



## **Some Problems Encountered in Delay in Start-up Claims**

This paper reviews a number of problems that may be encountered by adjusters of Delay in Start-Up (DSU) losses. Those looking for a fuller description of the mechanism of project delay insurances are referred to the Insurance Institute of London's Research Group Study Report No 254 "Insurance of Revenue for Projects Under Construction". For the purpose of this discussion we will presume a basic knowledge of DSU policies and project programming.

Although the principles behind DSU covers are easy enough to understand, it is when the principles come to be applied in the real world that difficulties arise. These mostly relate to the contractual realities of project execution.

### **The Parties and Their Interests**

Conventionally, we anticipate that projects will be commissioned by a client, designed by an independent designer, and executed by a contractor, although it is increasingly common to find these distinctions blurred. A group of promoters may undertake a project in which they can fulfil all these roles, having suitable resources within their various existing companies.

Most projects are financed by borrowing. The borrowings are usually arranged in the expectation that once it becomes operational, the project will generate a stream of revenue, sufficient to service the loan drawn down to fund the construction.

Timely performance of the contract may be encouraged by provisions in the construction contract that impose a financial penalty on the contractor for time overruns. Such a penalty is usually referred to as "liquidated damages" (LDs)

LDs are ideally set at a level that reflects the client's loss of income that it is anticipated could result from any delay due to the contractor's poor performance. However there are many reasons why delays occur on projects, and the fault does not always lie with the contractor. For that reason, there are many situations in which delays



are experienced, but no LDs are payable to the client. Also, it may not be commercially reasonable to demand a high level of LDs on a small value contract, even if the consequences of delay on that small contract may be financially very grave for the client. So even where LDs are payable, they may not provide a full indemnity.

Obviously a delay in the start of the revenue stream is of great concern to the lenders, since it will usually imply that the promoter will not have sufficient cash to service the loan. It is for this reason that DSU insurance is so frequently purchased by promoters at the insistence of the lenders. It is often made a condition of the loan.

From the above it is clear that DSU insurance of this kind is purchased solely for the benefit of the client and the lenders. This is of course reflected in the definitions of 'Insured' on the face of the policy.

The contractor has a different insurable interest in the event of delay – he may be exposed to LDs and extra cost. Contractors' delay insurance can be purchased, although its poor claims history renders it rather expensive.

The client is interested in getting his project realised and operational within the time and cost originally forecast. (There are some intriguing examples of situations in which clients may find that a project delay is in their interests, but we do not need to address these here.) It should also meet the contract specification in terms of quality and output performance.

The contractor's interests may be somewhat different. A contractor must maximise profit at every opportunity. He may have undertaken several contracts at once. It may benefit him to concentrate his resources on contract A rather than contract B, even at the risk of incurring LDs on contract B. The contractor is always eager to attribute additional cost and time to any cause which, under the provisions of the contract, entitle him to additional payment or extensions of the contract period; the most obvious example being variations in the scope of works ordered by the client after the contract has commenced.



These divergent interests inevitably create tensions between the parties. Where projects run into significant problems, these tensions can occasionally attain the aspect of open warfare. Frequently both sides accuse the other of bad faith and deliberate obstruction. Even formal provisions within the contract for dispute resolution may not be of much assistance where the working relationship between the parties has broken down.

### **Project Schedules**

The DSU insurance is normally contingent on indemnifiable physical loss or damage. It is the task of the adjuster to examine the claim that the loss or damage has caused the onset of revenue to be delayed.

Except in the most obvious of cases, the adjuster must examine the detail of the project schedule in order to establish which activities have really been affected, and what implications that might have for the project end date.

The schedule is almost always the creation of the contractor. It is the contractor who has tendered to execute the works. To price his tender, he must (or ought to) have determined how the works will be executed. Only the contractor knows what resources he can field (in terms of plant, labour and materials) and when these may be available. It is to be presumed that his tender reflects these real constraints.

Any client who might seek to instruct a contractor to adopt a different sequence of execution from that set out by the contractor in his tender is effectively inviting a claim for extension of time and extra cost.

For this reason, the client is well-advised to demand the contractor's schedule at the start of the works, and regular updates thereafter. Rather than seeking to tell the contractor how to do his job, if there are signs of the contractor failing to achieve project milestones by the scheduled date, the client can hold up the contractor's own schedule by way of recrimination, and the client can reasonably demand that the contractor explain what measures he will take to restore the schedule (by acceleration, for instance).



For these reasons the contract schedule is a very powerful weapon. Since the contractor prepares it, it is only natural that he should construct it in such a fashion as to maximise his contractual advantage.

Schedules are mostly nowadays constructed using proprietary software. These allow very complicated interdependencies between activities to be modelled, and can readily model various “what if” possibilities. Despite the authoritative appearance of the end product, schedules are assembled by planners, who choose all the relevant parameters. This allows the unscrupulous to fabricate traps and conceal float.

Completely spurious dependencies can be inserted, so that, for instance, X cannot start until Y is complete, even if in real life these two activities have no connection. This can be useful if the contractor’s estimators have realised that there is an error in the tender documents. Suppose the quantity in activity X has been under-stated. This means that when the error becomes apparent during the course of construction, the client will be compelled to issue a variation order, instructing extra X activity. When activity X becomes extended in this way, the contractor will claim that this delays the start of Y, and as it happens, Y is a critical activity to project completion, and so the client must give the contractor an extension of time.

Contractors realistically anticipate that delays will occur due to circumstances beyond their control, but for which no relief may be allowed under the contract. It therefore is quite common for the schedule to be padded with activities whose duration has been extended beyond that which is really intended. This can be achieved by under-resourcing the activity e.g. allowing only two painters to decorate an entire office block. This has two benefits; when the contract falls behind schedule, it can magically be restored simply by assigning three painters to that particular task, furthermore, if any variation by the client impinges on one of these activities that appears to be on the critical path, it may allow the contractor to claim an extension of time, even if in reality no delay would ever have resulted.



In fairness it should be said that the concealment of float in the way suggested above may not be so much the result of any unscrupulous motive, so much as the cautious contractor building in safeguards.

However it can be readily understood that the programme provided by the contractor to the client may not represent the real state of things. When a loss occurs, the adjuster will naturally wish to ascertain the true impact of the event on the end date of the project. To do this he would like to see the contractor's "real" programme. However the contractor is unlikely to disclose his true position. He would not want to prejudice his commercial position under the contract. The contractor is under no obligation to disclose anything to the adjuster, since the contractor is not an insured under the DSU policy.

This is of course a most unsatisfactory situation, and often not understood by underwriters. We can only stand in the shoes of the client, and attempt to analyse the schedule presented to him by the contractor. Internal inconsistencies may indicate where the reality is being manipulated, but we cannot hope to always discover how the schedule really operates. It accordingly behoves adjusters to be humble and tentative in asserting that any proposed adjustment is the "right" answer.

### **Combined Roles**

It might be thought that where the client is also the contractor (a situation not uncommon in Build-Own-Operate projects) there would be a common objective, and that the "true" schedule would be readily available. In the disappointing experience of the writer, this is hardly ever so.

Consortia are usually formed from several independent companies who join together to create a "vehicle" to raise finance and initiate the project. This vehicle constitutes the project client. Almost always a second joint venture company of some kind is created to undertake the role of the contractor.



This is done for a number of reasons, most obviously because it enables the parties to take some profit from the project in the role of contractor, long before any project revenue stream could be established.

Immediately the two distinct commercial entities have been created, all the usual contractual tensions reappear, and the problem with “client’s programme” as opposed to “real programme” persists. The fact that the shareholdings in the two companies may be differently weighted only adds to the problem.

### **Liquidated Damages**

Many underwriters make explicit stipulations within the policy that any liquidated damages receivable by the client should be set off against any claim for loss of revenue due to delay.

This is apparently reasonable. LDs are supposed to be set at a level which represents the real financial loss anticipated by the client in the event of delay. Since that is their function, if the client has received them, he has already been indemnified in respect of that delay and has no loss, or maybe only a much smaller loss.

However in real life, entitlement to LDs is often not quite so clear cut. There may already be uncertainty as to what is the real cause of the delay experienced, and whether this is a “culpable” delay for which LDs are payable.

Where all parties agree that the delay is caused by the contractor, it may still benefit the contractor to represent the delay as greater than that considered by the adjuster. The contractor may have cover under the material damage section for increased cost of working, additional cost of working and expediting which may still represent a net commercial gain even when LDs are taken into account. This is particularly so where the contractor has the benefit of LD insurance.

In many contracts, by the time completion approaches, a whole host of contractual disputes may have arisen, not just about delay but also about failure to conform to



specification, defective work, disruption of nominated subcontractors and similar topics, in respect of which the client may have offset monies claimed by the contractor as due under the contract. Thus where the client has withheld monies, it may be by no means clear at that stage that he is entitled to do so, or what proportion of the monies withheld can be properly attributed to which heads of dispute.

The settling of the final contract sum often involves negotiations that may stretch out over many months and, not infrequently, years. All the various disputes that arose during the construction period are reviewed. The larger issues may be offered up to arbitration. Even at the end of this whole process it may not be possible to establish what actual value can be attributed to any one component of the multiple dispute. This is particularly so when there has been no formal arbitration or adjudication on any of the topics. In fact a pragmatic solution is usually negotiated which rolls up all the heads of claim. The trouble is then that no one can (or would care to) answer the adjuster's question which is "How much delay did you agree was due to the crane collapse?"

Therefore during the period of delay it is not possible to be sure how much of the monies the client is setting aside can be properly attributed to a particular delay, or will have to be paid back to the contractor at the end of the subsequent protracted negotiations.

Where the adjuster has pronounced on the extent of the loss, and a settlement has been agreed with the client, there must always be the prospect that during the subsequent contractual battle between contractor and client, an independent adjudicator may issue a written opinion stating that the delay was actually greater than that allowed by Insurers. The client might then demand that the DSU claim is re-opened (say) two years after the settlement.

In BOO projects, the client may not wish to exercise the right to impose LDs, even if it is present in the contract, since he would in effect only be penalising himself. Some project promoters write contracts that specifically state that where a delay is due to a cause which is an insured peril under the project insurance policy, LDs are waived. This is of course just a logical provision which more accurately reflects the insurable interest



of the promoter. I suggest that adjusters would like to see clauses of this type more widely used in such projects.

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