INSURING THE INTEGRATED TEAM

A paper given to a meeting of the
Society of Construction Law
in Southampton on 21st March 2006

Steve Bamforth

July 2006

D69

INSURING THE INTEGRATED TEAM

Steve Bamforth

Introduction

The construction industry in the UK, and indeed in most common law countries, has for many years been characterised by an adversarial approach and 'risk dumping' by construction clients. The risks inherent to the construction process are turned into contractual liabilities which the members of the design and construction teams then have to insure to the extent that they can, or fund by alternative means (such as for example bonds, lines of credit or their balance sheets if, of course, they are sufficiently strong). Turning risk into liability in this way often achieves neither effective risk management nor effective risk transfer. It is inefficient, acts as a break on team working and actively encourages adversarial attitudes throughout the life of the project and beyond.

The intention of this paper is to:

1. Review the traditional approach to managing and insuring construction risks;
2. Consider the difficulties this approach creates for the insurance industry;
3. Review some of the solutions that have been proposed to date (including arbitration, adjudication and ADR);
4. Discuss how the use of partnering and integrated teams might be the opportunity to create a bright new future for the UK construction and insurance industries.

How might this bright new future work in practice? Well, in my opinion, as an insurance practitioner, the answer must be a move away from the insurance of blame-based liabilities – with all of the problems that go with it – towards a system whereby clients within construction are encouraged to retain, manage and insure more of what ultimately are their own risks. I am not referring to traditional owner-controlled project insurance programmes which are becoming increasingly common. Although such programmes do have marked advantages, they can only be a part of the solution rather than the solution itself; they are a necessary part of the solution but not, of themselves, sufficient. However, more of this later.

I would like to start by reviewing the traditional approach to professional risks within construction.

The traditional approach to professional risks in construction

As stated in the introduction, the traditional approach to risks within construction is to turn these risks into liabilities by way of contract terms. The contractual terms that are used to achieve risk transfer in this way vary considerably, as too have the courts' interpretation of the meaning, intent and impact of these contractual terms.

A number of standard professional agreements and conditions of engagement exist in the UK. Examples include those published by the Association for Consultancy and Engineering, the Royal Institute of British Architects, the Royal Institution of Chartered Surveyors and the NEC3 Professional Services Contract. Invariably standard conditions of engagement of this nature include a duty of care clause which mirrors the common law duty to exercise reasonable skill and care. For example, the ACE Conditions state that: 'The Consulting Engineer will exercise reasonable skill, care and diligence in the provision of the Services.'

However, it is far from unusual for clients, particularly on larger contracts, to use bespoke contracts which impose obligations upon consultants far in excess of the usual common law duty. Examples frequently seen include:

1. Indemnity provisions which can encompass losses which in the absence of an express provision, would not be recoverable at law as they are too remote; would otherwise be reduced by the client's duty to mitigate its loss or the client's contributory negligence; or would not be recoverable because they have not been properly or reasonably incurred;
2. Strict obligations in relation to achieving project completion on time and to cost;
3. Obligations in relation to the fitness for purpose of the end product.

Such contractual liabilities may or may not be covered by the consultant's professional indemnity insurance; emphasising that the client may or may not have effectively transferred the risk in practice if things go wrong.

Further, the varying contractual matrices that surround construction projects often create a fog of confusion and uncertainty, particularly when disputes arise. Confusion and uncertainty of this nature significantly add to the costs associated with dispute resolution, and constitute a waste of resource within the construction process that is ultimately funded by the client – and in the context of public sector projects that equates to society as a whole.

Below are two examples from my personal experience, which are all too typical.

Case Example A – Department for National Heritage v Steensen Varming Mulchay[1]

The dispute related to the construction of the British Library at Euston Station in London, a project which suffered from severe delays and increases in budgeted costs. Steensen Varming Mulchay (SVM) were appointed to provide building services design by the client, the Department for National Heritage (DNH). Substantial damage to electrical cabling occurred during installation and it was alleged that this was caused by unsuitable design of the cabling and trunking system, lack of co-ordination and integration with other services and, finally, lack of supervision.

Proceedings were issued by DNH against SVM in 1996, and the claim was £9.5m. Four experts were appointed by the insurers acting on behalf of SVM to consider design, supervision, construction and quantum. The opinions of counsel were also heavily relied upon. The total defence costs incurred through to trial were in the region of £3m and it is likely that similar costs were incurred by DNH. The trial lasted 15 weeks between January and March 1998. The claim against SVM was dismissed in its entirety and in an unusual move pre-trial costs were awarded to SVM on an indemnity basis.

The client incurred substantial costs in seeking to recover losses which were assumed to have been passed contractually to his consultant only to find in practice that they had not.

Case Example B – Unreported (claim settled out of court)

XYZ consulting engineers were retained as mechanical and electrical consultants in relation to a major development. Significant cost overruns and delays were encountered and loss expense and delay claims were submitted by the client. Allegations were made against XYZ consulting engineers that late production of drawings and inadequate co-ordination were a principal cause of the cost overruns. Lengthy proceedings were commenced and other parties were joined in the action. The matter settled before judgment with the professional indemnity insurers acting for XYZ making a payment to the claimant of £3m. However, by that stage the client had incurred in excess of £4m in bringing the action. The client would therefore have been financially better off had the action not been commenced in the first place.

There are many other examples which demonstrate the difficulties associated with managing and insuring project risk through the medium of contractual liabilities. In summary, the process – and the logic that underpins it – is fundamentally flawed as:

1. The process brings with it a lack of certainty which is not always appreciated. There are many reasons why a client may not recover losses allegedly caused by the negligence of a professional man including:

---

1 *Department for National Heritage v Steensen Varming Mulchay* [1998] EWHC Technology 305 (30th July 1998).

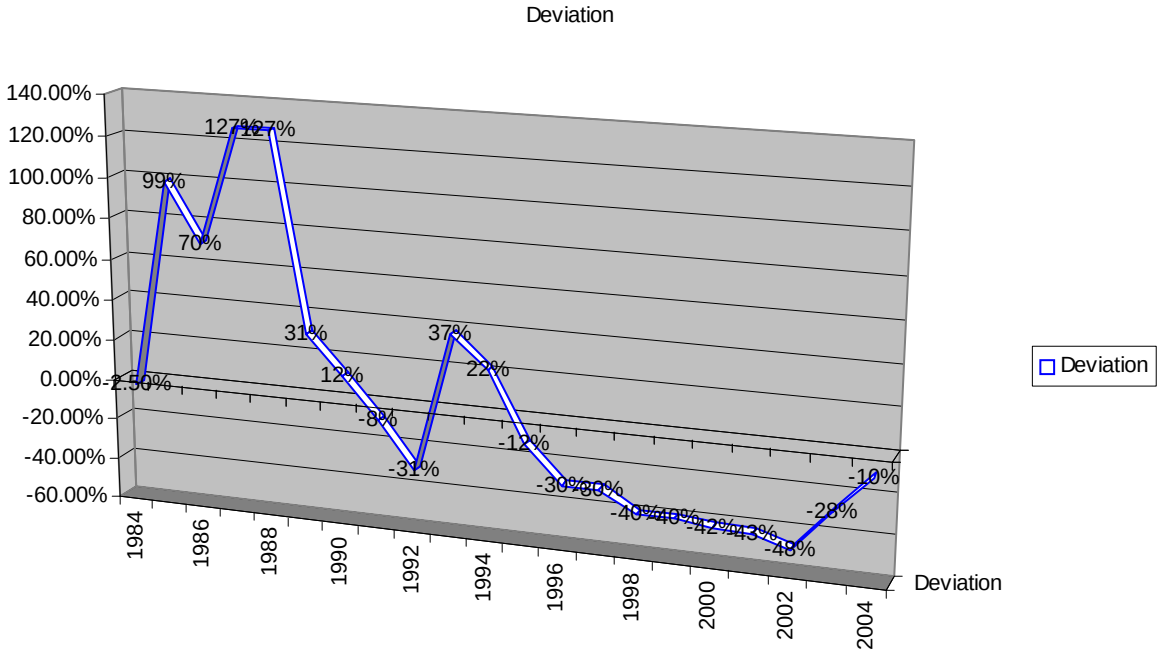
- a failure by the client to prove his case at law – and professional indemnity insurance only responds to proven liabilities;
- insolvency of the consultant involved in the proceedings;
- repudiation of coverage by the consultant's professional indemnity insurers for breach of a policy condition;
- insolvency of the consultant's professional indemnity insurers – the demise of Independent Insurance Company and HIH should be fresh in our minds.

2. A client has only successfully transferred risk when he receives a cheque that does not bounce – and there are many reasons why cheques within construction bounce.
3. The process is also wholly inefficient. It is estimated that in relation to professional indemnity insurance alone, in the round, £5 of legal and forensic costs are incurred for every £1 recovered by way of damages – what a waste!
4. There is often a lack of clarity with responsibility for particular areas of risk being unclear or not being allocated at all.
5. The system has an adverse effect on the inter-relationships between the parties involved in projects. The threat of litigation – whether real or perceived – encourages defensive attitudes and has a corrosive effect on relationships. It acts as a break on team-building and team-working.
6. Insuring risk by way of liability also prevents constructive feed-back; the aim of professional indemnity insurers is to protect the interests of their insureds and not to act as a free information service for the benefit of society as a whole.

Effect on the insurance market

Construction, like many other industries, tends to get the insurance products that it deserves. The effect of an uncertain legal climate allied to an approach to construction that is frequently adversarial is uncertainty and volatility within the insurance market, particularly in relation to professional indemnity insurance. The graph below sets out the mean variation in average insurance rates for consulting engineers in the UK over a 20 year period. The variation would be even more marked if the effect of excess or deductible levels were incorporated – excess levels tend to be much higher during hard market conditions (when insurance capacity is short and premium rates are high) but reduce during periods of softer market conditions (when the converse is true).

The volatility of pricing within the professional indemnity insurance market makes it very difficult for practitioners to plan for the future. As few consultants can fund liability in the absence of insurance, concerns over future insurability can create a climate of defensive design which threatens innovation.



Adversarial construction arrangements within construction cause the insurance market to create insurance products which themselves are adversarial – which only adds to the problem. Construction really does get the insurance products it deserves.

What solutions are available?

The problems associated with the construction industry are not new. Indeed they have existed and been acknowledged as existing for many years, and a number of potential solutions have been put in place. The potential solutions tend to fall into two categories:

1. Those which look to make the process of dispute resolution more certain, timely and cost-effective (but without looking to address the underlying causes of the disputes); and
2. Those which focus on changing the way in which construction projects in the UK are procured, by changing attitudes and cultures and encouraging integrated team working.

In the first category, examples include arbitration (as an alternative to litigation), adjudication, mediation and the Woolf reforms to the civil justice system.

Arbitration

It was hoped that arbitration might overcome the problems associated with litigation in that it would be speedy, cost-effective and private. However, in practice there is very little difference in terms of the timescales associated with hearing cases in arbitration rather than litigation, particularly given the new Civil Procedure Rules for litigation. Equally the costs of the arbitration (the

arbitrator and the venue) have to be paid by the parties, whilst the infrastructure required for litigation is provided by society.

The answer, therefore, to the question as to whether arbitration is to be preferred to litigation is, at, best neutral. Indeed, arbitration and litigation can be seen as two sides of the same adversarial coin. Arbitration has done little to diminish the number of construction disputes (although that, to be fair, was never its intent), rather it provides just one alternative to litigation.

Adjudication

Statutory adjudication[2] differs from arbitration and litigation in a number of ways but in particular that:

- The adjudicator's decision, whilst binding, is not final;
- The adjudicator, once appointed, must reach his decision within twenty eight days – although this can be extended by agreement between the parties;
- Not only is it quick but, as a process, relatively cheap.

The experience of adjudication within the UK has largely centred around disputes over money, and most adjudications have involved contractors and subcontractors. It has been successful in providing, on many occasions, a cheap and cheerful mechanism for certain kinds of construction disputes. However, to date, it has rarely been used in relation to complex disputes involving allegations of professional negligence.

In the round, adjudication appears to have been successful in reducing the costs associated with dispute resolution but nonetheless its prime function is to act as an alternative mechanism for resolving disputes which arise out of adversarial contracts.

Alternative dispute resolution (ADR)

Generally ADR processes (including mediation, conciliation, early neutral evaluation, mini-trials and expert determination) aim to achieve dispute resolution informally without recourse to the formalities of litigation or arbitration. The success rate for mediation is said to be as high as 90% and unlike formal proceedings is likely to minimise any feeling of confrontation and can prevent any further deterioration in the commercial relationship between the parties to the dispute. Where successful it can also be relatively cost effective.

ADR has, therefore, at least to some extent created a non-adversarial mechanism for resolving disputes which arise from adversarial contracts. However, when ADR fails the parties to a dispute can only revert to type and seek resolution through the adversarial dispute resolution mechanisms of litigation, arbitration or adjudication.

2 Introduced by the Housing Grants, Construction and Regeneration Act 1996.

Alternative procurement mechanisms

In order to overcome the problems associated with traditionally procured construction projects, the UK (and elsewhere) has looked to partnering as an alternative mechanism by which projects might be procured. However, what does partnering mean in practice and how might professional risks be better managed, allocated and financed in the context of partnering arrangements? The next section of this paper will seek to answer these questions, which are fundamental if any 'new' way of working within construction is to thrive.

Definition of partnering

Partnering is becoming an increasingly popular mechanism for project delivery within the construction industry world-wide. There are many definitions of partnering and many descriptive titles for the style of contracting that it encompasses – partnering, alliancing, integrated teams etc.

Rather than dwell on the semantics of titles and definitions it is more instructive to look at the key features of projects that operate on a true partnering basis. They include:

- Early stage involvement of the key participants in the project definition and design;
- The creation of an integrated team with each member of the team having clearly defined roles and responsibilities;
- An alignment of the commercial interests of all members of the partnering team;
- Transparency of the costing process;
- Managerial commitment to the partnering concept from all members of the team;
- An equitable contractual relationship and a fair allocation of project risk;
- Increased project certainty and more cost-effective and innovative project solutions.

However, not all partnering projects achieve these goals in practice.

The key aspects of an effective partnering project are the contractual arrangements that surround it; a rational and fair allocation of risk; and a distinction between those members of the partnering team who are best able to manage the risks inherent in the construction process and those best able to finance those risks.

As stated above there is no single definition of partnering. The next section of this paper will, therefore, examine some practical partnering arrangements from relatively simple 'call out' arrangements to contracts that operate on a fully integrated team basis.

Long term alliancing

In its narrowest sense, long term alliancing or partnering can operate simply on the basis of a framework arrangement between a client and a consultant (or contractor) or a panel of consultants. Normally such arrangements are put in place for between three and five years and enable the client to call upon the consultant (or consultants) to provide services according to specified rates. There is usually no obligation on the client to award any work under the framework agreement although the consultants involved, with some exceptions, are obliged to accept any services required by the client and which fall within the scope of the framework agreement.

Framework arrangements fall within the broad definition of partnering in that, at least to some degree, the interests of client and consultant are brought together. At least in theory the consultants involved have a guaranteed flow of work and income, in return for which the client receives better performance, enhanced project delivery and lower cost.

However, many framework arrangements or strategic alliances have at their core traditional adversarial contracts. Project risks are turned into contractual liabilities which consultants (or contractors) are obliged to insure, or fund through other mechanisms, to the extent that they are able so to do.

Adversarial contracts are at odds with the aims and aspirations of partnering and working as integrated teams. Contracts of this nature encourage each party separately to look to maximise the aims and objectives defined in their own contract rather than the wider aims and objectives of the project as a whole. The individual aims of the members of the project team rarely coincide in such circumstances. This can result in conflicts of interest, with the client looking for innovative solutions and best value for money and suppliers in the supply chain looking to provide the minimum level of defined contractual services at the lowest possible cost and, therefore, maximum total profit.

When difficulties arise on contracts let on an adversarial basis the parties involved invariably look to protect their respective positions, which prevents the project team creating solutions to project problems.

Partnering pacts

In a number of areas ancillary partnering contracts have been introduced, sometimes referred to as ‘partnering pacts’. The purpose is to establish agreed patterns of behaviour between members of the project team and they will invariably cover such aspects as:

- A duty to act in good faith;
- An obligation to share information with the project team;
- A definition of the aims of the partnering pact;
- Agreement as to the project aims and objectives;
- In some circumstances confirmation that each member of the team owes a duty of care to every other member of the team.

Such pacts may be expressed to be non binding or legally binding.

An example of the Partnering Charter (or pact) used by a major UK contractor is set out below:

> '**Consultant Partnering Charter**
>
> [The Contractor] and [the Consultant]
>
> have agreed the following key mutual objectives:
>
> - deliver beyond customer expectations;
> - develop an approach to 'Good Design' and the promotion of 'Places to Live';
> - deliver project to time, cost and quality;
> - provision of a value for money service;
> - develop long term relationships and repeat work;
> - a continuous approach to introducing innovation;
> - effective communication.
>
> Signed: …… Contractor
>
> Signed: ……. Consultant.'

In addition to this Partnering Charter, a number of protocols are put in place in order to achieve the objectives. These are intended to guide the parties towards continuous improvement in their relationships.

The NEC suite of contracts also includes a Partnering Option and detailed guidance is provided as to how it should be used in practice.

Partnering pacts have, in limited ways, had a positive effect in allowing project teams to manage relatively low level disputes quickly and cost effectively. However, as soon as the financial implications of any project-related problems start to escalate, the parties involved tend to reach for their traditional adversarial contracts. Consultants working on projects to which partnering pacts attach are still obliged to carry professional liability insurance which brings with it the difficulties set out above.

Courts in a number of jurisdictions are struggling to interpret roles, responsibilities and liabilities in relation to projects that have encountered significant financial difficulties and on which conflicts exist between the terms of both non-binding and legally-binding partnering pacts and underlying adversarial contracts.

Holistic partnering

If partnering is to work in its wider sense a more holistic approach needs to be taken, centered on a co-alignment of the strategic, financial and cultural interests of all project team members. This can be achieved by putting in

place mechanisms by which the team as a whole enjoy financial benefits if the project is delivered successfully but equally the team bear a degree of financial pain if the project is not delivered on time and to budget. If this pain/gain share structure is made to operate according to a pre-agreed formula irrespective of blame, and the project is sourced and costed through open-book accounting, the commercial and financial interests of all of the team – including the client – will be co-aligned throughout the course of the project and beyond.

An approach such as this has been successfully adopted on projects such as Terminal 5 at London Heathrow and the Sydney Waste Water Project.

However, a holistic approach to partnering as a mechanism for project delivery is not without its difficulties, in that radical new forms of contract and an equally radical approach to the financing of project risk are required. The first concern is less problematic as a number of multi-party, blame-free partnering contracts are already in existence.

The issue of funding project losses in a blame-free environment is more difficult. An allocation of project financial loss irrespective of 'liability', according to a pre-agreed formula and up to a specified financial ceiling is a laudable objective. However, each party to the loss-bearing formula must be able to fund their proportion of any loss. Allocation of loss to a party unable to fund that loss achieves neither effective risk transfer nor effective risk management. It is important, therefore, that the loss-sharing mechanism be subject to an upper limit, particularly as consultants' professional liability insurance arrangements are unlikely to respond to losses which are not linked to liability or blame.

In theory, the balance of risk over and above the pain-share ceiling reverts to the client. In practice, it would be preferable if this balance of risk were to be transferred to the risk-bearing partner in the partnering team – a professional risk taker or insurer. The insurance market should be encouraged to introduce new products to match the new and evolving methods of procurement within construction.

Single Project Financial Loss Insurance

What exactly am I proposing in practice? In effect, a multi-party partnering arrangement based on the principle that:

1. Except in certain circumstances, the parties to a construction contract agree to waive their rights to sue; but
2. All parties to the project – including to a significant degree the client – agree to share loss according to a pre-agreed formula but up to a maximum ceiling; and
3. Beyond that ceiling, the balance of risk rests in theory with the client but in practice is transferred to a professional risk-bearer: an insurance company.

If the maximum ceiling is set at a sensible level, each team member would bear a degree of pain in the event that a project suffered financial loss, but not to the extent that they are put out of business. Ideally, for example, the consultants involved would bear risk no higher than their normal professional indemnity insurance excess.

How would this work in practice? Take a project which has been properly costed as being capable of construction to a total cost of £10m. The design is locked down and agreed mechanisms are in place to calculate the effects of any client changes. The level of 'pain' to be borne by the project team – including the client – is set at, say, 5% of project value. Above that level of pain the balance of risk is transferred to the risk-bearing partner in the partnering team. An audit by insurers of the project concept, its partners and its finances would be required but this should be seen as having a positive part to play in managing risk.

And how would such an approach to the insurance of risk differ from what is currently available? As mentioned earlier, owner-controlled project insurance is becoming if not increasingly popular then, certainly, increasingly common. What do these policies cover? Essentially, they are aimed at:

1. Physical damage to the works during construction by perils such as storm, flood etc and any financial losses that might flow from such damage (eg loss of rent, additional financing costs etc);
2. Liabilities owed to third parties external to the project.

Insurance arrangements of this nature are, as I say, becoming increasingly common as they incorporate a number of benefits to construction clients. These include greater certainty and control over the insurance arrangements for projects and fewer disputes as to who is responsible for (and, therefore, whose insurances respond) when damage does occur.

However, even with these more traditional insurance arrangements there are issues. First, damage caused by defective design or poor workmanship is usually excluded; and even where cover is provided subrogation rights are retained against the negligent consultant or contractor. Secondly, there is no cover at all for pure financial losses in circumstances where there is loss but no damage (for example cost overruns).

It is here that the new concept that I propose would step into the gap. In addition to the cover ordinarily provided by material damage project-based insurance, an additional policy section focused on pure financial losses would be included. The financial loss extension would be subject to a significant deductible but one that is linked to the pain-sharing arrangement referred to earlier – and the cap or ceiling to that arrangement.

A name for the new insurance product? I propose 'Single Project Financial Loss Insurance'. Hardly imaginative, I accept, but it is an accurate description of what I am talking about. Could it work? Why not? The insurance market is showing interest in the concept. But will construction clients be similarly brave?

There are encouraging signs and government, through the Office of Government Commerce and the various spending departments, are keen to trial the concept on a series of demonstration projects. This is not because they are passionate about insurance but because some of the key players are passionate about the strategic advantages of integration and recognise that for integration to work a new approach to insurance is also required.

Will it work? Only time will tell. But even if it does, will the concept be attractive to clients in the private sector?

Conclusion

In conclusion, clients within the construction industry should ask themselves two key questions:

- Can partnering and integrated teams really work in the shadow of litigation or potential litigation?
- Have liability and litigation created the cohesiveness between client and the construction team that is so essential to efficient project delivery?

In many cases the answer to those questions is resoundingly 'no'. Indeed, the financial mismanagement of the risks inherent in the construction process has frequently increased the cost of those risks considerably.

Steve Bamforth is senior partner of Griffiths & Armour, insurance brokers.

'The object of the Society
is to promote the study and understanding of
construction law amongst all those involved
in the construction industry'

MEMBERSHIP/ADMINISTRATION ENQUIRIES
Jackie Morris
67 Newbury Street
Wantage, Oxon OX12 8DJ
Tel: 01235 770606
Fax: 01235 770580
E-mail: admin@scl.org.uk

Website: www.scl.org.uk