



# Design/Engineering Costs, Professional Fees Extensions and Sums Insured in Construction Policies



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## Design/Engineering Costs, Professional Fees Extensions and Sums Insured in Construction Policies

Is the *Professional Fees* clause an extension or a restriction of cover? Does this clause limit reimbursement of additional design and engineering costs incurred to repair indemnifiable damage? A brief review helps to resolve a conundrum.

**Scenario:** A construction insurance buyer deletes the original design and engineering costs (which comprise part of the EPC contract price) from the sum insured. The buyer believes that in the event of loss or damage these costs are non-recurring, and that the Professional Fees extension both provides and limits the amount of additional design and engineering costs insurers would pay. Deleting design and engineering costs could mean a reduction in the sum insured by hundreds of millions of dollars with a corresponding large reduction in premium. The buyer considers purchasing a higher Professional Fees limit; however, this extension usually attracts only a modest premium charge. The underwriter senses that something isn't right, but what?

It has become common in recent years for brokers to seek to reduce or delete original design and engineering costs from the sum insured on the basis that these are "non-recurring." This reasoning is, however, specious: if we consider the total premium as an aggregation of premiums for each element of the EPC contract, then truly non-recurring items attract no premium, so the impact of their inclusion in the sum insured is negligible. But the problem above is puzzling, because the Professional Fees extension usually does refer to architects and engineers fees.

We deduce the answer through a series of observations. We suppose that indemnifiable damage has occurred on a construction project, and that **additional design and engineering costs (ADEC)** are incurred to repair the damage and reinstate the works.

**OBSERVATION 1**

Following insured loss or damage, construction insurance will pay for ADEC necessarily incurred to restore the property to its original condition (or, where this is not possible, to an equivalent and satisfactory condition), if the original costs of design and engineering are included in the sum insured.

This is so because the premium charged on design and engineering costs within the sum insured considers that ADEC may be incurred in the event of loss or damage. The only ADEC which will be excluded are:

- (i) In the case of loss **arising from faulty design**: ADEC incurred to correct and/or eliminate the design defect that resulted in damage. These are design and engineering costs that would have (and should have) been incurred during the initial design phase to create an adequate design. These costs are excluded because they were not incurred and not included in the original sum insured. As no premium was paid on them, there is no cover.

This remains correct even if the defects exclusion is LEG-3 (but see Observation 4). If the defects exclusion is LEG-1, however, all ADEC are excluded since the damage is not indemnifiable.

- (ii) Other ADEC that result solely in **improvement** or **betterment** of the property or project, in the usual sense (increase in capability, performance, quality, strength, durability, etc.).

Observation 1 remains valid whether or not the damage is the result of faulty design, and regardless of which defects exclusion applies.

**Example 1:**

A tunnel under construction suffers collapse due to faulty design (LEG-3 applies). The Insured incurs the following costs:

- (a) ADEC to correct/eliminate the defect (e.g., improved shield or lining design)
- (b) ADEC to restore the tunnel to an equivalent, satisfactory condition (i.e., alteration of the route)
- (c) Costs to physically restore the tunnel to an equivalent, satisfactory condition

Insurers will exclude (a), but cover (b) and (c).

**Example 2:**

Several I-beams in a building under construction buckle due to faulty design, resulting in partial roof collapse (LEG-3 applies). The Insured incurs the following costs:

- (a) ADEC to correct/eliminate the defect
- (b) Costs to repair the damaged parts of the building
- (c) Costs to reinforce undamaged but defective parts of the building

Insurers will exclude (a) and (c), but cover (b).

**Example 3:**

Landslide causes damage to a spillway under construction in a hydroelectric power plant. The Insured incurs the following costs:

- (a) ADEC to restore the structure to an equivalent, satisfactory condition
- (b) Costs to physically restore the damaged structure

Insurers will cover both (a) and (b).

## OBSERVATION 2

The Professional Fees extension does not restrict or limit indemnification in respect of ADEC.

First, recall what the typical Professional Fees extension says:

*In the event of loss or damage insured by this policy, **this section extends to include** the reasonable costs of architects, surveyors, consulting engineers, and other professional fees necessarily incurred by the Insured in connection with the reinstatement, repair or replacement of the Property Insured.*

The Munich Re Comprehensive Project policy has a similar Professional Fees extension that begins:

*If specified in the schedule, **the following additional insurance cover** shall be provided subject to the terms contained herein...*

Notice the language “*this section extends to include*” and “*the following additional insurance cover*”: this suggests that this extension provides something **extra** — over and beyond normal policy indemnity. This is the first indication that the Professional Fees extension is not intended to limit indemnification of ADEC.

Secondly, if the Professional Fees extension were intended to restrict indemnification of ADEC, it would logically be included in the Basis of Loss Settlement or as part of an exclusion — not an extension. In the case of loss resulting from faulty design, while the temptation to limit ADEC can be appreciated, the right place for a restriction to appear would be in the defects exclusion. However, this is not the case: defects exclusions have been part of construction policies since at least 1985, and Professional Fees extensions even longer, but no connection between the two has ever been professed.

Thirdly, the majority of Professional Fees extensions mention costs for “architects, surveyors, consulting engineers and other professional fees, necessarily and reasonably incurred.” Additional design and engineering costs per se are not usually mentioned. This also suggests that the Professional Fees extension is not intended to limit ADEC.

Then what exactly is the Professional Fees extension for?

(i) It provides the insured with comfort and certainty that insurers will reimburse investigative and assessment costs that might not be universally regarded as “necessarily incurred.” In other words, the Professional Fees extension covers (and limits) additional costs incurred **in connection** with the repair, replacement or reinstatement, but does not limit costs incurred **to enable** the repair, replacement or reinstatement.

(ii) It may cover the costs for preparing a claim. Professional Fees extensions often exclude such costs; a standard reference states that with respect to this extension “fees incurred by the insured in preparing or contesting the claim are not covered unless specifically included.”<sup>1</sup> However, some Professional Fees extensions suggest that the extension was actually designed, at least in part, for this purpose. A few examples:

*This section extends to include the reasonable fees payable to the Insured’s accountants, architects, auditors, engineers and other professionals **for producing or certifying the particulars or details of the insured’s property or business in order to arrive at the amount of loss payable** under this policy.*

*This policy extends to include: architects, surveyors, legal, consulting engineers and other fees reasonably incurred by the Insured for the repair of damage and **for the preparation or obtaining of any information, documentation and professional opinions** which may be required by the insurer (but not for preparing any suit).*

*The insurers will pay to the insured the reasonable charges payable by the insured with the insurers consent for fees and legal costs including those of the insured **for producing such evidence as may be required by insurers for the purpose of investigating or verifying any claim** hereunder.*

It is indeed plausible that the Professional Fees extension can cover claim preparation costs, since such costs would not otherwise be indemnifiable in the absence of a specific extension to cover them. Indeed, policies with a Professional Fees extension that explicitly excludes such costs frequently include a separate *Claims Preparation Costs* extension.

A keen observer may draw an analogy with the Removal of Debris extension, which limits costs incurred to restore the project to a satisfactory condition following damage. Moreover, this extension is usually crisp and straightforward with little scope for misinterpretation. A possible resolution to this apparent contradiction is to conclude that Removal of Debris ought not to be sub-limited, and that the premium charged should consider potential costs reasonably incurred for debris removal to reinstate the works following damage.

<sup>1</sup> Insurance Institute of London Advanced Study Group Report 208B, “Construction Insurance”, 1999 (§11.4.11, p.232).

### OBSERVATION 3

The original costs of design and engineering should always be included in the sum insured, regardless of which defects exclusion applies.

This follows not only from Observation 1, but also from basic principles. As mentioned previously, the overall premium rate considers that some costs are non-recurring; also, underwriters should charge premium on original design and engineering costs in exchange for the promise of indemnification of ADEC incurred in the event of insured loss or damage (whether arising from faulty design or not).

It may happen that the project owner has contracted with a design/engineering firm and that this work is not included in the contract with the main contractor(s). In this case, the costs of design and engineering should be included in the sum insured as owner's costs to prevent a gap in coverage.<sup>2</sup>

It used to be common for construction policies to have a *Full Sums Insured* clause such as this:

*The sums insured specified in the Schedule shall be not less than the anticipated full value of the contract works and all property insured at the completion of the construction, inclusive of labor, materials, equipment, machinery, supplies, freight, customs duties, dues, profit, overhead and construction management fees, and (if applicable) the full value of materials or items, services and labor supplied by the principal and others.*

This clause is not often seen in manuscript wordings today, but remains in the standard Munich Re CAR and EAR policies. Implicit in this clause is that original design and engineering costs shall be included in the sum insured.

Another reason why design and engineering costs should not be deleted from the sum insured is that rating tools in widespread use assume that these costs are included. For example, the Swiss Re PUMA Guidelines 3.4 (April 2014) advise:

*The Total Contract Price (or Total Contract Value) is the value to be used in establishing the Total Sum Insured (TSI). There are a few exceptions for clearly identifiable costs such as pure financing costs, training costs (after handing over) which are not considered as insurable and should therefore not be included. In no circumstances should the value of any other item (e.g., a less exposed portion of the contract, overheads, etc.) which is incorporated into the contract price be deducted from the Total Contract Price.*

*The TSI so established is particularly important since it is the reference value for the Expected Loss calculation. In some cases other costs such as items supplied by the principal for incorporation in the project have to be included. **Design costs should be included in the Sum Insured**, even if design is provided under a separate contract.*

The Swiss Re Engineering Project Insurance Policy also has a *Full Insurance* clause:

*It is a condition of this policy that the Sums Insured specified in the Schedule shall not be less than... the anticipated Total Contract Price, without deduction of any costs; plus (if applicable) the anticipated full value of the materials, services and labor supplied by the employer, as at completion of the contract, during the whole of the Period of Insurance.*

<sup>2</sup> Ibid. §8.4.13, p.149.

**OBSERVATION 4**

For the sake of clarity, Observations 1-3 above refer only to ADEC, not to the costs to physically repair and restore damaged property.

Indemnification of the costs to physically repair damaged property is a separate issue from ADEC. There is a subtle point that deserves to be recognized: while ADEC incurred to correct a design defect are always excluded (because these costs were not included in the original sum insured), the costs to physically repair the defect are covered when the defects exclusion is LEG-3. In other words, **the physical repair of defective, damaged property, including physical rectification of the defect, is not considered to be improvement.** Otherwise a policy with LEG-3 would never cover the costs to rectify and rebuild the defective, damaged property (which it is supposed to). And restoring the damaged property to the same defective condition it was in prior to the occurrence of damage is not an option.<sup>3</sup>

To repeat: when the defects exclusion is LEG-3, insurers will pay the costs to repair and rebuild the damaged property in a way that is free of the original defect; that is, restored an equivalent, satisfactory condition:<sup>4</sup> this is not considered improvement. However, if the only possible remedy (or the chosen remedy) results in improvement, then the cost of works that result solely in improvement is excluded.

**In summary:**

1. Additional design and engineering costs incurred to repair and reinstate insured damage are indemnifiable in full\* if the original design and engineering costs are included in full in the sum insured. (\*Excluding costs that result in improvement, and in the case of loss arising from faulty design, to redesign and/or re-engineer the damaged property in order to correct and eliminate the defect.)
2. The Professional Fees extension does not limit indemnification of ADEC incurred to repair and reinstate the works following damage. It provides additional cover for investigative and assessment costs incurred in connection with the reinstatement, repair or replacement of the damaged property, and may provide cover for the costs of preparing a claim.

Underwriters may wish to engage brokers and clients with increased clarity on this issue, to ensure that the language of the Professional Fees extension reflects the understanding and expectation of all parties, and that improper deductions from the sum insured are not made.

All wording examples cited above are excerpted from actual policy wordings, with only minor alterations in punctuation for the sake of consistency.

<sup>3</sup> See "How the Defect Exclusions Are Operating in Practice: Some Case Studies", IMIA Conference, September 26, 2012.

<sup>4</sup> Excluding ADEC incurred to correct/eliminate the defect.



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