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Damage limitation: Latent defects insurance

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Latent defects insurance is a useful back-up for collateral warranties – it can ensure problems get fixed even if the contractor has gone bust

We all hate collateral warranties, don't we? But at least we know where we stand with them. If a building is

defectively designed or built, they give a third party (funder, purchaser, tenant or freeholder) the right to recover damages from the consultant or contractor responsible.

At least, that is the theory. In reality, claims under collateral warranties face a number of hurdles.

- The claimant must prove that the defendant was in breach of its obligations – for example, that a design was negligently prepared, or that work or materials did not comply with the contract's requirements.
- Even if the defendant is held liable, it may be insolvent or otherwise unable to meet a claim. Professional indemnity insurance offers, at best, a partial solution, since it covers only negligent design. Also, it operates on a "claims made" basis, so it must be renewed annually. This will almost certainly not happen if the defendant is insolvent.
- Collateral warranties frequently contain exclusions or restrictions limiting the third party's right of recovery.

The Contracts (Rights of Third Parties) Act 1999 has been touted as an improvement on collateral warranties. It is true that it offers an efficient way of minimising the paper chase, and there is a case for adopting it on that ground alone. However, it does not address any of the above issues. Rights under the act are equivalent to rights under collateral warranties.

So what is the alternative? For at least 20 years, latent defects insurance (LDI) has been talked about as a better way of providing long-term cover against defects. LDI is a non-cancellable policy, usually purchased by the developer at the start of the project. It provides "no fault" protection for owners, occupiers and mortgagees against the risk of damage occurring during the first 12 years after practical completion as a result of a structural defect in the building. Once damage occurs, there is no need to prove negligence; the policy will cover the cost of repairing the defect and consequential loss.

LDI is compulsory in France, but it has been viewed with scepticism in the UK. As a result, it has never caught on in a big way. Lawyers in particular have been quick to point out the drawbacks of typical policies. These include:

One of the problems with latent defects insurance is that it has been over-egged. It provides a useful extra layer of protection but it is not a substitute for collateral warranties

- The requirement for damage means that "pure" defects, which do not result in damage, such as M&E failures, are not usually covered.
- Consequential losses – such as loss of rent or trading profits – are usually excluded.
- Claims are generally subject to a large deductible, which can be more than £250,000.
- The policy wording is often unclear, leaving ample wriggle room for insurers.
- The requirement for technical inspections during construction is an extra expense for the developer.

All these criticisms are – or were – fair. Perhaps one of the problems with LDI is that it has been over-egged by its promoters. It provides a useful extra layer of protection and can go some way towards filling the gaps if collateral warranties are unavailable or one or more of the team members is insolvent. However, it is not a substitute for a robust package of collateral warranties.

More importantly, not all LDI policies are the same. There are now policies in the market that are written in (more or less) plain English and provide M&E cover as standard, with component failure and loss of rent as optional extras (for example the BLP Asset package offered by Building Life Plans).

They can be tailored to the requirements of residential, commercial and mixed-use developments and will be accepted by the Council of Mortgage Lenders as an alternative to NHBC cover on residential units. Both the price and the deductible have reduced considerably, and the approach to technical audit is much more pragmatic.

In the current climate, the risk of contractor or consultant insolvency is significant. This will colour the view of collateral warranties held by funders and tenants, who are taking a more risk-averse position and are looking for secure long-term protection against defects. The launch of an improved LDI package may prove to be well timed.

Postscript: John Hughes-D'Aeth is a partner in Berwin Leighton Paisner's construction group.
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