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• "NOT MY FAULT" CURRENT ISSUES UNDER THE DESIGN/WORKMANSHIP EXCLUSION SEPTEMBER 2014 (PART 2) •

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• In This Issue •

"Cost of Making Good"

Canadian courts have, on many occasions, considered what constitutes "cost of making good" faulty design or workmanship. "Cost of making good" the faulty design or workmanship has consistently been treated as the repair made costs necessary as a result of the faulty design or workmanship. Put another way, it is the cost of repair of that part of the insured property which was the subject of the faulty design or workmanship and which suffered damage as a direct result of the faulty design or workmanship. In a 2013 Alberta decision, *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*[*Ledcor*][1] the court held that the cost of making good faulty workmanship is restricted to the cost of properly carrying out the work in question and does not include cost of repair of the property damaged by the faulty workmanship. That decision was recently overturned.[2] The Court of Appeal applied the conventional interpretation of the exclusion and refined that interpretation by adopting what the Court of Appeal referred to as a "physical or systemic connectedness" test.

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This section of the article considers the pre-*Ledcor* cases; discusses the *Ledcor* decision; and then looks at the interpretation given to some alternate wordings, which do not refer expressly to "cost of making good".

Case Law Considering "Cost of Making Good"

Poole Construction Co. v. Guardian Insurance Co. of Canada [*Poole*][3]

The insured was constructing a bridge. One of the cofferdams failed and flooded due to faulty design. The design error was only in the cofferdams, not the piles, piers, or any other components of the bridge. The piles and piers were damaged as a result of flooding of the cofferdam and had to be removed and rebuilt. The insured argued that application of the exclusion should be restricted to the direct cost of the cofferdam, and should not apply to the costs of rebuilding the piers, piles, etc.

The court rejected that argument, saying:

> I take the view that the clear intent of the [exclusion] is to make it clear that the insurer will not indemnify the insured for costs caused by the insured's own use of faulty workmanship, materials or design. To do otherwise would give the insured *carte blanche* to use faulty materials, workmanship or design... The original exception talks of the "cost of making good faulty design". The cost of making good covers the entire structure in this case. To make good the faulty design the plaintiffs had to remove the structure and fill the excavation. Those are the costs for which they ask to be indemnified and they come precisely within the exception.[4]

Greene v. Canadian General Insurance Co.[5]

The insured was building a house. The contractor installed some temporary bracing which proved inadequate. As a result the house collapsed. The faulty bracing was found to constitute faulty workmanship. The insured argued that the "cost of making good" should be restricted to the cost of erecting proper bracing, and that the costs of rebuilding the house should be treated as

resultant damage. The Court of Appeal, after referring to various cases, said:

> All of these cases are concerned with how one draws the line between cost of making good faulty or improper material, workmanship or design and resultant damage to the property. The distinction is not, as the appellants argue, to be made on the basis of the smallest component part affected by the improper workmanship. Rather, the courts have used a common sense approach to decide what it was that was being worked upon. Here the defective or inadequate bracing was to stabilize the house during construction and the resulting accident caused the destruction of that house. I see no error in the decision of the trial judge that the loss suffered by the appellants was the cost of making good faulty or improper workmanship, not "resultant damage", nor in his analysis of the applicable case law.[6]

Thus, the entire cost of repair of the house under construction was the cost of making good the faulty workmanship.

Bird Construction Co. v. United States Fire Insurance Co.[7]

The insured was erecting trusses during construction of a building. The erection procedure was faulty and the truss being erected collapsed and was damaged. The truss itself was not faulty; the deficiency was only in the erection procedure. The insured argued that the cost of making good the faulty workmanship should be restricted to the cost of properly erecting the truss, and that the cost of repair should be treated as resultant damage. The court rejected that argument. The court held that the reason for the exclusion was to make it clear that the insurer would not indemnify the insured for "loss or costs incurred by the insured's faulty workmanship". The exclusion applied to costs incurred to repair the truss damaged due to the faulty workmanship.

Simcoe & Erie General Insurance Co. v. Royal Insurance Co. of Canada [*Simcoe & Erie v. Royal*][8]

A good description of this case is taken from the subsequent decision in *BC v. Royal*[9] where the court said:

> A bridge was being built. As it reached completion, rails for another bridge were stored on top of it. Because of a design error in the substructure of the bridge, the bridge collapsed. The superstructure had no design error but of course it also collapsed. The stored rails were destroyed. It was decided that the design error was a design error affecting the whole work, namely the bridge; that the bridge was an integral whole; and that it would be improper to separate the bridge into separate items of property, namely, substructure and superstructure, and so regard one of the parts (the substructure) as excluded from coverage through being damaged by faulty design, and the other part (the superstructure) as being excepted from the exclusion as being resultant damage. On the other hand, it was decided that the damage to the stored rails was resultant damage.

Thus, cost of replacing the entire collapsed superstructure of the bridge, which had no design error and collapsed simply as a result of an error in design in the substructure, was "cost of making good" the faulty design of the substructure.

Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada [*CN v. Royal*][10]

The facts are set out below (The "State of the Art" Standard) and involved an allegation of faulty design in connection with a tunnel boring machine. The insured argued that, if the faulty design exclusion applied, it was restricted to costs of modifying the machine. At trial, Ground J. rejected that argument.[11] Ground J. held that the exclusion for "cost of making good" faulty design "must be intended to apply to all loss or damage caused by faulty or improper design", not restricted to cost of rectifying the design. This was *obiter* given Ground J.'s conclusion on application of the foreseeability test (discussed below). The reasoning on this point was upheld by the Court of Appeal,[12] which held that the exclusion applied. The issue was not addressed by the Supreme Court of Canada. This was not necessary in light of the court's decision on the "state of the art" standard applicable to the exclusion (para. 67).

Sayers & Associates Ltd. v. Insurance Corp. of Ireland Ltd.[13]

The insured was an electrical contractor installing equipment in a building under construction. The insured did not adequately cover the equipment to protect it from the elements. There was water damage to the equipment. The insured's failure to properly protect the equipment was faulty workmanship. The insured argued that the "cost of making good" that faulty workmanship exclusion did not include cost of replacement of the damaged equipment. The court rejected that argument. The court found that the insured's work was to install the electrical equipment "and to keep it dry and clean until the contract was completed". Damage to the equipment, arising from the insured's faulty workmanship, was cost of making good that faulty workmanship, and was not resultant damage.

Ploutos Enterprises Ltd. v. Stuart Olson Constructors Inc.[14]

This case involved failure of hardwood flooring installed in a high rise. The flooring failed as a result of excessive moisture. A moisture barrier should have been, but was not, installed. Moisture testing was carried out improperly. As a result, there was faulty design, faulty workmanship, and possibly faulty materials (para. 96). The insured argued that the cost of making good the defects in design and workmanship should not include cost of repair of the flooring. The court rejected that argument. The "cost of making good" the flooring included the cost of repair of the flooring.

Cost of "Having Someone Else Do It Right"; the *Ledcor* Trial Decision

A different result was reached in *Ledcor*.[15] *Ledcor* concerned a builders' risk policy issued to owners in connection with construction of an office tower in Edmonton. Subcontractors, in carrying out a final construction cleaning of project exterior glass, did not use proper techniques. As a result, some of the exterior glass was scratched. The insured made a claim under the policy for the costs potentially to be incurred in remedying the exterior glass. Insurers denied cover on the basis of the faulty workmanship exclusion.

The matter was heard by Clackson J., on the basis of an agreed statement of facts. Clackson J. held that the poor cleaning constituted faulty workmanship, and went on to consider whether the "cost of making good" that faulty workmanship included cost of repair or remediation of the windows (the insurers' argument) or was restricted to cost of carrying out the cleaning properly (as argued by the insured). Clackson J. said this:

> **14** It is plausible that excluding the cost of "making good" faulty cleaning simply excludes the cost of having someone else do it right. That is the plaintiffs' position. It is also plausible that "making good" faulty cleaning extends to the damage done by the faulty cleaning. That is the defendants' position.

Clackson J. then referred to *Ontario Hydro v. Royal Insurance* [*Ontario Hydro*].[16] In that case a contractor conducted an acid wash of boiler tubes during commissioning of the boiler. As a result, the tubes were damaged. The insured argued that the exclusion was restricted to cost of properly carrying out the acid wash. The insurer argued that the exclusion applied to the cost of repair of the damaged tubes. The court accepted the insurer's argument, holding that "the cost of making good the improper workmanship is the cost of replacing the tubing which was the object of this procedure".[17]

After referring to *Ontario Hydro,* Clackson, J. continued:

> **15** However, while the result in *Ontario Hydro* is defensible, the reasoning that led to the conclusion reached is not provided. In the end, the result reached was simply one of two plausible alternatives, and why one was chosen over the other is not readily apparent.

> **16** In my view, either of the proffered interpretations presented by the parties in this case appears on its face to be reasonable. The policy does not clearly suggest one alternative in preference to the other. Returning to the Supreme Court of Canada's guidance in *Progressive Homes*, it appears, therefore, that the language of the exclusion is ambiguous. In the context of what is an all risk or builders policy stipulating coverage for virtually any event which might occur by way of negligence, third party action or act of God, one could conclude that an exclusion as suggested by the defendants is inconsistent. Additionally, Bristol, as a sub-contractor is an additional insured under the policy. Subrogation by the insurers against Bristol can be waived at the option of the plaintiffs. Again, all of that suggests broad coverage inconsistent with what the defendants say is the effect of the exclusion.

On that basis, the court held that the "cost of making good" the faulty workmanship was restricted to the cost of properly carrying out the construction clean of the exterior glass, and did not apply to cost to repair the scratching. None of the decisions referred to above are cited in the decision, apart from *Ontario Hydro*. The reference to *Progressive Homes* is to the general principles of interpretation, as reiterated by the Supreme Court of Canada in *Progressive Homes Ltd. v. Lombard Gen. Ins. Co*.[18]

That decision was overturned on appeal. The respondents' primary argument on appeal did not seek to uphold the trial decision on the grounds adopted by Clackson J. Respondents' primary argument on appeal was that, while the exclusion would apply to exclude cost of repair of physical damage to the damaged part of the project, the exclusion should not apply where there had been more than one party involved in the damaged portion of the project. The Court of Appeal referred to this as the "multiple contractor" interpretation. Under this interpretation, because the faulty work arose from cleaning of the windows, and because the contractor responsible for cleaning the windows had not also supplied and installed the windows, the exclusion should not apply. The Court of Appeal dealt with the issue in the following way:

- In connection with standard of review, the court found that, as the exclusion was on "standard" wording, requiring consistency of interpretation, the trial decision was reviewable on a correctness standard, pursuant to *Sattva Capital Corp. v. Creston Moly Corp.* (paras. 12–19).[19]
- The court referred to the observation from prior cases (including *Poole, supra*) that an overly narrow interpretation of the exclusion would be inappropriate as it would give the insured *carte blanche* to utilize faulty workmanship, materials or design, and require the insurers to pay for any repairs (para. 24). Having said that, the court pointed out that the cardinal rule of interpretation was to look first to the words of the policy, and to construe the words as a whole (para. 26). "Truisms" could be of limited assistance in interpreting the words of the policy.
- The court pointed out that in order to trigger cover under the Policy there must be physical loss or damage. Therefore, the exclusion must apply to some element of the cost of repair of physical loss or damage. Otherwise, the exclusion would be irrelevant (paras. 27–29).
- The faulty cleaning was clearly faulty workmanship. Workmanship encompasses any activity involving application of care and skill, including provision of a service such as a pre-acceptance construction clean (paras. 30–32).
- It was irrelevant that the contractor who carried out the cleaning did not also install the windows. On this point the court noted that, in many cases considering the exclusion of the facts involved work or design involving multiple parties, and held that, on the basis of the policy wording, case law, and commercial reality there was no reason that application of the exclusion should turn on the number of parties involved in the part of the project in issue. If the damage arose as a result of faulty cleaning,

it would make no difference whether the cleaning had been carried out by the same party who also supplied and/or installed the windows.

- The court held, considering the wording and prior case law, that application of the exclusion will generally depend on connectedness between the work, the damage, and the object or system being worked upon (para. 50), with the primary considerations being: (a) the extent to which the damage was to the specific part of the project being worked upon; (b) the nature of the work, how the damage relates to the work, and the extent to which the damage is the natural and foreseeable consequence of the work itself; and (c) whether the damage was within the purview of the normal risks of poor workmanship.
- The damage here was restricted to the windows, the very part of the project being worked upon. The scratching was highly likely, even perhaps, inevitable, if the work was done in a faulty way (para. 56). On that basis the exclusion applied.

The insureds have applied for leave to appeal to the Supreme Court of Canada.

Alternate Wordings

Courts have held that the exclusion has the same scope where the wording refers to damage "caused by" faulty design or workmanship, as opposed to "cost of making good", or where neither "damage caused by", nor "cost of making good" are expressly referred to, and where the wording simply excludes "faulty design or workmanship". Some of the wordings that have been considered are set out in Part 1 "Wordings". As was noted in *Sterling Crane v. Penner Bros Utilities Ltd.* [*Sterling Crane*],[20] the effect of an exclusion for a specific peril has to be to exclude loss or damage caused by that peril (paras. 8–9). *Sterling Crane* was cited for this point, in connection with faulty design, in *Triple Five Corp. v. Simcoe & Erie Group*,[21] (para. 242),[22] and in *CN v. Royal*,[23] (para. 91). Courts considering "caused by" wording (as in *Algonquin*[24] and *BC Rail*[25]) have relied on "cost of making good" cases, and *vice versa*, with the terms being treated interchangeably. As is clear from the decisions cited above, including *Poole,* "cost of making good" faulty design or workmanship is the cost of repair of the damage caused by the insured's use of faulty design or workmanship. Accordingly, courts are right to treat the two phrases as having the same meaning.

The Resulting Damage Exception

The final question that must be answered in connection with the application and scope of the exclusion is whether any part of the claim qualifies as "resulting damage". Canadian courts have given extensive consideration to the resultant damage issue. There is obvious interplay between the "cost of making good" and "resulting damage". Any costs that are included in the "cost of making good" by definition cannot qualify as "resulting damage". For that reason, several of the cases considered above also consider the resulting damage exception.

It is first worth noting that "resultant" damage within the meaning of the exclusion must be physical damage. Economic or financial loss does not constitute resultant damage within the meaning of the exclusion. Such loss may, of course, potentially be covered under the policy following covered physical damage, but such cover must be found in the business interruption, extra expense, delayed opening or soft cost provisions, not in the resultant damage exception. This issue has been considered in *BC Rail,*[26] and *CN v. Royal.*[27]

To qualify as "resulting" damage, the damage must be to property separate from that which is subject to the faulty design or workmanship. As with the "cost of making good", it is worth considering some examples. The following cases

have all expressly considered the resultant damage exception and the costs that are potentially within the exception.

British Columbia v. Royal Insurance Co. of Canada [*BC v. Royal*][28]

BC v. Royal involved a creek channelization project. The project involved channelization works within the creek, and also separate diversion works, for the purposes of diverting the creek flow during the project. The diversion works failed during a heavy rain. As a result there was damage to both the diversion works and the main creek channelization works. The insured did not make a claim for damage to the diversion works, but claimed that the damage to the main creek channelization works was resultant damage and that damage to the main channel was thus within the exception. This was due principally to the fact that the diversion system would have no continuing function in the completed creek channelization project, and the fact that the construction documents treated the diversion system as a construction device separate from, and not a part of the designed project. As a result, the cost of repair of the damage to the main creek channelization was covered as resultant damage.

Triple Five Corp. v. Simcoe & Erie Group [*Triple Five*][29]

The rollercoaster, as a result of the accident which gave rise to the claim, was destroyed. Other property was also damaged. The failure was due to one defective component of the rollercoaster. The insured argued that all costs of repair, including cost of replacement of the destroyed rollercoaster should be treated as resulting damage. The court said, at para. 253:

> The case law on the subject is to the effect that the "resulting damage" exception to the exclusion clause is not to be construed in a way that requires that the policy will cover the cost of repairing the property which was itself defective or improperly made, that is, the rollercoaster itself. In making this analysis, I do not think it right that I should consider the rollercoaster in its component parts. It is the rollercoaster which has failed, and no part of the rollercoaster should be included under the resulting damage exception. Only the property that is damaged by the violence of the ensuing accident, or surrounding property of the insured which was damaged by flying parts is covered here. This, in my opinion, would include only direct collision damage to the tracks, columns, superstructure and the surrounding demising walls, roof and staircase, and handrail that were damaged by the falling material from the wheel assembly.

The Court of Appeal, in upholding this decision, noted that the trial judge, after making the correct finding concerning the scope of the resultant damage exception, had awarded the insured the cost of repair of the resultant damage "and possibly a little bit more" (para. 51). That was likely a reference to the fact that the award included cost of repair of the track, which was a component of the roller coaster, and thus not resultant damage.

Algonquin Power (Long Sault) Partnership v. Chubb Insurance Co. of Canada [*Algonquin*][30]

A hydroelectric dam under construction failed. The cause of the failure was the dam's inability to deal with hydraulic piping in the soil and bedrock beneath the dam. The court found that no part of the cost of repair of the dam could be covered as resultant damage, notwithstanding the fact that only certain components of the dam were faulty. The court said, at para. 202:

> Where the loss was caused by faulty design, the insured (sic insurer) will not pay for loss resulting to the whole of the design including its various subcomponents. To hold otherwise would place on the insurer a virtual warranty for the items designed. The insured could then take risks on the design of a particular component of the item with assurance that it would at least be compensated for the damage that that component, if it turned out to be faulty, visited on the other components of the item.

The only portion of the claim which was covered as resulting damage was damage to a transformer station, a turbine, fences, and a retaining wall.

Like the stored rails in *Simcoe & Erie v. Royal*,[31] or the separate set of concrete channels in *BC v. Royal*,[32] the fencing etc. was entirely separate property from the dam and thus within the exception.

***Supreme Steel Ltd. v. Aon Reed Stenhouse Inc.* [*Supreme Steel*]**[33]

In *Supreme Steel* the insured constructed a temporary shoring tower for use in connection with erection of sections of the elevated sections of the Skytrain line. During the course of using the tower to jack a section of the line into place the tower buckled. The original tower was constructed of prefabricated sections and had not been tested for loads that would be applied during the jacking procedure. A new tower had to be built to replace the original tower and, to meet the design loads that would be imposed, had to be built at about ten times the cost of the original tower.

The policy was on standard design exclusion wording, but with this addition to the exception:

> … except that the original cost of the components that is/are proven to be either faulty and/or negligent in design shall be excluded.

The insured argued that the effect of this addition to the wording was to bring into cover cost of the replacement tower, minus the cost of the original tower. The court rejected that argument. The court accepted insurers' argument that the exception could not have been intended to permit the insured to recover the cost of constructing a properly designed tower. The court held that the closing words of the exception could mean only that, where there was resultant damage to other property as a result of the collapse of the tower, that resultant damage would be covered, less the original cost of the collapsed tower. The effect of the closing words of the exception was to clarify that no part of the cost of the collapsed tower *would ever* be covered.

***BC Rail Ltd. v. American Home Assurance Co.* [*BC Rail*]**[34]

In *BC Rail* a section of the insured's rail line collapsed, together with the rail bed and the fill beneath the rail bed. The design of the fill was faulty. The insured argued that, as the error was restricted to the fill, the cost of replacing the rail line, with a temporary and then permanent bridge, was covered as resultant damage. The court rejected that argument. The court relied on *Poole*[35] and certain other decisions referred to above. The fill could not be separated from the rail and other components. All were within the exclusion.

In the course of its decision the court referred to *Landru v. Inter City Contractors Ltd.* [*Landru*][36] and *Foundation Co. of Canada v. Aetna Cas. Co. of Canada*.[37] Both involved similar facts. In *Landru* the error was in failing to properly install a weeping tile system below a slab and in watering backfill after the slab was poured. As a result, the floor heaved and had to be replaced. In *Foundation v. Aetna* there was faulty compaction of material below a slab, resulting in damage to the slab. In both cases the courts held that the cost of repair of the slab was resultant damage. In *Poole,*[38] the decision in *Aetna* was expressly rejected and the case was found to have been incorrectly decided. In *BC Rail,* the Court of Appeal noted the negative treatment of those cases, for example in *Poole.* The decision in *BC Rail* concerning the scope of the exception is incompatible with the broad scope given to the exception in *Landru* and *Foundation v. Aetna*.

The "DE" and "LEG" Wordings

The "DE" and "LEG" wordings have been in use for many years in the United Kingdom. Both the DE and LEG wordings involve a graduated series of exclusions of decreasing breadth. Thus, the wording can be tailored, depending on the scope

of the exclusion desired (and the premium the insured wishes to pay).

The genesis of the DE clauses is explained in the Chartered Insurance Institute, *Construction Insurance*, 1999, Cromwell Press Limited (p. 159):

> In view of the number of different wordings prevalent, it was considered by leading building and civil engineering insurers in the London market to be desirable to establish standard versions of the wording of the exclusion to cater for the different levels of cover provided. A committee was formed of leading insurers; five alternative wordings were drafted, which were thought to define adequately the five different levels of cover which insurers were prepared to offer.

The "DE" Wordings

The "DE" wordings were originally drafted in 1985 and redrafted in 1995. The full text of the 1995 clauses is as follows:

- **DE1 (1995): Outright defect exclusion**

  This policy excludes loss of or damage to the Property insured due to defective design plan specification materials or workmanship.

- **DE2 (1995): Extended defective condition exclusion**

  This policy excludes loss of or damage to and the cost necessary to replace repair or rectify:

  (i) Property insured which is in a defective condition due to a defect in design, plan, specification, materials or workmanship of such Property insured or any part thereof;

  (ii) Property insured which relies for its support or stability on (i) above;

  (iii) Property insured lost or damaged to enable the replacement repair or rectification of Property insured excluded by (i) and (ii) above.

  Exclusions (i) and (ii) above shall not apply to other Property insured which is free of the defective condition but is damaged in consequence thereof.

  For the purpose of the Policy and not merely this Exclusion the Property insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design, plan, specification, materials or workmanship in the property insured or any part thereof.

- **DE3 (1995): Limited defective condition exclusion**

  This policy excludes loss of or damage to and the cost necessary to replace repair or rectify:

  (i) Property insured which is in a defective condition due to a defect in design, plan, specification, materials or workmanship of such property insured or any part thereof;

  (ii) Property insured lost or damaged to enable the replacement repair or rectification of Property insured excluded by (i) above.

  Exclusion (i) above shall not apply to other Property insured which is free of the defective condition but is damaged in consequence thereof.

  For the purpose of the Policy and not merely this Exclusion the Property insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property insured or any part thereof.

- **DE4 (1995): Defective part exclusion**

  This Policy excludes loss of or damage to and the cost necessary to replace, repair or rectify:

  (i) Any component part or individual item of the Property insured which is defective in design, plan, specification, materials or workmanship;

(ii) Property insured lost or damaged to enable the replacement repair or rectification of Property insured excluded by (i) above.

Exclusion (i) above shall not apply to other parts or items of Property insured which are free from defect but are damaged in consequence thereof.

For the purpose of the Policy and not merely this Exclusion the Property insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property insured or any part thereof.

- **DE5 (1995): Design improvement exclusion**

This policy excludes:

(i) The cost necessary to replace repair or rectify any Property insured which is defective in design, plan, specification, materials or workmanship;

(ii) Loss or damage to the Property insured caused to enable replacement, repair or rectification of such defective Property insured.

But should damage to the Property insured (other than damage as defined in (ii) above) result from such a defect, this Exclusion shall be limited to the costs of additional work resulting from and the additional costs of improvement to the original design plan specification materials or workmanship.

For the purpose of the Policy and not merely this Exclusion the Property insured shall not be regarded as lost or damaged solely by virtue of the existence of any defect in design plan specification materials or workmanship in the Property insured or any part thereof.

The "LEG" Wordings

The 1996 LEG exclusions are as follows:

- **LEG 1/96 model "outright" defects exclusion**

The Insurer(s) shall not be liable for Loss or Damage due to defects of material workmanship design plan or specification.

- **LEG 2/96 model "consequences" defects exclusion**

The Insurer(s) shall not be liable in respect of:

All costs rendered necessary by defects of material workmanship design plan or specification and should damage occur to any portion of the Insured Property (Contract Works) 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 said portion of the Insured Property (Contract Works) 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 (Contract Works) shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship design plan or specification.

- **LEG 3/06 model "improvements" defects exclusion**

The Insurer(s) shall not be liable in respect of:

All costs rendered necessary by defects of material workmanship design plan or specification and should damage (which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property)[39] occur to any portion of the Insured Property (Contract Works) 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.

> For 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.

These wordings are now more commonly seen in Canada. In fact, certain forms published by the Canadian Construction Documents Committee ("CCDC") (see Builders' Risk CCDC Endorsement, IBC 4047) provide for policy wording to be amended to incorporate the following definition of "resultant damage":

> "RESULTANT DAMAGE" shall mean physical damage to the insured property other than the cost of rectifying the defect or fault that caused the physical damage. The cost of rectifying the defect or fault (the cost of making good) shall be the cost which the Insured would have incurred to do so had such defect or fault been discovered immediately before the physical damage occurred and rectified at that time.

An amendment along these lines would give the exclusion a scope similar to LEG 2. While the CCDC forms require this endorsement, in the writer's experience the requirement is often, in practice, removed from construction contracts.

The scope of cover will be very different under some of these wordings as compared to the "traditional" Canadian design/workmanship exclusion. This can be seen in connection with the DE wordings, by considering an example set out in *Construction Insurance* (1999), *supra*. The example given is of a steel frame building partially complete, with a dwarf brick wall forming part of the building, but not relying on any other part of the building for support. Bolts used in construction with the steel framework prove to have inadequate capacity. As a result, the building collapses and in so doing damages the wall.

The result, on the various DE wordings, would be as follows:

1. On DE1 the entire loss would be excluded.
2. On DE2 the entire loss would be excluded, except cost of repair of the brick wall. That is because the walls and roof rely for support on the defective components (the bolts). The wall does not.
3. On DE3 the steel framework would be excluded but the roof, cladding, and brick wall would be covered. That is because the defect is in the steel framework only. The steel walls and roof were not defective but are part of the structure damaged in the collapse.
4. On DE4 only the bolts themselves would be excluded. That is because the DE4 wording is restricted to the "component part or individual item" of the property which is defective. Thus, with DE4 wording, even the steel framework would likely be covered.
5. On DE5 the entire cost of repair of the building to original standard, including the cost of placing the defective bolts to the original standard would be covered. The only element that would be excluded is any increased cost of reconstruction of the building, to correct the defect in the original construction.

The significance of these wordings, in terms of the covered portion of the cost of repair of these is obvious. Take *Simcoe & Erie v. Royal*.[40] The defect in that case was in the bridge substructure only. The bulk of the repair cost was replacement of the collapsed superstructure. Had the DE2 wording applied, the result would have been the same as on the Canadian wording (no cover for cost of the substructure as it was defective; no cover for the superstructure, as relied for support on the faulty substructure; coverage for the stored rails). Had the DE3, DE4, or DE5 wordings applied, the result would have been quite different. There would have been cover for the cost of replacement of the superstructure. It also would have been necessary to investigate, had the DE4 wording applied, whether the "particular part or

component" subject to faulty design was something smaller than the entire substructure. Of course, had the DE5 exclusion applied, the entire cost of replacing the substructure, to its original condition, would also have been covered. The only costs that would be excluded are additional engineering and construction costs associated with designing and building an improved substructure, so as to correct the deficiencies in the original.

LEG 2 Considered; *Acciona* and *PCL Constructors*

Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Co. [*Acciona*][41]

Acciona involved a project to construct a new hospital wing. Construction utilized cast-in-place reinforced concrete slabs. The concrete slabs, over time, began to exhibit excessive cracking and "over-deflection". The slabs were intentionally designed to be high at the centre when initially constructed, and then to undergo a certain amount of deflection to become level. However, the deflection did not stop at the intended point. The deflection continued, and the slabs eventually sloped down towards the middle. This raised no structural or safety issue but, due to the cracking and over-deflection, the slabs did not meet the standards set out in the governing contracts. As a result, substantial remedial work had to be undertaken. The builders' risk policy issued in connection with the project contained a design and workmanship exclusion on LEG 2 wording (the only difference from the wording quoted above being the omission of the reference to "Contract Works" at three points in the exclusion, following the reference to "Insured Property"). Insurers denied the claim on the basis of the exclusion. The trial judge, Skolrood J., found that use of slabs that had less than normal thickness combined with failure to use certain specific shoring procedures that would have accommodated those slabs. Accordingly, there were defects in workmanship within the meaning of the exclusion.

Skolrood J., in considering the scope of the exclusion, said:

> Read in its entirety, I find that the intent of clause 5(b) 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, 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.[42]

After referring to a paper drawing a comparison between LEG 2 and DE4, Skolrood J. went on to say:

> The "damage" in issue here is the cracking and over deflection of the concrete slabs. The "defect in material workmanship" is the improper formwork and shoring/reshoring procedures adopted that resulted in the damage to the slabs. 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.
>
> There was no evidence on which to quantify these costs except to say that they would have been minimal. [emphasis added][43]

With the greatest respect to the trial judge, in the author's view this conclusion is inconsistent with the wording and intent of the exclusion. The costs which are within the exclusion are the costs which would have been incurred to repair or rectify that part of the property containing the defect *immediately prior to the damage occurring*. As at the end of construction, the slabs were defective. It was inevitable that the slabs would suffer damage, but that damage had not yet occurred. To the

extent that cracking and over-deflection constitute physical damage, the cost of repair or rectification must be considered as at a date after construction and just prior to that damage occurring. This should, on the wording of the exclusion, comprise the cost of repairing/rectifying the defective slabs, post-construction, so that the cracking and over-deflection would not occur. If no such repair could be undertaken, the exclusion would have to apply to the full cost of replacing the defective slabs. What Skolrood J. held to fall within the exclusion is something quite different. Skolrood J. held that the exclusion applied only to any incremental costs that would have been incurred in order to carry out the work correctly during initial construction. In the author's view, that cannot be the correct interpretation of the exclusion. The extra cost that would have been incurred to avoid creation of the defective condition in the first place cannot constitute the cost of rectifying the defective condition, immediately prior to commencement of damage.

In addition, the interpretation given by Skolrood J. to the LEG 2 exclusion is that which properly applies to the LEG 3 exclusion. LEG 3 excludes only "that cost incurred to improve the original material, workmanship design, plan or specification". In other words, LEG 3 is limited to the incremental cost of doing the job properly. To the extent the graduated nature of the exclusions can be considered, this is an additional reason why, from the perspective of insuring intent, the decision in *Acciona* is incorrect.

An appeal of the decision has been heard, with judgment reserved.

Proper application of LEG 2 would not always result in exclusion of substantial repair or rectification costs. In some cases the costs excluded would be (or would be equal to) the additional costs that would have been incurred to carry out the job correctly in the first place. The result depends very much on the facts. This can be seen by considering the following scenarios:

1. Insufficient trusses. A building is constructed using 80 trusses. 100 trusses should have been used. The building collapses. It would have been possible to install the additional 20 trusses any time prior to the collapse. In those circumstances the exclusion should be restricted to the cost of installing the additional 20 trusses. Up to the moment of the collapse, the defect in the building could have been repaired by incurring those costs. Accordingly, those are the only costs that fall within the exclusion, on LEG 2 wording. Those are the same costs (possibly subject to additional costs such as mobilization/demobilization) that would have been incurred to do the job correctly in the first place. That is not why those costs are excluded; they are excluded because they are the costs that would have been incurred, just prior to the collapse, to repair or rectify that portion of the property containing the defect.[44] But the result is essentially the same as if the exclusion applied only to the cost of doing the job correctly.
2. Improper protection. A contractor fails to properly cover equipment on which he is working. As a result, the equipment suffers rain damage. Again, to the extent LEG 2 would apply at all here, it would be restricted to the cost of properly protecting the equipment. To the extent that the equipment contains a defect in workmanship, by way of the lack of protection, the defect could have been rectified by instituting proper protection. Accordingly, those are the only costs that fall within the exclusion.[45]

Thus, we can see that, in some scenarios, LEG 2 will have a scope much narrower than the traditional Canadian wording, and that costs falling within the exclusion will approximate the cost that would have been incurred to do the job

correctly. But where the only option that would have been available to repair or rectify the property, just prior to the damage, was removal and replacement, DE2 has to apply to full cost of removal and replacement.

The decision on any appeal in *Acciona* will no doubt be awaited with interest. As the first decision on a set of exclusions that is coming into increasing use, the decision is of real significance. The effect of the trial decision is to essentially nullify LEG 2, a wording that may currently be written into many builders risk policies (per the CCDC documents referred to above). In addition, to the extent some of the same principles arise in interpretation of the DE clauses, the decision may well have an impact on the interpretation given to those clauses as well.

PCL Constructors Canada Inc. v. Allianz Global Risks US Insurance Co. [*PCL*][46]

PCL involved a claim under a builders risk policy for damage to mullions (window frame components) installed in the Maple Leaf Square project in Toronto. The mullions suffered corrosion damage and required repair. The cause of the corrosion was excessive liquid, specifically urea and sea salt, trapped within the mullions during construction. The presence of excessive corrosive liquid had three causes: exposure during construction to road spray and de-icing salt used on the adjacent Gardiner Expressway; use of a urea-based snow melting product on parts of the project during construction; and general exposure to the elements, including de-icing and road spray, during construction.

Insurers relied on the faulty workmanship exclusion which was, in substance, on LEG 2 wording. The wording limited application of the exclusion to "…direct costs that would have reasonably been incurred to rectify such fault(s) immediately prior to the commencement of such loss or damage", and provided that all physical loss or damage would be "deemed to be" resulting damage. Insurers also relied on the policy's corrosion exclusion. The corrosion exclusion applied to loss or damage caused directly or indirectly by corrosion, but with an exception where the corrosion caused directly by a non-excluded peril. Insurers argued that, as faulty workmanship was an excluded peril, the corrosion exclusion would apply to all loss or damage caused directly or indirectly by corrosion.

The court rejected the insurers' argument on application of the corrosion exclusion. The court found that the LEG 2 exclusion was not, in fact, an exclusion at all. Instead, the court found that the LEG 2 wording should be treated, at least for purposes of the exception to the corrosion exclusion, as a "deeming" clause "that provides special treatment of losses or damage caused by faulty workmanship", rather than as an exclusion (para. 23). The court reached this finding on the basis that loss or damage caused by faulty workmanship was not excluded and was, instead, deemed to be resultant damage covered by the policy. The exclusion was restricted, the court pointed out, to the hypothetical direct costs that would have been incurred to rectify the defect prior to commencement of any physical damage (para. 23).

The court's conclusion that faulty workmanship was not an excluded peril, in the author's respectful view, is not correct. The LEG 2 wording in the policy was contained in the exclusions section of the policy, and stated "This Policy does not insure against faulty design or workmanship…". In the author's view, the LEG 2 exclusion must correctly be treated as excluding the peril of faulty workmanship. The court is certainly correct that there was a "deeming" aspect to the exclusion. The exclusion expressly "deems" all physical damage to be "resulting damage" and within the resulting damage exception, with the exclusion being restricted to the hypothetical cost

referred to above. This is, of course, much broader than the interpretation that would be given to the words "resulting damage" on the common "cost of making good" wording, or the other wordings referred to in the first part of this article. However, faulty workmanship surely remains an excluded *peril,* even if the physical damage arising from that excluded peril is, by virtue of the "deeming" aspect of the clause, treated as resultant damage, and covered.

In connection with application of the LEG 2 exclusion itself, the court left determination of the excluded costs to a further hearing, in the event the parties could not reach agreement on those costs. The court referred to the outstanding question (para. 31) as being the amount the parties would have had to spend "to avoid the exposure of the mullions to the corrosive liquid". Thus, the court arguably framed the question in the same way as thecourt in *Acciona,* not as requiring consideration of the costs that would have been incurred to repair or rectify the defective condition of the mullions just prior to physical damage occurring, but as requiring consideration only of costs that would have been incurred to avoid creation of the defective condition in the mullions in the first place. It is not clear, from the facts set out in the decision, whether those amounts would be different.

Insurers have appealed the decision in *PCL*.

[*Editor's note*: These materials were prepared by Gregory J. Tucker of Owen Bird Law Corporation, Vancouver, B.C., for the Continuing Legal Education Society of British Columbia, September 2014.

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1 [2013] A.J. No. 1088, 2013 ABQB 585.
2 [2015] A.J. No. 338, 2015 ABCA 121.
3 [1977] A.J. No. 784, [1977] I.L.R. para. 1-879.
4 *Ibid.*, 635.
5 [1991] N.J. No. 170, 5 C.C.L.I (2d) 193, aff'd [1995] N.J. No. 251, 23 C.L.R. (2d) 203.
6 *Ibid*., para. 60.
7 [1985] S.J. No. 902, 18 C.C.L.I. 92.
8 [1982] A.J. No. 722, [1982] 3 W.W.R. 628.
9 [1991] B.C.J. No. 2959, 4 C.C.L.I. (2d) 206, para. 12.
10 [2008] S.C.J. No. 67, 2008 SCC 66, [2008] 3 S.C.R. 453.
11 [2004] O.J. No. 4086, para. 81.
12 [2007] O.J. No. 1077, paras. 138 and 140.
13 [1981] O.J. No. 107, 126 D.L.R. (3d) 681.
14 [2008] B.C.J. No. 372, 2008 BCSC 271.
15 *Supra* note 1.
16 [1981] O.J. No. 215.
17 The exclusion in *Ontario Hydro* was on "caused by" wording, rather than "cost of making good" wording. This should, as explained elsewhere (see C. "Alternate Wordings") make no difference. The court in *Ontario Hydro* was right to equate "caused by" with "cost of making good".
18 [2010] S.C.J. No. 33, 2010 S.C.C. 33, [2010] 2 S.C.R. 245.
19 [2014] S.C.J. No. 53, 2014 SCC 53.
20 [1985] B.C.J. No. 1200, 12 C.C.L.I. 97 (S.C.).
21 [1994] A.J. No. 760, 29 C.C.L.I. (2d) 219, aff'd [1997] A.J. No. 248, 145 D.L.R. (4th) 236, 42 C.C.L.I. (2d) 132.
22 Keeping in mind the fact that the policy in *Triple Five* did not contain an express design exclusion, and that the decision was based on application of the latent defect, mechanical breakdown, and inherent vice exclusions.
23 *Supra* note 10.
24 *Algonquin Power (Long Sault) Partnership v. Chubb Insurance Co. of Canada*, [2003] O.J. No. 2019, 50 C.C.L.I. (3d) 107.
25 *BC Rail Ltd. v. American Home Assurance Co.*, [1991] B.C.J. No. 697, 54 B.C.L.R (2d) 228.
26 *Ibid*.
27 *Supra* note 10.
28 [1991] B.C.J. No. 2959, 4 C.C.L.I. (2d) 206.
29 [1994] A.J. No. 760, 29 C.C.L.I. (2d) 219, aff'd [1997] A.J. No. 248, 145 D.L.R. (4th) 236, 42 C.C.L.I. (2d) 132.
30 [2003] O.J. No. 2019, 50 C.C.L.I. (3d) 107.
31 *Supra* note 8.
32 *Supra* note 9.
33 Unreported, June 13, 2008, BCSC Vancouver Action S023382.
34 [1991] B.C.J. No. 697, 54 B.C.L.R (2d) 228 (C.A.).
35 *Supra* note 3.
36 [1987] S.C.J. No. 41, 24 C.L.R. 95.
37 [1976] A.J. No. 134, [1976] I.L.R. 1-757.
38 *Supra* note 3.

[39] The words in brackets in the second paragraph of the exclusion were added in 2006 following the decision in *Skanska Construction U.K. Ltd. v. Egger (Barony) Ltd.*, [2005] EWHC 284 (TCC). The decision gave rise to concerns that, in the absence of an amendment, physical manifestation of a defect might not be interpreted in a manner consistent with expectation of the market.

[40] *Supra* note 8.

[41] [2014] B.C.J. No. 2137, 2014 BCSC 1568.

[42] *Acciona*, para. 221.

[43] *Acciona*, paras. 223 and 224.

[44] Of course, on the "standard", non-LEG wording quoted in Part 1,all costs of repair of the building would be excluded. This scenario is analogous to *Greene, supra,* note 5. That would also be the result on LEG 1 or on DE1 or DE2.

[45] Again, on the "standard" wording, all costs of repair of the equipment would be outside cover. This scenario is analogous to *Sayers, supra*, note 13. The conclusion that the excluded costs would be limited to proper "protection" in this scenario assumes that "protection" includes measures such as cleaning that would have prevented any accumulated water from causing physical damage to the equipment. In other words, proper "protection" of the equipment is not simply the taking of steps necessary to avoid creation of the defective condition (*i.e.*, avoiding exposure to water); it is the taking of steps necessary to rectify the defective condition of the equipment prior to damage occurring (*i.e.*, removing water which would lead to corrosion). On this example, the cost of avoiding exposure to water, and the cost of removing accumulated water, would presumably be identical, or very similar.

[46] [2014] O.J. No. 6210, 2014 ONSC 7480.