

Construction focus: Professional indemnity insurance

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Everyone practising or operating in the construction sector over the last few years will be aware of the hardening of the professional indemnity insurance market. With the Royal Institute of British Architects recently having updated its practice notes on professional indemnity insurance, here we explore implications for development and construction.

The principles

In simple terms, professional indemnity (PI) insurance is an insurance product which is designed to provide coverage for an insured party against civil liability arising as a result of a negligent act or omission. In the construction industry, PI cover is often maintained by contractors, consultants and sub-contractors in respect of their liabilities arising from breach of a contractual duty or negligence associated with their business, such as a failure to use the appropriate level of skill and care in the undertaking design or the performance of services.

Many professional bodies such as the Royal Institution of Chartered Surveyors (RICS) and the Royal Institute of British Architects (RIBA) require their members to maintain professional indemnity insurance. For example, rule 9 of the RICS Rules of Conduct for Firms requires that:

... a firm shall ensure that all previous and current professional work is covered by adequate and appropriate professional indemnity cover that meets the standards approved by the Standards and Regulation Board.

The RICS goes on to stipulate minimum levels of cover and the basis on which cover must be maintained by its members.

Why is it so important for construction professionals to maintain PI insurance? Simply put,

PI cover provides protection to the relevant professional against a claim by a third party (eg its developer-client, or another party to whom it owes a tortious or contractual duty) which it could not otherwise meet from its assets. PI cover also provides important protection for the developer-client or third party, who will have the reassurance that there is an insurance policy which may be available to respond in respect of any loss or damage it suffers in the event of professional negligence on the part of the relevant professional. However, it is important to note that PI cover is not a universal solution. Crucially, PI cover will not respond in respect of losses arising from poor workmanship, nor does it provide cover for an insured's insolvency.

Professional indemnity insurance is generally written on what is known as a 'claims made' basis. This means that the policy will typically respond to a claim made during the requisite policy period, even where the act or omission which has given rise to the claim occurred before the policy was placed (subject to the inclusion of what is known as a 'retroactive date', which is the date from which coverage is afforded).

Why is professional indemnity insurance the subject of so much discussion?

As most construction practitioners and those involved in the delivery of construction projects will know, the level and basis of professional indemnity insurance to be maintained by a construction professional is always a point of contention. However, in the last couple of years, discussions regarding the basis of available cover, applicable policy limits and exclusions seem to be taking up more time than ever - a fact which has recently been acknowledged by RIBA.

In August 2021, RIBA published a new practice note and best practice guidance regarding the availability of professional indemnity insurance to its members. According to RIBA, renewing PI cover has become increasingly challenging for architects over the past few years.

However, the problems highlighted by RIBA are not limited to architects: most firms in the construction sector (whether they are contractors, consultants and specialist sub-contractors) have been affected by the rising cost of insurance premiums, increasing excesses, an inability to renew coverage at the same level or basis as they have historically, and/or insurers seeking to include policy exclusions or limitations which can impact the type of work firms are insured to undertake. Insureds are also reporting an increase in the amount of information which is being requested on policy renewals and delays in the processing of renewals and new applications.

Why has the PI market hardened?

Brokers and lawyers often talk about the 'hardening' of the insurance market in recent years. Various market factors have contributed to a lack of appetite by insurers and the withdrawal of some insurers from the market altogether. But what are some of the factors behind this?

1. The Grenfell Tower fire and the scrutiny to which the construction industry has been subjected: the Grenfell tragedy, the failings identified by the ongoing inquiry and subsequent fires at similar 'high-risk' buildings have all shone an uncomfortable spotlight on the construction industry and those involved in the manufacture, design and construction of products and buildings. In many cases, insurers will have direct experience of the significant number of notifications made against PI policies for claims associated with non-compliance with Building Regulations and other fire safety issues. The continued uncertainty generated by the ongoing inquiry, litigation and the introduction of new legislation, has all contributed to nervousness on the part of insurers.

2. Poor performance: in 2018, Lloyd's of London identified that the non-US PI market was one of its weakest-performing areas. Driven by the cost of claims being far in excess of premiums paid, many syndicates withdrew from the market or decreased levels of underwriting.

3. Brexit and Covid-19: like all businesses, the insurance market has undoubtedly been affected by the uncertainty created by both Brexit and Covid-19. For the construction industry generally, market conditions continue to be uncertain and volatile.

What effects has the hardening of the market had on the construction sector specifically?

The hardening of the market has undoubtedly made it more difficult and/or costly for professionals to seek PI insurance on the same terms as they received at previous renewals. Where insurers are prepared to make PI cover available to construction professionals, the fact that cover is brokered on a 'claims made' basis has meant that insurers have increasingly sought to protect themselves against the prospect of claims related to fire safety and cladding matters. In practical terms, this has led to the introduction of limitations, and in some cases, complete exclusions of liability for certain types of cover related to cladding products, the specification of certain materials or systems, and fire safety matters.

Tellingly, RIBA refers in its guidance note to a cross-sector survey undertaken by the Construction Leadership Council ('CLC') in early 2021, in which the CLC noted a 'widespread incidence' of construction practices having to alter the kinds of work they undertake, or lose work, because of the conditions and limitations imposed by insurers. The survey also revealed that over 60% of survey respondents (which numbered over 1000) had some kind of restriction on their cover related to cladding or fire safety and that one in three respondents' PI policies contained a complete exclusion on liability for cladding claims.

Similarly, cover which was once readily available on an 'each and every claim' basis is becoming increasingly harder to source, with some contractors only being offered aggregate cover, or cover with limited reinstatements.

Construction lawyers who act for developers or construction professionals will be well-used to having discussions at the outset of a project with their clients, project managers and members of the proposed professional team regarding the level and basis of professional indemnity insurance which might reasonably be required to safeguard the parties' interests

on any given development.

However, conversations which used to centre around the appropriate level and basis of cover are now being widened to include discussions about whether professionals are able to undertake certain kinds of work at all, or whether their liability will need to be limited in some way as a result of their insurer's demands and the terms of their policy. Clearly it is neither in an insured's interests to undertake work for which it does not have appropriate PI cover, nor is it in a third party's interests to accept that the work is uninsured.

The uncertainty generated by the hard market has also made it increasingly more difficult for real estate and construction lawyers to agree parameters for PI insurance at an early stage of a development deal. For example, it is common in an agreement for lease or funding arrangement for a tenant or a fund to stipulate the minimum levels of insurance cover that a contractor and professional team will be required to maintain, and to agree the parameters for any acceptable caps or other limits on the liability of the contractor and professional team. These discussions often happen months or even years ahead of contractors and consultants being selected or the development even commencing. What used to be a fairly easy negotiation based on a stable insurance market and set of commercial expectations, is now made much more complex by the ever-changing insurance market. What might be available in the market at the time that a real estate document is negotiated may not be available in nine months' time when the developer comes to appoint his team. For that reason, it is fundamental that the parties build appropriate flexibility into real estate documents to discuss these requirements again down the line if market conditions change for better or worse.

Unfortunately, these challenges do not cease once the developer is in contract with its contractor and professional team. We have numerous examples in practice of developer-clients finding out that its contractor and professionals are no longer able to maintain the PI insurance which they had at the outset of the project.

What happens if the contractor/consultant cannot renew PI cover on the agreed basis?

The suite of construction contracts often used for UK-based development work is the Joint Contracts Tribunal (JCT) suite. Where a contractor has design responsibility for works, the JCT includes provisions dealing with the requirement to maintain professional indemnity insurance. For example, clause 6.15 of the JCT Design and Build Contract 2016 confirms that:

- the contractor is required to take out (if he doesn't already maintain) a PI policy with the limit of indemnity stipulated within the Contract Particulars. The parties will agree an appropriate level and basis of cover and any applicable sub-limits, eg for pollution and contamination, and set these out within the Contract Particulars;
- thereafter, provided it is available at 'commercially reasonable rates', the contractor is required to maintain insurance until the expiry of the period stipulated within the Contract Particulars. Typically, this is 6 or 12 years from practical completion depending on whether the contract is signed under hand or as a deed; and
- the contractor must provide evidence upon request by the employer that coverage is being maintained.

Clause 6.16 of the JCT confirms that if the cover referred to in clause 6.15 ceases to be available at commercially reasonable rates, the contractor must immediately give notice to the employer so that the parties can discuss the best means of protecting their respective positions in the absence of such insurance.

Other forms of building contract, consultant appointments and collateral warranties or third-party rights will usually contain similar provisions to those set out in the JCT.

What happens when a contractor or consultant notifies its client or the beneficiary of a warranty or third-party rights that they are no longer able to maintain cover on the agreed terms?

Until 18 months ago, this happened rarely, but has become more prevalent as contractors and consultants seek to renew what was previously readily available PI cover.

As the JCT suggests, the parties should have a discussion at the earliest possible opportunity, ideally before the contractor/consultant has renewed its policy on terms which the client/third party might be unhappy with. The parties should be prepared to discuss:

- the level and basis of cover which is still available to the professional and whether this will suffice to protect the parties in respect of the particular project;
- whether the cover required to be maintained is no longer available to any professional of that discipline (irrespective of claims history) or whether the cover is available, but at a premium the professional considers to be unreasonable;
- any factors affecting the insurance renewal – has the contractor or consultant made a significant claim on the policy in recent years which is driving up premiums or causing the terms of the insurance to be more restrictive?; and
- is the insurer seeking to include any exclusions or limitations which cause a particular concern, bearing in mind the nature of the works being undertaken? For example, is the professional no longer insured to undertake work which is envisaged, or does the insurer require exclusions or limitations which might mean that the relevant contract or appointment is not viewed as institutional?

Ultimately, the parties will then need to reach a sensible compromise position having regard to the insurance which is available and the associated premium. It might be that developers or third parties have to agree to contribute towards a premium to get the benefit of the cover they want, or agree a lower level of PI cover for a period of time – perhaps with a view to reviewing the position again at the next insurance renewal in case more favourable terms become available when the market softens.

In the background, there are other considerations that developers and third parties should have in mind when considering how best to safeguard their interests:

- Developers or third parties should perform regular ‘health checks’ on those involved in a construction project, including checking that the requisite PI cover is actually being maintained (which can be done by requesting a broker’s certificate) and by periodically checking each company’s financial health.

- In addition to the protections afforded by the relevant professional, has the developer or other third party got an appropriate package of protections in respect of defective performance? It is often the case that a defect can be attributed to more than one member of the professional team, each of whom is likely to have a PI policy where it carries out design or services. Where the developer or third party has the benefit of a full package of protections (in the form of warranties, third-party rights or guarantees, many of which will be backed up by PI policies), they may have options in terms of who to pursue when things go wrong.
- Are there any other protections the developer can put in place to safeguard against defective performance? For example, does a contractor have a parent company with sufficient insurance and assets to make a parent company guarantee worthwhile? Is the contractor able to procure a performance bond from a third-party bondsman or insurance company to protect against breaches of contract during construction?
- Developers may also wish to explore other means of insurance, such as latent defects insurance policies, which can provide protection against defects.

Advice for those seeking to take out or renew professional indemnity insurance

Conversely, what can professionals do to protect themselves as much as possible when seeking to take out or renew insurance cover?

- Professionals should commence the process of obtaining or renewing cover as early as possible and ensure that their broker has access to a sufficient pool of insurers to find competitive coverage.
- Professionals should budget for insurance premiums to increase/excesses to be larger, whilst the market remains hard.
- As always, insureds should read and understand:
 - the terms of the insurance policy to understand what coverage is afforded and any applicable limits or exclusions; and
 - the terms on which they are appointed by clients, to ensure that they do not inadvertently prejudice their coverage by extending their prospective liability beyond that for which they are indemnified. Likewise, insureds should understand their contractual obligations upon an insurance renewal, eg any obligations to notify parties of an inability to procure cover at an agreed level or basis. It is particularly important to remember that these notification obligations may subsist for up to 12 years following completion of a development.
- Keep good records of any claims history, as well as the projects on which the professional has worked and is working – particularly high-rise residential buildings, as insurers are likely to request a significant amount of information to assess the potential likelihood of claims.
- Notify insurers of a potential claim immediately, to safeguard against insurers refusing to pay out.

Conclusion

The hardened PI market is affecting everyone in the construction industry. Doubtless the market will soften again in time, but for now, whether it be a lack of available insurers, high premiums or restrictive policy terms, both insureds and their clients face a difficult time ahead.

Citation reference:

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