Marsh

Latent defects insurance

2023

Contents

What is latent defects insurance

During the construction phase of a building, loss or damage is normally insured under an “all risks” contract works insurance policy. Following completion of construction, a property “all risks” policy is usually arranged; however, this policy does not provide protection for damage arising out of an inherent or latent defect in the building.

Latent defects insurance (LDI) provides cover in the event of an inherent defect in the design, workmanship, or materials becoming apparent in the structure or waterproofing envelope of a building resulting in physical loss or damage. It can indemnify you for the cost of the repairs to or replacement of damaged property and/or help pay to prevent imminent further damage caused by a defect up to the total sum insured, typically the full reinstatement value. Cover can be arranged for new buildings and significant extensions to or conversions of existing buildings.

Why is it important?

A property “all risks” policy on a completed building does not normally provide protection for damage arising out of an inherent or latent defect in the building. For this reason, serious consideration should be given to the procurement of an LDI policy.

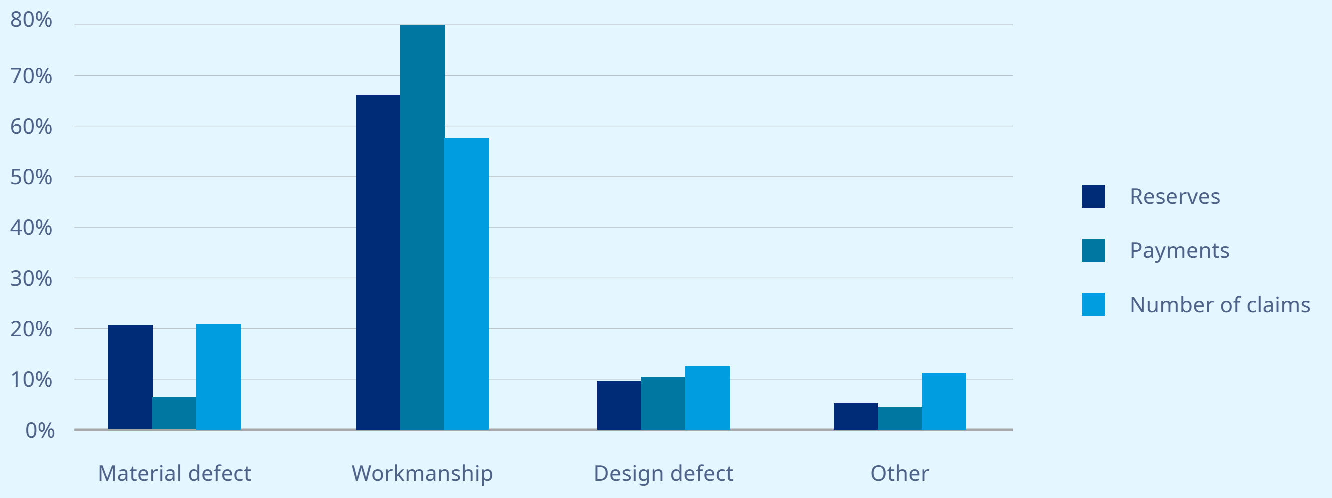
Unless LDI is procured, reinstatement of any damage caused by an inherent defect in the structure or waterproofing envelope and possible business interruption will fall to the owner’s balance sheet.

The policy is generally available for a set number of years from the date of final certificate of practical completion. The insured can be any party who has an interest in the property, which is often the owner or developer, and can be required by funders or incoming tenants with an obligation to repair under the terms of a lease agreement.

The owner’s likely recourse may be against the contractor’s (or subcontractor’s or consultant’s) professional indemnity (PI) insurance policy if caused by professional negligence, not workmanship or materials. Further, there may be a liability cap under their engagement preventing full recovery. In addition, proving liability may not be straightforward, meaning a claim could take years to reach a resolution, especially if courts are involved. If the contactor is no longer in business when the defect becomes apparent, there may be little or no recourse for the owner.

Contractual risks

Once the rectification or defects liability period stated under contract expires, the building owner does not have a contractual right to insist that the contractor rectifies defects which have not already been notified. Without an LDI policy, the building owner must seek indemnity via an action for damages, breach of contract or negligence.



Typically, the owner would claim a breach of contract, which they have a set period after practical completion to action. The main contractor, design consultants, and sub-contractors with design responsibility should therefore be required to hold a sufficient limit of professional indemnity (PI) insurance under contract, so compensation can be sought for any design-related defect. However, this only provides a degree of protection because:

- Negligence or fault must be proven in order for redress to be successful.
- PI insurance will not provide protection against defective workmanship or materials, unless a specification issue.
- Following the Grenfell Tower fire in London and the Lacrosse fire in Melbourne, there has been a significant increase in cladding-related claims. This has resulted in greater scrutiny of policies and, in turn, restrictions in limits or cover applied to many consultants' and contractors' PI policies. The situation has been further exacerbated by the impact of COVID-19 on the PI insurance market. As PI is underwritten annually on a claims-made basis, this will apply to any new claim made or potential claim circumstance advised to insurers post-renewal of existing PI insurances. This reduces the likelihood of a claim being fully, or even partially, paid.

Alongside this, trade contractors are likely to purchase a lower PI limit than a typical main contractor. Also, under a construction management agreement, the developer will need to seek recourse from the party(ies) responsible for the defect, rather than relying on the main contractor to do so, which can make the process more drawn out and complicated.

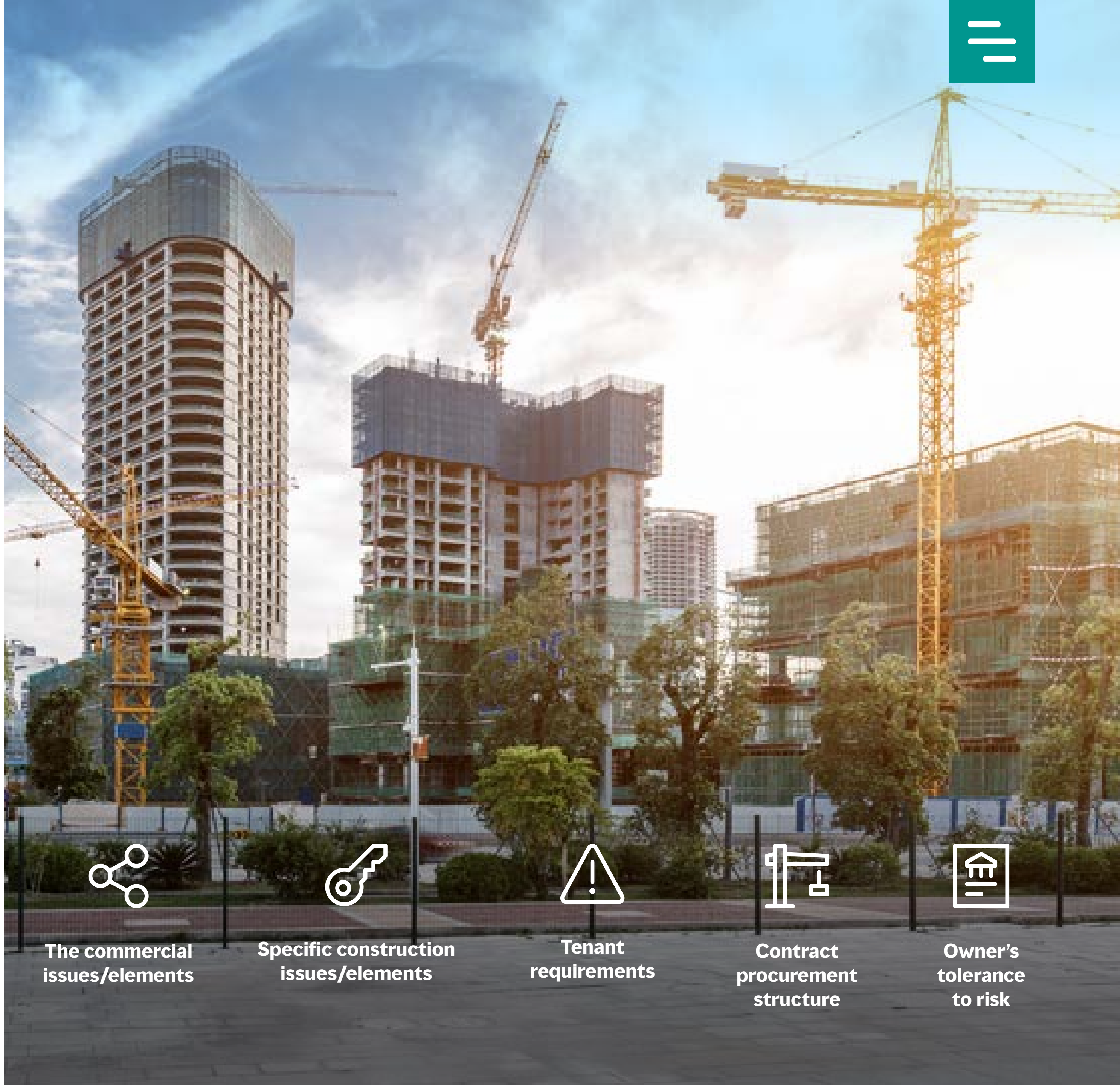
“PI insurance will not provide protection against defective workmanship or materials.

LDI releases developers and owners from reliance upon warranties provided by contractors or consultants, which can be complicated and costly to pursue and offer a different level of protection to that provided by an LDI policy.

The take up of commercial LDI policies is more sporadic than the residential equivalents, and can vary according to a number of factors, amongst which are commercial issues, construction issues, tenant requirements,
contract procurement structure and the owner's risk tolerance.

The standard policy provides cover for the structure and weatherproofing but, upon consideration of clients'/lease requirements, these polices can be extended to include non-structural elements and mechanical and electrical services (such as heating, ventilating, air-conditioning, water systems, and lifts). It can also cover consequential financial loss following a defect causing damage to the building, such as loss of rent, loss of profit, or the costs of working from alternative premises.

Use and enjoyment of residential property can be more sensitive to the impacts and disturbance resulting from a latent defect. Therefore, if defects are not rectified in a timely manner, developers may risk a negative impact on their reputation.

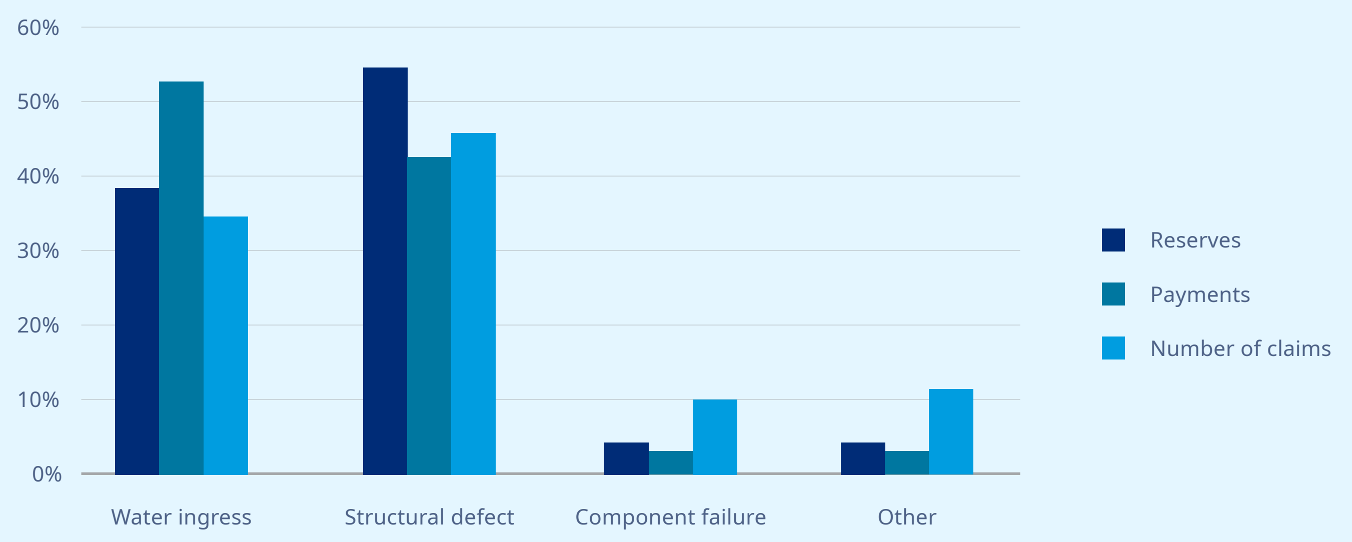


SCOPE OF COVER

- The policy will provide “full value” reinstatement cover with a built-in 5% per annum indexation to assist inflation over the policy period.
- Policy periods are usually 10 to 12 years from practical completion, which corresponds to applicable statute of limitations.
- Covers for defects in design, workmanship or materials. Policies can be extended to provide cover for mechanical and electrical defects, business interruption, and, if required, new home warranties to residential owners.
- Available for commercial, residential and mixed-use developments.

BENEFITS

- First party policy — there is no requirement on the policyholder to establish fault, negligence, or liability of the party(ies) to the construction contract.
- Insurance can be called upon quickly, if the insured property suffers physical loss or damage, or there is a threat of imminent damage due to a latent defect, within the terms and limits of cover.
- Costly, burdensome and time-consuming litigation does not need to take place before repairs can be carried out, which enables the building to be returned to use speedily. The policy is assignable to future owners and/or tenants of the building who, in current market conditions, are increasingly reluctant to assume the risks associated with building defects and will be more attracted to a building where latent defects insurance has been arranged as opposed to one where this protection does not exist.
- The technical audit process may detect defects prior to practical completion, allowing such defects to be rectified before the owner/developer takes over responsibility for the building from the contracting parties. This independent audit during the construction phase ensures not only quality but also compliance with plans and specifications, as well as the ultimate availability of insurance cover.
- Provides insurance protection to repair/replace damaged property even if contractors and/or professional team are no longer trading.
- Provides balance sheet protection.
- Inclusion of new home warranty assists the saleability of residential units.



Source: Analysis of more than 25 years of UK commercial inherent defects insurance policies by Castel Underwriting Agencies Ltd, 2018.

Water ingress (above or below ground) accounts for over 50% of all LDI losses.

Defects in the structure account for most of the balance of losses.

Claims

Insurers may take a long-term view of claims when assessing premiums, because the policies themselves are long term.

Consideration is given to the type of development when assessing a risk, because claims experiences differ between the residential LDI and commercial LDI market. This is particularly as a result of the higher deductible applying to commercial LDI policies and the fact that commercial policies are less frequently purchased, resulting in a relatively immature claims experience.

Claims are rare in the first two-year period post-completion, because many such claims will be rectified by the contractor(s) responding to their obligations in respect of defects liability under the terms of their build contract. It may also be the case that these defects are being responded to under construction all risks policies and therefore reducing the impact on LDI claims statistics.

The largest cause of loss is workmanship both in terms of frequency and overall quantum. Defective materials account for approximately 6% of losses, and design defects account for around 12% of losses. Albeit large claims are few and far between, most (but not all) large claims relate to the failure of weatherproofing/cladding systems, or below-ground water proofing.

CLAIMS EXAMPLES

Ground floor slab

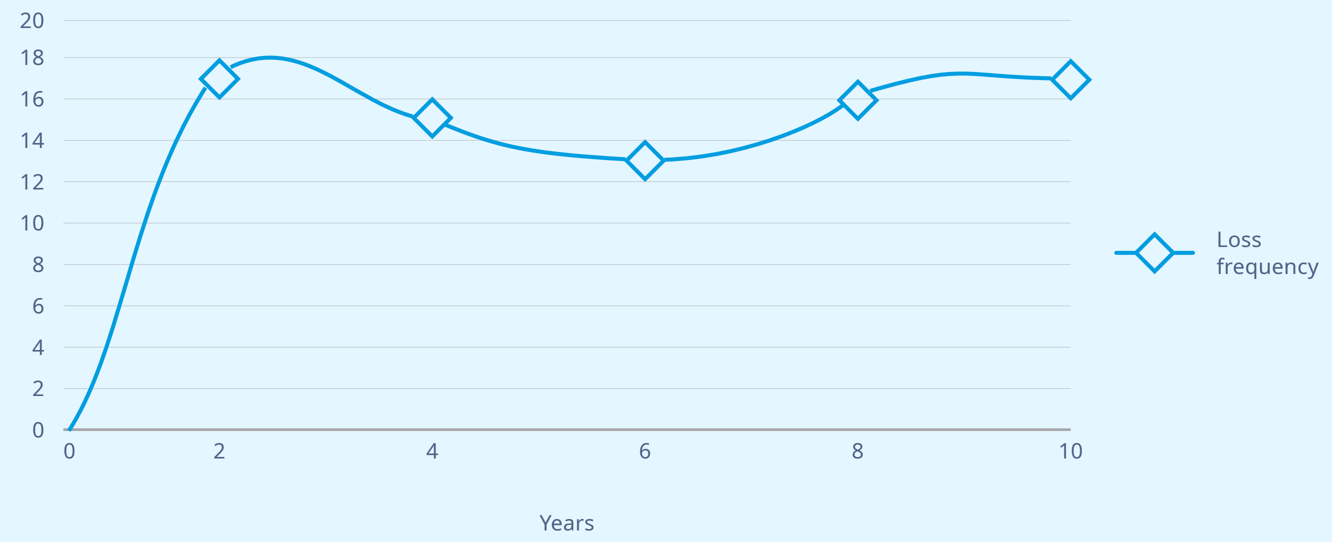
Cracks appeared in the floor slabs and damage was caused to doors and cladding in a four-storey office block, due to defective workmanship. This was covered under the LDI policy and the total cost of rectification amounted to more than $10 million Australian dollars.

Water damage

Ingress of water occurred at the basement of a three-storey building due to the inadequate design of the insured's drainage system materials used in construction and poor installation of the system. The pipes had to be replaced and the paving slabs, surface water drainage system, and waterproof membranes had to be reformed, totalling costs of nearly $1 million Australian dollars. This was covered under the LDI policy.

Glazing

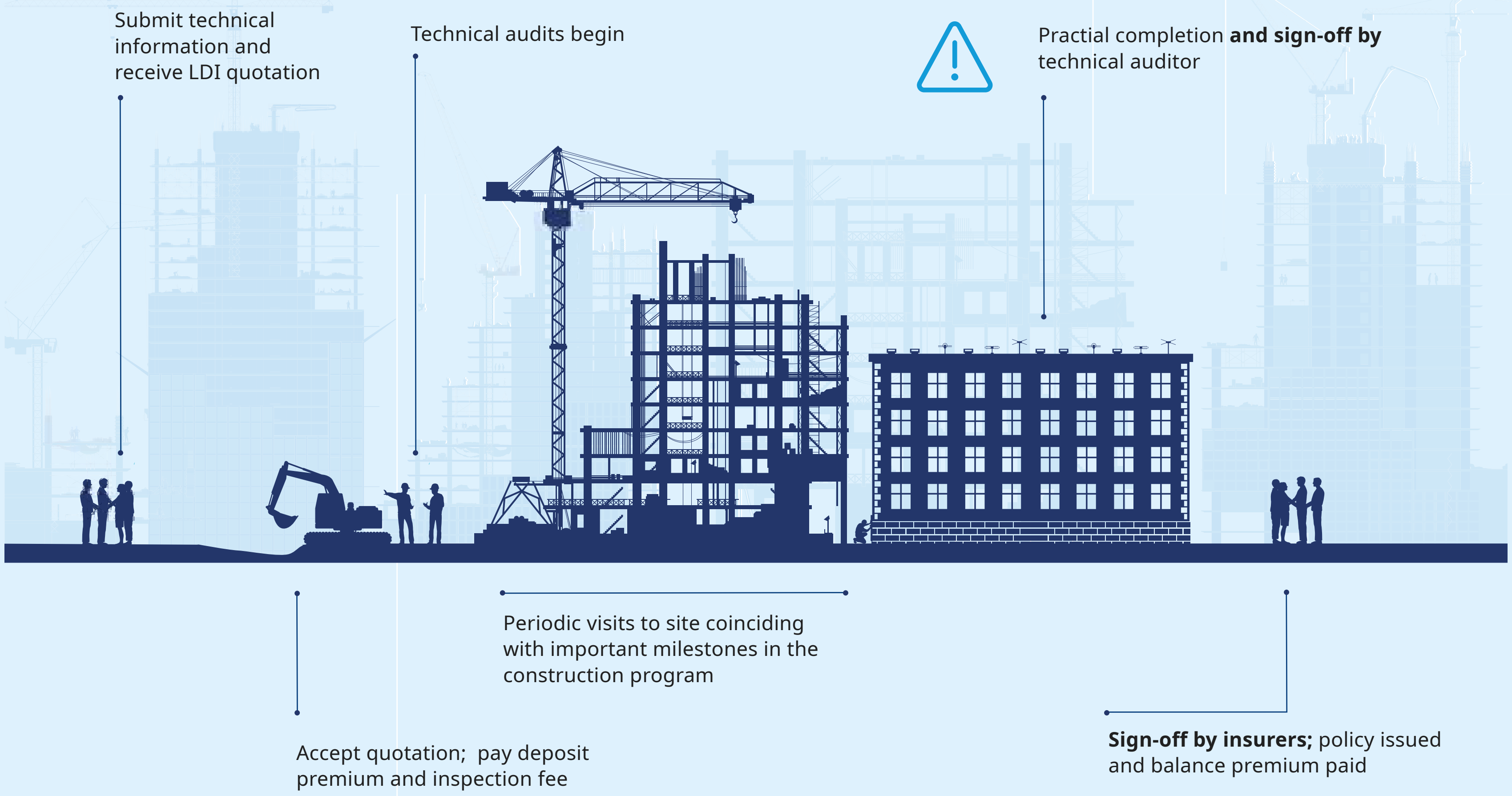
Glazing installed in an office building failed and fell to the ground as a result of the inclusion of nickel sulphide within the glass panels. These panels should all have been heat-soaked, but approximately 35% — 40% of them were not. This resulted in a successful multi-million dollar claim under the latent defects policy.



Early losses are primarily related to cladding and water ingress that manifest with seasonal weather variations.

Source: Analysis of more than 25 years of UK commercial inherent defects insurance policies.

PROCESS OF OBTAINING LATENT DEFECTS INSURANCE



BENEFITS

- The technical audits will flag potential defects to the client and insurer during the construction process. If these are not adequately resolved before practical completion, it will be flagged in the technical audit sign-off to insurers who may then consider altering their initial quotation.
- As part of the sign-off process, clients will be expected to provide:
  - Practical completion certificate
  - Snagging list
  - Reinstatement valuation to ensure that the correct value is being covered.

QUESTIONS?

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