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LENDER´S INTEREST IN CONTRACTOR´S (Builder's Risk) INSURANCE

This paper presented by Reinsurers at the 1997 IMIA Conference deals with the inclusion of Lenders/Bankers interests within the scope of Contractor's (Builder's Risk) Insurance.

One is presented with a brief overview on the historical development of the Contractor's policy, and an outline to the basics of non-recourse project finance. Furthermore, it develops the concept of risk transference to Insurance and the position of the lenders/bankers.The paper also comments on clauses/definitions which are of concern to Insurers, namely: The Insured, Loss Payee, Assignment and Non-invalidiation/ Non-vitiation (particular emphasis).

The authors conclude that the lenders real risk exposure in non-recourse financed projects is rather of political and commercial nature and less of the risk that the project policy would not respond in case of an accident. Finally the paper outlines the options available to lenders/bankers in order to get the protection needed.

Zurich, 29 March 1999

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Introduction

More and more often engineering insurers are pressured to extend their contractor's (builder's risk) policy to also cover lenders/bankers interest. Brokers nowadays requested insurers to accept exotic clauses such as:

bankers / lenders clause
loss payee
breach of conditions clause
innocent misrepresentation clause
several insured clause
breach of warranty clause
cross liability clause

"a rose by any other name would smell as sweet".

Though underwriters have traditionally been quite willing to go along with most of the brokers requests it seems that some of these clauses (in particular the non vitiation clause) give rise to concern.

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Historical development of contractor's all risk policy

Since the first contractors policy has been issued over 50 years ago the policy form has been subject to continuous modifications and widening of the coverage. From a once rather restricted (named perils) form - covering the on-site activities of a single contractor - the cover has developed into an "all risk" cover, however, subject to certain exclusions, providing cover for fortuitous physical loss or damage to insured property.

For a number of years each contractor participating in the project had to buy his own insurance cover and the same did apply for the employer/principal. The handling of claims however got rather cumbersome particularly in cases where an accident originating in one contractors work ensued in damage to another contractors work and thus in actual fact became an issue of third party liability claim.

Today the contractor's all risk policy (contrary to an individual contractor's policy) is to provide coverage for material damage the subject project might suffer from an insured peril and encompasses all "named" contractors and subcontractors participating in the project and also the employer/principal.

According to the FIDIC "conditions of contract" the contractor is obliged to insure the project and such insurance shall be in the joint names of the contractor and the employer.

The contractor negotiates with the insurer the cover on behalf of all parties who might become involved in the project at the project site. He obviously has been entrusted by the various parties involved to do so and this within the scope as defined in the "conditions of contract". He automatically assumes a certain responsibility to present to the insurer the necessary underwriting information and to pass on to all parties supposed to benefit from that cover the full extent of the policy conditions and warranties (if any).

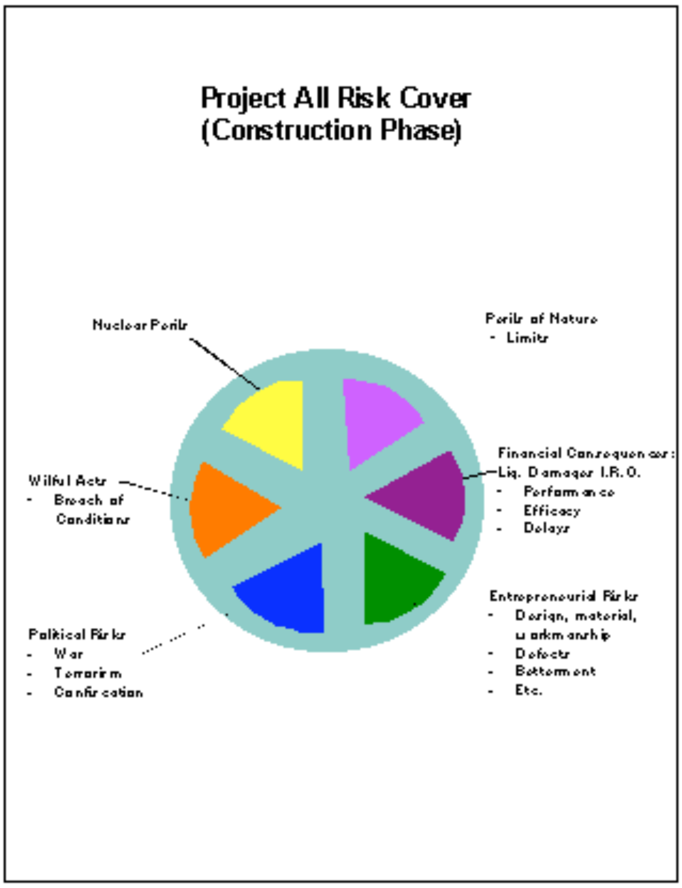
The insurer is only dealing with one party (EPC contractor or employer) without even knowing which additional parties (contractors, sub-contractors of all tiers) are supposed to eventually benefit from the cover negotiated with the policyholder. The policyholder solely is responsible to the insurer for the payment of the premium and entitled to collect claims (unless otherwise agreed). He would be the entity with whom the insurer negotiates amendments and endorsements to the policy.

As far as the project insurance is concerned, the parties involved in the project in actual fact entered into a "joint venture" and become a "community of fate". Consequently the rights and obligations of the "coinsureds" stand and fall together. This fits with the basics of any insurance which is solidarity.

Another aspect which should not be neglected is that in the volume-wise most important markets - the North American market and the German speaking market - the contractors policy does not provide any third party liability coverage.

Up to recently this concept appeared to be satisfactory. With this concept we insure all involved in the construction of a project for some of the risk they take.

This is fine when we are talking about traditionally financed construction risks which we as expert construction risk insurers are used to dealing with. However, as so many other things have changed the financing of projects has also changed and left its marks in the construction insurance.



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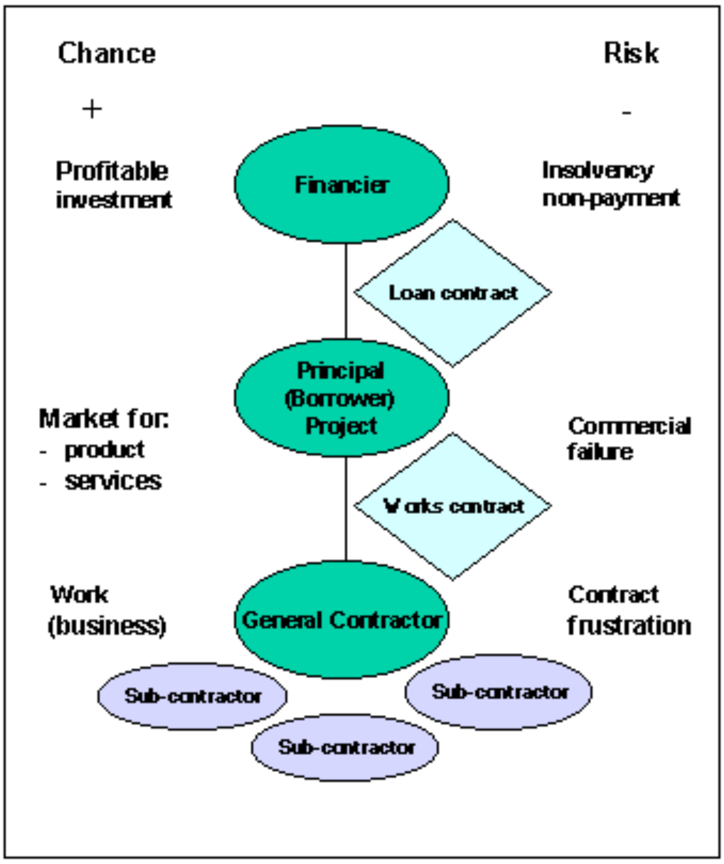
Project finance

Under the structure commonly employed in project finance a single purpose project company is formed to build and operate the project. The shares in the project company are owned by the project sponsors. The project is in part financed by a syndicate of banks who are paid out of the proceeds of the project after its completion. In addition the project company grants the lenders security over the project assets. The balance of the finance needed is provided by the sponsors.

There are various risks associated with any major project. Many of which are allocated between project sponsor and the lending banks to one degree or other. These include the risk that the project will not be completed on time or at all. E.g. because of technology failures, cost overruns, force majeure or necessary variations, and the risk that official licences and consents for the project will not be forthcoming or subject to costly conditions. Though the contract between the borrower and lenders effectively addresses the transference of risk associated with the project between the parties. The lenders, however, like to see as much of the risk transferred to the borrower be further transferred to a third party, i.e. to insurers (deep pocket theory).

Design-build contracting (Engineering Procurement Construction) is probably the most popular form of contract for project financed constructions. The advantage of this form of contract is to have single-point responsibility for design and construction of the project. The risks involved in the realisation of the project are allocated between the employer and the EPC contractor to one degree or other.

The risk of loss usually remains with the EPC contractor with the exception of force majeure perils and specified exceptions for which responsibility remains with the employer. The EPC contract addresses the transference of the risk associated with the project between the parties (employer, EPC contractor, vendor, sub-contractor, etc.) but in most cases the contract also stipulates that the contractor shall, without limiting his or the employer's obligations and responsibilities, insure the works in the joint names of the contractor and the employer, obviously, each party seeks to transfer as much of the risk assumed to a third party i.e. the insurance.



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Risk transference to insurance

By and large we have 3 parties involved in these projects, namely: (i) the lenders/banks, (ii) the employer/single-purpose project company and (iii) the EPC contractor.

The relevant contract documents, loan agreement and works contract effectively address which risk has to be born by which party. Some of these risks can be transferred to insurance and some of these risks remain with the party who had to assume the risk. There is no such thing as a 100 percent transfer of risk.

Insurers are now challenged to analyse which of the risks assumed by each party can be transferred to insurance and

- which of the risks of each party can be transferred to the contractor's (builder's risk) policy
- which of the risks which can be insured need to be insured separately by each individual party
- which of the risks are considered uninsurable

A clear allocation of risks into these three categories is of paramount importance in order to be able to understand to which degree lender's interests can be included and which will be their impact on the contractor's (builder's risk) policy.

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Position of the lenders

The risks of damage to the material property of the project are covered as far as possible by the project insurance. Cover for delay in start up (business interruption) is also commonly purchased. Such cover provides reasonable protection for the project investment against loss resulting from accidental physical loss or damage.

Whilst the project company (employer) and the EPC contractor and main sub-contractor will usually be a named insured under the policy, the position of the lending bank under the policy is somewhat in the dark.

The lender's goal is thus to get into contractual privity with the insurers so that in the event of an insured loss the bank is in a position to enforce the insurance claim without the need of recourse to assistance from one of the named insureds. Furthermore, the lenders wish to be as little dependent on the insured's compliance with the policy terms and conditions as possible and to avoid the situation where one of the insureds can prejudice the cover and hence the lender's ability to recover under the policy.

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Clauses / definitions

1. The insured

"Joint insureds or composite insureds"

It is not always clear whether the policy which insures the interests of various parties is generally considered to be based on joint insured status or composite insured status. Looking into the past where each party had his own policy a judge might tend to favour the composite status. The logic would than be to restrict that to those entities named in the policy which are identifiable e.g. listed with name and address (nobody would issue a policy in favour of Mrs. sub-contractors of any tier).

As the cover shall apply in the same manner and extent as if individual policies had been issued it seems fair and logic that insurers request: i.r.o. underwriting information and contract compliance.

"Underwriting information"

Each of the Insured severally hereby:

1. acknowledges that the insurers have agreed to enter into this policy on the basis of certain underwriting information presented to them and
2. adopts that underwriting information as if it were and had at all times been information provided by that insured and
3. assumes responsibility to insurers for the truth, accuracy and adequacy of that information.

Contract compliance

It shall be a condition precedent to the indemnification of any one or more insureds that all of the conditions, warranties and other terms and provisions of this insurance shall have been performed and complied with by all of the insureds.

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2. Loss payee: (acceptable)

A loss payee is simply a party designated under the insurance policy as the appropriate recipient to claim payments made under the policy.

The effect of a loss payee clause naming the lending bank as loss payee is that the insurer can discharge its payment obligation under the policy by paying the money to the lender rather than the policyholder.

The loss payee is not party to the insurance policy and has no contractual privy with the insurer and no rights under the policy.

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3. Assignment

Depending on the form of assignment the assignee could be placed in direct contractual privy with the insurers and thus in a position to prosecute a claim to recover under the policy directly against insurers.

Insurers are most reluctant to give consent to such an assignment.

Cut-through

From reinsurers perspective practically the same problem as with assignment.

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4. Non-invalidiation / non-vitiation

What is the meaning of non-vitiation?

Definition of vitiate: to impair; to make void or voidable; to cause to fail of force or effect; to destroy or annul, either entirely, or in part, the legal efficacy and binding force of an act or instrument; as when it is said that fraud vitiates a contract.

With other words: "vitiate" is to make invalid or ineffectual and therefore non vitiation implies the inability to make invalid or ineffectual.

What is the impact of these clauses on the contractor's (builder's risk) policy?

For better understanding let us briefly review the development of the contractor's policy.

If insurers do accept such a clause they could "save" issuing policies as all the conditions and warranties would become annulled with the non-invalidiation clause.

Turning the wheel back to the time when each party had actually bought his own policy obviously the policy of the party breaching a condition would have been invalidiated and no indemnification by whom so ever would have been collectable under that policy. However, each other party suffering damage to his works could collect indemnity for damage caused to his part of the work under his policy.

Obviously insurers cannot accept straightforward non-vitiation clauses. The LEG (London Engineering Group) has come forward with a suggestion which could be accepted by insurers:

"Non vitiation" (status of insured)

Paragraph (i) It is noted and agreed that if the insured described in the schedule comprises more than one insured party each operating as a separate and distinct entity then (save as provided in this multiple insured's clause) cover hereunder shall apply in the same manner and to the same extent as if the individual polices had been issued to each such insured party provided that the total liability of the insurers to all of the insured parties collectively shall not exceed the sums insured and limits of indemnity including and inner limits set by memorandum or endorsement stated in the policy.

Paragraph (ii) It is understood and agreed that any payment or payments by Insurers to any one or more such insured parties shall reduce to the extent of that payment insurers liability to all such parties arising from any one event giving rise to a claim under this policy and (if applicable) in the aggregate.

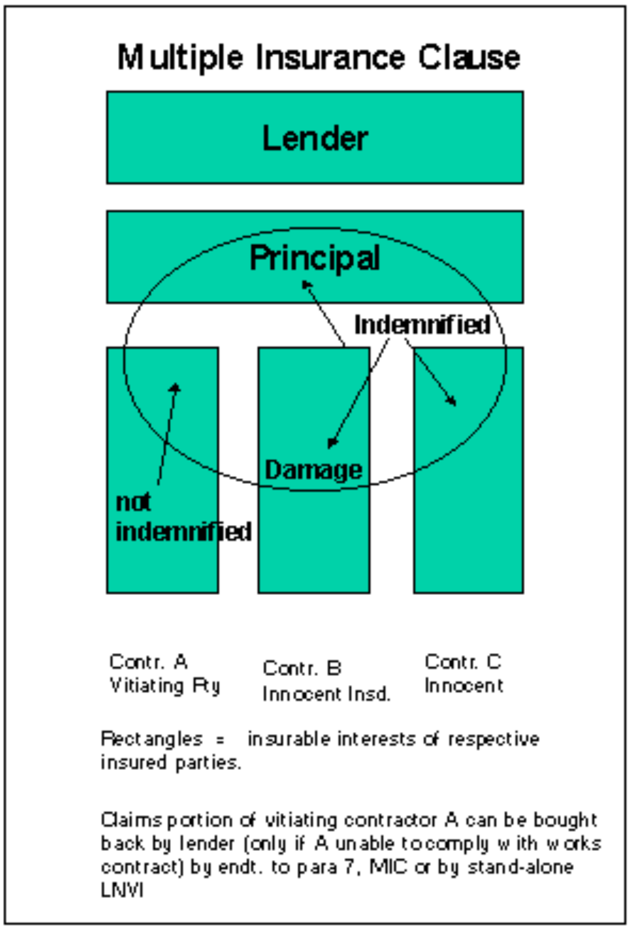
Paragraph (iii) It is further understood that the insured parties will at all times preserve the various contractual rights and agreements entered into by the insured parties and the contractual remedies of such parties in the event of loss or damage.

Paragraph (iv) It is further understood and agreed that insurers shall be entitled to avoid liability to or (as maybe appropriate) claim damages from any of the insured parties in circumstances of fraud, material misrepresentation, material non-disclosure or breach of any warranty or condition of this policy each referred to in this clause as a vitiating act.

Paragraph (v) It is however agreed that (save as provided in this multiple insured's clause) a vitiating act committed by one insured party shall not prejudice the right to indemnity of any other insured party who has an insurable interest and who has not committed a vitiating act.

Paragraph (vi) Insurers hereby agree to waive all rights of subrogation which they may have or acquire against any insured party except where the rights of subrogation or recourse are acquired in consequence of or otherwise following a vitiating act in which circumstances insurers may enforce such rights notwithstanding the continuing or former status of the vitiation party as insured.

Paragraph (vii) The lenders to the project shall not be entitled to any indemnity under this policy for or arising from loss or damage in respect of which insurers are by reason of vitiating act no longer liable to indemnity any one or more other insured party."



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Conclusion

The lender's real risk exposure in non-recourse financed projects is rather of political and commercial nature than the risk that the project policy would not respond in case of an accident. It is important to have the lender's position clearly documented in the policy.

1.For practical reasons the project policy should not be extended to entitle lenders to any indemnity under this policy for or arising from loss or damage in respect of which insurers are by reasons of vitiating act no longer liable to indemnify any one or more other insured party. Obviously, such an extension would render the policies stipulations on breach of conditions and forfeiture nil and void. However, lenders have two options of transferring some risk elements to the insurer:
A restricted buy-back of paragraph vii of above quoted Multiple Insured Clause, e.g. by way of following extension to paragraph vii (against adequate additional premium):

This exclusion shall only apply as long as the vitiating party isa able to comply with the conditions of the works contract.

It has to be noted that the insurable interest of the vitiating party only still would not be indemnified. As an iron rule, the party in breach should not benefit from any indemnity whether paid to any innocent co-insured or to the lender.

2.The lenders may acquire a separate "Lender's Non-Vitiation Insurance" as it is available in various markets. Such cover has to be specifically underwritten case by case and cannot be generally made available. However, the main criteria of such a stand-alone cover are:

Insured:	the lender only
Sum Insured:	equal to the Total Contract Value of the concurrent EAR/CAR-policy
Insurance Period:	Works plus Testing (if any)
Non-Disclosure/ Confidentialit	policy not to be disclosed to any other party insured under CAR/EAR (primary policy)
Trigger:	sudden and unforseen material damage to insured property plus total or partial invalidation of liability under EAR/CAR-policy due to breach of conditions by an insured party (normally to be established by court decision)
Indemnification:	based on underlying EAR/CAR-policy and applying all deductibles, sublimits, etc.
Limit of Indemnity:	actual loss sustained only respectively whichever is least of: unrecoverable claim(s) under the primary policy the outstanding indebtedness the sum(s) insured in respect of which claims are being made...
Right of recourse:	against vitiating party
Exclusions:	any amount of indemnification made good by the vitiating party non-payment of premium, breach of obligations of which lender had knowledge.

Final remarks: a problem the financing parties face is the requirement that coverage is provided only subsequent to a court decision finding that the underlying policy has been vitiated. That is one of the reasons why the integration of LNVI into the EAR/CAR policy has been proposed a few times in the recent past. Indeed, an endorsement attached to the policy and issued by the same insurers would reduce frictional cost in determining whether the policy has been vitiated.

As insurers and reinsurers are still studying whether and how the stand-alone LNVI coverage can be bundled into the project policy in such a way as to protect the lenders' interests without invalidating the restrictions and conditions for underlying insurance coverage, it is strongly recommended to consult reinsurers whenever such an endorsement or any wider covers of lenders' interest such as unlimited assignment to lenders and others are proposed.

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