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How the Defect Exclusions are operating in practice: Some Case Studies

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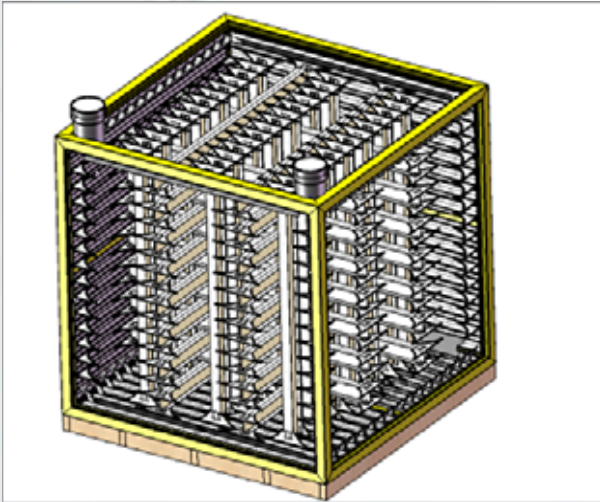
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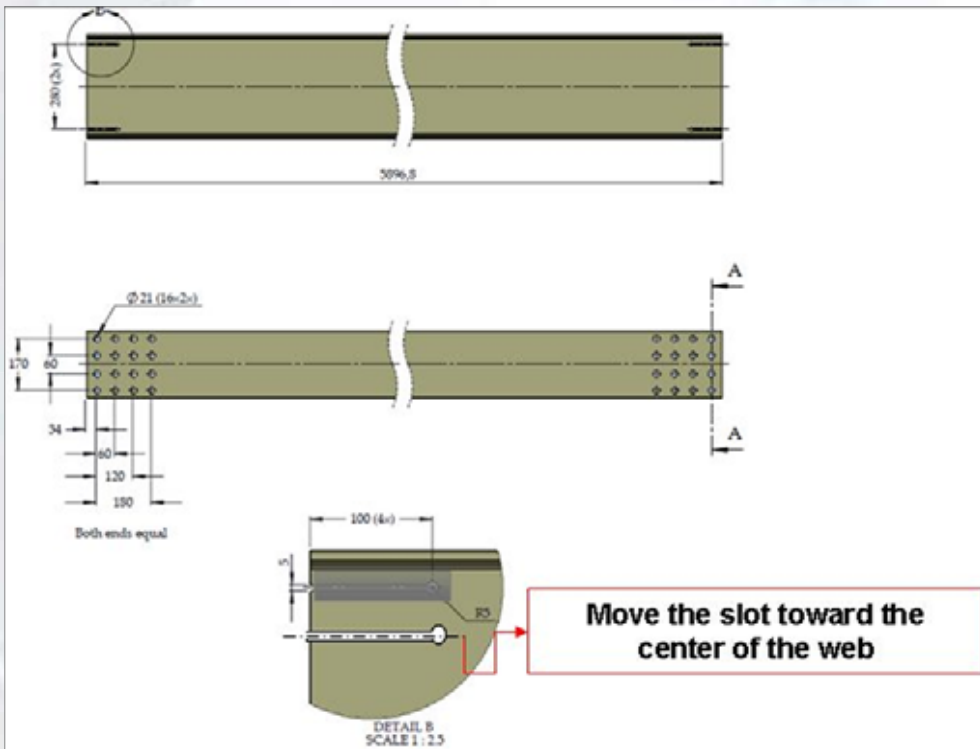
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We will cover five main points:

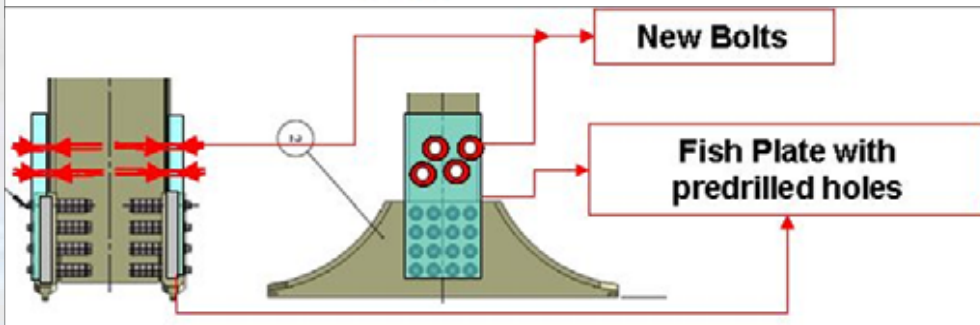
- Comparison of LEG2 and other defect Exclusions
- What LEG3 covers following 2006 review
- LEG3 and Actual Damage
- The “Additional Cost of Improvement” under LEG3
- The LEG3 deductible and “Drop Down”

Comparison LEG 2





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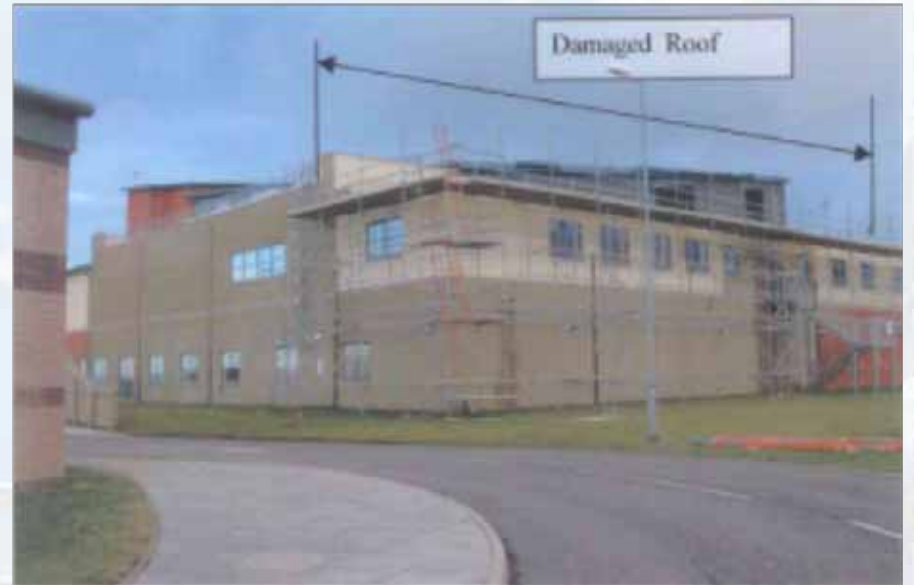


Prolongation of bracket with Fish Plate

LEG 2 - An improvement over DE3?

- LEG 2 puts insured in same position as before the loss
- Matches principle of indemnity
- No problem of identifying 'the property which is defective'
- Avoids paying break-out costs to reach defect





The Policy Excludes

- The cost of repair of damage to items due to defective material workmanship or design
- But this exclusion shall be limited to the items immediately affected and shall not be deemed to exclude damage to correctly executed items resulting from an accident but resulting from an accident due to such defects

Issues presented by LEG3

- The 'Damage' trigger : examples
- Manifestation of defect
- Delaminating paintwork
- Cracks in turbine blade
- Cracks in tiled floors
- Deliberate damage to concrete tanks



LEG3: The Issues

- Latent Defects become Patent Defects
- ‘Inevitable’ Damage
- ‘Doomed from the start’ argument
- Oceanic v Faber
- Promet v Sturge (‘The Nukila’)
- Where damage is more than the straightforward manifestation of defects

LEG3: Where the “damage is more than the manifestation of a defect”

- Damage due to a defect is always “inevitable”
- or “doomed from the start”
- What is the insurer’s intention?
- Suggestion: Pay if the costs are greater than simple defect rectification.

Definition of Damage

- “Damage in this context, will be deemed to have occurred if the cost of repair due to the adverse physical change to the works is greater than the cost that would have been incurred to rectify the defect immediately before the adverse physical change.”

LEG3 – Colin Edelman

- Briefing note: Colin Edelman QC
- “Should damage occur”
- “Which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the insured property”

Damaged and Undamaged areas

- The defect reveals itself gradually
- In most areas the defect is not yet latent
- Over time, these defects become patent
- How far does the policy cover the whole area which is defective?



LEG 3 Damage Illustrations

- Motorway: Defects span 15km. Crack in 5%
- Building Cladding: Predrilled holes cause cladding to crack
- Treatment Tanks: Partial damage and prolonged reinstatement
- Tunnel Settlement: Eliminate defect BUT is the area around the tunnel “damaged”



The 'Additional Cost of Improvement' and LEG3

- When is design rectification 'an improvement'?
- Major expense of correcting design faults
- Additional costs which the insured should have incurred in the original design
- Indemnity: Pre Loss v Pre Design
- Example: "If damage occurs (as defined), the cost excluded is the additional cost of any design changes if they had been implemented at the design stage".

The LEG3 Deductible and 'Drop Down'

- Deductible “£1,000,000 any one event in respect of damage caused by defective design, workmanship or materials”
- DE1 “this policy excludes damage to the property insured due to defective design or workmanship”

LEG3 and the Deductible

- Higher deductible only applies to the defective part
- DE1 wording is used for the deductible
- Deductible for 'losses due to defective workmanship'
- Electrical fault causes a fire
- Defective plumbing fitting floods the works
- 'Defective Workmanship' and workman error

Conclusion

- LEG3 – Excludes defective property insured – but access costs?
- LEG3 – Manifestation of a defect
- LEG3 – Damaged area vs defective area
- Additional Cost of Improvement – at design stage
- LEG3 deductible wording – similarity to DE1
- *Needed: A wording which mirrors indemnity*



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