



CONSTRUCTIVE VIEW

JLT'S CONSTRUCTION INSURANCE WHITE PAPER ISSUE 4



AN INTRODUCTION TO PROFESSIONAL INDEMNITY INSURANCE

Professional Indemnity (PI) policies indemnify insured's for claims made against them by third parties during the period of insurance arising out of professional acts, errors or omissions of the insured and/or parties for whom they are vicariously liable. Cover is usually provided on a Civil Liability basis which as the name suggests is liability that arises out of civil law, as opposed to criminal law.

CLAIMS MADE VS CLAIMS OCCURRING

All PI policies provide cover on a claims made basis. This means that regardless of when the professional act error or omission happened, it is the insurance policy in place at the time a claim is made that responds. This is particularly important when you consider that it often takes significant time for a professional act, error or omission to manifest itself into a PI claim. Furthermore, statute of limitation legislation in each State allows claimants 6-20* years to lodge a claim once they have suffered a loss.

Under a claims-made policy, determination of coverage is triggered by the date the Insured first became aware and notified its insurer of a claim or a circumstance which is likely to give rise to a claim. The insurer of the policy in force on the date the Insured became aware and gave notice is the insurer who must defend and settle the claim.

In the case of occurrence policies such as

Public Liability or Motor Vehicle insurance, the coverage trigger is tied to the date of the event or accident giving rise to the claim. Under an occurrence policy, the policy in force on the date of the event causing the loss must respond with both defence and indemnity. The claim may arise years after the policy has expired and the occurrence coverage trigger places little or no importance on the date the insured receives notice of the claim.

NOTIFICATIONS

The uncertainty of when claims could be made against the insured for past professional acts, errors or omissions means that PI policies often have strict notification requirements with failure to properly adhere to such requirements often eliminating coverage.

Although precise requirements will vary between policies, in general, four conditions need to be met in order for a notification to trigger a claims-made policy:

1. The insured must receive its first notification of a claim or circumstance during the policy period.

2. The claim or circumstance must be reported to the insurer during the policy period.
3. The act, error or omission giving rise to the claim or circumstance must occur after a "prior acts" or "retroactive" date that is set forth in the policy declarations.
4. The act, error or omission giving rise to the claim or circumstance must be within the professional services definition in the policy.

Insured's should easily recognise an actual claim or a notice of an intention to make a claim, but identifying a circumstance that is likely to give rise to a claim under a PI policy is and always has been more difficult. This is because, whilst a PI policy will often define a claim, it will rarely spell out what amounts to a circumstance. The Insured's dilemma is that at one end of the spectrum, failure to notify may produce a gap in cover, whereas a "laundry list" notification of all potential circumstances, however remote, may not be sufficient to trigger cover.

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RENEWAL OBLIGATIONS

In respect of Annual PI policies, as part of the renewal process, insured's will often be required to sign a declaration that they have conducted internal investigations and notified all known claims and/or circumstances which could give rise to a claim to insurers. This is important as the new period of insurance will specifically exclude any claims or circumstances that the insured had prior knowledge.

Where the insurer remains the same across the two periods of insurance some (but not all) policies have a continuous cover extension that provides cover for the non-fraudulent late notification of claims or circumstances.

However, such coverage is not available when cover is changed to a new insurer. As such, if an insured is considering changing PI insurers it is imperative that it makes thorough investigations throughout the business to ensure

that all claims and circumstances have been notified correctly prior to renewal. It is also important that the existing retroactive date is carried forward to the new policy otherwise claims arising out of prior acts may not be covered.

DISCLOSURE

As mentioned previously, it is important that the definition of professional services within the policy is adequate to cover the business activities of the Insured. This is because claims arising out of undeclared or unreferenceed professional services could be declined by insurers and may, depending on the policy wording, void the policy in its entirety.

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The exact professional services covered by a PI policy will vary depending on the specific activities of the Insured. However, common professional services undertaken within the construction industry include;

Design	Drafting	Technical calculation
Project management	Construction management	Feasibility studies
Quantity surveying	Surveying	Technical advice
Technical specification	Programming and time flow management	Inspection

UNDERWRITING CONSIDERATIONS

More often than not a PI policy will account for a significant element of a contractor's total insurance premium spend. It is also highly likely that the policy excess will be the highest of any policy within the contractor's insurance programme.

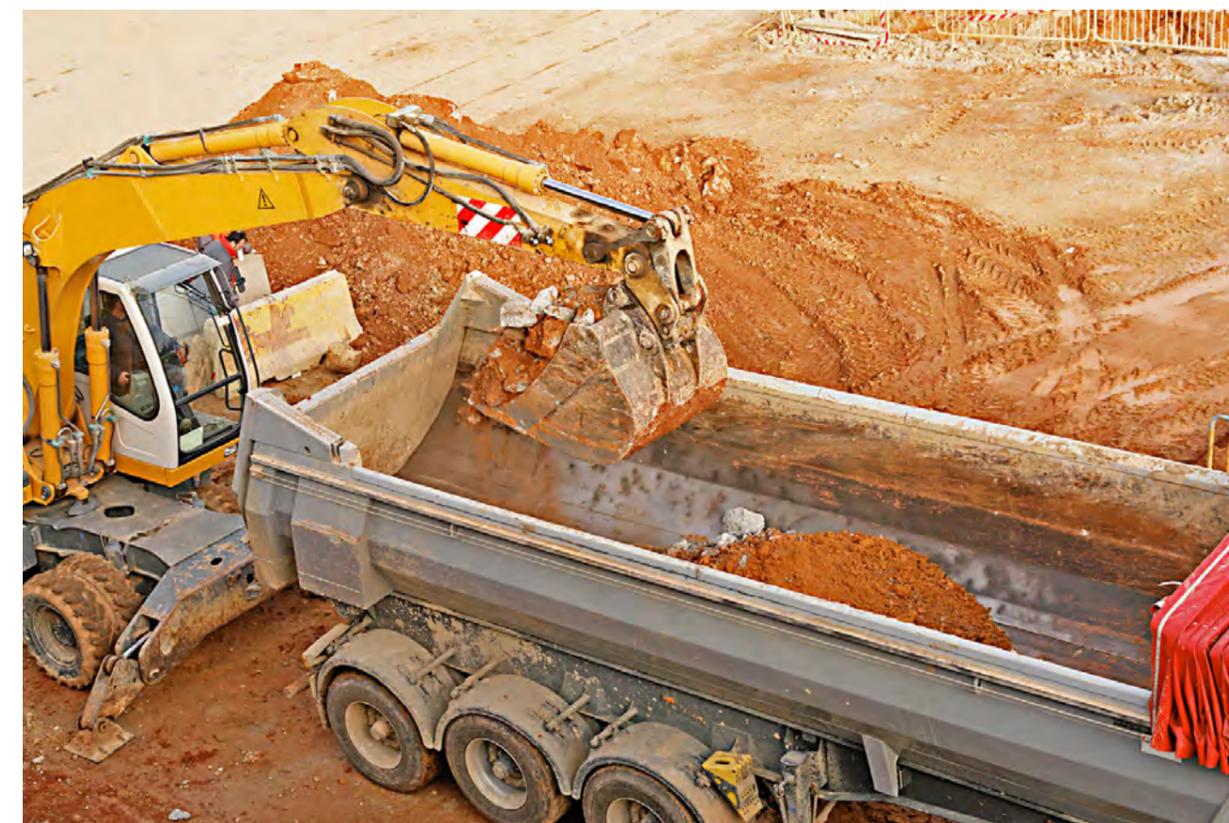
Although insured's can often be left feeling bewildered by this state of affairs, there are several underlying factors why PI insurers view the construction industry a higher risk sector;

1. The low frequency high severity of claims makes it difficult to accurately forecast future claims activity
2. The nature of claims made coverage creates uncertainty of when claims for past actions may be made

3. Parties for whom the insured is vicariously liable often manage to cap their liability thereby limiting insurer's rights of recovery against them
4. Similarly, the insured is often unable to cap its own liability to their Principals
5. PI claims are often complex with final settlement taking many years and defence costs often accounting for more than 50% of the overall claim
6. The commercial nature of the industry often means that indemnities may be agreed to by the insured beyond that of common law

To manage PI premiums insured's should work with their broker to evidence to insurers the procedures they have in place in respect of;

- Commercial contract management (both up and down stream)
- Procurement and control of subcontractors/consultants
- Internal risk management regarding the undertaking of professional service activities
- Expertise of personnel undertaking professional service activities.



TYPES OF POLICY

Annual Policy

In the vast majority of cases, Australian contractors will utilise an annual policy, renewed each year. Based on an unlimited retroactive date, this will cover each liability claim made against the contractor during the 12 month policy period. The annual PI policy is an advantageous approach from both a cost and coverage perspective with many more insurers prepared to offer cover on this basis compared to their project-based counterparts.

Single project (multi-year) policy

Single project policies are becoming increasingly popular with principals and financiers on large public or privately financed projects as they offer guaranteed multi-year coverage (up to 10 years) with a ring fenced policy limit for the specific project. Similarly, contractors increasingly look towards project PI when operating in joint ventures (JV)

with other companies to protect their annual policies from claims made against them due to the professional act error or omission of a JV partner.

Single project policies are also appropriate for projects conducted under alliance contracts, where the stakeholders have a pre-agreed allocation of liabilities and responsibilities under the contract. In this non-adversarial contract arrangement, it is agreed that claims will not be made between the stakeholders and therefore a traditional claims made policy is not effective. Therefore specialised drafting is required to ensure that coverage for first party costs associated with rectifying professional acts errors or omissions is provided.

Single project (annual) policy

Annual single project policies are also available and there are more insurers prepared to write this type of policy than those offering multi-year coverage. However, these are rarely used as costs

are less predictable and, in the event of a claim, the chances of renewal are significantly diminished.

Repercussions of such a breach can range from indemnity only being provided up to the limitation, the claim being invalidated or, depending on the policy wording, void the policy in its entirety.

A limitation of liability extension ensures an Insured's right to claim under its policy will not be prejudiced by contracts entered into by the insured with other parties that limit the other parties' liability.

AVAILABLE COVERAGE

Most PI policies in Australia provide coverage against civil liability that an Insured incurs in respect of claims arising out of an act error or omission of the insured in the performance of their professional services. Coverage for associated defence costs are also included as standard although whether the insurer requires notification prior to such cost being incurred is dependent on the policy wording.

Most PI policies will also cover civil liability an Insured incurs vicariously through the professional services performed by an agent (most commonly a subcontractor or consultant) engaged by the Insured.

Whilst these covers are relatively standard there are several areas of cover that can be provided upon the request by insured's. Although such extensions often have a premium impact, the

additional coverage they provide can be of real value depending on the nature of the Insured's business.

Contractual Liability

Robust commercial negotiations are a fact of life in the construction industry with market factors influencing the ability of each party to negotiate favourable terms. As such the indemnity clauses of contracts are often negotiated with one party accepting liabilities beyond what would normally attach to them under common law. Examples include but are not limited to 1) performance warranties such as fitness for purpose, 2) hold harmless provisions or 3) consequential loss agreements.

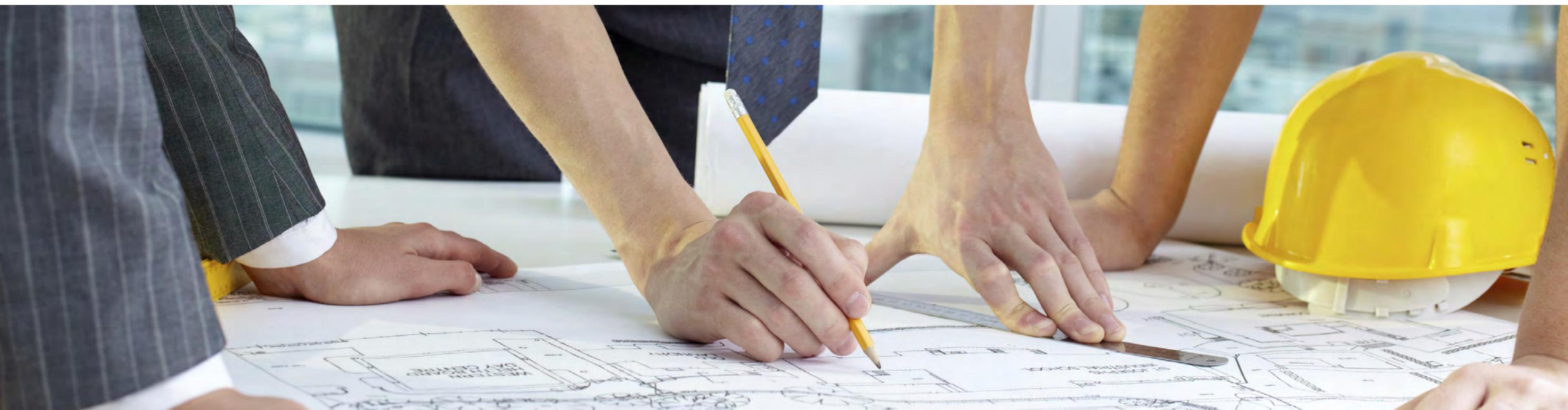
Although a commercial reality, Insured's must be wary of the cover their PI policy will provide. This is because most PI policies have a contractual liability exclusion limiting indemnity to losses that would attach under common law only. A contractual liability extension ensures the insured's liability to pay

under such indemnity or hold harmless term of a contract are covered so long as the liability results from the insured's performance of professional services.

Limitation of Liability Contracts

It is common place for third parties to attempt to limit their liability in contract with Insured's. Examples include limiting liability a) to an agreed insurance limit b) the value of the contract or c) a percentage of the contract value.

Whilst this represents good contractual risk management by the third party, such agreements can have a significant impact on the PI policy of Insured's who engage them. This is because most PI policies contain a condition requiring the Insured not to prejudice its insurer's actual or potential rights of recovery. Therefore, to the extent that a third party caused or contributed to a claim under the Insured's PI policy, acceptance of such limitation of liability agreements in contract breaches this fundamental policy condition.



Loss Mitigation & Rectification

Usually, PI policies only indemnify Insured's for claims made against them by third parties with the policy trigger being a written demand or legal proceedings for compensation being made against the Insured by a third party in the policy period. However, in certain circumstances, an Insured may become aware of an act error or omission having occurred on a project prior to a claim being formally made. Whilst the Insured may find it commercially desirable to rectify the act error or omission immediately, the absence of a third party claim means a normal PI policy would not respond.

A loss mitigation & rectification extension covers the direct costs and expenses incurred by the Insured in taking action to rectify or mitigate the effects of any act error or omission that would otherwise result in a claim covered under the policy.

The notification requirements are equivalent to that of the rest of the policy and Insured's must obtain prior written consent from insurers before incurring any such costs. However, having PI cover which incorporates an element of pre-claim response can allow the Insured to deal quickly and effectively with a matter in its early stages minimising disruption to the project and avoid an adversarial claims scenario with its principal. Early rectification can also result in a reduced payment than would have otherwise been payable to a future third party claimant and minimise legal fees. This can result in a significant saving in overall costs of the claim benefiting both the insurer and the Insured's claims experience.

Novated Contracts

Novation is where the contractual rights and obligations of one party are transferred to another party. Novation is a significant feature in the construction

industry, particularly in relation to design and construct procurement, whereby a principal may novate the appointments of its design consultants to the head contractor. However, it is also common for a party to accept a novation agreement during the purchase or acquisition of a business with the purchaser agreeing to be liable for any breaches of contract of the vendor prior to the novation.

Most PI policies specifically exclude novated contracts. Therefore, in order to be covered for liabilities assumed by reason of a novated contract, Insured's must seek a specific extension to their policy.

However, Insured's should be aware that having a novated contract extension under its PI policy doesn't necessarily mean automatic coverage is provided with many wordings still requiring each novated contract to be declared, pre-approved and separately priced by insurers prior to cover being granted.

Insured's should also be aware that even in the event of acceptance of the novated contract, coverage will still only be subject to the terms and conditions of the Insured's policy. The terms of the contract being novated may contain warranties, indemnities or professional services that may be outside of the scope of the Insured's PI policy.

Multiple Causes of Loss

At common law, the general principal is that where there are two or more proximate causes of loss but one of those causes is excluded, the insurer can deny the claim despite the other cause(s) of loss being covered by the policy. This legal precedent was established in 1974 following the trial of *Wayne Tank & Pump Co Ltd vs Employers Liability Assurance Corp Ltd* and although further cases** have tested its underlying principle; their varying degrees of success/failure have

been determined by the unique facts of the case and the terms and conditions of the relevant PI policy. As such the Wayne Tank Principle remains relevant case law that insured's should be wary of.

How the Wayne Tank Principle is addressed by insurance policies varies between an explicit or tacit exclusion, policy silence or an overt policy extension. JLT suggests Insured's err on the side of caution and get formal confirmation from its insurer that, if there are a number of insured and excluded causes which contribute to a loss, the policy will indemnify the insured for that part of the loss which is insured under the policy

