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Evaluating the role of the insurance industry in determining risk allocation in major projects

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There are very real dangers in viewing insurance arrangements as something to be considered once the contract terms governing the project have been finalised.

Problems which have arisen for project participants as highlighted by some of the court cases referred to below demonstrate that, ideally, the insurance strategy should be arrived at during the negotiation of the construction contract and not simply as an afterthought.

Types of insurances that would typically be found in a major project include contract works insurance (in an amount sufficient to cover full reinstatement of the works, including costs of demolition and removal of debris and fees for all consultants), public liability insurance, workers compensation, vehicles and plant and professional liability. In addition, the contractor may seek to insure wider risks designed to protect cash flow, including insurance against latent defects, business interruption, strikes and industrial action, and advanced loss of profits. Similarly, owners seeking to have protection against defective or late design under an alliance-style arrangement will generally require some tailored form of insurance, given that liability insurance is unlikely to be triggered in the absence of 'wilful default' which most policies will exclude in any event.

Another key feature that has been observed in terms of insurance and risk allocation in recent years has been the cost and availability (or lack thereof) of professional liability insurance for design consultants, the level of that cover and the level of the deductible which the design professional is being asked to bear. As a result of this lack of cover for defective design, there has been an increased desire on behalf of principals to seek to novate their design consultant's obligations to their principal contractor and to impose a fit-for-purpose risk upon that party.

Similarly, the large deductibles increasingly found in not just professional liability insurance but other forms of property and general liability cover have meant the need for a greater focus on both the financial wherewithal of project partners and the warranties and indemnities contained within project documentation.

Effective and efficient transfer of risk

One of the undesirable facets of leaving the negotiation of insurances for a project until the 11th hour is that insurance is often seen as a way to 'plug the gap'

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in respect of outstanding risks which have been identified, without the parties necessarily having formed a view as to which risks are best borne internally having regard to their own corporate risk profile and tolerance, and which risks are best borne by a third party such as an insurer. Given that the type and level of cover procured for a project will have differing financial costs, it may be merely fortuitous if the most cost-effective and efficient transfer of risk is achieved.

To illustrate: a principal undertaking a major capital expenditure program may see great benefit in insisting upon the head contractor effecting comprehensive insurance noting its interests (and the interests of all of its subcontractors). It may also insist upon the provision of blanket indemnities with respect to any claims arising out of the work under the contract. To ensure blanket cover, it may take out its own 'floater' policy which it regards as operating only on a difference in conditions (DIC) basis.

While this may at first instance appear to be a comprehensive exercise in risk transfer, it is arguably a very financially inefficient way for the principal to manage these risks on site. In effect, it may find itself paying three (or more) times for the same effective cover for the reasons below.

The head contractor will no doubt have sought to have priced into its contingency the risk associated with the blanket indemnities negotiated. As it will have been asked to assume responsibility for a number of risks outside of its control, the risk 'buffer' contained within the contract price may be substantial.

Also built into the price which will be paid by the principal will be the actual cost of the project-specific insurance which the contractor is required to procure. As this insurance is specified not just to cover the contractor but also to name the principal and the contractor's subcontractors, it will be rated at a high premium and that cost will be passed on.

The cost of the head contractor's subcontractors will also form a part of its bid price, and if they contain a 'back to back' requirement to similarly provide indemnities and secure insurance in like terms, their costs will also feed into the contractor's bid price.

Finally, while the principal may consider that the additional direct cost of it procuring its own insurance to 'cover the gaps' would be minimal, in fact underwriters in this country appreciate that due to the combined operation of ss 45 and 76 of the *Insurance Contracts Act 1984* (Cth) (and the judicial interpretation given to those provisions in cases such as *HIH Casualty and General Insurance Ltd v Pluim Constructions Pty Ltd* (2000) 11 ANZ Ins Law 61-47) it is very difficult to achieve true DIC cover with any certainty (at least not without the risk of dual insurance arising). Accordingly, they are often 'rating' the risk as though they are providing primary cover.

In these circumstances, it can be seen that what at first might be regarded as a fail-safe measure of risk transfer is economically inefficient in the extreme, and could in fact work against the principal's interests if multiple insurers take opposing views in relation to coverage as the project progresses. It might be suggested that the principal's interests may have been best served by procuring principal-controlled coverage for the whole of the site.

It should be noted that despite the longstanding ability to procure principal-controlled Contractors' All Risk Insurance — often with the inability for an underwriter to seek recovery against any of the project participants in any event as a result of the inclusion of cross-liability and waiver of subrogation clauses — there appears to be a certain reluctance from some underwriters to insure project alliances, notwithstanding that one would assume the key benefits flowing to the parties in a successful alliance would also ultimately be of benefit to an underwriter of that project.

Judicial interpretation of project insurances

A case such as *Speno Rail Maintenance Australia Pty Ltd v Hammersly Iron Pty Ltd* (2000) 23

WAR 291 highlights the need to consider the terms of the indemnity clauses within the project documentation, as well as those contained within the policies of insurance to determine the circumstances on which those liabilities may be said to be coordinate.

Reference should also be made to the case of *National Vulcan Engineering Insurance Group Ltd v Transfield Construction Pty Ltd* [2003] NSWCA 327; BC200306820, in which the obligation on the insurer to indemnify in respect of liability between the parties was held to arise as a result of the use of the expression 'the Insured' in an exclusion clause relating to damage to property of project participants — the position would have been different if the expression 'an Insured' had been used.

There are many instances where, as a result of a possible failure to consider or adequately appreciate the effect of the interface between the insurance and indemnities, unintended consequences have arisen which have tended to cut across what might otherwise have been the parties' carefully negotiated allocation of risks.

Examples of where judicial determinations have perhaps confounded parties' expectations can be found in the cases of *Woodside Petroleum Development Pty Ltd v A & R–E & W Pty Ltd* [1999] 20 WAR 380 and *GPS Power Pty Ltd v Gardiner Willis Associates Pty Ltd* [2001] 2 QdR 586, in which the respective states' appellate courts effectively held that in respect of project insurance, there was no basis for limiting the ambit of a waiver of subrogation clause to the cover provided and extended the operation of the clause to parties described in the definition as 'Insured', even though not insured against the particular risk in question.

There are some further specific instances which have arisen, where the parties, many of whom may have assumed that they had the benefit of insurance, in fact find themselves effectively uninsured or where a party, which has a contractual obligation to note the interests of other parties to the transaction, fails to do so.

These two specific aspects of insurance risks, which are considered below, highlight the need for a comprehensive review of insurance and indemnity arrangements in construction, civil and mining contracts against the underlying policy or policies to guard against any unintended exposures.

Actions brought against co-insureds

An issue often arises in circumstances where parties to a contract agree to effect joint insurance in respect of a particular risk and have both parties expressly named as the beneficiary of that insurance.

An example of this type of arrangement was considered in the UK decision of *Cooperative Retail Services Ltd v Taylor Young Partnership* [2000] EWCA Civ 207, where the Court of Appeal held that the insurer was subject to an implied term of the insurance contract that proceedings would not be brought against a coinsured and there would be no exercise of the insurer's rights of subrogation in relation to any loss covered by the joint names insurance (the House of Lords upheld this decision on appeal [2002] UKHL 17 (25 April 2002)). The Court of Appeal found that the contractual scheme had the effect that the contracting parties (at [73]):

> ... had entered into contractual arrangements which meant that if a fire occurred [during construction], they should look to the joint insurance policy to provide the fund for the cost of restoring and repairing the fire damage ... and that they would bear other losses themselves ... rather than indulge in litigation with each other.

In that case, there was no express waiver of a subrogation clause contained in the policy. This was not the case, however, in *Larson-Juhl Australia LLC v Jaywest International Pty Ltd* [2001] NSWCA 260; BC200104864, which concerned the purported exercise of rights of subrogation in respect of a claim paid under the business interruption section of an Insurance Special Risks policy.

The master, at first instance [2000] NSWSC 524; BC200003266, found that the defence of circuity of action would fail, but that the waiver clause, construed in accordance with its 'plain, ordinary and popular sense', would be effective to preclude recovery. On appeal, the NSW Court of Appeal considered that the construction adopted by the master of the waiver of subrogation clause of the relevant policy of insurance was correct.

The decision highlights the need for parties to carefully consider the provisions of a policy of insurance in respect of which they intend to take the benefit. In particular, the contract should require the relevant policy of insurance to contain a waiver of subrogation clause and the policy itself should be checked to confirm both the existence of the clause and its content. Importantly, the decision reinforces a number of important matters, including the following.

- In the absence of a waiver of subrogation clause, the notion of 'pervasive interest', traditionally relied upon by the courts as a basis to defeat subrogated claims against co-insureds, should be confined to project construction insurance.
- Co-insurance and waiver of subrogation are different concepts and it should not be presumed that the parties must have intended that one be co-extensive with the other.
- Waiver clauses will be construed in accordance with their 'plain, ordinary and popular sense' and, in the absence of a limitation which flows from a consideration of the terms of the policy or the circumstances of insurance, are unlikely to be read down.
- A restriction upon the extent of a waiver of a right of subrogation can only arise by varying the person in favour of whom there is a waiver or the nature of claims that are waived.
- An insurer appears to be entitled to subrogate to rights which are not rights arising from the conduct which causes the casualty.

In considering the adequacy of insurance arrangements, the commercial document prescribing the obligation should (subject to individual circumstances) also make the following clear.

- The policy is effective to insure each insured for their respective rights, interests and liabilities, such that, informed by the cross-liability clause (another important requirement), each party is considered as a separate entity 'in the same manner as if a separate policy had been issued to each of them'.
- No person insured may be affected by a misrepresentation, non-disclosure or breach by any other insured.
- An insured may recover the amount of any liability (and related costs) from the insurer, even if the person making the claim against the insured person is also insured under the policy.

Damages for breach of contract for failing to note other parties' interests

In a decision of the Full Court of the WA Supreme Court in *Thiess Contractors Pty Ltd v Norcon Pty Ltd* [2001] WASCA 364; BC200107211, the respondent was alleged to be in breach of a contractual term to procure and maintain the insurance policy on behalf of the appellant and respondent. The question for the court was whether the fact that the appellant had taken out public liability insurance on its own behalf precluded recovery of damages from the respondent for breach of contract.

The Court of Appeal considered it to be well established that where a plaintiff suffers a loss as a result of a defendant's negligence, that as the beneficiary of an insurance policy covering that loss, the sum received by the plaintiff from the insurer is not taken into account in reduction of the damages. The court went on to pose the question at [14]:

> But what should be the situation where the plaintiff is entitled to recover damages from the defendant for breach of a contract to take out insurance on the plaintiff's behalf, but has taken out its own insurance to cover the same event or events?

After consideration of relevant authorities, the court concluded that the fact was that the appellant had lost the benefit of the proposed policy and thought it was irrelevant that it might, by resorting to the policy which it had taken out, recover or avoid any expense which would otherwise have flowed from the loss of the benefit of the proposed policy.

The decision highlights the need for parties who accept an obligation via their commercial arrangement to effect insurance noting another party's interest to ensure that the obligation is carried out. While the decision provides no guidance as to how the courts would assess damages for breach of the failure to note a party's interests, that may well equate to the full value of the indemnity which would otherwise have been available to that party had the contract been effected.

If that is the case, a defendant who has failed to procure the relevant insurance may find itself exposed to a claim for breach of contract in respect of which it is not entitled to indemnity under its policy. By contrast, had it procured insurance as it was contractually obliged to, not only would it avoid potential exposure to an uninsured claim for damages, but its underwriter would be able to claim against the other party's insurer and seek contribution on the basis of dual insurance. ●

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