



## Professional indemnity insurance and the insurance of project risk

INTERNATIONAL FEDERATION OF CONSULTING ENGINEERS

### A Clients Guide

Fédération Internationale des Ingénieurs-Conseils  
International Federation of Consulting Engineers  
Internationale Vereinigung Beratender Ingenieure  
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The hardening of the insurance market over recent years has resulted in increased professional indemnity (PI) costs, higher premiums and excesses, as well as restrictions on cover.

The effect of this hardening market has had severe implications, not only for consulting engineers but also for their clients. Consulting engineers can only meet liabilities out of either insurance or assets. Most consulting engineers have few liquid assets; liabilities therefore have to be matched by insurance cover by way of a PI policy. In such a climate, it becomes all the more important for both clients and consulting engineers to work together to allocate project risks sensibly.

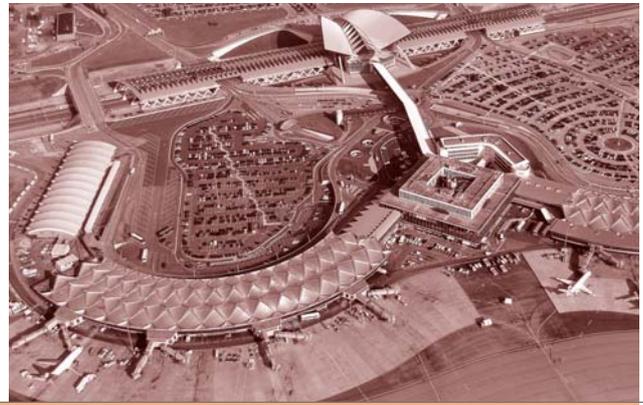
A sensible liability regime is likely to encourage insurers to continue to provide cover into the future. Onerous liabilities will only serve to hasten the withdrawal of cover or impose further restrictions on its provisions. This cannot be in the interest of either the consulting engineer or the client.

FIDIC believes that this guide will assist clients in better understanding professional indemnity insurance and the need for sensible risk allocation.

The guide has been prepared by Griffiths & Armour on behalf of the FIDIC Risk Management Forum.

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## 1 i n t r o d u c t i o n

Risk is an inherent part of the delivery of any engineering project. It can take many forms including the risk of personal injury or death, damage to the project itself or to third party property, and financial losses such as, for example, an increase in project costs.

Risk management as a tool to reduce both the probability and severity of risk events is an essential aspect of project delivery. It is improbable, however, that risk can be eliminated entirely. The allocation of residual risk should be on the basis of the party best placed to manage and finance that risk.

In the context of professional liability, the responsibility of the engineering consultant for activities should be clearly defined in the agreement between the client and the consultant. Clarity of responsibility for the potential risks arising out of the provision of professional services is an important element in the management of those risks.

A sensible allocation of risk is important. Of equal importance is the need for risk to be properly financed. In the absence of effective forms of financing, risk has been neither properly transferred nor managed.

Invariably, engineering consultants provide intellectual services - they do not usually provide capital. Consequently, they can only finance risk through appropriate insurance, which is usually professional indemnity insurance.

The aim of this guide is to provide clients advice on professional indemnity insurance, in particular:

- Some basic principles
- Agreeing indemnity limits
- Reviewing cover arrangements
- Limitations of liability
- Alternative methods for insuring project risk



## 2 P I : s o m e b a s i c p r i n c i p l e s

In its simplest form, professional indemnity insurance provides cover should an engineering consultant be held liable for damages and claimants costs which arise from any negligent performance of services or breach of professional duty.

It is important for clients to note that PI is not a form of insurance which directly applies to any losses which may incur on a project.

PI insurance is in place primarily to protect the interests of the insured and not those of the client. In order for any PI policy to be triggered, the claimant (usually the insured consultant's client) has to establish legal liability for the losses that have been incurred. This process is fraught with difficulty - the legal process can be lengthy, uncertain and expensive. A client has only effectively transferred a risk when there has been proper reimbursement to the consultant for any financial losses that flow from that risk.

### 2.1 Annual basis for cover

PI insurance is ordinarily only available for periods of twelve months. It is important, therefore, that engineering consultants renew their cover arrangements on an annual basis. A failure to do so would leave an individual consultant effectively uninsured.

### 2.2 "Claims made" nature of cover

The majority of PI policies, particularly in common law countries, operate on what is known as a "claims made" basis. This is a fundamental aspect of the operation of the cover. It means that it is the policy in force when a consultant first notifies a claim (or a circumstance that might give rise to a claim) to insurers which applies. The cover - if any - that may have been in force when the work in question was undertaken, or when the alleged act of negligence took place, is irrelevant.

The "claims made" nature of PI cover re-emphasises the need for individual consulting firms and, where relevant, individual consultants to maintain cover on an ongoing basis.

Consulting appointments will usually involve periods of potential liability (limitation periods) of twelve years or more. At the same time, PI insurance is only normally available for periods of twelve months and on a "claims made" basis. In these circumstances, should an engineering consultant fail to renew cover, the firm is effectively uninsured for any work undertaken and services performed at any time in the past.

It is important that clients are:

- a aware that cover operates in this way; and
- b undertake a review of the PI arrangements of the consultants that they employ, not only at the appointment stage but also during the subsequent period when liability might attach.

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## 2 P I : s o m e b a s i c p r i n c i p l e s

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### 2.3 The “Excess” or “Deductible”

Most insurance policies are subject to an “Excess” or “Deductible” - the first part of any claim that is paid by the insured as opposed to the insurer.

Excesses apply to the majority of PI insurance policies and it is not unusual for them to be set at significant levels, for example, up to 1% of the fee income of an engineering consultant. It is important that consultants be capable of funding an excess should this become necessary. A failure to pay an excess is a breach of policy conditions which can lead to insurers refusing to pay what might otherwise be a perfectly valid claim.

### 2.4 The Limit of Indemnity

The Limit of Indemnity, as chosen by each firm, is the maximum amount that insurers will pay. The limit can operate on one of two bases:

- a “each and every” claim, whereby the full limit of indemnity under the policy applies separately to each claim which might arise during the period of insurance; or
- b on an “aggregate” basis, whereby the limit of indemnity applies as a single total irrespective of the number of claims notified during the period of insurance.

### 2.5 Policy exclusions

As with all insurance policies, exclusions are incorporated into policies of professional indemnity insurance. The most notable exclusions, of which clients should be aware, are as follows:

- a claims which are more properly catered for by more appropriate forms of insurance such as, for example, motor vehicle insurance, employers’ or workmen’s compensation insurance, public liability, etc.
- b claims involving responsibility for strict liabilities such as fitness for purpose and other similar contractual guarantees that are not subject to the test of negligence.
- c fines, penalties and liquidated damages.
- d liability to pay under any bonding arrangements.

As stated earlier, the majority of engineering consultants are only able to fund risk to the extent that it can be insured. Clients should, therefore, look to adopt a sensible approach to risk based on what is likely to be acceptable to the PI insurance market not only now, but also into the future. A reasonable level of liability backed by insurance must be a safer option than onerous liabilities not matched by insurance protection.



### 3 agreeing indemnity limits

An important aspect of many consulting appointments is the extent to which the consultant in question is obliged to carry PI insurance and, if so, to what monetary limit and for what period of time.

In assessing what might represent a reasonable level of cover for individual project circumstances, a number of factors should be taken into account. The assessment should reflect the maximum probable claim that might arise out of an individual consultant's professional activities. This in turn will depend upon a number of inter-related factors such as:

- a the nature of the consulting services to be provided. For example, the provision of design services in relation to a large civil engineering project clearly has the potential to produce a larger claim than a small structural survey;
- b the size and complexity of the project;
- c the extent to which financial losses may be incurred if, for example, the project is delivered late;
- d the method of construction procurement that is being utilised;
- e the extent of any high risk activities such as work on contaminated land;
- f the extent to which local jurisdictions might award interest on damages;
- g the applicable law - for example is there a statutory limitation of liability in force - and local custom;
- h the level of fees being earned by the engineering consultant on the project;
- i the extent to which any design work might be used on a repeat basis - in these circumstances only one limit of indemnity is likely to apply even if there are multiple claims.
- j cost and cost effectiveness;
- k insurance options other than PI.

The list of factors set above is intended to be of an illustrative nature only - it is not, and cannot be, exhaustive.

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## 3 agreeing indemnity limits

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It is important when setting limits of indemnity that clients, particularly repeat clients, do not adopt a blanket approach by insisting that, for example, for all projects a minimum cover of \$5M be in force. An approach such as this could be unfairly disadvantageous to small specialist consultants, or consultants from developing countries. It could also prove to be inefficient and uneconomic by forcing smaller consultants to buy cover in excess of their likely maximum liability.

As stated earlier, a large majority of engineering consultants are only able to fund risk and liability to the extent that they carry insurance against those risks and liabilities. Very few firms have a

sufficiently large asset base to fund claims themselves. The concept of unlimited liability is fundamentally flawed. It is, therefore, recommended that having agreed with consultants the extent of cover that is required, the consultant's liability be limited to that amount, providing relative certainty for both parties. If the client perceives an exposure to risk over and above the cover carried by the consultant, the client could choose to make separate arrangements to fund that balance of risk - either through insurance arrangements or otherwise.

The issue of limitations of liability and the rationale that underlies them are expanded upon below.



## 4 reviewing cover arrangements

It is important for clients to satisfy themselves that the PI arrangements put in place by the consultants they retain are in accordance with the requirements of the conditions of engagement.

Confirmation can be sought from either the consultant or the consultant's insurance broker/insurer. Confirmation should be obtained not only after the appointment of each engineering consultant but also after each subsequent renewal date of cover. As PI operates on a "claims made" basis any exclusions or limitations that may be incorporated in the future will apply to all and any claims that arise out of any work undertaken in the past.

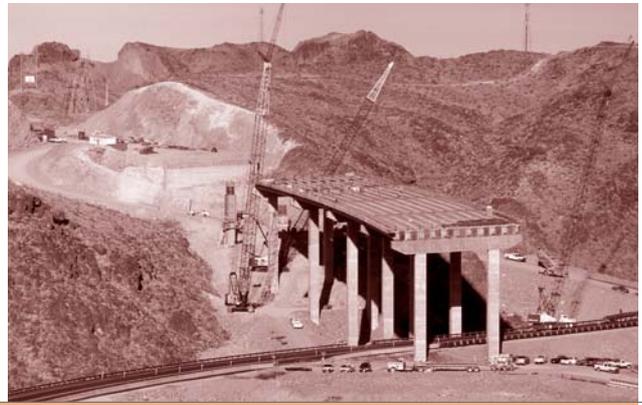
Clients can either carry out the review of their consultants' PI arrangements in-house or outsource that activity to a specialist such as an insurance broker. Alternatively, clients may seek to rely upon contractual obligations placed upon consultants to notify should their PI cover at any time become other than in accordance with the requirements of the conditions of engagement. However, in practice this arrangement may not prove to be as watertight as the client might like.

In undertaking any PI review, the clients' attention should be brought to a number of issues:

- a confirmation that the amount of cover is as required in the appointment.
- b confirmation of the renewal date, or any change thereof;
- c whether cover applies on an "each and every" or "aggregate" basis;
- d whether any unusual conditions or exceptions apply to the policy or have been introduced at the last renewal;
- e confirmation that all premiums properly due have been paid;
- f identity of the insurer(s).

The last point may be of particular importance. The collapse of Reliance (USA), HIH (Australia) and Independent Insurance (UK) in recent times indicate that cheap premiums do not always equate to good insurance protection.

PI claims in the construction industry have a notoriously long tail - they can take a considerable period of time to settle, in excess of twenty years in extreme cases. Clients should seek reassurance that the consultants they employ only place cover with reputable insurers having a long term commitment to the class of business - even if this means higher premiums and, therefore, slightly higher fees. Quality comes at a price.



## 5 limitations of liability

A common theme throughout this guide is the fact that risk is an inevitable aspect of any construction project.

In many areas, it has become entirely usual for clients to pass as much of that risk as possible to others, such as contractors and consultants. Very few consultants would argue against the broad principle that they should accept the legal consequences of any failure on their part to exercise the degree of skill and care ordinarily to be expected of a reasonably competent consultant. It is entirely proper that engineering consultants should accept liability for their own acts of negligence and that of their staff, agents and any sub-consultants they might employ.

The main capital of most engineering consultants is intellectual in its nature, as opposed to financial. The effect of this is that consultants can only fund their professional liabilities to the extent that they are insured. It would be unethical and potentially misleading to clients if consultants were to undertake financial obligations which they cannot meet.

Clients are advised, therefore, to require consultants to carry a reasonable level of insurance to meet their financial liability. In turn clients should accept that the level of cover carried by each consultant also equates to a limit to that consultant's financial liability. In this way, both the client and the consultant, achieve a good degree of certainty as to the responsibility of each to the other. Unlimited liability might exist in theory - in practice it does not.

If in any particular circumstance, a client feels that the level of a consultant's PI is inadequate, the client can either:

- a make arrangements for the consultant to increase the level of cover - in return for payment of any additional premium that is required; or
- b make alternative arrangements to ensure that additional finance will be available if required.

As engineering consultants can only realistically fund risk to the extent that they are insured, it should be in the client's interests to take measures to ensure a vibrant, competitive PI market in the future. To achieve this, consultants need to be able to present a risk profile that is reasonable as to amount, certain as to time and based on the discharge of their own responsibilities rather than those of others.

Therefore, clients are advised to incorporate the following provisions into all their appointment documents:

- a a provision that limits the consultant's liability to an amount no greater than the limit of indemnity under PI arrangements;
- b an indemnity in relation to claims brought by third parties (i.e., parties other than the client) to the extent that such claims exceed the financial cap referred to above;
- c a "net contribution" clause such that consultants will only be liable for that proportion of any loss which is directly related to their own negligence and not that of others;
- d an exclusion or cap for economic or consequential losses;
- e a clear point in time, from completion of the services, after which the consultant will be freed from liability.



## 6 alternative methods

The traditional approach to project risk by construction clients has been to seek to transfer risk to members of the construction team by way of contract terms. The risks transferred in this way are then insured, to the extent that this is possible, usually by way of liability insurance.

Managing risk in this way is in many ways flawed; it is closer to risk mismanagement than risk management since:

- a the process brings with it a lack of certainty - the lottery of litigation is not only uncertain but also time-consuming and expensive;
- b the process is inefficient;
- c there is a frequent lack of clarity;
- d the threat of litigation, whether real or perceived, encourages defensive attitudes, has a corrosive effect on relationships and inhibits team-building and team-work.
- e the process of insuring liability as opposed to project risk acts as a break on constructive feedback - the liability insurers' principal interest is in protecting the interests of their insured and not acting as a free information service for society as a whole.

Clients are, therefore, encouraged to explore new ways of managing and insuring project risk and utilise new forms of construction contracts in such a way that:

- a except in certain circumstances, the parties agree to waive their rights to sue;
- b all parties to the project, including to a significant degree the client, agree to share losses according to a pre-agreed formula, but up to a ceiling;
- c beyond that ceiling, the balance of risk rests in theory with the client but in practice would be transferred to a professional risk taker - an insurance company.

The medium of liability has not proved successful, either as a means of financing project risk or of creating the cohesiveness between the client and the construction team necessary to minimise that risk. Indeed, historically, the mismanagement of the financial risk of construction has materially increased the costs of those risks.



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