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PPP IN INFRASTRUCTURE RESOURCE CENTER FOR CONTRACTS, LAWS AND REGULATIONS (PPIRC)
website. It is an explanatory note for general guidance purposes only and should not be used as a substitute for
specific legal advice for a project.

INSURANCE EXPLANATORY NOTE¹

General

Insurance is an area of project finance that is often left to the end of negotiations, with little attention given to it. Availability of insurance, levels of cover and deductibles will, however, have an impact on the risks being taken by the authority, the operator/ project company and the lenders and so should be central to negotiations.

Insurance is not always the best solution for dealing with every risk that may arise.

It may also not be possible or economically feasible to obtain insurance for certain risks.

Whilst some generalizations can be made about the insurances necessary for projects, each project will require specific insurance coverage, based on the risks inherent to a particular project.

Often in the construction phase of a BOT project the insurances are obtained by the contractor, who is not that interested in the longer term implications of the insurance cover. It is important for the project company, with longer term interests, to co-ordinate this task so as to be sure that the insurances will suffice for the longer term.

This note is intended to be a general high-level guide to insurance issues. For more detail an insurance specialist should be consulted.

Types of Insurance

The parties need to consider what risks need to be insured and whether such insurance is available in the host country. Set out below is a summary of types of insurance that may be appropriate in a project: -

Insurance during transportation

Every element of materials and equipment to be used for the project should be insured during shipment to the site, including equipment to be integrated into the works, temporary plant and the construction contractor's equipment. This coverage may include marine cargo insurance. Transportation insurance must be correlated with the all-risk policy on the site. A "fifty-fifty claims funding" clause can help clarify liability for damage that may occur at or shortly after delivery, by stipulating that each insurer will pay 50 per cent. of the claim if it cannot be established whether it occurred during transit or after delivery.

Insurance of project assets

Equipment and materials will first need to be insured up to delivery to the site. This project asset coverage may include the construction contractor's equipment brought onto the site where such equipment is essential to progress and/or very expensive, for example, tunnel boring machinery. The loss of such equipment can seriously hamper the construction contractor and therefore the progress of the works. Project assets should be insured ex-works (i.e., cover transfer to the site) to delivery at the site either into the hands of the construction contractor or into the construction contractor's storage facilities.

¹ Vinter, Graham D. – Project Finance, A Legal Guide, 3rd. Ed., Delmon, J – Project Finance, BOT Projects and Risk, 2005

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Construction all-risk policy

Construction all-risk ("CAR") or construction and erection all-risk ("CEAR") insurance will cover all operations and assets on the site during the construction of the works. This policy generally excludes war-risk. Parties may include a war-risk endorsement to cover risks generally considered political in nature. The construction contractor may prefer to leave the grantor to provide the political aspect of the project asset insurance, to reduce costs and in an effort to maximise value-for-money in its insurance arrangements.

Professional indemnity ("PI")

This form of insurance is available under certain CAR or CEAR policies, or it may be provided separately. PI insurance covers design faults or other such professional services provided by the construction contractor or its designers. Such insurance is generally carried by a designer as a part of its normal business.

Operational damage

The final major aspect of project insurance will cover all-risk insurance during operation, including, in particular, insurance of property damage during operations.

Third party liability insurance

The project should be covered from commencement of construction to the end of the concession period by liability insurance for any claim by third parties for the acts or omissions of the project company, and any of the contractors, subcontractors or other persons for whom it may be responsible, during construction and operation of the project. The grantor and the lenders may also want to be covered by this policy. This policy should cover, as far as practicable, any environmental effects of construction and operation.

Consequential loss

Insurance cover will generally exclude consequential losses or damages incurred by the project company. Therefore, the project company or the lenders may require that the project company obtain insurance coverage for consequential losses. These include delayed start-up, advance loss of profit and business interruption insurance. The amount of such insurance obtained will generally be calculated to compensate for the fixed costs of the project. A separate consequential loss policy must be taken out for each form of insurance obtained. For example, where the construction contractor obtains a CAR policy and a marine cargo policy, it will need a consequential damage policy for each of them.

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Mechanical or electrical failure

The operational policy may not cover events of mechanical or electrical breakdown, therefore separate insurance must be obtained. The nature of, and need for, this insurance cover will depend on the works in question and the cost of replacement of key equipment.

Automobile liability insurance

This policy should cover all vehicles to be used on site, and will often be mandatory under local law. The vehicles in use during construction and operation may extend beyond motor vehicles, to airplanes, helicopters, boats and ships or possibly more expensive machinery requiring specialist local and/or international insurance.

Workers' compensation, employer's liability

The construction contractor and the operator will be obligated either to the host government or to its staff for some form of statutory compensation or other form of benefits or other liability, which should be covered by an insurance policy. The coverage of this policy will depend on the provisions of local law concerning such liability, and local and international practice.

Directors' and officers' liability insurance

The project company will want to be protected from the possibility that a director's or officer's act or omission may have an impact on the project. Generally, the director or officer in question will not have the financial wherewithal to compensate the project company for such damages.

Political risk

A range of political and war risks will not be covered by the above insurances. Therefore, the project company may need to obtain special insurance to cover these risks. This coverage usually involves a multilateral agency or an export credit agency.

Lenders Issues

Where a project involves lenders, insurance is a key area of interest for lenders and should be organized in conjunction with them – or with them in mind. Correcting insurances to meet lenders' requirements can be complex and time-consuming.

Lenders' interests are twofold: -

- To ensure that they are satisfied with the scope if the proposed insurance cover – the risks covered, the exclusions, the amount of cover and the deductibles
- To ensure that their interests in the insurances are adequately protected

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Lenders may therefore require pollution insurance and delay in start-up or business interruption insurance.

Main items Lenders will be expecting to be covered: -

Identity of insured

Lenders may prefer the project company rather than one of the participants to take out the insurances as the lenders have more influence over the decisions and acts of the project company, it is the party probably best placed to obtain insurance for the whole of the project period and having one single source may help to avoid gaps in coverage. However, it may sometimes be cheaper to have a project participant provide cover if it has good standing.

Long-term cover

Lenders will want assurances that the insurance cover will continue for the term of the loans – even though insurance can only be taken out on an annual basis. Lenders may require some direct contractual commitment from a member of a consortium, for example, to continue to renew the insurances. Brokers are usually required to enter an undertaking to notify lenders of any proposed cancellation of cover/ amendments to a policy.

Lenders as Co-insureds

In order to perfect insurance security interests and to have control over how insurance proceeds are spent, lenders may seek to become co-insureds on the policies (and become direct beneficiaries of separate and independent policies). Being co-insured rather than joint insured is important as non-disclosure by one co-insured will not entitle the insurers to avoid (vitate) the policy against the other insured.

However, insurers are resisting providing non-vitiation cover and endorsements for non-vitiation are resisted by them. It may be that insurers will give this cover for a higher premium. However, if it is intended that non-vitiation language is included, this should be made clear to the insurers from the outset otherwise they are likely to resist it. If it is not possible to obtain non-vitiation language, other ways to address the problem are: -

- Obtain a full non-vitiation endorsement from insurers in another insurance market
- Get project company's insurers to agree that they are satisfied that full disclosure of all material facts has been made to them (not that helpful if need to renew policy or there is a continuing duty on insureds to disclose material facts during course of insurance)
- Banks take a separate policy similar to non-vitiation scheme
- Parallel policy to main banks for lenders only - but onus of providing full disclosure falls on the banks

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- Obtain indemnity from other insured parties that if they cause insurance policy to be avoided it will indemnify banks against loss suffered as a result (only helpful if other parties credit worthy)
- Obtain indemnity from project company's shareholders against losses banks suffer as result of insurance policy being avoided – unlikely to be acceptable to shareholders if have limited recourse financing.

A lesser level of comfort would be having their interests in the policies noted (with or without “loss payable” clauses being attached to the policies), however this will at best mean that insurers cannot obtain good discharge by paying insured – or merely that it has to enquire as to the nature of the lender's interests before paying away insurance proceeds.

Loss payable clauses

Loss payable clauses are directions to insurers to pay all insurance monies below a certain level to project company and above a certain level to the lenders. Under certain legal systems care will need to be taken in relation to loss payable clauses in relation to third party liability insurance as they may be held to be ineffective. For this reason lenders tend to insist on being co-insureds on relevant policies taken out in connection with a project, with an appropriate loss payable clauses being attached.

Subrogation

Project insurances should also include a waiver by the insurer of its rights to subrogation (the right to pursue the party at fault in respect of amounts paid out under the insurance contract). These rights may be inconsistent with the intention of the project company. The project company will not want the project to fail because the insurers used their rights of subrogation against one of the project participants or subcontractors, rendering them unable to perform their obligations. The insurers may therefore be asked to waive certain of their rights of subrogation.

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Typical issues covered in the project documents: -

1. undertaking to effect required coverages – different for construction and operational phases – borrowers should ensure that obligation is to take them out “to the extent that the insurances are available” – to prevent the project company from being in default because relevant insurance markets withdraw certain insurance cover or raise premiums to unacceptably high level
2. insured amounts required and maximum deductibles (not always possible to specify this for operations phase at the outset) – borrower should ensure that lenders only have discretion to demand insurances that are “available” in the operations phase
3. mechanism for increasing insured amounts – e.g., index-linking or agreement between the parties, with resort to an expert in event of disagreement
4. is insurance for replacement value or indemnity (actual cash value) basis? Lenders usually insist on replacement value – lenders may agree to replacement value basis for terrorism insurance as it is difficult to obtain – but otherwise lenders insist on full reinstatement basis for insurance
5. undertaking to effect insurances through a broker and for approval of the insurers by the banks on terms acceptable to the banks (including, possibly, non-vitiating clause)
6. project company required to inform lenders direct of any changes to the terms of the policies
7. insurer required to give lenders notice of cancellation of policy (so lenders may be able to pay premium if cancellation is for non-payment, etc.)
8. undertaking to procure broker gives the banks a letter of undertaking, which will require broker to
 - arrange for loss payable clauses in agreed form to be included in policies
 - arrange for a notice of assignment to be endorsed on each policy (in some jurisdictions notice will need to be given jointly by borrower and the lenders in order to be valid)
 - hold insurance slips and policies to lenders’ order
 - advise the agent bank of any non-payment of premia and of any circumstances which might result in any insurance being avoided
9. undertaking to pay all premia when due and to provide the agent bank with evidence of payment
10. provision that if borrower defaults in any of his insurance obligations, banks can perform those obligations in his name and at his expense.
11. obligation to apply substantial physical damage insurance proceeds in prepayment of loans

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Reinsurance

The host government may have a rule that all insurances have to be written locally. The primary insurers are likely to reinsure as they may not otherwise be able to meet a major claim. Lenders may want to control the percentage of liability that local insurers reinsure (by insisting on a “maximum retained percentage” for a local insurer – above this percentage, the local insurer would be required to reinsure). Lenders will usually specify credit ratings for reinsurance – although this is not great comfort for the project company as it will have to rely on the credit worthiness of the local insurer. In order to reduce this risk, project company can: -

- require local insurers to give project company a security assignment of reinsurance policies – may not be possible to under local law to do this and insurers may themselves be subject to negative pledges
- require contractual cut-through agreements – tripartite agreement between local insurer, reinsurer and project company providing that in the case of a claim project company may call on reinsurer to pay it direct – lenders usually take security interest in project company’s interest in the agreement. They may not be possible under local insurance law, they may not be enforceable in the case of a bankruptcy because they are contractual and so may be capable of being avoided, and, from reinsurer’s perspective, it may face risk of double payment
- have project sponsors form own captive insurance company in jurisdiction – could then ensure that it only carried out insurance for this project – so all proceeds would be available – this is expensive and time-consuming but may be worthwhile for a huge project – e.g., major oil companies have done so in some jurisdictions because of lack of capacity in insurance markets for various aspects of business – especially pollution.