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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.

When is Faulty Workmanship Excluded From A Builders' Risk Policy?

One of the most difficult issues in construction law is the proper interpretation of an exclusion for faulty workmanship in a Builders' Risk policy. The amounts in issue can be huge and if the exclusion applies, the absence of insurance can be serious.

Take for example the recent Alberta decisions in ***Ledcor Construction Limited v Northbridge Indemnity Insurance Company*****.** Window cleaners were hired to clean the windows of the newly constructed building in the final clean up of the site. The cleaners scratched the windows, which necessitated very expensive replacement of the windows. The trial judge held that the damage was covered by the Builders' Risks insurance policy, and not excluded by the faulty workmanship exclusion. The Alberta

Court of Appeal has just held that the damage was excluded by that exclusion. This decision raises serious questions about the viability of Builders' Risk insurance with respect to damage to another contractor's work. I wrote about the trial decision in this case on December 29, 2013.

Background

A company known as Station Lands retained Ledcor as the construction manager to coordinate the construction of the EPCOR Tower in Edmonton, Alberta. Station Land also contracted with various trades to construct the building. The owner obtained an All Risk Builders' insurance policy from Northbridge. The policy covered all "direct physical loss or damage except as hereinafter provided". The named insureds were the owner and Ledcor, and the additional insureds were the owners, contractors, sub-contractors, architects, engineers, consultants, and all individuals or firms providing services or materials to or for the named insureds. The policy was a "blanket" policy, designed to cover all actors and activities on the site.

The policy contained the "faulty workmanship" exclusion and "resultant damage" exception to that exclusion found in most Builders' Risk policies. Those provisions read as follows:

> "Exclusions…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. (underlining added)

The windows were supplied and installed by one of the trade contractors. Station Lands retained another contractor, Bristol, to do the "construction clean" of the exterior of the building, including the windows.

Station Lands' contract with Bristol was in a standard CAA format which provided that the owner would maintain "all risks" property insurance for the project naming the owner and construction manager as insureds and the consultants, contractors and subcontractors as additional insureds.

The Court of Appeal's Decision

The Court of Appeal went through the following logic to arrive at its conclusion that the damage to the windows did not fall within the policy:

1. Cleaning involves workmanship

The court rejected the respondents' argument that cleaning is not workmanship because it does not create some physical product. In Bristol's contract, work included "services" and the contract refers to Bristol's "workmanship." In the court's view the "construction clean" was as much a part of the construction of

the building "as the designing of the foundations, the hammering of the nails, and the pouring of the concrete."

2. Multiple contractors do not create "resultant damage"

The respondents argued "that the exclusion does not apply to damage caused by one contractor to the work of another…. All other damage it is argued, particularly damage to the work of other contractors, is "resulting damage". The "cost of making good" only relates to the making good by any contractor of its own work product."

The court noted that "this argument contains echoes of the argument that what Bristol Cleaning was doing was not "workmanship", because the exterior cleaning involved did not create any physical product or structure." The court rejected this argument for many reasons.

First, it held that:

> "it is artificial (especially in the context of an all risks blanket insurance policy) to try to draw a dividing line between the product created by the work of other contractors, and the work to be done by Bristol Cleaning. GC 2.4 requires Bristol Cleaning to repair any damage it does to the work of other contractors. In effect Bristol Cleaning's "Work" included replacing the damaged glass, even if it was installed by another trade contractor. To say that the exclusion in the policy only applies to a trade contractor "making good" its own work seeks to sever that replacement work. The "cleaning" work that Bristol Cleaning was required to do under the contract is said to be of a different character than the "repair of damage" work that is also required to be done by GC 2.4. Yet all this work had to be done before Bristol Cleaning could claim substantial completion."

Second, the court noted that the respondents conceded that the exclusion is not limited to the cost of re-doing the cleaning and that there must be some "physical damage" caught by the exclusion. But, applying their theory, they could not point to any physical damage excluded in a case like the present one.

Third, this policy was a "blanket" wrap-around policy covering the entire project and all participants in the project. In this context, it was the court's the view "it does not make sense to interpret the policy such that the damage would be covered by the insurance if the work was done by two trade contractors, but not if it was all done by one trade contractor.

Fourth, this policy was a multi-year policy. It does not make sense, in the opinion of the court, that activities occurring later in the project would be covered merely because they damaged work done earlier in the project. In its words: "Whether something is the "cost of making good faulty workmanship" for the purposes of a multi-year insurance policy, related to a single construction "Project", does not depend on the exact sequence or timing of the various constituent tasks required to build such a complex building."

Fifth, "the scheme of the insurance policy is that all activities on the site are to be covered by one policy. There is nothing in the policy wording to suggest that coverage varies depending on the contractual relationships of the parties; the coverage depends on the type of "damage".

Sixth, there was "nothing in the wording of the policy to support the respondents' argument that the key to the exclusion is the identity of the person who performed the work that is subsequently damaged."

The court's problem with the respondents' position was summed up in the following paragraph:

> "The respondents' argument leads to the conclusion that coverage under the policy depends on how the work is divided up. Under the respondents' theory, if a single contractor is retained to supply the glass, install the glass, and do the construction cleanup, the scratches on the windows would not be covered by the insurance. However, because some other contractor supplied the windows, the very same damage caused by Bristol Cleaning is covered. This approach might create an incentive to artificially divide up the work as finely as possible, as then the maximum amount of damage would be covered by insurance. On the other hand, it would be dangerous for the owner to hire a single contractor to do all the work, as then nothing would be covered. That cannot have been the expectation of the parties, and is not a commercially reasonable outcome. It is, as noted, inconsistent with the philosophy behind a "wrap-up" policy covering all contractors.

3. The physical or systemic connectedness between the work and damage underlies the coverage and exclusion

The court accepted a variant of the insurer's approach to defining the ambit of the coverage and the "faulty workmanship" exclusion. In doing so it relied upon the provision in Bristol's contract requiring it to repair damage caused by it to the work of other contractors. It said:

> "If the workmanship itself directly causes the damage, then both re-doing the work and fixing the damage from the first attempt easily fall into the expression "making good faulty workmanship". This test identifies a class of physical damage that is excluded from coverage by the exclusion clause, while recognizing a significant class of physical damage that would be "resulting" and therefore covered. It is also consistent with GC 2.4, which requires Bristol Cleaning to repair any damage it does to the work of other contractors. While that covenant is expressly found in this construction agreement, it would likely be implied in any construction contract; it is natural that if a contractor causes damage while doing its work, it should be required to repair that damage as the consequence of its own poor workmanship. The appellants' interpretation is consistent with commercial expectations." (underlining added)

However, the court slightly altered the test proposed by the insurer as follows:

> "The proper test can more properly be described as a test of the connectedness between the work, the damage and the physical object or system being worked on. The application of the test will depend on an examination of the factual context, but the primary considerations will be:
>
> (a) The extent or degree to which the damage was to a portion of the project actually being worked on at the time, or was collateral damage to other areas. The test will be relatively easy to apply when the damage is caused directly by the work to the very object being worked on. There may be cases where several parts of the project work together as one system. Work on one part of the system may cause damage to another part, but repairing that damage might still properly be characterized as the cost of making good faulty workmanship if there is sufficient systemic connectedness;
>
> (b) The nature of the work being done, how the damage related to the way that work is normally done, and the extent to which the damage is a natural or foreseeable consequence of the work itself. If the damage is a foreseeable consequence of an error in the ordinary incidents of the work, then it presumptively results from bad workmanship; and
>
> (c) Whether the damage was within the purview of normal risks of poor workmanship, or whether it was unexpected and fortuitous." (underlining added)

The court concluded this analysis by saying that the "degree of physical or systemic connectedness is the key to determining the boundary between "making good faulty workmanship" and "resulting damage". (underlining added)

Here, the court said:

> "the scraping and wiping motions that caused the damage were the actual "Work". The damage was not "accidental" or "fortuitous". The scraping and wiping forces that caused the damage were intentionally applied to the windows, as a core part of the work to be done. Fixing the resulting damage is "making good the faulty workmanship" that caused the damage."

The Court of Appeal acknowledged that the test it was propounding might lead to "extreme results in extreme cases". It posed the situation of the window cleaner using a flammable solvent and causing the building to burn down. It acknowledged that such a loss would normally fall within the policy but said that "[e]xtreme cases should be decided when they arise. Whether these extreme situations call for a separate test, or are merely an exception to the connectedness test, need not be explored in this decision."

The Court of Appeal concluded its analysis with this over-all approach:

> "The key is to find the dividing line between physical damage that is excluded as "making good faulty workmanship", and physical damage that is "resulting damage" which is covered by the policy. As demonstrated in the previous discussion, the wording of the policy and the weight of the case law supports the test for physical or systemic connectedness. The exclusion (considered together with the exception) excludes from coverage the cost of redoing the work. But it also excludes damage connected to that work, such as any damage caused to the very object or part of the work on which the faulty workmanship is being applied. In this case, the cost of redoing the exterior cleaning of the EPCOR Tower is admittedly excluded. Also excluded is the damage to the windows being worked on at the time, which damage was directly caused by the cleaning activities that constituted the faulty workmanship. This damage was not only foreseeable, but it was highly likely (even inevitable) that this type of damage would result if the work was done in a faulty way. That type of damage is presumptively not within the scope of the insurance policy; the policy is not a construction warranty agreement.
>
> "The principle just stated reflects the proper interpretation of this wording of the insurance policy. The presumptive test is that damage which is physically or systemically connected to the very work being carried on is not covered. Whether coverage is nevertheless extended under that test in the factual context of any particular case will depend on the consideration of the factors listed above (supra, para. 50). Those factors all engage elements of "causation" and "foreseeability", concepts which are well known in the common law, when applying the policy wording to particular factual situations. The presumptive test stated above reflects the proper interpretation of the policy, but these collateral factors will come into play in applying the policy wording to particular factual situations, especially in extreme cases."

On this basis, the Court of Appeal held that the damage to the windows did not fall within the policy.

4. Contra Proferentem did not help

The Court of Appeal held that there was no need to resort to this rule of interpretation. These provisions of the Builders' Risk policy had been interpreted many times and their meaning did not become ambiguous just because the circumstances raised difficult questions of the application of the policy to the particular facts.

Discussion

This decision is a very important one and will take some time to digest. On a first reading, however, some of the remarks and the basis of the decision raise some apparent conflicts with prior decisions and raise fundamental issues about Builders' Risk insurance.

1. The Court of Appeal relies upon the provision of Bristol's contract, requiring it to repair the work of others which Bristol damages, to supports the court's "physical or systemic connectedness" test. Yet, that submission appears to be similar to the one which was rejected by the Supreme Court of Canada in the *Commonwealth Insurance v. Imperial Oil* decision. There, the Supreme Court explained that the contractor's obligation to repair work might well require it to perform work within the deductible but did not disentitle the contractor to protection under the policy. As the Supreme court said at paragraph 39 of that decision:

> "That paragraph [in the building contract] does not negate the basic proposition that everyone involved in the construction of the project will be insured under a policy issued to all as a group. The reference to fault occurs because this policy stipulates a deductible of $10,000 and because it contains a number of exclusions, e.g., error in design and latent defect; that reference has no other purpose."

2. The Court of Appeal makes reference to the insurance contract not being a "construction warranty agreement." That submission is one often relied upon by insurers, but was rejected in the *Progressive Homes v. Lombard Insurance* decision of the Supreme Court of Canada, where the court said that the proper approach is to interpret the policy, not arrive at a presumption as to what it means by saying that it will convert the policy into something else. At paragraph 45 of its decision, the Supreme court said:

> "Lombard argues that interpreting accident to include defective workmanship would convert CGL policies into performance bonds. In my opinion, these general propositions advanced by Lombard do not hold upon closer examination."

3. The Court of Appeal equated Bristol's work ("the scraping and wiping motions that caused the damage") with intentional harm ("The scraping and wiping forces that caused the damage were intentionally applied to the windows, as a core part of the work to be done.") and then concluded that "fixing the resulting damage is "making good the faulty workmanship" that caused the damage." This is a curious conclusion because it does not seem possible that Bristol intended to damage the windows. The damage occurred negligently, but fortuitously; otherwise the policy would not apply at all. As the Supreme Court said in ***Progressive Homes v. Lombard;***

> "Fortuity is built into the definition of "accident" itself as the insured is required to show that the damage was "neither expected nor intended from the standpoint of the Insured". This definition is consistent with this Court's core understanding of "accident": "an unlooked-for mishap or an untoward event which

> is not expected or designed" ….When an event is unlooked for, unexpected or not intended by the insured, it is fortuitous. This is a requirement of coverage; therefore, it cannot be said that this offends any basic assumption of insurance law.

4. The basic proposition of the Court of Appeal appears to be that a Builders' Risk policy does not cover damage caused by one contractor to the work of another contractor on the site. One must ask: where does the policy say that? Damage by one contractor to the work of another contractor seems such a foreseeable event. If the policy does not apply to that damage, should the policy clearly say so? And is this proposition consistent with the purpose of Builders' Risk insurance as described by the Supreme Court in the *Commonwealth v Imperial Oil* decision:

> "On any construction site, and especially when the building being erected is a complex chemical plant, there is ever present the possibility of damage by one tradesman to the property of another and to the construction as a whole. Should this possibility become reality, the question of negligence in the absence of complete property coverage would have to be debated in court. By recognizing in all tradesmen an insurable interest based on that very real possibility, which itself has its source in the contractual arrangements opening the doors of the job site to the tradesmen, the courts would apply to the construction field the principle expressed so long ago in the area of bailment. Thus all the parties whose joint efforts have one common goal, *e.g.* ,the completion of the construction, would be spared the necessity of fighting between themselves should an accident occur involving the possible responsibility of one of them." (underlining added)

Based upon this decision, contractors and subcontractors may want to obtain additional insurance to cover damage to each other's work and property during the project. It appears that a Builders' Risk policy may not cover that damage.

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

***Ledcor Construction Limited v Northbridge Indemnity Insurance Company*, 2015 ABCA 121**

Building contracts – Insurance – Exclusion for faulty workmanship – Exception for resultant damage

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