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BRIEFING NOTE

Interpretation of Standard Faulty Workmanship Exclusion Clauses in Course of Construction Policies

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Guild Yule LLP
BARRISTERS AND SOLICITORS
2100 – 1075 Georgia Street
Vancouver, BC V6E 3C9
www.guildyule.com
P 604 688 1221
F 604 688 1315
E feedback@guildyule.com

Introduction

Course of construction policies, also known as builders' risk or all-risks policies, protect property owners, developers and contractors during major construction or renovation. These policies cover the structure and materials, as well as liability issues which may arise. The Supreme Court of Canada has recognized that the purpose of these policies is to provide broad coverage for construction projects, which are singularly susceptible to accidents and errors, in exchange for relatively high premiums, such that there can be certainty, stability and peace of mind by ensuring construction projects do not grind to a halt because of disputes and potential litigation about liability for replacement or repair amongst various contractors involved, particularly in large and complex projects.[1] These policies frequently use standard form contracts, also known as contracts of adhesion, a characteristic of which are common faulty workmanship exclusion clauses developed by the London Engineering Group ("LEG"), a consultative body for insurers of engineering class risks. There is relatively little Canadian jurisprudence interpreting these clauses.

LEG Exclusion Clauses

LEG devised three model exclusion clauses for the insurance industry in 1996,[2] which operate on a sliding scale with premiums corresponding to the degree of coverage provided. They are widely used in builder's risk policies in Canada and Europe.

LEG 1/96: An outright defects exclusion clause that excludes coverage for all loss or damage due to defects of material, workmanship, design plan or specification.

[1] *Ledcor Construction v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 [Ledcor SCC] at paras. 66 and 68
[2] LEG Clauses: https://www.londonengineeringgroup.com/leg-clauses

LEG 2/96: A consequences defects exclusion clause that excludes the before-loss cost of remedying any defective material, workmanship, design plan or specification.

LEG 3/06 (originally LEG 3/96): An improvement defects exclusion clause that excludes any costs incurred for improvements to the original material, workmanship, design plan or specification following the loss.

This paper will review several landmark and recent cases that have interpreted the LEG 1 and 2 exclusions. Prior to these decisions, the exclusions had been interpreted rather broadly and any exceptions narrowly because the courts considered that construction projects should be viewed as one unit incapable of being segmented for insurance purposes. Coverage was generally denied unless the project could be functionally segmented into distinct units and the separation was only applicable to third parties and not the insured.

CNR v. Royal and Sun Alliance Cases (2004-2008)

In 1993, CN Rail designed and constructed one of the largest tunnel boring machines in the world for use in construction of a tunnel underneath the St. Clair River. Work stopped after contamination was detected caused by seals that were damaged due to excess differential deflection of the cutting head, which caused a 229-day delay. The design was then modified successfully for completion of the project. The insurers denied coverage under a builder's risk policy on the basis of a LEG 1 exclusion.

In 2004, the Ontario Superior Court of Justice ruled that the insurers were liable to CN Rail for the $30 million loss because the risk was unforeseen.[3] In 2007, the Ontario Court of Appeal reversed the trial decision.[4] In 2008, the Supreme Court of Canada restored the original ruling in a divided decision.[5]

The Court held that when interpreting insurance policies, coverage clauses should be construed broadly while exclusion clauses should be construed narrowly. The result should be a realistic interpretation that would be contemplated in the commercial atmosphere in which the parties contracted.[6] While the language of the exclusion was fairly standard for an all risks policy, it was a "manuscript policy" which had been negotiated between sophisticated commercial parties, rather than a policy of adhesion. All seven justices agreed that the exclusion was unambiguous so *contra proferentem* did not apply.[7]

The majority held that the insurers were not entitled to rely on the exclusion just because existing engineering knowledge and practice at the time lacked a proper appreciation of the design problem as failure is not

[3] *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada* (2004), 15 CCLI (4th) 1
[4] *Canadian National Railway Co.v. Royal and Sun Alliance Insurance Co. of Canada*, 2007 ONCA 209
[5] *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada*, 2008 SCC 66 [CNR SCC]
[6] CNR SCC at paras. 30, 32 and 53
[7] CNR SCC at paras. 33 and 116

Guild Yule LLP
BARRISTERS AND SOLICITORS
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Vancouver, BC V6E 3C9
www.guildyule.com
P 604 688 1221
F 604 688 1315
E feedback@guildyule.com

the same thing as fault or impropriety. The exclusion relates to faulty design, not designer fault.[8] Three justices dissented, ruling that the exclusion applied because it attaches to the machine that was designed as opposed to the work of the designer.[9]

Progressive Homes v. Lombard Cases (2007-2010)

BC Housing sued the general contractor, Progressive Homes, for significant water damage which caused rot, infestation and deterioration to four condominium developments built in the 1990s, also known colloquially as "leaky condo" defects. The general contractor had several CGL policies which required the insurer to defend and indemnify when the insured is legally obligated to pay damages because of property damage caused by an occurrence or accident. The initial CGL policy had an exclusion for property damage to work performed by or on behalf of the insured. A subsequent CGL policy had an exclusion with respect to the completed operations hazard to property damage to work performed by the insured.

In 2007, the general contractor was unsuccessful in applying for coverage in the BC Supreme Court which held that defective construction is not an "accident" unless it causes damage to a third party and that the courts cannot artificially divide the insured's work into components for the purpose of establishing resulting property damage.[10]

In 2009, the BC Court of Appeal overturned the trial decision, ruling that "work performed" by a subcontractor could be covered by the CGL policies, but only if the damage was caused by a distinct item installed by the subcontractor, such as a boiler exploding. The pleadings alleged that integral parts of the building itself failed to function properly, therefore there were no "distinct" components that could be covered.[11]

In 2010, the Supreme Court of Canada unanimously restored the original ruling, holding that the question of whether defective workmanship is an "accident" will depend both on the circumstances of the defective workmanship alleged in the pleadings and the way in which "accident" is defined in the policy, but the insurer failed to show that the exclusion applied.[12]

Ledcor v. Northbridge Cases (2013-2016)

In 2001, a subcontractor damaged windows of the EPCOR Tower in Edmonton while conducting cleaning work prior to completion which consequently had to be replaced. The general contractor, Ledcor Construction, was a named insured under the owner's builder's risk policy. The insurers denied coverage, relying on a LEG 1 exclusion.

[8] CNR SCC at paras. 5 and 38-48
[9] CNR SCC at paras. 83-87
[10] *Progressive Homes Ltd. v. Lombard General Insurance Company of Canada*, 2007 BCSC 439 at para. 43
[11] *Progressive Homes Ltd. v. Lombard General Insurance Co.*, 2009 BCCA 129
[12] *Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada*, 2010 SCC 33 at paras. 46 and 54

Guild Yule LLP
BARRISTERS AND SOLICITORS
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E feedback@guildyule.com

In 2013, the Alberta Court of Queen's Bench determined that the wording of the exclusion clause, specifically the "cost of making good faulty workmanship", was ambiguous, in that it was equally plausible that it meant the cost of redoing the cleaning work or both the cost of redoing the cleaning work and the damage caused to the windows. Due to the ambiguity, the Court applied the *contra proferentem* rule against the insurers such that the damage was not excluded from coverage[13].

In 2015, the Alberta Court of Appeal reversed the trial decision, ruling that just because the application of the exclusion clause to the facts was difficult does not mean the wording was ambiguous, concluding that the damage to the windows was excluded because it was not accidental but was directly caused by the cleaning work and was not only foreseeable but highly likely.[14]

In 2016, the Supreme Court of Canada held that the exclusion did not apply and the damage to the windows was covered. The Court referred to its ruling in *Sattva Capital Corp. v. Creston Moly Corp* from 2014, where it said a court must consider the factual matrix when interpreting a contract.[15] It determined that standard form contracts are an exception and the principle from *Sattva* does not apply to this case.[16] The factual matrix is unhelpful because the parties do not negotiate the terms. Rather, the insurance policy is presented to the insured as a take it or leave it offer.[17] However, 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, but they are generally not fact specific and the same for all builder's risk policies at a given time.[18]

The Court also provided a framework for courts to interpret the scope of coverage for policies subject to exclusion clauses, with the onus of proof shifting between the insurer and the insured, relying on the analysis from *Progressive Homes*. The insured has the initial onus of establishing that the loss claimed falls within the initial grant of coverage. If the insured is successful, the onus then shifts to the insurer to establish that an exclusion applies. If the insurer is successful, the onus then shifts back to the insured to prove that an exception to the exclusion applies[19]. The Court held that although the insurers did not undertake to cover the cost of making good faulty workmanship, they did agree to cover physical damage resulting from that faulty workmanship.[20]

Where the language of the exclusion clause is ambiguous, the general principles of contractual interpretation apply and in this case that lead to the conclusion that the scope of the exclusion was limited to the cost of redoing the faulty work, that is, the cost of recleaning the windows. The damage to

[13] *Ledcor Construction Limited v. Northbridge Indemnity Insurance Company*, 2013 ABQB 585 at paras. 13-18
[14] *Ledcor Construction v. Northbridge Indemnity Insurance Company*, 2015 ABCA 121 at paras. 52, 56 and 58
[15] *Sattva Capital Corp. v. Creston Moly Corp.*, 2014 SCC 53 at paras. 46-50
[16] Ledcor SCC at paras. 24 and 46
[17] Ledcor SCC at paras. 28-29
[18] Ledcor SCC at paras. 30-31
[19] Ledcor SCC at para. 52
[20] Ledcor SCC at para. 79

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the windows and therefore the cost of their replacement was covered. The financial implications were significant as the cost of redoing the cleaning work was $45,000, while the cost of replacing the windows was $2.5 million. The Court decided it was not necessary to turn to the *contra proferentem* rule.

The Court held that this interpretation is consistent with the reasonable expectations of the parties and aligns with commercial reality, which reflect and promote the purpose of builders' risk policies and their spreading of risk on construction projects, and is consistent with the established case law.[21] An interpretation of the exclusion clause that precludes coverage for 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 undermine the purpose behind builders' risk policies and deprive insureds of the coverage for which they contracted.[22]

Acciona v. Allianz Cases (2014-2016)

In 2009, Acciona and Lark Projects entered into a joint venture as general contractor of a hospital construction project in Victoria, BC. Concrete slabs that were poured were discovered near completion to be deflecting, cracking and bending, resulting in concave recessions in the centre of the slabs. The insurers relied on a LEG 2 exclusion in denying coverage under a builder's risk policy.

In 2014, the BC Supreme Court held that the damage constituted direct physical loss of or damage to insured property. The slabs themselves were not the "defective workmanship" but rather it was the improper formwork and shoring that was the defective workmanship which resulted in the damage to the slabs. The Court awarded the joint venture $8.5 million in repair costs, relying on *Progressive Homes*.[23]

In 2015, the BC Court of Appeal upheld the trial decision. The Court further explained that the policy was clearly intended to afford coverage for damage to unfinished work during construction. Only the hypothetical costs that would have been incurred had the defect been recognized and repair been conducted immediately prior to the consequential or resulting damage occurring is excluded. The exclusion does not extend to exclude the cost of repairing the damaged property. The financial ramifications were significant as the cost of redoing the shoring and formwork was minimal. There was no evidence before the court on the quantum of these minimal costs; therefore they were not deducted from the overall cost.[24]

Guild Yule LLP
BARRISTERS AND SOLICITORS
2100 – 1075 Georgia Street
Vancouver, BC V6E 3C9
www.guildyule.com
P 604 688 1221
F 604 688 1315
E feedback@guildyule.com

[21] Ledcor SCC at paras. 5, 8, 50, 64, 71, 78 and 80
[22] Ledcor SCC at para. 70
[23] *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Company*, 2014 BCSC 1568 at paras. 123, 149, 198, 223 and 259
[24] *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Company*, 2015 BCCA 347

In 2016, the Supreme Court of Canada remanded the case back to the appellate court for disposition in accordance with *Ledcor*.[25] However, the parties did not proceed in the BC Court of Appeal.

Monk v. Farmers' Mutual Cases (2014-2020)

In 2008, a homeowner hired a contractor to restore the exterior logs and wooden surface of her 1997 home, which included cleaning, grinding, sanding and finishing the log exterior. The work caused over $100,000 in damage to the interior and exterior of the home, including to the carpets, windows, doors, exterior fixtures and thermal pane glass units. In 2011, the homeowner submitted a claim under a standard all risk home insurance policy, which included a LEG 1 exclusion and another exclusion for property "while being worked on, where the damage results from such process or work", with an exception for resulting damage to other insured property. The insurer denied coverage on the basis of these exclusions.

In 2014, the insurer was successful in denying coverage on summary judgment in the Ontario Superior Court of Justice.[26] In 2015, the Ontario Court of Appeal set aside that judgment, ruling that the resulting damage to the insured property was covered by the policy whether or not that damage was the result of faulty workmanship and remanded the case back to the lower court to determine whether the owner's action was barred by reason of expiration of the limitation period.[27] In 2016, the summary trial judge released supplementary reasons, directing the parties to proceed to trial as the limitation period issue raised significant credibility issues that were not appropriate for summary disposition.[28]

In 2017, the Ontario Superior Court of Justice held that the "faulty workmanship" exclusion only applies to the cost of redoing the faulty work originally contracted for, namely the restoration of the logs, following *Ledcor*. The damage was outside the scope of work and constituted "resulting damage" which was not excluded. The carpets and light fixtures were not "property while being worked on" and the damage constituted "resulting damage to other insured property". Damage to windows and doors, which were not within the scope of work, also constituted "resulting damage to other insured property". However, the owner was still unsuccessful as a result of her failure to provide timely notice to the insurer, preventing the insurer from bringing a subrogated claim against the contractor at fault.[29]

In 2019, the trial decision was upheld by the Ontario Court of Appeal with respect to both the interpretation of the exclusions and the limitation bar.[30] In

[25] *Allianz Global Risks US Insurance Company v. Acciona Infrastructure Canada Inc.*, 2016 CanLII 70286
[26] *Monk v. Farmers and Muskoka Insurance*, 2014 ONSC 3940
[27] *Monk v. Farmers' Mutual Insurance Company (Lindsay)*, 2015 ONCA 911 at paras. 32-41
[28] *Monk v. Farmers and Muskoka Insurance*, 2016 ONSC 3488 at paras. 14-19
[29] *Monk v. Farmers and Muskoka Insurance*, 2017 ONSC 3690 at paras. 111-175 and 187-227
[30] *Monk v. Farmers' Mutual Insurance Company (Lindsay)*, 2019 ONCA 616 at paras. 38-55

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2020, the owner's application for leave to appeal to the Supreme Court of Canada was denied.[31]

G&P Procleaners v. Gore Mutual Cases (2016-2017)

The Court in *Ledcor* suggested that the case may have broader application beyond the builders' risk context, specifically in the interpretation of CGL policies.[32] The facts in *G&P Procleaners* are similar to *Ledcor*. In 2014, a contractor provided window cleaning services at a newly constructed commercial building. Airborne cement debris from nearby stone cutting machines settled on the windows. When the squeegees were used on the windows, the cement debris scratched 180 windows. The contractor paid the owner for the cost of replacing the damaged windows, which amounted to $134,000, and then made a claim under its CGL policy. Coverage was denied on the basis of a "your work" faulty workmanship exclusion, which excluded damage caused by the contractor's own work caused on property that the contractor is performing work on.

In 2016, Ontario Superior Court of Justice confirmed in an unreported summary judgment that there was no coverage on the basis of the exclusion. In 2017, the Ontario Court of Appeal upheld the decision, ruling that the scratching occurred as a result of the cleaning work and was excluded. CGL policies are generally intended to cover an insured's liability to third parties for property damage. They also cover consequential damage to property other than the part of the property where the insured is performing its work. They do not cover the cost of repairing damage caused by their own work. The Court further explained that CGL policies afford less coverage than builder's risk policies, implying that those were the circumstances which distinguish it from *Ledcor*.[33]

Condominium No. 9312374 v. Aviva Cases (2018-2020)

In 2011, a condominium corporation contracted with an engineer and a waterproofing and restoration contractor to work on the surface of a parkade of a large mixed-use commercial and residential complex in Calgary. A contractor cut too deeply into the concrete slab while stripping and coating the membrane, causing damage to the structural integrity of the parkade.

Actions against the contractors were settled. However, the settlement funds did not cover the full loss. The condominium then submitted a claim to Aviva to recover the shortfall under a multi-peril policy covering the condominium corporation and condominium owners. Aviva denied coverage, relying on a LEG 1 exclusion with an exception for "loss or damage caused directly by a resultant peril" not otherwise excluded by the policy.

[31] *Monk v. Farmers' Mutual Insurance Company (Lindsay)*, 2020 CanLII 13145
[32] Ledcor SCC at para. 83
[33] *G & P Procleaners and General Contractors Inc. v. Gore Mutual Insurance Company*, 2017 ONCA 298

Guild Yule LLP
BARRISTERS AND SOLICITORS
2100 – 1075 Georgia Street
Vancouver, BC V6E 3C9
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P 604 688 1221
F 604 688 1315
E feedback@guildyule.com

In 2018, the case management master ruled against Aviva in an unreported decision. Later that year, the Alberta Court of Queen's Bench held that the circumstances were distinguishable from *Ledcor* because that coverage dispute involved a builder's risk policy which covered the contractors, whereas this dispute concerned an all-perils policy which covered the condominium corporation and individual condominium unit owners, but not a specific construction project. There is an exception to the exclusion if damage was caused by a "resultant peril not otherwise excluded". For example, if the faulty workmanship caused a fire, damages arising from faulty workmanship which caused the insured peril of fire would be covered by virtue of the exception to the exclusion. However, if no insured peril occurs, then the exception does not apply.[34]

In 2020, the Alberta Court of Appeal unanimously restored the original ruling. The exclusion language along with its exception was ambiguous as the policy failed to define "resultant peril", therefore the Court should look to the "reasonable expectations" of the condominium owners and the insurer, applying the analysis from *Progressive Homes*, *Ledcor* and *Monk*. The Court held the faulty workmanship exclusion was limited to the scope of work in the contract, namely the repair work to the parkade membrane. In fact, the contract provided that the contractors were not to perform any work that would impact the structural integrity of the concrete slab.[35]

Conclusion

Ledcor and *Acciona* are key decisions with respect to interpretation and application of faulty workmanship exclusion clauses under builder's risk policies and have significant ramifications for the construction industry. The courts' interpretation of these exclusions are not quite as broad as the underwriters and LEG had intended, resulting in coverage for damage that is outside the contractor's scope of work.

The Supreme Court of Canada in *Ledcor* limited the LEG 1 exclusion to the cost of the defective work (not the resulting damage) and connected the scope of the exclusion to the contractual obligations of the contractor. Application of these principles is straightforward in contracts with only one component like in *Ledcor*. However, applying this approach to projects where the contract has multiple severable components and the defective work relates to only one of them may be problematic and lead to a broader interpretation of the exclusion.

The Ontario Court of Appeal in *Acciona* explained that with a LEG 2 clause, the excluded costs crystallize immediately prior to the damage occurring and as such the exclusion is only limited to those costs that would have prevented the damage from happening and does not include the damage itself. The Insurance Bureau of Canada has recommended adding a definition of "resulting damage" to delineate the faulty workmanship and resulting

[34] *Condominium Corporation No. 9312374 v. Aviva Insurance Co. of Canada*, 2018 ABQB 674 at paras. 23-36
[35] *Condominium Corporation No. 9312374 v. Aviva Insurance Co. of Canada*, 2020 ABCA 166 at paras. 14-45

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2100 – 1075 Georgia Street
Vancouver, BC V6E 3C9
www.guildyule.com
P 604 688 1221
F 604 688 1315
E feedback@guildyule.com

damage in accordance with *Acciona*.[36] As the parties did not return to the appellate court for proper interpretation of the LEG 2 clause in accordance with *Ledcor*, the case law remains somewhat unsettled. However, in our view, had the case been reconsidered, the result would have been largely the same, as it is consistent with the purpose of the policy and parties' intention as found by the Court in *Ledcor*.

The appellate courts applied the *Ledcor* analysis in *Monk* and *Condominium* and we learned that damage caused by faulty workmanship may even be covered under multi-peril or home insurance policies. *G&P Procleaners* suggests that the type of policy and specific policy wording will determine whether *Ledcor* is to be applied. The lack of litigation after *Ledcor* may indicate that the Supreme Court of Canada was successful in its objective to reduce private law litigation in complex construction projects. However, insurers appear to have responded to *Ledcor* by increasing premiums and modifying the LEG exclusions in an attempt to widen the exclusions. Insureds may also attempt to apply the *Ledcor* interpretation to different insurance policies, like in *Monk*, *Condominium* and *G&P Procleaners*. These circumstances have the potential for further judicial consideration. The Canadian courts have also yet to interpret a LEG 3 exclusion.

Should you have any questions about your specific circumstances, please do not hesitate to contact the writers or any of our Construction group lawyers.

D. Mark Gyton
Direct Line: 604-844-5502
Email: mgyton@guildyule.com

Charlotte C. Leung
Direct Line: 604-844-5587
Email: cleung@guildyule.com

Guild Yule LLP
BARRISTERS AND SOLICITORS
2100 – 1075 Georgia Street
Vancouver, BC V6E 3C9
www.guildyule.com
P 604 688 1221
F 604 688 1315
E feedback@guildyule.com

[36] IBC 4047