

Introduction to All Risks Insurance Policies

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Introduction

Owners of infrastructure projects will often purchase Construction All Risks and Delay in Start Up insurance for the construction and commissioning phase of the project. After handover, the project operator will usually purchase Machinery Breakdown and Business Interruption All Risks insurance. This Guidance Note provides an overview as to how such “All Risks” policies work with particular reference to: (i) the Insurer’s obligation to indemnify and (ii) the amount of the indemnity payable.

General: The Cover

All Risks insurance policies provide an indemnity in respect of: (i) Section I Property Damage: the cost of repairing or reinstating damage that occurs during the period of insurance and results from, or is caused by, “all risks” or perils and (ii) Section II Delay in Start Up or Business Interruption: the financial cost of the delay to the project or interruption to the business during the indemnity period and resulting from, or in consequence of, the damage insured by Section I or by another insurance policy.

General: The Exclusions

Having agreed to provide an indemnity for all damage resulting from all risks or perils, the Insurer then reduces the scope of cover (or its obligation to indemnify) by excluding: (i) specified causes of damage; (ii) specified types of damage; or (iii) certain costs (such as repairing damage below a certain limit). In addition, the Insurer relies on general principles of insurance, for example that any damage must be sudden and accidental and that reasonable precautions have been taken to prevent damage.

General: The Amount of the Indemnity

Once the obligation to indemnify is established then the amount of the indemnity is calculated in accordance with the terms of the policy, usually set out within the basis of loss settlement clauses within Sections I and II. The amount of the indemnity to repair or reinstate damaged property is calculated by reference to the replacement cost value (new for old) or actual cash value of the damaged property, excluding any betterment or improvement. The amount of the indemnity payable in respect of the financial loss is calculated by reference to finance charges, standing charges, loss of gross profit and increased cost of working incurred to minimize the financial loss, less any savings.

Section I: The Insuring Clause

The Insuring Clause is an important clause because it determines whether Insurers are obliged to indemnify the Insured. If the Insuring Clause is satisfied then the cover holder should look at the exclusions and write backs to see if cover still attaches. The Section I Insuring Clause usually states:

“The Insurers will indemnify the Insureds in respect of (i) Damage occurring during the Period of Insurance to Insured Property within the Geographical Scope (ii) by any cause or peril not otherwise excluded by this Policy.”

Section I: The Obligation to Indemnify: What, When, Why and How?

In order to trigger the Insurer’s obligation to indemnify, the cover holder must establish that damage to its insured property occurred during the policy’s insurance period. If it discharges this burden then the onus shifts to the Insurer to establish that one (or more) of the exclusions applies. This can be described as the What, When, Why and How of establishing cover, or the obligation to indemnify.

Section I: What Damage has Occurred?

The “what” is the obligation to establish that damage has occurred. The policy may include a definition of damage, usually an adverse physical change in the condition of the insured property. The change can be adverse in the sense of function, purpose, appearance or value and can be temporary or permanent, but there must be a change in condition to constitute an occurrence of damage. That is to distinguish the occurrence of damage from the existence of a defect. A defect describes a particular condition of the property, which defect may also be the cause of the damage. Generally, Insurers do not provide an indemnity against the cost of rectifying a defect, on the basis that the cover holder should look to the manufacturer or supplier, unless the defect has caused damage to the insured property and the Insured rectifies the defect as part of the repairs and reinstatement of the damage.

Section I: When did the Damage Occur?

The “when” is the obligation to establish that damage occurred during the period of insurance. The cover holder does not have to establish that all the damage occurred during the policy period. And it does not have to establish that the damage led to destruction (or a catastrophic failure) during the policy period. But it must establish that some damage, or adverse change, to the insured property did occur during the policy period. And it establishes when the damage occurred by reference to factual evidence or by reference to expert evidence such as a metallurgist or mechanical engineer.

Section I: Why did the Damage Occur?

The “why” is the obligation to establish the cause of the damage, because some All Risks policies exclude the cost to repair damage that results from certain excluded clauses. For example, defective design, workmanship, materials, plans, drawings or specifications are causes of damage that are commonly excluded, because the cover holder has recourse against the designer, manufacturer, supplier or draughtsman. We say commonly because the cover holder may remove some or all of these excluded causes by paying a higher premium. In most policies, when the cause of the damage arose is irrelevant to cover. The cause of the damage, such as defective design or workmanship may have occurred many years before the policy incepted or the damage occurred. It does not matter.

Section I: How did the Damage Occur?

The “how” is to establish the failure mechanism and, by extension, the type of damage that has occurred. Again, that is because some All Risks policies exclude certain types of damage, such as corrosion, gradually developing flaws and cracks, and wear and tear. These types of damage are generally excluded because they are associated with the usual operation of the insured property, are not fortuitous and are a maintenance cost that should fall on the cover holder and not the Insurer.

Section I: Write Backs: Or the Exceptions to the Exclusions

Some policies include write backs if the cover holder has paid an additional premium to narrow or eliminate the application of the exclusions. They are called write backs because calling them exceptions to the exclusions is too confusing. The write back may bring back into cover the cost of repairing excluded types damage if the cause of that damage is not otherwise excluded. For example, if defective design was not an excluded peril and caused cracking to occur, but cracking was excluded as a type of damage, the write back may bring the cost of repairing the cracks back into cover.

Section I: Amount of the Indemnity: Property Damage

If the Insurers’ obligation to indemnify the cover holder is established then the amount of the indemnity payable is the cost of repairing or reinstating the damaged property on the replacement cost value (“RCV”) or the actual cash value (“ACV”) basis. The RCV basis is calculated by reference to the cost of repairing or reinstating the damaged property back to its condition when new. Hence it is known as the new for old basis of indemnity. The ACV basis is calculated by reference to the cost of repairing or reinstating property back to its condition at the time when the damage occurred.

Section I: Amount of the Indemnity: Betterment

If the cover holder has purchased a policy that provides for the amount of the indemnity to be calculated on the RCV or ACV basis then betterment will apply. In other words, the damaged property is to be reinstated to a condition the same as, but not better, than its condition when new or at the time when it was damaged. If the reinstated property improves productivity, efficiency, durability, etc. then the cover holder is to pay for those improvements as a discount from the indemnity payable.

Section I: Amount of the Indemnity: Depreciation

If the cover holder has purchased a policy that provides for the amount of the indemnity to be calculated on the ACV basis then depreciation will have to be applied to determine the value of the damaged property at the time when it was damaged. Depreciation may be calculated on the straight line (buildings) or reducing balance (machinery and equipment) basis.

Section II: Insuring Clause

The Section II Insuring Clause requires the cover holder to establish that: (i) insured damage has occurred during the insuring period and (ii) the insured damage has caused a delay to the project or interruption to the business and (iii) the delay or interruption has caused a financial loss to the insured.

A typical Section II Insuring Clause (for business interruption) states:

“The Insurers hereby agree with the Insureds that if during the Period of Insurance specified in the Schedule, any Insured Property used by the Insureds for the purpose of the Business be (i) Damaged by any cause not excluded under Section I of this Policy and (ii) the Business carried on by the Insureds at the Insured Premises be in consequence thereof interrupted or interfered with, the Insurers, to the extent hereinafter provided, will pay to the Insureds the loss resulting from such interference.”

Section II: Amount of the Indemnity: Calculation of the Financial Loss

If the obligation to indemnify is established then the amount of the indemnity payable in respect of the financial loss is calculated by reference to: (i) finance and/or standing charges incurred during the indemnity period; (ii) the loss of gross profit incurred during the indemnity period; and (iii) increased costs of working incurred to avoid or reduce the financial loss. The indemnity period starts at the date when the project would have been completed but for the damage (DSU) or the date of the damage (BI). It ends on the date when the project is commissioned (DSU) or the date when (i) the reinstated equipment is returned to operation or (ii) the results of the business return to the pre-loss condition (BI), all subject to the maximum period specified in the policy’s schedule (3, 6, 12, 24 or 36 months).

Section II: Amount of the Indemnity: Special Circumstances Clause

Some All Risks policies include a Special Circumstances clause that requires the amount of the indemnity payable in respect of the financial loss to be adjusted to allow for any special circumstances that may occur during the indemnity period such that the insured is put back into the position in which it would have been if the peril or the damage resulting from the peril had not occurred.

Section I and II: The Amount of the Indemnity: Under Insurance

If the cover holder does not purchase adequate limits for the insured interest then the amount of indemnity payable will be reduced to reflect the under insurance using the following formula:

$$\text{SUM INSURED} / \text{VALUE AT RISK} \times 100\% \times \text{ADJUSTED INDEMNITY} = \text{INDEMNITY AMOUNT PAYABLE}$$

If the sum insured is 50 and the value at risk (whether ACV, RCV, DSU or BI) is 100 then the cover holder will be deemed to be 50% under insured and average will apply to reduce the claim by 50%.

General Conditions

All Risks policies include general terms and conditions that govern Insurers' obligation to indemnify. For example, the damage must have been unforeseen by the Insured before it occurred or started to occur. In other words, the damage must be accidental or fortuitous. Also, the Insured must exercise all reasonable skill and care to prevent any damage from occurring, and particularly must not operate its machinery recklessly, knowing that there is a risk of damage but running that risk in any event.

General Conditions: Accidental

All risks policies require the occurrence of damage to be accidental, or unforeseen. This means that the damage must have been unforeseen standing in the shoes of the Insured, not unforeseeable which is an objective test. In practice, this means that if damage that occurred during the insurance period was foreseen by the Insured at that point in time at the start of events leading up to the damage then the Insurers are not obliged to indemnify the costs of repair. That is because the damage is not accidental. For example, if the Insured was aware that a part was defective and knew that it was likely to cause damage but decided to run the machine anyway, any resulting damage would not be covered.

General Conditions: Reasonable Precautions

All risks policies will include a reasonable precautions clause, requiring the Insured to take all reasonable precautions to prevent damage from occurring during the period of insurance. Despite its name, and because all risks policies usually provide an indemnity against damage resulting from negligent operation, Courts tend only enforce this clause in circumstances in which the cover holder has acted recklessly in the operation of the machinery. If the cover holder can establish that it has maintained and operated the machinery and equipment in accordance with the OEM's recommendations or industry standards, then this clause will likely be held to have been satisfied.

Summary

All risks insurance, the determination of the obligation to indemnify and the amount of the indemnity payable is a complex area. The success of a claim turns on the application of the insurance agreement to the factual, technical and legal issues that are unique to each claim. That best approach is to present a claim on a simple factual and technical basis that is fully supported with quantum evidence. Then to meet each coverage and quantum point as it is raised by Insurers until settlement is achieved.

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