WOMBLE BOND DICKINSON

Back to Basics

Professional Indemnity Construction and Engineering

Contents

Introduction

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.

Hannah Cane
Partner, Head of Construction Insurance

Hannah Cane is **"tough yet commercially astute ... incisive in her analysis ...[and] goes out of her way to put the clients' needs at the heart of the excellent service she delivers"**

Legal 500 2018

"Commercial, responsive, pragmatic and approachable"

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Part A
Understanding construction contracts and claims

Construction contracts

Parties

The construction and engineering sector is wide. It covers the construction of everything from schools to offshore oil platforms. The principles of construction and engineering contracts are very similar, whatever you are building, but the terminology used can be very different. We have focused on the design and construction of buildings in order to keep things simple.

Main Parties

The main participants in a construction project are:

- **Employer / Developer / Client**: the person or entity who wants a project built
- **Funder**: financing the project
- **Main Contractor**: overall responsibility for building and can have design responsibility if it is a Design & Build 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

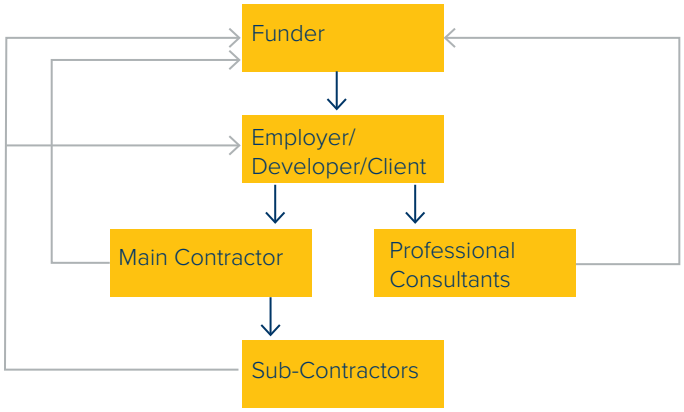
Procurement Methods

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

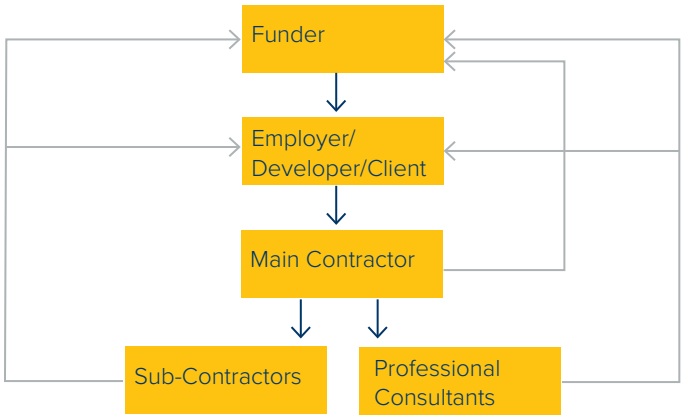
- Traditional
- CDP (Contractor's Designed (or Design) Portion)
- Design & Build
- Management contracting
- Construction management
- EPC (Engineer, Procure and Construct)
- DBO (Design, Build and Operate)
- Multi-contracting, and
- Bespoke.

The most common procurement methods are Traditional and Design & Build. Examples of how these types of projects would work are set out below (contracts shown with blue arrows; typically agreed collateral warranties shown with grey arrows):

Traditional



Design and Build



Standard Form Contracts

Contracts in the construction sector are usually based upon standard form contracts (although sometimes they are bespoke contracts drafted from scratch by lawyers). Standard form contracts are published and maintained by a range of construction and engineering industry bodies. Many of the standard form contracts are published as a suite of contracts covering the different procurement methods and contractual links in a construction project. The choice of standard form is normally based upon the sector. For buildings, the most common set of contracts are the JCT contracts.

Examples of some commonly used standard form contracts are:

Construction

- JCT and NEC.

Engineering

- FIDIC, ICC and IChemE.

Professional Consultants

- RIBA, RICS, NEC and ACE.

Collateral Warranties (and Third Party Rights)

These create a contractual link between participants in a project that are not directly connected by the main construction contracts on the project (see the grey arrows on the diagrams on page 5) e.g. a tenant or subsequent purchaser.

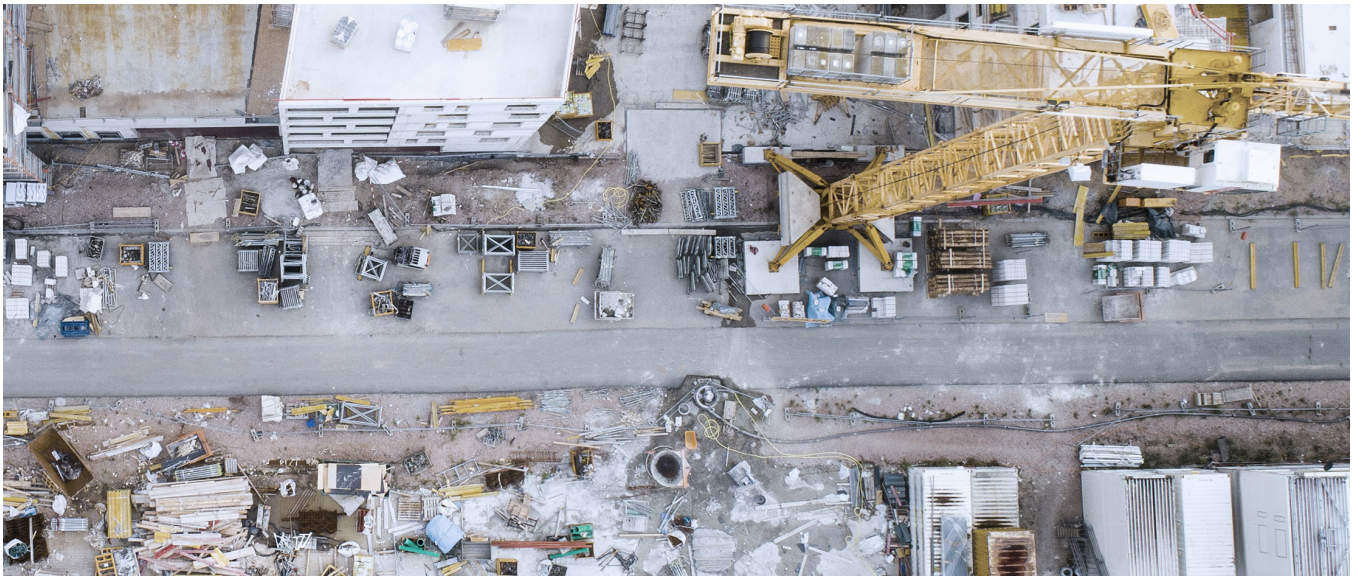
The Contracts (Rights of Third Parties) Act 1999 can be used to achieve effectively the same result without the need for executing collateral warranties, referred to as "third party rights" – but collateral warranties remain the more popular and arguably more certain route.

Collateral warranties (or third party rights) are often relied upon when one party in the construction project becomes insolvent or has breached their construction contract.

If there is no contractual link between a party that has suffered a loss and the person that it wants to make a claim against then the party with the claim has to rely on rights in tort (negligence) or statutory rights.

Collateral warranties (or third party rights) 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.

NOTE: collateral warranties may be excluded by insurance policies if they impose obligations exceeding a party's common law duties unless expressly agreed with insurers.



Completion of construction works

Key concepts

We have set out the terminology used in construction contracts in relation to buildings. Process plants have more complicated structures because of the need to commission and test the plant.

Practical Completion

- There is no precise legal definition but it is sometimes defined in the contract by the parties.
- Generally seen as when the works are complete apart from minor works which do not affect the safe use of the building ("snagging" items), or latent defects (which are discovered later).
- Often referred to as 'PC'.

Practical Completion Statement

- A statement or certificate issued once the work reaches 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 of the building.
- Also referred to as a Practical Completion or PC Certificate.

Rectification 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 this period and / or has the right to return to site to remedy defects which appear.
- Sometimes called the Defects Notification Period, Defects Correction Period or Defects Liability Period.
- Note that the Contractor's liability for defects may not stop at the end of this period. It depends what the contract says.

Notice of Completion of Making Good

- Issued once defects have been rectified at the end of the Rectification Period.
- 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.

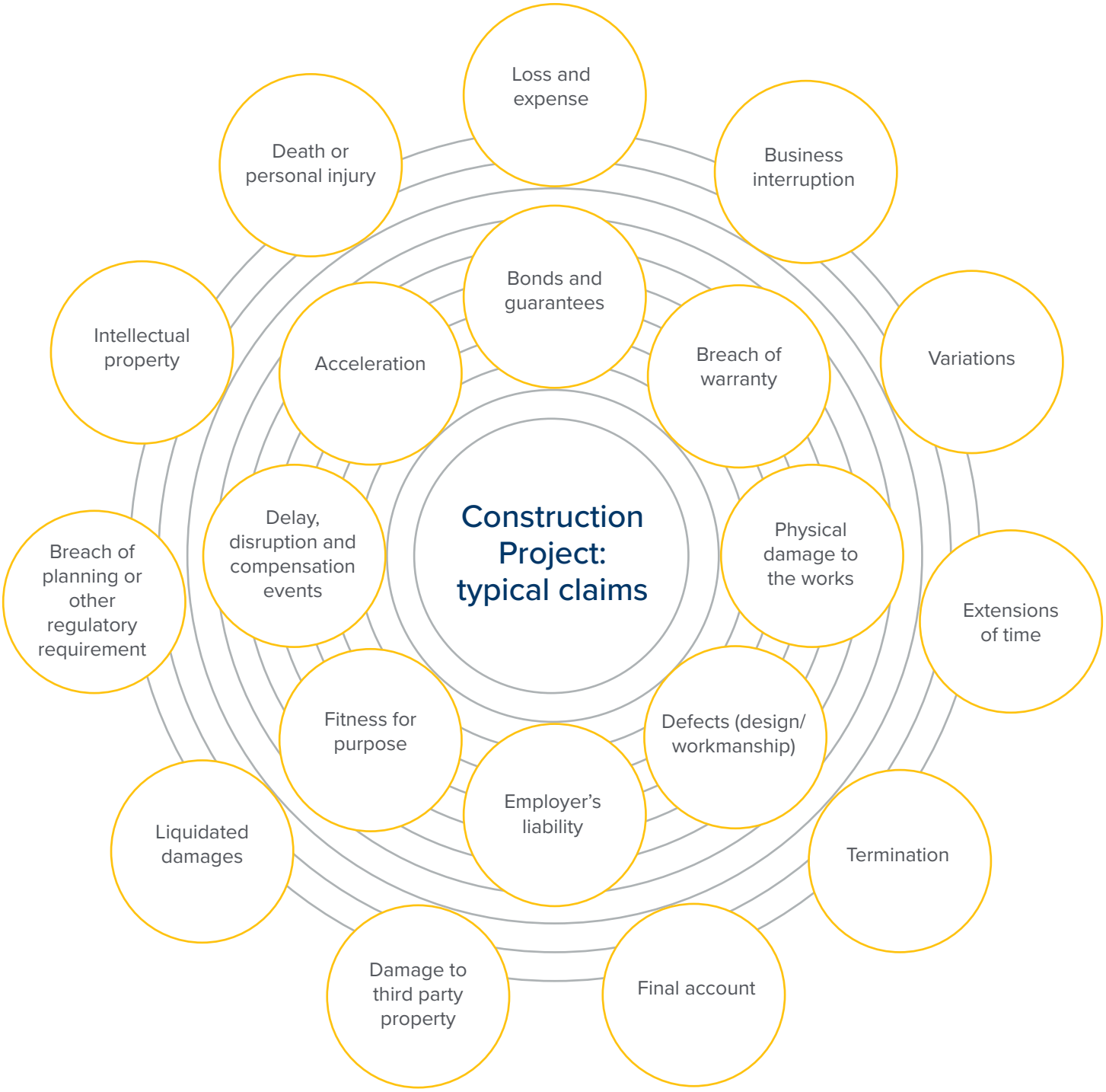
Latent Defects

- 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.

Claims in construction projects

Types of claims



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.

	Employer	Main Contractor	Sub-Contractor	Professional Consultant
Employer		Main Contractor might claim against Employer for: • Unpaid sums • Variations • Loss & Expense • Delays, Extensions of Time and Compensation Events • Acceleration, and / or • Termination.	Sub-Contractor might claim against Employer for: • Unpaid sums • Variations • Loss & Expense, and / or • Delays… …where the Main Contractor is insolvent.	Professional Consultant might claim against Employer for: • Unpaid fees, and / or • Termination.
Main Contractor	Employer might claim against Main Contractor for: • Defective design • Workmanship defects • Delay (general or liquidated damages), and / or • Termination.		Sub-Contractor might claim against Main Contractor for: • Unpaid sums • Variations • Loss & Expense • Delays, Extensions of Time and Compensation Events • Acceleration, and / or • Termination.	Professional Consultant might claim against Main Contractor for: • Contribution for defective design.
Sub-Contractor	Employer might claim against Sub-Contractor for: • Defective design • Workmanship defects, and / or • Delay (general or liquidated damages)… particularly where the Main Contractor is insolvent/not insured/not liable.	Main Contractor might claim against Sub-Contractor for: • Any sums claimed against it by Employer, and / or • Termination.		Professional Consultant might claim against Sub-Contractor for: • Contribution for defective design.
Professional Consultant	Employer might claim against Professional Consultant for: • Defective design • Indemnities for breaches eg in relation to Final Account • Inadequate supervision • Incorrect payment documents • Incorrect certification • Failure to warn, and / or • Termination.	Main Contractor might claim against Professional Consultant for: • Defective design, and / or • Failure to certify.	Sub-Contractor might claim against Professional Consultant for: • Contribution for defective design.	

Part B
Key legal principles behind professional indemnity claims in construction projects

Contract vs common law

What is contract law and common law?

Contract law

Contract law is simply the law in relation to the agreements. Most contract law is common law, but there is some statute law e.g. the Contracts (Rights of Third Parties) Act 1999.

Common law

Common law is the body of law made by the Courts through their judgments over the last 800 years, as opposed to statute law which is made by the Crown via Parliament. For our purposes we are using the term to mean rights that the parties to a construction project are given by the law, as opposed to the rights that they agree to give each other by contract.

Key concepts

Breach of Contract

Occurs when a defendant breaches the term(s) of its contract.

Tort

The law of tort is the remedies provided by the Courts if one person has injured another.

Negligence

- Occurs when a defendant breaches a duty to take reasonable care, which causes loss to the claimant.
- Negligence is a tort.
- It is also possible to be liable for breach of contract as a result of breaching a contractual duty of care, often referred to as "contractual negligence".

Measure of Damages

- Breach of contract - measure of damages is to put the injured party in the position it would have been in had the contract been performed.
- Negligence - measure of damages is to put the injured party in the position it would have been in had the tort not been committed.

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, loss of profit, wasted expenditure or diminution in value.
- Recovery of pure economic loss in a claim for negligence is generally not possible but there are exceptions to this rule.

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 page 13.

Direct and Indirect Losses

- Distinction as to what damages are recoverable for breach of contract.
- These terms are used in exclusion clauses to limit the parties' liability to each other for certain 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 are due to special circumstances which were known by the parties.
- Loss of profit could be either direct or indirect.

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.
- The cause of action in tort and contract may occur at different times even though the wrong or breach is the same. This is important because there may be a longer limitation period in tort than in contract.
- 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
- The scope of the contractual duty of care depends on the wording in the contract. See Robinson v PE Jones (Contractors) Limited [2011] EWCA Civ 9 for discussion on concurrent liability.

Key differences between contract and common law

	Contract	Common Law/Tort (Negligence)
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 (see comments on Pure Economic Loss on p.11).
Quantification of Loss	• To put the claimant in the position it would have been in had the contract been performed. • Useful for claimants in "good bargain" cases.	• To put the claimant in the position it would have been in had the tort not been committed. • Useful for claimants in "bad bargain" cases.

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. For example, a guarantee as to quality.

Fit for Purpose

- A professional can expressly agree 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.
- A design and build contractor is considered to impliedly agree that the final product will be fit for purpose.
- Often not covered by insurance policies.
- Can be excluded or limited by contract.

Strict Liability

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

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 by the Developer and the Developer transfers the professional team's appointments to the Main Contractor.

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

	Assignment	**Novation**
Effect	Transfers the **benefit** of a contract (eg to have works carried out), but not the burden (eg to pay for the works).	Transfers both the **benefit and burden** of the contract (eg to have works carried out and pay for those works). Extinguishes one contract and replaces it with a new contract on the same terms but between different parties. Parties often agree to apportion services pre and post novation.
Formalities	Requires the consent of **just the parties** 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. Can be a **legal or equitable** assignment. Best practice is a legal assignment. In order to be effective, it must be: • In writing: a verbal agreement is not sufficient; • Absolute: it must be the unconditional assignment of the whole of a right under the contract; and • On notice: the third party (e.g. the Professional) must be given notice in writing of the assignment. An equitable assignment is less formal, but also less certain: • Can be verbal or written; • Does not require notice; and • Transfers the equitable ownership, but not the legal ownership. The assignor (ie the Developer) may therefore need to be involved in any subsequent court proceedings against the Professional.	Requires the consent **of all the parties** (eg the Developer, Contractor and the Professional). Best practice is to use a formal Novation Agreement.

What you need to establish 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

- 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!

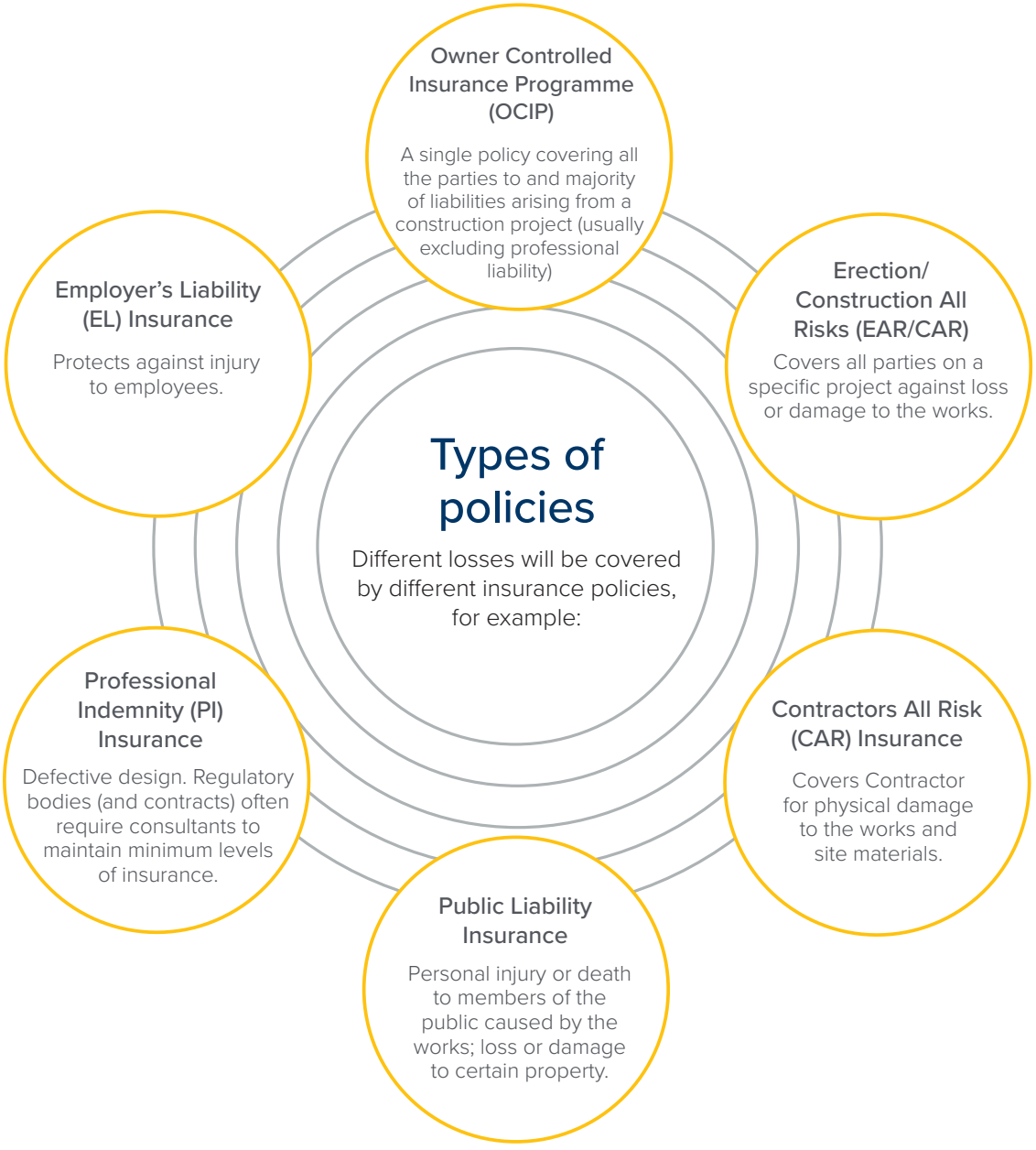
Summary of main dispute resolution forums

Dispute Resolution Forum	Basis for forum	Binding?	Confidential?	Usual timescales	Qualifications of decision maker	Normal cost position	Comments
Adjudication	Contract or Statute (Housing Grants Construction and Regeneration Act 1996)	Yes (usually on interim basis, until finally determined by litigation or arbitration)	Yes – unless application made to court	28 days (although it is often extended)	Anyone: lawyer, engineer, quantity surveyor, architect...(parties often agree in their contract either on the individual or Adjudicator Nominating Body)	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)	The use of "smash and grab" adjudications spiked and is in decline Smash and grab adjudications are where one party claims for the full amount it says is owed (even though the true amount payable may be lower) by arguing the other party failed to give valid payment or pay less notices on time or correctly
Expert Determination	Contract or ad-hoc agreement	Yes	Yes	Up to a couple of months	Expert in the relevant field: eg quantity surveyor, lawyer, engineer	Depends	Very difficult to appeal
Mediation	Facilitated agreement between the parties	No (unless binding settlement agreement signed)	Yes	Quick – a day or so, with a couple of weeks' preparation	No decision maker. Mediator is normally accredited	Each party bears their own Share mediator's fees and expenses	Requires a desire from both parties to settle the claim
Litigation	Default if parties do not agree to something else	Yes	No	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	Judge	Loser pays To be recoverable, costs must be proportionately incurred. Rare to recover 100% of costs Note Part 36 offers	Pre-Action Protocol for Construction and Engineering Disputes or Pre-Action Protocol for Professional Negligence Claims (as applicable) should be followed prior to commencing claim, unless there is a limitation deadline Significant developments in recent years in relation to disclosure, cost management and procedures

Dispute Resolution Forum	Basis for forum	Binding?	Confidential?	Usual timescales	Qualifications of decision maker	Normal cost position	Comments
Arbitration	Contract or ad-hoc agreement.	Yes.	Yes.	Normally over 1 year, but generally shorter than litigation.	Varies. Can be a sole arbitrator or a tribunal. Arbitrators can be legally qualified, or may be in the industry eg a quantity surveyor.	Loser pays. Parties can agree otherwise, however any agreement ineffective if made before the dispute arises. Note Calderbank offers.	Can be quicker than litigation.
Early Neutral Evaluation	Contract or ad-hoc agreement.	No.	Generally.	Quick (weeks).	Expert in the relevant field: eg quantity surveyor, architect, engineer. Judges sometimes agree to do so at an early stage of litigation.	Each party bears their own. Expert's costs normally shared.	Quick and relatively cheap.
Industry or other regulatory bodies eg RIBA Disciplinary Committee	Professional Consultant's membership of regulatory body.	Yes.	No.	Varies.	Member of disciplinary tribunal of regulatory body.	Varies.	Often in conjunction with another dispute resolution forum.

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

Insurance



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

Note: defective workmanship is 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.

Experts

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

Note: Experts giving evidence as an Expert Witness in Court must comply with various obligations including eg The Civil Procedure Rules and the Technology and Construction Court Guide. In particular, the Civil Procedure Rules state that "it is the duty of experts to help the court on matters within their expertise...this duty overrides any obligation to the person from whom experts have received instructions or by whom they are paid". Sanctions may apply if they fail to comply with this.

The Practice Directions to the rules also say that their evidence should be "uninfluenced by the pressures of litigation".

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**, eg standard of care.
3. **Consider incorporating contractual wording to protect yourself where possible**, such as:

   a) **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.

   b) **Caps on liability**; for example by reference to the Professional Consultant's PI insurance.

   c) **Shorter limitation periods** than provided by the Limitation Act 1980.

   d) **Exclude certain types of losses**; for example, exclude consequential losses or anything excluded under the PI policy.

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>
> Legal 500 2019

> "Outstanding defendant-focused practice...excellent reputation for defending negligence claims"
>
> Chambers and Partners UK Guide 2019

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Notes

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