



Chairman's Address

Delivered by Nigel Rogers at the Annual General Meeting 2006

I now turn to my address for today - "Shipbuilders' Risks", a topic which has been under the spotlight in the recent past. Not least amongst the reasons is the horrendous run of losses suffered in this particular sector of insurance business. During the period from October 2002 until January 2004 the total worldwide estimated premium for shipbuilders' risks was approximately US\$125 million, but the major losses alone for this period were approximately US\$740 million. Amongst the most notable of such losses were "Diamond Princess" (US\$310 million), "Westerdam" (US\$75 million), "Typhoon Maemi" which hit Korean yards (US\$50 million) and "Pride of America" (US\$228 million). More recently there have been further significant losses, such as those resulting from insulation problems experienced on an LNG carrier at the French yard, "Chantiers de L'Atlantique", and also of course the havoc wreaked by hurricanes Katrina and Rita in the Gulf coast area. I should add that the figures I have quoted only relate to major individual losses in excess of US\$20 million, and do not include numerous other substantial claims below that level.

This kind of recent record has quite naturally induced a number of reactions from the underwriting community, which have included the increased use of pre-risk surveys such as JH143, an enhanced focus on loss prevention procedures and quality issues, and a review of rating and deductible levels, etc. As I mentioned in my opening remarks, it has also led to a review of the standard clauses in London for these risks - the Institute Clauses for Builders' Risks - 1.6.88 (hereafter referred to as ICBR 88). This review has come about not simply as a response to the heavy losses, but also because of certain perceived shortcomings in ICBR 88 and further to meet the demands in the new environment of contract certainty. In so doing it should go some way to respond to the concerns of one judge, who commented rather cuttingly, after what was clearly a bad day, that the policy he was addressing was:

"made up of a jumble of ill assorted documents expressed in that distinctive style which insurance companies have made their own".

As I mentioned earlier, the new draft ICBR are to be issued imminently. It is clearly not my place today to in any way provide an introduction to the new clauses, but I did think it would be worthwhile highlighting some of the problem areas which the clauses committee have had to wrestle with. In so doing, I should state at the outset that what follows are my personal comments and are not given on behalf of the clauses committee:

The problem areas I would like to highlight are as follows.

1. Who is the assured ?
2. What is the value of the subject-matter insured ?

3. What is the coverage position ?
4. What is the reasonable cost of repairs ?

Not much to worry about there then!

1. Who is the assured ?

Turning firstly to the identity of the assured, this is primarily a matter for the slip rather than the clauses themselves, although clearly the identity of the assured is a matter of huge importance in the overall context, and the clauses need to provide appropriate clarification where necessary.

Let me begin by providing an example of a description of the assured under a particular policy. The assured was identified as the shipyard itself

“and/or Purchasers and/or Co- and Sub-contractors and/or Suppliers and/or Associated and/or Subsidiary and/or Affiliated Companies and/or whomsoever might be concerned with or without order for their respective rights and interests”.

The need for such broad descriptions of assureds arises primarily as a result of the various contracts which are likely to be involved in any particular construction project. As regards the purchaser of the ship, the construction contract will frequently require the yard to take out an insurance not only in its own name but also in the name of the buyer. When it comes to sub-contractors, suppliers etc., again the contracts between these parties will often entail them requiring the benefit of the cover taken out by the principal assured.

The importance of this issue has a number of different aspects, including the following.

a) Firstly, and most obviously, there is the question of who can take advantage of the principal assured's policy. As discussed in the recent case of BP Exploration and Kvaerner (2004) it is not enough for an unidentified *“other assured”* to obtain the benefit of cover by reason of a wide *“other insured”* definition in the policy. Instead the principal assured *“must have assumed a contractual obligation to such sub-contractor to procure the benefit of cover for him.”* Therefore, sub-contractors etc will qualify as *“other assureds”* where

- 1) they have written contracts with the principal assured; and
- 2) such written contracts provide for such parties to have the benefit of cover.

Having stated that, it should be noted from National Oil Wells v Davy Offshore Ltd (1993) that the extent of the cover provided might vary from that of the principal assured and also that the intention of the parties to the contract is critical. The court said

“..... the subjective intention of the principal assured can be directly material to the resolution of the question whether a particular party has been bound to the policy and if so to what part of it or to what extent of its cover”

However, intention is not of itself sufficient to be definitive as to whether a sub-contractor is covered and to what extent. The importance of properly describing parties to be insured was demonstrated in the recent case of Talbot Underwriting Ltd and Nausch Hogan & Murray (2005) where the yard in Singapore responsible for the completion, outfitting, commissioning and testing of a barge was unable to recover as a co-assured, since the yard was not deemed to come within the

specific description contained in the Assured Clause, although it had been the intention of both the principal assured and the yard that the latter should be covered. I believe the case is going to appeal but, as things stand, it serves to indicate the dangers of relying on “catch all” descriptions.

b) Another issue with regard to the identification of the assured relates to rights of subrogation. Frequently builders’ risks policies contain a waiver of subrogation clause, whereby the insurer specifically waives such rights against the parties nominated. In any event, where the contract between principal assured and sub-contractor precludes a recovery, then clearly no rights under subrogation can accrue to underwriters. Also, where the sub-contractor is a co-assured under the policy and then negligently carries out his work, it is clear from the conclusions in the National Oil Wells case that:

“An insurer could not exercise rights of subrogation against a co-assured under an insurance on property in which the co-assured had the benefit of cover which protected him against the very loss or damage to the insured property which formed the basis of the claim which underwriters sought to pursue by way of subrogation”.

In summary, since the contractual relationships between principal assured and other parties appear to govern the question as to whether such other parties are insured under the main yard cover and to what extent, and will also impact on the ability of the insurer to be subrogated against such other parties, then clearly aspects such as the selection of sub-contractors, and the manner in which they are contracted with and monitored thereafter are of considerable importance to underwriters. It is one thing for underwriters to seek to offer a product which responds to the general industry requirements, and quite another to leave themselves completely open to the problems entailed by improper contractual terms with badly selected sub-contractors etc.

2. What is the value of the subject-matter insured ?

Moving on to the question of the value of the thing insured, the first question to be asked is whether or not a shipbuilders’ risks policy in standard form is a valued or unvalued policy. The first page of ICBR88 provides for the identification of provisional values, but this page is rarely completed. Instead, declarations as to value are normally dealt with in the slip, albeit frequently on a gradual declaration basis as different components arrive on site and the overall value increases.

After page 1, ICBR 88 goes on to contain provisions as to how the insured value is to be assessed (i.e. final contract value or total building cost plus a percentage) without definitively quantifying what that value is. Thus, the valuation provisions of the clauses create something of a hybrid between valued and unvalued status. All of this is of course understandable when one appreciates that the value in a construction risk is a moveable and developing entity, but it also leads to certain difficulties in application.

Section 27 (2) of the Marine Insurance Act states that:

“A valued policy is a policy which specifies the agreed value of the subject-matter insured.”

And under section 27 (3):

“..... the value fixed by the policy is, as between the insurer and assured, conclusive of the insurable value of the subject intended to be insured.....”

However, it is a bit difficult to be conclusive in the circumstances of an evolving value, particularly if it is only provisionally indicated.

An example of the difficulties encountered in practice with regard to the value of the subject matter insured might be where a significant damage occurs perhaps two-thirds of the way through a particular construction project. With regard to a potential constructive total loss situation, the cover under Clause 12 of the ICBR 88 is as follows:

“12.1 In ascertaining whether the subject matter insured is a constructive total loss, the insured value shall be taken as the repaired value...”

12.2. No claim for constructive total loss based upon the cost of recovery and/or repairs shall be recoverable hereunder unless such costs would exceed the insured value.....”

These provisions, and indeed the entirety of Clause 12, are extracted directly from the Institute Time Clauses-Hulls (1.10.83). However, they serve to demonstrate the difficulties in allowing trading risk wordings to migrate into construction risks policies. In the context of a construction project, it will clearly only be at or close to the end of the project when the cost of recovery/ repair is likely to exceed the insured value as currently defined. In our example, where a serious damage is suffered at some earlier intermediate stage, then the cost of repairs is most unlikely to exceed the insured value and the assured might find himself in a position where there is an abandonment of the construction project due to the significant damage sustained, but no CTL can be demonstrated and the only option then is for the assured to claim under the unrepaired damage clause.

However, turning to that clause, the indemnity is as follows under ICBR 88.

“11.1 The measure of indemnity in respect of claims for unrepaired damage shall be the reasonable depreciation in the market value of the vessel at the time this insurance terminates arising from such unrepaired damage, but not exceeding the reasonable cost of repairs.”

Again this clause is taken straight from the ITC 1.10.83 wording. But how do you assess depreciation in the market value of something that has no real market because it is only partially built ?

A solution therefore needs to be found which more clearly reflects the commercial reality of potential abandonment of the construction project following significant damage, and in general to meet the peculiar circumstances of valuation in the context of construction risks.

3. What is the coverage position?

I now turn to the question of coverage. The ICBR 88 provide under section 5.1. as follows:

“... this insurance is against all risks of loss of 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...”

ICBR 88 goes on, under Clause 8, to include loss or damage caused and discovered arising from faulty design, but to exclude the cost of making good the faultily designed part and any cost incurred by reason of betterment or alteration in design.

Whilst these standard clauses are in themselves broad in scope (and note that they do not contain any form of due diligence proviso), they are as nothing by comparison with some of the imaginative yard wordings which I have encountered - individual yard wordings having been quite a regular feature of construction risks over the years.

To give a couple of examples in this respect, one policy provided as follows:

“This insurance is against all and every risk of whatsoever nature that may arise to the hurt, detriment, damage to or destruction of the vessel hereby insured or any part or parts thereof, including latent defect.”

A broad enough cover, one would think, but evidently not since the same policy then went on to specifically cover:-

“misconduct”, “malice”, “any accident or cause whatsoever, or the existence of any defect (whether latent or otherwise) in the vessel hereby insured or any part or parts thereof”, “all expenses to make good defective workmanship” and “ the cost of dismantling and re-assembling sound parts which have been wrongly assembled due to a risk covered by this policy” and so on.

And then there is my personal favourite.

“This insurance also specially to cover repairs..... however caused....”.

Returning to the less exuberant terms of ICBR 88, I will examine a specific example. A sub-contractor improperly constructs a particular item of machinery, whereby the part is rendered defective. The part is then transported to the yard and built in to the main engine which is then found not to work satisfactorily during final trials. At considerable cost the main engine is dismantled, the offending part is examined and found to be defective, a new part is supplied for inclusion in the re-assembly of the main engine, and trials need to be re-run.

In the green for “go” corner, the assured and his advisers would probably begin from the onus of proof perspective whereby, under all risks wordings, it is generally deemed to be the case that

- a) The assured is only required to make a prima facie case that a fortuitous loss has in fact occurred; and
- b) An insurer must make policy exclusions clear and unmistakable and any ambiguity is usually construed against the insurer.

Having reached this position, the assured would no doubt then advance the argument that a risk has operated (error in construction), and further that the engine is now damaged, since it is injured or at least rendered unfit for purpose by reason of the inclusion of the faultily constructed part in such a way so as to impair its value or usefulness, according to the dictionary definition.

So how, in the red for “*now just hold on a minute*” corner, does the insurer respond, bearing in mind that the onus of proof rests on him if he wishes to refute the claim. Well, the law does offer him some possible salvation, and this is particularly with regard to the critical issue as to whether anything has actually happened during the period of insurance.

In the famous case of the “Nukila” (1997) Lord Justice Hobhouse stated that:

“A policy of insurance does not cover matters which already exist at the date when the policy attaches”.

The same judgment goes on to consider with approval the comments of Lord Justice Fletcher-Moulton in *Oceanic Steamship Co v. Faber* (1906) as follows, with regard to the affected part in that case.

“It was not loss or damage caused by latent defect, but the latent defect itself. To hold that that clause covers it would be to make the underwriters not insurers, but guarantors and to turn the clause into a warranty that the hull and machinery are free from latent defects, and, consequently, to make all such defects repairable at the expense of the underwriters. The fact that it begins with the word insurance negatives in my opinion the possibility of its being so interpreted”.

In his concluding remarks, Lord Justice Hobhouse poses the three critical questions to be asked as follows:

- “(1) Was there damage to the subject-matter insured?*
- (2) Did that damage occur during the period covered by the policy?*
- (3) Was that damage caused by a latent defect in the machinery or hull of the vessel?”*

For our example, please note in particular the second question – i.e. did the damage occur during the policy period – which is a matter of particular difficulty having regard to a construction risk, where clearly the policy incepts on the commencement of construction rather than merely being the renewal of a trading risk.

But even if in such a context, an impairment is deemed to take place when the defective part is built in to the vessel’s main engine, is that enough? Of interest here are the comments of Lord Justice Pill in the Court of Appeal judgment in *Hunter v London Docklands Development Corporation* (1994), where he stated:

“The damage is in the physical change which renders the article less useful or less valuable”.

Or the comments in a Commonwealth insurance case (*Ranicar v Frigmobile* (1983)).

“In my view, the ordinary meaning, and therefore the meaning that I should prima facie give to the phrase “damage to” when used in relation to goods, is a physical alteration or change, not necessarily permanent or inrepairable, which impairs the value or usefulness of the thing said to have been damaged”.

Therefore, whilst undoubtedly the impairment to value or usefulness remain key tests, the law appears to demand that such impairment needs to be as a result of a physical alteration and that alteration needs to take place during the currency of the policy.

However, returning to our example, let us assume that the defect introduced by the error in construction is latent in nature. In such an instance, and as will have been noted, ICBR 88 specifically cover the cost of *“any defective part condemned solely in consequence of the discovery therein during the period of this insurance of a latent defect”*. In other words, mere discovery seems sufficient and hence the policy appears to contract out of the legal position as outlined above. But should it be the proper subject of an insurance policy that insurers are held liable in cases where no risk operates and no change of condition occurs during the period of the policy?

At this point, it is also worth considering a judgment in the United States which appears to go even further than the English law judgments referred to above. In *Trinity Industries Inc. v Insurance Company of North America* (1990), a vessel called “*Leam Alabama*” was constructed by a shipyard, in such a way that two of the modular hull sections were misaligned during construction,

resulting in a 7 to 12 inch twist in the vessel. Whilst such a twist might seem sufficient to fulfill most practitioners' concept of a risk operating (error in construction) resulting in damage occurring during the policy (i.e. construction) period, the judge in the appeal judgment found against the claim for a variety of reasons, including the coverage perspective. In this regard, he stated as follows:

“We have trouble with the notion that a Builder’s Risk policy covers the cost incurred by the policy holder to correct faulty workmanship. While we recognise that courts, including ourselves, have used broad language in describing the extent of the coverage provided by an all risks policy, we are convinced that neither party intended for the Builder’s Risk policy to cover the cost of repairing plaintiff’s mistakes in construction.

We are mindful of the many cases that have found defective workmanship to be a risk covered by all risk policies. These cases, however, have dealt with an accident caused by defective workmanship, not with the cost of replacing or repairing defective workmanship”.

He goes on to indicate that “... a discrete event that a reasonable person would call an accident...” is required, and that there needs to be “... an initial satisfactory state that was changed by some external event into an unsatisfactory state...”. In other words, something must happen, providing a change in state.

So where does all this leave the participants of a construction risk policy in achieving an acceptable level of coverage and contract certainty in this regard. In my own view, and rather simplistically, it seems to me the trick should be in achieving a balance between, on the one hand, insurers responding to an industry expectation and requirement for coverage of all risks of physical loss or damage, and on the other hand, not leaving themselves in a position of being guarantors of functionality, whereby they are liable even where no event or change of state whatsoever occurs during the policy period.

4. What is the reasonable claim quantum?

Moving from one minefield to another, I now turn to issues relating to the reasonable cost of repairs. You will no doubt be relieved to know that I do not intend to cover this topic in detail, but instead merely to highlight again some peculiarities regarding this issue in the construction risk context.

Before doing so, let me again refer to some “curiosities” which have appeared in yard wordings I have encountered in previous cases. In one instance the generosity of the underwriters concerned knew no bounds, inasmuch as they covered not only the reasonable cost of repairs to the loss or damage, but included, following the failure of the trials, “*all additional expenses....until trials re-run*” and elsewhere “*liability for maintenance of the ship during any period of delay caused by making good or repairing faults....*”.

Let us take an example of a main engine failure during final trials. Typical issues that might arise would include the following.

Firstly, the underwriters' surveyor considers the main engine to be repairable, but the purchaser says “No. I'm buying a new ship and I want that ship to have a new engine”. Fair enough, one might say, from the purchaser's perspective, but where does that leave the yard with regard to the entitlement under the policy? Can the yard claim for the new engine on the basis that in a construction risk context he must deliver a new ship and therefore it is always to be expected that replacement rather than repair should form the proper basis of the claim? Or should his claim be limited to the cost of the perfectly viable repair to the damaged engine?

Secondly, because the main engine breakdown has occurred at a late stage and the building contract contains provisions for penalty payments to be made in the event of late delivery, the yard work around the clock to fix the problem and expedite delivery of the ship, and thereby mitigate the penalty payments. Is the yard entitled to claim from underwriters covering the construction risk for the premium overtime costs incurred on the basis that all yards would do the same thing under the circumstances, and such costs should therefore be recoverable as part of the reasonable cost of repairs? Alternatively, will his claim fail since he is basically incurring such expenses to mitigate penalty payments which aren't themselves even a potential exposure to construction risks underwriters in the first place (in the absence of a special wording).

Thirdly, as a result of the accident, there is a contractual requirement for the totality of the trials to be re-run, as opposed to merely the lesser degree of trials which the main engine damage itself might require. Is the yard able to claim against underwriters for the considerably higher expense of re-running all trials because of the contractual obligations, or is his claim limited to merely what is required as part of the main engine repair process ?

Such issues (and numerous others) relating to the reasonable cost of repairs question in construction risk cases tend to indicate that trading risk practices are not always appropriate and that some clear redefinition might be beneficial, in some instances at least, if both sides are to know where they stand.

Problems, problems and more problems. Problems and uncertainties. Achieving contract certainty in such an area of risk can only be described as tricky, and clearly a set of standard clauses cannot cater for all scenarios in such a complex area. But they can go a long way towards providing clarification and a balanced approach to the numerous problem issues.

In order to better understand the phrase, "contract certainty", I went to various relevant quotations websites. I found nothing on "contracts" but plenty on "certainty". Included amongst these was one from Rudyard Kipling which I personally found rather discouraging:

"A woman's guess is much more accurate than a man's certainty".

But, moving briskly on, I found another by Albert Camus. Now, I am not aware of Albert ever having sat on a clauses committee but it sounds as if he might have done and in doing so had a rather bitter experience, when he stated:

"We are not certain, we are never certain. If we were we could reach some conclusions, and we could, at last, make others take us seriously."

Well, the shipbuilders' risks clauses committee have reached some conclusions, and I hope that they will at least be taken seriously.

Thank you.