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Builders' Risk Insurance: Interpreting the Usual Faulty Workmanship and "LEG" Exclusions in connection with Ledcor and Acciona

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The issue in *Ledcor*[1] was whether the builder's risk policy taken out by the contractor that was contractually responsible for cleaning the windows of a building, covered damage to the windows caused by its poor cleaning work. The financial impact was significant since the cost of re-doing the cleaning was $45,000, while the cost of replacing the damaged windows amounted to $2.5 million. The Supreme Court decided that only the cost of re-doing the cleaning was excluded and so replacement of the windows, which was damage resulting from the faulty workmanship, was covered.

The decision of the Supreme Court of Canada in *Ledcor* has clarified the interpretation of the faulty workmanship exclusion in builder's risk insurance cases by limiting it to defective work and connecting the scope of the exclusion to the contractual obligations of the contractor responsible for the faulty workmanship (our Lavery bulletin on this issue can be accessed by clicking here). We would start by pointing out that the wording of the faulty workmanship exclusion in *Ledcor*[2] is similar to the usual wording for this type of exclusion in builder's risk policies.

The decision in *Ledcor* is a landmark ruling. The approach it suggests, of examining the obligations set out in the contract in order to draw the line between faulty workmanship and damage caused by the faulty workmanship, is easy to apply in cases where the contract has only one component, as was the case in *Ledcor*.

However, in cases where a faulty contractor's contract has multiple severable components and the defective work relates to only one of them, applying the contract-based approach presents problems. In that situation, considering strictly the contract-based approach, the costs associated with the components that were properly performed would be excluded. However, that result would

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run counter to the objective of builder's risk insurance policies, which are intended to provide broad coverage in order to avoid construction projects being paralyzed by disputes.

LEG Exclusions

LEG exclusions could well offer a solution in the case of contracts consisting of multiple severable components. These exclusions are worded in precise terms and have a clearly defined scope.

LEG exclusions are clauses developed in the 1990s by the London Engineering Group ("LEG"). They are found in some builder's risk insurance policies, and are widely used in Europe. They are less common in Canada, particularly on major projects, and are rarely used in the United States.

LEG exclusion clauses can be briefly described as follows:

> Exclusion LEG 1/96 - "Outright Defects Exclusion": excludes all loss or damage due to defects of workmanship, materials or design.
> Exclusion LEG 2/96 - "Consequences Defects Exclusion": excludes only costs inherent in the proper performance of the work and rendered necessary to rectify a fault or defect discovered immediately prior to the damage occurring.
> Exclusion LEG 3/96 (revised in 06) - "Improvement Defects Exclusion": excludes only costs incurred to improve the original design, material or performance of the work beyond the damage that occurred.

These three exclusion clauses thus represent three graduated levels of coverage, with a premium that corresponds to the level of coverage that the parties wish to take out.

Acciona and the recommendations of the IBC

The decision of the British Columbia Court of Appeal in *Acciona*[3] interpreted exclusion LEG 2/96 in a builder's risk insurance policy for the first time in Canada. Also called "Consequences Defects Exclusion", that is the exclusion that deals with damage resulting from faulty workmanship.

IBC endorsement 4047, which has been recommended since 2010 to improve IBC 4042 in connection with builder's risk insurance, essentially adopts the wording of exclusion LEG 2/96.

The change between form 4042 (the wording of which was similar to the exclusion in *Ledcor*) and endorsement 4047 (the wording of which is similar to exclusion LEG 2/96 in *Acciona*) lies in the addition of a definition of the expression "resulting damage". Like the text of exclusion LEG 2/96, that definition refers specifically to costs incurred to rectify the fault or defect if it had been discovered immediately before the damage occurred and if the damage had been rectified at that time. Exclusion LEG 2/96 underlies severability.

This exclusion proposes a method by which the faulty workmanship, which is excluded, on the one hand, and the damage, which is covered, on the other hand, can be delineated. Only those costs that are inherent in the proper performance of the work to rectify the faults or the defect before the damage occurs will be covered by the exclusion.

The decision in *Acciona*[4] in connection with the application of exclusion LEG 2/96 proposes that the defect and the resulting damages be delineated as follows:

> "… the excluded costs are only those costs that would have remedied or rectified the defect immediately before any consequential or resulting damage occurred, but the exclusion does not extend to exclude 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."

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This approach implies that the exclusion crystallizes immediately before the damage but does not include the damage, which will, on the other hand, be covered[5].

To the extent that the builder's risk insurance market wants to adopt it, endorsement 4047 suggested by the IBC, like the text of exclusion LEG 2/96, makes it possible to delineate the faulty workmanship and consequential damage, precisely, at a point in time.

The Ledcor and Acciona approaches will help to reduce builder's risk insurance litigation

The decisions of the Supreme Court in *Ledcor* and of the British Columbia Court of Appeal in *Acciona* are key decisions in respect of questions of coverage that arise under builder's risk policies. The wording of the exclusions they analyzed differs significantly and the two approaches they suggest are different. However, these two decisions provide a clear and specific methodology for delineating the scope of the exclusions.

The approach based on the obligations set out in the contract suggested by the Supreme Court in *Ledcor*, like the approach based on severability suggested in *Acciona*, will make it possible to easily resolve some problems in applying faulty workmanship exclusion clauses in builder's risk policies. These approaches will also reduce the volume of litigation.

If you have questions or would like to know whether the methods proposed in *Ledcor* and *Acciona*apply to your case, our specialists in construction insurance will be able to help you.

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1. *Ledcor Construction Ltd.* v. *Northbridge Indemnity Insurance Company* et al. [2016] 2 SCR 23.
2. This wording in *Ledcor* is similar to the wording suggested by the IBC in drafting a similar exclusion in form 4042 (builder's risk insurance) 1998.
3. *Acciona Infrastructure Canada Inc.* v. *Allianz Global Risks US Insurance Company*, 2015 BCCA 347. This decision of the British Columbia Court of Appeal is final; the case had been referred back by the SCC after the decision in *Ledcor*and was withdrawn before the hearing scheduled for June 2017.
4. *Supra*, note 5.
5. On this point, see Sharon C. Vogel, Journal of the Canadian College of Construction Lawyers 2016, *The Evolution of Builder's Risk Insurance in Canada: A Brave New World for Resulting Damages?*

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