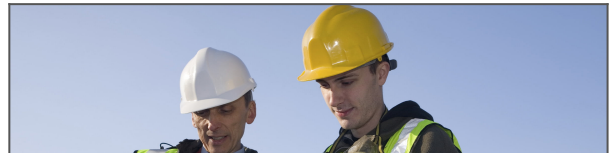


Faulty or Improper Material, Workmanship, and Design - Interpreting the Exclusion Clause in Construction Insurance Policies

Authors: Andrew Sain

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Builder's risk (also known as course of construction) insurance policies almost always contain some form of exclusion relating to the cost of repairing or replacing faulty or improper material, workmanship, and design. This exclusion is usually qualified by an exception to the exclusion, or 're-inclusion', for "resultant damage" to insured property. The application of this exclusion is a frequent source of disagreement as between insurers and insureds on construction projects.



The typical wording for this exclusion is:

This Form does not insure:

- (a) the cost of making good
- (i) faulty or improper material;
- (ii) faulty or improper workmanship;
- (iii) faulty or improper design;

provided, however, to the extent otherwise insured and not otherwise excluded under this Form, resultant damage to the property shall be insured.

(a) Faulty or Improper Design

The faulty or improper design aspect of the exclusion was considered by the Supreme Court of Canada in *Canadian National Railway v Royal & SunAlliance Insurance Co. of Canada*, 2008 SCC 66.

This case related to a builder's risk insurance policy issued to CNR with respect to the construction of a railway tunnel under the St. Clair River between Sarnia, Ontario and Port Huron, Michigan in the autumn of 1993. The claim arose from the failure of a 'tunnel boring machine' ("TBM"), a massive piece of equipment with a cutting head 32 feet in diameter and

a body 278 feet long. The TBM was halted when dirt penetrated its cutting head and threatened the integrity of the main bearing that drove the machine forward. In the result, the project was delayed by 229 days. The Court was required to consider whether the failure of the TBM was captured by the “faulty or improper design” exclusion.

The majority of the Court held that a design would not be “faulty or improper” provided it complied with the state of the art at the material time. Binnie J. wrote for the majority that:

[53] ...In my view, the words “faulty or improper” require the insurers to go beyond simply showing a failure in circumstances of foreseeable risk. **The words “faulty or improper”, and in particular the word “improper”, require the insurers to establish that the design fell below a “realistic” standard. Such a standard can require no more than that the design comply with the state of the art.** A standard of perfection in relation to all foreseeable risks, in my view, was not required by the words used by the parties. It was for the insurers to demonstrate that the exclusion applies.

In other words, if an innovative design fails despite being in compliance with the state of the art known at the material time, it will not be excluded from coverage under the builder’s risk policy.

In the result, the Court did not need to consider whether the “resultant damage” exception applied in that case. However, in the subsequent case of *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 (“*Ledcor*”), the Supreme Court commented on the application of that exception to “faulty or improper design” cases as follows:

[90] Though this interpretation of the resulting damage exception to the faulty workmanship exclusion may, at first glance, seem to run contrary to the interpretation generally given to it by courts in faulty design cases, it is actually consistent with those cases.

[91] **It is true that, in faulty design cases, courts generally interpret the resulting damage exception as encompassing damage done to something other than the property which is faultily designed.** Such language may thus appear to be more closely in line with the physical or systemic connectedness test established by the Court of Appeal, as exclusion from coverage may appear to depend on whether the damage has been done to the very thing being worked on or to something else. Only in the latter case would the loss qualify as “resulting damage”. For instance, in *British Columbia v. Royal Insurance Co. of Canada* (1991), 1991 CanLII 5732 (BCCA), 7 B.C.A.C. 172, the British Columbia Court of Appeal wrote that “[d]amage for faulty or improper design encompasses all the damage to the very thing that was designed faultily or improperly. Resultant damage is damage to some part of the insured property other than the part of the property that was faultily designed”: para. 11; see also *Algonquin Power (Long Sault) Partnership v. Chubb Insurance Co. of Canada* (2003), 50

C.C.L.I. (3d) 107 (Ont. S.C.J.), at para. 204.

[92] These decisions, however, are not inconsistent with holding that the faulty workmanship exclusion precludes from coverage only the cost of redoing the faulty work. **Indeed, in faulty design cases, a contractor is obligated to design a given item, with the design being integral to the whole of that item. Thus, the cost of repairing the damages caused to that item will be included within the cost of redoing the faulty work, and the resulting damage exception will necessarily apply to damages caused to items other than the item being designed.** As held in *Simcoe & Erie General Insurance Co. v. Royal Insurance Co. of Canada* (1982), 36 A.R. 553 (Alta. Q.B.), at para. 34:

... the total contractual obligation of [the engineer] was to design and supervise the construction of a bridge required by the [city]. The damage to the structure that [the engineer] first designed was the product of its failure to properly design a bridge, which in turn prevented it from properly performing its contractual obligations. It follows therefore that the contract was not performed until a stable bridge was constructed.

[Emphasis added.]

(b) Faulty or Improper Workmanship

The faulty or improper workmanship aspect of the exclusion was recently considered by the Supreme Court of Canada in *Ledcor*.

This case involved the construction of an EPCOR office building in Edmonton.

The property was owned by Station Lands Ltd. Station Lands hired Ledcor Construction Ltd. as construction manager. As the project was nearing completion, Ledcor hired a company called Bristol Cleaning to perform a “construction clean” of the site. They were responsible for removing “construction debris” from the exterior of the building’s windows. Through their negligence, Bristol Cleaning scratched the windows of the building, which needed to be replaced at a significant cost.

Station Lands and Ledcor filed claims under their Builders’ Risk Policy. The claim was denied on the basis that the work provided was “faulty workmanship”. Station Lands and Ledcor argued that it was “resultant damage”.

In *Ledcor*, the Supreme Court held that the language of the exclusion clause was ambiguous. Therefore, the Court resorted to the general principles applicable to the interpretation of insurance policies to determine whether the damage at issue was related to “faulty or improper workmanship” or “resultant damage”. The Court held that:

[63] ... As I will detail below, the application of these principles 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. As such, excluded under the Policy is the cost of recleaning the windows, but the damage to the windows and therefore the cost of their replacement is covered.** This is consistent with previous interpretations of similar clauses in the jurisprudence. Indeed, as I explain below, I disagree with the Insurers' contention that the case law consistently supports their interpretation of the Exclusion Clause.

The Court was of the view that this interpretation best fulfilled the broad coverage objective that underlies builder's risk policies. The Court held that:

[79] As already discussed above, the interpretation advanced by the Insureds in these appeals best fulfills the broad coverage objective underlying builders' risk policies. These policies are commonplace on construction projects, where multiple contractors work side by side and where damage to their work or the project as a whole commonly arises from faults or defects in workmanship, materials or design. In this commercial reality, a broad scope of coverage creates certainty and economies for both insureds and insurers. **In my opinion, it is commercially sensible in this context for only the cost of redoing a contractor's faulty work to be excluded under the faulty workmanship exclusion.** Such an interpretation strikes the right balance between the two undesirable extremes described by Estey J. in *Consolidated-Bathurst*, at pp. 901-2: "... the courts should be loath to support a construction which would either enable the insurer to pocket the premium without risk or the insured to achieve a recovery which could neither be sensibly sought nor anticipated at the time of the contract". Under the Policy, the Insurers did not undertake to cover the "cost of making good faulty workmanship", but they did promise to cover "physical damage [that] results" from that "faulty workmanship". It can hardly be said that recovery for the damages to the Tower's windows in the circumstances of this case could not have been sensibly sought or anticipated when the Policy was purchased.

It is important to note, therefore, that different lines of authority may be applicable depending on whether the "faulty or improper design" or "faulty or improper workmanship" aspects of the exclusion are being relied upon.

(c) Faulty or Improper Materials

It should be noted that the faulty or improper materials aspect of the exclusion may be applicable even if the faulty design or workmanship aspect of the exclusion does not apply in a given case.

In *CIC Mining Corp. v Saskatchewan General Insurance*, 1994 CarswellSask 165 (SKCA), the Court of Appeal considered a situation where a loss was caused by the provision of a

defective pipe. Under that policy, coverage was afforded for faulty or improper workmanship but not for faulty or improper materials. The manufacturer and supplier of the pipe attempted to argue that the reason for the pipe's failure was faulty or improper workmanship in the production of the pipe. This argument was rejected.

The Court of Appeal was of the view that the reason for the defect in the material was not relevant to its analysis.

The Court of Appeal held that:

[34] This contention that faulty workmanship includes such workmanship when it occurred at the Fiberglass plant is not easy to accept. For one reason, counsel for the appellant had to acknowledge that he could produce no direct supportive authority to indicate that if faulty material was involved, the cause of the fault was a relevant factor. For another, he agreed such an argument would not apply to faulty material which was purchased from the shelf. In other words, the position advanced was an apparent extension of the usual concept that what caused the faulty material was not relevant, which extension would only go so far as to relate to custom material such as was involved in this case.

[35] **If one concludes, as I quite readily do, that faulty material is excepted from coverage because it is not a risk the insured needs to be protected against, then it matters not to the purchaser what the reason for the fault might be.** The insured takes the responsibility of checking the quality of the material it has ordered and if it fails to meet the required standard it is rejected. If the supplier can and does correct the fault, then the material is accepted and paid for. If the supplier cannot or will not correct the fault then the insured looks elsewhere for the material. **There is no need in this scenario to insure for faulty material or to look at the reason for the fault or where it has occurred.** This being the situation, there is no justification for the creation of an extension of the law on this point when it serves no purpose but to needlessly complicate a rather straightforward and apparently well accepted approach to the way in which protection against the loss involved from faulty material has been handled on projects of this nature.

Accordingly, it appears that the analysis under the "faulty or improper materials" prong of the exclusion will be limited to the adequacy of the supplied material, without reference to the conduct of the supplier.

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