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Thomas Heintzman is the author of ***Heintzman & Goldsmith on Canadian Building Contracts***, 5th Edition which provides an analysis of the law of contracts as it applies to building contracts in Canada.

This article contains Mr. Heintzman's personal views and does not constitute legal advice. For legal advice, legal counsel should be consulted.

Faulty Workmanship Exclusion In A Builders' Risk Policy Excludes Only The Cost Of Re-Doing The Faulty Work: Supreme Court Of Canada

In ***Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.***, 2016 SCC 37, the Supreme Court of Canada has issued a definitive decision about the scope of the "faulty workmanship" exclusion in Builders' Risk insurance policies. The Supreme Court has held

that the clause only excludes coverage for the cost of re-doing the faulty work, and does not exclude the cost of repairing the damaged work.

In this landmark decision, the Supreme Court has set at rest the ongoing debate about the proper interpretation of this clause, a debate which has embroiled the construction and insurance industries for many years.

Background

During the construction of a building, the windows which had been installed were dirtied. Before the project was completed, the owner hired cleaners to clean the windows. Because the cleaners used improper tools and methods, they scratched the windows. The windows had to be replaced and the building's owner and the general contractor made a claim for the replacement cost under the builders' risk insurance policy covering the project. The insurers denied coverage, asserting that the claim fell within the policy's exclusion for the "cost of making good faulty workmanship".

Proceedings Below

The trial judge in Alberta held that the clause was ambiguous and applied the ***contra proferentem*** rule to find that the claim was not excluded.

The Alberta Court of Appeal reversed the trial judge's decision. It applied a test of physical or systemic connectedness to decide if the physical damage was excluded as the "cost of making good faulty workmanship" or covered as included within the exception for "resulting damage." The Court of Appeal concluded that the damage to the windows was excluded because it was directly caused by the intentional scraping and wiping motions involved in the cleaners' work.

These decisions were reviewed by me in my articles dated December 27, 2013 and March 30, 2015.

The Supreme Court reversed the Court of Appeal's decision and re-instated the trial judge's decision.

The Exclusion and Exception

In the policy in question, the Exclusion for "faulty workmanship" and the Exception to that exclusion for "resulting damage" read as follows:

"This policy section does not insure:

(b) The cost of making good faulty workmanship, construction materials or design unless physical damage not otherwise excluded by this policy results, in which event this policy shall insure such resulting damage."

The Supreme Court's Reasoning

Justice Wagner delivered the judgment for all the judges of the Supreme Court of Canada on this issue. Justice Wagner arrived at his decision through the following reasoning:

1. The Court of Appeal had held that the Exclusion must relate to physical damage since the policy covers physical damage. The Court of Appeal then went on to develop a new theory about how the Exclusion should be construed in light of that requirement.

   The Supreme Court held that this conclusion by the Court of Appeal was wrong. The mere fact that the policy covered physical damage did not require that the exclusions also relate to physical damage. The Supreme Court pointed to several other exclusions in the policy that clearly did not relate to physical damage.

2. There were two competing interpretations of the Exclusion. The Insureds said that only the cost of redoing the faulty work — in this case, cleaning the windows — is excluded from coverage. The Insurers said that the Exclusion covers not only the cost of redoing the faulty work, but also the cost of repairing that part of the insured property or project that is the subject of the faulty work.

   On balance, and while the Supreme Court was of the view that the clause was ambiguous, the Supreme Court favoured the Insured's interpretation, stating its reasons as follows:

   > "The word "damage" figures only in the exception to the Exclusion Clause; it is not included in the language setting out the exclusion itself, i.e., the "cost of making good faulty workmanship". As such, "making good faulty workmanship" can, on its plain, ordinary and popular meaning, be construed as redoing the faulty work, and "resulting damage" can be seen as including damages resulting from such faulty work. "

3. Any ambiguity in the Exclusion should not, in the first instance, be resolved by reliance on the ***contra proferentem*** rule, as that is a rule of last resort. Rather, the ambiguity should be resolved by reference to the true purpose of the policy. The Supreme Court expressed its conclusion on this point as follows:

> "…the purpose of these polices is to provide broad coverage for construction projects, which are singularly susceptible to accidents and errors. This broad coverage — in exchange for relatively high premiums — provides certainty, stability, and peace of mind. It ensures construction projects do not grind to a halt because of disputes and potential litigation about liability for replacement or repair amongst the various contractors involved. In my view, the purpose of broad coverage in the construction context is furthered by an interpretation of the Exclusion Clause that excludes from coverage only the cost of redoing the faulty work itself — in this case, the cost of recleaning the windows."

The Supreme Court was of the view that the Insurers' interpretation of the Exclusion would re-introduce the very uncertainty that the insurance was intended to eliminate:

> "Consequently, an interpretation of the Exclusion Clause that precludes from coverage any and all damage resulting from a contractor's faulty workmanship merely because the damage results to that part of the project on which the contractor was working would, in my view, undermine the purpose behind builders' risk policies. It would essentially deprive insureds of the coverage for which they contracted.
> [71] In my opinion, therefore, the Insureds' position on the meaning of the Exclusion Clause better reflects and promotes the purpose of builders' risk policies. In the words of this Court in ***Commonwealth Construction***, it keeps "to a minimum the difficulties . . . created by the large number of participants in a major construction project" and "recognizes the realities of industrial life" (p. 328). Their position finds additional support in some of this Court's other comments in that case, at pp. 323-24, where it was emphasized that these policies exist to account for the fact that work of different contractors overlaps in a complex construction site and "there is ever present the possibility of damage by one tradesman to the property of another and to the construction as a whole". (underlining added)

4. The contract between the owner and the window cleaning company was irrelevant to the proper interpretation of the insurance policy, and the Court of Appeal erred in referring to that contract in interpreting the policy. After all, the window-cleaning contract was between different parties than the policy, and was entered into years after the policy was placed.

Moreover, the fact that the cleaners' contract provided that the cleaners accepted responsibility for its work and agreed to pay for damages arising from its work did not preclude coverage under the policy. As in the present case, insurance contracts often have deductibles or limits, and the contractor may be responsible within those features of the policy.

5. The Court of Appeal's new "physical and systemic connectedness test" did not solve the alleged disconnect between the policy's coverage and the cleaners' obligation for damages under its contract with the owner. The cleaners would be liable for collateral damage to areas where it was not working, yet there would still be coverage under the policy for this damage. In these circumstance, the Supreme Court said: "In effect, there would be dual responsibility for payment, under both the Policy and the service contract, even though, as discussed above, the Court of Appeal stated it would be artificial to draw the dividing line where such dual responsibility would result."

6. The Insureds' interpretation of the policy was commercially sensible, best reflected the reasonable expectations of the parties and did not result in an unreasonable result:

> "As already discussed above, the interpretation advanced by the Insureds in these appeals best fulfills the broad coverage objective underlying builders' risk policies. These policies are commonplace on construction projects, where multiple contractors work side by side and where damage to their work or the project as a whole commonly arises from faults or defects in workmanship, materials or design. In this commercial reality, a broad scope of coverage creates certainty and economies for both insureds and insurers. In my opinion, it is commercially sensible in this context for only the cost of redoing a contractor's faulty work to be excluded under the faulty workmanship exclusion. Such an interpretation strikes the right balance between the two undesirable extremes… " (underlining added)

7. The Insureds' interpretation "did not transform the insurance policy into a construction warranty. It does not inappropriately spread risk, nor would it allow or encourage contractors to perform their work improperly or negligently." The Supreme Court noted that the cleaners were "precluded from receiving initial payment for its faulty work and then receiving further additional payment to repair or replace its faulty work" and that the "cost of redoing faulty or improper work is excluded from coverage."

8. The Insurers argued that Insureds' interpretation of the policy would create an incentive for the owner or contractor to divide up the work, in order to maximize the amount of damage that would be covered under the policy. To this suggestion, the Supreme Court said:

> "With respect, I do not find this persuasive. It is premised on a theoretical concern that does not reflect the commercial reality of construction sites on the ground. In my view, it is unreasonable to expect that the owner of a property or the general contractor on a construction site will divide up

work exclusively on the basis of potential coverage under their insurance policy. Many other considerations, such as costs, subcontractor expertise and the risk of delay, will likely be more relevant in deciding how to allocate work."

9. The Supreme Court undertook a lengthy review of the cases dealing with the Exclusion for faulty workmanship. It concluded that the case law was consistent with its present decision once the facts in each case were understood. In each case, it is necessary to determine exactly what work was undertaken by the contractor or sub-contractor whose work was allegedly faulty. The Exclusion only excludes that work. In the present case, the cleaners were responsible for cleaning the windows, not installing them. Accordingly, the Exclusion applied to the work of re-cleaning the windows, not installing replacement windows.

10. The Supreme Court pointed out the necessity to distinguish between cases dealing with Exclusion clauses relating to "faulty workmanship" and those relating to "faulty design". In the latter cases, a contractor's obligation to provide the design (and therefore the scope of the Exclusion) may be much broader than would be the case for a contractor's obligation to provide work, and the factual circumstances that have been found to fall within the Exclusion for "faulty design" are not necessarily a guide to the circumstances that fall within the Exclusion for "faulty workmanship".

11. Interpreting the Exclusion Clause as precluding coverage for only the cost of redoing the faulty work was consistent with the accepted approach to interpreting similar exclusions to comprehensive general liability insurance policies. These policies usually contain a "work product" or "business risk" exception, which excludes from coverage the cost of redoing the insured's work.

12. If the general rules of contractual interpretation had not clarified the meaning of the Exclusion clause, and the clause still remained ambiguous, then the court would have reached the same conclusion on the basis of the ***contra proferentem*** rule.

In its decision, the Supreme Court also dealt with the standard of review to be applied by an appellate court when reviewing (as in this case, by the Court of Appeal or the Supreme court of Canada) the decision of a lower court interpreting a standard form contract such as a construction contract. A majority of the Supreme Court held that the review should be conducted according to a standard of correctness, not reasonableness. This important part of the ***Ledcor*** decision will be reviewed by me in a future article.

Discussion

It will take some time to digest the full ramifications and impact of this seminal decision. This article has sought to identify the ingredients in the decision as a basis for further discussion.

Clearly, the decision results in a much narrower interpretation of the ”faulty workmanship” Exclusion than insurers have been arguing for, and one that does not depend upon the “resulting damage” Exception to achieve that interpretation.

This decision requires the parties to exactly determine the scope of the defaulting contractor’s work. The “faulty workmanship” Exclusion is limited to the cost of making good that work, and not the cost of correcting damage to the subject matter of that work.

How far this decision will impact the faulty “construction materials or design” elements of the Exclusion will have to await future cases. However, the logic of the Supreme Court’s decision would seem to apply to all three elements of the Exclusion: once the defaulting contractor’s work, materials or design is determined, the Exclusion applies no further.

See *Heintzman and Goldsmith on Canadian Building Contracts*, 5th ed., chapter 14, paras. 3(b), 4(b)

***Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co*., 2016 SCC 37**

Insurance – Exclusions and Exceptions- Builders’ and All Risk Insurance – Exclusion for faulty workmanship

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