IN THE SUPREME COURT OF NEW ZEALAND

SC 118/2014
[2015] NZSC 110

BETWEEN	SOUTHERN RESPONSE EARTHQUAKE SERVICES LIMITED Appellant
AND	AVONSIDE HOLDINGS LIMITED Respondent

Hearing:	25 June 2015
Court:	Elias CJ, William Young, Glazebrook, Arnold and O'Regan JJ
Counsel:	B D Gray QC, C R Johnstone and S E Waggott for Appellant N R Campbell QC and A M E Parlane for Respondent
Judgment:	22 July 2015

JUDGMENT OF THE COURT

A **The appeal is dismissed.**

B **The appellant is to pay costs of $15,000 to the respondent, plus all reasonable disbursements, to be fixed if necessary by the Registrar.**

REASONS

(Given by Glazebrook J)

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Introduction

[1] Avonside Holdings Ltd (Avonside) owned a residential rental property in Christchurch (the property). It was insured under a policy issued by AMI Insurance Ltd (AMI). AMI's liability under the policy has been assumed by Southern Response Earthquake Services Ltd (Southern).

[2] The property was damaged in the earthquakes of 4 September 2010 and 22 February 2011. The property is in the residential red zone[1] and Avonside accepted the Crown's offer to buy the land but retained its rights against Southern in relation to the improvements.[2] It is agreed that the house is beyond economic repair. As it was entitled to do under the policy, Avonside elected to buy another house. The policy provided that the cost of the other house can be no more than "rebuilding your rental house on its present site".[3]

[3] This appeal concerns whether there should be a sum for contingencies and the extent of an allowance for certain professional fees when calculating the amount payable under the policy.[4] MacKenzie J in the High Court found in favour of Southern on those issues.[5] These findings were overturned by the Court of Appeal.[6]

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1 Delineated in June 2011.

2 For more information on the red zone and the Crown's offers, see this Court's judgment in *Quake Outcasts v Minister for Canterbury Earthquake Recovery* [2015] NZSC 27 at [2]–[6].

3 It is accepted that the house area in the policy was understated but there is no issue needing determination by us in this regard. We also note that, after each of the earthquakes, the Earthquake Commission (EQC) paid Avonside $115,000 including GST (the maximum amount available under the Earthquake Commission Act 1993), being a total of $230,000. Southern's liability is for the excess over the amount paid by EQC to Avonside.

4 Leave was granted by this Court in *Southern Response Earthquake Services Ltd v Avonside*

The terms of the policy

[4] The policy provides as follows:

> **1 What we will pay**
>
> a. We will pay to repair or rebuild your rental house to an 'as new' condition, up to the floor area stated in the Policy Schedule.
>
> b. We will use building materials and construction methods in common use at the time of repair or rebuilding.
>
> c. If your rental house is damaged beyond economic repair you can choose any one of the following options:
>
> i **to rebuild on the same site.** We will pay the full replacement cost of rebuilding your rental house.
>
> ii **to buy another house.** We will pay the cost of buying another house, including necessary legal and associated fees. This cost must not be greater than rebuilding your rental house on its present site.
>
> iii **a cash payment**. We will pay the market value of your rental house at the time of the loss.
>
> d. If your rental house is damaged and can be repaired, we can choose to either:
>
> i repair your rental house to an 'as new' condition, or
>
> ii pay you the cash equivalent of the cost of repairs.

[5] The term "Full replacement", as used in cl 1(c)(i) of "What we will pay", is defined in the policy to mean "replacement with a new item, or repairing to an 'as new' condition". The term "market value" means "the value of an item immediately before the loss or damage occurred, taking into account wear and tear and depreciation".

Holdings Ltd [2015] NZSC 49.

5 *Avonside Holdings Ltd v Southern Response Earthquake Services Ltd* [2013] NZHC 1433 (MacKenzie J) [*Avonside* (HC)].

6 *Avonside Holdings Ltd v Southern Response Earthquake Services Ltd* [2014] NZCA 483, (2014) 18 ANZ Insurance Cases 62-040 (Stevens, Lang and Clifford JJ) [*Avonside* (CA)].

[6] Cover is also provided for certain additional costs in the following terms:[7]

4 [C]over for additional costs

We will pay for the following additional costs.

1	Professional fees	a. We will pay the reasonable cost of any architects' and surveyors' fees to repair or rebuild your rental house. These expenses must be approved by us before they are incurred.
2	Demolition and debris removal	a. We will pay the reasonable cost of demolition and debris removal. These expenses must be approved by us before they are incurred.
3	Removal of rental house contents	a. We will pay the reasonable cost of removing your rental house contents from your rental house when this is necessary to carry out repair or reinstatement of your rental house.
4	Compliance with building legislation and regulations	a. If additional work is required to ensure that the repair or rebuilding of your rental house complies with the building code, we will pay the reasonable costs of the additional work. b. We will not cover any additional work required: i if a notice has been served requiring compliance with the Building Act 1991 or the Resource Management Act 1991 before the loss or damage occurred, or ii if your rental house did not comply with the relevant governing building controls when it was built or at the time of any alteration, or iii to any undamaged part of your rental house, whether or not it complies with the building code.

What is at issue

[7] The witness for Avonside was a quantity surveyor, Mr Harrison. Witnesses for Southern were Mr Phillips, the "Build Technical Advisor" employed by Southern, and Mr Farrell, a quantity surveyor and the commercial manager of Arrow International (NZ) Ltd (Arrow). The primary focus of Mr Farrell's work is the damaged homes of policy holders of Southern.

[7] For ease of reference, we have numbered this clause 4.

Contingencies

[8] Mr Harrison for Avonside and Mr Farrell for Southern agreed on the following definition of contingency sums:[8]

> Contingency sums are for items, the nature or extent of which cannot be defined otherwise in the contract document. Such sums are wholly under the control of the architect, engineer or client's representative administering the works and may be expended or deducted in part or in whole under his/her authority.

[9] Mr Harrison, for Avonside, included a figure of 10 per cent of the total price calculated, some $143,200, for contingencies.[9] Mr Farrell, for Southern, made no allowance for contingencies.

Professional fees

[10] Mr Harrison made an allowance for the fees of various consultants of 10 per cent of the total cost (including the allowance for contingencies) amounting to some $157,180.[10]

[11] Mr Farrell made an allowance of $29,000 to cover geotechnical fees, consent fees, engineering and architectural drafting.

High Court decision

[12] MacKenzie J held that there should be no allowance for contingencies on the basis that this was a notional rebuild and unexpected events will thus not occur. He said:[11]

> In a notional rebuild, there can, by definition, be no unexpected items. What is required is the best assessment of the cost of rebuilding, based on all known circumstances. Because there will be no actual rebuild, that assessment will never be put to the test. There is no need to add a contingency sum to reflect possible contingencies which will never be encountered.

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8 See *Avonside* (HC), above n 5. The definition is taken from Standards New Zealand "NZMP 4212:1998 – Glossary of building terminology" (1998).

9 This figure is taken from Arrow and Mr Harrison's costing comparison exhibit produced at trial and the Court of Appeal judgment: *Avonside* (CA), above n 6, at [19].

10 This figure is taken from the respondent's submissions but we note the figure of $157,500 is given in Arrow and Mr Harrison's costing comparison. Nothing turns on this difference.

11 *Avonside* (HC), above n 5, at [24].

[13] As to professional fees, MacKenzie J considered that the amount allowed by Mr Farrell was the "appropriate estimate of the fees for items which would be necessarily incurred in the notional rebuild".[12] He rejected what he described as "Mr Harrison's approach of adopting a percentage figure based on the expected professional fees for an individually designed new house".[13] In any event, MacKenzie J held that the policy treated architects' fees as additional costs under cl 4 and not part of the basic cover.[14]

Court of Appeal decision

[14] First, the Court of Appeal held that the limit of Avonside's entitlement under cl 1(c)(ii) involved both the full replacement cost and additional costs under cl 4. The cost of rebuilding the rental house on the present site would include both the full replacement cost and necessary additional costs and thus is the amount the insurer would be liable for if the insured exercised the option to rebuild on the same site. If the policy intended to limit the costs payable under cl 1(c)(ii) to replacement cost only, then it would have said so.[15]

[15] Second, the Court rejected the distinction made by MacKenzie J between a notional and an actual rebuild. It said:[16]

> … it is irrelevant in the present context that rebuilding will not take place: what is required is an assessment of the costs that would be incurred if rebuilding were actually to occur. … [C]osts cannot be excluded merely because the rebuild is not going to happen and costs will not be incurred.

[16] This meant that a reasonable estimate for professional fees and contingencies should be included in the sums payable, as if the house is actually being rebuilt.[17] The Court of Appeal thus preferred Mr Harrison's approach to the issue of professional fees and contingencies.[18] It commented that this result was in any event

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12 At [31].
13 At [31].
14 At [30].
15 *Avonside* (CA), above n 6, at [51].
16 At [52].
17 At [53].
18 At [54].

close to Southern's approach when it prepared what the Court understood to be an actual estimate of rebuilding costs.[19]

Issues

[17] The issues for this appeal are:

(a) whether there should be a sum for contingencies;

(b) the extent of the allowance to be made for professional fees; and

(c) the relationship between cl 1 and cl 4 of the policy.

[18] As the last issue was stressed by Southern in its submissions to us, we deal with that first.

Relationship between cl 1 and cl 4

Parties' submissions

[19] Mr Gray QC, for Southern, challenges the Court of Appeal's holding that Avonside's entitlement under cl 1(c)(ii) includes both additional costs and full replacement cost. He submits that cl 4 of the policy (additional costs) applies only if the house is rebuilt. The costs covered by cl 1(c)(ii) are the costs associated with a notional rebuild to an "as new" condition. Southern does, however, accept that some professional fees ($29,000) would be incurred in the replication of the existing house on its existing site.

[20] Mr Campbell QC, for Avonside, says that it was not part of Avonside's argument before the Court of Appeal that cl 4 costs are encompassed within the cost of rebuilding. Neither party included, within their estimates of the cost of rebuilding Avonside's house, any allowance for improved foundations or for additional work required to comply with the building code. Whether an allowance should be made

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[19] At [54]. The Court said, at [55]–[58], that its approach was similar to that taken by Dobson J in *Turvey Trustee Ltd v Southern Response Earthquake Services Ltd* [2012] NZHC 3344, (2012) 17 ANZ Insurance Cases 61-965. It is not necessary for the purposes of this appeal for us to make any comment on whether that is the case or on Dobson J's approach.

for the costs of such additional work under the "buy another house" option is not an issue on this appeal.

[21] Further, the cover under cl 4(1)(a) for additional costs of professional fees is for fees that the insured wishes to incur that are additional to the necessary costs of rebuilding or repairing. The insured will be covered for that additional cost only if the insurer approves it before it is incurred. Neither Mr Harrison nor Mr Farrell allowed for "additional" fees in that sense. The professional fees allowed for by both Mr Harrison and Mr Farrell related to rebuilding the existing house and thus came within cl 1(c)(ii). MacKenzie J was therefore wrong to characterise them as additional costs.

Our assessment

[22] We accept Avonside's submission that the relationship between cl 1 and cl 4 of the policy does not arise in this appeal. Avonside's claim relies only on cl 1. We also accept Avonside's submission that MacKenzie J mischaracterised architects' fees in his judgment.

Contingencies

The evidence

[23] Mr Harrison's evidence for Avonside was that, taking into account that the notional rebuild was to replace an existing house to the same configuration and size, "your unknowns are mainly in the ground" but that there would also be risks in the documentation and consultants, and clients "changing their minds or being awkward". Later in his evidence he agreed that builder's staffing could also be an item of risk.

[24] As to documentation, this may not be complete. There could be missing details or a clash in detail between, for example an architect's document and an engineer's document. Mr Harrison confirmed that this applied to building contracts generally, including where there are existing plans:

> Q. On this specific exercise the same house with existing plans that exist at the moment but will be demolished under the notional exercise there will be some work to prepare the existing plans for a building consent now. We've heard there might be some geotechnical input to the same design and configuration of the house. What potential unknowns would exist in that scenario that you need to factor in to your contingency allowance?
>
> A. Whether it's for this site or any site I think the contingency factor would still be there. There is that element that something's not going to be in the drawing that needs to be. Whether it's a notional build or an actual build. I don't think there's any differences between the two.

[25] Mr Harrison did not accept that, if good ground is assumed, the contingency should be nil. He would still allow a 10 per cent contingency to take soft spots into account.

[26] Mr Phillips, for Southern, agreed that quantity surveyors often include contingencies in preparing budgets for rebuild projects and that this fits with the budget exercise a quantity surveyor is commonly called upon to complete. He agreed that "there's always risks of unknowns" in the build process and that a contingency percentage of 10 per cent is not unreasonable in the context of quantity surveying, "particularly since the earthquakes". He, however, drew a distinction between an actual and a notional rebuild. In his view, additional costs actually incurred would be covered on an actual rebuild but not on a notional rebuild.

[27] Mr Farrell, for Southern, said that no contingency had been applied "as we have assumed good ground and precluded any 'unknowns' within the foundations and excavation". The same applied to the "super structure"[20] as "we are applying the theory of a notional build to compliant drawings, under a 'fixed lump sum contract'". Mr Farrell agreed there would be risks in the ground post earthquake but said that:

> Where we've come from with the estimate is that this is a notional build. The build has been priced as per good ground. We are familiar. We have designs for the current foundation therefore as far as we can see being a notional build there is no risk around the ground.

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[20] Mr Farrell explained in examination in chief that this was from Bottom Plate (top surface of the foundations) up.

[28] Asked whether one unknown might be the preparation of the ground beyond the design of the foundation,[21] Mr Farrell said:

> A. You could encounter soft spots during excavation which would obviously have to be engineered, filled to replace them and so forth which is why you, if you were doing a build on certain ground you would hold the contingency. In this case we've assumed good ground.

[29] Later he said that, in an actual rebuild, soft spots, if encountered, would be treated not as a contingency but as an unknown, and would be dealt with as a variation to the contract:

> A. No, no we wouldn't carry contingency assuming good ground an existing house has been built there. We have the foundation design. I accept that there is a risk of finding soft spots in any build absolutely but we're assuming good ground on this estimate on a notional build.
>
> Q. You've given evidence before that Arrow would have a fixed price contract. If you came across soft spots which Mr Harrison has identified how would you deal with that in a fixed sum contract?
>
> A. That would be an unknown which is effectively a variation to the contract.
>
> Q. It wouldn't be a contingency in the build contract. It would be an unknown is that your evidence?
>
> A. Correct.

[30] Mr Farrell agreed that the fact the property was red zoned and by a river would create risks but, if there was an actual rebuild, the insurers would get a full geotech report and know the state of the land and therefore would not hold a contingency, although he accepted there would remain a possibility of still encountering an unknown once construction physically started.

[31] As to documentation, Mr Farrell said:

> A. Yes I mean the documentation's always a risk. Any gaps that may exist between engineering, architectural in a physical build, builder coming on site they are risk items, unknowns.

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[21] Which would be the same design as the current foundation.

He did, however, say that, given the house is an existing house and assuming good ground, the likelihood of holes in the documentation is "limited but still possible".

[32] Mr Farrell said that the fact that it is a notional rebuild changes things insofar as documentation was concerned:

> Q. Mr Farrell. Does the notional rebuild change things for you?
>
> A. In my view yes.
>
> Q. Why?
>
> A. A notional build is not going to happen. There is no risk.

[33] Mr Farrell agreed that the use of 10 per cent as a contingency is not unusual. He also agreed that a builder could include some risk items into a lump sum contract, such as weather and subcontractor delay issues.

Parties' submissions

[34] Southern submits that the rebuild contemplated under cl 1(c)(ii) of the policy is of a known structure in a known location. There are no variations by the building owner. There is no risk of ground conditions being unknown or unsuitable because known foundations are being built in the same place on the site, assuming the same ground as at the original construction. For this reason, there are no contingencies. There is no uncertainty about what is being built.

[35] Avonside points out that Mr Harrison identified various risks or uncertainties for which a contingency should be allowed: ground conditions, quality of documentation, variations by consultants or clients, and staffing.

[36] Mr Phillips, for Southern, accepted that there were risks, that Mr Harrison's approach to costing the rebuild was standard orthodox quantity surveying practice and that a contingency allowance of 10 per cent was not unreasonable, particularly since the earthquakes.

[37] Mr Farrell accepted that there were uncertainties in relation to ground conditions, quality of documentation, product availability and weather. He also

agreed that it was not unusual to use 10 per cent as a contingency allowance. His reason for not allowing any contingency sum was not that there were no uncertainties. It was, rather, that this was a notional rebuild and an actual rebuild was not going to happen. In Avonside's submission, that is not a valid basis of distinction for the reasons given by the Court of Appeal.

Our assessment

[38] The amount payable under the policy can be no more than the cost of rebuilding the house on its present site. The exercise that is required is to estimate the actual cost of rebuilding the house on the site.

[39] Mr Harrison, in accordance with what is agreed to be standard quantity surveying practice,[22] included a sum of 10 per cent for contingencies. Southern's witnesses both agreed that there were "unknowns" in any building project, including in a rebuild of this type (existing house in an existing location).

[40] We accept Avonside's submission that the fact that this is a notional, rather than actual, rebuild does not affect the inclusion of an allowance for risks generally encountered. Such risks are relevant to estimating the cost of an actual rebuild and, as noted above, it is the actual cost of rebuilding that must be estimated. The Court of Appeal was thus correct to accept the inclusion of an allowance for contingencies.[23]

Professional fees

The evidence

[41] Mr Harrison's evidence was that historically 10 per cent has been applied to a "lot of our estimates" and that it was "a number we have got from the consultants". He said that he had been talking to an architect "the other morning" whose rate was

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[22] We do not understand that the 10 per cent includes any particular additional allowance for the effect of the earthquakes. Mr Harrison confirmed that, even if good ground is assumed, there could still be the risk of "soft spots". Mr Farrell agreed that "soft spots" could be encountered in any build.

[23] Part of the "unknowns" described by Mr Harrison were for client changes of mind. These would not, unless approved, be paid for by an insurer. Neither party attempted to separate out the percentage attributable to this factor so we assume for these purposes it is minimal.

10 per cent just for architectural services. In this case the 10 per cent included various consultants. The approximate breakdown of that allowance was:

(a) structural engineer – 1.5 per cent;

(b) design fees (allowing for an architectural draftsperson, not an architect) – 5.5 per cent;

(c) geotechnical fees – 1 per cent;

(d) land survey – 0.25 per cent; and

(e) project manager or quantity surveyor – about 1 per cent.

[42] Mr Harrison said that his calculation of professional fees applied even where there are existing plans:

> Q. I'm going to focus on the notional rebuild exercise because I interpret your answer Mr Harrison to apply to a rebuild of a new house. Here we have existing plans so wouldn't that affect your 5.5 allowance for the design?
>
> A. No, no, the existing plans still need to be redrawn. They need to comply with the current code. These plans are dated 1977 I think they are. There's a fee involved in redrawing it.

[43] As to professional fees, Mr Farrell accepted that what Mr Harrison said was reasonable in terms of orthodox surveying practice. Mr Farrell's evidence was that Arrow applied a reasonable cost to prepare the documentation for the building consent for the notional rebuild of the insured dwelling, including a cost to redraw the existing drawings and make any changes required to secure consent for that same design. Mr Farrell said that, based on previous experience, $12,000 would suffice for an architectural draftsperson in the circumstances.[24]

[44] Asked about the previous estimate by Arrow of $100,399.58 for design and consent fees he said:

> Q. We'll just put a context to that calculation. That exercise was undertaken for what purpose?
>
> A. That exercise was conducted to give Southern Response an indication of full exposure if they were to rebuild that house with full architectural input.

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[24] The rest of the $29,000 estimated by Mr Farrell consisted of consent costs, engineering and geotechnical investigations.

Q. And under the rental house policy that would be on site?

A. Correct.

Q. That's not the figure that applies am I correct for a notional rebuild exercise?

A. Not at all.

Parties' submissions

[45] Southern accepts that some professional fees would be incurred in replication of the existing building on its existing site. However, in this case the building was comparatively new and plans were available. Mr Farrell believed that $12,000 would be spent for an architectural redrawing. It is submitted there is no need for other experts and no need for an allowance to be made for services not required.

[46] Avonside notes that Mr Farrell accepted that Mr Harrison's approach was reasonable and yet his estimate of $29,000 made no allowance for two of the professionals that Mr Phillips acknowledged would be needed: land surveyors and project managers. Mr Farrell also estimated geotechnical fees on the assumption of "good ground".

[47] In addition Mr Campbell points out that Arrow had, in an earlier costing for the rebuild, allowed a sum of $100,399.58 for design and consent fees. That same sum was also in Arrow's revised DRRA[25] produced by Mr Farrell as Appendix A to his brief, where the figure for design and consent was expressed as nine per cent of the core building costs. In Mr Campbell's submission Mr Farrell did not explain the reason for the reduction from Arrow's earlier estimate of $100,399.58 to $29,000, apart from to say that the former was not the figure that applied "for a notional rebuild exercise". It is submitted the fact that a "notional" rebuild is involved is irrelevant.

[48] Mr Campbell also submits that MacKenzie J was in error when he described Mr Harrison's figure as being for the fees typically involved in "an individually designed house building project". That was not Mr Harrison's approach. Mr Harrison made it clear that the allowance he had made for design fees (about

[25] Detailed Repair/Rebuild Analysis.

5.5 per cent) would not be affected by there being existing plans. Mr Farrell agreed that those plans needed to be redrawn. Mr Farrell and Mr Harrison disagreed over their estimate of the fee cost for this and for professional fees generally, but not their approach to them.

Our assessment

[49] As mentioned earlier, the exercise that is required is to estimate the actual cost of rebuilding on the site. Mr Harrison did this, while Mr Farrell's approach was based on his erroneous assumption that a different approach was required for a notional rebuild.[26] Mr Harrison's allowance for professional fees was based on orthodox quantity surveying practice. Contrary to MacKenzie J's view, the estimate was based on the use of an architectural draftsperson and not an architect and took full account of the fact that the notional build was a rebuild on an existing site with existing plans. The percentage Mr Harrison used was also very similar to the percentage (nine per cent) used by Arrow in its estimate of what it would actually cost to rebuild. We thus accept Avonside's submission that the Court of Appeal's approach to this issue was correct.

Result

[50] The appeal is dismissed.

[51] The appellant is to pay costs of $15,000 to the respondent, plus all reasonable disbursements, to be fixed if necessary by the Registrar.

Solicitors:
Wynn Williams, Christchurch for Appellant
Grant Shand, Christchurch for Respondent

[26] See above at [38].