WHITE PAPER

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The importance of clarifying LEG2 and LEG3 during the transition to clean energy

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Overview

The *W+K Turning Point competition* has been established to promote international thought leadership across key sectors – mining, power generation, gas and renewables – via the lens of risk and insurance. The annual prize aims to inspire the leading professionals across the industry to submit novel and inspired thinking in a publishable format to challenge how the customary world of transactional insurance products will need to evolve to meet accelerated change in the technologies and industries that insurers are underwriting.

Wotton + Kearney is delighted to congratulate our inaugural (2023) winner, Nathan McLellan from Liberty Specialty Markets, who partnered with Matthew Foglia from W+K's national Property, Energy & Infrastructure team to write this insightful and important paper on the importance of clarifying LEG2 and LEG3 during the transition to clean energy.

As part of the winner's prize, Nathan receives funding to attend a conference of his choice specifically relevant to his career anywhere in the world in 2024.

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1. Introduction

LEG2/96 and LEG3/96 or LEG3/06 **(LEG2 and LEG3)** have become ubiquitous in Australian CAR and EAR policies and each plays a commercially necessary role. However, as *Acciona*[1] showed in considering LEG2, the structure and language of the clauses can yield unpredictable outcomes.

This paper non-exhaustively calls attention to several difficulties in LEG2 and LEG3 that warrant refinement, at least for the Australian market, particularly as:

- firstly, the commitment to reduced carbon will necessitate new technology and construction techniques that, by virtue of their novelty, are potentially fertile sources of defects; and
- secondly, those new technologies are likely to often be deployed on projects that are located in geographically remote areas subject to extremely hostile environmental conditions (which may become even more hostile with global warming), thereby increasing the risks associated with the durability and performance of those new technologies.

We have chosen to focus on the need for greater clarity:

- in distinguishing between defect and damage; and
- when adjusting costs that remain excluded even after the proviso in each clause is engaged.

Save as to suggesting minor changes to LEG2 that we trust are largely uncontroversial, it is beyond the scope of this paper to attempt to solve the issues ventilated. That, we say, should be entrusted to an industry working group comprised of insurers, insureds, brokers, and relevant experts. We hope this paper provides the impetus for such a group to be convened.

[1] *Acciona Infrastructure Canada inc. V. Allianz Global Risks US Insurance Company* 2015 BCCA 347.

2. Distinguishing 'damage' and 'defect'

Typically, a policy will be triggered by either "loss, destruction or damage" or "*physical* loss, destruction or damage". In Australia, these are similar but not synonymous concepts. For now, it will suffice that whereas the requirement for adverse physical alteration or change is common, impaired value or usefulness alone will not necessarily amount to "physical damage". [2, 3] In any event, we use "damage" to encompass both concepts.

Both LEG2 and LEG3 similarly rely on "damage" to qualify the broad, opening exclusion of all costs rendered necessary by defects. Crucially, however, how does the damage required differ from the ordinary manifestation and consequences of any relevant defect? Put another way, can insured property, in effect, "damage itself" by the existence or manifestation of a defect, or is the existence or manifestation merely a form of economic loss solely because the insured property contains the defect in question?[4]

The ambulatory final paragraph of each of LEG2 and LEG3[5] relevantly provides:

> *For the purpose of the policy and not merely this exclusion… 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.*

On one view, that paragraph is not controversial. Viewed through the *Ranicar* lens, defective insured property will often (if not always) suffer a reduction in utility or value but will not always satisfy the concurrent requirement for physical alteration or change.

Thus, insured property would not typically be regarded as damaged simply because of the existence of a defect.[6] A ready example would be the use of inadequate bolts to support the construction of a roof that are likely to fail and weaken at some future point but initially, support the weight of the structure.

However, certain factual scenarios can encourage debate about whether damage has occurred solely due to the existence of a defect. For example, we have seen some insureds argue that the creation of a defective weld is damage because it meets both elements of the *Ranicar* test – as (1) the two steel pieces undergo a physical alteration during the welding process and (2) that physical change adversely affects the value or usefulness of the welded steel because the defective weld will not perform as well over time as a non-defective weld.

Consider, as another example, the defective and irreversible application of an unsuitable sealant to steel pipes. The sealant begins to deteriorate once exposed to its intended marine environment, also exposing the underlying pipe to deterioration.[7] Might *Ranicar* permit it to be argued:

a) the pipe and the sealant have experienced a reduction in utility and value? and

b) the requirement for physical alteration or change is satisfied by:

   I. the irreversible application of the sealant to the steel pipe? and/or

   II. any deterioration of the sealant and consequent degradation of the underlying pipe upon exposure to environmental conditions for which it is unsuited?

[2] *Ranicar v Frigmobile Pty Limited* [1983] 2 ANZ Ins Cas 60-525, [1983] Tas R 113. A similar formulation was adopted in *Switzerland Insurance Australia Ltd v Dundean Distributors Pty Ltd* [1998] 4 VR 692 (where it was held that damage required that insured property be "interfered with in such a way as to render it less useful or valuable, such that time and money are required to restore that use or value") and in *Mainstream Aquaculture Pty Limited v Calliden Insurance Ltd* [2011] VSC 286 (which referred to a need for impairment, harm hurt or injury, possibly even where the reduction in utility or value was produced by the intended operation of the insured property – in that case, a fuse).

[3] The oft-cited judgment of Meagher JA in *Transfield Constructions Pty Limited v GIO Australia Holdings Pty Limited* [1997] 9 ANZ Ins Cas 61-336 held that a loss of usefulness (or functional inutility) may amount to damage but not to physical damage.

[4] As somewhat analogously appears to be the case in respect of negligence claims in building disputes – see, for example, *Heyman v Sutherland Shire* (1985) 157 CLR 424).

[5] Beyond the words "for the purpose of the policy and not merely this exclusion", the ambulatory character of the final paragraph is affirmed by the London Engineering Group's decision to release a modified version of the paragraph intended to be added to the policy insuring clause in lieu of the exclusion.

[6] As such, the final paragraph of LEG2 and LEG3 ostensibly does no more than affirm a generally accepted proposition. However, it was presumably inserted to achieve some aim beyond re-stating something widely accepted and whilst we are tempted to explore this further, it is well beyond the ambit of this paper.

[7] [2023] WASC 61. This example is very loosely drawn from an interlocutory judgment in an active matter that has not yet been substantively determined and as such, we will respectfully limit our observations. We use it here for illustrative purposes only and make no comment on the issues between the relevant parties.

We suggest that any physical change and/or reduction in utility or value in that scenario arises solely because of the defective, unsuitable sealant and any impact on the underlying steel pipe or deterioration of the sealant is due to the ordinary and expected outcome produced by that defect. As such, in our view, it should not be said, without more, that there has been damage sufficient to trigger either the policy or the narrowed exclusion for costs rendered necessary by defects. Others can, and have, taken a different view on similar facts.

Additional complexity exists where LEG3 applies after the 2006 amendment (giving rise to LEG3/06) in response to *Skanska*[8]. The Court was concerned with whether contractual obligations accepted by *Skanska* required it to take out insurance that relevantly covered any defects for which the contractor was responsible. Mance LJ observed (at [30], emphasis added):

> *In this contractual scheme, the mere manifestation of a defect under ordinary usage, which the contractor is anyway obliged to make good… cannot in my judgment constitute loss or damage to the slab for the purposes of the insurance requirement…*

Although recognising *Skanska* did not bring the operation of LEG3 into question, the London Engineering Group subsequently introduced the words *"(which for the purposes of this exclusion shall include any patent detrimental change in the physical condition of the Insured Property)"* to LEG3.

In so doing, the Group said[9] (emphasis added):

> *… Once the policy cover has been triggered, the intention of underwriters to meet the cost of replacing or repairing defective property that has itself been damaged (excluding only the costs of improvements) is fairly represented by this exclusion.*
>
> *However, there could be scope for an argument at law as to whether there could be said to be "damage" to the defective property if the existence of the defect had, in truth, already rendered the property less useful or less valuable, with the manifestation of the physical changes merely drawing the parties' attention to the defect being present. Since it is desirable to remove any such doubts, some modification was suggested.*

Reed KC[10] has observed the 2006 amendment to LEG3 potentially creates ambiguity. We respectfully agree and suggest such non-exhaustive language leaves open at least three questions:

a) if damage includes patent detrimental change, is any alteration or change occasioned by the expected behaviour or consequences of the defect itself sufficient without more?

b) if the answer to (a) is "yes", is any reduction in value or utility due to the defect itself sufficient for *Ranicar* when that expected or ordinary alteration or change is considered?

c) if damage includes (and inferentially, is thus not limited to) patent detrimental change, might it also include latent detrimental change?

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[8] *Skanska Construction Ltd v Egger (Borony) Ltd* [2002] EWCA Civ 310. The case involved the design, management and construction of a woodchip facility. During construction a floor slab "cracked and broke up" and both parties accepted that the design, materials and/or workmanship were defective. At issue was whether the risks against which Skanska was obliged to ensure Egger was insured against included Egger's contractual duty to rectify defects for which it was responsible.

[9] https://www.londonengineeringgroup.com/sites/londonengineeringgroup.com/files/resoure_library/clause_guidance_notes/1255569500_[LEG-3-2006-Update]_[na].pdf

"Additional complexity exists where LEG3 applies after the 2006 amendment in response to *Skanska*.

We suggest there should be absolutely no room for ambiguity about whether the qualification to the broad exclusion for costs rendered necessary by relevant defects in LEG2 or LEG3 can be enlivened by either:

a) physical alteration or change happening in the ordinary and expected course of effecting the contract works which, when "married" with a defect, creates insured property that meets both elements of the *Ranicar* test (e.g. the welding scenario); and/or

b) physical alteration due to the normal behaviour of a defect which supplements any reduction in value or utility that may have already been produced by the mere existence of the defect (e.g. the sealant scenario).

Clearly differentiating between defect and damage is neither straightforward nor merely academic. If both physical alteration and poor performance/a diminution in utility or value solely due to the existence of a defect can be characterised as damage, then on certain facts insurers might arguably, albeit unwittingly, become performance guarantors in some circumstances.

Any such outcome should only arise from a clear expression of intent and not from debate about where damage due "solely to the existence of a defect" ends and damage sufficient to trigger the policy and qualified exclusion in LEG2/LEG3 begins.

3. LEG2: "rendered necessary" and "immediately prior"

LEG2 excludes costs "rendered necessary" by a relevant defect and where the broad exclusion is qualified due to damage occurring to insured property, the costs excluded are those that would have been incurred if repair and rectification of the defect(s) had been "put in hand immediately prior"[11] to damage occurring. Essentially, LEG2 requires a determination of the overall cost of repairing/reinstating damage to insured property, and from that amount, it is necessary to deduct a sum equal to that which would have been incurred to repair/replace the defect(s) had such repair/replacement been instigated immediately prior to the damage to insured property occurring.

Reasonably or otherwise, the language of LEG2 has been known to give rise to at least three issues:

a) what causal test is required by "rendered necessary"?

b) does the residual exclusion, by virtue of the words "immediately prior", modify or supplant the "rendered necessary" test in addition to specifying a temporal point of assessment?

c) how does any adjustment account for damage that triggers the qualified exclusion but is of such a nature as to inevitably vary the costs that would have been incurred if the rectification of a defect had been put in hand immediately prior to that damage occurring?[12]

It has been asked whether, in practical terms, "rendered necessary" demands substantially the same inquiry as "but for"[13]? There is also a school of thought that recognises the possibility that "rendered necessary" may be read as importing a different causal test.

[10] P Reed QC, Construction All Risks Insurance, 2021 3rd ed. Sweet & Maxwell, 16-095 – 16-097.

[11] As various authors (including Reed KC) have noted, the phrase "put in hand" adds little to the overall clarity of LEG2. It is difficult to resist any suggestion that it be replaced with, for example, "commenced" or "initiated".

[12] Consider, by way of example, a newly constructed, multi-level data centre with a significant number of solar panels at risk of water ingress due to defective installed roofing materials. The replacement of the defective roofing will be impacted by the height of the facility and the fact the solar panels are in-situ. However, before the agreed works can commence, an unrelated fire destroys the centre entirely. Does one adjust the claim having regard to the full extent of defect rectification costs that would have been incurred if the damage had not otherwise necessarily modified such costs, or does the adjustment only reflect the (presumably, reduced) costs that can be harmonized with the broader reinstatement works post-fire?

[13] Whilst typically invoked in assessing the causal significance of a defendant's negligence, and whilst not without its own difficulties (including where damage can be attributed to multiple or concurrent necessary conditions), the enquiry called for by the "but for" test is whether, on the balance of probabilities, harm or damage would not have occurred absent such negligence (*Wallace v Kam* [2013] HCA 19; (2013) 250 CLR 375).

[14] LEG3 provides the most generous cover to an insured and we have no wish to disturb that that intent.

[15] https://www.fenchurchlaw.co.uk/you-have-to-be-pulling-my-leg3/

[16] https://dwfgroup.com/en/news-and-insights/insights/2019/2/engineering-risks-leg-306-excluding-the-cost- incurred-to-improve

Similarly, in applying the residual exclusion, the consensus view is that when reading LEG2 as a whole:

a) "rendered necessary" continues to define the applicable causal nexus; and

b) "immediately prior" only defines when, temporally, the relevant assessment is made.

However, it has been queried whether "immediately prior" imposes a temporal nexus between cost and exclusion rather than (or perhaps, in addition to) the "rendered necessary" test?

To deal with the foregoing, we suggest the following amendments to LEG2 for Australian policies (and note that the concurrent application of the "but for" test could also be extended to LEG3):

> *The Insurer(s) shall not be liable for:*
>
> *All costs that are, or would be, rendered necessary by and/or that would not need to be incurred but for, defects of material workmanship design plan 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, and without regard to the nature of, 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.*

4. LEG3: "cost incurred to improve"

Like LEG2, LEG3[14] excludes costs "rendered necessary" by a relevant defect. If the qualification to that broad exclusion is enlivened, the costs excluded are those incurred to "improve the original material, workmanship, design, plan or specification". Unlike DE5 (to which LEG3 is often compared), the excluded costs are not confined to those which are "additional".

"Improvement" is not defined in LEG3 and whilst "betterment" might seem the concern to which the residual exclusion is directed, it would have been simple for LEG3's authors to use "betterment" in lieu of "improvement". As they did not, we are left to wonder whether (and arguably, to necessarily assume that) something other than betterment was intended.

It has been suggested[15] that LEG3 requires an assessment of whether something amounts to an improvement by reference to whether the following are both answered in the affirmative:

a) are the remedial works "different in some way" to the original works? and

b) if so, is that difference an "equally valid way of performing the works" that also produces a "tangible benefit" to the insured?

We can see the utility and inherent pragmatism in that view. Respectfully however, we suggest it relies on an impermissible degree of exegesis. Relevantly:

a) there is nothing in the language of LEG3 that requires a comparison between the original works and any proposed remedial works, nor any "tangible benefit" to the insured. Instead, LEG3 requires the identification of costs incurred to "improve" the original defect, and we must strive to identify such costs without importing words or tests absent from the clause itself.

b) the focus of LEG3 is on excluding the cost of improving the original defect, not the precise reinstatement methodology or remedial measures adopted[16].

As to the last point, it is not the mere fact of improvement that brings something within the ambit of the residual exclusion. Rather, it is the fact that the improvement entails a cost. Further, the excluded cost does not explicitly need to be additional or extra according to the language of LEG3. Thus, the question is whether the clause excludes:

a) the cost of the improvement per se, even if it does not increase the overall cost of repair/reinstatement?; or

b) only any additional or increased costs incurred to realise the improvement?

Finally, we also need to ask what constitutes the benchmark above or beyond which something constitutes improvement? For example, are the costs to bring a defective design or material, or defective workmanship, up to an originally intended standard or plan covered or excluded?

We don't propose to answer the questions posed above but do suggest LEG3 should be refined in the interests of clarity and commend that task to the proposed Australian working group.

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