INTERNATIONAL MARINE CLAIMS CONFERENCE

DUBLIN, 26th OCTOBER 2005

BUILDERS' RISKS - PROPOSED CHANGES

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Delegates will be aware that the London Joint Hull Committee is considering changes to the Institute Clauses for Builders' Risks (01/06/88). I have been asked to explain the changes proposed to the clauses and the reasons behind these changes.

1 Introduction

(a) At the risk of stating the obvious, builders' risks cover is purchased by yards and sometimes by owners – usually in cases of conversion. They form an important part of the contractual matrix in any construction project and most construction contracts will require the yard to purchase cover on terms equivalent to the 1988 clauses.

(b) The clauses date back to 1963, were amended in 1972 and again in 1988. The proposed revision, which I shall come to shortly, will be significantly more extensive than those undertaken in 1972 and 1988.

2 What has prompted change?

(a) Before looking briefly at those clauses, many have asked why the change.

(b) Builders' risks took centre stage at the Singapore IUMI conference in October 2004. This followed a horrendous run of losses between October 2002 and January 2004. Notable amongst these was the "DIAMOND PRINCESS" (US$ 310 million), the "WESTERDAM" (US$ 75 million), Typhoon Maemi (US$ 50 million) and more recently the "PRIDE OF AMERICA" (US$ 228 million). It is estimated that the premium for builders' risks for the period October 2002 until January 2004 was US$ 125 million against losses in the same period totalling nearly US$ 740 million – a loss of more than US$ 600 million.

(c) More recently there has been a very substantial claim by the French yard, Chantiers De L'Atlantique relating to adhesion problems between various layers of insulation in the cargo tanks of an LNG carrier. And, of course, a number of yards on the Gulf Coast have been suffered significant damage through Hurricanes Katrina and Rita. Some reports put the figure at US$ 250 million (to include damage to projects and yard property and equipment).

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[1] These comments are personal and are not made on behalf of the Joint Hull Committee considering the new Builders' Risks clauses

(d) The market response has included rating reviews, pre risk surveys such as JH143 and quality issues generally.

(e) The 1988 clauses have also been the subject of scrutiny and a number of concerns have been expressed about certain aspects of those clauses. The review is also driven by the need for clarity and contract certainty and also to introduce a degree of flexibility in the extent of the cover to be provided.

3 A short history

(a) As noted above, the 1988 clauses draw heavily on their predecessors. Interestingly, neither the 1963 nor the 1972 forms contains an express sue and labour provision, no doubt because in those times, the insurance was written on the SG form.

(b) The 1963 and 1972 clauses provided cover against all risks of:

> *"loss of or damage to the subject matter insured including the cost of repairing, replacing or renewing any defective part condemned solely in consequence of the discovery therein during the period of this insurance of a latent defect*".

(c) A number of amendments were made in 1972:

- **(i)** Clarification that the insurance terminated *"upon delivery to Owners"* – no doubt to ensure that the policy did not pick up guarantee type liabilities or claims.

- **(ii)** The inclusion of a new valuation provision (taken from the Institute Full Value Clauses), providing for an automatic escalation in the insured value, subject to a pre-determined percentage limit. This automatic increase does not apply to a *"material alteration in the plans or fittings of the vessel or a change in type from that originally contemplated"*, which requires specific agreement from Underwriters.

- **(iii)** A new exclusion was introduced in clause 6: *"Notwithstanding anything to the contrary which may be contained in the Policy or the clauses attached thereto, this insurance includes loss of or damage to the subject matter insured arising from faulty design of any part or parts thereof but in no case shall this insurance extend to cover the cost or expense of repairing, modifying, replacing or renewing such part or parts, nor any cost or expense incurred by reason of betterment or alteration in design."* The clause draws a distinction between the damage done by the fault in design and the fault itself. No doubt, this was introduced to address concerns about inadvertently covering straight research and development costs as the construction of ships became more sophisticated.

(d) The main amendments made in 1988 were:

(i) The amendment to the perils clause such that loss and damage have to be "*caused and discovered*" during the policy period. The plain intention was to reinforce the point that cover comes to an end on delivery to owners. The cover does not respond to damage first found post delivery. This is so even if that damage can be referred back to the construction period. Again, the guarantee risk is not covered under the builders' risk clauses and other insurances are available to cover that.

(ii) A new exclusion, added to the end of the principal insuring clause: "*In no case shall this insurance cover the cost of renewing faulty welds*".

(iii) The earthquake and volcanic eruption exclusion was amended – the old clause provided "*warranted free of claim arising from earthquake or volcanic eruption, or tidal wave arising therefrom*". The 1988 clause excludes loss and damage caused by earthquake and volcanic eruption. The potential significance of this particular amendment was graphically demonstrated by the tragic events on Boxing Day of last year.

4 The process of change

(a) A sub-committee to the Joint Hull Committee is reviewing the clauses. The sub-committee consists of Marine Claims Adjusters, Underwriters, Brokers and the current Chairman of the Association of Average Adjusters.

(b) The initial intention was to give the 1988 clauses a face-lift and to address some of the more unsatisfactory aspects. However, we have moved into the realms of a re-write. It was felt that amendments would not be sufficient to introduce the level of clarity desired by Underwriters and Assureds alike.

(c) Given both the insurance and contractual significance of the clauses, it is intended to release a consultation draft later this year and, following a longish consultation period, to finalise the clauses in April or May of next year.

5 The unsatisfactory aspects of the 1988 clauses

(a) The particular areas initially thought necessary for review were:

(i) The first page of the 1988 clauses identifying provisional values for hull and machinery. This is, I am told, rarely, if ever, completed.

(ii) The identity of the assured – whether yard or owner - particularly given the tendency for "and/or" and "and/or" definitions of the assured found in slips.

(iii) The uncertainty in the perils clause whether simple discovery of a latent defect is sufficient to trigger cover where that latent defect has not caused other damage.

(iv) The latent defect cover also sits uncomfortably with the faulty design provision. On the one hand, cover is given for the cost of repairing or replacing any defective part (probably only where other damage is caused) in clause 5, whereas clause 8 excludes the cost of repairing or replacing any defectively designed part. A defect can still qualify as a latent defect even if it is defective by reason of its design.

(v) The constructive total loss provision is the same as that found in ITC-Hulls (01/10/83). This has limited application in the context of a construction project. Only at or close to the end of a project is the cost of recovery and repair likely to exceed the insured value, which is generally the anticipated value of the project as a whole.

(vi) The unrepaired damage provisions – again not entirely appropriate to an ongoing project, particularly the assessment of the measure of indemnity by reference to depreciation in market value.

(b) The new clauses will address these points and a number of others which I shall come to.

6 The authorities

(a) In recent times, there have been surprisingly few cases concerning the 1988 clauses. This is a testament to those involved in the process and possibly a natural consequence of the breadth of an all risks form.

(b) However, there have been two notable cases, which raise issues that the committee intends to address in the new clauses.

(c) The first case is **The State of Netherlands v Youell**[2]. This was a case on assumed facts concerning the de-bonding of paint applied by a Dutch yard to submarines being constructed for the Dutch Navy.

(d) On those assumed facts, the yard had failed to prevent excessive thickness in the primer coating and this is something which the Navy had properly drawn to the attention of the yard. The yard refused to carry out repairs without prior payment by the Navy. Eventually, the Navy paid certain costs and sought to recover those costs from Underwriters.

(e) The contract between the yard and the Navy required that both should be insured under the builders all risks insurance. Underwriters defended the claim based on the failings by the yard and sought to visit those failings on the Navy.

(f) However, the Court held that the builders all risk insurance was composite, rather than joint, such that a failure by the yard would not prejudice cover in favour of the Navy. Underwriters argued in the alternative that the yard were

[2] [1997] 2 Lloyd's Rep 440 and [1998] 1 Lloyd's Rep 236

the Navy's agents for the purposes of the statutory and contractual duty to sue and labour – however this argument failed.

(g) The case settled following the Court of Appeal decision, which was unfortunate, in that the Court did not determine whether the de-bonding of paint could amount to "damage".

(h) More recently the Commercial Court was asked to consider a CAR policy based in part upon the 1988 clauses in **Shell UK v CLM Engineering**[3].

(i) This was a decision on preliminary issues on the basis of agreed facts. Central to the case was whether the breakdown of insulating gel in oil and gas flowlines contained in sub-sea carrier pipes amounted to damage. The bespoke wording in that case was based on the 1988 clauses, but contained a further provision that the assured contended provided cover for *"pure economic loss"*.

(j) If the assured was right, this would dispense with the issue of whether the breakdown of the gel in the flowlines amounted to damage or not. The Commercial Court held that the assured could not recover for pure economic loss, and the case settled following that decision. Once more, the Court did not decide whether the breakdown of gel amounted to "*damage*".

7 Form of the new wording

(a) The new wording will take the form of 6 sections. It will remain as an all risks wording with a number of exclusions and optional clauses to extend cover.

(b) There will be a set of general provisions including definitions, provisions concerning the payment of premium, a due diligence provision, definition of the measure of indemnity in cases of partial or total loss, a revised CTL provision and provisions concerning subrogation and recoveries.

(c) Section A will contain the principal insuring conditions providing all risks cover subject to certain exclusions. Section B will contain the liability cover based upon the current P&I wording and to include collision liability.

(d) Section C will contain war risks cover which will be effective from launch, albeit subject to a 7 day termination provision in the usual way. Section D will contain the strikes, terrorist, political motive and malicious acts cover and this will be effective from inception (rather than launch). Section E will contain optional buy backs in respect of the exclusions in section A.

8 Some of the new provisions in more detail

Assureds, "other" assureds and subrogation

[3] [2000] 1 Lloyd's Rep 612

(a) It is not uncommon for the assured to be defined on the slip as including affiliates, contractors, sub-contractors and those for whom the principal assured may receive instructions to insure.

(b) Frequently, the construction contract will require the yard to take out insurance in its own name and in the name of the buyer. Sub-contracts may also provide that sub-contractors have the benefit of cover or may be required to take out their own liability cover.

(c) As Colman J recently held in the context of an offshore construction policy in **BP Exploration v Kvaerner**[4], it is not generally sufficient for an unidentified *"other assured"* to have the benefit of cover by virtue of a wide *"other assured"* definition. Rather, the insured operator "*must have assumed a contractual obligation to such contractor to procure the benefit of cover for him*". The scope of the cover to the other assured is reflected by the intentions of the parties as set out in the sub-contract.

(d) The new clauses will seek to reflect the commercial reality of the contracts and sub-contracts, such that the principal assured is the yard or buyer as applicable and contractors will qualify as "*other assureds*" where:

(i) They have written contracts with the principal assured.

(ii) Those written contracts provide for contractors to have the benefit of cover.

(e) Cover to sub-contractors will be no wider than provided for in that written contract and the contractor will have no greater rights under the insurance than the assured.

(f) The identity of the assured is closely tied in with the question of subrogation. A waiver of subrogation will be granted, to the extent provided for in the written sub-contract. This reflects the obvious position that if the sub-contract provides that the yard will not sue the sub-contractor, then there are no valuable subrogation rights which Underwriters can acquire, in any event.

(g) Equally, where the sub-contractor is required to take out liability cover, the clauses will seek to provide that Underwriters may subrogate against the sub-contractor, to the extent of the liability cover.

Due diligence

(h) A due diligence proviso will be introduced into the new clauses. This will address due diligence by the assured in the choice of subcontractors (whether retained under written contract or not).

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[4] [2005] 1 Lloyd's Rep 305

(i) It will impose on all assureds a duty to exercise due diligence in the conduct of operations under the insurance. This test will likely be objective. Breach of the duty will mean that Underwriters are not liable for loss, damage, liability or expense attributable to such breach. There will, therefore, need to be a positive causal connection between the breach of the duty and resultant loss.

Works Value/CTL

(j) The sum insured will be set out in the slip and will be capable of "escalation". However, the escalation will be limited to 10% (unless otherwise agreed) and will apply if and when the "Works Value" exceeds the sum insured.

(k) The Works Value will comprise: labour cost, material cost and contractor cost (where not duplicated in labour or material cost) spent by the assured, plus an agreed percentage uplift by way of overhead.

(l) The Works Value will of course increase as the project advances. As mentioned above, the present CTL provision is not appropriate to a vessel under construction, given that the cost of repairs is unlikely to exceed the final contract value, until very late in the project. In the absence of an actual total loss, the only option under the 1988 clauses is to repair or claim by way of unrepaired damage. This does not reflect the commercial reality that the parties may wish to abandon a construction project at an early stage in the event of significant damage.

(m) It had been intended to amend the CTL provision such that it mirrored the basic provisions of the standard form building contracts. In other words, if in a given set of circumstances, the yard was relieved of its obligations to build, then the insurance would respond by payment of a total loss (assuming obviously that the loss was covered). The measure of indemnity in respect of a total loss would not be the "sum insured", but rather a sum reflecting the money spent at the time of loss.

(n) However, the standard Japan and European forms of building contract both provide that the builder's obligation to build may come to an end if the vessel is *"determined"* or "*deemed to be*" a total loss (which includes constructive total loss). In the case of the Japan form, there is an option for the parties to agree to apply the proceeds to reconstruction with a delay in the delivery date, or for the contract to be treated as at an end, once necessary refunds have been made to the buyer.

(o) The question under the standard form building contract whether the builder is relieved of the obligation to build is determined by the insurance. As a result, it is proposed that a constructive total loss is triggered where, at the time of loss, the cost of repair exceeds the "Works Value" – being the value of labour, material and contractor cost spent by the yard.

The principal insuring clause

(p) The cover remains against "all risks".

(q) The cover will be stated as providing cover against all risks of "*physical loss and physical damage*". Whilst the definition of *"damage"* under English insurance law is not absolutely clear, at the very least it probably requires a *"physical change in state or condition leading to a loss of value or usefulness*". I will not explore further[5], save to say two things:

(i) Whilst it may not be necessary under English law to describe damage as "*physical damage*", this reinforces that Underwriters are providing cover in respect of physical damage and not pure economic loss. *"Physical damage"* is generally found in offshore construction policies.

(ii) There is authority in Australia which suggests that simple "*loss of usefulness*" may amount to damage, whereas it may not amount to "*physical damage*".

(r) The present intention is to resist the temptation to define *"damage"* and no doubt this will be the subject of many comments during the consultation period. It is felt that it will be difficult to find a definition of damage which is acceptable and, indeed, appropriate to all cases. There will inevitably be issues on particular facts as to whether something is damaged or simply defective, but these are just as likely to arise whether "damage" is defined in the wording or not.

Latent defect/faulty workmanship and design

(s) At present, the latent defect cover is stated in these terms:

> "*this insurance is against all risks of loss or damage to the subject-matter insured caused and discovered during the period of this insurance including the cost of repairing, replacing or renewing any defective part condemned solely in consequence of the discovery therein during the period of this insurance of a latent defect".*

(t) It is not clear under the 1988 clauses whether cover is provided against simple discovery of a latent defect, without that defect causing loss or damage. There is no direct authority on the point, although the Judge in **Shell UK v CLM Engineering** was of the view that for cover to be engaged, the latent defect has to cause damage. In other words, simple discovery of something defective is insufficient to trigger cover.

(u) This line will be followed through in the new clauses. The basic section A cover is likely to include cover for physical damage done by latent defects.

[5] See Michael Harvey's paper entitled "*Tale of Blocked Pipes, Fly Tipping, Acid, Degas and an Alcoholic Beverage*" presented at the May 2005 general meeting of the Association of Average Adjusters

Specific wording over and above the "all risks" cover is required to override the inherent vice exclusion contained in section 55(2)(c), Marine Insurance Act 1906. However, the basic cover will not extend to the costs of rectifying the latent defect or the latently defective part.

(v) At the time of writing, these issues are being discussed by the committee – particularly whether the new clauses should retain the traditional reference to defective parts or refer to the defect alone and exclude the cost of rectifying the defect. It is not an easy debate and is one that is likely to continue into the consultation period.

(w) The position in relation to design and materials is likely to be treated in a similar manner – with section A providing cover for consequential damage done by defective design or materials, but not extending to rectification of the defective design – or the defectively designed part.

(x) It is intended that the cost of repairing or rectifying latent defects or defective design will be available as a buy back in section E. Not unlike the Additional Perils clause, cover will be given in the optional section for repair of the defect, where that defect has caused physical loss and physical damage.

(y) Finally, it is intended that the costs of renewing faulty welds and the costs of betterment or alteration in design will be excluded both in the standard cover and in the optional extensions, in the same way as they are presently.

9 Summary

(a) The 1988 clauses are in need of update – it is worth considering whether insurance clauses last amended in 1988

(i) which are closely based upon a form developed in 1963;

(ii) for use in conjunction with the SG form (adopted by the members of Lloyd's in 1779)

are appropriate for the insurance of complex modern constructions, such as high value cruise vessels and LNG carriers.

(b) The view of the committee is that they are not and the new form will provide a more flexible and user-friendly approach to construction insurance in a maritime context.

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17th October 2005