

## **Broker Briefing Notes - Defects Exclusion LEG3/96**

### **Subject**

The insurance of Contract Works following physical loss or physical damage to insured property caused by defects in material workmanship design plan or specification – LEG3/96 exclusion

### **Background**

Concerns had been raised within the insurance community about the application of LEG3/96 exclusion in the light of observations made in the 2005 Court of Appeal case *Skanska Construction Ltd v. Egger (Borony) Ltd* (2003) Lloyd's Rep IR 479, a dispute under a building contract (not an insurance policy dispute).

Some insurance practitioners and their advisors wondered whether remarks made by an appeal court judge brought into question the application of LEG3/96 and whether the clause needed to be modified to reflect underwriters' true intentions when offering this, the widest form of cover, for physical damage caused by defects.

The debate (and the emergence of broker modified clauses in the market) prompted London Engineering Group to seek clarification on the law and guiding advice from leading counsel on the subject matter. Accordingly, a sub-committee was formed and Colin Edelman QC was instructed to give advice. Broadly, he responded on two fronts:-

- by putting into proper context the remarks made by the judge
- by commenting on the clarity of LEG3/96, given underwriters' intentions, on which he was made fully conversant.

Discussions served to remind members of LEG of the varying degrees of cover being provided (and excluded) when applying the different defects exclusions e.g. LEG1/96, LEG2/96 and LEG3/96.

### **Legal Advice**

The comments made by Mance LJ (one of three judges in *Skanska*) that drew a distinction between the contractor's obligation to perform the contract (including the rectification of defects) and responsibility for loss or damage sustained while carrying out the works, were *supplementary observations*, which related to the *contractual scheme* in that case.

These supplementary observations, on what had been said in the judgement of Latham LJ and Aldous LJ, do not amount to a decision by the Court of Appeal.

The judge was not seeking to propound some general principle applicable to all clauses which require there to be *damage* but merely construing the words which appeared in the building contract between the parties.

As such, LEG3/96 is not brought into question by the *Skanska* case, which causes no basis for concern.

If required to consider the application of LEG3/96, a court would do so in the context of the insurance policy as a whole and in the “factual matrix” in which it was used. This would include the alternative (and more restrictive) defects exclusion options that are available. Once the policy cover has been triggered, the intention of underwriters to meet the cost of replacing or repairing defective property that has itself been damaged (excluding only the costs of improvements) is fairly represented by this exclusion.

However, there could be scope for an argument at law as to whether there could be said to be “damage” to the defective property if the existence of the defect had, in truth, already rendered the property less useful or less valuable, with the manifestation of the physical changes merely drawing the parties’ attention to the defect being present. Since it is desirable to remove any such doubts, some modification was suggested.

Guided by this initial advice LEG developed further ideas on how best to effect the change and reverted to C Edelman QC with a proposed wording. LEG wanted to avoid using the word “deterioration” in this context because it appears in a separate exclusion elsewhere in a normal policy. Also, LEG did not want to make any changes in the second paragraph of the exclusion to preserve consistency with LEG2/96. It is pleasing to report that strong approval has been received by LEG and a new exclusion is introduced below (changes in emboldened font for the purposes of this paper only).

## LEG3/06

The revised exclusion that will be known as LEG3/06 and reads:-

“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 or specification”.

This is the result of a comprehensive study carried out by LEG on behalf of the market and is backed by formal advice from leading counsel. The amendments serve to affirm the intentions of underwriters when providing this cover, and to remove any doubts that might have otherwise arisen; they do not alter the scope or width of cover when LEG3 is applied. The LEG3/06 exclusion has the full support of the London Engineering Group membership and is available for use with immediate effect.

LEG1/96 and LEG2/96 exclusions are not affected and remain unchanged.

A copy of this paper will appear on LEG’s website – [www.leg-uk.org.uk](http://www.leg-uk.org.uk)

(NB. The cost of Colin Edelman QC’s advice has been met out of LEG funds.)