W—T

The Faulty Workmanship in Builders' Risk Policies vs. CGL Policies:
The Reach of the 2016 SCC Ledcor Decision

Prepared by Melissa Santalucia

Introduction

On 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 builders' risks policies: *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 ("*Ledcor*").

In its reasons, the SCC assessed the scope of the faulty workmanship exclusion found in a builders' risk policy and clarified that the faulty workmanship exclusion will be interpreted narrowly. The practical effect of the SCC's decision in *Ledcor* is to expand the scope of coverage that will be available under builders' risk policies, even in cases involving faulty workmanship.

The *Ledcor* decision left open the question of what impact, if any, the SCC's interpretation of the faulty workmanship exclusion may have on the interpretation of similar exclusions in other types of insurance policies, and in particular in CGL policies.

That said, a recent decision from the Ontario Court of Appeal dealing with very similar facts suggests that *Ledcor* may be of limited import when interpreting a faulty workmanship exclusion under a CGL policy and confirms that, ultimately, the type of insurance policy and the specific policy wording matters when determining whether property damage connected to faulty workmanship is covered or excluded.

The Facts in *Ledcor*

The facts of the case are as follows.

The owner, Station Lands Ltd. and construction manager, Ledcor Construction Limited, hired a contractor, Bristol Cleaning, to clean windows of a building under construction.

The building's windows were supplied and installed by a trade contractor. As construction neared completion, concrete splatter, paint specs, and other construction dirt remained on the windows. Bristol Cleaning was to "provide all necessary equipment, manpower, [and] materials required to complete a construction clean" of the building's windows.

During the cleaning process, Bristol Cleaning caused damage to the windows by using inappropriate tools and methods. It scratched the glass.

Bristol Cleaning was obliged under the construction contract to pay the cost of replacing the glass it had damaged. Bristol Cleaning sought coverage under the builders' risk policy.

The policy contained a standard exclusion for "the cost of making good faulty workmanship" but this exclusion was subject to an exception for "physical damage not otherwise excluded by this policy ... in which event the policy shall insure such resulting damage". The insurer denied coverage for the claim based on the exclusion. Specifically, the insurer's position was that the cost of replacing the windows was the cost of making good Bristol's faulty workmanship. The owner and the general contractor, on the other hand, took the position that the cost to replace the windows was resultant damage arising from the Bristol's faulty work and, therefore, it fell within the exception for resulting damage.

The Decisions Below

The trial judge held that although Bristol's cleaning work was faulty, the "making good" wording in the exclusion was ambiguous and 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 holding that the exclusion did not operate to exclude the cost of replacing the windows.

The insurer appealed. The Alberta Court of Appeal allowed the appeal finding that the exclusion was not ambiguous. The Court of Appeal developed a new test to determine whether or not the window replacement was "resulting damage", which was "physical or systemic connectedness" to the faulty work being carried out. The Court of Appeal concluded that the cost to replace the windows was excluded because the damage that occurred was to the very thing that was the subject of the faulty workmanship.

Supreme Court of Canada

The SCC reversed the Court of Appeal decision concluding that only the cost of redoing the cleaning work would be excluded from coverage and reinstating coverage for the cost of replacing the damaged windows, but on different grounds than the trial judge.

The SCC found that the exclusion was ambiguous because both the insured's interpretation and the insurer's interpretation of the faulty workmanship exclusion and the resulting damage exception were plausible. The SCC resolved the ambiguity by employing the general rules of contract construction without needing to resort to the rule of *contra proferentem*. The SCC began by articulating the principles of insurance policy interpretation, which are well known and settled:

> a. where the language of the insurance policy is unambiguous, effect should be given to that clear language, reading the contract as a whole;
>
> b. where the policy's language is ambiguous, general rules of contract construction must be employed to resolve that ambiguity; and
>
> c. if ambiguity still remains after the above principles are applied, the *contra proferentem* rule be employed to construe the policy against the insurer.

The SCC articulated the general rules of contract construction as follows: the interpretation should be consistent with reasonable expectations of the parties, as long as the interpretation is supported by the language of the policy; it should not give rise to results that are unrealistic or that the parties would not have contemplated in the commercial atmosphere in which the insurance policy was contracted; and it should be consistent with the interpretations of similar insurance policies.

As set out above, the SCC held that the exclusion's wording was ambiguous. As such, it first reviewed the reasonable expectations of the parties entering into this type of standard form contract by looking at the purpose of builders' risk policies. The SCC noted that the purpose of builders' risk policies was to provide broad coverage for projects while under construction, which are susceptible to accidents and errors, as well as broad coverage for all those involved in the project, in order to avoid disputes over responsibility for repair or replacement of components of the project. This broad coverage, the SCC said, provides certainty, stability and peace of mind and reduces the need for litigation as between the parties to the construction project.

In the SCC's view, 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 on would undermine the purpose behind builders' risk policies. The reasonable expectations of the parties here was that Bristol Cleaning and others would be covered broadly against accidents and errors arising out of the construction project, subject only to narrow exclusions.

The SCC acknowledged that, in discussing the interpretation of insurance policies, there is a need to avoid interpretations that would bring about unrealistic results or results that would not have been contemplated by the parties. In the SCC's view, the interpretation advanced by the insureds in this case did not bring about unrealistic results as it would not transform the policy into a construction warranty, inappropriately spread risk, or allow or encourage contractors to perform their work improperly or negligently.

Finally, the SCC reviewed the jurisprudence in which the exclusion had been previously interpreted. It disagreed with the insurer's assertion that the case-law supported the insurer's position. Rather, it concluded that "many of these faulty workmanship and faulty design decisions can be read as limiting the faulty workmanship exclusion to only the cost of redoing the faulty work".

The SCC stated that whether certain damage falls within the resulting damage exception to the faulty workmanship exclusion will greatly depend on the scope of the contractual obligation pursuant to which the faulty workmanship was carried out. It then acknowledged that had Bristol Cleaning been responsible for installing the windows in good condition, and not merely cleaning them, damage to the windows themselves would not have constituted "resulting damage".

Application of *Ledcor* to CGL Scenarios?

It has been said that the decision in *Ledcor* may have broader application beyond the builders' risk context. This sentiment arises from paragraph 83 of the SCC's decision where Wagner J. states:

> I also note that interpreting the Exclusion Clause as precluding from coverage only the cost of redoing the faulty work breaks no new ground in the world of insurance, as it mirrors the approach courts have adopted when construing similar exclusions to comprehensive general liability insurance policies. These policies cover the risk that the insured's work might cause bodily injury or property damage. However, they generally contain a "work product" or "business risk" exception, which excludes from coverage the cost of redoing the insured's work.

This suggests that how the insured's "workmanship", "work", or "work product" will be interpreted in other forms of coverage, particularly under CGL coverage, may be consistent with the SCC's interpretation in *Ledcor*.

That said, the Ontario Court of Appeal's recent decision in *G&P Procleaners and General Contractors Inc. v. Gore Mutual Insurance Company*, 2017 ONCA 298 ("*G&P Procleaners*"), released in April 2017, which was another window cleaning case, suggests that the interpretation of the faulty workmanship exclusion in *Ledcor* may be of limited import in the context of CGL policies and that the type of policy and the specific policy wording matters when determining when assessing coverage.

In *G&P Procleaners* the insured was hired to provide window cleaning services at a newly constructed commercial building. During the cleaning, a number of windows were scratched as a result of airborne cement debris from nearby stone cutting machines having settled on the windows. When squeegees were applied to the windows, the cement debris scratched the surface of the glass. The insured paid the owner of the building for the cost of replacing the windows and then made a claim on its CGL policy. Coverage was denied pursuant to a faulty workmanship or "your work" exclusion. The insured then brought an action seeking indemnification under the policy. The insurer brought a motion for summary judgment to dismiss the action on the ground that coverage was excluded. The motion was granted and the claim was dismissed and the insured appealed.

While in *Ledcor*, the SCC held that replacement of the windows arising from faulty workmanship was covered as resultant damage under the builders' risk policy at issue in that case, in *G&P Procleaners*, the Ontario Court of Appeal held that the replacement of the windows was excluded based on the "your work" exclusion in the insured's CGL policy.

The "your work" exclusion at issue in *G&P Procleaners* is a common exclusion in CGL policies which states:

> 2. **Exclusions**
>
> This insurance does not apply to:
>
> (h) "Property damage" to:
>
> (v) that particular part of real property on which you or any contractor or subcontractor working directly or indirectly on your behalf is performing operations, if the "property damage" arises out of those operations; or
>
> (vi) that particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

The motion judge on summary trial held that the property damage claimed fell within both exclusions (v) and (vi) and the insured appealed. The Court of Appeal agreed, holding that the scratching of the windows was the "occurrence" and that it resulted from or arose out of the insured's window cleaning operation and, therefore, exclusion 2(h)(v) applied to exclude coverage. It found that no property damage occurred until the insured performed its window cleaning, by applying their squeegees to the windows. If the workers had chosen not to undertake the window cleaning amid the airborne cement debris given the conditions on the site, there would have been no property damage. Therefore, the property damage clearly arose out of the window cleaning operation.

Although not necessary for the disposition of the appeal, the Court of Appeal noted that the motion judge had also found that exclusion 2(h)(vi) also applied.

The insured tried to argue that the motion judge's interpretation of the policy would render coverage under the policy illusory. The Court of Appeal disagreed and made the following observations with regards to commercial general liability policies:

- they are generally intended to cover an insured's liability to third parties for property damage other than to the property on which the insured's work is being performed;

- they also cover consequential damage to parts of the property other than to the particular part of the property on which the work is being performed;

- they do not insure the manner in which the insured conducts its business; and

- do not cover the cost of repairing the insured's own defective or faulty work.

The Court noted that the result in this case reflected what the parties had bargained for.

The Court further noted that CGL policies are distinct from all-risk policies. While the Court did not elaborate on the distinction, in *Ledcor* the SCC stated that the purpose of builders' risk policies is to provide broad coverage for construction projects, which are susceptible to accidents and errors. Therefore, the implication appears to be that since CGL coverage is more restrictive than all-risk coverage found in builders' risk policies, the type of policy at issue will largely dictate whether there is coverage for damage arising from the insured's faulty work.

Ultimately, the divergent results in *Ledcor* and *G&P Procleaners* appear to arise from the specific wording of the faulty workmanship exclusion in each type of policy. Whereas in *G&P Procleaners* the exclusion specifically excluded damage to the "particular part" of the property being worked on, in *Ledcor* the exclusion was not as specific, allowing damage to the particular part of the property being worked on to fall within the resulting damage exception.

Conclusion

Ledcor remains one of the most important insurance decisions coming out the highest court of this land in recent times and has a number of practical effects in the insurance world.

For one, *Ledcor* provides confirmation of the already widely accepted principle that coverage provisions under a policy are to be construed broadly and exclusions are to be construed narrowly.

The SCC has also clearly stated that faulty workmanship exclusions in builders' risk policies only apply to the cost of redoing the faulty work. Whether certain damage falls within the resulting damage exception to the faulty workmanship exclusion will greatly depend on the scope of the contractual obligation pursuant to which the faulty workmanship was carried out.

As a practical matter, the impact of the decision in *Ledcor* is that coverage under builders' risk policies has been broadened even in situations involving faulty workmanship or design, which had previously been thought to have been excluded. If insurers wish to exclude any damage connected to faulty work, they will need to employ very clear language to that effect in the insurance policy. Further, in addition to reconsidering the wording of their forms, insurers may also wish to re-evaluate insurance ratings, premiums charged and deductibles in light of the broader coverage now potentially available.

The decisions in *Ledcor* and *G&P Procleaners* suggest that there is broader coverage for property damage involving faulty workmanship under a builders' risk policy than under the CGL. Therefore,

the implication from these decisions is that the type of insurance policy at issue does matter when considering whether property damage arising from faulty workmanship is covered or excluded under the policy.

The broader lesson to be had is that while different insurance policies may contain similar grants of coverage or exclusions, their effect in the context of the specific insurance policy might not always be the same. The type of policy and the specific policy wording matters when assessing coverage.