



## Are all defects clauses created equal?

The insurance market has dramatically shifted in the past 18 months and the broadest defects coverages available under a Contract Works Material Damage policy are no longer widely available. Do the second-tier defects coverages provide equivalent protection or should insured parties be more selective?

### Setting the scene

A fundamental feature of a Material Damage - Contract Works (CW) policy is cover for damage caused to the works arising out of a defect in design, plans, specification, materials or workmanship.

There are two sets of defects wordings that are commonly utilised, – the London Engineering Group (LEG) and Design Exclusion (DE) clauses. Each set of exclusions starts with an absolute exclusion for damage to the works caused by defects and then provides incremental levels of expanded cover. A full drafting of the respective LEG and DE clauses are included within Appendix A. However, at a very high level each of these clauses provide coverage as detailed on the following pages.

Comparison of DE and LEG clauses

DE Clauses	LEG Clauses
<p><b>DE1</b> Excludes all loss or damage due to defective design, plan, specification, materials or workmanship.</p>	<p><b>LEG1/96</b> Excludes all loss or damage due to defective design, plan, specification, materials or workmanship.</p>
<p><b>DE2</b> 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.</p>	<p><b>No equivalent LEG Clause.</b></p>
<p><b>DE3</b> Excludes damages to property that is in a defective condition.  Covers consequential damage to any other property free of defective condition.</p>	<p><b>LEG2/96</b> Excludes all costs that would have been incurred if replacement or rectification of the defect had been carried out immediately prior to the damage occurring.</p>
<p><b>DE4</b> Excludes damage only to the component part or individual item of the property that is deemed defective.  Covers consequential damage to any other property free of defective condition.</p>	
<p><b>DE5</b> Covers all damages resulting from the defect, excluding only the additional costs of improvements to the original design, plan, specification, materials or workmanship.</p>	<p><b>LEG3/06</b> 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 Skanska Construction Ltd -v- Egger (Barony) Ltd. This case dealt with a dispute under a building contract not an insurance policy dispute</p>

Illustration of costs typically excluded

	DE1	DE2	DE3	DE4	DE5	LEG1	LEG2	LEG3
Costs to remedy defects where no damage has occurred	X	X	X	X	X	X	X	X
Costs to remedy resultant damage due to defects	X	✓	✓	✓	✓	X	✓	✓
Costs to remedy resultant damage to property supported by defective property	X	X	✓	✓	✓	X	✓	✓
Costs to remedy defective property	X	X	X	🔍	✓	X	🔍	✓
Loss, damage or costs incurred to access defective part, portion or item	X	X	X	🔍	✓	X	🔍	✓
Costs to remedy defective part, portion or item	X	X	X	X	✓	X	X	✓
Costs to improve the original design, plan, specification or materials	X	X	X	X	X	X	X	X

X Cost excluded    ✓ Cost included    🔍 Cost may be excluded or included

The LEG clauses were originally drafted with a focus on electrical and engineering projects while the DE clauses focused on building and civil engineering projects. Over time the two sets of clauses have become interchangeable in Australasia with brokers often giving little regard as to the most appropriate form to be used based on their client's activities and/or the project's specific exposures.

As recently as Q3 2018, most insured parties under a CW policy would have become accustomed to enjoying the broadest form of defects exclusion of either LEG 3/06 or DE5 (1995) which provide almost identical cover. However, with the hardening of the insurance market this has become increasingly difficult to achieve and the default position in such situations is to fall back to the respective second tier defects cover - either LEG 2/96 or DE4 (1995)<sup>1</sup>.

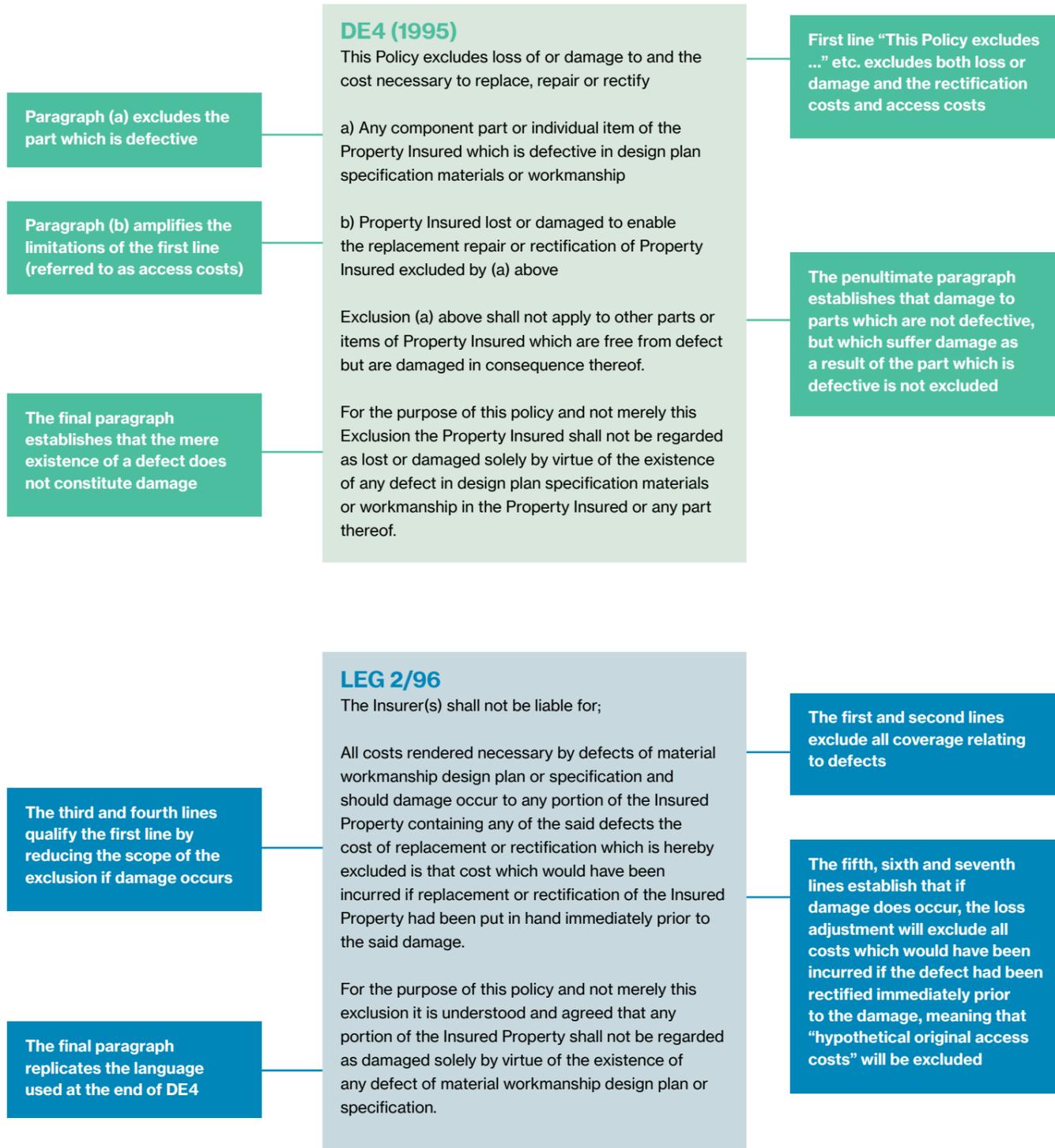
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1. In some instances, insurers may insist on DE3 (1995). As such commentary is included within the below claims examples on the potential claims outcomes under a DE3 (1995) position.

**A big difference**

While there is little to no difference between cover provided under LEG 3/96 and DE5 (1995), there is certainly scope for differentiation between the coverage provided between LEG 2/96 and DE4 (1995).

First, let us review how the two respective clauses are constructed and how their drafting looks to exclude cover.



The two exclusions seem to approach the same problem from opposite perspectives:

- DE4 (1995) is quite precise, seeming to work from the inside outwards by excluding first the defective part and then the access costs, emphasising that damaged property which is not defective is insured and then making it clear that a defect does not, in itself, constitute damage
- LEG 2/96 is much less precise, preferring to work backwards by first creating a hypothetical scenario of works that would always have needed to be performed to rectify the defect prior to damage occurring, and stating this as the excluded sum, and then see if any works are outside of this premise. Only then would they be considered for inclusion in the eventual quantum adjustment process.

**Do these differences impact claims outcomes?**

Absolutely yes. In some cases, DE4 (1995) has two considerable advantages over LEG2/96:

**1. Access Costs**

Paragraph (b) uses the words "lost or damaged" in its attempts to address the access costs to the "component part or individual item" which is defective and therefore leaves an ability for the insured to claim that, as access costs relating to the rectification of non-defective property are not specifically excluded, insurers cannot avoid them as they can under the terms of LEG 2/96

Consider also the following scenarios:

- If loss or damage occurs to insured property which is free of defect, then the remedial costs will include the costs to access such non-defective property but, depending on the specific circumstances of the loss, these costs will probably coincide with the costs to access the defective part as well. Under DE4 (1995), the insured would be able to recover access costs relating to rectification of loss or damage to non-defective property as opposed to accessing the defective "component or individual item" as it may be argued that becomes the prime reason for its requirement. However, under LEG 2/96, these costs, if also required for access to the defective component part, would be specifically excluded, removing what is often a considerable portion of the remedial costs.

- If property can be removed and re-used, then this property is arguably not damaged and therefore will not be excluded by DE4 (1995). Under LEG2/96, this cost will form part of the hypothetical cost incurred immediately prior to the loss and therefore excluded.
- "access" or rather loss or damage to Property Insured to allow for rectification of the defective component of Property Insured can potentially be a broad term. If the insured incurs costs relating to:
  - Shut down
  - Re-testing
  - Shoring/Propping and other temporary works
  - Stripping back
  - Breaking out
  - Dismantling

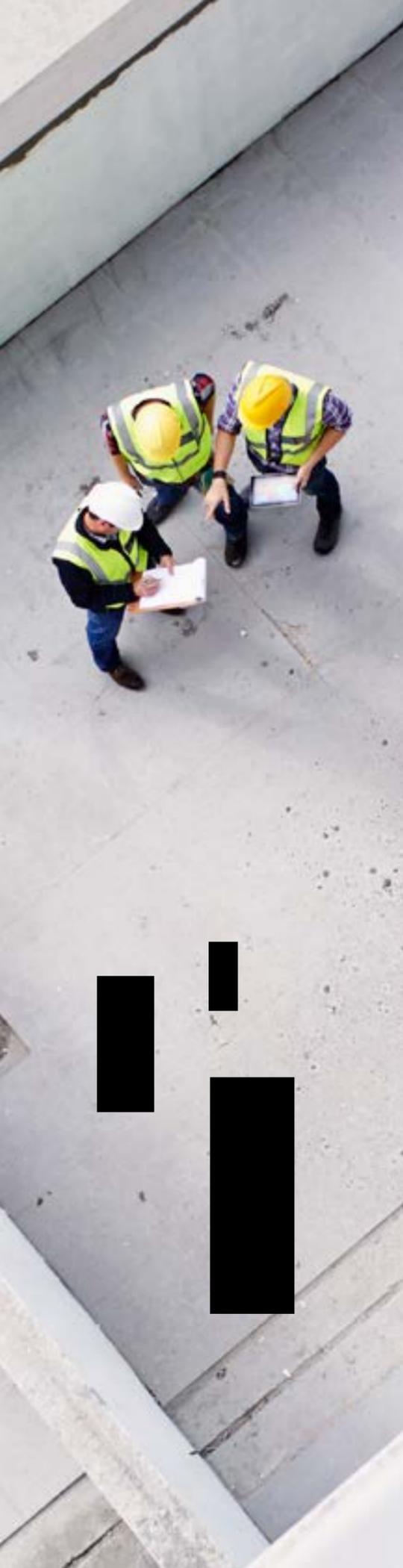
of the Property Insured as part of the "access" process, then an argument can be advanced that paragraph (b) of DE4 (1995) does not exclude the costs relating to such actions as there is no "damage" to the Property Insured.

In comparison, the use of the word "all" at the beginning of LEG 2/96 and the exclusionary proviso regarding "the 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" probably kills any chance that the insured might have to argue for payment of some of the access costs.

**Claims example<sup>2</sup>**

*Windows throughout a multi-storey building have defective seals, allowing rainwater to enter. The rainwater damages non-defective plasterwork immediately behind the windows, but unfortunately, because there is expensive oak panelling covering the plasterwork, all of that has to be broken out in order to remedy the plasterwork and in order to remedy the defect.*

*Under LEG 2/96 no cover would be afforded as the insurer would argue that prior to any damage occurring the contractor would have had to rectify the defective window seals and, in order to do that, he would have had to break out the oak panelling and all the plasterwork in order to reach the seals and change them.*



If however, DE4 (1995) applied, that states that the exclusion will not apply to property insured which is free of the defective condition but is damaged in consequence thereof. Essentially in order to repair the non-defective plasterwork (not to rectify the defective seals) the contractor has to break out the surrounding non-damaged oak panelling and that is the cost of repairing the damage. The distinction is fine but material. The plasterwork (which is not defective) needs the oak panelling removed whereas the replacement of the defective sealant itself does not require removal of the panelling. Naturally at the same time the contractor will take the opportunity to remedy the underlying defective seals but there is nowhere in DE4 (1995), or indeed in the lesser clause DE3 (1995), which explicitly states that if he does this he should be penalised as a result.

## 2. Hypothetical scenario

Under LEG 2/96 the requirement to create a hypothetical scenario of works that would always have needed to be performed to rectify the defect prior to damage occurring can often remove, in its entirety, the recovery value of a claim under this clause.

### Claims example<sup>3</sup>

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.

As the finishing touches are applied, cracking and heave occurs throughout the slab caused by expansion of the defective aggregate having come into contact with moisture. Once the cause is established, the contractor must replace the entire slab and the aggregate with a suitable material before re-laying the concrete.

No coverage would be afforded if LEG2/96 were operative, as immediately before the loss occurred the insured would have already needed to break out the slab to rectify the defective aggregate.

However, DE4 (1995) 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".

Even under the lesser DE3 (1995) scenario, cover would exclude the cost of breaking out and replacing the aggregate but would cover the insured for resultant damage to the slab.

## LEG 2/96 cover for access costs

The examples above demonstrate how in the majority of cases LEG2/96 can result in the exclusion of access costs. This is not a constant, however, and there are circumstances under which access costs may well be recovered.

### Claims example

A contractor is assembling and installing machinery into a building. Prior to testing and commissioning the machinery is primed with fuel or oil. There is a defect in the fuel/oil inlet valve, however, which during the commissioning process results in fuel/oil being spilled into the machinery and as a result causing extensive damage.

In these circumstances it is possible that the fuel inlet valve could be a readily accessible repair, but the consequent damage to the machinery requires a considerable expense in terms of access and dismantling equipment and machinery in order to access and repair or replace the damaged parts. In such circumstances these access costs would not have constituted a part of the hypothetical repair scenario for the original defect and as such could not be excluded from the claim. In this scenario the same cover would be provided if DE4 (1995) had been applied instead.

## Business Interruption (Delay in Start Up)

Defects exclusions can have a very significant effect on Business Interruption. In most cases any defects exclusion in the CW section of a policy will be carried over into the business interruption section i.e. only a delay to the project caused by indemnifiable damage under the CW policy will be covered.

Therefore, where no cover is afforded under a CW policy, as is the case in the above examples where LEG 2/96 was operative rather than DE4 (1995) or DE3 (1995), there would be no trigger for any associated business interruption policy thereby amplifying the inferior indemnity outcome for the insured.

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**Insureds and their brokers should consider carefully which set of defects clauses are most appropriate for the specific risk profile of their business and/or their project.**



## Summary

Both the LEG and DE set of defects clauses are well established and widely utilised across the full spectrum of the construction and engineering industries.

Although insurers would argue that the LEG clauses more closely follow the principle of returning the insured to the position they were in prior to the loss occurring, DE clauses have been in existence longer and, under many claims circumstances, can offer a more favourable indemnity outcome for insureds than LEG.

Ultimately, the precise factual scenario of a claim will impact the outcome and regrettably the principles are much easier in the hypothetical that they are in practice.

With the market hardening and the choice of the second tier defects clause being imposed on insureds, they and their brokers should consider carefully which set of defects clauses are most appropriate for the specific risk profile of their business and/or their project.

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3. <https://insider.zurich.co.uk/app/uploads/2018/03/Damage-or-Defect-Construction-Whitepaper-1.pdf>

# Appendix A.

## DE and LEG clauses

### 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.

But should damage to the Property Insured (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.

### 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

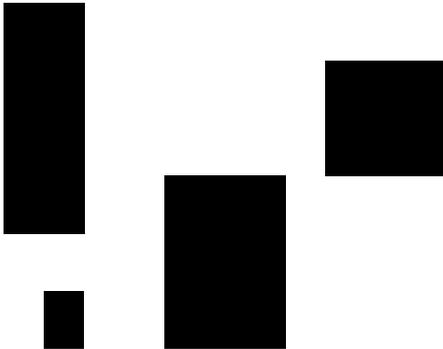
### LEG 3/06: The London Engineering Group Model Design Improvement Exclusion

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.





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