

## **SHIPBUILDERS' RISKS INSURANCE CONTRACT**

### **Summary**

Shipbuilders' risks insurance protects the builders from the loss of or the damage to the vessel under construction. It covers the entire period of construction until the delivery of the completed vessel to the buyer. The subject matter of insurance is the hull with all its parts and appurtenances, including materials, parts, engines and equipment that are awaiting installation. The standard coverage further includes the protection against certain liabilities arising out of the ownership of the vessel. The cover is commonly contracted on an "all risks" basis subject to several standard exclusions. The insurance can be for the total value of the vessel, or it can be adjusted upwards according to the construction phases. Shipbuilders' risks insurance in the world markets is mostly standardised and based on internationally recognised clauses, such as the Institute Clauses for Builders' Risks 1/6/88. The aim is to explain the main features and particularities of the internationally recognised terms and conditions of the shipbuilders' risks insurance contracts.

*Keywords: marine insurance, shipbuilding, builders' risks*

## **UGOVOR O OSIGURANJU BRODA U GRADNJI**

### **Sažetak**

Osiguranje broda u gradnji štiti brodograditelja od gubitka i oštećenja broda u gradnji. Pokriće obuhvaća sve faze gradnje do predaje broda naručitelju. Predmet osiguranja je trup broda sa svim sastavnim dijelovima i pripacima, uključujući i materijale, dijelove, strojeve i opremu koji će tek biti ugrađeni na brod. Uobičajenim uvjetima osiguranja pokrivene su i određene vrste odgovornosti koje proizlaze iz vlasništva broda. Pokriće se najčešće pruža po načelu «svi rizici», uz neka standardna isključenja. Osiguranje može biti na punu vrijednost gotovog broda, ili može biti ugovoreno uz osiguranu vrijednost koja postupno raste sukladno fazama gradnje. Općenito, osiguranje broda u gradnji na svjetskim je tržištima osiguranja uglavnom standardizirano te se pretežito temelji na međunarodno prihvaćenim osigurateljnim klauzulama kao što su primjerice Institutske klauzule za osiguranje brodova u gradnji 1/6/88. Cilj je rastumačiti glavne karakteristike međunarodno prihvaćenih uobičajenih uvjeta ugovora o osiguranju broda u gradnji te ukazati na njegove specifičnosti.

*Ključne riječi: pomorsko osiguranje, brod u gradnji, rizici brodogradnj*

## 1. Introduction

During the shipbuilding process, there is a risk of an accidental loss or damage to the newbuilding. Under the Croatian Maritime Code<sup>1</sup> (hereinafter: the CMC), it is presumed that the vessel under construction belongs to the shipbuilder, unless it is specifically agreed otherwise under the shipbuilding contract (CMC, Art. 432). Therefore, it also means that the risk of the loss or damage to the newbuilding lies on the shipbuilder until the time of delivery of the vessel to the buyer. Likewise, according to the widely known standard forms of shipbuilding contracts, such as SAJ form<sup>2</sup>, AWES<sup>3</sup> form and BIMCO Newbuildcon<sup>4</sup>, the shipbuilder will assume the risk of the loss or damage to the vessel in the pre-delivery period.<sup>5</sup> The shipbuilder therefore holds the insurable interest in the vessel during the entire shipbuilding process until the time of delivery of the vessel to the buyer. This insurable interest arises from the fact that the shipbuilder is the one, whose economical interests will be negatively affected in case of the loss or damage to the newbuilding. Moreover, under the most common standard forms of shipbuilding contracts, the builder is usually required to keep the vessel and all machinery, materials and equipment delivered to the shipyard for installation in the vessel, including the buyer's supplies, fully insured.<sup>6</sup>

To respond to the legitimate needs of the shipbuilders to protect themselves by financially managing the risks of the loss or damage to the vessel under construction, a specific type of insurance contract has been developed within the marine insurance law and practice, that is the shipbuilders' risk insurance contract. Under the Croatian law, shipbuilders' risk insurance is regulated as a type of marine insurance contract by the provisions of the CMC<sup>7</sup>. Similarly, in the most of the comparative legal systems it is generally accepted that this type of insurance contract is governed by the rules of the maritime law.<sup>8</sup>

Shipbuilders' risk insurance is specific when compared to other marine insurance contracts, due to the fact that the shipbuilding process is associated with a number of very specific risks. The construction works and activities are associated with the particular construction risks. The launching, which is one of the regular phases in a shipbuilding process, is associated with very specific launching risks. Finally, the final works taking place after the launching, including the equipping of the vessel and the sea trials are associated with the perils of the sea and other risks to which a ship in navigation is exposed. All these risks are commonly referred to as (ship)builders' risks.

The specific nature of shipbuilders' risks has led to the development of particular standard terms and conditions of builders' risks insurance. The London marine insurance market has designed the widely accepted Institute Clauses for Builders' Risks (hereinafter: ICBR). These clauses have also been traditionally used in the practice of the Croatian marine

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<sup>1</sup> The Official Gazette of the Republic of Croatia, Nos 181/04, 76/07, 146/08, 61/11.

<sup>2</sup> Standard shipbuilding contract form of the Shipbuilders Association of Japan.

<sup>3</sup> Standard shipbuilding contract form of the West European Shipbuilders.

<sup>4</sup> Standard shipbuilding contract form designed by the Baltic International Maritime Council (BIMCO).

<sup>5</sup> E.g. SAJ form, Art. VII.5 states: "until delivery is effected, title to and risk of loss of the Vessel and her equipment shall be in the Builder [...]".

<sup>6</sup> E.g. BIMCO Newbuildcon, cl. 38 (a) (Builder's Insurances) states: "From the time of first steel cutting or equivalent (or delivery of the Buyer's Supplies, whichever is earlier) until the Vessel is completed, delivered to and accepted by the Buyer, the Builder shall [...] effect and maintain at no cost to the Buyer, Builder's Risk Insurance for the Vessel and Buyer's Supplies."

<sup>7</sup> The contract of marine insurance is regulated by the provisions of Part VII, Heading IV of the CMC (Art. 684-747). Art. 684, para. 2 specifically states that the respective provisions of the CMC apply to the insurance of the vessels under construction and of all the things (meaning parts and materials) intended to be used in the construction of the vessel.

<sup>8</sup> Pavić, D.: "Osiguranje brodova u gradnji", *Osiguranje i privreda*, vol. XXXIII (1993), No. 5, p. 3.

insurance and shipbuilding. This article will therefore primarily focus on the ICBR as the most commonly contracted terms and conditions of shipbuilders' risks insurance.<sup>9</sup>

The latest revision of the ICBR is the one of 1988.<sup>10</sup> In accordance with the usual marine insurance practice, war and strike risks are excluded from regular builders' risks coverage, but can be insured additionally. There are special institute builders' risks clauses for the coverage of war and strike risks. Therefore, the ICBR are the following:

- Institute Clauses for Builders' Risks 1/6/88,
- Institute War Clauses for Builders' Risks 1/6/88,
- Institute Strikes Clauses for Builders' Risks 1/6/88.

ICBR are intended primarily for the insurance of the vessels under construction, commonly purchased by shipyards. They can also be used for the insurance of major reconstructions or conversions, in which case they are usually purchased by shipowners. They form an important part of the contractual matrix in any construction project and, as already mentioned, most construction contracts will require from the shipyard to purchase cover on terms equivalent to the 1988 clauses.<sup>11</sup>

This article examines the salient features of the contract of insurance of a vessel under construction, i.e. the insurance of shipbuilders' risks. It in particular analyses the subject of insurance, the identity of the insured, the particularities of the insured value, the period of insurance, the extent of the insurance coverage (the insured risks) and the types of the loss or damage covered. The analysis is based on the ICBR 1988 as interpreted under the Croatian marine insurance law, i.e. primarily in the context of the provisions of the CMC dealing with the contract of marine insurance (Art. 684-747).

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<sup>9</sup> The other internationally predominate insurance clauses for shipbuilders risks are the American Institute Builder's Risk Clauses, which are in many ways similar to the London ones. It is worth noting that the Norwegian Insurance Plan 1996 (version 2010), used in the Scandinavian marine insurance market (hereinafter: *NMIP*), also contains a chapter (Ch. 19) on builders' risk insurance. The rules of the NMIP on builders' risks insurance are based on Cefor Form 250, which is in turn based on the ICBR. The NMIP builders' risks conditions have so far only been applied to the building of ships in Norway. See Norwegian Marine Insurance Plan 1996, version 2010 – Commentary Part IV, p. 80.

<sup>10</sup> The clauses date back to 1963, they were amended in 1972 and in 1988.

<sup>11</sup> Zavos, C., "Builders' Risks – Proposed Changes", International Marine Claims Conference, Dublin, 26<sup>th</sup> October 2005, <http://www.marineclaimsconference.com/2005/docs/Chris%20Zavos%20paper.pdf>.

## 2. Subject of insurance

### 2.1. General

The subject of insurance is the vessel under construction. According to the Croatian maritime law, the vessel under construction is defined as the building of a vessel from the laying of the keel or a similar process of construction until the registration in the ship registry (CMC, Art. 5, point 29). In Croatia, ships under construction are subject to registration in a special registry, i.e. the register of ships under construction. However, in the context of the marine insurance law, a vessel under construction, as the subject of builders' risks insurance, is a term that encompasses a wider meaning than the one prescribed by the general rules of the maritime law. Namely, the subject of insurance encompasses the hull and machinery of the vessel and everything else inbuilt in the vessel (equipment, materials, etc.), all its parts and appurtenances. According to the ICBR 1988, the insurance further covers all those things (including materials) intended to form a part of the vessel, although not yet inbuilt in it. The subject of insurance is covered even prior to the laying of the keel, as the contract of insurance covers all construction phases, including the building of the sections of the hull and machinery prior to the laying of the keel, the construction of the vessel after the laying of the keel, the launching, further building and equipping of the vessel after the launching and the trials. As regards the parts and materials intended for the construction of the vessel, they are covered by insurance provided that:

- a) they are included in the contract of insurance and sufficiently identified in the insurance policy,
- b) they are located in the insured shipyard, or the premises of the subcontractors, or elsewhere within the port or place of construction,
- c) they have been allocated exclusively to form a part of the vessel under construction, or as an appurtenance thereto, or they have been visually marked and allocated to the vessel under construction.<sup>12</sup>

The standard form of the ICBR 1988 contains text boxes for the identification marks of the newbuilding, including the description of the vessel, the contract or yard number, the name of the builders, the builders' yards and the place of construction, the provisional value of the vessel and the provisional period of construction.

The stores of fuel, water, food and drinks for the crew, which are loaded on board the vessel after the launching for the purpose of trial voyages, are not subject of insurance. Furthermore, builders' risks insurance does not cover certain other property and values belonging to the builders, such as shipways, cranes, machinery and equipment used for the construction.<sup>13</sup>

### 2.2. Insured Value

The provisional insured value of the vessel under construction is normally agreed upon at the time of effecting insurance. Namely, the construction process usually lasts a number of months and at the time of effecting insurance it is practically impossible to assess the final value that the subject insured shall have at the end of the insurance period. Among the main reasons for this uncertainty are inflation and currency fluctuations. Furthermore, the usual

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<sup>12</sup> PAVIĆ, op. cit. fn. 8, pp 4-5.

<sup>13</sup> Štambuk, D.: "Osiguranje brodova u gradnji: tehnike osiguranja – rizici i pitanja obrade šteta brodogradnje", *Osiguranje*, Vol. 49 (2008), No. 5, pp 4-5.

terms and conditions of builders' risks insurance contracts take into consideration that the value in a construction risk is a moveable and developing entity. In practice, declarations as to the value of the insured subject are frequently dealt with on a gradual declaration basis as different components arrive on site and the overall value increases. The ICBR 1988 contain provisions as to how the final insured value is to be assessed (i.e. the final contract value or the total building cost plus a percentage, whichever higher), without definitively quantifying what that value is (ICBR 1988, cl. 1.1 "Insured Value Clause"). If the insured value determined in such a way exceeds 125 % of the provisional insured value agreed upon at the time of effecting insurance, the maximum liability of the insurer in case of the loss or damage to the vessel under construction shall be limited to 125 % of the provisional insured value (ICBR 1988, cl. 1.3). This means that in case of a total loss of the vessel, the insurance shall pay 125 % of the provisional insured value, regardless of the real value of the vessel at the time of loss. If the final insured value exceeds the provisional insured value, the insured is obliged to declare the increase and pay additional premium. Similarly, if the final insured value is lower than the provisional one, the insurer must return the respective portion of premium for the decrease (ICBR 1988, cl. 1.2). The explained rules of the ICBR 1988 regarding the insured value do not apply to any variation of the value for insurance on account of a material alteration in the plans or fittings of the vessel or a change in type from the one originally contemplated. Such a variation requires a specific agreement of the insurer (ICBR 1988, cl. 1.4). It can thus be concluded that the valuation provisions of the clauses create some sort of a hybrid between the valued and the unvalued status.<sup>14</sup>

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<sup>14</sup> Rogers, N., Chairman's Address to the Annual General Meeting 2006, The Association of the Average Adjusters, <http://www.average-adjusters.com/AAA%20Charimans%20Address%202006.pdf> (2.5.2012.)

### 3. The Identity of the Insured

#### 3.1. General

It is a general rule under the Croatian law, not to be derogated, that the insured may only be a person who has or can expect to have a justified material interest in the subject matter insured. Consequently, the insured is entitled to insurance indemnity only if he had an interest in the subject matter insured at the time of the occurrence of the damage insured against or if he acquired the interest thereafter (CMC, Art. 685). Furthermore, the insured is entitled to assign his rights from the insurance contract only to such a person who has or can expect to have a justified material interest in the subject matter insured, and the assignment can take place only prior to the occurrence of the damage insured against (CMC, Art. 692, para. 1).

The identity of the insured is primarily to be determined in the policy. Besides the shipyard itself, the insured (co-insured or additionally insured) may also be the buyers, co- and sub-contractors, suppliers, associated, subsidiary and affiliated companies and whoever might be concerned with or without order for their respective rights and interests. The need for such broad descriptions of the insured may arise as a result of various contracts that are likely to be involved in a particular construction project (shipbuilding contract, various contracts between the shipbuilder and the subcontractors, etc.).<sup>15</sup>

#### 3.2. Insurer's Subrogation

The identification of the insured further relates to the insurer's rights of subrogation. Frequently builders' risks policies contain a waiver of subrogation clause, whereby the insurer specifically waives such rights against the parties nominated. Namely, where the contract between the principal insured and a sub-contractor precludes a recovery, there no rights under subrogation can accrue to the insurer. Additionally, if the sub-contractor is co-insured under the policy and then negligently carries out his work, it is clear that the insurer cannot exercise the rights of subrogation against such co-insured "under an insurance on property in which the co-assured had the benefit of cover which protected him against the very loss or damage to the insured property that formed the basis of the claim, which underwriters sought to pursue by way of subrogation".<sup>16</sup>

It is therefore noted that the choice of sub-contractors and the manner in which they are contracted and monitored are of considerable importance to insurers. This is due to the fact that contractual relationships between the shipbuilder as the principal insured and the sub-contractors govern the question as to whether such other parties are insured under the main builders' risks cover and to what extent. Furthermore, these contractual relationships will also have an impact on the ability of the insurer to be subrogated against such other parties.<sup>17</sup>

#### 3.3. Change of Interest and Assignment of Insurance

In respect of the identity of the insured, it is also important to note that the ICBR 1988 contain a special clause dealing with the change of interest in the vessel, which is the subject of insurance. Namely, according to the ICBR 1988, cl. 15, any change of interest in the

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<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

subject matter insured shall not affect the validity of this insurance. Such change of interest exists e.g. in case that the vessel is sold prior to the completion of the construction. Under builders' risks insurance, the coverage remains in full force regardless of the change of interest, whereas under the usual terms and conditions of insurance of ships in operation, such change of interest results in an automatic termination of coverage. The difference is justified by the fact that the change of interest in the ship in operation represents a material change in the risk insured, whilst under builders' risks insurance, such change of interest does not affect the level of risk assumed by the insurer to a larger extent, as long as the vessel under construction is still in the possession of the same shipbuilder. In case that there is a sale of the vessel under construction and the interest therein passes to the buyer,<sup>18</sup> then the shipbuilder loses the position of the insured under builders' risks insurance. For the buyer to be able to exercise the rights from the respective insurance contract, it is necessary that the rights be assigned to him according to the "Assignment Clause" (or similar), i.e. ICBR 1988, cl. 16. Therefore cl. 15 ("Change of Interest") and cl. 16 ("Assignment") must be read and interpreted together. The assignment must be in a written form. The insured's notice of assignment needs to be dated, signed and endorsed on the policy. The policy with such endorsement must be presented to the insurer before payment of any claim or return of premium hereunder.<sup>19</sup> Besides the described assignment of insurance, there is often an assignment of the sole right to claim proceeds under a builders' risks insurance policy. This assignment is commonly exercised in favour of the creditor financing the construction, i.e. usually a lending bank, by means of a so-called loss payable clause. In such a case, the assignment is given as a type of security for the loan repayment. Unlike the assignment of insurance, the loss payable clause does not affect the identity of the insured.<sup>20</sup>

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<sup>18</sup> On the other hand, it is possible to assume a situation where there is a sale, but the shipbuilder retains the right of ownership, or certain other material interest until a certain additional condition has been fulfilled. In such case, the shipbuilder remains the insured to the extent of his retained interests in the vessel under construction.

<sup>19</sup> ICBR 1988, cl. 15.

<sup>20</sup> PAVIĆ, op. cit. fn. 8, pp 18-19.

#### 4. Period of Insurance

The insurance covers all phases of construction, including the building of the sections of the hull and machinery prior to the laying of the keel, the construction of the vessel after the laying of the keel, the launching, further building and equipping of the vessel after the launching and the trials. The cover starts with the commencement of the construction and ends upon the delivery of the vessel to the buyer.

Initially, a provisional period of insurance is agreed upon according to the insured's declarations of the date of the commencement of the construction and the planned date of delivery. If the delivery of the vessel to the buyers takes place prior to the expiry of the provisional insurance period, the coverage terminates upon delivery. If the delivery does not take place within the provisional insurance period, the cover may be extended up to a maximum of 30 days from the completion of the trials, subject to an additional premium (ICBR 1988, cl. 3).

The items and materials already allocated for the construction are covered from the inception of the provisional insurance period. The items and materials, which at the inception of the provisional insurance period are not yet allocated to the vessel, are covered from the time of allocation by the shipbuilder or from their delivery to the shipbuilder (if allocated when delivered). The subject matter is insured whilst at the shipbuilder's yard and at his premises elsewhere within the port or place of construction and whilst in transit between those locations.<sup>21</sup>

By way of analogy, it may be agreed that the items and materials allocated for the construction of the parts of the vessel by sub-contractors are covered whilst at sub-contractors' works and at sub-contractors' premises elsewhere within the port or place of construction at which the sub-contractors' works are situated and whilst in transit between those locations. The items and parts constructed by sub-contractors are then also covered whilst in transit to the shipbuilder if the transit is within the port or place of construction at which the shipbuilders' yard is situated, as well as at shipbuilders' yard and their premises elsewhere within the port or place of construction and whilst in transit between those locations.<sup>22</sup> Alternatively, it may be agreed that such parts constructed by sub-contractors be covered only from the time of their delivery to the shipbuilder. In such case, those parts are covered whilst at the shipbuilder's yard and at his premises elsewhere within the port or place of construction and whilst in transit between those locations.<sup>23</sup>

The insurance remains in force subject to an additional premium even during the transit between other locations (ICBR 1988, cl. 2). It is allowed that the vessel sails under its own power for fitting out, docking, trials or delivery, within a distance by water of 250 nautical miles from the port or place of construction. In the event of this distance being exceeded, the insurance remains in force subject to an additional premium. The vessel under construction remains covered in case of any movement in tow within the port or place of construction. However, in case of such movement outside the port or place of construction, the insurance remains in force subject to an additional premium and provided previous notice be given to the insurer (ICBR 1988, cl. 9).

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<sup>21</sup> ICBR 1988, Section I (A).

<sup>22</sup> Ibid, Section I (B).

<sup>23</sup> Ibid, Section II.

## 5. Risks insured

### 5.1. General

Under the general rule of the Croatian maritime law, marine insurance is a contract of insurance against named perils, i.e. named risks (arg. CMC, Art. 704). However, that rule is of a dispositive nature, and can therefore be derogated by a contractual provision. In deed, the ICBR 1988 in that respect provide for an "all risks" coverage. The approach is justified, because a vessel under construction is exposed to a variety of risks that are by their nature entirely different from the risks a ship in operation is exposed to. Some examples of construction risks are accidents in assembly, faulty design or construction, defects in material, errors in technical calculation, accidents in launching, etc. Furthermore, a vessel under construction is exposed to the risks of contact with land vehicles or aircraft, fire, explosion, storm, tidal wave, flooding, subsidence, etc. Finally, after launching, a vessel under construction is exposed to the perils of the sea and all other risks a ship in navigation is exposed to. Since it is practically impossible to predict all the risks related to the construction of a vessel, it is more appropriate to contract an "all risks" coverage subject to a conclusive list of clear exclusions. The ICBR 1988, cl. 5 provides that the insurance against all risks of the loss of or the damage to the subject matter insured is caused and discovered during the period of insurance. The "all risks" coverage is limited by the meaning of the term "risk"<sup>24</sup> and by the exclusions from insurance (contractual and statutory).

The "all risks" coverage exists only during the period of insurance. This means that any damage that occurs after the delivery of the vessel to the buyer is not covered by insurance, even though the risk that caused the damage was present before the delivery. Moreover, according to the ICBR 1988, the damage does not only have to occur during the insurance period, but it also has to be discovered during that time in order to be covered by insurance. Any damage discovered after the delivery of the vessel to the buyer is not covered by the regular builders' risks insurance. That on the other hand does not in any way affect the shipbuilder's liability for defects of the sold vessel or his liability under any guaranty given to the buyer. Those types of liability are insurable under the so-called guaranty insurance.<sup>25</sup>

### 5.2. Latent defect

According to the ICBR 1988, the insurance covers the cost of repairing, replacing or renewing any defective part condemned solely in consequence of the discovery therein during the period of insurance of a latent defect (ICBR 1988, cl. 5.1).

In order to be covered by insurance, the defect must be latent. A defect in construction, machinery or equipment of the vessel may be a consequence of an error in design, material or workmanship. It is considered to be latent if a qualified duly diligent person could not have detected it by means of a common or a recognized method of inspection.<sup>26</sup> The cited interpretation of the term "latent defect" is similar to the recognized interpretation of that term in the practice of the English courts, i.e. under the common law. The English case law, as the most developed and refined court practice in the field of marine insurance, especially in the

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<sup>24</sup> "Risk" is a fortuitous event, which means that it is uncertain and independent from the exclusive will of the insured.

<sup>25</sup> PAVIĆ, op. cit. fn. 8, p. 8.

<sup>26</sup> Pavić, D. *Pomorsko osiguranje - pravo i praksa*, Književni krug Split, 2012, p. 356. See also Pavić, D. *Pomorsko osiguranje II*, Croatia osiguranje d.d. Zagreb, 1994, p. 114.

interpretation of the institute clauses, by virtue of its authority necessarily influences the respective court practice in other countries. It should therefore certainly be taken in consideration by the Croatian courts.<sup>27</sup> In the case of *Jackson v. Mumford*<sup>28</sup>, the court held that there is a latent defect when there is a legal duty and the means of knowledge, for which the owner or the user of the subject matter insured ought in the particular case to be held responsible. In the case of *Prudent Tankers Ltd. SA v. Dominion Insurance Co Ltd (The Caribbean Sea)*<sup>29</sup>, the court held that a latent defect is such a defect that is non-detectable on such an examination as a reasonably careful skilled man would make, although a more meticulous examination would have revealed its existence.<sup>30</sup>

Unlike the hull and machinery insurance, which normally only covers the adverse consequences of a latent defect, according to the ICBR 1988, builders' risks insurance covers the cost of repair of the latent defect itself, including the replacement of the defective part. The insurance covers all the materials, parts, equipment and machinery installed on the vessel provided that the damage occurred during the insurance period, i.e. that the defect was discovered before the expiry of the insurance period.

According to *Zavos*, it is not clear under the ICBR 1988 whether cover is provided against simple discovery of a latent defect, without that defect causing loss or damage. There is no direct case law on the point. However, in *Shell UK v CLM Engineering*<sup>31</sup>, the Judge held that in order for the cover to be engaged, the latent defect has to cause damage. In other words, a simple discovery of a defect is not sufficient to trigger the cover.<sup>32</sup>

The paint used in construction of the vessel is also included in the cover, as a necessary material for the construction. The faults of sub-contractors may be treated as latent defect, too, subject to other general conditions being fulfilled.<sup>33</sup> Faulty welding is explicitly excluded from the coverage (ICBR 1988, cl. 5.1), and so are the cost or expense of repairing, modifying, replacing or renewing a badly designed part and the cost or expense of a betterment or alteration in design (ICBR 1988, cl. 8).

Faults resulting from wilful misconduct of the insured<sup>34</sup> cannot be treated as a latent defect.<sup>35</sup>

### 5.3. Faulty welding

The explicit exclusion of faulty welding from the coverage under the ICBR 1988 refers only to the cost of renewing faulty welds. Any consequential physical damage to the vessel under construction arising from faulty welding is covered. E.g. in case of a crane falling during trials due to breakage of the faulty welded console and causing damage to the hull of

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<sup>27</sup> For a more detailed analysis on the interpretation of the institute clauses as foreign standard insurance clauses when the insurance contract is subject to the Croatian law see in Pavić, D., *Ugovorno pravo osiguranja*, Tectus, Zagreb, 2009, pp 129-134.

<sup>28</sup> [1902] 8 Com Cas 61, at p. 69.

<sup>29</sup> [1980] 1 Lloyd's Rep 338, at pp 348-349.

<sup>30</sup> Bennett, H., *The Law of Marine Insurance*, 2<sup>nd</sup> Edition, Oxford University Press, 2006, p. 369.

<sup>31</sup> [2000] 1 Lloyd's Rep. 612, cited from ZAVOS, op. cit. fn. 11.

<sup>32</sup> ZAVOS, op. cit. fn. 11, p. 8.

<sup>33</sup> PAVIĆ, op.cit. fn. 8, p. 9.

<sup>34</sup> For there to be a wilful misconduct of the insured, there has to be a wilful misconduct of a leading manager of the shipyard or of a person managing and supervising the works of the construction.

<sup>35</sup> PAVIĆ, op. cit. fn. 8, p. 9.

the vessel, the damage to the hull is covered by insurance, whilst the cost of renewing the faulty weld on the console of the crane is not.<sup>36</sup>

#### 5.4. Faults in design

The insurance covers the loss of or the damage to the vessel caused and discovered during the period of insurance arising from the faulty design of any part or parts thereof. However, the cover does not extend to the cost or expense of repairing, modifying, replacing or renewing such part or parts, nor to any cost or expense incurred by reason of a betterment or alteration in design (ICBR 1988, cl. 8). Therefore, the insurance only covers the consequential physical damage to the vessel, similarly to the cover of faulty welding.

#### 5.5. Failure of launch

The insurance covers the risk of a failure of launch. Such failure may result in damage to the vessel, but also to the property of the shipbuilder. For various reasons, during launching the vessel can get stuck on the slipway and the entire process of launching must be repeated. Launching is the most risky phase of construction. The damage to the vessel arising from the failure of launch is covered under the "all risks" coverage (ICBR 1988, C. 5.1). The damage to the property of the shipbuilder (crane, slipway, other shipways, etc.) is in principle not covered by builders' risks insurance. However, insurance covers all subsequent expenses incurred in completing the launch (ICBR 1988, cl. 5.2), and these expenses may include the cost of reconstructing the slipway damaged by prior failure of launch, since such reconstruction is necessary for completing the launch. The criterion is the actual cost necessary for a successful launch.<sup>37</sup>

#### 5.6. Pollution hazard

The insurance covers the loss of or the damage to the vessel caused by any governmental authority to prevent or mitigate a pollution hazard, or the threat thereof, resulting directly from the damage to the vessel, for which the insurer is liable under builders' risks insurance (ICBR 1988, cl. 7). The cover is given provided such act of governmental authority has not resulted from the want of due diligence by the insured. This risk by its nature can only arise after the launching, in the final phase of construction.

#### 5.7. Excluded risks

The risks of earthquake or volcanic eruption are explicitly excluded under the ICBR 1988, cl. 6. Furthermore, the insurance does not cover the risks of war (ICBR 1988, cl. 21), strikes (ICBR 1988, cl. 22), malicious acts<sup>38</sup> (ICBR 1988, cl. 23) and nuclear risks (ICBR 1988, cl. 24).

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<sup>36</sup> Ibid, p. 10.

<sup>37</sup> PAVIĆ, op.cit. fn. 8, p. 10.

<sup>38</sup> The malicious acts exclusion refers to the detonation of explosive and the use of weapons of war by any person acting maliciously or from a political motive.

## 6. Types of loss or damage

The insurance covers:

- a) actual and constructive total loss of the vessel;
- b) particular loss or damage to the vessel;
- c) salvage award and general average;
- d) sue and labour costs.

The insurance is usually subject to a deductible applying to all losses resulting from one accident or occurrence, except in case of a total loss of the insured vessel under construction.

### 6.1. Total loss

The total loss of a ship under construction can be an actual total loss or a constructive total loss. The insurer and the insured can agree to settle a claim as a compromised total loss. When the subject matter insured is a ship under construction, there are certain particularities that have to be taken into account. The total loss of a ship under construction means the loss of the insured subject matter in the phase of its construction that was completed at the time the loss occurred. It is therefore important to distinguish between the total loss before and after the launching of the vessel under construction.

In case of an actual total loss prior to the launching, the vessel needs to be entirely reconstructed. In such a case, the insurance indemnity is measured according to the actual value of the subject matter insured at the time of loss. It is adequate to take into account the costs of the reconstruction, i.e. the full replacement value. The total loss of machinery, sections of the hull or equipment that have not yet been installed is considered and treated as particular damage, and the insurance indemnity equals the actual cost necessary for the replacement of the respective parts. However, if the engine is individually identified in the policy as the subject matter insured, the insurance indemnity is determined according to the rules applying to the total loss. This means that the insurance pays for the cost of construction of the engine plus 25 % of that value (arg. ICBR 1988, cl. 1.3, I.B.C), without applying the deductible. In case of an actual total loss after the launching, the insurance pays for the total cost of construction or for the contract price of the vessel (from the construction contract) if the construction had been completed, plus 25 % of that value (arg. ICBR 1988, cl. 1.3, I.B.C).<sup>39</sup>

The rules on the constructive total loss are applicable to the vessel under construction only after the launching.<sup>40</sup> Namely, in the context of a construction project, it will clearly only be at or close to the end of the project when the cost of recovery or repair is likely to exceed the insured value as currently defined.<sup>41</sup> If the conditions for the constructive total loss are fulfilled, the insurance pays for the total loss of the subject matter insured, without applying the deductible. In order to determine whether the conditions for the constructive total loss have been fulfilled, it is necessary to compare the costs of repairing the damage with the insured value. The insured value at the time of loss is determined according to the ICBR 1988, cl. 1 as discussed above. There is a constructive total loss only where the costs of repairs exceed the insured value. Thereby, only the cost relating to a single accident or a sequence of damages arising from the same accident is to be taken into account. Furthermore,

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<sup>39</sup> PAVIĆ, op. cit. fn. 8, pp 12-13.

<sup>40</sup> Ibid, p. 13.

<sup>41</sup> ROGERS, op. cit. fn. 14.

nothing in respect of the damaged or break-up value is to be taken into account.<sup>42</sup> According to the rules of the Croatian marine insurance law, the insured is obliged to present a written and reasoned claim for the constructive total loss within two months from the day of having become aware of the circumstances allowing him to claim for a constructive total loss (CMC, Art. 710, para. 3).

In practice, the rules of the constructive total loss applied to builders' risks insurance, in particular the effect of the ICBR 1988, cl. 12 on the constructive total loss combined with cl. 1 on insured value, lead to certain difficulties. An example is the case of a significant damage that occurs at some earlier intermediate stage of a construction project. Then the cost of repairs is most unlikely to exceed the insured value, and the insured might find himself in a position where there is an abandonment of the construction project due to the significant damage sustained, but no constructive total loss can be demonstrated and the only option in such a case is for the insured to claim under the unrepaired damage clause. However, turning to that clause, the indemnity is as follows under ICBR 1988, cl. 11.1:

“The measure of indemnity in respect of claims for unrepaired damage shall be the reasonable depreciation in the market value of the vessel at the time this insurance terminates arising from such unrepaired damage, but not exceeding the reasonable cost of repairs.”

The question is then how to assess the depreciation in the market value of something that has no real market because it is only partially built.<sup>43</sup>

## 6.2. Particular loss

In case of damage to the subject matter insured or in case of loss of a part thereof, the insurance covers the actual costs necessary for the repair of the subject matter insured or for the replacement of its damaged or lost part (arg. CMC, Art. 712). The cost of repairs must be reasonable. It also includes the cost of repairs carried by the insured shipbuilder himself. The maximum limit of insurance indemnity is the insured value, subject to the agreed deductible.

## 6.3. Salvage and general average

The insurance covers the vessel's proportion of salvage, salvage charges and general average. In case of the general average sacrifice of the vessel, the insured may recover in respect of the whole loss, without first enforcing his right of contribution from other parties (ICBR 1988, cl. 13).

General average and salvage as particular institutes of the shipping law can only arise after the launching of the vessel under construction. They must be incurred to avoid or in connection with the avoidance of a peril insured against. The question is whether general average<sup>44</sup> is even possible in case of a ship under construction, since it presupposes the existence of a common maritime adventure.<sup>45</sup> The answer is positive, although such cases are rather rare. An example of such a case is when a vessel under construction prior to delivery sails under a charterparty carrying materials and equipment as cargo from one shipyard to the other for the purpose of the final fitting and equipping of the vessel. Furthermore, it is

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<sup>42</sup> ICBR 1988, cl. 12.

<sup>43</sup> ROGERS, *op. cit.* fn. 14.

<sup>44</sup> There is a general average act, where any extraordinary sacrifice or expenditure is voluntarily and reasonably made or incurred in time of peril for the purpose of preserving the property imperilled in the common adventure.

<sup>45</sup> There must be a community of various interests, typically the hull interests, the cargo interests and the freight interests.

possible that in the period after the launching and prior to delivery there is property of various owners on the vessel. E.g. when the shipbuilder is the owner of the vessel under construction, the equipment on board of the vessel can be of the buyer.<sup>46</sup>

As regards the salvage of a vessel under construction, it is noted in particular that the ICBR 1988 contain a special clause applying to the cases where salvage was provided by the use of the insured's vessels (the vessels belonging to the shipyard, i.e. the shipbuilder). Namely, according to the "Sistership Clause" (ICBR 1988, cl. 18), if the insured vessel under construction receives salvage services from another vessel belonging wholly or in part to the same owner (the shipbuilder) or under the same management, the insured shall have the same rights under the insurance as he would have were the other vessel entirely the property of a different owner. This means that in such a case, the insured would be entitled to claim for a salvage award from the insurer, although there was no salvage in the sense of the specific shipping law institute, since there can be no salvage of one's own property.

#### 6.4. Sue and labour

In case of any loss or misfortune, it is the duty of the insured to take such measures as may be reasonable for the purpose of averting or minimizing a loss that would be recoverable under the insurance. The insurance covers the charges properly and reasonably incurred by the insured, their servants or agents for such measures. These charges are recoverable from insurance even if they exceed the insured value, and even though the measures were not successful. They are therefore recoverable even in the case of a total loss and in addition thereto.<sup>47</sup>

#### 6.5. Insurance of liability risks

ICBR 1988 contain two clauses covering the liability of the insured for the damage caused to third parties. One covers collision liability and the other the so-called P&I risks. Since P&I clubs do not provide a cover for the vessels under construction, whilst their owners (shipbuilders) are exposed to certain liabilities related to the construction including the usual shipowner's liabilities in the phases of construction after the launching, especially during the trials. Therefore, the insurance markets resolved the problem by including the coverage for the so-called P&I risks and for the collision liability in the standard builders' risks insurance.

According to the "Protection and indemnity clause" (ICBR 1988, cl. 19), the insurance shall indemnify the insured for any sums he had paid to any other person by reason of his liability as owner of the vessel, where such liability is in consequence of any of the risks prescribed by the P&I clause. The cover extends to all phases of construction, before and after the launching. The liabilities covered must be in relation to the construction of the vessel. The liabilities related to the equipment and machinery not yet installed on the vessel are not covered. The liabilities covered can be contractual and tortious. They can arise from the damage to property or from the death, illness or injury of a person. The insurance further covers the insured's liabilities arising from administrative regulations. The limit of liability covered per accident or occurrence is equal to the insured value of the vessel.

According to the "Collision liability clause" (ICBR 1988, cl. 17), the insurance covers the insured's liability arising in consequence of the insured vessel coming into collision with any other vessel. The insurance shall indemnify the insured for any sums he had paid to any other person on the basis of this liability for damages and for the legal costs of contesting or

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<sup>46</sup> PAVIĆ, op. cit. fn. 8, pp 15-16.

<sup>47</sup> See the ICBR 1988, cl. 20 and the CMC, Art. 715.

limiting liability. The cover includes liability for: a) loss of or damage to any other vessel or property thereon; b) delay to or loss of use of any such other vessel or property thereon; and c) general average and salvage of any such other vessel or property thereon. Naturally, the vessel under construction is exposed to this sort of risk only after the launching.

According to the "Sistership clause", should the insured vessel come into collision with another vessel belonging to the insured, he shall have the same rights under this insurance as he would have were the other vessel entirely the property of a different owner.

The P&I clause, as well as the Collision liability clause, represents an independent contract provision. The insurance indemnities payable under any of these two clauses are independent from any other indemnity provided by other terms and conditions of the insurance contract, i.e. they are in addition thereto (ICBR 1988, 17.2, cl. 19.4).

## 7. Conclusion

Shipbuilders' risks insurance covers the loss of or the damage to the vessel under construction during the entire construction process. It also covers the materials, parts, equipment and machinery allocated to the vessel under construction, which have however not yet been installed thereon. In addition, the insurance covers certain liabilities of the shipbuilder that may arise in relation to the construction. The insurance in principle protects the shipbuilder as the person who bears the risk of the loss of or the damage to the vessel under construction and the risk of liability in relation thereto. This insurable interest of the shipbuilder arises from the fact that in most cases, the shipbuilder remains the owner of the vessel under construction until the delivery of the completed to the buyer, but in any case, it is common that under the standard terms and conditions of the shipbuilding contracts, the shipbuilders presumes these risks. It is also common that under the shipbuilding contracts, the shipbuilder is obliged to insure these risks according to the standard builders' risks insurance clauses such as the ICBR 1988 or similar.

A particularity of builders' risks insurance is the insured value. At the time of effecting insurance, it is practically impossible to assess the final value, which the subject insured shall have at the end of the insurance period. Furthermore, the value in a construction risk is a moveable and developing entity. In practice, the insurance is contracted on a provisional insured value, whilst standard insurance clauses contain special rules for determining the final value of the insured vessel. Declarations as to the value are frequently dealt with on a gradual declaration basis as different components arrive on site and the overall value increases.

The cover is usually provided on an "all risks" basis. Some examples of construction risks are accidents in assembly, faulty design or construction, defects in material, errors in technical calculations, accidents in launching, risks of contact with land vehicles or aircraft, fire, explosion, storm, tidal wave, flooding, subsidence and perils of the sea (after launching). The insurance covers losses or damages caused and discovered during the insurance period. The "all risks" coverage is subject to some contractual and statutory exclusions, such as war, strikes and nuclear risks, malicious acts, earthquake or volcanic eruption, wilful misconduct and gross negligence of the insured.

The types of loss insured are total loss, particular loss or damage, salvage, general average, sue and labour, and in addition the damage arising from certain liabilities of the insured as the owner of the vessel under construction. The constructive total loss, general average and collision liability coverage becomes relevant only after the launching. The said types of losses may only arise during the final phases of construction, when the vessel starts floating and sailing (trials).

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