Back to Basics:
Professional Indemnity
Construction and Engineering

December 2015
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Dear all,

Welcome to the Back to Basics booklet on construction and engineering professional indemnity issues.

The aim of the booklet is to assist those who are relatively new to construction and engineering professional indemnity, or for those who would benefit from a quick reminder of some key points.

I hope you will find the material useful. Of course, please do not hesitate to contact me, or the rest of the team, should you have any questions.

With best wishes,

Emily

Emily Monastiriotis
Part A - Understanding the construction industry
1 Construction contracts

Parties

The main parties to a construction project are:

- **Funder**: financing the project;
- **Employer / Developer / Client**: the party who wants a project built;
- **Main Contractor**: overall responsibility for building and can have design responsibility if it is a D&B contract;
- **Sub-Contractors**: employed by the Main Contractor to carry out specific parts of the works;
- **Professional Consultants**: such as Architects, Engineers, Surveyors, Specialist Consultants etc. employed by either the Employer or the Main Contractor depending on the procurement method; and
- **Validation / Checking Engineer**: employed directly by either the Employer or the Main Contractor to check and report on the Sub-Contractor's work.

Contracts

**Procurement Methods**

How these all fit together depends on the procurement method used, for example:

- Traditional;
- CDP (Contractor's Designed (or Design) Portion);
- Design & Build;
- Management contracting;
- Construction management;
- EPC (Engineer, Procure and Construct);
- Multi-contracting; and
- Bespoke.

The most common procurement methods are Traditional and Design & Build. Examples of how these types of projects would work are set out below (→ Contract → Collateral warranty):

**Traditional:**

```
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Funder

Employer / Developer / Client

Main Contractor

Professional Consultants

Sub-Contractors
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```
Contracts may be bespoke to the parties, but are often based on standard form contracts.

Examples of some commonly used standard form contracts are:

**Construction:**
- JCT;
- NEC; and
- GC/Works.

**Engineering:**
- FIDIC;
- ICC; and
- IChemE.

**Professional Consultants:**
- RIBA;
- RICS;
- NEC; and
- ACE.

Collateral Warranties

Parties often also use collateral warranties.

These create a contractual obligation where one would otherwise not exist, making it easier for parties to claim directly, rather than relying on a claim in tort or statutory rights under the Contracts (Rights of Third Parties) Act 1999. See grey arrows above by way of example.

They are often used when one party in the construction project becomes insolvent or by parties who are not part of the construction project (eg tenant or subsequent purchaser).

These normally create obligations up the contractual chain only, and not down it. For example, a Sub-Contractor would agree with the Employer that it will carry out the works with reasonable skill and care but the Employer would not agree to pay the Sub-Contractor's invoices should the Main Contractor fail to do so.
2 Completion of construction works

Key concepts

Practical Completion

- There is no precise legal definition; it is usually defined in the contract by the parties.
- Generally seen as when the works are complete apart from minor, de minimis, works ("snagging" items), or latent defects (which are discovered later).

Certificate of Practical Completion

- Often has far reaching consequences, for example in relation to liquidated damages, Contractor's liability for patent defects, retention, risk for the works and possession.

Defects Liability Period

- Period following Practical Completion (normally 6 or 12 months; often 24 months in engineering contracts).
- Contractor normally must return to site to remedy any defects which appear during the period and / or has the right to return to site to remedy defects which appear.

Certificate of Making Good Defects

- Issued at the end of the Defects Liability Period or once defects have been rectified.
- Confirms that any defects which the Employer required the Contractor to rectify have been rectified.

Patent Defects

- Defects which can be detected at Practical Completion.
- Works should be free from patent defects at Practical Completion.

Latent Defects

- Defects which cannot be detected at Practical Completion, even upon reasonable inspection.

But ... there are always exceptions to the rule! Parties may agree otherwise in their contract or approach matters differently in practice.
3 Claims in construction projects

Types of claims

- Acceleration
- Guarantee
- Breach of Warranty
- Physical Damage to the Works
- Defects (Design/Workmanship)
- Employer’s Liability
- Breach of planning or other regulatory requirement
- Delay, Disruption and Compensation Events
- Liquidated Damages
- Fitness for Purpose
- Final Account
- Variations
- Extensions of Time
- Business Interruption
- Loss and Expense
- Defects (Design/Workmanship)
- Breach of planning or other regulatory requirement
Who might have a claim against whom?

The table below sets out some examples of the types of claims which might be experienced in a traditional building contract, with a Contractor’s Designed Portion.

<table>
<thead>
<tr>
<th></th>
<th>Employer</th>
<th>Main Contractor</th>
<th>Sub-Contractor</th>
<th>Professional Consultant</th>
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<tbody>
<tr>
<td><strong>Employer</strong></td>
<td>Main Contractor might claim against Employer for…</td>
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<td>Sub-Contractor might claim against Employer for…</td>
<td>Professional Consultant might claim against Employer for…</td>
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<td>• Unpaid sums;</td>
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<td>• Unpaid sums;</td>
<td>• Unpaid fees; and / or</td>
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<td>• Defective design;</td>
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<td>Sub-Contractor</td>
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<td>…where the Main Contractor is insolvent / not insured.</td>
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4 Insurance
Types of policies

Different losses will be dealt with by different insurance policies, for example:

**Property Damage and Business Interruption (PDBI) Insurance:** Damage to property and interruption to the business (normally held by the Employer).

**Contractors All Risk (CAR) Insurance:** Physical damage to the works and site materials.

**Professional Indemnity (PI) Insurance:** Defective design. Regulatory bodies (and contracts) often require consultants to maintain minimum levels of insurance.

**Public Liability Insurance:**
Personal injury or death to members of the public caused by the works; loss or damage to certain property.

**Employer’s Liability (EL) Insurance:**
Protects against injury to employees.

**BUT** scope of the insurance policy may be different from the wording in the contract, leaving some losses uninsured.

**NOTE** Defective workmanship: Normally not covered by professional indemnity insurance. Performance bonds or guarantees may protect Employers.

Always check the policy wording! If in doubt, speak with your broker or legal adviser.
5 Experts

Experts can be used throughout a project and/or a claim. Some examples of the roles that experts can play are:

- **Prior to works commencing to advise on tenders and potential flash points**
- **During the works to bring the project back on track**
- **Defence and promotion of claims**
- **Court / regulatory body may appoint expert to assist them**
- **During the works as and when disputes arise to enable the works to progress**
Part B - Key legal principles behind professional indemnity claims in construction projects
6 Contract v common law
Key concepts

Negligence

- Occurs when a defendant breaches a duty to take reasonable care, which causes loss to the claimant.
- Can be in tort or in contract (in which case it is often referred to as a contractual duty of care or contractual negligence).

Pure Economic Loss

- This is where the claimant's only loss is economic, which is not consequential on damage to the claimant's own property (see for example the "Spartan Steel" case).
- For example, wasted expenditure or diminution in value.

Causation

- In order to recover any losses, a claimant must establish that the defendant's action or inaction caused its loss. This has two steps; factual and legal causation.
- Factual causation: The defendant's action (or inaction) must have, as a matter of fact, caused the claimant's loss. This is established by the "but-for" test. So, but-for the defendant's action or inaction, the claimant's loss would not have occurred.
- Legal causation: This is often referred to as "remoteness". The tests in contract and tort are set out on the next page.

Direct and Indirect Losses

- Direct losses are often referred to as the first limb in Hadley v Baxendale. They are losses which occur in the ordinary course of things. The parties are deemed to have knowledge of such losses, regardless of whether or not they actually knew.
- Indirect (or consequential) losses are often referred to as the second limb in Hadley v Baxendale. These are losses which occur outside the ordinary course of things and due to special circumstances which were known by the parties.
Limitation

• Once the limitation period for a claim has expired, the defendant can raise limitation as a defence to the claim. If successful, the court will not consider the substance of the claim.

• The basic principles are set out in the Limitation Act 1980 (1980 Act), which provides that limitation periods start to run from when the “cause of action accrues”. When the “cause of action accrues” is set out in case law.

• Limitation periods can be suspended by a standstill agreement. These require the consent of the claimant and defendant.

Concurrent Liability

• Parties can have concurrent liability, which is where they owe each other obligations under both a contract and at common law. However:
  – This can be excluded through contractual terms;
  – A concurrent duty does not arise simply because a contract exists;
  – A concurrent duty is more likely to arise in professional appointments than a building contract, due to an “assumption of responsibility”; and
Key differences between contract and common law

<table>
<thead>
<tr>
<th>Key Elements</th>
<th>Contract</th>
<th>Common Law / Tort (Negligence)</th>
</tr>
</thead>
</table>
| **Summary**  | • Obligations between the parties are set out in the contract.  
                   • If either party breaches the terms of the contract (including terms implied by common law or statute), the other party will have a claim for breach of contract.  
                   • Obligations between the parties are set out at common law. These obligations are built up through case law, which the courts continue to review and update.  
                   • There is no requirement for a contract between the parties but a duty of care must be established.  
                   • In a construction project, the most relevant claim at common law would be in the tort of negligence. |
| **Limitation** | • Cause of action accrues on the date the contract is breached.  
                          • 6 years for a contract signed under hand. 12 years for a deed (1980 Act s5 and s8).  
                          • Parties can agree to shorten or lengthen this period in their contract.  
                          • Cause of action accrues on the date damage is suffered (which can be significantly later than for a contractual claim).  
                          • Normally 6 years (1980 Act s2). For latent damage, it is the later of 6 years from when the cause of action accrued and 3 years from when the claimant knew, or ought to have known, the material facts about the loss suffered, the identity of the defendant and the cause of action. This is subject to a long stop date of 15 years from when the negligent act / omission occurred (1980 Act sections 14A and 14B). |
| **Pure Economic Loss** | • Recoverable, unless specifically excluded under the contract.  
                           • Only recoverable if there is a "special relationship" between the parties, which depends on the facts.  
                           • Current case law suggests a building contract will not normally imply such a "special relationship". |
| **Remoteness** | • Losses must be within the contemplation of the parties at the time of formation of the contract.  
                           • Direct losses are generally recoverable (unless excluded under the contract).  
                           • Indirect losses are not always recoverable. It depends on the facts and in any event they are often excluded under the contract.  
                           • Losses must have been reasonably foreseeable by the defendant at the time the duty was breached.  
                           • Often referred to as "The Wagon Mound" test.  
                           • No distinction between direct and indirect losses (although see comments on Pure Economic Loss). |
| **Quantification of Loss** | • To put the claimant in the position it would have been had the contract been performed.  
                               • Useful for claimants in "good bargain" cases.  
                               • To put the claimant in the position it would have been had the tort not been committed.  
                               • Useful for claimants in "bad bargain" cases. |
7 Contractual "standard of care"…and what it actually means

Reasonable Skill and Care

- The professional agrees to carry out its work using reasonable skill and care.
- Whether or not this has been complied with is an objective test: the "man on the Clapham omnibus".
- For professional liability cases, the "Bolam" test is relevant. This judges professionals on the standard of a reasonably competent practitioner having regard to the standards normally adopted in his profession at the time of the act or omissions.
- For example, if a professional complies with standard practice or guidelines at the time of acting, he most likely will not be in breach, even if that guidance later turns out to be incorrect.
- Normally covered by insurance policies, but be careful of inadvertently agreeing to a higher standard without insurers’ approval. Eg where a project concerns a high rise building, an Employer will often require a standard of a professional experienced in tall buildings.

Fit for Purpose

- A professional agrees that their work will be fit for the purpose required. For example, an architect agrees the drawings he produces will be suitable for a specific use.
- If the drawings are not suitable, then the architect will be liable – regardless of whether he was negligent, the reason for the unsuitability or whether it was someone else’s fault.
- Often not covered by insurance policies.

Strict Liability

- Similar to fitness for purpose.
- A professional (eg architect) agrees that the work they produce (eg drawings) will be entirely accurate.
- If the drawings are not accurate, then the architect will be liable – whether or not he was negligent, the reason for the error, the impact of someone else, or any damage actually caused to the claimant.
8 Transferring obligations in construction projects

Parties often need to transfer rights and obligations in construction projects. For example, in a design and build scenario, the Developer often appoints the professional team to develop the initial design. A Main Contractor is then appointed and the Developer transfers the professional team's appointments to the Main Contractor.

This can be achieved in two main ways; assignment or novation.

<table>
<thead>
<tr>
<th>Assignment</th>
<th>Novation</th>
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<tr>
<td>Transfers the <strong>benefit</strong> of a contract (eg to have works carried out), but not the <strong>burden</strong> (eg to pay for the works).</td>
<td>Transfers both the <strong>benefit and burden</strong> of the contract (eg to have works carried out and pay for those works).</td>
</tr>
<tr>
<td>Extinguishes one contract and replaces it with a new contract on the same terms but between different parties.</td>
<td>Parties often agree to apportion services pre and post novation.</td>
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**Effect**

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<th>Assignment</th>
<th>Novation</th>
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<tr>
<td>Requires the consent of <strong>just the parties</strong> to the assignment (eg the Developer and the Contactor, but not the professional). However, this can be amended through the terms of the contract, for example by limiting the number of assignments or the identity of the assignee.</td>
<td>Requires the consent of <strong>all the parties</strong> (eg the Developer, Contractor and the Professional).</td>
</tr>
<tr>
<td>Can be a <strong>legal or equitable</strong> assignment.</td>
<td>Best practice is to use a <strong>formal Novation Agreement</strong>.</td>
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**Formalities**

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<th>Assignment</th>
<th>Novation</th>
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<tr>
<td><strong>Best practice</strong> is a <strong>legal assignment</strong>. In order to be effective, it must be: • In <strong>writing</strong>: a verbal agreement is not sufficient; • <strong>Absolute</strong>: it must be the assignment of the entire contract (not just a discrete part) and it must be unconditional; and • On <strong>notice</strong>: the third party (eg the professional) must be given notice of the assignment.</td>
<td>An <strong>equitable assignment</strong> is less formal, but also less certain: • Can be <strong>verbal or written</strong>; • Does <strong>not require notice</strong>; and • Transfers the <strong>equitable ownership</strong>, but not the legal ownership. The assignor (ie the Developer) may therefore need to be involved in any <strong>subsequent court proceedings</strong> against the professional.</td>
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9 What you need to establish to bring a claim

Establish the relationship

Tort:
• Duty of Care: "Caparo" test.

Contract:
• Agreement, consideration and intention.
• Can be verbal.
• Includes express and implied terms.

Breach

Tort:
• "Reasonable man" test or "Bolam" test for professional liability.

Contract:
• Depends on the specific terms of the contract.

Causation

Same basic principles in tort and contract, but see comments elsewhere on specific tests.

Factual Causation:
• "But-for" test.

Legal Causation:
• Intervening acts.
• Remoteness.
• Scope of the defendant's duty of care in respect of the kind of loss suffered: SAAMCo principle (tort or contractual duty of care only).

Loss

• Mitigation: A claimant must take reasonable steps to minimise its loss and not take unreasonable steps which increase its loss. Burden of proof is on defendant to prove a failure to mitigate.

• Contributory Negligence: Damages will be reduced where the claimant was partly at fault (tort or contractual duty of care only).

• Loss is not essential for breach of contract claim. If there is no loss, an award can be made for nominal damages (normally £1). Of course if there is loss, then that must be proven…

Records are key!

Remember – the claimant must prove its case on the balance of probabilities. The facts must support the claim!
## 10 Summary of main dispute resolution forums

<table>
<thead>
<tr>
<th>Dispute Resolution Forum</th>
<th>Basis for forum</th>
<th>Binding?</th>
<th>Confidential?</th>
<th>Usual timescales</th>
<th>Qualifications of decision maker</th>
<th>Normal cost position</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjudication</td>
<td>Contract or Statute (Housing Grants Construction and Regeneration Act 1996). Usually specific provisions in insurance policy about this.</td>
<td>Yes (usually on interim basis, until finally determined by litigation or arbitration).</td>
<td>Yes – unless application made to court.</td>
<td>28 days (although it is often extended).</td>
<td>Anyone: lawyer, engineer, quantity surveyor, architect...(parties often agree in their contract either on the individual or Adjudicator Nominating Body).</td>
<td>Normally each party bears their own (parties can agree otherwise but ineffective if agreed prior to service of adjudication notice). Adjudicator typically has jurisdiction to order either party to pay his costs (although they both remain jointly and severally liable).</td>
<td>&quot;Smash and grab&quot; adjudications becoming frequent.</td>
</tr>
<tr>
<td>Mediation</td>
<td>Agreement between the parties.</td>
<td>No (unless binding settlement agreement signed).</td>
<td>Yes.</td>
<td>Quick – a day or so, with a couple of weeks' preparation.</td>
<td>No decision maker. Mediator is normally accredited.</td>
<td>Each party bears their own. Share mediator's fees and expenses.</td>
<td>Requires a desire from both parties to settle the claim.</td>
</tr>
<tr>
<td>Litigation</td>
<td>Default if parties do not agree to something else.</td>
<td>Yes.</td>
<td>No.</td>
<td>Normally 1 - 2 years. Specialist procedures can sometimes be used, which can be shorter, eg Part 8 procedure can be as quick as 1 month.</td>
<td>Judge.</td>
<td>Loser pays. To be recoverable, costs must be proportionately incurred. Rare to recover 100% of costs. Note Part 36 offers.</td>
<td>Pre-Action Protocol for Construction and Engineering Disputes should be followed prior to commencing claim, unless there is a limitation deadline. Significant recent developments in relation to cost management and procedures.</td>
</tr>
<tr>
<td>Arbitration</td>
<td>Contract or ad-hoc agreement.</td>
<td>Yes.</td>
<td>Yes.</td>
<td>Normally over 1 year, but generally shorter than litigation.</td>
<td>Varies. Can be a sole arbitrator or a tribunal. Arbitrators can be legally qualified, or may be in the industry eg a quantity</td>
<td>Loser pays. Parties can agree otherwise, however any agreement ineffective if made before the dispute arises.</td>
<td>Can be quicker than litigation.</td>
</tr>
<tr>
<td>Dispute Resolution Forum</td>
<td>Basis for forum</td>
<td>Binding?</td>
<td>Confidential?</td>
<td>Usual timescales</td>
<td>Qualifications of decision maker</td>
<td>Normal cost position</td>
<td>Comments</td>
</tr>
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<tr>
<td>Industry or other regulatory bodies eg RIBA Disciplinary Committee</td>
<td>Professional Consultant's membership of regulatory body.</td>
<td>Yes.</td>
<td>No.</td>
<td>Varies.</td>
<td>Member of disciplinary tribunal of regulatory body.</td>
<td>Varies.</td>
<td>Often in conjunction with another dispute resolution forum.</td>
</tr>
</tbody>
</table>

Tip: Make sure all the contracts in the chain have the same dispute resolution forum
11 Reduce the risk

If in doubt, take legal advice to ensure that you are not exposed to unnecessary risks. For example:

1. **Check the contractual chain**: are contracts up and down the chain back to back? If not, you may get caught out.

2. **Always make sure that the contract and insurance policy are back to back**, e.g., standard of care.

3. **Consider incorporating contractual wording to protect yourself where possible**, such as:
   - **Net contribution clause**: limits a party's liability when two or more parties to a construction project are liable for the same loss or damage. The liability of each party will be limited to the amount for which it is responsible, as would be apportioned to that party by a court. Without it, each party could be liable for 100% of the loss and would then have to recover a contribution from contributing parties. This takes time and money – and could potentially be impossible if the other party is insolvent or does not have sufficient insurance to cover the loss.
   - **Caps on liability**: for example by reference to the Professional Consultant's PI insurance.
   - **Shorter limitation periods** than provided by the Limitation Act 1980.
   - **Exclude certain types of losses**: for example, exclude consequential losses or anything excluded under the PI policy.

Any Questions?
**Contact us**

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Shortlisted for UK Law Firm of the Year 2015 by Legal Week

Nominated by Legal 500 for Professional Negligence Team of the Year 2015