

# MANDATORY INHERENT DEFECTS INSURANCE IN SAUDI ARABIA

## Introduction

In June 2018, the Kingdom of Saudi Arabia (“KSA”) became the first of the Gulf Cooperation Council (“GCC”) countries to introduce mandatory inherent defects insurance (“IDI”) for construction projects in the private sector <sup>(1)</sup>. Whilst this insurance has been mandatory in KSA for four years now, its integration has been staggered, many of the projects to which it applies are unlikely to have reached practical completion yet and the standard policy wording, which was only introduced in March 2020, remains untested.

In the meantime, Market interest in the product remains high, and there are perhaps some unrealistic expectations of, and confusion about, what the policy is designed to cover, its scope, who can benefit from it and how it will operate in practice.

In this paper, we seek to explain what risks this policy is designed to meet and whether it does so and, of equal importance, consider what it is not designed to meet. We also look at the potential problems with its application and highlight some of the questions it raises.

For example: What benefit does the contractor obtain from the policy? Can the contractor/designer be named as an insured? Does the insurer retain subrogation rights? How does this cover interact with other insurances that might be obtained in respect of construction projects?

## Why has mandatory IDI been introduced in KSA?

The GCC countries operate a civil legal system underpinned by civil codes. Those codes include provisions which impose strict liability on contractors and supervising consultants and designers (for defects in their design) in certain circumstances.

They are jointly and severally liable to the owner of the building for a period of 10 years post practical completion (or issuance of an occupancy certificate), if the building suffers a total or partial collapse, or there are inherent defects which threaten the safety and stability of the building. This type of liability is called decennial liability. In KSA, the legal principles of decennial liability are set out in the Saudi Building Code Application Law (“SBCAL”) and apply to supervising designers (who supervise construction), designers and contractors <sup>(2)</sup>. Subcontractors appear to be relieved from the application of the decennial liability provisions. It is important to note that it is not possible to limit liability for or contract out of decennial liability.

Although decennial liability is strict, it is still necessary for the owner to prove that the relevant decennial liability provision has been triggered. In other words, it is necessary to prove that there has been a total or partial collapse of the building or that there are hidden defects which threaten the safety and stability of the building. However, it is not necessary to prove fault on the part of the contractor and designer; the only bases on which professionals can defend a decennial liability claim are to argue force majeure or that there was an external

intervening cause (for example, the actions of the employer or a third party, after practical completion).

Even so, litigation against the contractors and designers involved can be incredibly lengthy and costly, with cases almost always going all the way to the highest court before they are finally determined. Often, the parties who are ultimately held to be liable have become insolvent by the time the courts have determined the outcome. In the meantime, the relevant structure requires repair and, in a worst case scenario, may not be fit for occupancy or have to be entirely rebuilt, resulting in significant losses to the building owner.

The purpose of IDI is to provide funding to the owner as quickly as possible for the costs of repairing, replacing and/or strengthening the structure.

## What is IDI?

IDI provides first party cover to the owner of a building for the cost of remedying any inherent defects in the load bearing elements of a building (such as the foundations, slabs, walls, beams and columns) which have caused a partial or total collapse of the building, or threaten the safety and stability of the building. IDI cover commences at practical completion of the building and is usually for a 10-year period.

Inherent defects in construction can be traced back to one of, or a combination, of unforeseen ground conditions, faults in design, plans, materials, geological investigation or construction. A defect is inherent if it existed before practical completion of the building works but was neither discovered, nor capable of being discovered, at the time of practical completion.

IDI is deliberately limited in scope, aimed at protecting owners from inherent defects and enabling them to fund the cost of repairing or rebuilding for up to 10 years after practical completion, thereby removing potential difficulties with suing contractors and/or designers who may have ceased trading, become insolvent, or stopped buying insurance in the meantime. The standard policy wording that has been introduced goes some way to achieving this limited aim but it does not remove the need for the parties to any major private project to secure and maintain other construction insurance, including construction all risks (“CAR”), property all risks, professional indemnity (“PI”) and/or project insurance depending on the particular circumstances.

## What type of projects does it apply to?

In order to start work on “qualifying projects” in KSA, and obtain a building permit, it is necessary first to provide the Ministry of Municipality and Rural Affairs with a copy of an IDI policy issued by a Saudi Arabian insurer <sup>(3)</sup>.

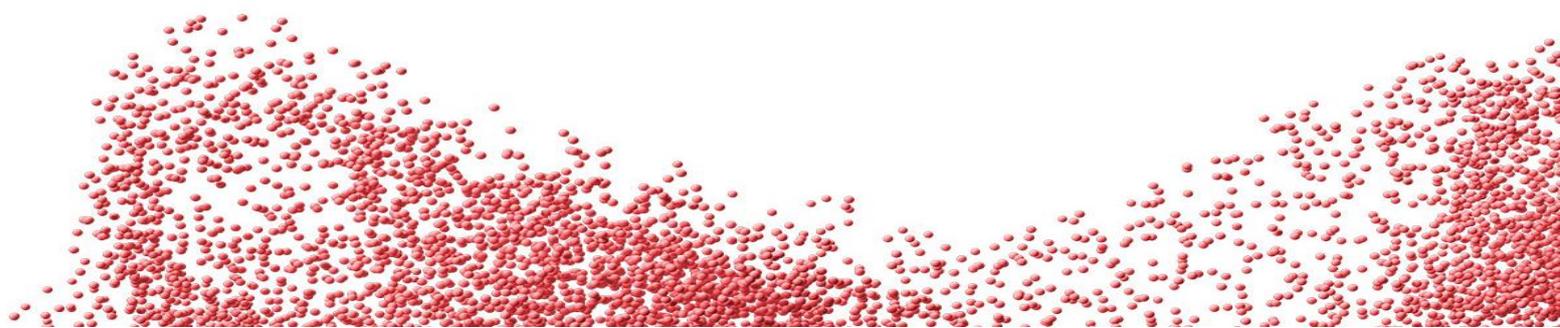
IDI is mandatory in KSA for all “non-governmental sector projects”, both residential and non-residential. Public Private Partnerships (“PPPs”) are also considered to fall within the scope of qualifying projects.

## What does the mandatory IDI in KSA cover?

On 31 March 2020, Saudi Central Bank (“SAMA”) published the Standard Policy of Inherent Defects Insurance (the “SAMA Policy”), which sets out the minimum coverage required. Any deviations from the standard wording must be pre-approved by SAMA in writing. We have set out in the table below a brief explanation of the key provisions and our commentary on each.

Provision	Commentary
<b>Insured</b>	<p>The party mandated to procure the IDI is the Contractor, defined as the “<i>natural or juristic person licensed to undertake construction works... and mandated by the concerned authority to obtain Inherent Defect Insurance</i>”.</p> <p>The reason why the Contractor is mandated to take out the IDI is because the requirement is linked to the construction permit process in KSA – it is the Contractor who must obtain the construction permit and, therefore, the mandatory IDI. This contrasts with other jurisdictions (for example, France), where the obligation to obtain mandatory decennial liability insurance is on all parties involved in the design, construction, renovation or sale of a building. In this instance, the insurance is for the benefit of the owner.</p> <p>The SAMA Policy specifies in the definition of “Insured”: “the Contractor shall be the Insured before the start of the Period of Insurance, and the owner of the Premises shall be the Insured during the Period of Insurance as stated in clause (3) of Article (3) of the Policy (such article being the operative insuring clause).”</p> <p>The policy period does not commence until an Occupancy Certificate has been issued (i.e. after construction works have been completed and the building has been handed over). It is, therefore, unclear what cover is afforded to the Contractor before the policy period has commenced (during construction). However, the Contractor is the party who bears the responsibility for procuring the insurance, paying the premium instalments and paying for the technical inspection (see below) during construction.</p> <p>This definition seems to suggest that the Contractor cannot, therefore, benefit from an indemnity after the policy has commenced. Furthermore, there is no express provision which waives the Insurer’s right to bring a subrogated claim against the Contractor. The Contractor seems, therefore, to be in the unattractive position of bearing the burden of obtaining the insurance and paying the premium without having the benefit of the cover and whilst also retaining the risk of litigation against it.</p> <p>We understand that Malath Cooperative Insurance Co (“Malath”)<sup>(4)</sup> have confirmed that contractors and designers can be expressly included as Insureds in the SAMA Policy Schedule. However, we are not aware of any policies that have been agreed with this amendment. It remains to be seen how this would apply in practice. For example:</p> <ol style="list-style-type: none"> <li>1. The definition of “Insured” would need to change such that the Contractor and Designer are also covered for the Period of Insurance.</li> <li>2. A waiver of subrogation against insureds should be expressly included in the policy as a matter of KSA law.</li> <li>3. It is not clear how the addition of insureds would impact the premium, both in terms of the total amount of premium payable, and allocation of premium payments between the parties.</li> <li>4. It is not clear when and how the contractor and/or designer would become involved in the discussions regarding placement of the cover and try to insist on being named as an insured.</li> <li>5. Even if a designer and contractor are included as insureds, and rights of subrogation are waived, IDI cover is limited in the types and causes of defects to which it applies, whereas the decennial liability provisions provide for strict (i.e. wider) liability. For example, the SAMA Policy excludes cover for the cost of repairing damage arising from, or consequent upon, fire. It also excludes cover for changes in geological conditions. Another example is the exclusion of cover for economic loss. There are no such exclusions in the decennial liability provisions. There would, therefore, be gaps in cover for the contractor/designer in the event that the owner brought a decennial liability claim against the contractor / designer in respect of losses that are not covered by the IDI policy but fall within the scope of the decennial liability provisions, which are strict.</li> </ol>

Provision	Commentary
<b>Policy period</b>	<p>10 years from the date of inception stipulated in the policy schedule. Inception will only occur after:</p> <ol style="list-style-type: none"> <li>1. The Occupancy Certificate (approving occupancy of the building by the necessary authority) has been issued – permission to occupy will be issued by the authority confirming substantial completion and that the building is fit to be occupied. We understand that this is likely to be on practical completion of the building.</li> <li>2. A Certificate of Approval has been issued. A Certificate of Approval is issued by a TIS – the insurer must approve the appointment of a Technical Inspection Services expert, who will examine the plans, specifications, bills of quantities and any other documentation as required by the insurer. The Contractor is responsible for the fees of the TIS expert.</li> <li>3. Payment of the premium – the premium is paid in two instalments. A deposit premium is calculated by reference to the estimated Total Sum Insured specified in the policy schedule and is paid upon acceptance of the policy. A final premium is calculated after practical completion and the issue of the Certificate of Approval. The balance of final premium minus the deposit premium must be paid before the issue of the Occupancy Certificate.</li> <li>4. The insurer has issued an endorsement stating that cover is operative.</li> </ol>
<b>Insuring clause</b>	<p>The operative clause in the SAMA Policy provides cover for the cost of repairing, replacing and/or strengthening the insured building following and consequent upon an Inherent Defect which:</p> <ol style="list-style-type: none"> <li>1. Is discovered and is notified to the Insurer during the Period of Insurance; and</li> <li>2. Causes physical damage or the threat of imminent collapse, which requires immediate remedial measures for the prevention of an actual collapse within the Period of Insurance.</li> </ol> <p>We anticipate that a potential coverage issue may arise in relation to whether the Insuring Clause has been triggered; in particular (i) whether the definition of Inherent Defect has been fulfilled (ie is there a defect that has caused total/partial collapse or which threatens the safety and stability of the building?); and (ii) has that defect caused physical damage or does it threaten imminent collapse?</p>
<b>Inherent defect</b>	<p>“Any defect in the Structural Works or the Envelope weakening the strength and steadiness or stability of the Premises and attributable to a fault, error or omission in design, materials, geological investigation or construction which was undiscovered at the date of issue of the occupancy certificate”.</p> <p>As mentioned above, decennial liability is strict. According to the definition in the SAMA Policy, the “Inherent Defect” must be “attributable to a fault, error or omission in design, materials, geological investigation or construction...” On a strict reading, this part of the definition seems potentially to undermine the overall purpose of the insurance (to ensure availability of funding as quickly as possible for the owner to repair the defects) as it would take time to prove fault. Whilst a collapse, partial collapse or threat of imminent collapse may have been caused by deficient design or construction, proving that this is the case is often very difficult, especially where a combination of factors are alleged causes of the collapse, partial collapse or structural defect.</p> <p>However, we consider that, in the context of the overall purpose of the insurance, this phrase is included to indicate that the inherent defect must have been caused by one of the things listed, as opposed to an external cause, as they mirror the responsibilities of the designer and contractor on whom decennial liability can be imposed. This is consistent with the fact that the only defence (other than force majeure) to a decennial liability claim is that there is an external cause of the loss.</p>



Provision	Commentary
<b>Exclusions</b>	<p>Alterations of geological conditions – the SAMA Policy does not provide cover for losses arising from or consequent upon alterations of geological conditions <i>“including but not limited to changes in the groundwater flow, whether due to a natural event or man-made, suffered after the date of the Occupancy Certificate.”</i></p> <p>Certificate of Approval Reservation – the SAMA Policy does not provide cover for any costs caused by, arising from or consequent upon any matter notified to the insurers by the TIS (see above) and referred to as a reservation in the Certificate of Approval or recorded in the Occupancy Certificate <b><u>unless subsequently rectified and approved in writing by the insurer.</u></b></p> <p>Economic Loss – there is no cover for any direct or indirect loss, such as loss of enjoyment, use, income, business opportunity, inconvenience, distress or any other indirect or economic loss.</p> <p>This means that the SAMA Policy does not provide cover for business interruption and loss of the income that could have been generated had the building been occupied. This is different from what the position would normally be under a decennial liability policy, as opposed to an IDI policy.</p> <p>Structural changes – there is no cover for any structural alterations, repairs, modifications or additions to the Premises during the policy period unless the insurers has been informed, the policy endorsed and any appropriate additional premium paid to the insurer.</p> <p>Insured’s Professional Advisors or Contractors responsibility – there is no cover for defects which are the responsibility of the insured’s professional advisors or contractors <i>“whether within the terms of the Building Contract or otherwise identified and notified to the Insured before issue of the Occupancy Certificate unless subsequently rectified and approved in writing by the Insurer”.</i></p>
<b>Claims procedure</b>	<p>The <b>Claims Procedure</b> stipulates that, upon discovery of an Inherent Defect or any damage that may threaten the stability of the insured building, the Insured will i) notify the insurer as soon as reasonably practicable; ii) take all precautions to prevent further damage; iii) submit written details of the claim within 60 days of discovery; and iv) assist the insurer in procuring all information necessary.</p> <p>The owner is the party who would be responsible for making the notification. The level of information that will be required by insurers in respect of (iii) is unclear. However, the insured will need to demonstrate that the Insuring Clause (and the definition of Inherent Defect) has been triggered (see above).</p>
<b>Subrogation</b>	<p>Insurers’ right of subrogation is recognised in the SAMA Policy and imposes an obligation on the insured parties to cooperate with insurers in any subrogation claim.</p> <p>Insurers are likely to want to bring a subrogated claim against the Contractor and/or the designer pursuant to the KSA decennial liability provisions. If the contractor and/or the architect are included as insureds in the policy, then the prudent course of action would be to include an express waiver of insurers’ rights of subrogation in the policy as a matter of KSA law.</p> <p>Subrogated recovery could get fairly complicated in this instance, with the involvement of a reinsured, reinsurer and retrocessionaire.</p> <p>Subrogation is a recognised concept in KSA law. Article 20 of the KSA Insurance Law(5) indicates that the Insurance Disputes Committee is the court with jurisdiction over all disputes arising from insurance contracts, including subrogated recovery actions.</p> <p>However, there are limited formalities stipulated in KSA law and the right is not automatic in that further documentation is required by the courts to prove insurers’ subrogation rights. The insured must give written authorisation to the insurer before a recovery action is commenced and this is usually done by way of a subrogation form and a power of attorney. The subrogation form will also set out the insured’s and insurer’s obligations regarding the recovery action, for example the required cooperation and support from the insured. Pursuant to these documents, the insurer can commence proceedings in its own name.</p> <p>The drafting of the subrogation form is extremely important as it will set out the extent of insurers’ rights. For example, where the limit of indemnity under the policy is lower than the amount of potential recovery from a third party, it may be necessary for insurers to obtain an assignment of the uninsured aspect of the insured’s claim, as well as the insured aspect, in order to avoid parallel proceedings being brought by both the insured and the insurers.</p>

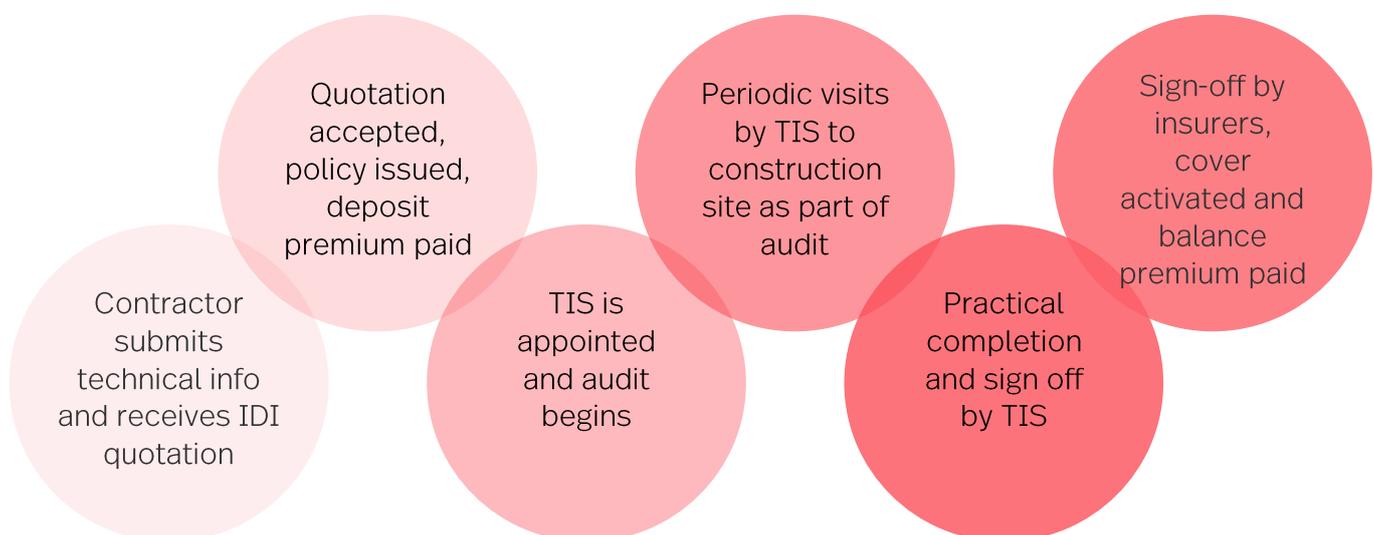
### What is the role of the Technical Inspection Service?

The SAMA Policy provides for an independent third party to be appointed before construction commences and to be approved by the insurer. The role of the third party is to carry out a technical inspection of the construction works during construction in order to flag any potential defects in the design, materials and/or construction works.

The technical inspection will start once the IDI policy quotation has been accepted, and the first instalment of the premium and the fee for the inspection have been paid by the Contractor.

In the event that defects are discovered during the ongoing inspections during construction, the insured must try to resolve them before practical completion. If they have not been resolved, they will be flagged in the Certificate of Approval for insurers' consideration before sign-off. Cover under the IDI policy will only commence once sign-off has been provided by insurers and the balance of the premium has been paid.

A simple illustration of the process is set out below.



### How does IDI interact with other classes of insurance?

IDI has some important differences to other types of property or construction insurance that might be taken out in respect of any given project. It is, therefore, important for all construction insureds to consider which particular insurances are required for specific projects.

IDI and decennial liability insurance are sometimes referred to interchangeably. Whilst there are several similarities, IDI should not be confused with decennial liability insurance. IDI is typically procured on behalf of a building owner only and permits subrogation against contractors/designers. It does not provide cover to construction professionals for decennial liability claims (and associated defence costs) that are brought against them.

At present, whilst decennial liability insurance (and its broader cover) may be available in KSA, it is not mandatory for contractors or designers to purchase it (as is also the case in other Middle East jurisdictions). As mentioned above, even if the contractor and designer are joint insureds, and rights of subrogation are waived against them, inherent defects cover is more limited in scope than decennial liability cover.

Construction All Risks (also known as Erection All Risks) insurance is taken out at the beginning of a construction project or contract to cover material damage to the contact works up to practical completion and may include defect and maintenance cover post completion. Typically, it only provides cover for defects caused by workmanship and not for any damage caused by off-site / pre-construction activities (such as design, specification, materials).

Property All Risks insurance is arranged to cover damage arising from any fortuitous causes following practical completion. However, it usually contains an exclusion for inherent defects.

Professional Indemnity provides cover for the legal liability of professionals for breaches in their professional services to clients. Breach of professional duty (negligence) must be proven and it does not cover strict liability, such as decennial liability. PI policies are "claims-made" policies which are taken out on an annual basis and cover only those claims that are made (and notified) to insurers during the policy year. PI policies usually have an aggregate policy limit which is applicable to all claims made within the particular policy year. Such limit can, therefore, be eroded by one or more claims on multiple different projects.

## Who is providing the product and how is it working in practice?

The mandatory IDI scheme is regulated by SAMA and only approved KSA insurance companies are entitled to underwrite insurance policies for the IDI scheme.

In December 2019, Malath obtained SAMA's approval to offer a construction guarantee insurance product that covers IDI. We are not aware of any other insurance companies that have received this approval. In 2020, Malath entered into a proportional treaty reinsurance agreement with Saudi Reinsurance Company ("Saudi Re") for five years. We understand that this agreement is exclusive and Saudi Re will be the only reinsurer who will provide reinsurance of IDI for five years. Saudi Re have stated that they have "arranged a special retrocession protection to manage the long-tail business"<sup>(6)</sup> and we are aware that at least 3 international insurers have become involved in the scheme as retrocessionaires. Saudi Re have recently reported<sup>(7)</sup> written premiums of SAR 223M (c.USD 60M) in respect of IDI during the first half of this year.

## References:

- (1) KSA Cabinet Resolution No. 509 21/09/1439AH dated 05 June 2018.
- (2) In particular, Article 29(1) of the Implementing Regulations of the SBCAL states: "the supervising designer who supervising the implementation of the construction and the contractor shall be jointly responsible for compensating the owner for 10 years - from the date of issuance of the occupancy certificate - for the total or partial demolition of the buildings they constructed or the facilities they built and for every hidden defect that threatens the durability and safety of the building." Article 29(3) states, for design consultants only: "an accredited designer shall be responsible for design defects if its work is limited to drawing up the design only, without supervising the implementation."
- (3) Since 01 July 2021.
- (4) Malath obtained SAMA's approval to offer a construction guarantee insurance product that covers IDI in December
- (5) Law of Control of Cooperative Insurance Companies 2003, as amended in 2012.
- (6) [Saudi Re named exclusive reinsurer for Inherent Defects Coinsurance Program \(zawya.com\)](#)
- (7) Middle East Insurance Review article dated 22 August 2022.



# Watch this space.....

## Conclusion

As mentioned above, the SAMA Policy has not been tested yet in any claims due to the relative nascency of the product and the fact that the projects for which IDI became mandatory are unlikely to have reached practical completion yet.

It is important to bear in mind what it is intended to cover and be wary of what it does not cover. It remains to be seen whether the SAMA Policy is sufficiently wide or whether additional products and/or variations on this product will be introduced in order to address some of the potential gaps.

We anticipate that the following points will need to be considered / clarified as the product matures.

### 1. Type of project

- a) As mentioned above, at present the mandatory IDI scheme only applies to non-governmental projects. It remains to be seen whether this will be expanded to governmental projects in due course.
- b) Since the mandatory scheme only applies to non-governmental projects at the moment, it does not apply to other structures such as bridges and dams (as these are predominantly governmental projects). It principally applies to private projects for residential and non-residential buildings.

### 2. Identity of the Insureds

- a) Can and should both the contractor and designer (and any party supervising construction) be included within the definition of "Insured" in the policy, along with the building owner, and have the benefit of cover for the policy period?
- b) If they are included:
  - i. How does this impact:
    1. Negotiations for placement and practical involvement of the relevant parties?
    2. Subrogation rights?
    3. The level of premium and the apportionment of the premium between the parties?
  - ii. What about the limitations of cover under the SAMA Policy when compared with the scope of decennial liability? Does this leave gaps in cover for the contractor/designer?
- c) Is a separate decennial liability or other insurance policy required for contractors/designers?

### 3. Definition of Inherent Defect / trigger of insuring clause

- a) What information / documentation will be required by Insurers to demonstrate that the inherent defect definition has been fulfilled? In particular:
  - i. Will there be debate about whether or not an inherent defect is serious enough such that it threatens the safety and stability of the building?
  - ii. Will the insured be required to demonstrate that the inherent defect was "*attributable to a fault, error or omission in design, materials, geological investigation or construction...*" as opposed to an external cause?

### 4. Notification

- a) What information will the insured need to provide to satisfy the requirement to provide written details of the claim within 60 days from the notification?

### 5. Technical Inspection Service

- a) What process will insurers follow to assess reservations made in the Certificate of Approval and whether or not any defects discovered during construction which have subsequently been rectified and approved by insurers should be covered?

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