Posted on: September 15, 2016

SUPREME COURT OF CANADA RULING ON "FAULTY WORKMANSHIP" EXCLUSION

Richards Buell Sutton Insurance Newsletter

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Today, the Supreme Court of Canada issued its highly anticipated ruling on the applicability of a "faulty workmanship" exclusion in a builders' risk insurance policy. In *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.,* 2016 SCC 37 the court held that the subject exclusion served to exclude from coverage only the cost of redoing the faulty work. It did not exclude the cost of replacing approximately $2.5 million worth of damaged windows caused by the faulty work.

THE FACTS

Station Lands Ltd. ("Station") is the owner of the recently built EPCOR Tower office building in Edmonton (the "Tower"). Ledcor Construction Ltd. ("Ledcor") was the general contractor that built the Tower. As the Tower was nearing completion, paint specks, dirt and concrete splatter were removed from the windows by Bristol Cleaning, a company hired by Station. The service contract between Bristol and Station required the latter to obtain all-risk property insurance for the Tower which Station did in the form of a builders' risk insurance policy (the "Policy"). As usual with builders' risk policies, the Policy provided coverage for all risk of direct physical loss or damage to the property undergoing construction. The Policy, as is also usual, excluded "the cost of making good faulty workmanship… unless physical damage not otherwise excluded by this policy results, in which event the policy shall insure such resulting damage" (the "Exclusion"). During the window cleaning process, Bristol used improper tools and methods and scratched the Tower's windows necessitating their replacement. Both Station and Ledcor claimed the window replacement cost under the Policy and the insurer denied coverage on the basis of the Exclusion.

THE JUDICIAL BACKGROUND

At trial in the Court of Queen's Bench in Alberta, the insureds argued that the "cost of making good" portion of the Exclusion dealt only with redoing the cleaning work whereas the insurer argued it dealt with that plus the cost of replacing damaged windows as the windows were the very subject of the faulty workmanship. The trial judge found Bristol's cleaning work faulty but also found the "making good" portion of the Exclusion ambiguous. Applying *contra proferentem* the trial judge held that the Exclusion did not

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remove from coverage the cost of replacing the windows.

The insurer appealed and the Alberta Court of Appeal, applying a correctness standard of review to the interpretation of the Policy, found the Exclusion unambiguous and the replacement of windows thereby excluded from coverage. In distinguishing between physical damage that was excluded as the "cost of making good faulty workmanship" and physical damage covered as "resulting damage" the Court of Appeal devised a test of "physical or systemic connectedness" and concluded that the damage was not accidental or fortuitous but rather the direct consequence of scraping and wiping, the very workmanship employed by Bristol. As such, the Exclusion operated to remove from coverage the window replacement cost.

THE RULING

The Supreme Court of Canada, because of one of its 2014 decisions and the varied way in which that decision had been interpreted and applied by various provincial appellate courts, spent considerable effort in settling the law on standard of appellate review for standard form contracts such as insurance policies. By way of an 8:1 majority, the standard of review was settled as being one of correctness. This means that insurers and insureds alike now have a clear question to answer when considering appellate review of superior court decisions on insurance policy interpretation: is the subject decision correct at law?

In respect of the Exclusion, the court applied the principles of insurance policy interpretation established in *Progressive Homes Ltd. v. Lombard General Insurance Co.*, 2010 SCC 33. In applying these principles, the court first found that the Exclusion was ambiguous. The source of its ambiguity was that the word "damage" figured only into the Exclusion's exception (i.e. the exception for "resulting damage"). The word "damage" was not used in the language of the Exclusion itself (i.e. the "cost of making good faulty workmanship"). Given the Policy did not define either "resulting damage" or the "cost of making good faulty workmanship" and the Exclusion was capable of being read in the manner exhorted by both the insured and the insurer, the court turned to the next principle of policy interpretation, namely the reasonable expectation of the contracting parties.

In addressing the reasonable expectations of the parties, the court placed heavy emphasis on the purpose of builders' risk policies. Such policies have the purpose of providing "broad coverage for construction projects which are singularly susceptible to accidents and errors". This coverage is obtained in exchange for high premiums with a view to providing all involved with the construction process certainty, stability and peace of mind that the project will not grind to a halt because of disputes around responsibility for replacement or repair of project components. Consequently, an interpretation of the Exclusion that would remove from coverage not only the cost of redoing the window cleaning but the damage resulting to that

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part of the project on which the work was done would undermine the very purpose of builders' risk policies and essentially deprive insureds of their contracted for coverage.

The court went on to address whether its interpretation of the Exclusion would lead to an unrealistic or commercially nonsensical result and whether the interpretation was consistent with prior jurisprudence. It undertook these steps in an extensive manner and determined that the interpretation aligned with commercial realities and was consistent with prior jurisprudence.

PRACTICAL CONSIDERATIONS FOR INSURERS

First and foremost, *Ledcor Construction* firmly establishes that the "faulty workmanship" exclusion in builders' risk policies that provide coverage on an "all-risk" basis (as opposed to named-peril basis) operates to exclude only the cost of redoing the faulty work. These exclusions do not operate to exclude the cost of making good property damage caused by or resulting from the faulty work.

Should insurers wish to exclude from coverage the damage caused by faulty work, clear language must be included in their policies to this effect. This clear language may include the addition of specific definitions for terms such as "faulty workmanship", "resulting damage" and others. It may also entail removing the "resulting damage" or any other exception contained in the faulty workmanship exclusion. Of course, such alterations to policy language and presumably coverage may have a negative impact on the market for such a product given the pervasiveness of all-risk course of construction or builders' risk policies in the market and the purpose of these policies as expressed by the court.

Secondly, *Ledcor Construction* firmly establishes that the standard of appellate review on the interpretation of insurance policies is one of correctness as opposed to palpable and overriding error. This conclusion erases over two years of debate and unrest on the standard of review and provides both insurers and insureds a clearer and easier route to determining the meaning of disputed insurance policy language. Insurers, insureds and their counsel can now better focus on the correctness of any coverage determination rather than whether the determination is capable of being corrected by an appellate court.

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