Supreme Court of Canada on Contractual Interpretation and the Faulty Workmanship Exclusion

A Commentary on *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*

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On Sept. 15, 2016, the Supreme Court of Canada released its decision in *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, *2016 SCC 37*.

This decision dealt with two important issues:

1. The standard of review on appeals involving the interpretation of standard form contracts.
2. The interpretation of the "faulty workmanship" exclusion in builders' risk policies.

A. The Factual Situation

The fact situation is succinctly set out in the headnote as follows:

> "During construction, a building's windows were scratched by the cleaners hired to clean them. The cleaners used improper tools and methods in carrying out their work, and as a result, the windows had to be replaced. The building's owner and the general contractor in charge of the construction project claimed the cost of replacing the windows against a builders' risk insurance policy issued in their favour and covering all contractors involved in the construction. The insurers denied coverage on the basis of an exclusion contained in the policy for the 'cost of making good faulty workmanship'."

The exclusion clause excluded:

> "(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."

B. The Courts Below

The trial judge found the exclusion ambiguous and applied the *contra proferentum* rule to hold in favour of the party seeking coverage.

The Alberta Court of Appeal held that the standard of review for standard form contracts was "correctness".

The Court of Appeal created a new test of "physical or systemic connectedness" to determine "the dividing line between the physical damage that was excluded as the 'cost of making good faulty workmanship' and the physical damage that was covered as 'resulting damage'".

The new test was based on three primary considerations,

> (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."

In the result, the Court of Appeal overruled the trial judge finding that "the damage to the building's windows was excluded from coverage, as the damage was physically or systematically connected to the very work the contractor had performed."

C. The Supreme Court of Canada on the Standard of Review

On an 8 – 1 majority, Cromwell, J. dissenting, the Supreme Court held that:

> "The appropriate standard of review in this case is correctness. The interpretation of a standard form contract should be recognized as an exception to the Court's holding 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."

While several reasons were given for this exception, the most compelling one was set out as follows:

> "Establishing the proper interpretation of a standard form contract amounts to establishing the correct legal test, as the interpretation may be applied in future cases involving identical or similarly worded provisions. The mandate of appellate courts — ensuring consistency in the law — is also advanced by permitting them to review the interpretation of standard form contracts for correctness. The result of applying the interpretation in future cases will of course depend on the facts of those cases."

D. The Supreme Court of Canada on Interpretation of the Faulty Workmanship Exclusion

The Supreme Court of Canada overruled the Court of Appeal and restored the trial judgment, but for different reasons.

The majority of the Court found that the ambiguity in the exclusion clause could be resolved by ordinary rules of contractual interpretation and therefore there was no necessity to apply the *contra proferentum* rule or to apply the Court of Appeal's test of "physical or systemic connectedness".

Wagner, J. writing for the majority, stated:

> "I am of the view that the exclusion clause serves to exclude from coverage only the cost of redoing the faulty work. This interpretation is dictated by the general rules of contractual interpretation. It best represents the parties' reasonable expectations, as informed by the purpose of builders' risk policies, aligns with commercial reality, and is consistent with the jurisprudence on the matter. In this case, the cost of redoing the faulty work is that of recleaning the windows."

He went on to explain:

> "…in my view, the purpose behind builders' risk policies is crucial in determining the parties' reasonable expectations as to the meaning of the Exclusion Clause. In a nutshell, the purpose of these polices is to provide broad coverage for construction projects, which are singularly susceptible to accidents and errors. This broad coverage — in exchange for relatively high premiums — provides certainty, stability, and peace of mind. It ensures construction projects do not grind to a halt because of disputes and potential litigation about liability for replacement or repair amongst the various contractors involved. In my view, the purpose of broad coverage in the construction context is furthered by an interpretation of the Exclusion Clause that excludes from coverage only the cost of redoing the faulty work itself — in this case, the cost of recleaning the windows. "

…

> "Consequently, 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 would, in my view, undermine the purpose behind builders' risk policies. It would essentially deprive insureds of the coverage for which they contracted."

In a nutshell then, the law now is that the standard of review of the interpretation of standard form contracts is "correctness". The faulty workmanship exclusion in builders' risk policies excludes only the cost of redoing the work done by the particular contractor and does not exclude consequential damage resulting from that work.

(Note that the issue of the standard of review for interpretation of standard form contracts was previously discussed in our Commentary #37.)