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Construction: Impact from Reduced Supplies/Workers and Fixed Price Contracts on Policy Coverage

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Agenda

- Issues impacting on the construction section
- Supply and worker shortages
- Fixed price contracts
- Coverage issues arising from fixed price contracts and reduced supplies
- Contractor insolvencies and related insurance issues
- Claims against Insurers where the contractor is insolvent
- Questions

Historical trends in the Construction Market

What do these events have in common?

GFC

COVID

Wars

High inflation

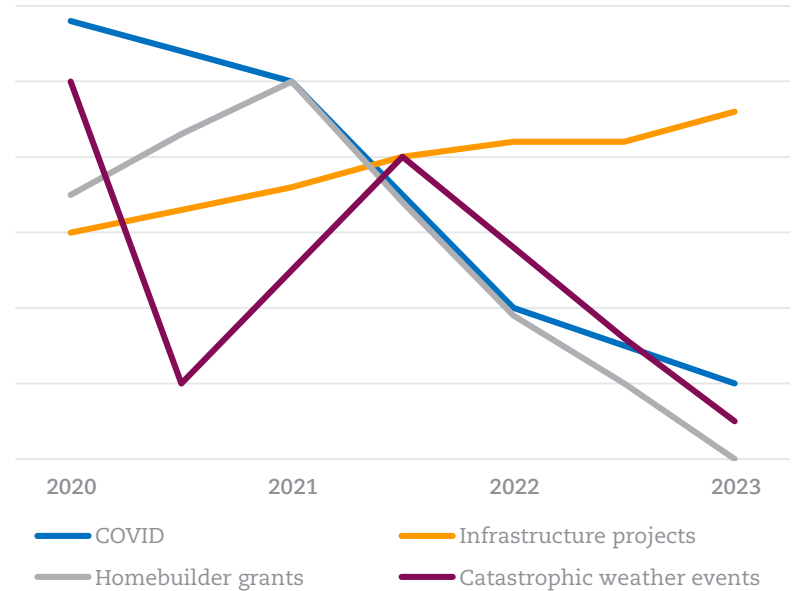


Current state of the Construction Market

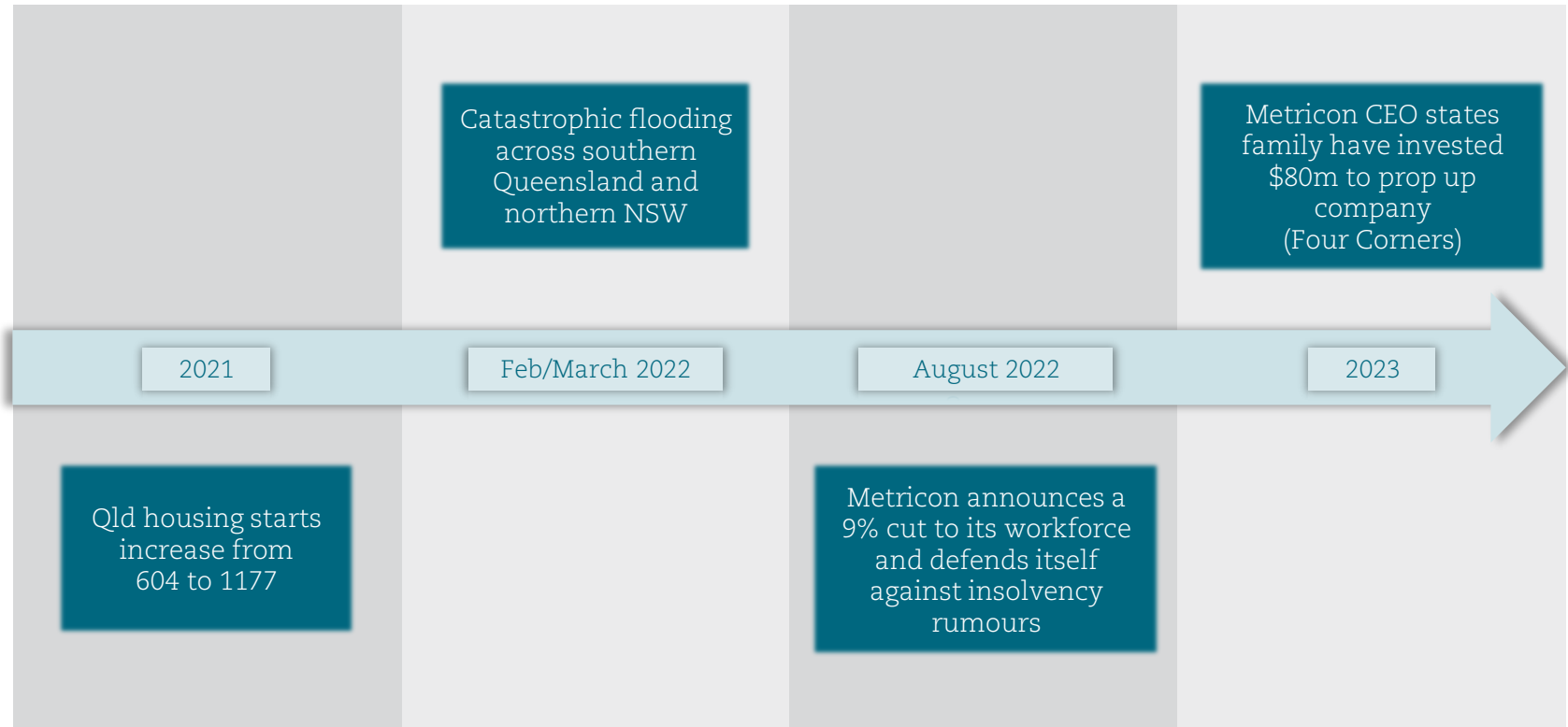
National/global labour shortages

Supply shortages – arose due to the ‘perfect storm’ of events

2023 – supply chain pressures remain, higher construction and borrowing costs have slowed the domestic market, investment in infrastructure remains strong



Metricon timeline

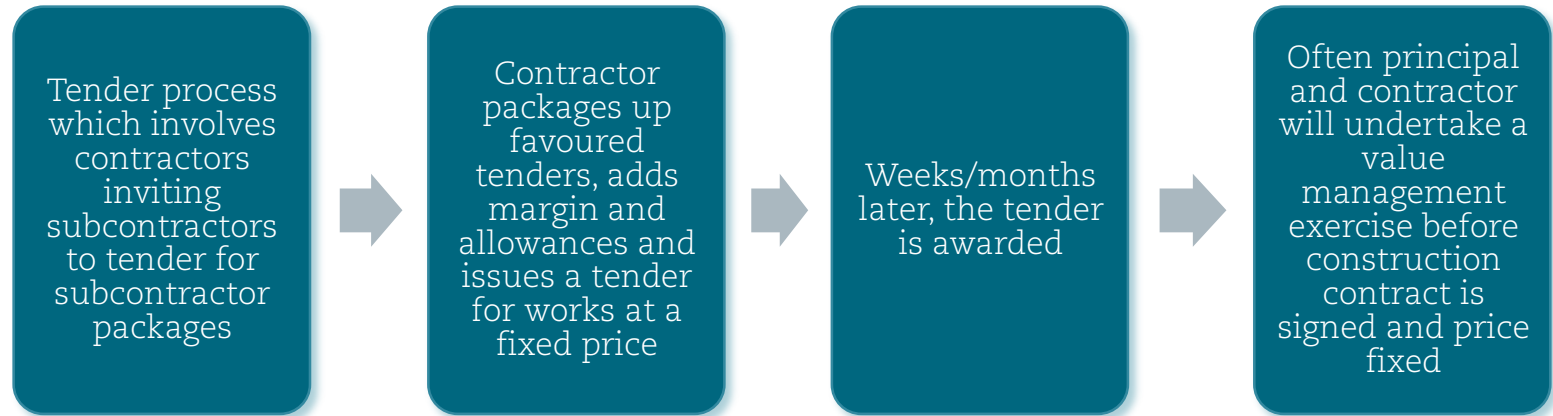


Fixed Price Contracts

- Provide for the works to be carried out within a certain period, for a specified price
- There are ways to build in provisions for price increases for labour or supplies:
 - cost escalation/rise fall clauses
 - variations
 - provisional sum/prime cost items
 - indexation clauses (usually for certain types of materials)
- Sunset clauses provide a mechanism for contractors (and principals) to void contracts



How are supply and labour shortages impacting the fixed price model?



Outcomes for Contractors

- The Contractor carries the risk of price inflation and delays (unless a delay that is permissible under contract)
- Where labour and supply shortages cause delays, commercial construction contracts and most domestic building contracts will have liquidated damages clauses which are triggered upon a delay to practical completion
- Delay costs deplete a Contractor's margin.
- Plus labour/supply shortages can increase the base cost of the project, depleting profit margins



How does this affect Insurance coverage?

Insuring clause – is there a claim for civil liability...based on the Insured's provision of professional services? (PI policies)

Delays costs are a contractual risk or assumed liability and not typically covered under insurance policies

Mitigation clauses

Quantum of claims is higher; uninsured risks

Costs assessment exclusions ie failure to make an accurate pre-assessment of the cost of performing professional services

PI policies – Insuring Clause and Contractual risks and assumed liability exclusions

- Debate about whether liquidated damages are covered by a PI Policy
- Arguable in many cases LDs are not covered for reasons including:
 - PI policies insure against civil liability/loss arising from a Claim in connection with the provision of Professional Services
 - look at meaning of ‘Claim’, ‘Loss’, civil liability
 - What is the source of the alleged duty in the claim against the Contractor? Are the causes of action contingent on the Contractor providing professional services (per Jagot J in *FKP v Zurich*)
 - LDs typically a debt due under contract and do not have a compensatory or restorative component



Quantum of claims

- Construction based claims particularly PI claims are often long tail claims that are not made for many years after the works have completed.
- Quantum of rectification of defective works/property damage is then much higher than the amount allowed in the contract
- What is the 'reasonable' cost of rectifying defects/remediating Damage?
- Escalation clauses will assist in some contracts works policies but only up to a certain amount ie 120% of the Sums Insured



Cost escalation

Owners Corporation PS623721 v Shangri La Construction [2022] VCAT 1499

| | Issue of proceedings (Nov 2018) | End of Trial (July 2022) | Final orders (March 2023) (estimated) |
|--------------------------------------|------------------------------------|-----------------------------|---|
| Raw costs (November 2018) | \$6M | \$6M | \$6M |
| Uplift on raw costs | - | 12.1% | 15.5% |
| Preliminaries | 11% | 11% | 11% |
| Builder's margin | 12% | 12% | 12% |
| Consultant fees | 4% | 4% | 4% |
| Contingency | 10% | 10% | 10% |
| Total Uplift (compounded) (%) | 29.3% | 59.4% | 64.3% |
| Total quantum (inc. GST) | \$8.54M | \$10.52M | \$10.84M |

Mitigation and uninsured risks

Where the claim is covered, the quantum of the claim may exceed the Sum Insured

Insured faces uninsured risk

Mitigation clauses become important – often quicker and more cost effective option for insured contractor to fix the defects/Damage and then look at recovery options

Insolvency risk

Insurer/Insured response

- Construction contracts for commercial/government projects typically favourable to Principals with Contractors taking on most if not all of the risk
- Typically indemnities and other commercial risks will not be covered under PI policies
- Insurers are carefully reviewing risk profile of Insureds and contractual arrangements
- Insureds should engage with brokers early and ensure they have effective QC and QA processes in place, together with risk management processes concerning liquidity of sub-contractors
- Where there is a claim, Insureds should engage promptly with brokers/insurers and attempt to mitigate losses
- Settle claims as soon as possible



What does the future hold – Regulatory reform?

- Proposal for a trust fund system where monies are required to be held in trust by Contractors, for sub-contractors
- Master Builders Australia sustainability goals 2050 which includes:
 - develop a roadmap to understand the problems that give rise to business stress/failure
 - support the development of solutions that are fair, tangible and effective; and
 - develop and implement an advocacy plan on sharing contract risk and promoting the use of fair contracts within the next 3 years



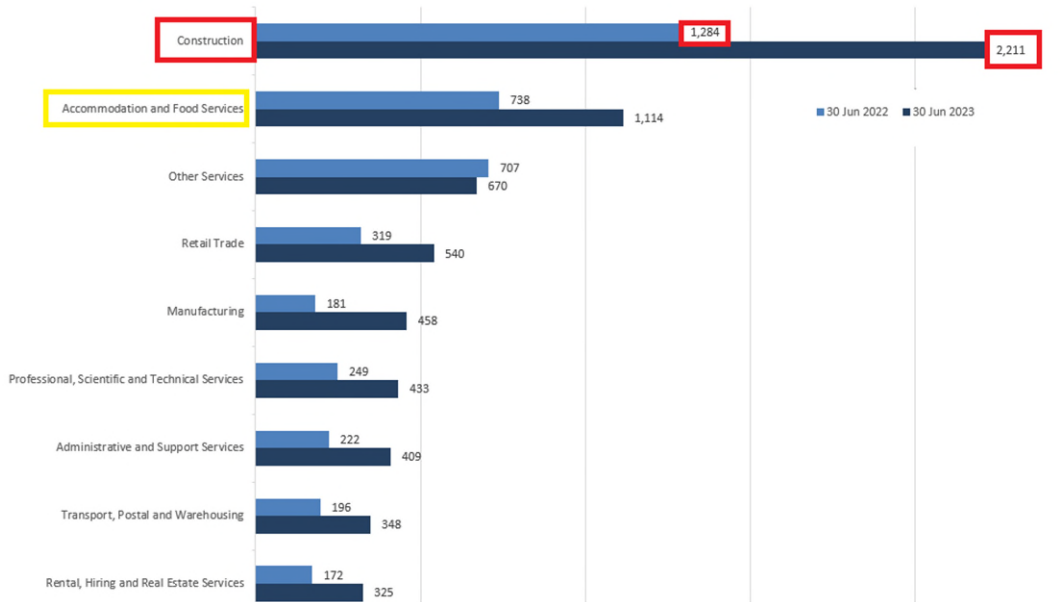
Current state of Australian construction insolvencies

Australian insolvency statistics

Released: 24 July 2023
© Australian Securities & Investments Commission

More recent figures are provisional, refer to
INFORMATION SHEET 80: How to interpret ASIC insolvency statistics.
The most recent month is published to 9 July 2023.

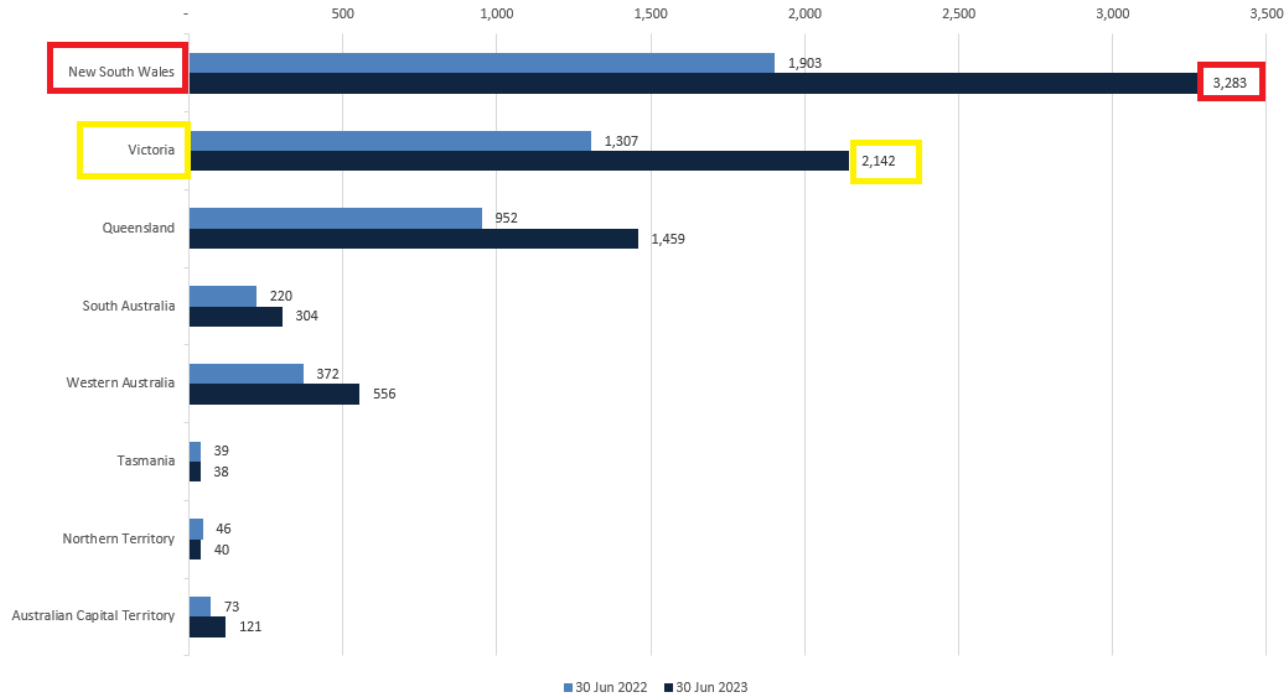
Chart 1.2: The first time a company enters external administration or has a controller appointed—Industry type, FINANCIAL YEAR TO DATE



State vs. state

© Australian Securities & Investments Commission

Chart 1.3: The first time a company enters external administration or has a controller appointed—Principal place of business, FINANCIAL YEAR TO DATE



Note: ASIC will update the above Chart to publish data for FY2024 once a full month of data is available for FY2024

Recent examples of construction insolvencies

- Melbourne based Kleev Homes which owes \$3.29 million to 162 creditors.
- Sydney building company Allura Homes - with 39 homes in jeopardy - debts of \$3.3 million to 102 creditors.
- Porter Davis, It was Australia's 13th largest builder, leaving 1,700 projects and another 779 empty blocks of land in jeopardy across Victoria and Queensland.
- Toplace.

Toplace's troubled projects



Atmosphere, Castle Hill

Owners are suing the developer, JKN Hills Pty Ltd, in the Supreme Court. The Building Commissioner issued prohibition order and rectification orders over serious defects.



Vicinity, Canterbury

In 2021, a structural engineer warned the tower, constructed by Toplace Pty Ltd, was at risk of collapse and emergency propping was put into place. The Building Commissioner has issued rectification orders for the building over many issues including inadequate beams and support columns.



Skyview, Castle Hill

Developer S1 OCHR Pty Ltd has been placed into administration. In 2021, the Building Commissioner issued prohibition orders due to serious defects in the building, including basement ground slabs showing "extensive signs of cracking".



Rise, Parramatta

The Owners Corporation is suing the developer, JKN Para 1 Pty Ltd, in the NSW Supreme Court.



Riviera, Parramatta

Owners Corporation is suing the developer, Toplace Pty Ltd, in the Supreme Court, over dozens of alleged defects including corroding concrete and defectives windows and doors.

Insolvency trends

- End of Safe Harbour protections.
- Tax and other liabilities.
- Interest rates and inflation.
- Slowdown in residential construction and approvals.

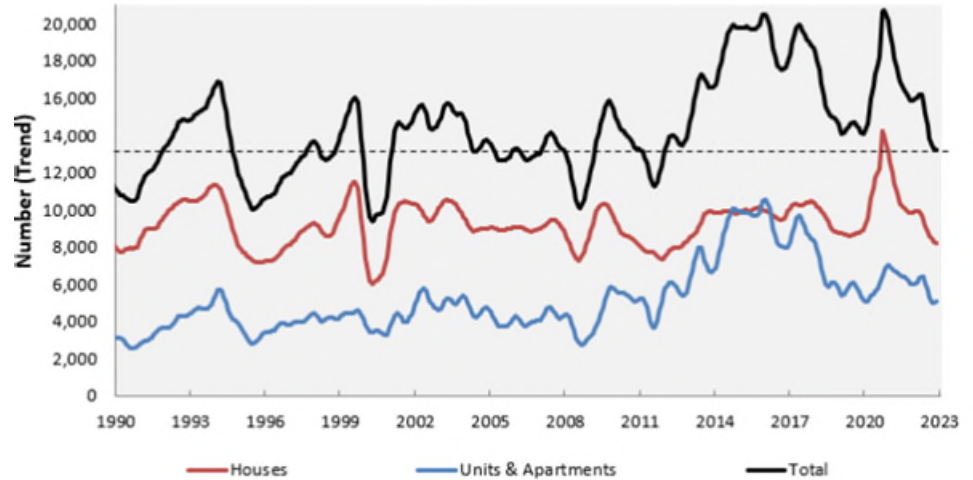
Australian Housing Construction Loans

Source: Australian Bureau of Statistics



Dwelling Approvals - Australia

Source: Australian Bureau of Statistics



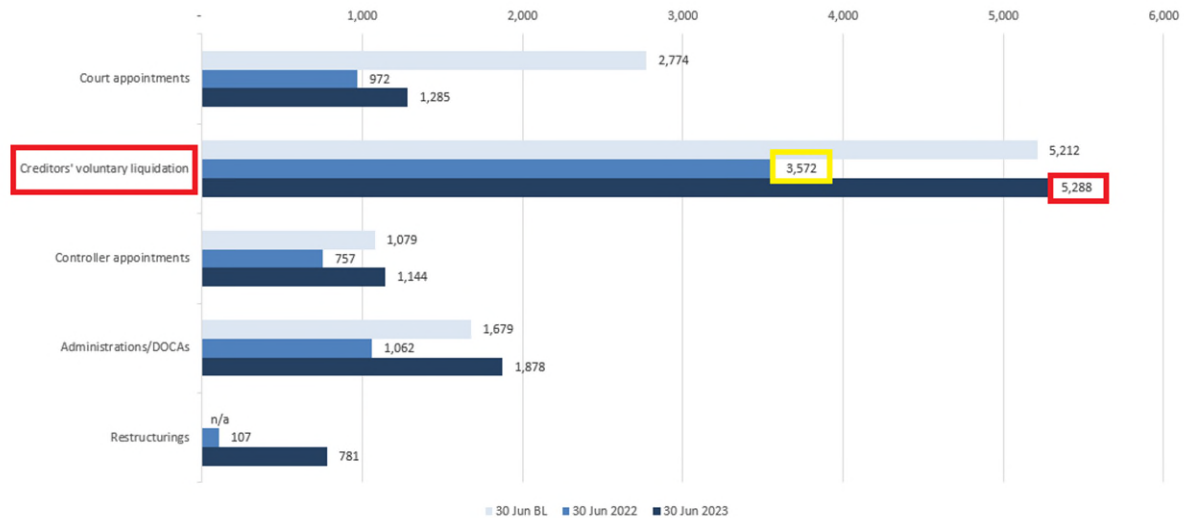
Insolvency causes

Australian insolvency statistics

Released: 24 July 2023
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Chart 2.1.2: All appointments over a company including the first, subsequent and transitional appointments—Appointment type, FINANCIAL YEAR TO DATE



Note: Base level is the average of the financial years FY17, FY18 and FY19.

Note: ASIC will update the above Chart to publish data for FY2024 once a full month of data is available for FY2024

Effect of insolvencies on the market

- Impacts on consumers.
- Oracle collapse leaving debts to subcontractors of \$14m.
- Impacts on subcontractors and principals.



Bentley Homes had been in operation for 17 years.



Oracle Homes has collapsed leaving of customers and suppliers not paid. Picture: Steve Pohlner

Claims trends

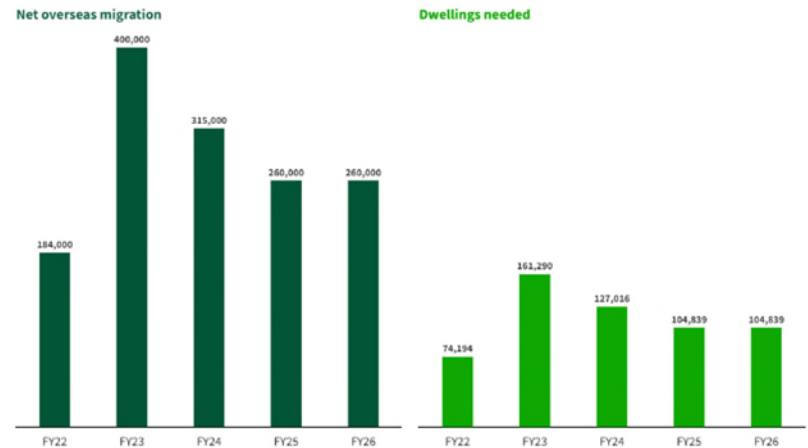
- More claims against consultants, including for contract administration type claims.
- Impacts on Policy premiums.
- Investigations into policies held.
- Uptick in D&C PI coverage claims.
- Third Party Claims against insurers.

Mitigating against insolvencies

- Due diligence regarding insured's projects, relationships and circumstances.
- Financial due diligence on insureds, and due diligence on companies undertaking rectification works.
- Monitoring of Phoenixing activity.
- Latent defects insurance.
- iCIRT ratings.



Figure 1. Forecast net overseas migration and estimated dwellings needed.



Source: Domain, Federal Budget 2022-23, IIRSA, the number of dwellings needed are based on 2.46 people per dwelling. <http://www.dta.gov.au/publications/bulletin/2022/mar/pdf/a-new-measure-of-average-household-size.pdf>

Relevant caselaw

Section 4 of the Third Party Claims Against Insurers Act provides as follows:

4. *Claimant may recover from insurer in certain circumstances:*

- (1) If an insured person has an insured liability to a person (the claimant), the claimant may, subject to this Act, recover the amount of the insured liability from the insurer in proceedings before a court.*
- (2) The amount of the insured liability is the amount of liability (if any) payable pursuant to the terms of the contract of insurance in respect of the insured person's liability to the claimant.*
- (3) In proceedings brought by a claimant against an insurer under this section, the insurer stands in place of the insured person as if the proceedings were proceedings to recover damages, compensation or costs from the insured person. Accordingly (but subject to this Act), the parties have the same rights and liabilities, and the court has the same powers, as if the proceedings were proceedings brought against the insured person.*
- (4) This section does not entitle a claimant to recover an amount from a reinsurer under a contract or arrangement for reinsurance.*

Relevant caselaw

Section 5 of the Third Party Claims Act provides as follows:

Leave to proceed

- 1. Proceedings may not be brought, or continued, against an insurer under section 4 except by leave of the court in which the proceedings are to be, or have been, commenced.*
- 2. An application for leave may be made before or after proceedings under Section 4 have been commenced.*
- 3. Subject to subsection 4, the court may grant or refuse the claimant's application for leave.*
- 4. Leave must be refused if the insurer can establish that it is entitled to disclaim liability under the contract of insurance or under any act or law.*

The general effect of Section 5 of the Third Party Claims Act is that the court has discretion to grant or refuse leave to bring or continue proceedings against an insurer in the court but it must refuse leave if the insurer can establish that it is entitled to disclaim liability under the policy.

Owners – Strata Plan No 91086 v Fairview Architectural Pty Ltd (No 3) [2023] FCA 814.

- Fairview manufactured Vitrabond panels – combustible cladding
- Owners commenced proceedings on behalf of a class of claimants
- AAI (Vero) was public liability insurer for Fairview
- Fairview entered into voluntary administration – Owners sought leave to bring claim directly against AAI for:
 - *loss or damage arising from the supply of the Vitrabond panels, including the costs of, and incidental to, the removal of the panels and the remediation of the buildings and parts thereof to remedy any damage caused by their affixation to the buildings*
- Wigney J concluded that:
 - *While panels made buildings less suitable for use – not sufficient to satisfy definition of property damage; but*
 - *Affixation of the panels caused physical damage – nails and screws left holes in walls, struts etc*
 - **Granted leave for Owners to bring and continue proceeding against AAI**

Conclusion and key takeaways

- Issues impacting on the construction section
- Supply and worker shortages
- Fixed price contracts
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Thank you. Any questions

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