Important Supreme Court of Canada Decision on the Scope of the "Faulty Workmanship" Exclusion

Court Case Announcement:

Yesterday, September 15, 2016, the Supreme Court of Canada released an important decision that impacts both the interpretation of insurance contracts generally, and the interpretation of the "faulty workmanship" exclusions often found in Builder's Risks Policies: Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co., 2016 SCC 37.

The facts of the case are as follows. A contractor was hired to clean windows of a building under construction. The contractor scratched the windows, which had to be replaced. The building's owner and general contractor made a claim under the builder's risk policy in place for the cost of replacing the windows. The Insurer denied coverage for the costs to replace the windows based on a standard form exclusion that denied coverage for the "cost of making good faulty workmanship". This exclusion contained an exception for "physical damage" that "results" from the faulty workmanship.

The trial judge held that the exclusion was ambiguous and that "making good" could encompass either the cost of redoing the cleaning or the cost of replacing the windows. The trial judge applied the rule of contra proferentem against the Insurers, and held that the cost of replacing the windows was not excluded.

The Alberta Court of Appeal reversed the trial judge's decision and held that the exclusion was not ambiguous. The Court of Appeal then developed a new test of "physical or systemic connectedness" to determine whether physical damage was excluded as the "cost of making good faulty workmanship" or covered as "resulting damage". The Court of Appeal concluded that the damage to the windows was physical loss excluded from coverage, because it was not accidental or fortuitous, but was directly caused by the intentional scraping and wiping motions involved in the cleaners' work.

The Supreme Court of Canada reversed the Court of Appeal decision, reinstating coverage for the cost of replacing the damaged windows, but on different grounds than the trial judge.

The SCC found that although the exclusion was ambiguous, it did not have to resort to the rule of contra proferntem, because the general rules of contractual interpretation, namely considering the reasonable expectations of the parties and the commercial reality, allowed the SCC to resolve the ambiguity.

In coming to its conclusion, the SCC held that standard form contracts, such as insurance contracts, are an exception to the SCC decision in Sattva Capital Corp. v. Creston Moly Corp., 2014 SCC 53, [2014] 2 S.C.R. 633 that contractual interpretation is a question of mixed fact and law subject to deferential review on appeal. Instead, the SCC held that the interpretation of a standard form contract is better characterized as a question of law subject to the standard of review of correctness. The SCC based its finding on the fact that the interpretation of standard form contracts are often of precedential value, and there is no meaningful factual matrix that is specific to the parties to assist the interpretation process. Rather, a consideration of general factors such as the purpose of the contract, the nature of the relationship it creates, and the market or industry in which it operates should be considered when interpreting a standard form contract.

The importance of this decision on the insurance industry is that it provides appellate courts with discretion to review policy interpretation issues, increasing the chance that a decision of a trial court may be overturned if the appellate court does not agree with the interpretation of the lower court.

With respect to the SCC's interpretation of the standard form "faulty workmanship" exclusions, the SCC held that the exclusion only excludes the cost of redoing the faulty work, as the resulting damage exception covers costs or damages apart from the cost of redoing the faulty work. In this particular case, it only excluded the cost of redoing the window cleaning. This is important to the insurance industry because all Canadian Courts are

now bound by the decision that the faulty workmanship exclusion is limited to the cost of redoing the faulty work. Each case will still be fact dependent with respect to what costs are included in redoing the faulty work, versus what costs are not related. The SCC provides guidance and held that whether certain damage falls within the resulting damage exception to the faulty workmanship exclusion will depend on the scope of the contractual obligation of the contractor that caused the damage. In this case, the scope of the work was only to clean the windows.

In conclusion, the Supreme Court of Canada has now clearly stated that the interpretation of insurance contracts is a question of law, and are subject to the standard of review of correctness. This provides appellate courts with more discretion to overturn trial decisions that are based on the interpretation of an insurance contract. The Supreme Court of Canada has also clearly stated that "faulty workmanship" exclusions only apply to the cost of redoing the faulty work. The cost of redoing the faulty work will depend on the scope of the contract under which the work was performed.

If you have any further questions please feel free to contact us.