

Legal update

Supreme Court of Canada provides guidance on interpretation of insurance policies

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Insurance

The Supreme Court of Canada has provided important guidance in *Ledcor Construction Ltd. v Northbridge Indemnity Insurance Co.*¹ on interpreting insurance policies, particularly in the context of construction projects.

Background

The source of this litigation was the construction of a 28-storey office building in downtown Edmonton. As one of the final steps in the project, the general contractor retained a subcontractor to clean the tower's exterior windows for \$45,000. Unfortunately, the subcontractor used improper tools and methods and ended up scratching the tower's windows to the point where they had to be replaced at a cost of \$2.5 million.

The general contractor and subcontractor made a claim under the project's builder's risk policy for the cost of replacing the scratched windows. The policy covered all risks of direct physical loss or damage to the property undergoing construction, subject to certain exclusions. The insurer denied the claim on the basis that it fell under the following exclusion for the "cost of making good faulty workmanship":

This policy section does not insure... [t]he 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.

Trial judge and Alberta Court of Appeal

At trial, the insureds argued that the exclusion for the "cost of making good" only referred to the cost of redoing the cleaning work, while the insurer argued it also included the cost of replacing the scratched windows. The trial judge found that the exclusion clause was ambiguous because the interpretations of the insureds and insurer were equally plausible. The trial judge applied the rule of *contra proferentem* (any ambiguity should be resolved against the insurer) and found that the policy covered the cost of replacing the windows.

The Alberta Court of Appeal reversed the trial judge's decision. The court developed a new "physical or systemic connectedness test" to determine whether the scratched windows were the result of "faulty workmanship" (excluded) or "resulting damage" (covered). Under this novel test, the court found that damage to the windows was the result of "faulty workmanship" because it occurred during the intentional scraping and wiping of windows. The court accordingly found that the policy excluded the replacement cost of the windows.

Supreme Court of Canada

The Supreme Court granted the insured's appeal and found that the policy covered the cost of replacing the windows. In coming to this decision, the court provided important guidance on interpreting insurance policies:

- The court found that **the decision of a trial judge on the interpretation of an insurance policy is not typically owed any deference on appeal**. The court noted that the use of the correctness standard of review for insurance policies and other standard form contracts was an exception to the general rule the court had recently affirmed in *Sattva Capital Corp.*² that appellate courts should review the interpretation of contracts using the palpable and overriding error standard of review. An appellate court should only apply this more deferential standard of review to insurance policies in exceptional cases where, for instance, the parties actually negotiated the terms of the policy.³
- The court rejected the Alberta Court of Appeal's new "physical or systemic connectedness test" as unnecessary and affirmed that **courts should rely on the general rules of interpretation for insurance policies set out in *Progressive Homes***.⁴ The court noted that the general rules in *Progressive Homes* were equally applicable to a builder's risk policy even though the court was dealing in that case with a commercial general liability policy. In short:
 - The insured has the onus of establishing that the damage falls within the initial grant of coverage. The insurer then has the onus to establish that one of the exclusions to coverage applies, with the onus then shifting back to the insured to apply any exception to the exclusion.
 - If the policy's language is ambiguous, the court may consider the reasonable expectations of the parties, as long as that interpretation is supported by the language of the policy, does not give rise to results that are commercially unrealistic, and is consistent with the interpretations of similar insurance policies.

On the claim before it, the court agreed with the trial judge that the exclusion clause was ambiguous and accordingly turned to the reasonable expectations of the parties.

The court found that the purpose of a builder's risk policy is to provide broad coverage for construction projects, providing "certainty, stability, and peace of mind" in exchange for "relatively high premiums." In this context, the court found that the insureds would be deprived of the very thing they had contracted for if the exclusion clause removed coverage for the cost of replacing the windows merely because the windows were the part of the project on which the subcontractor had worked. The court accordingly found that while the policy would not cover the cost of redoing the subcontractor's work, it did cover the cost of replacing the scratched windows.

Conclusion

This decision provides guidance to lower courts on the proper interpretation of insurance contracts, removing the temptation to come up with novel ways of resolving coverage disputes. This should lead to greater certainty for insureds and insurers on the interpretation of insurance policies.

This decision could also cause an increase in claims under builder's risk policies, as insureds latch on to the Supreme Court's generous interpretation of the reasonable expectation of parties involved in construction projects. All insurers that write builder's risk policies need to review their policy wording to ensure any exclusionary language is free from the ambiguity found in *Ledcor Construction*.

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Footnotes

- ¹ *Ledcor Construction Ltd. v Northbridge Indemnity Insurance Co.*, 2016 SCC 37.
- ² *Sattva Capital Corp. v Creston Moly Corp.*, 2014 SCC 53.
- ³ Justice Cromwell concurred with the result but found that there was no reason to depart from the general rule in *Sattva* for the interpretation of standard form contracts.
- ⁴ *Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada*, 2010 SCC 33.

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