RPC

International risk team

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What's my part in all this?

One of the most common issues to arise in offshore energy construction claims is the application of WELCAR's Defective Parts clause.

The opening paragraphs of the clause state:

"The insurance afforded by Section I covers physical loss and/or physical damage to the property insured herein occurring during the Policy Period and resulting from a Defective Part, faulty design, faulty materials, faulty or defective workmanship or latent defect even though the fault in design may have occurred prior to the attachment date of the Policy.

Section I, however, **does not provide coverage** for loss or damage to (including the cost of modifying, replacing or repairing) any Defective Part itself, unless all of the following are satisfied:

a. such Defective Part has suffered physical loss or physical damage during the Policy Period
b. such physical loss or physical damage was caused by an insured peril external to that part, and
c. the defect did not cause or contribute to the physical loss or physical damage."

In short, the aim is to exclude the cost of loss or damage to a Defective Part itself (unless paragraphs a. to c. are satisfied which are to the effect that the defect in the Defective Part did not cause the damage to it)[1], but to cover the cost of 'consequential' damage resulting from a Defective Part (or indeed other specified perils). In theory then, the clause is perfectly simple.

In practice, however, the clause is problematic for a number of reasons. Perhaps most fundamentally, disputes arise because the clause requires the identification of a 'part'. Whereas it will generally be in the insured's interests to argue that the 'part' is the smallest possible

component, thereby minimising the cost which is excluded and maximising the covered consequential damage, insurers may have an incentive to construe the 'part' as the largest identifiable element for the opposite reasons[2].

Even leaving that tension aside, defining something as nebulous as a 'part' is inherently difficult. Dictionary definitions of a 'part' include "Some but not all of a thing" and "component of a machine"[3]. The issue, of course, is that one person's 'part' will be another person's 'part of a part' and so on and so on.

The unsatisfactory nature of that debate is illustrated by English case law. For example, in the *Nukila*[4], the first instance judge held that the entire leg of a jack-up rig was a 'part', whilst the Court of Appeal suggested that a weld could be as much a 'part' as the entire leg.

The Defective Parts clause does include a definition of 'Defective Part', which reads as follows:

"...any part of the subject matter insured which is or becomes defective and/or unfit or unsuitable for its actual or intended purpose, whether by reason of faulty design, faulty materials, faulty workmanship, a combination of one or more thereof or any other reason whatsoever..."

So essentially, a Defective Part is a "part" which "is or becomes defective" for "any...reason whatsoever". However, that definition is circular and so does not take the debate any further forward.

There is, however, English case law which takes a more constructive approach to this problem and which suggests that a 'part' is whatever would be considered to be a 'part' in commercial terms[5], ie a part is comprised of the assembly components that are supplied to the insured as a single commercial unit or package. That said, (i) there have been no cases on the Defective Parts clause itself; and (ii) even the cases on similar wordings leave the position open to argument and differing interpretations.

Rather than continuing to ask a question to which there is often no obvious answer, we should perhaps query why we continue to persist with this approach at all. It doesn't have to be this way. Indeed, an alternative approach is employed by the London Engineering Group, who produce a suite of provisions known as the 'LEG defects clauses'[6].

Rather than requiring the identification of a 'part', the LEG defects clauses exclude "All costs rendered necessary by defects of material workmanship design plan specification", but then define the available cover by reference to the cost of resolving the defect at the desired level.

For example, LEG2 provides that:

"...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**" (emphasis added).

Similarly, LEG3 provides that:

"...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 incurred to improve the original material workmanship design plan or specification**" (emphasis added).

Although there is still often a debate under such clauses about the level of costs which should be excluded, it is at least a discussion which can be informed properly by expert evidence (including the Root Cause Analysis which will be invariably carried out), and one where the merits and deficiencies in each party's position can be objectively assessed.

In fact, the WELCAR Defective Parts clause itself hints at the LEG approach when it says: "the term "Defective Part" shall also include such ancillary components, which are not themselves faulty, but which would normally be removed and replaced by new components when the component that is faulty is rectified". However, the clause as a whole does not follow through with the LEG approach.

For the reasons set out above, we would suggest that the LEG approach is far more preferable than continuing to ask whether your entire platform leg or a weld (or rivet or bolt) on the leg is the relevant part for the purposes of applying an exclusion.

Notes

1. It is possible to purchase a Defective Part Exclusion Buy-Back which covers the cost of repairing or replacing a defective part which has suffered physical loss or damage subject to a separate deductible and aggregate limit.
2. Those 'incentives' may of course be 'reversed' depending on the applicable deductible(s).
3. The Concise Oxford Dictionary.
4. *Promet Engineering (Singapore) Pte Ltd v Sturge (The Nukila)* [1997] 2 Lloyd's Rep. 146. The case concerned the *Inchmaree Clause* rather than the Defective Parts clause. Ultimately, the Court of Appeal held that clause covered damage to the 'part' whatever it was. However, the fact that the trial judge and the Court of Appeal judges disagreed on the relevant part illustrates the point.
5. Seele *Austria GmbH & Co KG v Tokio Marine Europe Insurance Limited* [2008] EWCA Civ 441.
6. Apart from LEG1, which is an "outright" defects exclusion.

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