

# Defects: Coverage, exclusions and claims



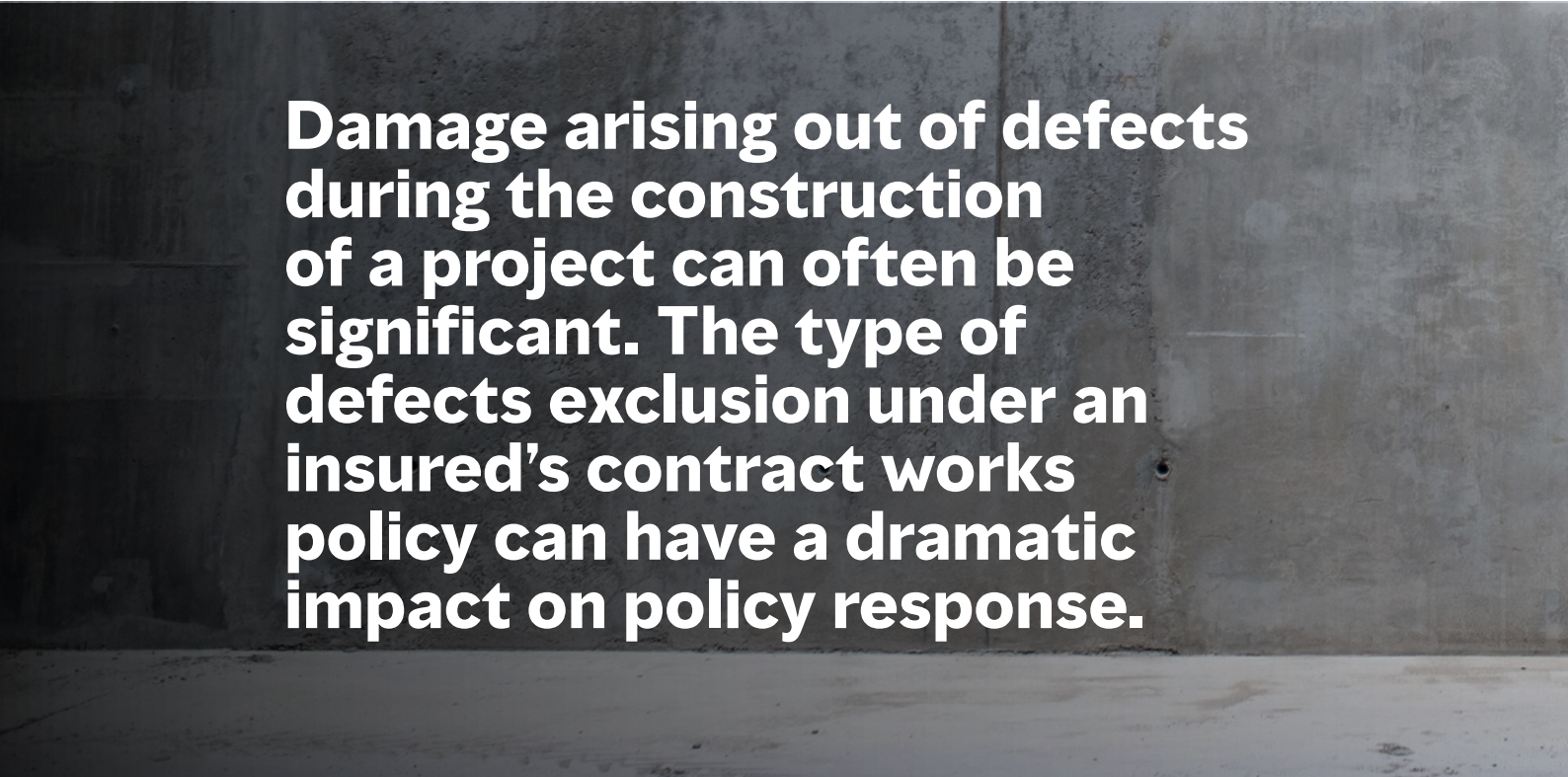
# Defects: Coverage, exclusions and claims

Construction projects like any other risk requires a balance of risk control and risk transfer as part of ongoing risk management exercises and it is how contractors, developers and owners decide to balance these two elements that often determines how successful a project will be.

Risk control methods such as quality control, subcontractor management, site security and safety are heavily utilised by the industry but such measures cannot completely remove risk from a project. Risk managers therefore generally elect to transfer the remaining risks with the insurance market being the principal method utilised for risk transfer.

The insurance industry has developed specialist products that offer contractors, developers and owners comprehensive risk transfer solutions for the unique risks that construction projects pose. Although these insurance products are now quite familiar to the construction industry there are certain aspects of coverage that are often overlooked and/or underappreciated by insureds that can make a significant difference in a claims situation.

Here we explain the different levels of coverage available under contract works policies in respect of defects and how the differing levels of coverage would respond in a claim scenario.



**Damage arising out of defects during the construction of a project can often be significant. The type of defects exclusion under an insured's contract works policy can have a dramatic impact on policy response.**



## Defects Exclusions

Contract works insurance policies in Australia (and other parts of the world) provide varying coverage responses for defects and whilst the drafting of these clauses may be subtle, they can have a dramatic impact on the policy response to a claim.

Damage as a result of defects during the construction of a project can often be significant (potentially running into the millions of dollars). Accordingly, a number of claims made under contract works policies (subject to these various defects exclusions) have generated some interesting court decisions over the years, particularly in Australia.

The courts' approach in Australia is generally to rely on the language used in the policy wording, examining the words used in minute detail (rather than necessarily understanding the original intent of coverage). It is for this reason that it is critical for insured parties of a construction project to fully understand and appreciate the subtle (but important) differences in coverage available under contract works policies and, with the assistance of your insurance broker, draft a tailored policy that adequately deals with the specific risks of the construction project to be covered.

The purpose of this paper is to give a brief explanation of the main defects exclusions used in contract works policies and the key differences between them.



# Market Defects Wordings

There are two key sets of defects wordings used in the Australian market: “DE” wordings written by the UK CAR Group, designed for building and civil engineering projects and “LEG” wordings written by the London Engineering Group customarily designed for electrical and mechanical projects though now used more broadly.

## Market Standard “DE” Clause Wordings

### DE1: Outright Defects Exclusion (1995)

This Policy excludes loss of or damage to the Property Insured due to defective design plan specification materials or workmanship.

### DE2: Extended Defective Condition Exclusion (1995)

This Policy excludes loss of or damage to and the cost necessary to replace repair or rectify:

- a) Property Insured which is in a defective condition due to a defect in design plan specification materials or workmanship of such Property Insured or any part thereof
- b) Property Insured which relies for its support or stability on a) above
- c) Property Insured lost or damaged to enable the replacement repair or rectification of Property Insured excluded by a) and b) above

Exclusion a) and b) above shall not apply to other Property Insured which is free of the defective condition but is damaged in consequence thereof.

For the purpose of the Policy and not merely this Exclusion the Property Insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property Insured or any part thereof.

### DE3: Limited Defective Condition Exclusion (1995)

This Policy excludes loss of or damage to and the cost necessary to replace, repair or rectify:

- a) Property Insured which is in a defective condition due to a defect in design plan specification materials or workmanship of such Property Insured or any part thereof
- b) Property Insured lost or damaged to enable the replacement repair or rectification of Property Insured excluded by a) above

Exclusion a) above – shall not apply to other Property Insured which is free of the defective condition but is damaged in consequence thereof.

For the purpose of the Policy and not merely this Exclusion the Property Insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property Insured or any part thereof.

### DE4: Defective Part Exclusion (1995)

This Policy excludes loss of or damage to and the cost necessary to replace repair or rectify

- a) Any component part or individual item of the Property Insured which is defective in design plan specification materials or workmanship
- b) Property Insured lost or damaged to enable the replacement repair or rectification of Property Insured excluded by a) above



Exclusion a) above – shall not apply to other parts or items of the Property Insured which are free from defect but are damaged in consequence thereof.

For the purpose of the Policy and not merely this Exclusion the Property Insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property Insured or any part thereof.

### **DE5: Design Improvement Exclusion (1995)**

This Policy excludes:

- a)** The costs necessary to replace repair or rectify any Property Insured which is defective in design plan specification materials or workmanship
- b)** Loss or damage to the Property Insured caused to enable replacement repair or rectification of such defective Property Insured.

Should damage to the Property Insured which is free of such defective condition (other than damage as defined in b) above) result from such a defect, this exclusion shall be limited to the costs of additional work resulting from and the additional costs of improvements to the original design plan specification materials or workmanship.

For the purpose of the Policy and not merely this Exclusion the Property Insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property Insured or any part thereof.

## **Market Standard “LEG” Clause Wordings**

### **LEG 1/96: The London Engineering Group Model “Outright” Defects Exclusion**

The Insurer(s) shall not be liable for loss or damage due to defects of material workmanship design plan or specification.

### **LEG 2/96: The London Engineering Group Model “Consequence” Defects Exclusion**

The Insurer(s) shall not be liable for: All costs rendered necessary by defects of material workmanship design plan or specification and should damage occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost which would have been incurred if replacement or rectification of the Insured Property had been put in hand immediately prior to the said damage.

For the purpose of this policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship design plan or specification.

### **LEG 3/06: The London Engineering Group Model Design Improvement Exclusion**

The Insurer(s) shall not be liable for: All costs rendered necessary by defects of material workmanship design plan or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property) occur to any portion of the Insured Property containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification.

For the purpose of the policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship design plan and specification.





# Comparison of DE and LEG Clauses

## Comparison of DE and LEG Clauses

<b>DE1</b>	<b>LEG1/96</b>
Excludes all loss or damage due to defective design, materials or workmanship.	Excludes all loss or damage due to defective design, plan, specification, materials or workmanship.
<b>DE2</b>	-
Excludes property that is defective and property that relies for its support on the defective property, and access costs but gives cover for other insured property that is free of defect but is damaged by the defective property.	No equivalent LEG clause.
<b>DE3</b>	<b>LEG2/96</b>
Excludes property that is defective and access costs but gives cover for other insured property that is free of defect and is damaged by the defective property.	Excludes any component part or individual item that is defective and access costs but gives cover for damage to property containing the defects and other parts of the insured property that are free of defect provided there is damage to the defective portion.
<b>DE4</b>	
Excludes any component part or individual item that is defective and access costs but gives cover for other parts or items of the insured property that are free of defect and damaged by the defective part.	The measure is to exclude the costs of correcting the defect, which would have been incurred, had this been carried out immediately before damage occurred.
<b>DE5</b>	<b>LEG3/06</b>
Provides full cover for both defective and non-defective property provided there is damage to non-defective insured property as a result of the defect. No cover for the costs of improvements to the original design, plan, specification, workmanship or materials.	Provides full cover for both defective and non-defective property provided there is damage to any portion of the property containing the defects as a result of the defect. No cover for the costs of improvements to the original design, plan, specification, workmanship or materials.  In the case of LEG3/06, "damage" has been qualified so as to include "any patent detrimental change in the physical condition of the insured property" – a change made to the original LEG3/96 clause in response to observations made in the 2005 Court of Appeal case <i>Skanska Construction Ltd -v- Egger (Barony) Ltd</i> . This case dealt with a dispute under a building contract not an insurance policy dispute.



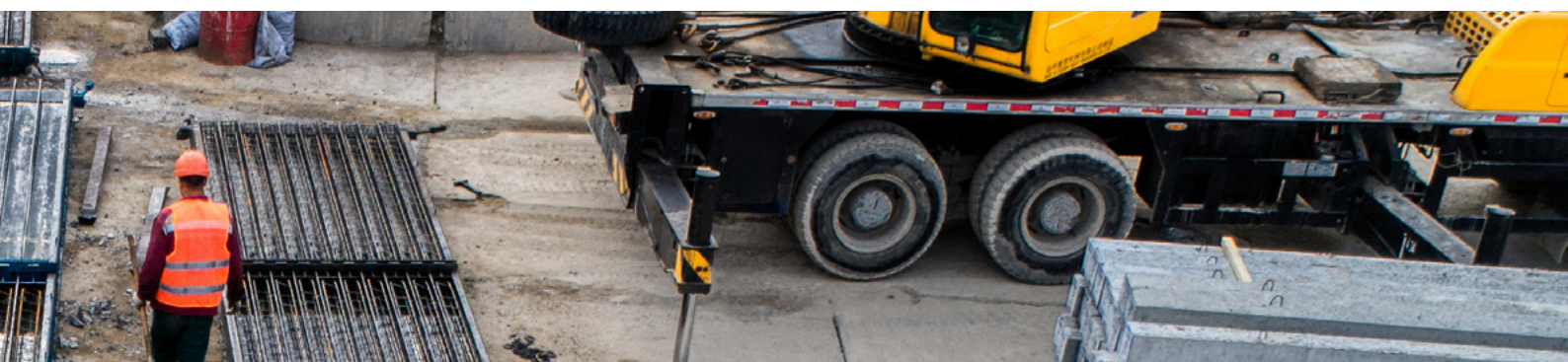
The following table demonstrates which costs are typically excluded when damage is caused by defects of design, plan, specification, materials or workmanship under the various DE and LEG exclusions (denoted by crosses) and conversely which costs are typically covered (shown by ticks). The triangles indicate those costs that may be included or excluded depending on the circumstances.

### Table of comparison

	DE1	DE2	DE3	DE4	DE5	LEG1/96	LEG2/96	LEG3/06
Costs to remedy defects where no damage has occurred	×	×	×	×	×	×	×	×
Costs to remedy resultant damage due to defects	×	✓	✓	✓	✓	×	✓	✓
Costs to remedy resultant damage to Property supported by defective property	×	×	✓	✓	✓	×	✓	✓
Costs to remedy defective property	×	×	×	△	✓	×	△	✓
Costs to remedy defective part, portion or item	×	×	×	×	✓	×	×	✓
Loss, damage or costs incurred to access defective	×	×	×	×	✓	×	×	✓
Costs to improve original design, plan, specification, workmanship or material	×	×	×	×	×	×	×	×

#### NOTES

- 1] Apart from DE1 and LEG1/96 the clauses include a final paragraph that clarifies that the mere existence of a defect (without damage) does not constitute damage itself.
- 2] The LEG2/96 and LEG3/06 clauses approach the issue of what is excluded by way of an exclusion solely related to the cost of replacement or rectification, rather than through an exclusion of damage and costs (DE3 & DE4). Note also that LEG2/96 and LEG3/06 use the term portion rather than “item” or “part” or “component part”.
- 3] There is a fundamental difference with regard to the wordings, between DE2 to DE5 and the other defects wordings in that DE2 to DE5 relate to property that is in a defective condition whilst the other clauses relate to damage caused by the defect. The trigger for cover under DE2 to DE5 is that damage must be caused to other property which is free from such defect but is damaged in consequence of the defect.



# Practical Application of DE and LEG Clauses

In practice, bespoke contract works insurance policy forms include either DE3, DE4 or DE5 or LEG2 or LEG3. The use of DE1/LEG1 is restricted to some insurers' "off the shelf" policy wordings and would not be acceptable to most insureds, or indeed compliant with, for example, the Australian Standard AS4000 1997 Form of Contract which requires at least DE2 cover. In reality it is rare to see cover below DE3 or LEG2.

In the Australian market a relatively high level of deductible is applied to cover under DE5 or LEG3. It is not unusual for a policy's standard deductible to apply to cover under DE3 (or DE4) or LEG2 where that, more restricted, scope of cover is selected.

Coverage with a "DE3 (or DE4)/DE5 Option" or "LEG2/LEG3 Option" can be secured in the market. Where provided, in the event of a claim, the option lies with the insured to decide which level of cover will give the best result having regard to the deductibles that apply. For example, where the value

of the defective part itself is less than the higher deductible applied to the DE5 or LEG3 Clause, it may be preferable to seek cover excluding the defective part, under the DE3 (or DE4) or LEG2 clause option to which a lower deductible applies.

Whilst the LEG exclusion clauses are more usually thought to be relevant to engineering risks on machinery erection/process engineering type projects rather than standard construction risks for building or civil engineering projects, it has become a matter of preference of the insured or insurers as to which are used.

## EXAMPLE: HOW DIFFERENT DEFECTS EXCLUSIONS WOULD RESPOND

A number of steel-framed industrial units are being erected on an estate. The designers have miscalculated the stress on the bolts that secure the roof beams together. Mid-way through the project, bolts fail as the final roofing panels are being fitted to one unit, which collapses, damaging the neighbouring completed unit.

Costs are incurred for replacing the bolts that failed, replacing the roof structure that was damaged when it collapsed, making good damage to the supporting wall, repair of damage to the neighbouring unit, redesign costs for the defective bolts and replacement of the bolts already fitted in the other units.

Exclusion	Excluded costs
DE1	This is an outright defects exclusion - All costs are excluded
DE2	This clause excludes property which is in a defective condition and property which relies on the defective property for support, namely the roof and roof panels
DE3	The property which is in a defective condition i.e. the roof frame and bolts which constitute an integral structure is excluded but all property which is free of defects including the roofing panels and the wall would be covered
DE4	In this case it is only the cost of the bolts that are excluded
DE5	It is only the additional cost of improving the design that is excluded
LEG 1/96	This is an outright defects exclusion - All costs are excluded
LEG 2/96	The cost excluded is the cost that would have been incurred to replace the bolts had it been established that they were defective prior to the failure.
LEG 3/06	It is only the additional cost of improving the design that is excluded
ALL Exclusions	The cost of replacing the defective bolts in the other units which have not suffered damage.



# Relevant Court Cases

For a more in-depth understanding of how defects and defects exclusions may be interpreted by the courts the following cases may be relevant:

- **Promet Engineering (Singapore) PTE Ltd v Sturge & Others**  
(Cracking nothing more than manifestation of latent defects)
- **Hutchins v Royal Exchange**  
(Latent damage not defect)
- **Pilkington v CGU – Waterloo station**  
(Glazed units defective but not found to be damaged)
- **Graham Evans & Co (Qld) Pty Ltd v Vanguard**  
(Layers of paint only the primer found to be defective)
- **Walker Civil Engineering v Sun Alliance – Sewerage tank**  
(All parts comprised the part immediately affected)
- **Seele Austria Gmbh & KG v Tokio Marine**  
(“Punched” Windows – standalone indemnity and number of events)
- **CA Blackwell v Gerling Allgemeine Versicherungs**  
(M60 – rainfall damage to earthworks, definition of the part)
- **Cementation Piling v Aegon**  
(Improvements that are required to achieve the original design requirements are not excluded)

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