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# Construction all risks (CAR) defects exclusions

UK Construction Insurance



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# Why CAR defects exclusions matter more than ever



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Understanding defects exclusions under construction all risks (CAR) policies first require clarity on several core concepts. Before we investigate these interesting clauses further there are some important concepts that needed to be addressed which will frame the discussion.

## Introduction

The first of these areas is the nature of a CAR wording, an area to which we alluded in our [introductory article](#). CAR is short for construction all risks, which can be a misleading description for a policy that plainly does not cover all eventualities. In this context, the term “all risks” refers to the structure of the policy, whereby the insured is covered for all risks of damage except those that are expressly excluded. This contrasts with a “specified perils” insurance policy which only covers those losses arising out of a finite and pre-determined list of causes. In concept, an all risks policy starts covering everything and then narrows inwards, whereas a specified perils policy starts with no cover and works outwards.

This all risks concept is particularly important in relation to defects exclusions. As these are all exclusions, they take away cover from that “all risks” position. They are not extensions and therefore do not add cover to the policy. The critical point here is that the policy only covers damage, so the application of any exclusion can only narrow this position as opposed to broaden it.

The next step is to clarify what is meant by damage. The best descriptions normally reference the concept that there is a detrimental physical change in state of material or tangible property. This recognises that there is something good that has subsequently gone bad through some external or internal factor. We will address this area in more detail towards the end of this article where we look at cases that have influenced the interpretation of the DE & LEG clauses.

Property being damaged has to be seen as independent to it being in a solely defective condition. I find it helpful to think of this using the following diagram. There are four separate states where defect and damage can coincide, and it is useful to consider examples of each in the context of construction projects.

	Defective	Not Defective
Damaged	<p><b>Damaged &amp; Defective</b></p> <p>A concrete retaining wall is designed with insufficient steel reinforcement. Shortly after completion, following heavy rainfall, a section of the wall fails, cracking in several places and becoming displaced by the weight of the ground.</p>	<p><b>Damaged &amp; Not Defective</b></p> <p>This is a common situation. High winds damage a blockwork wall, which would not be defective assuming the wind speed was in excess of those for which the wall was designed to resist.</p>
Not Damaged	<p><b>Not Damaged &amp; Defective</b></p> <p>The steel frame of a light industrial unit was designed to be coated with intumescent paint once erected, but the contractor erroneously used a non-intumescent fire-retardant paint. The steel and paint are not damaged but are defective as the paint does not meet the correct specification.</p>	<p><b>Not Damaged &amp; Not Defective</b></p> <p>Fortunately, most construction projects comprise works which are neither defective nor damaged. These are of no concern to construction insurance practitioners!</p>





# Understanding DE clauses

Armed with this knowledge, we can now start to investigate the common defect clauses used in the construction insurance market. There are two key suites of clauses, which are generally (but not exclusively) used for different types of projects. These are as follows:

## **DE Clauses**

Five separate variants which are commonly used on building and civil engineering projects

## **LEG clauses**

Three separate variants which are commonly used on engineering projects

We are not seeking to analyse these clauses on a word for word basis, but we will look at the net impact and the differences between each variant.



Clause	Summary
<p><b>DE1: Outright Defects Exclusion (1995)</b></p> <p>This Policy excludes loss of or damage to the Property Insured due to defective design, plan, specification, materials or workmanship.</p>	<p>This is a complete exclusion of all damage arising from defective work, be that in design, workmanship or materials.</p> <p>This is a very restrictive position and is only seen on basic policies or those for extremely poor or prototypical risks.</p> <p>Equates directly to LEG 1/96</p>
<p><b>DE2: Extended Defective Condition Exclusion (1995)</b></p> <p>This Policy excludes loss of or damage to and the cost necessary to replace repair or rectify</p> <ul style="list-style-type: none"> <li>a) Property Insured which is in a defective condition due to a defect in the design, plan, specification, materials or workmanship of such Property Insured or any part thereof</li> <li>b) Property Insured which relies for its support or stability on a) above</li> <li>c) Property Insured lost or damaged to enable the replacement repair or rectification of Property Insured excluded by a) and b) above</li> </ul> <p>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.</p> <p>For 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 the design, plan, specification, materials or workmanship in the Property Insured or any part thereof.</p>	<p>This is a narrower exclusion than DE1 as it only excludes the defective work and those elements which rely upon it for support. For example, if a bridge deck relies on a defective pier for support, any damage to the deck resulting from the defective pier would be excluded. However, if the bridge deck collapsed and damaged other non-dependent works on site this would not be excluded.</p> <p>In the final paragraph, DE2 reinforces the concept that damage and defect are to be considered separately, and that defective conditions themselves do not constitute damage.</p> <p>As with DE1, these clauses are rare, with most entry level policies starting with DE3 coverage (see below).</p>

Clause	Summary
<p><b>DE3: Limited Defective Condition Exclusion (1995)</b></p> <p>This Policy excludes loss of or damage to and the cost necessary to replace repair or rectify</p> <ul style="list-style-type: none"> <li>a) Property Insured which is in a defective condition due to a defect in the design, plan, specification, materials, or workmanship of such Property Insured or any part thereof</li> <li>b) Property Insured lost or damaged to enable the replacement repair or rectification of Property Insured excluded by a) above</li> </ul> <p>Exclusion a) above - shall not apply to other Property Insured which is free of the defective condition but is damaged in consequence thereof.</p> <p>For 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 the design, plan, specification, materials or workmanship in the Property Insured or any part thereof.</p>	<p>This clause is a further development of the restrictive DE1 and DE2 clauses. The coverage excludes damage to property that is defective, but the exclusion does not apply to other non-defective insured property that is damaged as a result. For instance, in the DE2 example above, if the bridge deck was damaged as a result of a defective pier, the policy would respond to the damaged deck. The critical subtlety between DE3 and DE4 (see below) is understanding the difference between the covers as they can, on the surface, appear to be very similar.</p>
<p><b>DE4: Defective Part Exclusion (1995)</b></p> <p>This Policy excludes loss of or damage to and the cost necessary to replace repair or rectify</p> <ul style="list-style-type: none"> <li>a) Any component part or individual item of the Property Insured which is defective in the design, plan, specification, materials, or workmanship</li> <li>b) Property Insured lost or damaged to enable the replacement repair or rectification of Property Insured excluded by a) above</li> </ul> <p>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.</p> <p>For 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 the design, plan, specification, materials or workmanship in the Property Insured or any part thereof.</p>	<p>As we have suggested above, there is a very close similarity between the DE3 and DE4 exclusions. The difference is to be found at the start of sub-clause (a).</p> <p>Whereas DE3 excludes property insured that is defective, DE4 restricts this to the component part or individual item which is defective. This can provide a greater extent of cover for works that are damaged in consequence, as the exclusion is more restricted.</p> <p>As an example, defective bolts in a steel frame might render the entire frame as defective under DE3, whereas the DE4 exclusion would be limited to the bolts themselves.</p>

Clause	Summary
<p><b>DE5: Design Improvement Exclusion (1995)</b></p> <p>This Policy excludes:</p> <ul style="list-style-type: none"> <li>a) The costs necessary to replace repair or rectify any Property Insured which is defective in the design, plan, specification, materials or workmanship</li> <li>b) Loss or damage to the Property Insured caused to enable replacement repair or rectification of such defective Property Insured.</li> </ul> <p>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.</p> <p>For 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 the design, plan specification materials or workmanship in the Property Insured or any part thereof.</p>	<p>This is the most favourable of DE clauses to the insured. The clause does not exclude damage to defective work and only excludes the cost of improving the defect. For example, if a concrete column is under designed in respect of steel reinforcement, the policy will deal with any consequential damage and only exclude the cost of the additional materials to correct the original design error.</p>



# LEG clauses explained and why they're not always the same as DE

Clause	Summary
<p><b>LEG 1/96 Model “Outright” Defects Exclusion</b></p> <p>The Insurer(s) shall not be liable for loss or damage due to defects of material workmanship, design, plan or specification.</p>	<p>This is a complete exclusion of all damage arising from defective work, be that in design, workmanship or materials.</p> <p>This is a very restrictive position and is only seen on basic policies or those for extremely poor or prototypical risks.</p> <p>Equates directly to DE1.</p>
<p><b>LEG 2/96 Model “Consequences” Defects Wording</b></p> <p>The Insurer(s) shall not be liable for all costs rendered necessary by defects of material, workmanship, design, plan or specification. 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.</p> <p>For 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.</p>	<p>LEG 1/96 is analogous with DE1 and LEG 3/06 is analogous with DE5, so it is tempting to assume that LEG 2/96 matches with either DE 2, 3 or 4.</p> <p>However, the basis of coverage is completely different. LEG 2/96 invites us to assume what remedial works would have been required to correct the defect had the damage not occurred. This is the cost that is excluded from the claim.</p> <p>We can compare this to the DE4 example provided above, again considering defective bolts in a steel frame resulting in a collapse. The cost which would be excluded is the cost of replacing the bolts immediately prior to the collapse event, which is equivalent to DE4.</p> <p>However, in different circumstances the extent of indemnity can vary dramatically, especially if any resultant damage would be included within the notional cost of defect rectification prior to the damage occurring.</p> <p>Let us use road construction as an example; defectively compacted sub-base has failed causing cracking to the base and surface courses.</p> <p>DE4 will exclude the defective sub-base but will not exclude the resulting damage to the other non-defective components (base &amp; surface courses).</p> <p>LEG2, however, will exclude the cost which would have been incurred to rectify the defective sub-base immediately prior to the loss. In this instance the costs associated with excavating and replacing the two upper courses would also be excluded as such damage would be inevitable to enable the repair to the sub-base (unless the sub-base can be rectified from below!).</p>

Clause	Summary
<p><b>LEG 3/06 Model “Improvement” Defects Wording</b></p> <p>The Insurer(s) shall not be liable for all costs rendered necessary by defects of material, workmanship, design, plan or specification. Should damage (<i>which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property</i>) occur to any portion of the Insured Property containing any of the said defects, the cost of replacement or rectification – being the cost incurred to improve the original material, workmanship, design, plan or specification.</p> <p>For 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.</p>	<p>This is the most favourable of LEG clauses to the insured. The clause does not exclude damage to defective work and only excludes the cost of improving the defect. For example, if a concrete column is under designed in respect of steel reinforcement, the policy will deal with consequential damage and only exclude the cost of the additional materials to correct the original error.</p> <p>The text highlighted in the clause section was introduced in 2006 to provide clarification following the Skanska v Egger case (see below).</p>

## Current use

As the breadth of defects coverage increases, so do the excesses and deductibles that apply. You will see a much higher excess for DE5 and LEG 3/06 coverage to account for the greater loss potential faced by insurers. Nevertheless, these coverage/excess options can result in inequitable results where insureds benefit less having paid for wider coverage as the excess is higher.

To address this problem, it is now common for London market CAR policies to contain several defects clause options, which the insured can select during the course of a claim. This provides flexibility of coverage where, for example, DE3 with a £50,000 excess will deliver a greater indemnity than DE5 with a £250,000 excess.



The broadest cover available under these “hybrid” wordings is provided by an option involving DE5, LEG 2/96 and DE4.

# Three court cases that changed the market

## Judgements that have impacted policy interpretation

It is tempting to think of these clauses and concepts as fixed, but this can be dangerous, as the application of wordings is dynamic and always subject to the interpretation of the courts. There have been a number of cases addressing defects clauses which have been interesting in their contrasting interpretation of what is damage and what is a defect. It is worth investigating these in more detail to gain some more context to the continuing evolving interpretation of defects exclusions.

### Case study 1: Skanska v Egger (UK)

In the late 1990s, Egger engaged Skanska to design and construct a wood chipboard manufacturing facility in Scotland. There were problems with the project and losses incurred as a result of defects. A part of the ensuing dispute centred upon whether the insurance arranged by the employer provided adequate protection to the contractor. This policy included the DE3 exclusion, and Skanska argued that had DE5 cover been purchased, the loss would be indemnified by the insurance market. The point before the court centred on whether the employer's policy was adequate, as opposed to whether the loss would be covered under DE5 (it being accepted that DE3 excluded the claim).

The appellate court handed down its judgement in 2002 and found in favour for Egger that DE3 was an acceptable form of cover to have provided. Nevertheless, the court noted, *obiter dicta*, that even had DE5 been utilised,

the "damage" as we would have understood it would not have been covered as it was simply the manifestation of the defect and did not constitute damage.

This unhelpful and unnecessary intrusion by the court resulted in a temporary panic where suddenly the well-established market understanding and the equilibrium was upset. The LEG 03 clause was amended (see above) to add clarity and there was a lot of discussion whether DE5 also needed amending. Some insurers were indicating that they would follow the Skanska v Egger decision and some expressed a wish to ignore it. There was talk of brokers signing insurers up to memoranda of understanding before further business could be placed. Ultimately, the situation settled, and everyone resumed their activities as though nothing had occurred.



## Case study 2: South Capitol Bridgebuilders v Lexington Insurance Company (US)

This is a more recent case where South Capitol Bridgebuilders (SCB) presented a claim under its CAR policy where it had experienced “honeycombing” of concrete following a pour. In the UK, this condition is normally accepted to be a defect in formation of the concrete as opposed to be considered as a change in the state of completed works. On this basis, it is not usually considered to be damage within the terms of a CAR policy and specifically as the trigger to a claim under DE or LEG clauses.

SCB incurred significant additional costs in replacing elements of the bridge support structures that manifested as a result of the honeycombed concrete. In this case, brought in the US, the court was persuaded by SCB’s arguments and found that the insurer was liable for the loss. This has led to a widespread review of the use of LEG 3/06 on US business. SCB may ultimately find this to be a pyrrhic victory if insurers decline to offer LEG 3/06 coverage in future due to this unfavourable ruling.

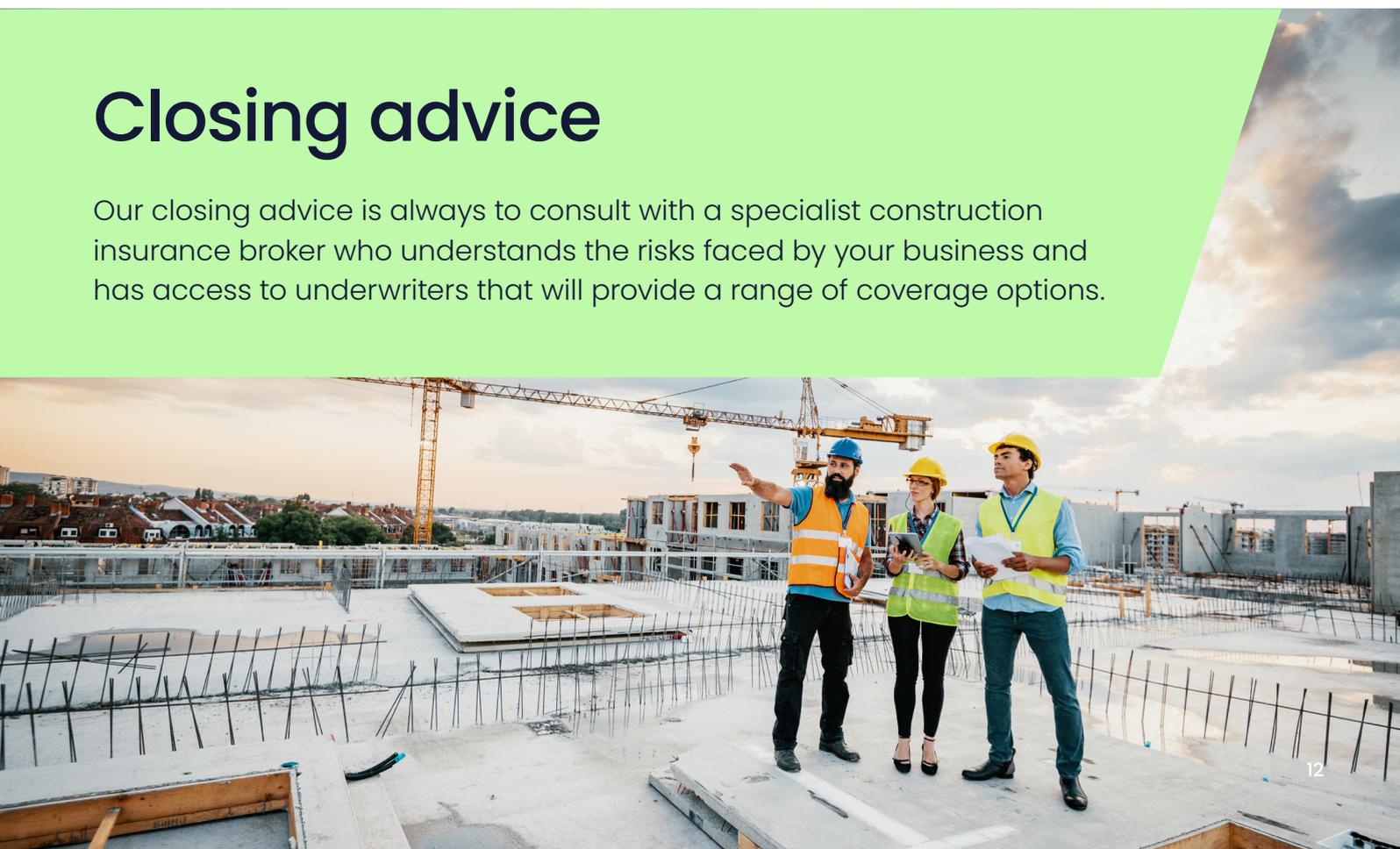
In February 2024, this ruling was followed in a Florida court and it will be interesting to see how this interpretation propagates through the US market and whether there is a possibility for application in other jurisdictions.

## Case study 3: Archer Western v Ace (US)

The South Capitol judgement was followed quite quickly by this hearing for summary judgment on the LEG 3 wording. The insured was undertaking an infrastructure project where concrete had become contaminated with fly ash. The court dismissed the insurer’s application for summary judgment and, referring to South Capitol, found that the exclusion did not apply as the concrete was deemed to be damaged as opposed to being simply defective. Again, this is a departure from how defects exclusions have been applied in the UK.

# Closing advice

Our closing advice is always to consult with a specialist construction insurance broker who understands the risks faced by your business and has access to underwriters that will provide a range of coverage options.



# Sources

## **Skanska v Egger**

<https://www.casemine.com/judgement/uk/5b46f1fb2c94e0775e7ef572>

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<https://www.fenchurchlaw.co.uk/the-worlds-first-leg3-court-decision-and-what-it-means-for-the-builders-risk-market/>

## **Archer Western v Ace**

<https://fenchurchlaw.com/archer-v-ace-or-the-demise-of-leg3/>