

Fault Exclusions in Course of Construction Policies: *Ledcor and Acciona Infrastructure*

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Course of construction policies (“COC”), also known as builders’ risk or all-risks policies, underwrite specific risks that arise during the construction process. A significant amount of judicial ink continues to be spilled in Canada (and abroad) about the common exclusion clauses within such policies pertaining to faulty or improper workmanship, design, or materials.

This paper addresses some of the recent case law involving faulty design/faulty workmanship exclusions in the context of construction projects. We first comment on the current judicial approach to the more common exclusions and then address a new line of authority developing from the market’s adoption of “LEG exclusions”, which are described below.

Typical Canadian Policy Wording: Ledcor

The faulty design/faulty workmanship exclusion commonly found in Canadian insurance policies comes with a well-established line of cases. Most recently, a faulty workmanship exclusion was considered by the Court of Appeal of Alberta in its March 2015 decision of *Ledcor v. Northbridge*.²

Ledcor involved damage to a new building’s windows, which was apparently caused during a “construction clean” nearing the end of the project. The trial court found that the exclusion did not extend to encapsulate the cost of replacing the windows, and so the replacement was a covered loss. The Court of Appeal of Alberta reversed the decision, and the cost of replacing the windows was excluded.

The exclusion at issue applied to:

The cost of making good faulty workmanship, construction materials or design unless physical damage not otherwise excluded by this policy results, in which event this policy shall insure such resulting damage.³

The policy wording in *Ledcor*, and the ensuing judicial interpretation, highlights the importance of distinguishing between immediate damages, and consequential or “resultant” damages. The general notion is that while insurers are not willing to indemnify insureds for such things as the incompetence of their workers or for design flaw (such risk being properly within the contractor’s commercial or entrepreneurial endeavour), insurers often accept

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² *Ledcor Construction Limited v Northbridge Indemnity Insurance Company*, 2015 ABCA 121.

³ *Ledcor*, *supra* note 2 at para. 4.

(occasionally with judicial persuasion) that non-defective property which sustains damage as a result of defects can access coverage.⁴

While exclusions are traditionally interpreted narrowly,⁵ this exclusion in this example has broad effect. Resultant damage has been interpreted to be damage to property *other than* to the product of the faulty or improper workmanship or design. As the Court of Appeal in *Ledcor* succinctly put it: “the exclusion is not limited to the cost of re-doing the faulty work, but also extends to the cost of repairing the thing actually being worked on”.⁶ Further, distinguishing the faulty work from the resulting damages becomes: “ ... a test of the connectedness between the work, the damage and the physical object or system being worked on”.⁷

Less familiar exclusions are arising with increasing frequency in Canadian COC policies. We refer specifically to the standard exclusions developed by the London Engineering Group, which has been widely used in the UK and more frequently in the US. These are known as “LEG 1/96”, “LEG 2/96”, and “LEG 3/06” - with LEG 2 being the most popular.⁸ The LEG 2 exclusion is different in that it limits the exclusion of coverage to the cost that would have been incurred to rectify or replace the defect just prior to the damage occurring. In addition, we note that some parties are modifying and amending these LEG exclusions, which has much potential for further judicial direction (i.e. litigation) ahead.

The first time the standardized LEG wording was considered in Canada was in the Supreme Court of British Columbia’s 2014 decision in *Acciona v. Allianz*.⁹ It is therefore important for industry stakeholders to be aware of the Court’s decision in *Acciona*, as it will have ramifications for insurers and insureds alike as use of this wording continues to increase.

Understanding the LEG Exclusions

As stated above, there are three standard LEG exclusions: LEG 1, which is the most expansive exclusion and therefore offers the narrowest coverage; LEG 3, which is the narrowest exclusion and therefore offers the widest coverage; and LEG 2, which is typically seen as a middle ground between LEG 1 and LEG 3. It states:

- **LEG 2/96**

Model “Consequences” Defects Wording

The Insurer(s) **shall not be liable** for

All costs rendered necessary by defects of material workmanship design plan specification and should damage occur to any portion of the Insured

⁴ Research Study Group 208B, *Construction Insurance* (London, UK: The Insurance Institute of London, 1999) at 158-65.

⁵ *Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada*, [2010] 2 SCR 245.

⁶ *Ledcor*, *supra* note 2 at para. 46, citing several decisions, e.g. *Algonquin Power (Long Sault) Partnership v. Chubb Insurance Co. of Canada*, [2003] OTC 446, 50 CCLI (3d) 107; *Ontario Hydro v. Royal Insurance*, [1981] O.J. No. 215 (H Ct J); *British Columbia Rail Ltd. v. American Home Assurance Co.* (1991), 79 DLR (4th) 729 (BC CA).

⁷ *Ledcor*, *supra* note 2 at para. 50.

⁸ It is estimated that upwards of 85% of onshore construction projects in the UK are underwritten with a LEG2 exclusion. See Karina Whalley, *Faulty Towers* (Insider Quarterly), Spring 2015 - <http://www.insiderquarterly.com/faulty-towers>

⁹ *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Company*, 2014 BCSC 1568.

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.

For the purpose of this 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.

The benefit of the wording in the LEG 2 exclusion, over the “resultant damage” wording referenced in *Ledcor*, is purported to be greater certainty and predictability. This point was highlighted by the defendant insurers in *Acciona*:

The Insurers say that the LEG2/96 wording avoids the “metaphysical debates” that often arise in those cases about where defective property ends and other property, containing resultant damage, begins. It does so by crystallizing the quantum of damage that is excluded at the moment just before any consequential damage resulting from defective work occurs. The Insurers say further that the intent is made clear by distinguishing the costs of remedying any defects, which are excluded, from any actual damage.¹⁰

LEG 2 is considered: Acciona v. Allianz

In *Acciona*, ISL Health (Victoria) Partnership was contracted by the Vancouver Island Health Authority to finance, design, build, and operate a new 500-bed patient care facility at the Royal Jubilee Hospital in Victoria. ISL further contracted with Acciona Infrastructure Canada Inc. and Lark Projects (2004) Ltd. (who had formed a joint venture) as the design-build contractors.

The facility was to be an eight-storey building with four wings that were connected by a central core. Central to this case were the casted-on-site suspended concrete slabs. After several of the suspended concrete slabs were poured on site, the slabs were found to have over-deflected; which may be described as “rather than flattening out towards a level surface, the slabs were over deflecting resulting in a concave recession in the centre of the slab”.¹¹ In addition to the over-deflection, the concrete slabs were cracking near the support walls and columns.

Repairing the slabs required them to be ground and scarified, resulting in approximately six months of repairs and cascading delays to the various subcontractors.

The COC insuring the construction of the facility was underwritten by four insurers. These insurers denied coverage for the expensive repairs to the slabs, citing the LEG 2 wording (included as clause 5(b)). The contractors then brought an action seeking a declaration that the insurers were to indemnify the plaintiffs for damages in the amount of \$14,952,439.00.

¹⁰ *Acciona*, *supra* note 9 at para. 170.

¹¹ *Acciona*, *supra* note 9 at para. 36.

The Court accepted that the root cause of the over-deflection and the cracking of the concrete slabs was caused by the way in which the formwork, shoring, and re-shoring was carried out by one of the subcontractors. These procedures did not fully consider the fact that the slabs were extremely thin, and too much weight had been placed on them during construction.

The Court considered the wording of the LEG 2 exclusion, and held that there are two components to the exclusion that must be read in conjunction with one another. Specifically, the exclusion first makes reference to all costs rendered necessary by defects of material workmanship, design, plan or specification. It then adds that should damage occur the excluded replacement or rectification costs are those costs that would have been incurred for remedying or rectifying said defect the moment before the damage occurs.

The analysis first identified the damage that was caused, and then identified the defect that caused the damage. The Court could then look to what replacement or rectification, if in the hands of the insured, would have avoided the damage. On that basis, Justice Skolrood held that the excluded costs were those of “implementing proper formwork and shoring/reshoring procedures”.¹² No evidence was before the Court on this point, “except to say that they would have been minimal”.¹³

Justice Skolrood’s analysis is consistent with the wording of the exclusion. However, writers reviewing the case have suggested that the decision errs in its application of the LEG 2 exclusion, with the result being that it improperly broadens the scope of coverage underwritten by the insurers.

It is important to restate that within the LEG 2 exclusion, “the excluded costs crystallize immediately prior to the damage occurring and are thus limited to those costs that would have prevented the damage from happening”.¹⁴ However, Justice Skolrood qualified this comment by stating that “the exclusion does not extend to exclude the cost of rectifying or replacing the damaged property itself”.¹⁵ To support this proposition, Justice Skolrood referred to a paper issued by the International Association of Engineering Insurers, which states:

LEG2 ... does not specifically exclude damage to the defective property itself. The approach is to exclude the cost that would have been incurred to rectify the defect if that effort had been put in hand immediately prior to the damage. The advantage of this approach is that it avoids a need to distinguish between the “defective property” and “other property” - a consideration which ... can become problematic.¹⁶

The IAEI highlighted the fact that the analytical approach to determining where coverage begins and ends should not involve a determination of what “defective” property is, versus what “other” property is.

¹² *Acciona*, *supra* note 9 at para. 223.

¹³ *Acciona*, *supra* note 9 at para. 224.

¹⁴ *Acciona*, *supra* note 9 at para. 221.

¹⁵ *Acciona*, *supra* note 9 at para. 221.

¹⁶ *Acciona*, *supra* note 9 at para. 222, referring to International Association of Engineering Insurers, “Design Exclusion Wordings (DE 1995/LEG 1996) and Physical Lesson Damage” (IMIA - WGP 44(05)).

The conclusion reached by the Court was as follows:

Applying clause 5(b), the excluded costs are those that would have remedied or rectified the defect before the cracking and over deflections occurred i.e the costs of implementing proper formwork and shoring/reshoring procedures or incorporating additional camber into the formwork.¹⁷

Commentators have criticized the Court's analysis for excluding only the cost of avoiding the defect to begin with. According to some writers, the result in *Acciona* ought to have been very different. They note that once the defect had occurred, the only way to prevent the damage would have been to replace the slabs entirely. Therefore, the entirety of this cost ought to have fallen within the exclusion from the outset.

Conclusion

Acciona has been appealed to the Court of Appeal for British Columbia. That Court recently denied the insurers' request to have a stay of execution implemented pending the appeal of the decision.¹⁸ At the time of writing it remains unknown to the authors whether the *Ledcor* decision is also under appeal. The impact of the decision by the Court of Appeal for British Columbia will have ramifications for the construction industry and perhaps also whether the language of the LEG exclusion continues to gain traction in the Canadian underwriting industry for construction policies. The outcome of any appeal will be keenly anticipated.

¹⁷ *Acciona*, *supra* note 9 at para. 223.

¹⁸ 2015 BCCA 6.