

Insured vs. Insured and Related Parties Entities Exclusions and the Implications for Professional Indemnity/Liability Insurance

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1) The background for the Insured versus Insured Exclusion

Insured vs. Insured (“IvI”) has been a traditional exclusion in Professional Indemnity/Liabilities (“PI/L”) policies. The Insurers rationale for this exclusion is:

- To avoid conflicts of interest, i.e. Insurers are not comfortable with covering claims between Insureds named under the same policy;
- To avoid a collusion between Insureds to frame a claim between them and potentially enhance the profit of a project;
- To avoid covering pure financial losses or

extra costs suffered by one Insured party due to another Insured’s decision.

Insurers consider the above to be moral hazards.

The typical IvI exclusion reads:

This Policy will not make any payment for a claim or costs directly or indirectly due to a Loss or Mitigation Loss, resulting from any Claim made against an Insured or any Mitigation Event arising from any Professional Liability Claim or Protective Claim made by an Insured against any other Insured.

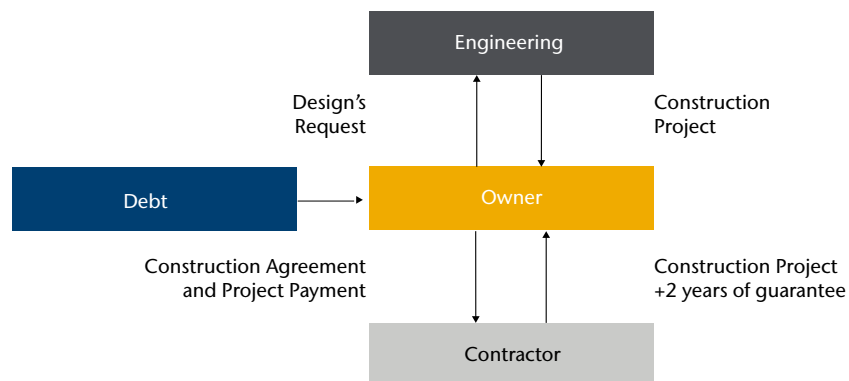
2) What does this mean?

The real impact of this exclusion depends substantially on the contractual framework of the project. We will examine the three most frequent situations where this exclusion might affect coverage:

- Historically, the most traditional contractual framework to develop new projects was Design-Bid-Build (D-BB). In this scenario, the Owner requests a Designer to prepare

the project design and specifications. Once the design has been completed, the Owner selects a Contractor who will be responsible for delivering the works in accordance with the design prepared by the Designer. The Contractor might also assume the Project Management (PM) role, but in most cases the Owner employs a separate PM team. This PM team oversees the works and ensures coordination between Designer, Contractor and Owner.

Design-Bid-Build Projects



Under the D-BB contract form, the Designer, PM and Contractor have separate contracts with the Owner which contain unique responsibilities and obligations. For example, the Designer and PM are obligated to provide their services free of negligence, while the Contractor must warrant their workmanship and materials are free of defect. Each party will then purchase insurance coverage to address their respective duties and risks. Because each party takes out a different policy, the lvi exclusion does not apply, and thus each party may bring claims against the other party's negligence or errors.

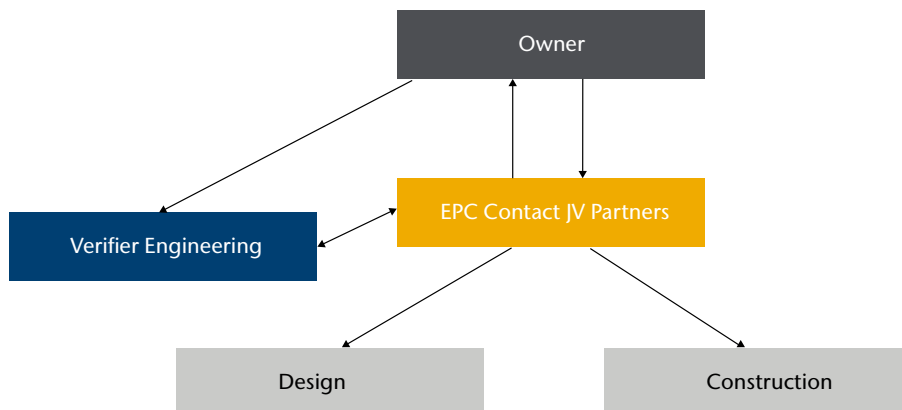
b) Design-Build (D-B), and/or Engineering, Procurement and Construction (EPC) contracts are now more common. Under these formats, the Contractor (which is often a Joint Venture in larger projects) is the party with sole responsibility for the design to the Owner. The design may be undertaken either in-house, or the Contractor may choose to sub-contract the design to one or more specialist Designers. It is not unusual for the designer to be a Contractor partner within a Joint Venture, or even a works sub-contractor.

The Owners contract with the D-B or EPC often requires that a specific PI/L policy be purchased for the particular project (Single Project Professional Indemnity– SPPI, or Contractors Protection Professional Indemnity

– CPPI in the USA). If the Owner requires that the D-B or EPC include all designers on the project specific policy the lvi exclusion becomes a prominent issue. If the Designer were to make an error causing damage or loss to the D-B or EPC Contractor, no recovery could be sought under the project specific policy because both are named insureds and the lvi exclusion would apply.

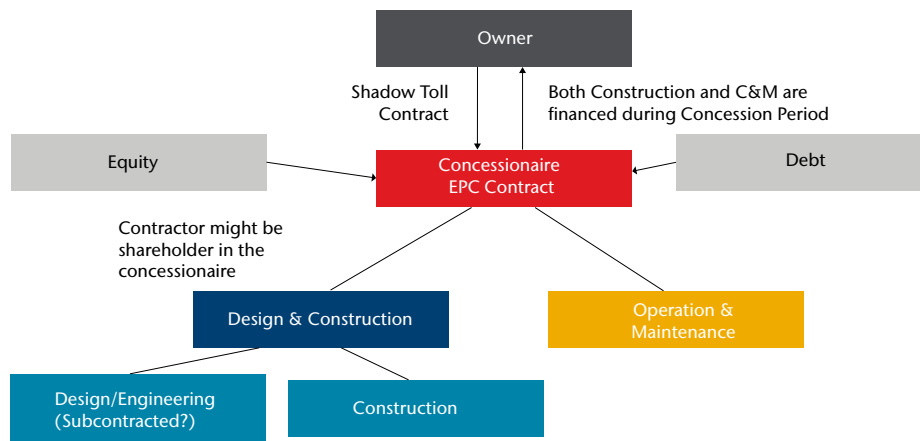
Many Owners also insist on being named as an Insured under the PI/L policy covering a D-B or EPC contract. They believe that the policy will cover them for their costs in making a claim against the Contractor or Designer. This is simply not the case. In fact, naming an Owner as an Insured under the project policy would eliminate the Owners ability to seek recovery under the project specific policy due to the lvi exclusion.

Obviously – or ironically depending on the perspective - in the event that each party buys their own practice PI/L policy, there is no an lvi issue. Each party could seek recovery for perceived errors without concern the policy would not respond due to the lvi exclusion. But Owners also perceive they are inadequately protected if all Contractors and Designers are not Insureds on a project specific policy and purchasing separate project policies for each party can be cost prohibitive.



c) Public Partnership Project (PPP) scenarios are even more complex. In PPP projects, normally a Consortium (or Special Purpose Vehicle) is formed to develop a project, with two different phases: first the Design and Construction period, and then a Commercial operation period for a set number of years. Typically, different parties are

involved: a D-B Joint Venture, a Concessionaire (or Special Purpose Vehicle), a Maintenance firm and Financiers. Some of them carry out their activity during the Design and Construction period, and others start their activity during the following years after the handover of the works.



In this case, if the Concessionaire and the D-B JV are Insureds, the Ivl exclusion has a critical role and not just because of the contractual matrix of the parties involved. In this case, the Concessionaire assumes the role that traditionally corresponds to the Owner. If the works have any defect, the Concessionaire is the one that suffers the damage, the one that has the capacity to discover a potential problem, and the one that will raise any issue with the D-B JV.

Concessionaire responsible for the Operation can belong to the same holding entity. In this case, the “Related Entities” exclusion plays a similar role, and has the same effect of excluding cover from possible claims between various parties involved in the same PPP. Provided the Concessionaire is not undertaking any professional services, the Principals Indemnity extension could potentially provide adequate cover for them.

To further complicate a potential claim, most of the time one or more of the Contractors or Designers involved in the D-B JV, and the

3) How can we provide cover and give comfort to Insurers?

There is not a simple solution, and this can depend upon the type and nature of the project, in addition to the country/region where the project is situated. Some examples of the different options are as follows:

- a) One option is to negotiate the removal of the I/L exclusion. This is in general very idealistic, and in certain circumstances may be achievable: for instance, in simple projects where insurers have a special “commercial” interest; in certain countries where the SPPI/CPPI insurance market is not very sophisticated; or where the legal system is not particularly litigious. Note: in order to address the issue in its entirety, we recommend that not only should the I/L exclusion be deleted but also affirmative language added, with the inclusion of a “Cross Liability Clause” (similar to the cover used in General Liability). This is a desirable option; however, if the PI/L policy is required by the Owner, as usually is the case, the Owner can refuse this “improvement” for a couple of reasons:
 - I. For the Owner, this extension can restrict the Owners ability to recover their losses: a claim between insureds would erode the available indemnity limit if the policy has any aggregate limits, which is typically the case for project policies (for annual policies this varies according to the country/region). The Owner might then be left without any protection for defects on their asset.
 - II. The aggregate indemnity limit is eroded exclusively by costs and expenses as a result of a dispute between the insured parties, where the Owner is not involved.
- b) A more realistic option is to amend the I/L Exclusion to include coverage for certain claims. Clause Example: “However, this exclusion shall not apply to Loss resulting from a Claim brought by or originating from the Owner against the Designer team”. With this text, claims from the Contractor against the Designer may be eligible for coverage, even if both are Insureds under the same policy.
- c) Another option is a tailor-made solution that consists of limited downwards coverage (i.e., with an endorsement permitting claims brought from the Concessionaire against the Contractor and from the Contractor against the Designer - but not in reverse). Similar to 3a) above, this solution tends to be limited to more simplistic projects or projects in countries with less developed insurance markets, or where the legal system is less litigious.

d) A further solution has been developed in the US where Insurers are not prepared to readily amend the Ivl exclusion. It is similar to the situation outlined in 2b) above where the parties rely upon their own professional policies. In the US, because most annual policies have aggregate limits, the requirement to effect project professional policies is more frequent. So where the Ivl exclusion could deny a great element of cover, often two project professional policies are implemented, and in some rare situations more than two project policies have been considered for the same project.

A project policy for the Designers (PSPL = Project Specific Professional Liability), and in addition a policy for the Contractor/ Joint Venture (CPPI = Contractors Protective Professional Indemnity) will be put into place. On more than one occasion the Owner/Concessionaire has considered their own project professional policy (OPPI = Owners Protective Professional Indemnity).

This is an effective way of circumventing the Ivl (and in certain cases the Related Parties) Exclusion(s), but one that comes at the price of higher project premiums.

e) Another approach might be to rely upon a robust First Party/Loss Mitigation or Rectification provision if a PI/L single project policy is required with all parties being named as Insureds, and in certain countries, the separate policies of each party with such a First Party/Loss Mitigation or Rectification provisions could also be considered. The Contractor can notify a potential circumstance that may give rise to a claim (even if it emanates from the professional activities of the Designer) and obtain Insurers' consent to rectify the defect; although the amounts that can be claimed under these Mitigation/Rectification provisions are generally for direct costs only, and would not typically include indirect costs that could be passed on to the Designer under a legal action for damages at large.

4) The "Related Parties or Entities" Exclusion.

"Related Parties or Entities" is another typical exclusion in PI/L policies, and sometimes it is part of the Ivl exclusion. Here is an example of a standalone exclusion:

This Policy will not make any payment for a claim or costs directly or indirectly due to a Loss or Mitigation Loss arising from a Professional Liability Claim or Protective Claim by an entity or individual that wholly

or partially owns, operates, or manages an Insured; in which an Insured has a direct or indirect ownership interest; that is controlled, operated, or managed by an Insured; or that is an affiliate of an Insured.

In PPP projects it is not unusual to have different companies from the same holding entity enrolled in different phases. A number of the largest Construction groups, have a Contractor company

and a Concessionaire company within their family of companies. Simply amending the I/I exclusion is not sufficient to cover claims between all the parties involved, and some amendment to this exclusion would also be advisable. If a

sufficient “arms-length” relationship between the Concessionaire, Contractor and Designers can be demonstrated, Insurers are more likely to agree to amend the Related Parties or Entities Exclusion.

5) Conclusions

There is no easy solution. Contractual frameworks, obligations and responsibilities agreed between parties are a key issue to establish damages and liabilities in a claim between two parties involved in a project. The ability to deliver a solution will depend on the specific project aspects, companies

involved, the country’s litigation panoply and insurance market practices. Insurance market relationships are key to delivery of the solution, and those Insureds who have an established dialogue with their Insurers are more likely to obtain amendments to these exclusions.

Contacts

Lead Author:

Julian del Saz Gutierrez

Professional Indemnity Specialist and CBO-Construction
Aon Risk Solutions - Spain
+34.91.340.5522
julian.delsaz@aon.es

Contributing Authors:

Mark Peterson

Managing Director
Construction Professional Liability
Aon Risk Solutions – US
+1.816.698.4645
mark.peterson1@aon.com

Michael Earp

Senior Vice President and Executive Director Design
Firms, Professional Liability
Aon Risk Solutions – US
+1.312.381.1187
michael.earp@aon.com

Mhairi Hawken

Executive Director and Senior Vice President
Design and Consulting Firms
Aon Risk Solutions – London GBC
+44.2070.860.108
mhairi.hawken@aon.co.uk

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