

**IN THE HIGH COURT OF NEW ZEALAND
CHRISTCHURCH REGISTRY**

**CIV-2012-409-2536
[2013] NZHC 1433**

BETWEEN AVONSIDE HOLDINGS LIMITED
Plaintiff

AND SOUTHERN RESPONSE
EARTHQUAKE SERVICES LIMITED
Defendant

Hearing: 27-28 May 2013

Counsel GDR Shand and AME Parlane for Plaintiff
C R Johnstone and S E Waggott for Defendant

Judgment: 11 July 2013

JUDGMENT OF MACKENZIE J

*I direct that the delivery time of this judgment is
4 pm on the 11th day of July 2013.*

Solicitors: Grant Shand, Christchurch, for Plaintiff
Wynn Williams Lawyers, Christchurch, for Defendant

Background

[1] The plaintiff (Avonside) is the owner of a property at 1146 Avonside Drive, Avondale, Christchurch. The property suffered earthquake damage in the earthquakes of 4 September 2010 and 22 February 2011.

[2] The property was insured under a rental property policy issued by AMI Insurance Limited (AMI). AMI's liability under the policy has been assumed by the defendant (Southern Response). The policy was first issued on 22 November 2009 and was renewed on 22 November 2010. The two earthquakes were thus in different policy periods, but nothing turns on that. The parties are agreed that the house is damaged beyond economic repair. The plaintiff has chosen an option under the policy to buy another house. The maximum amount to be paid by the insurer is the cost of rebuilding the house on its present site.

[3] The parties have been unable to agree a figure for the cost of rebuilding the house on its present site.

[4] Arrow International (NZ) Limited (Arrow), the project manager appointed by Southern Response for the assessment and management of all repair and rebuild projects of AMI insured houses, has calculated an estimated cost for rebuilding the house. Ian Harrison and Associates Limited, quantity surveyors engaged by Avonside, have separately estimated the cost of rebuilding. There are differences between their estimates.

[5] I heard evidence from Mr Stewart Harrison of Ian Harrison and Associates for the plaintiff and from Mr Farrell of Arrow for the defendant. In the course of hearing their evidence, as a panel, it became apparent to me that some of the differences between them would be difficult to resolve. The different approaches which they had adopted to the preparation of their estimates meant that it was not possible to make a direct comparison between their figures. I therefore adjourned the hearing overnight to give them an opportunity to prepare a scope of works on a common basis. The purpose of that was to enable a direct comparison to be made between the two estimates so the monetary value of differences between them could be identified. I record my gratitude to them for their efforts.

[6] In conducting that exercise, Mr Farrell and Mr Harrison were able to resolve a number of issues, so that the scope of the dispute was narrowed.

The policy

[7] The policy provides replacement cover for the house and its associated structures and works, and loss of rents cover. An issue over the extent of the loss of rents cover was resolved shortly before trial. The main provisions which are relevant to the matters now in issue can be quite shortly stated.

[8] The basic cover under the policy is 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.
 - c. 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.

[9] There is also cover for some additional costs. Two items are relevant. These are:

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.

[10] As a result of that narrowing of the issues, the question which remains for determination is whether and to what extent a number of items are to be included in the calculation of the cost of rebuilding the house on the present site. The items in dispute are:

- (a) builder's margin;
- (b) contingency;
- (c) professional fees;
- (d) demolition costs; and
- (e) external works.

The issues

(a) Builder's margin

[11] The issue is the extent to which a sum should be added to the estimated costs of the individual items in the costs estimate, to allow a margin to the builder beyond that allowed in the individual item costs.

[12] Mr Harrison, in his calculations, allowed a builder's margin of 10 per cent, which he applied to the total cost including preliminaries and general, and including demolition costs. Mr Farrell allowed a builder's margin of eight per cent of the estimated costs, excluding the preliminary and general component of those costs. A decision is therefore required on two issues:

- (a) the appropriate percentage; and
- (b) the figure to which that percentage is to be applied.

[13] The sum to be calculated is the notional cost of rebuilding the house on the site. The house will not actually be rebuilt. The approach which both parties have adopted in calculating that notional cost is to assess the sum which a contractor would be likely to tender for the work involved in rebuilding the existing house on that site. For the most part, they have calculated that by using estimated rates for each unit of work. Both parties, however, accept that a contractor would be likely to add a margin, over its actual costs, to allow for such matters as overhead costs not reflected in the unit rates, profit, and other items. Estimating the rate to be used involves assessing the likely approach of a reasonable contractor. The margin likely to be applied will be within a range. Mr Harrison's percentage was based on his experience. Mr Phillips, the build technical adviser of Southern Response, said that in his opinion the range would be somewhere between eight and 12 per cent. Mr Farrell said that he had applied a percentage margin based on the contracts that Arrow currently has in place with its builders. Mr Farrell's figure of eight per cent reflected market information based on close to 300 contracts involving Southern Response. Larger contracts generally command a lesser margin than smaller ones.

[14] On the evidence, I find that the builder's margin is likely to be in the range of eight per cent to 12 per cent. The choice within that range is essentially an arbitrary one. Because this is a notional rebuild, I consider that constraints and other factors affecting the actual market in Christchurch should be given limited weight in making that choice. I consider that the appropriate course is to adopt the midpoint of the range. I allow a 10 per cent builder's margin.

[15] The next issue is the sum to which that percentage should be applied. Mr Harrison and Mr Farrell differ in their approach as to whether that sum should include:

- (a) preliminary and general items; and

(b) demolition costs.

[16] Preliminary and general items cover such matters as the costs of establishment on site, the supply of services for the period of building, general overheads attributable to the particular building project, and decommissioning on completion.

[17] Mr Farrell's reason for excluding preliminary and general items in calculating the builder's margin was that Arrow has a preferred agreement in place within the Southern Response project where preliminary and general margin arrangements have been made with preferred suppliers and buildings.

[18] I do not consider that a distinction should be made between preliminary and general items and other items in calculating the builder's margin. The preliminary and general items represent costs incurred by the builder, and I would allow a margin on them. Arrow's ability to negotiate special terms in Christchurch should not affect the calculation of the cost of a notional rebuild.

[19] I deal later with demolition costs. As I disallow these costs, the builder's margin does not apply to that component.

[20] I therefore allow a builder's margin of 10 per cent calculated on the assessed cost, including preliminary and general items.

(b) *Contingencies*

[21] For contingencies, Mr Harrison allowed a figure of 10 per cent of the total price. The total price included all the items taken into account in calculating the builder's margin, plus the builder's margin itself. Mr Farrell made no allowance for a contingency sum.

[22] Mr Harrison referred to the following definition in New Zealand Standards 4212, a glossary of building terms:

Contingency sums are for items, the nature or extent of which cannot be defined otherwise in the contract documents. 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.

[23] Mr Farrell accepted that definition.

[24] I consider that it is not appropriate to include a contingency allowance in calculating the cost of a notional rebuild. As the definition indicates, contingency sums are allowed to deal with unexpected items encountered as the work is carried out. They are subject to the control of the professional person administering the works. They may not be expended unless such unexpected items are encountered, and accepted as such by that administrator. 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.

[25] I make no allowance for contingencies.

(c) *Professional fees*

[26] This item is concerned with the fees which would be incurred for the professional services required in designing the replacement house, obtaining consents, and supervising construction. Mr Harrison made an allowance for professional fees of 10 per cent of the total cost, including builder's margin and contingency. Mr Farrell made an allowance of \$29,000 to cover geotechnical fees, consent fees, engineering and drafting.

[27] Mr Harrison's figure for professional fees includes fees for the different consultants typically involved in an individually designed house building project. His 10 per cent figure is a composite figure, based on his experience as to the fees of the categories of consultants involved. The approximate breakdown is structural engineer 1.5 per cent; design fees 5.5 per cent; geotechnical 1.0 per cent; land survey 0.25 per cent; and a project manager or quantity surveyor at about 1.0 per cent.

[28] Mr Farrell accepted that Mr Harrison's evidence represents orthodox quantity surveying practice. Mr Farrell's approach was different. He took the view that, because the costing is of a notional cost to rebuild the previous house, the estimate should not include the full range of fees likely to be involved in designing and building a new house. He considered that the necessary design would be limited to the cost of redrawing the original plans to meet the current building code. He allowed a figure of \$12,000 for that. He allowed a further sum of \$17,000 to reflect other professional fees likely to be incurred if the house was rebuilt on that site.

[29] Both approaches recognise that the cost of rebuilding the house on the present site will require that certain professional fees will be incurred and will be covered under the basic cover provision in the policy. The difference is as to the extent of these fees.

[30] I consider that the amount to be included in the cost of the notional rebuild should be an allowance to reflect the likely cost of those fees which will be necessarily incurred. I do not consider that it should include other professional fees which a homeowner might choose to incur, but which would not be essential to the rebuilding. Not every home is architect designed. In the notional rebuild involved here, that is not required. Furthermore, the policy itself deals differently with architect's fees. These are covered as additional costs, not as part of the basic cover.

[31] For these reasons, I do not consider that Mr Harrison's approach of adopting a percentage figure based on the expected professional fees for an individually designed new house is the appropriate measure in this case. I consider that the amount allowed by Mr Farrell is an appropriate estimate of the fees for items which would be necessarily incurred in the notional rebuild.

[32] I accordingly allow professional fees in the sum estimated by Mr Farrell, of \$29,000.

(d) *Demolition costs*

[33] The dispute between the parties is, in essence, whether the cost of the notional rebuild should include the cost of demolishing the damaged house to allow for rebuilding on the site.

[34] Avonside has accepted an offer to sell the land to the Crown acting through the Canterbury Earthquake Recovery Authority (CERA). That sale means that Avonside has no ongoing responsibility to meet any demolition costs. The evidence given at trial suggested that Southern Response had some responsibility to the Crown to meet the demolition costs for which Southern Response would have been liable if the land had not been sold. Counsel for Southern Response has, following my inquiry at the hearing, filed a memorandum on this issue. Counsel advises that the cost of demolition of houses in the red zone sold to the Crown was the subject of discussions between CERA and insurers. Those discussions recognised that the policy obligations of insurers to demolish buildings beyond economic repair would continue, notwithstanding the sale to the Crown. Further, the sale contract included an obligation on Avonside as vendor to use reasonable endeavours to require the insurer and the Earthquake Commission to remove fixtures from the land.

[35] That background is relevant to the issue of whether the costs of demolition form part of the costs of the notional rebuild. If those arrangements were determinative of the insurer's ongoing liability to the insured, then proper evidence of the arrangements would be needed. However, those other arrangements, while relevant, are not determinative of that issue. I am therefore able to proceed to judgment on the present evidence.

[36] I consider that, in terms of the policy, the costs of demolishing the existing structures and preparing the site do not form part of the cost of a notional rebuild. The costs of a notional rebuild fix the maximum sum to be paid by the defendant towards the cost of buying another house. That cost "must not be greater than rebuilding your rental house on its present site". That does not expressly require that any costs incurred in removing the damaged house to prepare 'the present site' for rebuilding are included. Under the cover for additional costs, the insurer is liable to

pay “the reasonable cost of demolition and debris removal”. That is an additional cost, not part of the cost of rebuilding. The combined effect of those clauses is that the cost of demolition and debris removal is dealt with as a separate item, and not part of the cost of rebuilding on the present site.

[37] I find that demolition and debris removal costs do not fall under the cover in cl 1(c)(ii) of the policy. As the site is no longer owned by Avonside, no issue of their payment to Avonside as additional costs arises. I need not determine whether Southern Response has any responsibility to the Crown for those costs.

(e) *External works*

[38] There are a number of items, external to the house itself, which have been damaged and which would, if the house was rebuilt, have to be replaced or at least repaired. Some of these are in a state where replacement would be required. Others are in a state where, if assessed separately from the house, they would be repairable. That is, while the parties accept that the house is a total loss, there are some items of external works which could be repaired, and incorporated into the new house, if it was built to the same design on that site. The main items in that category are fences, walls and a driveway.

[39] The essence of the dispute between the parties is whether the amount to be included in the cost of the notional rebuild is:

- (a) as the plaintiff contends, the costs of replacing all external works, even if they are repairable and reusable at lesser cost; or
- (b) as the defendant contends:
 - (i) the cost of replacing external works damaged beyond repair; and
 - (ii) the cost of repairing external works which are repairable and reusable.

[40] The parties have agreed the quantum of those two options. The cost of (a) is agreed at \$114,376.34. The cost of (b) is agreed at \$79,421.50. The amount in issue is the difference between these figures, \$34,954.84.

[41] The trigger to the three options in cl 1(c) of the coverage clause is that the rental house is damaged beyond economic repair. The question is whether “your rental house”, which includes all items coming within that definition, is damaged beyond economic repair. The external works in issue all form part of the policy definition of “your rental house” and are covered by the policy, so that damage to those works is to be taken into account in deciding whether the rental house is damaged beyond economic repair. It is not in dispute that the house “is damaged beyond economic repair” in terms of cl 1(c).

[42] The question whether the trigger, namely that the house is damaged beyond economic repair is reached, must be assessed on a global basis. An item by item assessment of each item included in the definition of the rental house is not required. However, once that trigger is met and the insured chooses option (ii), the question is different. Under that option, set out at [8] above, the maximum amount payable is fixed at the cost of “rebuilding your rental house on its present site”. The cost of rebuilding the house on its present site can require an item by item assessment. There is nothing in the policy which precludes the reuse of any part of the house or its associated works which is not itself damaged beyond economic repair and which can, when repaired, perform its function as part of the rebuilt house. I consider that, on the proper interpretation of the policy, the rebuilding of the house could include incorporating into the rebuilt house external works which are capable of repair. Clause 1(a) of the coverage clause provides that the rebuilding is to be to an ‘as new’ condition. That might, if the house were rebuilt under option (i) be achieved by repairing some items to an ‘as new’ condition. The assessment of the cost of a notional rebuild under option (ii) can similarly take into account that possible reuse.

[43] For these reasons, I consider the defendant’s contention, set out in [39](a), is correct. I hold that the allowance for external works is \$79,421.50.

Result

[44] I find that the cost of rebuilding the house on its present site:

- (a) includes a builder's margin of 10 per cent calculated on the assessed cost of rebuilding, which includes the preliminary and general expenses as agreed;
- (b) does not include any additional allowance for contingencies;
- (c) includes an allowance of \$29,000 for professional fees;
- (d) does not include any allowance for demolition costs; and
- (e) includes an allowance of \$79,421.50 for the replacement or repair of the external works.

[45] I anticipate that the parties will be able to apply this judgment to the figures agreed between them so as to determine the total cost of rebuilding the house on its present site. In case that is not so, I reserve leave to the parties to apply for further directions in settling the terms of the judgment to be sealed.

[46] Costs are reserved. The parties may file memoranda if they are unable to agree.

“A D MacKenzie J”