingent liabilities and consider methods to minimise or insure against them. 	<ul style="list-style-type: none"> - Rely on the quantification of future insurance or claim costs by non-qualified consultants - Forget to review the financial worthiness of the target's past liability Insurers for those insurance lines which are 'loss occurring' and which may have to be accessed and assessed post-deal in the event of a loss or claim - Assume access to your current Professional Liability/ Indemnity carrier's programme – or its current terms and conditions – post-deal - Assume that there will be any return premium post-deal - Overlook uninsured risks.

Companies of course do not turn to mergers and acquisitions every time their capacity or resources are stretched. Other responses include:

- Increasing investment in technology and integration
- Establishing joint ventures and other project-specific entities to compete for and deliver projects
- Outsourcing to offshore locations that have the resources to perform the work – and often for less cost.

These approaches come with their own risk management issues, which will be the subject of future commentary.

PPP PROJECTS

PPP stands for Private-Public Partnership. It refers to a facility for infrastructure, construction, finance and procurement model, which is well known in the U.K. and Australia. The Channel Tunnel is probably the most famous PPP product. This method of procurement is now becoming accepted in the U.S.A. and Canada and the model has developed as a response to the increasingly limited pool of public funds for large-scale projects, particularly in the current recession.

Given the need for public agencies to better manage project risk, and given the unusual nature of these arrangements for the private participants, PPP demands creative risk management and transfer solutions for everyone involved. Contractors and design firms considering PPP opportunities should be aware of what may lie ahead.

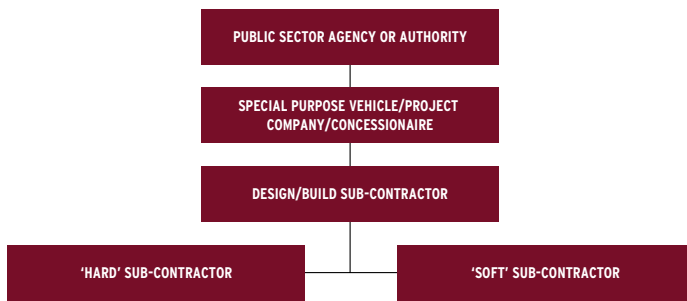
Design-build, procurement or project delivery by a single entity (a contractor with sub-consultants, or team of contractors and engineers, often with sub-consultants) is entrusted with both design and construction of a project. This contrasts with traditional procurement where one contract is bid for the design phase and then a second contract is bid for the construction phase of the project.

Build-operate-transfer (BOT), a public-private partnership arrangement involving private construction, private operation for a given period of time, and eventual transfer to public ownership. The public sector sponsor is responsible for raising the finance.

Build-own-operate (BOO), a public-private partnership arrangement involving private financing, design and construction of a project in its entirety and at the sole risk of the private sector entity. The public sector entity may provide some form of payment guarantee via long term contracts, but any residual value of the project accrues to the private sector entity.

Build-lease-transfer (BLT), which is similar to a BOT project except that a lease of the facility, project site, buildings and equipment is granted to the private sector entity during the term of the lease.

Given that the PPP model revolves around a novel sharing of responsibilities, it is no surprise that unusual liability and risk management questions would arise. Typically, government agencies seek to transfer as much risk as possible to the concessionaire. In this process, design risk is typically passed down from the public sector entity to the project company and then, often, in turn to a design-build contractor and its design consultants.



These arrangements are established in the high-level agreements that frame the PPP projects. The requirements in these agreements are often passed on – via ‘linkage’ – to the design and construction entities as they negotiate their lower-level agreements.

It is imperative that design and construction professionals are familiar with the terms and conditions of the higher-level agreements so they have an idea what they are in for. Linkage may result in design and construction companies assuming liabilities more akin to those of a full joint-venture or special-purpose vehicle partner – without participation in the profits.

Contractors and designers should be specially wary of the warranty and guarantee requirements that are often characteristic of the higher-level agreements. PPP projects are very frequently subject to ‘out-put’ or ‘performance-based’ specifications in order for the public sector entity to ensure that design risk stays with the project company and to foster innovation and creativity in design, engineering and construction technology.

The scope of professional services to be provided should be carefully defined. Responsibilities should be confined to only those professional services outlined and to the design and construction phase of the project – they should not inadvertently flow to the post-availability date phase and subsequent operations and maintenance exposures. Consultants should also pay attention to duty and standard of care provisions. They should be sure that ‘reasonable skill and care’ (or similar wording) is the standard for the provision of professional services.

The pass-through of design-risk that is typical of PPP agreements must always be carefully checked against applicable professional liability/indemnity policies. The potential damages resulting from a design error – particularly in an environment that encourages innovation – will potentially far exceed the likely level of professional liability/indemnity cover provided by the design team. This situation is particularly problematic as a result of the significant reduction in capacity for project-specific insurance coverage.

LIMITS OF INDEMNITY: 'EACH CLAIM' VS. 'AGGREGATE'

In the U.K. over the last twenty years there has been a significant move towards the purchase of professional liability/indemnity insurance on an **each claim** basis. The reason for this stipulation has been largely driven by Professional Bodies wishing to protect the consumer, a very laudable aspiration, and one embraced by lawyers when advising and drafting contracts, professional terms of appointment and collateral warranties. Interestingly there is not an insurance company in the world that has unlimited capital and there have been examples – in the U.S. market – where insurance companies have become insolvent because they gave any one loss coverage without an aggregate. One would hope that the likelihood of this happening in the U.K. is very rare, but nonetheless it is not without the bounds of possibility.

The **Limit of Indemnity** (sometimes referred to as the Limit of Liability or even the Sum Insured) relates to the maximum amount of compensation for **each claim**, with costs and expenses incurred in the defence of that claim either payable in addition, or included within the limit. The perceived wisdom is that an **each claim** basis of cover provides the Professional and his Client with the best protection, as this allows for an unlimited number of claims to be brought in any one period of insurance. In theory this premise may seem correct, but in practice rarely are there multiple claims paid for the Total Limit of Indemnity in one year, and there could be situations where the definition of claim actually inhibits how much can be recovered from the Insurer. Furthermore, certain of the ‘higher’ risk areas such as Asbestos and Pollution, are only covered on an **aggregate** basis.

The potential weakness of an **each claim** basis of cover is in the definition of what is a claim and/or the series clause that will seek to link ‘similar’ claims together arising from the original mistake. For example should there be an incorrect design of a roof truss that is used in a number of different structures, then, depending upon the basis of cover in the policy wording, Insurers may seek to link the claims from different claimants as one claim under the insurance policy. Why should Insurers wish to link the various claims (i.e. ‘stacking’ multiple claims due to a common cause as opposed to a ‘sideways’ exposure)? It is because when Insurers purchase reinsurance usually it is arranged on a non-proportional excess of loss basis, and linking claims will assist them in their ability to recover from reinsurers.



The problem is further exacerbated by use of other terminology for **each claim**, including: **any one claim, each and every claim** and even the use of **any one occurrence**. The last of these is persistently used (incorrectly) by lawyers, when drafting contractual instruments, and all too often it has to be explained that professional liability/indemnity is not an occurrence based insurance but one written on a **claims made** basis.

When there is a major incident, for example the World Trade Centre disaster or even the devastation caused by Hurricane Katrina, there is often a dispute as to how many actual claims can be paid by insurance or reinsurance. Professional liability/indemnity insurance is not immune to such debate and the Pensions Mis-selling debacle spawned such a dispute. To clarify the position the Law Society amended the minimum terms for English and Welsh Solicitors, but it will probably require a legal case to test the drafting of that alteration.

There is a viable alternative to an **each claim** basis of cover, and that is for the Limit of Indemnity to be arranged on an **aggregate** basis for the period of insurance. This historically was the basis of all professional indemnity insurance policies, and is still the prevalent basis of cover for all classes in most countries outside of the U.K. and continues to be the basis for certain classes in the U.K. including 'Design & Construct' risks. Often expressed as **any one claim and in all**, in the event of a

very severe loss an aggregate Limit of Indemnity could afford better protection than **each claim**, the latter being more beneficial if a frequency problem is perceived. But the statistics and experience would seem to indicate that severity is more prevalent than frequency.

It is recognised by Insurers, particularly in the construction industry, that when major projects are undertaken a single aggregate limit does not always provide the comfort Clients require, and that alternative options need to be considered. A reinstatement of the Limit of Indemnity can be an option, but the method by which the Limit of Indemnity is reinstated is absolutely critical, and clarity as to what is an **unrelated claim** has baffled a number of the best legal minds in the professional liability/indemnity market.

In an era of contract certainty, perhaps insurance brokers should be drawing attention to the deficiencies of **each claim** policies, compared to a policy with an **aggregate** Limit of Indemnity which may provide more certainty. Furthermore, certain Insurers recognise the differences in rating, and **aggregate** policies – for the same maximum limit – should be far cheaper in comparison to an **each claim** limit, thus allowing more vertical limit to be purchased which allows the Client more certainty of coverage.

PROFESSIONAL INDEMNITY REVIEW

2010 will go down as the year in which professional indemnity insurers were anticipating a hardening in premiums across the board, but exactly the reverse has occurred (with just two exceptions) and with no signs of this changing in the short-term.

Leading up to January 1 this year Insurers were forecasting at least a 10% uplift in rates – the factors behind such an increase being a combination of low interest rates on their investment income; an increase in claims notifications and concern that the recession would generate a significant number of further claims.

The primary reason for the actual softening in premium rates is the unforeseen increase in professional indemnity capacity which has become available during the year. The two exceptional 'hot spots' are: U.K. Surveyors and England & Wales Solicitors.

Insurers remain concerned about the U.K. property market (remembering the last property crash in the late 1980s and early 1990s) and specifically the exposure of surveyors to valuation claims. This has led to a continuing shortage of capacity and as a result high rates and deductibles being imposed on the

profession. This trend is likely to continue with the fear of a double dip recession and concern that claims from Lenders will significantly increase.

The England and Wales Solicitors rates are likely to be hit hard on their common renewal date of October 1 this year. This segment of the professional indemnity market has tended to follow its own 'cycle' since 2000, as it collectively accounts for annual premium of circa GBP 250 million. However, the volume of recession related claims from negligence and fraud continues to increase. The position is being exacerbated by the requirement for Insurers to provide the widest cover which is available in the professional indemnity market as well as underwriting a 'pool' (Assigned Risks Pool) for those solicitors who cannot get any cover from Insurers in the normal way. All Insurers who write solicitors professional indemnity must share in insuring this 'pool' – this cost to Insurers has been rising significantly during the recession.

We will report on the outcome of the solicitors renewal season in our next report for this Review as well as comment on anticipated rates for 2011.

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