

Following the Court of Appeal decision in *Seele Austria GmbH & KG -v- Tokio Marine Europe Insurance Ltd* (7th May 2008) are Construction All Risks insurers providing a guarantee to contractors against defects in respect of workmanship? John Farrell, Partner, of Kennedys hopes to provide some assurance to the market.

Background

The case concerned coverage under a Combined Contract Works (Construction All Risks or 'CAR') and Third Party Liability policy. In dispute was an indemnity claimed by a subcontractor in respect of the cost of the rectification of defective windows in an office development in Paternoster Square, London. The insurers denied cover for a number of reasons. At first instance Mr Justice Field agreed that there was no indemnity under the policy in the absence of accidental damage to the works. His decision was overturned on this point by the Court of Appeal. However, the Court of Appeal held that a separate deductible applied each defective window. This case could have wider implications for the CAR market. Issues often arise as to what cover is available when defects are discovered during the construction phase and whether multiple deductibles can be relied upon by insurers when there is defective workmanship.

The facts

The Claimant, Seele entered into a trade contract with the main contractor, BLS Martins Ltd (BLS) under which it was to design and install windows at a site. "Punched" windows were to be installed in spaces between vertical load bearing concrete columns and horizontal concrete floors. The windows had been assembled off site and had also been successfully tested off site in a laboratory. However, when a number of the installed windows were tested in situ against water penetration, they failed and leaked. Consequently, the cladding had to be removed and internal wall and ceilings had to be opened up in order to allow access to the defective windows and for remedial works to undertaken.

The CAR policy

The policy was in the form of a Contractors All Risk Policy which was taken out by the Developer, Paternoster Associates. The policy provided for three groups of Insured. The third group of Insured ("Insured (3)") included all other Contractors and/or Sub-Contractors, who were covered by Section 1 of the policy and to the extent stated in Memorandum 15 of the policy. The Claimant fell within this group.

Memorandum 15 of the policy provided that the indemnity provided to the Insured (3) under the insuring clause was, "in respect of any works carried out by them for which they are responsible which are lost or damaged due to a defect in design plan or specifications materials or workmanship", restricted to the extent provided for by Memorandum 18(2) and (3).

Memorandum 18 was titled “Design Workmanship and Materials”.

Memorandum 18(2) operated to exclude from the “the cost necessary to replace repair or rectify (a) Insured Property ... which is in defective condition due to a defect in design plan specification materials or workmanship of such Insured Property or any part thereof...”. However, the last sentence of that clause contained a saving provision which stated: “2(a) shall not apply to other Insured Property which is free of the defective condition but which is unintentionally damaged in consequence thereof ... ”.

In essence, Memorandum 18(2) corresponds to a standard form of defects exclusion clause known in the construction insurance market as ‘DE3’ or the ‘Limited defective condition exclusion’. Such clauses exclude from the scope of cover the costs of repairing or rectifying property which itself is in ‘defective condition’, but do permit recovery for damage to ‘other’ insured property which is damaged in consequence of the defect, so long as this is otherwise covered by the policy. Accordingly, in order for the assured to recover under such a clause, fortuitous damage must occur to some other part of the works.

Memorandum 18(3) provided: “(3) The Insurers will additionally indemnify the Insured in respect of intentional damage necessarily caused to the Insured Property... to enable the replacement repair or rectification of Insured Property... which is in a defective condition...” This indemnity was subject to deductible for the first £10,000 “of the cost of each and every occurrence or series of occurrences arising out of any one event”.

The issues

The Claimant sought to recover under Memorandum 18(3) for the damage intentionally caused to the stone cladding and internal finishes in order to allow access to repair the defective windows.

The main issue before the Court of Appeal was whether Memorandum 18(3) operated as a free-standing provision providing additional cover to the sub-contractor, or whether it was conditional upon the operation of the defects exclusion in Memorandum 18(2) and hence subject to a requirement that there be some accidental loss or damage to bring the indemnity into play.

A secondary issue - but one of potential importance to the parties - was whether the retained liability limit in Memorandum 18(3) applied to the workmanship deficiencies in respect of each individual window (as the insurer contended), or whether, instead, the defects could be aggregated so that there was a single deductible in respect of the entirety of the remedial work (as the Claimant contended).

The Court of Appeal decision

It was held by a majority (Lord Justices Moore-Bick and Richards, Lord Justice Waller dissenting) that Memorandum 18(3) operated as a stand-alone indemnity

and was not subject to the operation of the rest of the Memorandum. Therefore, whereas Memorandum 18(2) required there to be accidental damage consequent on a defect, under Memorandum 18(3) the assured subcontractor was entitled to an indemnity for damage deliberately caused to the works to gain access to remedy a latent defect even in the absence of any accidental damage. Lord Justice Moore-Bick recognised that Memorandum 18 was on the whole “a difficult provision to construe” and that it “bears the hallmarks of a provision which has been fashioned from various different clauses rather than having been drafted as a single integral whole”. Nonetheless, he held that Memorandum 18(3) should be construed quite literally and independently of the rest of the clause.

With respect to retained liability, however, the Court held that a separate deductible applied under Memorandum 18(3) in respect of each defective window. Lord Justice Moore-Bick reasoned that since poor workmanship was to blame for the leaks, in the absence of evidence that the mistakes were attributable to a single event, it could not be said that the series of defects arose “out of a single event”. This was an important finding for the parties as multiple deductibles in respect of the numerous windows could potentially reduce the value of the claim by a substantial degree.

Discussion

It is widely assumed that there needs to be some form of accidental damage to the works before a CAR policy will respond. Yet the upshot of the Court of Appeal’s decision in this case was that an assured subcontractor was able to recover access costs for work to remedy a series of latent defects despite the fact these defects had yet to actually cause any damage to the property. This result may cause some alarm for underwriters of CAR policies. Would the same result happen if one had DE3 and not the bespoke Wording in this case?

Despite the decision of the Court of Appeal, the answer to this question is ‘no’ - so long as the standard ‘DE’ wording is adopted. The present case was decided very much on the particular bespoke wording of the policy. The subcontractor was only able to recover because: (1) the policy included an additional indemnity for intentional damage to the works necessarily caused to allow a defect to be remedied, and (2) that additional cover was drafted (mistakenly or otherwise) as a stand-alone indemnity and not subject to the occurrence of accidental damage to the rest of the works.

Importantly, the Court of Appeal confirmed that the claimant would not on these facts have been able to claim under Memorandum 18(2) (which corresponds to the standard defects exclusion clause ‘DE3’). So far as the removal of the stone cladding and internal finishes to gain access to the windows was concerned, this was not covered by the savings provision in the defects exclusion clause because it was intentionally caused damage. So far as the defective windows were concerned, Memorandum 18(2) would not have responded because the faulty sealing had yet to cause damage to any other part of the works. Lord Justice Moore-Bick rejected the Claimant’s argument that pin-holes made in the sealing membrane by the Claimant’s workmen constituted ‘damage’ to the works: this was to be regarded as

“part and parcel of inherently faulty workmanship rather than as consequential damage”.

The decision confirms that it is paramount that the policy wording is clear in stating what is covered and what is not covered. There must be careful consideration of the construction project as a whole and the type of cover required by sub-contractors. It may be that the policy wording in this case failed to reflect the cover that was intended to be provided. If, indeed, the intention had been to make the indemnity for access damage to remedy defective works conditional upon there being damage to which Memorandum 18(2) responded, an error was certainly made in the numbering of that clause. Perhaps, one can surmise, the ‘auto-numbering’ feature of modern word-processing software was to blame.

The case also provides practical guidance on the application of retained liability provisions in construction insurance claims. It is quite common for a series of design flaws or repeated cases of bad workmanship to arise in a single property - so that several of the, say, roofing slabs or electricity fittings are affected. Where these defects cause a cascade of instances of damage, the question will arise under a standard retained liability provision as to whether that damage is a single “occurrence or series of occurrences arising out of any one event”. The judgment of Lord Justice Moore-Bick makes it clear that the mere fact that the same mistake by workman is repeated over and over again is not enough to find that there has been “one event” for these purposes. But the result would have been different had the poor workmanship been attributable to a single event “such as giving the workmen wrong instructions which they then conscientiously followed so as to produce a series of similar defects”. By the same logic, it seems that had the leaking been wholly attributable to a design defect in the manufacture of the window units, the Claimant might have succeeded in arguing for a single deductible for the totality of the damage caused by the windows.

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