SHIPBUILDERS' CLAIMS

Address by Tony Brain, Chairman of the Association of Average Adjusters of the United States and Canada, at the Annual Meeting, New York City, October 4, 2018

For as long as I have been in this business of Average Adjusting, I quite frequently hear, from people I meet, that we only are concerned with General Average. I would suggest that the majority of all of the qualified Average Adjusters worldwide would not be in business if that was the case. We are experts in preparing average adjustments on marine insurance risks and providing sound opinions and advice to Underwriters, Insurance Brokers and the Legal Profession on a multitude of marine claim matters. Whilst Particular Average claims on Hull & Machinery policies generally occupy the majority of my productive time, I am, like my colleagues in this profession, also involved with marine claims on Loss of Revenue, Shiprepairer's liabilities, Shipbuilder's risks, Cargo, Charterer's liabilities and, of course, some General Average.

The subject of my address this morning is therefore on one of those other non-General Average areas of our expertise. It is on Shipbuilders' claims

I have, over my 50 years of Average Adjusting, been involved with numerous Shipbuilders' claims. These have ranged from relatively low valued scows and inshore fishing craft through a broad spectrum of marine vessels and values, some of which have had a completed value in excess of the GNP of many countries in this world.

However, I would firstly like to talk to you, not just on the actual day to day adjusting of above deductible claims falling under a Builder's risk insurance, but on the potential work for an Average Adjuster in the lead up to the commencement of construction and also for those below deductible claims, or self retained claims, that arise therefrom. Whether a single construction or a multi vessel building programme, a construction project lends itself to the expertise of an Average Adjuster. This expertise does not cease at delivery, but continues beyond delivery through to expiry of the guarantee period and can extend to contract disputes which may linger on long after the guarantee period has expired.

Obviously, the planning for a new vessel or vessels starts many years before the keel is laid or the first piece of equipment arrives in the shipyard's warehouse. But the time it takes to get to this construction stage, especially in major military (Government) projects, sees the seasons go by quickly

and more than once. From the time of that initial twinkle in an admiral's eye, through the many layers of government, to approval and appropriation of funds, design (and redesign), the awarding of contracts to the prime contractor and major subcontractors, a decade or so can have elapsed. But somewhere along this road to construction, in the numerous manuals that are produced to overflow bookshelves and become the backbone of the shipbuilding contract, there exists in that contract an insurance section. At the early stages this is usually just a wish list of values and coverage wordings and, as is common for military construction, a nationalist demand to first exhaust that country's insurance market before proceeding to seek coverage elsewhere.

Also, in the case of military construction maybe there is no requirement for insurance. Maybe the insurance premium is prohibitive, maybe there are insufficient markets willing and able to write the risk, or maybe the government simply does not want to have the risk insured. Values can be horrendous. For example, the Ford class carriers are in excess US$13 billion each. However, whether these projects result in insurance being purchased or not, there will be a demand for a reconciliation between the Builder and the Shipowner as to what the Shipowner is prepared to absorb in Builders losses during the currency of a building contract. In addressing this matter and I would not wish to detract from the singleton vessel construction or vessels that may be added to pre-existing open builder's risk cover, I am generally focusing on military (Government) construction and a series of buildings as I believe this best serves to highlight the expertise that an average adjuster can bring to these projects. Apart from the actual adjusting of claims which will arise during the construction period and the guarantee period thereafter, as well as assisting in the drafting of the insurance contract wording as it relates to the conditions of insurance; the average adjuster is ideally placed to collect and manage all claims below and above deductible that arise during the construction project. In particular, the number of below deductible claims on a major project can run into the thousands.

So, the project is coming along fine, money has been allocated, the prime contractors and their consortium (being made up of the shipbuilder, designers, major equipment suppliers, etc.) have been selected and the initial design approved. Incidentally, in a multi-vessel military construction project the prime contractor is usually a major military provider whose expertise lies in the providing of the weaponry, sensors and other associated electronics and to which most of the overall construction cost will relate. In that instance, the Shipbuilder would be a prime subcontractor. However, for this address,

let us assume that the Shipbuilder is the prime contractor.

In accepting that there is an insurance requirement for the building project, the level of deductible, as in any placing, is set in the insurance contract. Like any deductible, what does the Assured want and is able to afford and what is the Insurer prepared to agree to for the risk? A willing buyer and a willing seller. So, with the awarding of the construction contract it is time for the insurance broker to officially make an appearance. Maybe the insurance broker had already been involved with the successful prime contractor as part of their consortium in the run up to contract selection or maybe the Shipowner deferred the selection of the insurance broker until naming of the successful prime contractor. But now it is time for the insurance broker to step up to the plate to mould, to a willing buyer and willing seller, a shipbuilding contract of insurance that is acceptable to all parties.

However, with the setting of the deductible or deductibles (the deductible could vary for different types of losses, or maybe there is an annual aggregate project deductible) there is invariably an agreement under the building contract that the Government will make good all below deductible insurance losses. That could entail all losses from $zero up to the policy deductible or, more usually, an agreed per incident retention for the Builders. This would then brings about 3 layers of involvement:

Firstly - The Builders retention which is from $zero up to whatever cap is agreed with the Government of (the Shipowners),

Secondly - The Government's retention above that of the Builders and up to the insurance deductible,

Thirdly - The Insurers, for claims in excess of deductible up to the maximum insured value

As the Builder's retention is usually a low number, the majority of losses will fall on the second layer of retention, which is that taken by the Government. Also, as these losses are invariably subject to the same conditions of insurance that is included in the insurance policy, the unbiased expertise of an Average Adjuster is invaluable, as the intermediary between the Shipowner and the Shipbuilder, to correctly quantify these below insurance deductible losses which, as I have previously stated, can run into thousands of claims.

With the implementation of a claims reporting and claims management system these below

insurance deductible losses, or self-insured losses as the case may be, can be managed, easily and cost effectively, by the Average Adjuster as the agreed intermediary between the Shipowner and the Builder. To achieve this goal it is therefore important for the Average Adjuster to be brought into a Shipbuilding programme at the contract stage when the insurance deliberations between the concerned parties are ongoing.

But, jumping ahead. With much nationalistic pride the newly built vessels are delivered to the navy, the building contract is completed. Claims arose and were amicably settled to the contentment of all concerned parties. In particular, it is hoped that Underwriters have made a profit. However, there is still more work out there for the Average Adjuster. The job of awarding the contract for the periodic maintenance of these vessels is now at hand. These 'in service' maintenance programs, over and above what the navy would normally carry out themselves during a vessel's in port stay, are a substantial cost and requires the same amount of deliberations in the awarding of this work to a commercial contractor. These 'in service' maintenance programs do generate marine claims, either under insurance or as retained losses, and the employment of an Average Adjuster to correctly manage these claims is again invaluable.

But now to the claims.

Coverage and the building contract

The building claims that I generally deal with, and with no disrespect to those conditions of insurance emanating from our friends in mainland Europe, have as their foundation three sets of clauses: the American Institute Builder's Risk Clauses (February 8, 1979), the Institute Clauses for Builders' Risks (1/6/88) and the B55 Builders Risks Clauses. These B55 clauses are a set of conditions that, although I do not actually know their origin, I first came across them over 40 years ago. Whilst today I do not see the actual B55 conditions put out under that name, some of the expansive all risk wording they afforded has been manuscripted into many current building projects.

Nevertheless, subject to the policy terms, conditions and exclusions, under these three forms of insurance, coverage is against all risk of loss of, or damage to the subject matter insured and occurring during the period of the insurance. The period of this Builder's risk insurance can be extended beyond

Coverage and the building contract (Cont'd)

the delivery date for a guarantee period. I very rarely see this being for more than 1 year from delivery, should coverage for this guarantee period be a viable insurance option to purchase.

It is not my intention today to provide you with a line by line commentary and comparison of the clauses making up these conditions of insurance for Shipbuilders' risks (so you can put your pens away!), but to highlight to you some of those interesting areas in the adjusting of Shipbuilders' claims.

In the writing of a builder's risk, Underwriters need to be provided with a copy of the building contract, or, in the case of military construction, at least the contract section which pertains to insurance and other pertinent sections thereto. In the subsequent underwriting of the risk, it is then not uncommon to see manuscripted in the policy wording something along the lines of "...and to cover all expenses and/or liability which the Builders may incur by reason of their obligation under the building contract..." and to make it even better for the Builders this sometimes go on to state "... and to make good at their own expense all defects in the hull, machinery, etc. due to defective materials and or workmanship and or design...". What a grand collection of words. However, I do see wording such as this.

Faulty design and faulty welds

Standard coverage is generally provided by Underwriters for the cost of repairing consequential damage sustained as a result of faulty design. However, there is no recovery for the cost of betterment or design alteration. Whilst the cost of faulty designed part or parts which gave rise to this damage may not be recoverable under this exclusion, is there coverage elsewhere in the conditions insurance for renewal of a latent defect, which the offending part(s) may be?

Faulty welding claims are specifically excluded under the Institute Clauses for Builders' Risks (1/6/88) and it is not uncommon for Underwriters in other regimes to exclude faulty welding, by endorsement.

Faulty design and faulty welding claims can be exceedingly costly and time consuming to rectify Nevertheless, the insurance buying power of the high end projects do beget improved areas of coverage, such as the deletion of the welding exclusion and the addition of the Liner Negligence clause. With failed welds and this type of improved wording, as we have recently encountered, the Builder will

Faulty design and faulty welds (Cont'd)

most likely be made whole by his Underwriters for this loss.

Reasonable cost of repairs

Certainly, Underwriters should see as much of the building contract as possible. This can then avoid or reduce the number of protracted claim discussions when dealing with certain areas of claims. I am thinking specifically of the reasonable cost a Builder can charge to correct a loss or damage.

It is sometime a bone of contention as to whether a builder's charge for labour should include an element of profit in their hourly charge out rate to correct an error of their own making. I am of the opinion that, subject to the Underwriters' surveyor's approval, a shipyard's charges, inclusive of profit, as contained in the building contract and adjusted annually for inflation, do represent the reasonable cost of repair.

Project contracts, especially when dealing with major military providers who are the experts at seemingly putting a bullet proof contract together (*for their benefit)*, can give rise to some mind blowing equations to arrive at the cost of a repair. Apart from a yard's labour costs, there are formulas to calculate the costs of direct and indirect labour, subcontractors, material costs and, at the end of all that, there is invariably a prescribed overall markup. All of these costs together will therefore represent the basis for the allowable reasonable cost of repair.

A further concern on the reasonable cost of a repair arises when damage is sustained due a defect caused by the builder erroneously not following the drawings and thereby failing to install all that is required, such as insufficient internal members or supports. Of course, this type of loss is usually never discovered soon after the negligent act has taken place, but typically several months into the construction during testing and when cable runs, machinery or equipment have been installed in way thereof. The cost to uninstall and reinstall for access to the damage can therefore be significant. On this matter I have had many discussions over the years with builders who claim that access work in instances such as this should be charged fully against the damage claim as if they, the Builders, had done the work completely and correctly in the first instance they would not have had to move machinery, etc! However, if the acid test reveals that the access work was necessary for all work (insurance and unrecoverable Builders work), then this is a common cost and should be allocated accordingly.

SHIPBUILDERS' CLAIMS (Cont'd)

Reasonable cost of repairs (Cont'd)

Now, I did mention that in major construction projects the coverage wording does becomes more 'all risk', or perhaps I should say there are even fewer exclusions. Defects are brought back in, Liner Negligence clauses are introduced, etc., etc. With these additions and I would specifically wish to dwell here on defect claims, the cost to rectify the defect can also be recovered. In other words, the costs incurred to correct a defect (including that resulting from error in design) are covered even if no physical damage has been sustained. However, such costs would not include those for modifications or improvements and would also be confined to the actual loss sustained by the Builders after applying a formula to arrive at the net claim, before deductible. This formula is:

A. Actual cost of original incorrect construction with built in defect
B. Plus, cost of repairing/renewing the defect
C. Less estimated cost to have originally carried out fault free prime construction had the error not occurred

Subcontractors

Recoveries by the insurers against subcontractors are usually excluded under a builder's risk coverage as subcontractors are effectively additional assureds. However, it is advisable that the builders put the subcontractors on notice for the loss. The builders can elect to have the claim paid initially by their insurers and thereafter continue to investigate their and their insurers' potential rights of recovery against the subcontractor.

Examination of the contract between the parties, or the conditions of sale, will obviously have a great bearing on proceeding to seek a recovery, or not, from the subcontractor. However, it is not uncommon in construction projects for the Builders to require the subcontractors, at least the major subcontractors, to carry a certain amount of liability insurance for the product and/or the work that they are providing. I would even suggest that regardless of any agreement or understanding with the shipyard, all subcontractors most likely maintain their own insurance regardless. This then brings you into the realms of double insurance and the potential for the subcontractor's own insurers to contribute towards the loss.

The Average Adjuster, being tasked with handling the claims for the building project, is ideally situated in preparing the yard's quantified loss if a claim should be warranted against a subcontractor.

SHIPBUILDERS' CLAIMS (Cont'd)

Reasonable cost of repairs (Cont'd)

The Average Adjuster's assistance in this matter would also extend to working with attorneys that may be instructed to investigate and prosecute a recovery.

Deductions new for old

There is an assumption that a building is completely a new building and therefore, and perhaps with the exception of the American Institute Builder's Risk Clauses (February 8, 1979), there is not a deductions 'new for old' clause contained in the insurance conditions wording. However, in those instances where, perhaps, a used piece of equipment is fitted (it does happen) this 'new for old' omission can bring about a reduction in the claim.

For example, the omission of a 'new for old' clause in the conversion of a vessel, and in the case of major conversions the insurance is invariably under Builder's Risk conditions, can result in a very expensive uninsured retention. I have seen single hulled tankers, when they were being phased out some years ago, being converted to dry bulk carriers by replacing the forebody. However, a fire in the old retained stern section where accommodation and machinery is located would not allow for the full recovery of the cost of repairs without the 'new for old ' clause being added to the insurance conditions.

Residual values

Underwriters are entitled to the net residual value of replaced or condemned parts and materials that form part of an insurance claim. Normally there will be a straightforward question and answer with the Underwriters' surveyor to arrive at the net residual value. However, in the case of military construction, a potential and appreciable net residual value to Underwriters can be negated when, due to the alleged sensitive nature of the parts or materials, they have to be disposed of at a designated military site and with Underwriters receiving no credit. Or, as I have seen, the military destroyed the part to postage stamp sizes and returned a pile of scrap to the shipyard who, albeit they were able to realize a residual value, it was a shadow of what the part would otherwise have achieved. Although this is unfair to the Shipyard and the Underwriter and can bring about some healthy discussions, these discussions are invariably negated by the building contract making provision for all scrap to become the property of military.

Autonomous vessels

Let us not forget, in the dawn of autonomous vessels and an interest to perhaps change Hull & Machinery wordings to apply to this mode of transport, the Builders insurance clauses will require review. The obvious areas of concern being the trials, delivery and navigation sections, in particular where the vessel has to be removed to repair port to rectify a guarantee claim.

What I have tried to relay to you this morning is my encapsulated view of where the rubber meets the road in the planning and handling of day to day Shipbuilders' claims for a practicing Average Adjuster.

I am sure that you have all come across many different types of claims made by Builders, but where does a Builder's risk insurance stand on claims, for:

A funnel that is painted white. It should have painted red.

A vessel that does not achieve its stated performance speed. Or, main engine fuel consumption was excessive.

Guns that were incorrectly positioned and posed a catastrophic threat to the vessel itself at a certain firing angle.

Generators and cable runs were fitted, then the builder realized that they had been fitted into the space where the stabilizers were to be installed.

Two sections of a vehicle/passenger ferry are prefabricated ashore but they did not correctly fit when assembled in the drydock.

Maybe you can glean the answer from what I have said this morning, or maybe there needs to be a Part2?

This concludes my address to you this morning. I trust that it has been of interest to you and I thank you for your attention.

Anthony E. Brain

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