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Coverage under GCL Policies for Construction Defects

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Much has been written and said by both legal commentators and the judiciary about the coverage available to general contractors and their subcontractors under general liability policies for claims brought against them for "property damage" on projects they have worked on. The issue has arisen not when there are claims for "property damage" to property external to the project in question, but when the claim is for the cost of repairing portions of the project itself as a result of faulty workmanship or materials supplied by a general contractor or its contractors.

Although the topic has a long history, there is more recently a limited number of cases in Canada which properly define the nature and extent of the coverage available under these policies for this type of claim.

THE FACTUAL BACKGROUND

The leaky condo debacle in British Columbia offers a good factual background against which to measure and analyse CGL coverage for general contractors and subcontractors. In the typical leaky condo case, there has been water or moisture infiltration into the building envelope for a variety of reasons, whether it be a failure at the regulatory level to identify defects in design and standard construction procedures, a failure at the design level to properly design the envelope, or a failure at the construction level to properly assemble the envelope in accordance with the plans and specifications or good industry practice. In all of these cases, the consequence is rotting or rusting of various components of the building envelope with the real potential for structural failure of the wall in the absence of remedial work. So condominium owners, whether they be individual owners or strata corporations, bring a claim against multiple participants in the design and construction of the envelope, alleging negligence on their part and claiming damages for the cost of repairing the envelope.

Faced with a situation of this nature, the named defendants present the claim to their liability insurers, in the case of a builder or trade, to their CGL or wrap-up liability carrier.

In the case of a general contractor, having signed a contract with the original developer to supply all the work and materials necessary to construct the entire project, the question which arises is whether they are entitled to either defence or indemnity coverage under the CGL policy for the claim brought against them by the condominium owners. And a similar question arises in the case of the general contractor's subcontractors or trades, that is whether they are entitled to coverage for the claim brought against them, taking into account the fact that they signed a



contract for building or installing only a portion of the wall assembly, say the windows, the balcony membranes or sheet metal flashings at various junctures in the wall assembly.

These questions are now definitively answered, at least in a relative sense, in a trilogy of cases in Canada: in the decision of the B.C. Supreme Court in *Privest v. Foundation Co. of Canada*, (1991), 57 B.C.L.R. (2d) 88; in the B.C. Supreme Court in *Swagger Construction Ltd. v. ING Insurance Co. of Canada*, [2005] B.C.J. No. 1964 ; and in the Ontario Court of Appeal in *Bridgewood Building Corporation v. Lombard General Co. of Canada*, [2006] O.J. No. 1288. Although there is a roomful of other cases discussing the same topic, these three cases provide an excellent summary of the law as it exists at this time, and provide clear guidelines for interpretation of coverage available to general contractors and subtrades for “property damage” claims arising on the projects they worked on.

Privest v. Foundation Co. of Canada

Privest was not a leaky condo case, but a case involving a claim by Privest for the cost they expended in removing sprayed cementitious asbestos fireproofing from the underside of most of the concrete slabs in a building owned by them and their partner in downtown Vancouver. Privest had negotiated a new lease for a large portion of the building, and a new tenant had imposed a condition on Privest that the sprayed asbestos insulation must be removed before they took occupancy. In their case against the original designers, builders and material suppliers of the project, Privest argued not only that the presence of the sprayed cementitious asbestos fireproofing constituted a human health hazard, and for this reason they were not only justified in removing the material, but also that the named Defendants were liable for the cost of removal.

Prior to the trial of the main action, the general contractor on the project, Foundation Co. of Canada Limited, brought an action against various general liability insurers who had issued policies to Foundation both during the course of the project, and after, seeking a declaration that they were obliged to defend Foundation in the action brought by Privest.

Although there were a half-a-dozen policies being pursued by Foundation, they were of only two wordings: one providing coverage for liability for “property damage” defined as “physical injury to or destruction of tangible property” and the other defining “property damage” as “injury or damage to property”.

The first policy type received the greatest attention from the Chambers Judge, Drost J. of the B.C. Supreme Court. His analysis of the coverage issues and the conclusions to which he came in each instance, have formed the basis for decisions in dozens of general liability coverage cases in the construction industry.

Central to the fact pattern in front of him, Drost J. determined that the installation of an allegedly inherently dangerous building product did not constitute “property damage”, at least not “physical injury to or destruction of tangible property”. Rather, the true nature of the claim advanced was one for the recovery of pure economic loss, that is the cost of repairing or removing and replacing an alleged inherent building defect. Relying on a number of authorities, he found that the cost of remedying an inherent defect in a structure did not constitute property damage. In the words of the Court:



“So far as Canadian law is concerned, it seems clear that unless there has actually been personal injury or damage to other property, the cost of repairing or replacing defective work is considered to be pure economic loss rather than damage to property (*Rivtow Marine Ltd. v. Washington Iron Works and Walkem Machinery & Equipment Ltd.* [1974] S.C.R. 1189).

This finding in and of itself has been determinative of a number of cases involving claimed coverage under a CGL policy by general contractors and subtrades. If the claim brought against them is seeking to recover the cost of repairing an inherent defect in the materials or workmanship provided by them on the project, then the claim does not satisfy the basic insuring agreement insuring against liability for “property damage” where that term is defined in the policy as being “physical injury to or destruction of tangible property”. Although there is historical wording in CGL policies defining “property damage” as requiring no more than injury or damage to property (as in the other policy type before Mr. Justice Drost), the modern wording defines property damage as “physical injury to or destruction of tangible property”, or words to that effect. So in the modern context, the Court’s finding that the cost of remedying inherent defects in building projects constitutes pure economic loss, is of broad significance and application.

In the case of the other policy type before him, Mr. Justice Drost found that coverage might be triggered under the policy as there was the prospect that the Plaintiff’s claim might also incorporate a claim for damage to some incorporeal right as opposed to being a claim just for the cost of remedying an inherent defect in property. So he left to be decided another day (a day which never arrived) whether or not the Plaintiff’s claim as presented might trigger coverage under that policy wording. This theme was later picked up in three other British Columbia cases, all arising out of the leaky condominium debacle, which were later explained, and in one case disapproved of by the B.C. Supreme Court in the *Swagger* decision.¹ The *Swagger* case is discussed more fully below.

Although not necessary to his decision that coverage was not available to Foundation under the first policy type, Mr. Justice Drost also considered the work product exclusion under the policy wording. It contained the standard work product exclusion which provides that the policy does not apply to “property damage” to “your work” arising out of it or any part of it, although excepting from the exclusion any damaged work or work out of which the damage arises performed by or on behalf of Foundation by one of its subcontractors. This exclusion, in and of itself, the Court found would preclude coverage being made available to Foundation as the claim presented by Privest was in its entirety a claim arising out of Foundation’s work. So even if Privest’s claim constituted a claim for “property damage”, it was for damage to Foundation’s work itself and therefore excluded by the work product exclusion. In the words of the Court:

“The Canadian authorities to which I was referred also support the proposition that the work or product of a general contractor, such as Foundation, is the project for which the contractor was engaged (see *Foundation of Canada Engineering Corp. Ltd. v. Canadian Indemnity Co.* (1977), 74 D.L.R. (3d) 266

¹ *Allstate Insurance co. v. Axa Pacific Insurance* [1998] B.C.J. No. 1762, Van. Reg. No. C963705, July 23, 1998; *F.W. Hearn/Actes v. Commonwealth Insurance Co.*, [2000] B.C.J. No. 964; *Axa Pacific Insurance v. Guildford Marquis Towers*, [2000] B.C.J. No. 208; *Swagger Construction Ltd. v. ING Insurance Co. of Canada*, [2005] B.C.J. No. 1964



(S.C.C.) and *Sayers & Associates Ltd. v. Insurance Corp. of Ireland Ltd.* (1981), 176 D.L.R. (3d) 681 (Ont. C.A.)).

Conclusions

On the strength of these authorities, and bearing in mind the underlying purpose of a CGL policy, I am of the opinion that the work/product exclusion clause found in each of the subject policies, including those of Allstate and Dominion, relieves the insurer from any obligation to defend Foundation against the claims that have been advanced by the plaintiffs with respect to the removal and replacement of the MK-3, the installation of which was part of Foundation's "work" or "product".

One would think that this analysis by Mr. Justice Drost would preclude any further protracted discussion on whether or not general contractors were entitled to coverage under CGL policies for claims brought against them for the cost of repairing or replacing defective workmanship or materials on projects they had built. But such is rarely the case and there have been other decisions in British Columbia and elsewhere which continued the debate, and in some instances brought confusion and uncertainty to the table. So further clarification became necessary and was provided by Mr. Justice Smith of the B.C. Supreme Court.

The *Swagger* Decision

In *Swagger Construction v. ING Insurance*, [2005] BCSC 1269 (SC), Swagger was the general contractor for the construction of the new Forest Sciences Centre at the University of British Columbia. A dispute arose between the parties and Swagger sued UBC for delays and extras during construction. UBC counterclaimed against Swagger, alleging a variety of construction deficiencies.

Specifically, UBC alleged Swagger was negligent and in breach of its contractual obligations resulting in the provision of faulty workmanship and materials, which in turn lead to water ingress and damage to various other components of the building. It was the cost of remedying these deficiencies and repairing the resulting damage to the building which UBC sought to recover against Swagger.

Swagger had purchased three commercial general liability ("CGL") insurance policies, from ING Insurance Company of Canada, Zurich Insurance Company and American Home Assurance Company, which they said attracted coverage for Swagger in the case pleaded against them by UBC. Each policy covered Swagger's liability for damages arising out of "property damage", defined to mean "physical injury to or destruction of tangible property". Each policy, like all CGL policies, also required the property damage to arise out of an "occurrence", meaning that the property damage had to be neither expected nor intended from Swagger's perspective.

Swagger's position was that all three policies provided coverage to it for the claims advanced by UBC, arguing that the alleged negligence and breach of contract on the part of Swagger caused "physical injury to or destruction of tangible property". It relied on, amongst other cases, two earlier decisions of the British Columbia Supreme Court: *Axa Pacific Insurance v. Guildford Marquis* (2000), 74 BCLR 194 (SC); and *F.W. Hearn/Actes v. Commonwealth Insurance Company* (2000), 75 BCLR (3d) 272 (SC).



Mr. Justice Smith rejected Swagger's arguments and found that they were not entitled to coverage under any one of the three policies of insurance.

With respect to the two cases relied upon by Swagger, Mr. Justice Smith first observed that the *Axa Pacific* case involved wording different than that found in the three policies in question. The policy in *Axa Pacific* provided coverage for "injury to or destruction" of property, not "physical" injury to or destruction of "tangible" property. Based on this difference, Mr. Justice Smith determined that *Axa Pacific* was not applicable to Swagger's case.

The *Hearn/Actes* case presented a little more difficulty, as it involved CGL wording similar to that before the Court in *Swagger* and resulted in a judgment granting the general contractor coverage under a CGL policy. After a comprehensive review of the reasoning in *Hearn/Actes*, Mr. Justice Smith rejected the Court's findings and chose not to follow the decision. Mr. Justice Smith referenced a long line of authorities preceding and succeeding *Hearn/Actes* which not only made the result in *Hearn/Actes* difficult to understand, but also strongly supported the conclusion to which Mr. Justice Smith came.

Having distinguished or disapproved these two earlier decisions, Mr. Justice Smith adopted a line of authorities which would preclude coverage when granted to Swagger. In the result, the decision in *Swagger* is entirely consistent with the *Privest* decision.

The decision in *Swagger* also parallels an earlier decision of the Ontario Superior Court of Justice in *A.R.G. Construction Corporation v. Allstate Insurance* (2004), 38 CLR (3d) 221 (OSC), where the Court on very similar facts refused to trigger coverage under a CGL policy issued in favour of a general contractor, reasoning that faulty or defective workmanship was not an "accident" or "occurrence". Mr. Justice Smith in *Swagger* followed this decision, determining that the appearance of deficiencies in workmanship or materials in a building brought about by the negligence or breach of contract by the general contractor for the building did not constitute an "occurrence" under a CGL policy.

Mr. Justice Smith reasoned that faulty workmanship or materials in these circumstances did not constitute an unexpected or unlooked for mishap and therefore did not constitute an "accident" as required by the three CGL policies held by Swagger. Although not cited in the decision, Mr. Justice Smith's conclusion in this regard was consistent with a long line of authorities in the United States which have similarly concluded that damage to a general contractor's work product does not constitute an "occurrence" as that term is used in a CGL policy. American courts have held damage to a policyholder's own property or work is foreseeable, and therefore not an "accident" under the above definition. As stated generally by the South Carolina Court of Appeals (*C.D. Walters v. Fireman Insurance*, 316 SE 2d 709 (S.C. Ct. App. 1984)), a CGL policy held by a general contractor does not cover faulty workmanship, but rather faulty workmanship which causes an accident.

Looking only at the results in *Privest* and *Swagger*, it has been well established that under the modern policy wording, coverage is not available to general contractors or subcontractors for claims brought against them for damages for the cost of repairing or replacing their faulty work product. Whether one uses the argument that in such circumstances there is no "property damage" as that term is defined in the policy, or the "work product" exclusion applies, or there is no "occurrence", the result is the same: there is no coverage available under the CGL policy for a claim which amounts to no more than the cost of repairing, replacing or making good faulty



work product where the damage to the work product arises out of a defect in the materials or workmanship supplied by the contractor or subcontractor to that work product.

Two other significant cases which have come to the same conclusion are *GCAN Insurance Co. v. Concord Pacific Group* [2007] BCSC 241 and *Progressive Homes Ltd. v. Lombard General Insurance Company of Canada* [2007] I.L.R. I-4626.

There is an exception to this rule found in the modern wording of the work product exclusion. It stipulates that the general contractor is entitled to coverage for the cost of repairing its work product where the damage is caused to the work of a subcontractor. A sample wording containing this exception to the work product exclusion is as follows:

“This insurance does not apply to:

...

j. “Property Damage” to

(1) that particular part of “your work”,

...

(3) a component or constituent of “your work” described in (1) above, whether such component or constituent is a separate physical part or an integral element of “your work”,

that is defective or actively malfunctions. This exclusion applies only to “property damage” to “your work” included in the “products completed operations hazard”.

This exclusion does not apply if the damaged work or if the work out of which the damage arises was performed on your behalf by a subcontractor.”

So under this wording, which is now commonly found in CGL coverage issued to general contractors, the general contractor would have coverage for repairing damaged work product if the product was the work of a subcontractor, or if the damage is caused by work performed by a subcontractor. Of course all of this presumes that the damage in question can in the first instance be properly classified as “property damage” within the meaning of that term as defined by the policy.

The “Business Risk” Argument

A still further argument which has historically been advanced on behalf of CGL insurers endeavouring to avoid coverage for making good faulty work product is what has become known as the “business risk” implied exclusion. The theme of this argument is that CGL policies are not meant to protect insureds from what would otherwise be classified as “business risk” and thereby turning the CGL policy into a surety bond. And the insurers argue that extending coverage to the cost of making good faulty work product would do just that: it would underwrite what is otherwise a business risk to the general contractor or subcontractor, license, if not



encourage shoddy workmanship and materials, and would turn the CGL policy into a performance bond. Although the argument has a general attraction, the Ontario Court of Appeal in the *Bridgewood Building* case has made it clear that it is the policy wording in any specific instance which must govern the result and not this general proposition.

In the *Bridgewood Building* case Lombard General Insurance Co. of Canada ("Lombard") appealed orders made by a Chambers Judge requiring Lombard to indemnify Bridgewood under two CGL policies for the cost of repairing a number of new homes built by Bridgewood and a developer, Beige Valley Developments. Defective concrete had been supplied by a subcontractor of Bridgewood and this resulted in structural deficiencies in the homes.

Lombard took the position that there was no coverage under the policy and advanced the general proposition that CGL policies do not pay for the cost incurred to repair defective work product. Although work product exclusion in the policy contain the subcontractor exception, Lombard continued to maintain its position. They said that CGL policies are generally not intended to cover repair or replacement costs of defective work and that such a term or condition should be implied in all CGL policies. This argument was rejected both by the Chambers Judge and by the Court of Appeal. In the words of the Chambers Judge:

"Further, although Lombard has not relied on any "work" or "product" exclusion in the Policies it nevertheless mandates that a CGL policy, by its very nature, is intended only to cover an insured's tortious liability to third parties, not including the cost of repairing or replacing the insured's own defective work or product. I am not satisfied that this assertion provides a full answer to the Applicants' claims. Rather, I prefer the approach taken in recent decisions of both the Ontario and British Columbia Courts of Appeal - that "the focus should be on the language of insuring agreements and their interpretation" (see: *Alie v. Bertrand & Frère Construction Co.*, [(2003), [62 O.R. \(3d\) 345](#) (C.A.)], at para. 26). As was noted by the British Columbia Court of Appeal in *Ellet Industries Ltd. v. Laurentian P & C Insurance Co.* (1996), [34 C.C.L.I. \(2d\) 294](#):

While general descriptive terminology distinguishing different categories of insurance coverage no doubt serves a useful purpose in some contexts it cannot be determinative of the rights and duties of the parties to the policy. Those matters can only be resolved definitively by ascertaining the intent of the parties from the language used.

As already noted, I am of the view that the language of the policies should be interpreted in favour of the Applicants in this case.

In support of its assertion that a CGL policy is not meant to be a Performance Bond and that these Policies for CGL coverage do not extend to provide indemnity for anything that is the result of the fault of the insured, Lombard cites the public policy argument that extending coverage to shoddy workmanship or product would serve to encourage poor workmanship and manufacturing. Lombard maintains that if coverage is extended in this case, the liability policy effectively becomes "enormously expanded", opening the floodgates to claims that would include building code infractions, substitution of sinks, repair of chipped tiles, drywall repair and essentially all of the Applicants' work. In



considering that position, I am cognizant of Lombard's election not to rely on certain other provisions of the Policies, including the "work" and "product" exclusions. Further, I am of the view that the facts of these cases, combined with the ONHWP [Ontario New Home Warranty Program, now Tarion Warranty Corporation] legislative requirements, raise public policy considerations that serve to outweigh Lombard's concerns."

Accepting this analysis of the Chambers Judge, the Court of Appeal said:

"In that regard it is not now, nor, to my knowledge, has it ever been the position of this court that, standing alone, the "general principle" excludes coverage of an insured's own defective work or product regardless of provisions in the policy that evidence a contrary intent. Rather, it constitutes an interpretive aid that can be helpful, but not decisive, when interpreting particular provisions of a CGL policy in an effort to determine the scope and extent of the risks that insurer has agreed to cover." (at para. 9, p.5)

So although the business risk defence proffered by CGL carriers has its appeal, it is not an argument which trumps the provisions of the particular coverage issue. The wording of the policy, particularly that defining "property damage" and "occurrence", and the wording of the "work product" exclusion, still has to be taken into account in the analysis. These provisions of the policy will most often be largely determinative of the issue, and resort to the "business risk" analysis will be required only to justify the conclusion which would otherwise be generated by this analysis.

SUMMARY

With the recognition that one cannot summarize that which is not capable of summary, I think the following propositions flow from the foregoing decisions and can be generally applied to a coverage analysis under current CGL wording when coverage is sought by a general contractor or subcontractor for claims arising out of defects in their work product:

1. If the claim can properly said to be one which is seeking to recover no more than the cost of making good faulty work product, then it is not a claim for "property damage" at all in the sense that it is a claim for pure economic loss, and not a claim for physical injury to or destruction of tangible property.
2. Similarly, if the claim is one for the cost of making good faulty work product, there is an absence of an "occurrence", in the sense that there is no accident or unlooked for mishap or event which has given rise to the claim. The result of the faulty work product is foreseeable and predictable and the element of fortuity "or accident" is removed, thereby offending a basic requirement of coverage being triggered.
3. If there has been "property damage" that meets the definition under the policy wording, then coverage is still not available to a general contractor being pursued for the cost of repairing that property damage, if the property damage to the general contractor's work product, whether part of the damaged work or not.



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4. If the work product exclusion contains the subcontractor exception, then a general contractor will have coverage for “property damage” to work performed by or on behalf of the subcontractor, or to property damage to the general contractor’s work if the damage arises out of work performed by or on behalf of a subcontractor.
 5. A subcontractor will have coverage under its general liability policy subject to the same foregoing analysis.
 6. The “business risk” defence does not trump the specific provisions of the policy, but rather is to be used only as an interpretive tool in analyzing those terms and conditions.

It must be emphasized that these conclusions are applicable only to the modern wording of CGL policies. Quite different considerations may apply to some historical wording which variously defined “property damage” and “occurrence”, and used different wording for the “work product” exclusion. Indeed, the term “modern” is by definition a temporal concept, and even this analysis will be inapplicable as the insurance industry continues to edit the CGL wording to adapt to new-found conditions and judicial interpretations of its chosen wording. Indeed, the industry is in the process of doing just that at the present time.