



INSURANCE & REINSURANCE | APRIL 2024

US ISSUES TWO DECISIONS ON THE LEG 3 DEFECTS EXCLUSION

IMPLICATIONS FOR THE AUSTRALIAN MARKET

In the absence of any legally binding authority, the United States District Court for the District of Columbia (applying Illinois law) in *S. Capitol Bridgebuilders "SCB" v. Lexington Ins. Co1* (SCB v Lexington)¹ ruled against an insurer attempting to restrict coverage under a LEG3 exclusion, after finding that it was 'ambiguous' and should therefore be interpreted in favour of the insured. This decision was followed, with a similar outcome, by the United States District Court of Florida on 12 January 2024 in *Archer Western - De Moya Joint Venture v Ace American Insurance Co2* (Archer Western v Ace)².

The LEG3 exclusion is part of a series of defect exclusions prepared by London Engineering Group (LEG), a consultative body for insurers of engineering class risks. These exclusions, numbered LEG1, LEG2 and LEG3, provide different levels of coverage, with LEG3 providing the broadest level of coverage. Although LEG3 is often used in builder's risk/contract works policies internationally until now there have been no authoritative cases providing judicial guidance on the interpretation of LEG3.

SCB v Lexington

Background

In *SCB v Lexington*, SCB was hired to build the Frederick Douglas Memorial Bridge in Washington DC. SCB obtained a builder's risk insurance policy from Lexington that provided cover for "all risks of direct physical loss of or damage to insured property". The policy also included a LEG3 defects extension which stated:

Perils Excluded, Item C. is deleted and replaced by the following:

[This policy shall not pay for loss, damage or expense caused directly or indirectly by any of the following.]

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) 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 incurred to improve the original workmanship design plan or specification.

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.

Whilst integrating and building the structural support for the bridge, due to inadequate vibration of concrete during placement, once the concrete dried and workers removed the formwork, SCB observed structural deformities in the

¹ 2023 U.S. Dist. LEXIS 176573 (D.D.C. Sep. 29, 2023)

² Docket No: CASE NO. 1:22-CV-21160-GOODMAN

concrete called "honeycombing" and "voiding". Voiding in particular can diminish concrete's weightbearing capacity. SCB was accordingly required to replace significant portions of the bridge's structural support.

SCB submitted an insurance claim seeking indemnity for the costs of the replacement work, but this was rejected by the insurer on two grounds. First, that there was no direct physical damage, and second, the LEG3 extension.

The decision

a. Was there damage sufficient to trigger the policy?

The United States District Court noted that the term 'damage' was not defined in the policy. Thus, the Court used the "plain, ordinary, and popular meaning of the term", relying on Black's Law Dictionary. The Court noted that SCB's inadequate vibration caused a decrease in the weightbearing capacity of the bridge and its support structures which was an "injury" or "bad effect" and accordingly damage.

The insurer unsuccessfully contended that the LEG3 Extension defined 'damage' in a way that excluded defects caused by workmanship. The insurer's argument rested on the fact that the final paragraph of the provision stated, "any portion of the Insured Property shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship."

The Court rejected this argument, stating that, "caused by" and "solely by virtue" were not the same. The exclusion did not mean that property was not capable of being "damaged" if there had been defects of workmanship in the chain of causation. Instead, it meant that defects of workmanship "in and of themselves" are not sufficient to constitute damage.

b. What was the effect of the LEG3 Extension?

Given that SCB was able to establish that they had coverage under the policy, the burden shifted to the insurer to show that an exclusion applied. The insurer relied on the LEG3 Extension to do so. In rejecting the insurer's reliance on the LEG3 Extension the Court held that:

"The LEG 3 Extension is ambiguous-egregiously so. To understand this, one need only attempt to read it. In just three sentences, Lexington managed to squeeze in a run-on sentence, an undefined term, several misspellings, and a scrivener's error." Exhibit 1, ECF No. 1-1, at 39. The Extension is internally inconsistent and bordering incomprehensible."

The Court considered the extension piece by piece and noted that, in replacing a broad exclusion from coverage with a narrower exclusion, the endorsement functionally extended what SCB was entitled to recover for, although exactly which exclusion the extension replaced was unclear.

The Court also noted that the extension excluded costs incurred to improve the original workmanship, however it was unclear what this meant. The Court rejected the insurer's argument that simply replacing something defective is an improvement. Rather, they held that the context of the extension suggested that to improve meant to make a thing better than it would have been but for the defective work. Ultimately, the Court held that the LEG3 extension was subject to more than one reasonable interpretation and was ambiguous. Therefore it must be construed against the drafter (i.e. the insurer).

Archer Western v Ace

Background

In *Archer Western v Ace*, an insured joint venture undertaking a highway reconstruction with bridge components used batches of concrete that were purportedly contaminated with excessive amounts of fly ash before being transferred to various pour sites throughout the project. As a result, it was alleged that the concrete had reduced compressive strength and increased hardening time and certain bridge elements had to be rectified. The applicable property damage policy had a LEG3 exclusion clause.

The United States District Court of Florida considered an application by Ace for summary judgment on the basis that there was no insurance coverage.

The decision

The JV contended that there had been damage sufficient to trigger the policy. The JV's argument was that raw cement mix was damaged by contamination with fly ash, the damaged cement mix was combined with water and other elements to form damaged concrete batches, and the damaged concrete batches were then incorporated into various Project structures causing damage to adjacent components such as rebar, forms, steel etc, and the structural integrity of the highway superstructure.

ACE argued the opposite, and sought to distinguish the case from *SCB v Lexington* on the basis that, here, there was no alteration to non-defective aspects of the Project as there was no allegation that any of the properly constructed elements suffered a loss of weight bearing capacity. ACE argued that, as the insured was seeking costs to rectify defective material and workmanship, and the repairs would improve the property, coverage was excluded applying LEG3.

The Judge referred to *SCB v Lexington* and noted that, consistent with *SCB*, the JV here was contending that it is not seeking coverage solely for defective work, but rather damage caused by defective work. The Judge cited the findings in *SCB* that the LEG3 clause is ambiguous and must be construed against the drafter and noted that Florida law is the same on this point. The Judge observed that the insurer's arguments on damage had been categorised as unpersuasive in *SCB*, which could apply here too.

Ultimately, the Judge held that "*Given the significant factual disputes and the ambiguous language in the policy....ACE's primary position of no coverage should be evaluated at trial and not conclusively determined in summary judgment setting.*"

Key takeaways

While these decisions are not binding on an Australian Court, they are significant decisions globally and may trigger a review of the wording of the LEG exclusion clauses. In the interim, these US Courts' analysis of the ambiguity of the LEG3 exclusion clause as currently drafted has intuitive appeal. It also makes commercial sense for the exclusion to exclude only improvements to the originally intended product rather than the defective version. Accordingly, these decisions tend to support a view that LEG3 will have a limited effect provided an insured can establish that there has been damage and not merely a defective product or defective workmanship.

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