



Property Development – The Business Interruption Risk Protecting The Developer’s Interest

The prudent developer, having secured finance through various means to undertake a major building project, with associated finance costs, must always retain a commercial view as far as the development is concerned in anticipating bottom line profit levels. The vagaries of the property market aside, the management of financial risks is essential before and during the construction period to enable the developer to achieve his goal. Even for relatively small developments, or the conversion of existing structures, he will undoubtedly surround himself with a team of construction professionals and will ensure that proper contractual relationships are established with his advisers, the main contractors, and specialists sub-contractors. Consideration will be given to works and liability insurances, and the future of the development through the acquisition of collateral warranties. Such subjects will not be discussed on this occasion, although, through the contractual route and the imposition of liquidated and ascertained damages, the developer will seek to protect himself against delays in completion of the constructional work, and the consequent delay in the commencement of the return from the capital investment. That achieved, the developer may sit back content in the knowledge that he has done all that he can to protect his position. However, circumstances often arise where the indemnity due from, for example, the main contractor, is insufficient and additional protection is necessary. It is here that business interruption or consequential loss insurance can be essential, either as a stand alone product, or alternatively, as an additional section to the bespoke project policy albeit that the indemnity provided thereunder will undoubtedly be restricted to those with an insurable interest, i.e., the developers themselves, and perhaps their funders.

Before considering policy covers and providing some advice to avoid common pitfalls, it is perhaps prudent to consider the nature of the risk exposure the developer can face. The range and variety of building contracts is immense, although, by and large, when considering property development work, one of the standard JCT forms will be utilised.



It is Clause 24 within the standard main contract forms that deals with damages for non completion, and Clause 25 being of particular relevance, regarding applications for extensions of time. Thereunder the contractor is obliged to give notice as soon as it becomes reasonably apparent that the progress of the works is being, or is likely to be delayed, and details of all material circumstances and whether or not in the contractors opinion the event is a Relevant Event is necessary. What is and is not a Relevant Event is detailed within sub-clause 25.4, which amongst other things can grant the contractor the release from liquidated and ascertained damages subsequent to delays arising from loss of or damage to the works by one or more of the specified perils, compliance with architects instructions or alternatively, exceptionally adverse weather conditions. Leaving aside Clause 26 which may leave resultant loss and expense claims sitting firmly with the contractor the possibility for the developer sustaining the loss is clear to be seen. Whilst not the subject of this review, developers should be aware of some differences with the Standard JCT Form of Management Contract (1998 Edition), whereby the professional team can deny any application for an extension, if the delay arises from any omission on the part of either the management or works contractors, even if the resultant damage could have arisen from one of the specified perils. For example, a situation could easily arise where a pipework joint was improperly made, leading to “bursting or overflowing of water apparatus”, so that whilst a peril operated, workmanship error could deny the management or trade contractors from liquidated and ascertained damages.

Equally, even if liquidated and ascertained damages can be applied to any delay scenario, the reality of the impact upon the developers financial position can often be beyond the level of liquidated and ascertained damages set during tender negotiations. Whilst every effort is made to set the level of damages at an appropriate level, often, the full consequences are not appreciated until a loss is sustained. Equally, it can be the case that on smaller projects it is difficult to reach agreement with the contractor involved for an appropriate level of damages, as if set accurately, they may preclude the contractor from becoming involved in the development or alternatively, the position of such damages would vastly affect any tender submitted. One example of such a scenario would be the fit out of an existing office building to accommodate, for example, the traders dealing room where actual losses for delays may be truly significant. Consequently, another avenue for shortfall and irrecoverable losses for the developer arises. Relatively common



extensions to contract works policies can assist in mitigating delays and losses arising therefrom, for example expediting expenses, increased costs of working and the additional cost of outstanding construction work. That said, the case for the developer securing appropriate insurances for potential exposure is clear.

Policy covers for this category of risk come in many guises, entitled either advanced loss of profits or rent, or more basically, consequential financial loss or business interruption. However, the cover is titled, the essential detail of the operative clause will however remain relatively consistent, with the indemnity extending to interruption or interference with the policyholders business or financial losses incurred by the policyholder, consequent upon damage to the property insured. It is important at this stage to note that the trigger is “damaged”, and further, that there are exceptions or excluded causes which by and large follow those within the contract works policy. Circumstances will therefore arise where the developer does not have the protection of liquidated and ascertained damages, and insurances that can be obtained will not apply, i.e., resultant from extensions of time due to adverse weather conditions.

When deciding the nature of the cover to be provided however, the developer should bear in mind what is in effect a material damage proviso. Whilst the basic cover will cater for the majority of the volume of claims, for example, fire, floods etc, it will often be the case that the “material damage” cover available under either an annual or project specific contract works policy will be subject to a standard defects exclusion. As far as the works cover is concerned this will exclude the cost of rectifying any part of the works which are in themselves defective in either design, plan, specification, materials or workmanship, and the standard business interruption cover will consequently not indemnify the policyholder in respect of loss resulting from the replacement or rectification rendered necessary by the existence of such defects. Particularly if any aspect of the design incorporates new building technology or construction methods, it may well be to the developers advantage to enhance the cover provided to include delays resultant from the cost of rectifying defects, albeit this will only be available when damage to the defective item has occurred.



Rectification of any element which is defective in design etc can lead to serious delays. Particularly with ongoing developments in cladding design and the complexities involved in erection and defined tolerances that exist between individual building elements, it has often been found that failures occur, and that in periods of adverse weather conditions rainwater ingress occurs. Whilst there is usually resultant damage, i.e., to works undertaken within the building envelope, the delays by and large arise from rectifying the weather proofing system itself. This is where the business interruption risk lies, and where the developers position should be protected, particularly where the contractor has no design responsibility. A purchase of such cover is however costly, and, as with any commercial insurance, an assessment of the relative cost benefits should be undertaken before acquisition.

The next question to be addressed is exactly what indemnity the developer requires. If a building is being fitted out for letting purposes, the cover could simply extend to loss of rental income during the delay period. Alternatively, if the development is being financed, through specific or mezzanine loans, it may be prudent to restrict the level of cover to, for example, interest payable on any loan during the delay period, or alternatively, interest receivable if the developer is utilising his own funds. The nature of the potential loss must be thoroughly considered, as if the delay in the sale of, for example, apartments within the block, occurs, then if loans have been taken out, the loss to the developer will only be the additional payments made under the loan due to delayed receipt of the funds arising from the sale. This will have a significant effect on premiums rendered. It is only when the nature of the cover required is decided that the level of cover can be appropriately set. Consideration should however be given to additional cover for increased costs of working, or alternatively, further additional expenditure which would cater for, for example, the additional cost of re-marketing an apartment should a sale fall through due to delays arising.

It is also necessary to consider the nature of the indemnity period granted by Insurers. This will usually only commence at the date which, but for the damage, construction of the premises would have been completed and in that respect, some difficulties can arise, particularly when a project is subject to sectional completion. In a four or five block development, damage may occur in Block A, and unless the policy is noted to reflect



sectional completion, it has been, in error, seen that the indemnity period would not in fact commence until the anticipated completion date of the project as a whole. Whilst Block A may be severely delayed, this may have no effect on the end date for the project, so that policyholders have seen some disputes arise with Insurers. As long as the business interruption cover is seen to be “back to back” with the main construction project, i.e., sectional completion is allowed for, then the developers position should be protected. The indemnity period utilised might also be considered, and bearing in mind that it is entirely possible that an entire development could burn down the day prior to Practical Completion, so that the project would have to re-commence after demolition debris removal, an indicator of the period required should always be the anticipated construction period for the development originally leased.

Having considered the nature of the indemnity required, (basis of settlement) and the indemnity period, consideration must be given to any excess or deductible. It will usually be the case that a time excess is applied, and perhaps coupled with a greater franchise time period. The nature of the deductible arrangement will have an effect on premium, and the developer and his advisers should carefully consider what risk the developer is willing to carry in the first instance, so that deductible terms can be agreed with an eye to the commerciality of any premium to be rendered.

If properly established, covers of this nature can be of great assistance to protect the developers position. Indeed, there is no bar to the developer looking to the Insurer for an indemnity in the first instance, in the event that a delay occurs, leaving the Insurer to subrogate in the form of liquidated and ascertained damages against the contractor once any contractual position has been agreed. Often, the contractual negotiations can take some considerable time, and therefore, the developer can receive the benefit of the policy he has purchased in advance.

Subsequent to the presentation of any claim, somewhat complex negotiations can take place, to not only establish the extent of the developers loss in the terms of the policy, but more particularly, to agree the basis of that loss, which will be the actual delay period. Agreement of the time span involved can be difficult, and ultimately involve the forensic analysis of proposed and actual work plan. It is however advantageous if the developers



professional team maintain a close watch on programming issues, and in particular address applications for extension of time at the earliest possible date. This is particularly relevant in the case of a minor loss, where the application of any time deductible or franchise may be of particular relevance. It is this area where, post loss, the most disputes arise, so that as much information as can be provided at the earliest stage is always appreciated by the investigating adjusters.

There is of course a limit to the time that any writer can maintain the readers interest, and further, the forbearance of the publisher involved. It would perhaps be easy for the writer to enter into detailed descriptions of claims events that have occurred, although, before your attention wanes we will conclude on the basis that with proper advice from his brokers, the developer should be aware of the nature of the financial risks he is undertaking, and utilise to the best advantage an established insurance market can provide him with protection, albeit, that as ever, a cost analysis of the insurance purchase should be made.

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