

Defect or damage?

Conceptual challenges on construction claims



Foreword

The dividing line between defects and damage is important, but difficult to distinguish on some construction claims. We look at the challenges this distinction can present, and how they can be overcome in practice.

Whether resulting from design, plan, specification, materials or workmanship, defects can cause damage to project assets, and therefore have a range of associated costs.

While material damage cover – such as that found under a Contractors' All Risks (CAR) policy, or similar – will protect a project's physical assets against unexpected damage, it is not intended to guarantee quality of work by covering losses resulting from defects.

Issues caused by 'pure' defects are primarily a contractual issue, or one for the responsible party's professional indemnity insurer. However, where defects have caused damage, a CAR policy is triggered and the cover available is determined by the exclusions in the wording.

Distinguishing between defects and damage is therefore important for determining whether, and the extent to which, there is recourse under a material damage cover.

However, the dividing line between these concepts is not so easy to distinguish in practice and often presents complex challenges on construction claims that involve defects.



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Not always absolute exclusions

Historically, the CAR market was unwilling to provide cover for damage resulting from defects. Over the last 35 years the position has shifted and CAR policies now provide broad cover for such damage events. The scope of the cover available is defined by exclusion.

A policy's defects' exclusion is typically drawn from one of two established sets of London Market wordings – the London Engineering Group Defects Clauses (LEG) or the London Market Defects Exclusions (DE). While these are exclusions, some of the clauses contain important “write backs” that address how the policy will respond to claims for damage arising out of defects.

Both the LEG and DE wording present an opportunity for policyholders to purchase incremental cover for instances involving defects, with LEG offering three levels of cover and DE offering five.

The broadest exclusions within each set (LEG1 and DE1) are absolute defect exclusions, while the narrowest exclusions (LEG3 and DE5) will preserve cover for resultant damage, excluding only any costs that improve upon the original design, plan, specification or materials (see below for an illustration of the different cover available via the LEG and DE clauses).

“In the large project and major contractor insurance market, few, if any, ever choose to completely exclude damage caused by defects,” says Christopher Lynch, Senior Claims Adjuster at Zurich. “I have personally never seen a policy that contains narrower exclusions than LEG2 or DE3. Most customers will buy a policy that covers consequential damage to non-defective property, or opt for even wider coverage (LEG3, DE4 and above) in return for an enhanced excess and additional premium.”



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Cover summary – London Market Defects Exclusions (DE) 1995

DE 1 – Outright Defect Exclusion	Excludes any and all damages due to property in a defective condition
DE 2 – Extended Defective Condition Exclusion	Excludes damages to property that is in a defective condition, or property that relies upon it for support. Covers consequential damage to any other property free of defective condition
DE 3 – Limited Defective Condition Exclusion	Excludes damages to property that is in a defective condition. Covers consequential damage to any other property free of defective conditions
DE 4 – Defective Part Exclusion	Excludes damages only to the constituent part of the property that is deemed defective. Covers consequential damage to any other property free of defective conditions
DE 5 – Design Improvement Exclusion	Covers all damages resulting from the defect, excluding only the additional costs of improvements to the original design, plan, specification or materials

Cover Summary – London Engineering Group Clauses (LEG)

LEG 1_96 – Model “Outright” Defects Exclusion	Excludes loss or damage due to defects of material workmanship, design, plan or specification
LEG 2_96 – Model “Consequences” Defects Wording	Excludes all costs that would have been incurred if replacement or rectification had been carried out immediately prior to the damage occurring
LEG 3_06 – Model “Improvement” Defects Wording	Covers damages resulting from the defect, excluding the cost of improvement to the original workmanship, design, plan or specification



Difficult distinction to draw

Defects often occur within the insured property – for example, a defective mix that results in low-strength concrete within a pile, which then causes a piled wall to collapse. This makes notions of defect and damage difficult to completely separate in reality, as they are often so closely intertwined.

Furthermore, with each increment of the LEG and DE clauses introducing further distinctions, it can demand a very complex factual analysis to be carried out to establish the extent of recovery available.

“You need to first separate out and attach costs to a number of distinct concepts. These might include: defective property; property free from defects; the constituent part deemed to be defective; consequential damage;

and aspects that might be considered improvements,” explains Lynch.

“While this can be relatively simple, circumstances can easily arise where these distinctions are not so easy to make, which creates uncertainty over what is and what is not excluded by these clauses.”

Concrete, a common challenge

Unlike, for example, a piece of machinery, where a defective bolt and the resultant damage caused by it are easily distinguishable, concrete can prove especially challenging.

Concrete defects can stem from a range of sources (many of which can remain unidentified) and its resultant structures frequently intertwine with other insurable property. This can make it particularly difficult to distinguish the

key concepts necessary for determining the extent of cover.

Using this example of concrete, the following scenarios demonstrate what cover would be available under the various clauses that are typically bought (LEG2, DE3 and above), and how uncertainty can easily arise for even the slightest variation in circumstances.

In each scenario, the policyholder, a contractor, is building a large warehouse. The floor is a raised concrete slab on a base of aggregate. However, the aggregate has been erroneously supplied, and expands rapidly when it comes into contact with moisture.

Scenario 1 – excluded, no damage

As the finishing touches are being applied to the floor slab, it is discovered that the aggregate fill is not fit for purpose and needs to be replaced.

As no damage has occurred to the insured property, the CAR policy will not respond.

Scenario 2 – clear on coverage

As the finishing touches are applied, cracking and heave occurs throughout the slab caused by expansion of the defective aggregate as it comes into contact with moisture.

Once the cause is established, the policyholder must replace the entire slab and the aggregate with a suitable material before re-laying the concrete.

Costs of breaking-out and relaying the damaged slab are covered under the widest clauses, DE5 and LEG3. Only the increased cost of replacing the aggregate with one that is suitable is excluded, as this would constitute an improvement.

No coverage would be afforded if LEG2 were operative, as immediately before the loss occurred the insured would have already needed to break out the slab to rectify the defective aggregate.

DE4 would cover the costs of breaking out and replacing the slab, but would exclude the cost of replacing the defective fill, on the basis that this was the “defective part”. DE3 would exclude the cost of breaking out and replacing the aggregate. It would however cover the insured for resultant damage to the slab.

Scenario 3 – extent of recovery unclear

The aggregate comes into contact with moisture, causing cracking to discrete areas of the slab. These are capable of being repaired in sections, but to satisfy contractual obligations the contractor will still need to break out the entire slab, replace the defective aggregate and lay a new slab.

In such circumstances, it can be said with confidence that the costs of replacing the discrete, damaged areas of the slab are covered under LEG2, DE3 and above. The undamaged areas however present some challenges.

The insured is obliged to mitigate any potential future damage at their own cost – replacing the undamaged portions could therefore be considered such mitigation.

If, for example, it is accepted that the aggregate is damaged in its entirety, the insured might argue that replacing any part of the slab is a consequence of this damage and therefore covered. Whether or not this is the case, however, will require careful factual analysis, as both wording sets require us to distinguish between parts damaged as a consequence of the defect and those replaced in order to rectify the defect to satisfy contractual obligations.

Furthermore, to be covered, damage must be caused by a fortuitous event. As the defective aggregate was always going to react with the groundwater in the way that it did, any damage is arguably not fortuitous.



Lack of judicial scrutiny

Scenario 3 demonstrates the type of challenges that can easily arise when applying the LEG and DE clauses. However, despite difficulties in their application commonly occurring, very few judicial decisions actually exist to offer any meaningful guidance.

“While lack of litigation is usually an indication of clarity, the opposite is actually true for the LEG and DE clauses,” says Lynch. “In fact, because such ambiguity exists there is, understandably, a preference to settle claims on a pragmatic basis in order to avoid the uncertainty of litigation.”

“It would take cases at Supreme Court level to deliver ultimate clarity, which looks an unlikely development. In the meantime, it is therefore down to insurers, brokers and policyholders to work together and find appropriate solutions when challenges do arise.”

A pragmatic approach

Brokers and their clients choose the LEG and DE clauses to define an appropriate level of protection against damage caused by defects.

“When the situation is clear cut, and recovery is not available under material damage cover, we will always be open with the customer and broker about this

from the outset,” says Bernadette Hackett, Head of the Global Construction Industry Community.

“There may still be other sources of recovery available – perhaps in contract, or via other insurance covers, such as professional indemnity – and we will prompt our brokers and customers to consider these and take further advice where appropriate.

“Crucially, when circumstances are such that the coverage position is unclear, and the application of these clauses presents challenges, we stand out from others in the market due to our desire to work collaboratively and find a solution.

“Zurich is in the business of paying claims, and we always start from that position. We work hard to form genuine relationships with our brokers and customers so that when such challenges do arise, we can work together to find a constructive solution.”

For more information on insurance cover for defects on construction projects, or to discuss anything else, please speak with your local Zurich account executive.



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How can we help?

To find out more about Zurich's approach to defects on construction projects, please contact Bernadette Hackett by email at bernadette.hackett@uk.zurich.com or Christopher Lynch at christopher.lynch@uk.zurich.com

You can also gain further insights regarding risk management in the construction sector by following Zurich Construction Services on LinkedIn

<https://www.linkedin.com/company/zurich-construction-services>

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