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# COURSE OF CONSTRUCTION ("ALL RISKS") INSURANCE STANDARD DEFECT EXCLUSION INTERPRETED FOR FIRST TIME; FORTUITY, DAMAGE AND OTHER INSURANCE COVERAGE ISSUES CLARIFIED

On August 19, 2014, Mr. Justice Skolrood of the British Columbia Supreme Court issued reasons following a 21 day trial in *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Company et al*, 2014 BCSC 1568 ("*Acciona*"), regarding coverage under a Course of Construction (COC or Builders Risk) Policy issued during the construction of a major hospital expansion (the "Policy"). The decision should be noted by Canadian construction and insurance lawyers, owners, contractors, subtrades, insurers and brokers. It is also relevant to similar parties in the British Commonwealth and United States, as the Court interpreted for the first time the LEG2/96 clause, a design/workmanship exclusion developed by the London Engineering Group which is commonly used in insurance policies for large infrastructure projects. The Court also provided clarification on common insurance issues required to establish coverage in a COC Policy, including the need for a fortuitous loss and what constitutes "damage to insured property". A copy of the reasons can be found at http://www.courts.gov.bc.ca/jdb-txt/SC/14/15/2014BCSC1568.htm.

## FACTS AND CLAIM

In *Acciona*, the Plaintiffs were the Design/Build Contractor of the $250 million P3 hospital extension in Victoria, BC. The Project was an eight storey reinforced cast in place concrete structure, comprising four wings connected to a central core. The structural design was complex with each floor consisting of thin suspended slabs (250 mm thick) with large spans (over 9 m) to accommodate the long term flexibility of the hospital. The concrete slabs were designed to be poured with an initial camber (upper curvature) of up to 30 mm to account for the expected long term downward deflection due to the design loads and creep of the concrete such that the slabs would eventually be level. During construction, the slabs "over deflected", which resulted in

the slabs throughout the facility not being level as planned. The Court accepted the Plaintiffs' engineering experts that the cause of the "over deflection" was the formwork and reshoring procedures which did not accommodate the complexity of the slab design during each successive pour. This overloaded the slabs while curing and stretched the slab's steel reinforcing bars (rebar) beyond its yield point, resulting in extensive cracking and permanent slab deflections well beyond level. Although the slabs were subsequently tested and determined to be completely safe, meeting the design strength requirements, they required extensive remediation (grinding the high points and levelling the low points with concrete topping) to meet the Project's serviceability requirements of level floors. The Plaintiffs claimed recovery of all remedial costs under the Project's COC Policy issued by Allianz and three other Insurers. The Insurers denied coverage, following which the Plaintiffs commenced the lawsuit.

The "Perils Insured" provision of the Policy contained a typical insuring agreement covering "ALL RISKS of direct physical loss of or damage to the property insured … except as hereinafter provided". The Plaintiffs submitted that the yielding of the rebar due to the over loading of the slabs along with the extensive cracking and permanent downward deflections of the slabs were "damage" covered by the insuring agreement. The Insurers denied coverage asserting that the slabs were merely defective, but not physically damaged. Further, the Insurers asserted that the loss was not fortuitous, as the Plaintiffs ought to have stopped the concrete pours during construction when slab deflections were occurring. Finally, the Insurers denied coverage relying on two exclusions in the Policy: a "settling" or "shrinkage" exclusion; and a "defects of material workmanship or design" exclusion commonly known as the "LEG2/96" exclusion.

## IMPORTANT LEGAL FINDINGS

In detailed Reasons for Judgment, the Court found that the Plaintiffs' loss was covered by the Policy and they were entitled to recover all costs relating to the slab repairs plus site indirect costs and profit margin, totalling $8.5 million. In particular, the Court held that the slabs were "damaged" as defined in the Policy and that the loss was fortuitous, as it was unexpected and unintended by the Insured. As such, the loss fell within "Perils Insured" clause of the Policy, whereby the Plaintiffs were entitled to coverage subject to the exclusions. The Court accepted the evidence of Plaintiffs' experts that the slab over deflections were not "settling" or "shrinkage", and as such that exclusion did not apply. With respect to the LEG2/96 defects exclusion, the Court held that although the slab deflections were caused by defective workmanship, the Insurers did not meet their onus of establishing the "costs hereby excluded", which the Court accepted were the minimal costs of changing the reshoring procedure during each of the slab pours. As such, all remedial costs to the concrete slabs, corresponding site General Conditions, and profit were covered. The Reasons for Judgment provide several important rulings as follows.

### *"Damage"*

The Insurers noted that in many Canadian cases the issue of whether "physical loss or damage" has occurred to the insured property has not been disputed and the focus of the court's analysis has been on whether any of the policy exclusions apply. However in *Acciona*, coverage was disputed by the Insurers in part as the parties disagreed as to whether the over deflections and related effects to the suspended slabs constituted "damage" within the insuring agreement.

The Court held that the slab over deflections, cracking and yielding of the supporting rebar all constituted "damage" as referred to in the Policy. After reviewing various authorities cited by the parties, the Court held that the evidence was uncontroverted in that the slabs experienced "significant and varying degrees of over deflection and cracking throughout the facility that rendered the facility unfit for its intended purpose". This included the serviceability requirements of a hospital to accommodate wheeled traffic (wheelchairs and numerous types of rolling equipment).

The Court did not accept the Insurers' argument that the over deflections and cracking were merely defects in the slabs which did not constitute damage. Mr. Justice Skolrood held that "[w]hile some degree of deflection and cracking is expected in concrete slabs, the extent of what occurred in this case and its permanent nature support the conclusion that the slabs were left in an altered physical state, which some courts have again held to be the touchstone for a finding of damage". This conclusion was supported by the uncontradicted evidence that the supporting rebar in the slabs had been stretched beyond its flexural yield point resulting in permanent deformity.

Finally, in response to the Insurers' assertion that the over deflection was the result of faulty design, the Court noted that "the issue of causation does not enter into the analysis at this stage where the key question is whether the state of the slabs falls within the Perils Insured clause". The issue as to whether the damage was caused by a defect in design or workmanship was only relevant

to the subsequent determination as to whether the LEG2/96 exclusion applied. Causation was not relevant to the Insured's onus of establishing coverage under the Perils Insured clause.

### *Fortuity*

The COC Policy did not contain an express requirement that the loss or damage be fortuitous (compared to the express requirement of an "occurrence" or "accident" in a Commercial General Liability policy). As such, the Plaintiffs submitted that there was no fortuity requirement in order to trigger coverage. The Court disagreed and held that in order for coverage to be triggered under the COC Policy, the loss or damage must be fortuitous. On this point, Mr. Justice Skolrood held:

> In my view, while there is no doubt that the modern approach to the interpretation of insurance contracts demands that the language of the policy take precedence, I do not read *Progressive Homes* as obviating the requirement that loss or damage must be fortuitous in order to trigger coverage. That again is the very essence of insurance.... [T]he concept of fortuity is, in any event, built into the Policy here. Again, the "Perils Insured" include "all risks" of direct physical loss or damage. Use of the term "risk" underscores that the Policy is intended to insure against possible occurrences, as distinct from certain events or intended consequences.

However, the Court agreed with the Plaintiffs that the fortuity requirement was met in this case, as the extent of the over deflections and cracking were both "unexpected and unintended". The slabs were not designed to deflect to such a degree as to render them unfit for their intended purpose. Further, the Court held that the extent of the problem was not discovered until very late in the Project and the actual cause was not determined until after construction was completed. As such, it could not be said that the Plaintiffs "courted a risk", particularly given the evidence that the concrete subtrade used formwork and shoring/reshoring procedures that were standard in the industry, had been utilized for many years, and were performed in accordance with the formwork engineer's design and erection procedures.

Overall, the Court found that the Plaintiffs had met their onus of establishing coverage under the insuring agreement. In particular, the Court held that the over deflection and cracking of the concrete slabs fell within the Perils Insured clause of the Policy, in that it constituted damage that was fortuitous. As such, the onus shifted to the Insurers to establish that an exclusion applied.

### *LEG2 Defects Exclusion*

The Court then turned to what it considered to be the central question on coverage, whether the loss was excluded under the "LEG2/96" defects exclusion. This is a "defects" exclusion clause developed by the London Engineering Group ("LEG"), a UK think tank for the insurance industry which develops model policy wordings for its members for use in various insurance policies including COC and All Risks policies. Prior to this judgment, the LEG2/96 exclusion had not been interpreted by any court in the world, although it had been commented on in various articles and papers. As worded, the LEG2/96 clause excludes:

> all costs rendered necessary by defects of material workmanship, design, plan, or specification, and 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.
>
> 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.

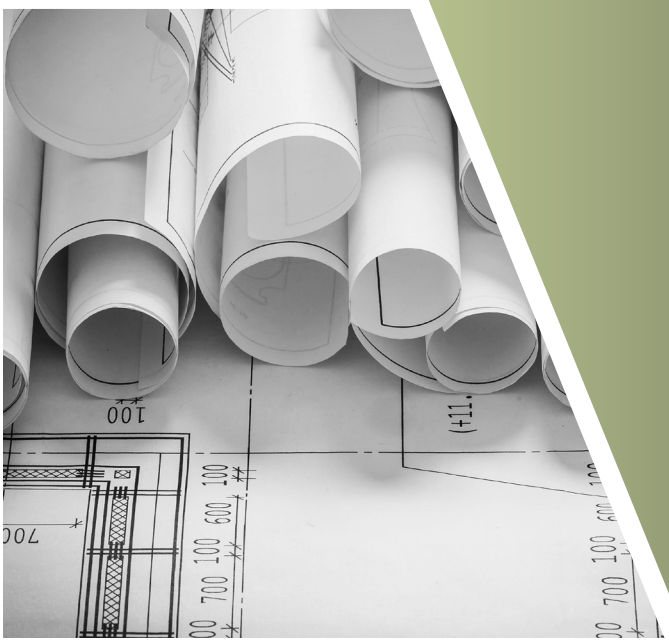
The Court held that the LEG2/96 exclusion is not limited to defective design of the work or facility as a whole, but rather includes any "defects of material workmanship, design, plan, or specification" which would include defective design of component pieces of the work, including the formwork and shoring/reshoring. The Court then held that the failure to address the complex slab design with respect to the formwork and shoring/reshoring procedures constituted a "defect in workmanship", but not a defect in the slab design itself as asserted by the Insurers.

The Court noted that the two components of LEG2/96 do not operate in isolation, but must be read together as a single exclusion to give meaning to the clause as a whole. Further, in interpreting the latter part of the LEG2/96 clause, the Court held that read in its entirety, the intent is to exclude those costs rendered necessary by one of the named defects, but is limited to costs "which would have been incurred if replacement or rectification of the Insured Property had been put in hand immediately prior to the said damage". In other words, the

excluded costs are only those costs that would have remedied or rectified the defect immediately before any consequential or resulting damage occurred. The exclusion does not extend to the cost of rectifying or replacing the damaged property itself. 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.

The Court did not accept the Insurers' submission that the intent of LEG2/96 was to insure contractors against damage that results from their defective work but not for the costs of remedying that defective work. The Insurers referred to numerous cases which interpreted COC policies with defects exclusions containing a typical "resulting damage" exception as being informative on the intent of the LEG2/96 exclusion. In those cases, the defects exclusion typically provides that the costs of making good faulty design or workmanship are excluded, but resulting damage is otherwise covered. The LEG2/96 clause noticeably does not contain an exclusion followed by an exception for resulting damage. Instead it clearly limits the exclusion for defects to only those costs which would have been incurred to avoid the damage before it occurred. The Court noted that where the Insurers have language available to them that will remove an ambiguity from the meaning of an exclusion clause or will clearly specify the scope of an exclusion, they should incorporate such language. Otherwise, normal principles of interpretation will apply, including the principle that coverage provisions will be interpreted broadly and exclusion clauses narrowly. Had the Insurers intended the defects exclusion in the COC Policy to be interpreted similarly to a resulting damage clause, they should have incorporated such readily available language in the Policy. They did not do so as the LEG2/96 exclusion is worded substantially differently, whereby it clearly limits the excluded costs as noted above.

In *Acciona*, the "damage" was held to be the over deflections and cracking of the concrete slabs. The "defect in material workmanship" was the improper formwork and shoring/reshoring procedures adopted which resulted in the damage to the slabs. As such, the LEG2/96 clause excluded only those costs that would have remedied or rectified the defect before the cracking and over deflections occurred. In this case, the Court held there was no evidence on which to quantify these costs except to say they would have been minimal (i.e. the additional cost to release and retighten the reshores after each successive slab pour or incorporating additional camber into the formwork). As such, the Insurers failed to meet their onus of establishing that the exclusion applied.



This is an important decision for the construction and insurance industry, as it interprets the LEG2/96 clause for the first time. It also clarifies the requirement of fortuity and the definition of "damage" under a COC Policy, issues not frequently litigated by Canadian or other courts. This decision is currently being appealed by the Insurers.

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