Fit for purpose extensions in professional indemnity policies

This article considers the common features shared across policies that have a fit for purpose extension.

Professional indemnity (PI) insurance policies generally cover obligations to exercise reasonable skill and care, not strict obligations, such as a warranty that the design will be fit for its intended purpose. However, extensions to PI policies for design and build contractors to cover fitness for purpose warranties are available. The trouble is, they are subject to extensive limitations and there is reason to doubt whether this is always understood. This creates the potential for at least two problems:

1. contractors agreeing to give fitness for purpose warranties in the mistaken belief that they will be covered by their insurance; and
2. brokers and other advisers being at risk of claims for negligent advice.

Implied fitness for purpose

One common feature across policy wording that I have read, is that they provide cover only for an ‘implied fitness for purpose warranty in respect of the design and/or specification of the works’.

At common law, in the absence of an express standard of care or other term or circumstance to the contrary, a fitness for purpose obligation is likely to be implied in the case of contractors (IBA v EMI and BICC [1980] 14 BLR 1 and Viking Grain Storage v TH White Installations Limited [1985] 33 BLR 103), but not in the case of construction professionals (Greeze & Co (Contractors) Limited v Baynham Meikle & Partners [1975] 1 WLR 1095 and George Hawkins v Chrysler (UK) Limited and Burne Associates [1986] 38 BLR 36).

A fitness for purpose obligation may also arise under a statute, ie, s4(5) of the Supply of Goods and Services Act 1982 (SGSA) (fitness for purpose of goods and materials), s1 of the Defective Premises Act 1972 (fitness for habitation of dwellings) and the Construction (Design and Management) Regulations 2007 (safety). The fact that cover relates only to an implied warranty begs a number of questions.

Does the existence of an express warranty negate the existence of an implied one?

Section 11(2) of the SGSA says that it does not negate the statutorily implied term unless inconsistent with it, but at common law it may do so, see Broome v Pardess Co-operative Society of Orange Growers Limited [1941] All ER 603 ‘where the parties have made an express provision as regards some matter with regard to the contract, it is, and must be, extremely difficult for either of them to say in regard to that subject matter, as to which there is an express provision, there is also an implied provision or condition in the contract’ (paragraph 12 of the judgment). See also Miller v Emcer Products Limited [1956] Ch 304.

However, such an interpretation of the policy wording would seem to go against the objective intentions of the parties, not least because in many building contracts there will be an express warranty. Some policy wordings are less clear in this regard than others, but, consistent with
the approach to other forms of contractually assumed liabilities, the intention appears to be that cover will apply to an express warranty to the extent that such a warranty would have been implied.

What are the potential differences between an express and implied warranty?

At common law and under s4(6) of SGSA, a fitness for purpose warranty will only be implied where the employer can show reliance upon the contractor and the absence, extent or reasonableness of that reliance may result in the implied term not existing or being more limited than an express one. This could arise where, for example, the employer:

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1. specifies a particular supplier of materials (see Gloucestershire County Council v Richardson [1968] 2 All ER 1181, HL and University of Warwick v Sir Robert McAlpine (1988) 2 BLR 1),
2. deals directly with or relies upon a specialist sub-contractor rather than the main contractor, or
3. relies on its design team but they leave some aspect, such as choice of materials, to the contractor. See, for example: Adcocks Trustee v Bridge Rural District Council [1911] 75 JP 241 and Rotherham MBC v Frank Haslam Milan Co Ltd [1996] 78 BLR 1.

In both those cases, the contractor complied with the architect’s specification, but the materials proved unsuitable. It was held that the employer had not relied upon the contractor and so a fitness for purpose warranty was not implied.

In Trebor Bassett Holdings Limited and Another v ADT Fire & Security Plc [2011] BLR 661, Mr Justice Coulson expressed the view that general reliance only was insufficient for a fitness for purpose warranty to be implied in that case, what was required was evidence that a particular purpose had been communicated.

In all these cases, if an express warranty had existed, the absence of reliance would not have been an impediment to holding the contractor liable. A contractor who took out fitness for purpose cover and found itself so liable, might be surprised to find that it was not covered. The judgment in Young & Marten Limited v McManus Childs Limited provides other examples of where the requisite reliance would be absent, i.e., where the goods could only be supplied by one manufacturer and the employer knew that they were not willing to provide a fitness for purpose warranty or where the contractor warned against a particular good/material or manufacturer.

Often a design and build contractor will take responsibility for designs produced by the employer, as under clause 4.1 of the FIDIC silver book for Engineering Procurement and Construction contracts. I understand that it is intended that cover should apply in such situations, but surely there will be cases in which it could be argued that this kind of contractually assumed liability goes beyond that which would have been the subject of an implied warranty. Differences may also emerge in respect of what is meant by ‘fitness’ and ‘purpose’. The meaning of those words in the context of the statutorily or common law implied term is to be determined objectively in all the circumstances. However, for the purposes of an express warranty, the contract may specifically define these terms, and situations may arise in which the contractual definitions impose a broader or otherwise more onerous obligation than would otherwise have existed.

Cover, so I am told, does not extend to a fitness for purpose warranty in a collateral warranty, this being a contractually assumed liability that would not have been the subject of an implied warranty. Contractors could be forgiven for assuming that because they have cover for a fitness for purpose warranty in their contract, that this would apply to a collateral warranty relating to their performance of the same. They would be wrong to do so.

Defective materials and intended purpose
The extensions do not cover defective materials; the cause of many of the reported cases on fitness for purpose. Whether a material is defective (so not covered) or merely unsuitable (so presumably covered) may be a matter of some debate.

The extensions require that the contract defines the intended purpose and coverage is limited to that defined purpose. This opens up another potential gap. In implying a term the court may look outside of the contract to determine what was understood to have been the purpose of the project. Typically, the court will look at the parties’ discussions and correspondence and the normal purpose of a building of the type in question. As previously stated, the contract may define the purpose in broader or more onerous terms than would be implied. However, the opposite may also be true. Most contracts will state the purpose of the project to some extent, but there are myriad circumstances in which an intended use could be made known (expressly or by implication – see s4(4) of SGS), changed or elaborated upon at a later date or otherwise outside of the contract. Contractors may have to be able to point to a part of a contract which specified the purpose in question to benefit from cover. Some FIDIC and IChemE contracts expressly provide the ‘purpose’ is that stated in the contract, but this approach is not universal.

**State of the art defence**

Cover is limited to that which would have existed if the insured’s contract, had entitled it to defend the claim on the basis that the design was ‘in accordance with practice conventionally accepted as appropriate at the time having regard to the size, scope and complexity of the project’. One of the classic illustrations of the difference between a skill and care and fitness for purpose obligation is that, under the former, it is a defence to show that services were performed in accordance with the ordinary professional knowledge at the date of the act or omission complained of. Industry knowledge may have improved following, or perhaps because of, the incident in question, but the professional’s performance is to be judged at the time at which services were provided, subject to questions of whether, if the design is novel, the client should have been made aware of the risks.

Such a defence is not available in respect of a fitness for purpose warranty so that is an area in which cover would be of particular value, but this caveat removes it.

The rationale for the caveat is, however, understandable since it removes the temptation for contractors to speculate on untried materials or techniques at their insurer’s risk. This brings about the question as to whether all contractors have read their policies closely enough to appreciate this? Of course, building contracts rarely (if ever) contain the kind of wording assumed by the extensions and it seems unlikely that such wording would be agreed.

**Unforeseen ground conditions**

Another classic illustration of the difference between skill and care and fitness for purpose is the party who advises on ground investigations or produces a design based on such investigations. They may act competently, but unforeseen conditions are encountered. The cover provided expressly excludes unforeseen ground conditions. Given the commercial pressures to which contractors are often subject when deciding what, if any, ground investigations to carry out during the tender period, this seems a sensible exclusion, but contractors should be aware of it and it does substantially reduce the benefit of the cover.

**Process Engineering**

It is common in process or power plant contracts for fitness for purpose to be defined by reference to performance tests and for liquidated damages to be levied for any failure to meet those standards as part of a pain/gain sharing mechanism. These are commercial arrangements and as a result, to varying degrees, process engineering is excluded from the extensions.

**Other limitations in PI policies**
The extensions are of course subject to the limitations that apply to the policy generally, they exclude workmanship and are subject to the particular definition of ‘professional services’ and commonly, contain an exclusion of liquidated damages and pollution / contamination.

Know your limits

I understand that fitness for purpose extensions are often offered for little or no additional premium. The principal benefit of such cover may come, not in terms of the scope of the cover it provides, but in terms of its potential to obviate the need for an enquiry into the contractor’s negligence before insurers are satisfied that the contractor is liable. That of course has a down side for insurers since it may be difficult for them to obtain a contribution from other parties before settling with the employer.

That aside, contractors should be mindful of the limitations on this cover and consider matters carefully before agreeing to take on a fitness for purpose obligation that they would otherwise have shied away from. Brokers and others advising contractors on this cover would be well advised to obtain a full copy of the policy wording and to highlight its limitations to their client, as some are doing already. In my view, insurers should proceed with caution and be mindful of the fact that where ambiguities exist in their policy wording, the courts are more likely to construe the terms in favour of the insured if to do otherwise would substantially reduce the benefit that appeared to be provided by the cover.

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