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Builder's Risk Insurance and Exclusion Clauses:

A review of Ledcor Construction Ltd. v. Northbridge Independent Adjustors Ltd., 2016

SCC 37 and Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Company, 2015 BCCA 347

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A Review of *Ledcor Construction Ltd. v. Northbridge Independent Adjustors Ltd.,* 2016 SCC 37 and *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Company*, 2015 BCCA 347

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I. *Ledcor Construction Ltd. v. Northbridge Independent Adjustors Ltd.,* 2016 SCC 37

On September 15, 2016, the Supreme Court of Canada released their decision in *Ledcor Construction Ltd. v. Northbridge Independent Adjustors Ltd.*

In *Ledcor*, a subcontractor was hired to clean the windows of a building that was under construction. The subcontractor used the wrong tools to clean the windows, causing damage that required the replacement of the windows. The general contractor and building owner sought to claim the replacement cost of the windows under a builder's risk policy issued in favour of the owner and all contractors. The insurer denied the claim as being excluded by the "cost of making good faulty workmanship" clause.

The court was asked to determine whether the windows, which were being cleaned following the completion of their installation, but prior to the completion of the project, would be covered by the policy or excluded.

The trial judge determined the cleaning work constituted "workmanship" and that it had been faulty. However, he determined that the Exclusion Clause did not apply to exclude the repair cost of the windows. He preferred the interpretation advanced by the insureds, who had argued "the cost of making good faulty workmanship" applied only to the cost of redoing the cleaning work, rather than the interpretation advanced by the insurer, who argued the costs of replacing the windows should be included under the "making good faulty workmanship" banner.

The Alberta Court of Appeal held differently.

In coming to this conclusion, the Court of Appeal developed a new test to differentiate between physical damage that is excluded as the “cost of making good faulty workmanship” and physical damage that is covered as “resulting damage”. The Court of Appeal outlined three primary considerations at paragraph 50:

> (1) 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";
> (2) 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"; and
> (3) "[w]hether the damage was within the purview of normal risks of poor workmanship, or whether it was unexpected and fortuitous."

Applying this test, the Court determined that cleaning involved workmanship, and that the cost of repairing the damage should be excluded as the “cost of making good faulty workmanship”. The exclusion applied as the damage was not an accident or fortuitous, but rather the result of the scraping and wiping involved in the cleaning work.

This decision was then appealed to the Supreme Court of Canada.

The issues on appeal were:

1. What standard of review applies; and
2. What is the proper interpretation to be given to the Exclusion Clause and the “resulting damage” exception of the builder’s risk policy.

The Supreme Court first considered the standard of review, and clarified how *Sattva Capital Corp v. Creston Moly Corp*, 2014 SCC 53 applies to the interpretation of standard form contracts.

Justice Wagner, writing for the majority, stated that:

> where an appeal involves the interpretation of a standard form contract, the interpretation at issue is of precedential value, and there is no meaningful

> factual matrix that is specific to the parties to assist the interpretation process, this interpretation is better characterized as a question of law subject to correctness review.

He based this conclusion on the nature of standard form contracts – parties may negotiate prices, but the terms of the contract are generally set out without negotiation as a "take it or leave it" proposition. The nature of the contract's formation minimizes the importance of the factual matrix, eliminating the factual element and leaving only a question of law behind.

He went on to further note that the mandate of appellate courts – to ensure consistency of the law – is furthered by allowing courts to review standard form contracts to a correctness standard:

> Establishing the proper interpretation of a standard form contract amounts to establishing the "correct legal test", as the interpretation may be applied in further cases involving identical or similarly worded provisions.
>
> [para 45]

The Court did caution that not all standard form contracts would be subject to correctness standard. Judges and lawyers need to consider whether the impugned provision is a general proposition, or "a very particular set of circumstances that is not apt to be of much interest to judges and lawyers in the future."

Following the conclusion that the appropriate standard of review was correctness, the Court then considered the exclusion clause.

The Supreme Court indicated that the Court of Appeal's new physical or systemic connectedness test was unnecessary. The Court noted that it had previously stated in Progressive Homes that "perfect mutual exclusivity in an insurance contract is not required", and further observed that the policy before the court contained provisions regarding pure economic loss as well as fines, penalties and costs, none of which constitute physical damage.

Justice Wagner observed:

> the application of [general principles of contract interpretation] points to one interpretation that is consistent with the reasonable expectations of the parties and commercial reality: the faulty workmanship exclusion serves to exclude from coverage only 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.
>
> [para 63]

The Court agreed with the insured's interpretation of the contract. They noted that the intent behind builder's risk policies is to ensure coverage in the event that damage resulted from negligence or poor work on a construction site. Covering the cost of the negligent contractor re-doing their work does not make commercial sense. However, failure to cover the repair of the resulting damage negates the purpose of obtaining builder's risk insurance in the first place, and deprives insureds of the coverage they had contracted for.

The Court found further support for a narrow interpretation of exclusion clauses in a review of jurisprudence and legal texts.

The majority then commented, at paragraph 83:

> 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

The Court rejected the insurers' arguments that construction companies would divide up contracts for work to ensure maximum coverage over policies. This was taken to be a theoretical argument that neglects the commercial reality of construction projects.

Rather, work is more likely to be allocated on other considerations including costs, subcontractor expertise and the risk of delay.

The subcontractor had only been retained to clean the windows, and thus the cost of re-cleaning the windows was the work covered under “making good faulty workmanship”, while the replacement of the windows was covered as “resulting damage”. However, the Court noted that had the subcontractor been retained to install the windows, and had the windows been damaged during the installation process, then the re-installation of new windows would have fallen under the exemption clause as “making good faulty workmanship”, as proper installation of the windows would have been the workmanship contracted for.

Justice Cromwell wrote a separate concurring opinion, in which he rejected Wagner’s application of *Sattva*, but came to the conclusion that the trial judge’s opinion should be upheld and the Court of Appeal’s decision set aside.

II. *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Company*, 2015 BCCA 347

In *Acciona Infrastructure v. Allianz Global Risks US Insurance Company*, 2015 BCCA 347, the BC Court of Appeal reviewed the decision of the trial judge, Justice Skolrood, which was the first to interpret LEG2/92, the “Defects Exclusion” clause, which stipulated:

> The insurer(s) shall not be liable in respect of all costs rendered necessary by defects of material workmanship design plan or specification and should damage occur to any portion of the Insured Property (Contract Works) containing any of the said defects the cost of replacement or rectification which is hereby excluded is that cost which would have been incurred if replacement or rectification of the said portion of the Insured Property (Contract Works) has been put in hand immediately prior to the said damage.

> For the purpose of this policy and not merely this exclusion it is understood and agreed that any portion of the Insured Property (Contract Works) shall not be regarded as damaged solely by virtue of the existence of any defect of material workmanship design plan or specification.

In *Acciona*, the builders were retained to build an eight-story reinforced concrete structure for the Royal Jubilee Hospital in Victoria. The design called for thin concrete slabs, which were to be the flooring. During construction, the slabs over-deflected, resulting in curving and bowing of the floor. While the floors were still structurally sound, they were unacceptable to hospital. The floors could not be levelled by adding concrete, as it would add weight and cause structural issues. Rectification work had to be done, which required grinding and shot blasting of the slabs to smooth and level the slabs, sealing with polyurethane and negative air pumping to remove the dust and ensure the cleanliness was to hospital standards. This resulted in a significant cost increase to complete the project.

The insured sought to recover this cost from their insurer, Allianz Global Risks. The insurer denied the claim on the basis of LEG2/92, arguing that the defect was a result of faulty design and thus excluded by the clause.

The trial judge expressly found that the damage was due to issues with the shoring of the slabs, and noted that the experts who testified all agreed there were no issues with the slab designs and that they were structurally sound.

The insurers appealed, arguing that using LEG2/92 to exclude only those costs that would have been incurred to prevent the damage from occurring was not the intention of the parties when negotiating the contract.

The Court of Appeal rejected this argument, agreeing with Justice Skolrood's finding that interpreting the provision differently would fail to give effect to the parties' intentions.

The Court of Appeal noted Justice Skolrood had correctly interpreted the standard for “fortuitous” loss, and accepted his finding that the over-deflection of the concrete slabs was not a latent defect, but was actual damage to property. The defect lay in the shoring of the slabs, not the slabs themselves.

Had the defect been in the design of the slabs, the exclusion clause may have operated to allow the insurer to deny the majority of the claim. As it was, the exclusion clause only exempted the minimal cost of the additional shoring that could have been used to prevent the deflection. In other cases, the cost of doing the work correctly the first time may be large enough to negate much of the claim.

The trial judge had denied Acciona’s claim for increased subcontractor costs, noting that these costs did not arise directly out of the damage to the floor, but were instead a “consequential” expense due to Acciona’s contractual obligations with the subcontractors.

The Court of Appeal also upheld this finding, determining that Acciona was only entitled to $8 million of the $15 million loss, as that was the portion of direct loss attributable to rectifying the property damage.

The Court of Appeal dismissed the appeal and cross appeal and upheld the trial judge's decision.

In both these decisions, the courts sought to parse what were excluded damages, and considered exception clauses relating to both. The business intention of the parties, and the commercial reality of the insurance sought, played a role in the conclusions each court came to in the respective cases.

In *Ledcor*, the Supreme Court set out an exception to *Sattva* standard of review where a standard form contract is in use. The Court then considered whether an exclusion clause addressing the cost of righting faulty workmanship covers the whole cost of repairing the mistake, or if it is limited to solely that which the contractor was retained for. Ultimately, the court determined the exception was only for the work the contractor

had been hired to do, and that repairing the damage for faulty workmanship would be covered by the policy beyond that limited exception. To find otherwise, the court concluded, would be to defeat the purpose of builder's risk insurance.

In *Acciona*, the over-deflection of the slabs was actual damage, was not foreseeable, and was owed coverage under the policy. The court did allow for the deduction of the cost of what preventative action could have been used. In some cases, this cost may be significant. However, the additional costs due to subcontractor obligations were not covered, as those costs were not directly attributable to rectifying the defect, but were instead collateral costs due to the contractual relationship with the subcontractors.

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