

DEFECTS LIABILITY COVER, CONSTRUCTION INSURANCE

Report to 1998 Conference
by
Derrick Werner

Defects Liability Cover
Construction Insurance

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Historic Development

Contractual obligations and responsibilities relating to Maintenance or Defects Liability prior to the 1960s were somewhat vague and loose, especially so far as the Contractor was concerned. This situation was more prevalent in the case of Electrical and Mechanical Works where, on completion of Erection and Testing, the Works were handed over to the Purchaser and the Contractor's responsibilities ceased, but for any Manufacturer's Guarantees and Manufacturer's Products Liabilities that could be processed through the Contractor.

The first stage of development was the introduction of Maintenance Visits Responsibilities, whereby the Contractor had the obligation, contractually imposed, to make good loss or damage and liabilities incurred as a consequence of the work undertaken by him during a specified period after handover. This work usually entailed adjustments, calibration and like activities. Bearing in mind that, at that time, insurances for Contract Works were the responsibility of the Contractor, thus policy covers were extended to provide for these additional obligations of the Contractor (maintenance visits).

The next stage of Risk Transference to the Contractor was that relating to Defective Workmanship or Materials which were introduced during the Construction Period; these were essentially Site Risks and continued to exclude the Manufacturer's

Guarantee and Liability Risks. The requirement was to make good the defective condition as well as Loss or Damage or Liabilities incurred as a direct consequence of the Loss or Damage or Liabilities, but of importance, the discovery or manifestation of damage had to occur during a prescribed period - usually six or twelve months. Accordingly, Wordings of Insurance Policy Operative Clauses and Exceptions were adjusted to absorb the additional risks, except the costs incurred in rectifying the defective condition.

The last stage of this development had two facets to it, firstly the Purchaser or Employer wished to shed any responsibility of recovering from Manufacturers on the grounds that the Legal Nexus was between Contractor and Manufacturer / Supplier and, as ultimate Purchaser, they were not party to that Supply Agreement or Contract. Insurers rightfully pointed out that the Contract Works Policy did not cover the off-site manufacturing risk, nor did the Insurers have any quality control involvement during manufacture. Accordingly, where damage occurred as a result of defective manufacture, the defective machine itself would be excluded.

The second facet involved the Manufacturer making representation to Insurers stating that they were prepared to replace the defective component part but wished to be absolved from responsibility to make good damage to the whole machine. Some Insurers reluctantly agreed to extend policy cover to include these risks and some even went so far as including the defective component part, in other words providing full Guarantee cover.

Today many covers even go to the point of including full Design Plan and Specification cover, that is Professional Indemnity.

The foregoing developments applied equally to Civil and Structural Projects as for Electrical and Mechanical Projects. However, in the case of Building Works there had been a form of contractual responsibility to make good defects and this became the norm in the early 1950s.

Decennial Liability responsibilities on behalf of the Contractor has been Law in France since the early Eighteenth Century.

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Introduction

The Insurance Cover during the Defects Liability Period, otherwise known as the Maintenance Period, following Construction or Erection, has evolved in conjunction with the Contractual Obligations and Responsibilities of the Contractor. Generally, these obligations and responsibilities are similar in most ideal Conditions of Contract. F.I.D.I.C. Conditions will be used for the purpose of this Paper as they are the most widely and generally used Conditions and are reasonably representative of most ideal Contract Conditions.

It has become increasingly apparent that the requirements of the Contract are often ignored or inadequately considered. Unfortunately, Policy Wordings are not always as they are believed to be, often the legal interpretation conflicts with the intentions. In many instances Insurers are the "authors of our their misfortune", in that, for one reason or another, they do not pay adequate attention to Policy wordings nor to Contract Documents.

In many instances Insurers have not had sight of the Contract Conditions and, more particularly, are unaware of any modifications to the Contract by way of Special Conditions of Contract. Accordingly, this ignorance defies their ability and competence to structure the Policy cover appropriately.

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Objektive

The purpose of this investigation is to establish:

- (i) the intended scope and extent of cover;
 - (ii) the period when it is intended to provide indemnity;
 - (iii) whether there should be a cut-off for damage discovery;
- in respect of the Insurance Cover during the Defects Liability or Maintenance Period.

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Background Information

For some time now there has been the perception that all is not as not perceived to be in Defects Liability (or Maintenance) Period Standard Wordings. The Wording deficiency came to the fore when a Claim was notified two years after the expiry of a Contract Works Policy (specifically the Insured Maintenance Period).

The matter was referred to Legal Opinion, the Brief was given to two Senior Counselors. It was alleged that damage occurred to parts of the Contract Works during the Maintenance (or Defects Liability) Period as a result of defective workmanship during Construction and also in consequence of defective specification or procedures during Maintenance Visits.

Both Counselors concurred in the opinion that, to the extent damage could be demonstrated to have occurred during the Maintenance Period, the Insured Contractor would have a legitimate Claim under the Policy. The question of the expiry of the Policy cover was raised. In response, it was stated that the wording did not contain any form of cut-off for the discovery of manifestation of damage. The Legal Advisors suggested that if there is any intention to limit the time for discovery or manifestation of damage, then Policy Wordings should contain an appropriate Clause.

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Investigations

As a preliminary investigation, a selection of International Policies were appraised to establish the nature and style of Cover during the Defects Liability or Maintenance Period. Specifically, the focus was initially directed towards the incorporation of any Manifestation or Discovery Clauses. Thereafter, the scope and nature of cover was considered.

The next stage was to send all IMIA Member Countries a Questionnaire raising a number of pertinent enquiries relative to the subject matter of this Paper. Most Member Countries responded to the Questionnaire and some provided Policy Wordings. In addition, some Members gave commentary relating to the intention of Cover in their Market.

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Findings

Clearly, the basic intention of Cover, subject to minor differences, is similar in all Countries represented at IMIA, with the exception of the United States of America where Defects Liability or Maintenance Period Cover is not generally given. In the USA following Practical Completion of the Construction or Erection Works any ongoing cover generally transfers to the Assets Policy.

A number of interesting factors emerge from the responses:

- Markets are divided as to whether cover should be given for Maintenance Visits only;
- The Markets are divided on the question of providing cover for Defective Design, Plan or Specification, Excluding the Faulty Part;

- Most Markets are willing to provide cover for Defective Design, Plan or Specification, Including the Faulty Part;
- Most Markets are willing to provide cover for Defective Materials or Workmanship, whether Including or Excluding the Defective Part;
- All, except one Country, require that Damage should occur during the Defects Liability or Maintenance Period:
- All Countries intend that Damage should Manifest itself or be Discovered during the Defects Liability or Maintenance Period;
- Most Countries would not accept Claims for Damage Discovered after the expiry of the Defects Liability or Maintenance Period;
- Most Countries' Policy Wordings exclude a Discovery or Manifestation Clause, but do not have any other Clause restricting the period of discovery to the Period of Insurance for the Defects Liability or Maintenance Period;
- All, except one Country, do not provide for Off-Site Manufacturing Risks (including Manufacturers Guarantee) and retain Rights of Recourse against Manufacturers for errors and omissions during manufacture;
- Markets are divided on the question of limiting indemnity to Insured Parties to their interests as Contractors and excluding their interests as Manufacturers;
- The majority of Markets do not intend to provide for Professional Indemnity under the Construction Policy and would retain Rights of Recourse against Professional Parties;
- Where the Contractor is also the Designer, there is a divided view as to whether indemnity would be restricted to his Construction Activities only.

The Wordings considered do not necessarily reflect the responses outlined above. In many instances we came to the conclusion that cover was open-ended as to Discovery or Manifestation, although, clearly, Damage had to occur during the Defects Liability or Maintenance Period.

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Conclusions

Only one of the Wordings appraised contained any form of Discovery Clause. It must, therefore, be assumed that, in respect of most Countries' Policies, discovery can occur at any time after the expiry of the Defects Liability or Maintenance Period. The only qualifying factor is that Damage must be proved to have occurred during the Insured Period. In general, the various National Wordings are not dissimilar. Accordingly, it is suggested that Wordings be standardised to reflect the intentions of the Underwriter. To this end, the following wording parameters are proposed:

1. full defects comprising design, workmanship and materials:-
 - (i) excluding the defective part, or
 - (ii) including the defective part;
2. as in 1 (i) or (ii) above, but:- excluding the Manufacturers' risks, or including the Manufacturers' risks;
3. defects or workmanship and materials only:-
 - (i) excluding the defective part, or
 - (ii) including the defective part;
4. as in 3(i) or (ii) above, but:- excluding the Manufacturers' risks, or including the Manufacturers' risks;
5. any combination of the above including Maintenance Visits;
6. Professional Indemnity to be excluded and where it is intended to be provided, this to be the subject of a separate wording.

The foregoing assumes that the underlying cover during the Construction and Testing (if applicable) period(s) will follow similar terms.

Wordings

Refer to Annexures of suggested wordings covering the alternatives, as outlined above.

Our sincere thanks and appreciation to those members who assisted us by submitting information and policy wordings to enable the completion of this paper.

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ANNEXURE (a)

Defects Liability Cover Construction Insurance

Typical Wording Currently In Use(Excluding the Defective Part and costs relating thereto): (rights of recourse retained against Manufacturers, Designers & Professionals - see General Memorandum)

Operative Clause

The Insurers will indemnify The Insured in respect of fortuitous physical loss of or damage to The Property Insured or any part thereof from any cause not hereinafter excepted:

- a) whilst:
 - i) in Transit
 - ii) in Storage
 - iii) being Constructed

- b) during the contractual Defects Liability or Maintenance Period not exceeding() months but only insofar as The Contractor and/or Sub-Contractor may be liable for loss or damage under the Defects Liability or Maintenance Condition(s) of The Insured Contract.

Dominant Exceptions

The Insurers shall not be liable to indemnify The Insured in respect of:

- 1) the cost of:
 - a) repairing replacing reinstating or making good any part of The Property Insured which is defective in material workmanship design plan or specification. Should any defect in material workmanship design plan or specification give rise to loss or damage which but for this Exception would be insured by this Policy The Insurers shall in respect of such loss or damage only be liable for costs additional to the costs that would have been incurred in replacing reinstating or repairing the defect had the resultant damage not occurred
 - b) re-design modification improvement alteration or overhaul on the occasion of repair replacement or reinstatement of loss or damage
- 2) loss of or damage to the permanent works or part thereof occurring during any Defects Liability or Maintenance Period other than from:
 - i) a cause occurring prior to the commencement of such Period
 - ii) any act or omission of The Contractor(s) or Sub-Contractor(s) in the course of work carried out in pursuance of their obligations with regard to maintenance or defects rectification in terms of The Insured

Contract

provided always that the provisions of i) and ii) above shall apply to new Property Insured

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ANNEXURE (b)

Defects Liability Cover Construction Insurance

Wording - Widest Form{as in Annexure (a)} Modified to Include Discovery: (rights of recourse retained against Manufacturers, Designers & Professionals - see General Memorandum)

Operative Clause:

The Insurers will indemnify The Insured in respect of fortuitous physical loss of or damage to The Property Insured or any part thereof from any cause not hereinafter excepted:

- a) whilst:
 - i) in Transit
 - ii) in Storage
 - iii) being Constructed

- b) during the contractual Defects Liability or Maintenance Period not exceeding () months but only insofar as The Contractor and/or Sub-Contractor may be liable for loss or damage under the Defects Liability or Maintenance Condition(s) of The Insured Contract.

Dominant Exceptions:

The Insurers shall not be liable to indemnify The Insured in respect of:

- the cost of:
 - repairing replacing reinstating or making good any part of The Property Insured which is defective in material workmanship design plan or specification. Should any defect in material workmanship design plan or specification give rise to loss or damage which but for this Exception would be insured by this Policy The Insurers shall in respect of such loss or damage only be liable for costs additional to the costs that would have been incurred in replacing reinstating or repairing the defect had the resultant damage not occurred
 - re-design modification improvement alteration or overhaul on the occasion of repair replacement or reinstatement of loss or damage
 - 2) loss of or damage to the permanent works or part thereof occurring during any Defects Liability or Maintenance Period other than from:
 - i) a cause occurring prior to the commencement of such Period
 - ii) any act or omission of The Contractor(s) or Sub-Contractor(s) in the course of work carried out in pursuance of their obligations with regard to maintenance or defects rectification in terms of The Insured Contract
- provided always that the provisions of i) and ii) above shall apply :
- 1) to new Property Insured

- 2) only where physical loss or damage has been discovered or manifested itself during the Period of Insurance

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ANNEXURE (c)

Defects Liability Cover Construction Insurance

Restrictive clause applicable to annexures (a) & (b) refer particularly sub-clause (c) hereof (reserving rights of recourse against Manufacturers and Professionals)

General Memoranda - Indemnity to Insured Parties:

Subject always to The Terms Exceptions Memoranda and Conditions of this Policy it is hereby declared and agreed that:

- (a) other than work performed or undertaken by The Principal on his own behalf The Contract(s) entered into between The Principal and/or The Contractor(s) and/or Sub-Contractors shall form the basis on which this Insurance is arranged but such Contract(s) shall not override The Terms Exceptions and Conditions of this Policy.
- (b) the indemnity by this Policy shall be granted to The Insured Parties to the extent required by The Conditions of Contract(s) between The Principal and The Contractor(s) and between The Contractor(s) and Sub-Contractor(s) whilst engaged on The Contract Site in performance of The Insured Contract(s) of whilst the Property Insured is in transit (including loading and unloading) or whilst such Property Insured is temporarily situated at other Premises as provided for herein
- (c) in respect of Manufacturers or Suppliers or Independent Project Managers Consultants Engineers Architects Quantity Surveyors and other Professional Party who may be deemed to be included as an Insured under this Policy The Insured by this Policy shall not apply in respect of loss damage or liability arising from their Professional Activity or Off-Site Manufacturing which should be insured under an appropriate Insurance Policy or Policies
- (d) nothing contained in this Policy shall preclude any Party named herein as The Insured to proceed against any other Parties named as The Insured for loss damage or liability arising directly or indirectly from any Un-Insured Activity or Activities

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ANNEXURE (d)

Defects Liability Cover Construction Insurance

- 2) CONTINUED {ANNEXURE (b)} (Excluding Design Plan Specification and Manufacture during Maintenance Period). Add to Exception 2 Provisos
3. only to loss or damage originating at The Contract Site arising out of and as a direct consequence of defective materials or workmanship but excluding any costs incurred directly or indirectly from any deficiency in design plan or specification or off-site manufacturing process or any consequences thereof.

To provide full cover for Defective Part and Consequence following damage to

other sound parts replace Exception 1a) by the following (cover during Construction and Maintenance)

A a) repairing replacing reinstating or making good any part of The Property Insured which is defective in material or workmanship design plan or specification. Should any defect in material or workmanship design plan or specification give rise to loss or damage which but for this Exception would be insured by this Policy The Insurers shall in respect of such loss or damage indemnify The Insured for cost(s) of repairing replacing or reinstating such loss or damage as well as the costs of repairing replacing or reinstating the defective part

To be added as 1c) where it is intended to exclude design and consequences thereof throughout the Construction and Maintenance Periods (where this Exception is included the appropriate words are to be deleted from 1a):

repairing replacing reinstating or making good any defective design plan or specification or any consequence thereof whether incurred directly or indirectly

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