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Will Builders Risk Get “LEGs”?

It can be very complicated to figure out from a pile of rubble whether a construction loss resulted from an insured peril or from faulty workmanship that is typically excluded.

Traditionally, construction insurers have excluded coverage for any defect in the design, materials, or workmanship of a project, but it has become common practice to provide first-party coverage for damage to insured property arising from an error or defect, if the damage is caused by an insured peril that ensues from the error of defect.

Insurers and contractors are well aware that very large losses—e.g., building fires—can result from very small errors—e.g., using the wrong rated wiring. When the stakes are big enough, the resulting claims involve very costly forensic investigation and coverage litigation.

For that reason, London-based insurers of construction and engineering projects developed a tiered approach 30 years ago to excluding or providing coverage for losses arising from faulty workmanship.

In the mid-1990s, the London Engineering Group (LEG), an adjunct of the Association of British Insurers, developed three exclusions for losses arising from faulty workmanship or design, but providing progressively more coverage to the insured by limiting the scope of the exclusion.

LEG1, 2, 3

LEG1 is the most restrictive for the insured, as it excludes coverage for all loss or damage “due to defects

of material workmanship, design plan, or specification,” whether damage to other property has occurred or not.

LEG2 excludes coverage for all loss or damage “due to defects of material workmanship, etc, ...” but maintains coverage for insured property damaged by the defect, except for the cost that would have been incurred if the replacement or rectification had been done before the damage.

LEG3 excludes coverage for all loss or damage “due to defects of material workmanship, etc, ...” but provides broader coverage for insured property damaged by the defect by limiting the exclusion to the cost “incurred to improve the original material workmanship, design plan or specification.”

LEG2 and LEG3 each contain an additional provision stating that it is “understood and agreed” that insured property shall not be considered damaged “solely by virtue of the existence of any defect of material workmanship, etc...”

While providing progressively more coverage to the insured, the LEG exclusions seek to adhere to the principle of indemnity and maintain the cost of correcting a defect as an uninsurable enterprise risk.

North America

Observers agree that language like that in the opening sentence is appearing in more and more policies covering construction and installation projects in the U.S.

Although LEG endorsements are still rarely used in the United States, they are being seen more and more often in

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North America as common features of policies covering large construction projects in Canada and in the North American components of the master policies of major European firms.

Perhaps more importantly, knowledgeable brokers and risk managers are becoming aware of the choices provided by LEG endorsements and are asking for them, or something analogous to them.

“There is a growing understanding among sophisticated brokers and risk managers of how LEG 2 and LEG 3 can avoid big claims coverage litigation,” says Tracy Alan Saxe, an insurance coverage attorney at Saxe Doernberger & Vita and an expert on faulty workmanship claims who represents policyholders.

According to Saxe, the use of LEG endorsements is becoming more common for projects in the U.S. energy sector and increasingly sought in civil and building construction by sophisticated general contractors, construction managers and developers and brokers.

Mark Katz, an attorney with Mound Cotton Wollan & Greengrass, who represents builders risk carriers, agrees that LEG provisions are showing up more often in policies covering risks in the United States.

Katz adds, however, that that is principally because those policies are written overseas for European and Asian contractors in the energy sector developing projects in North America.

“I still do not see LEG endorsements too often, but I’m certainly seeing them more than I used to,” he says. “I don’t believe it’s because they are used more often. Instead, policies issued overseas that include those endorsements are showing up more often on U.S. risks.”

Engineered

LEG endorsements are also starting to appear in policies on large construction projects, especially those written on a subscription basis, according to Geoffrey Miller, senior vice president of inland marine for AIG.

“I don’t see the LEG wording very often in my world,” he says, “because we typically focus on basic four-walled constructed buildings with a total completed value of less than \$50 million.

“Our construction group, which focuses on much larger and heavily engineered risks, typically in excess of \$100 million, sees them quite regularly.”

According to Katz, builders’ risk carriers in the U.S. generally seem satisfied with the approach that has evolved in this country to excluding faulty workmanship while covering ensuing losses from insured perils, and are not pushing to change established understandings.

As an example of the U.S. approach, the AAIS Builders’ Risk exclusion for “Defects, Errors, and Omissions” excludes coverage for loss or damage arising from “an act, defect, error or omission” related to a range of planning, design, and operational activities.

However, if the act, defect, error or omission results in a covered peril, the loss or damage caused by that peril is insured.

“Although the wordings vary, U.S. policies generally cover ensuing losses from a separate peril,” Katz says. “They do not cover the cost of correcting a defect, or damage caused directly by that defect, without some covered ensuing peril.”

“Insurers from the U.S. never pick up the cost of correction,” he adds. “I don’t see LEG endorsements creeping into U.S. policies at this time.”

Benefits

Saxe, who represents insureds in builders risk claim disputes, says the LEG endorsements provide benefits to carriers, as well.

The worst scenario facing builders risk carriers, he says, is to believe there is no coverage for a loss related to faulty workmanship, only to learn after costly litigation that part of a loss—perhaps most—is, in fact, covered.

“The more certainty you have regarding the exposure, the more accurately you can underwrite and rate it,” he says. “With that there will be less litigation, and lower litigation costs.”

Saxe acknowledges, however, that it appears that it will be quite some time before LEG endorsements or a U.S. equivalent are a common feature of U.S. builders’ risk policies. ■