INSURANCE & REINSURANCE | FEBRUARY 2024

LEG 3 - HAS AMERICA SNEEZED?

We have recently seen a further eyebrow raising decision on LEG 3 (a defects exclusion/write back) under a Construction All Risks ("CAR") policy coming out of the US, the second in only three months. These will attract some attention for insurance market participants in other jurisdictions because of the dearth of reported LEG decisions, partly because such issues usually arise in the context of arbitrations which do not get reported. When America sneezes, sometimes the world can catch a cold, but insurers in this area may be hoping that is not the case here.

Background

CAR policies provide cover for all risks of loss and damage on a building or construction project but will usually exclude coverage for certain matters such as design errors or workmanship mistakes, to varying degrees.

The LEG defects clauses provide three alternative exclusion wordings for CAR policies. The widest exclusion (i.e. providing the least coverage) is LEG 1 – which provides that the insurer "*shall not be liable for Loss or Damage due to defects of material workmanship design plan or specification.*"

The clause that offers the narrowest exclusion/the most cover is LEG 3. It is often referred to as "full defects design cover". The 2006 version states:

"The Insurer(s) shall not be liable in respect of:

All costs rendered necessary by defects of material workmanship design plan or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property) occur to any portion of the Insured Property (Contract Works) containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification

For the purpose of 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."

Reed[1] notes that the general scheme of LEG 3 is that:

- there is a general exclusion of costs rendered necessary by a defect of material workmanship design plan or specification;
- but if damage occurs to a portion of the insured property that contains the defect there is a more limited exclusion; then the exclusion applies only to the cost incurred to improve the original defect.

However, how exactly all elements of the LEG 3 provision would be interpreted by a court has not been in all respects clear. This is due in part to the fact that most cases are arbitrated so there has been no judicial interpretation.

We have now had two decisions in the US courts, which in both cases favoured the insured. In this article we explore the most recent of the two.

Archer Western – De Moya Joint Venture v Ace American Insurance Company

This matter was before the Southern District of Florida Miami Division District Court.

[1] Construction All Risks Insurance 3rd edition

The construction works consisted of an improvement of roadways in Miami, including the building of a signature bridge. The insurer issued a builder's risk policy to the design-build contractor, which contained a LEG 3 extension[2].

The concrete being used for the project was mixed by the insured with excessive amounts of fly ash due to a defect in equipment at the insured's plant, and as a result the concrete used in some of the project was of lesser compressive strength[3]. Various project components that the concrete was poured into failed to meet the required 28-day compressive strength test. As a result, it was necessary to strengthen or re-pour the concrete.

The insured sought to make a claim under the policy, governed by Florida law for the costs of performing work on the bridge components built with inadequate concrete, and this was rejected by insurers on the basis that defective initial construction is not "*physical loss or damage*" and that the work carried out by the insured was an improvement. The insured brought a claim, and this judgment related to a summary judgment application by the insurers to strike that out.

Damage

The policy insured against "*all risk of direct physical loss or damage*". Insurers sought to argue that the bridge elements did not sustain a distinct, physical, tangible alteration, following locally applied case law. The LEG 3 extension defined "*damage*" as something involving more than damage "*solely by virtue of any defect of material, workmanship, design, plan or specification*". Defective initial construction was not damage under the policy, according to insurers, and therefore it had not been triggered.

Insurers pointed to previous Florida case law arising in the context of COVID-19 which determined that damage must involve an "actual" and "tangible" alteration to the property. Insurers also cited *Trinity Indus v Ins Co of N Am* which applied Louisiana law to a similar clause, in which it was determined that physical loss or damage strongly implies an initial satisfactory state that was changed by an external event into an unsatisfactory state. Applying this to the current facts, insurers argued that this was not a scenario in which the defective components collapsed and destroyed other property and there was no event that that changed the concrete in the bridge components from a satisfactory state to unsatisfactory one.

The Judge referred heavily to the decision of the District Court of Columbia, applying the law of Illinois in *South Capitol Bridgebuilders v Lexington* (*"SCB"* dated 29 September 2023) - the other recently reported LEG 3 decision - to similar facts and noted that the insurer's arguments on damage had been categorized as unpersuasive in that case, which could apply here too:

- Insurers had not explained how concrete that failed its 28-day test is anything other than a compromise to the physical integrity of the bridge components. According to the insured's expert[4], the cement mix and the fly ash had each been in a satisfactory state before being combined in the process of making concrete, and the mix suffered damage when it was contaminated with the fly ash.
- The *SCB* Court rejected case authorities relied on relating to COVID-19, and found that they undermined the insurer's position because coverage had been rejected on the basis that what was required was compromise to the physical integrity of the insured property.
- The insurers in this case had already accepted that there was coverage for certain adjacent project components that became encapsulated in or adhered to the damaged concrete, which had to be reinforced or torn from the concrete structures and replaced, and this was inconsistent with there being no coverage for the current claim.

LEG 3

The LEG 3 provision operated by deleting certain existing exclusions and replacing them with a narrower (less severe) exclusion and an additional deductible. As set out above, the LEG 3 cover authorised replacement or repairs for costs created by defects of material, workmanship, design, plan or specification, but does not cover costs to improve the original material, workmanship, design, plan or specification.

The Court noted the arguments in *SCB* that LEG 3 was ambiguous. In particular, did the word "*improve*" refer to improvement as compared to how the final design of workmanship was supposed to be, or improvement as compared to how it turned out to be?

---

[2] The relevant clause was materially the same as LEG 3/96 ie did not contain the additional words in LEG 3/06 which indicate that damage for the purposes of the exclusion will include any patent detrimental change in the physical condition of insured property.

[3] The root cause of the subject's low compressive strength appears to have remained in dispute

[4] Although the expert evidence was questioned by the insurers in a motion to exclude testimony, but this was denied on the basis that the issues were to be determined at trial

Following the *SCB* decision it was noted that the LEG 3 language does not suggest that property could not be damaged if there were defects in material workmanship somewhere in the causal chain, but that defects of material workmanship in and of themselves are insufficient to constitute damage.

The insurers in this matter sought to distinguish *SCB* by arguing that in *SCB* there was damage to property other than the defective concrete, as in that case the bridge built with honeycombed concrete had suffered a reduction in weight bearing capacity. In this case there was no allegation that any other properly constructed elements suffered in this way. Insurers argued that the facts involved defective concrete pours and nothing more, therefore the insured was seeking costs to rectify defective material and workmanship. Further, the repairs were to improve the property. Therefore, they argued, coverage was excluded. The insured argued that it was seeking cover for damage caused by the defective work, not solely the defective work, relying in its expert evidence, and that these were repairs not improvements.

In relation to the issue of improvement, the Court found that the term "improve" was ambiguous and so must be construed against insurers.

The Court concluded that as there were factual disputes and ambiguous language, the summary judgment motion by insurers must be denied, and the matter (involving late notification issues as well) was to be determined by a jury at trial.

Comment

It will disappoint but maybe not totally surprise insurers that a court in the US has been so ready to find "*damage*" in insured material which insurers would say is purely "*defective*". It has long been controversial to what extent there can be cover in respect of a single "item" which has become damaged due to a defect, as opposed to a separate item damaged as a result. LEG 3 on its face seems to allow such an interpretation. The interpretation of "*what is damage*" as compared to purely a "*defect*" is also difficult in contamination cases in English law. As always it would also depend on the wording and facts, but an English court could easily find that the cement mix was already insured property, which then became damaged in the circumstances of this case. As to "*improve*" being ambiguous, the English courts would almost certainly seek to find the interpretation which makes most commercial sense, rather than simply apply an extreme form of insured-friendly 'contra proferentem' rule as has happened here. However, the outcome would likely be the same, as surely the exclusion refers to improvement on the originally intended product as opposed to the defective version. Otherwise the exclusion would end up being potentially very much wider even than LEG 2, which was not the drafters' intention. Anyway, Insurers will be holding their breath for a more favourable outcome when this case gets to trial.

For more information, please contact the author(s) of this alert

JONATHAN BRUCE
Partner, London
T +44 (0)20 7264 8773
E jonathan.bruce@hfw.com