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Damage Insurance

EXCLUSIONS OF WORK PERFORMED BY THE INSURED NEW INTERPRETATION AND DUTY TO DEFEND

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ON SEPTEMBER 23, 2010, THE SUPREME COURT OF CANADA ISSUED AN UNANIMOUS JUDGMENT IN THE CASE OF *PROGRESSIVE HOMES LTD. V. LOMBARD GENERAL INSURANCE CO. OF CANADA*[1] , REVERSING TWO LOWER COURT JUDGMENTS OF BRITISH COLUMBIA WHICH HAD CONCLUDED THAT THE INSURER, LOMBARD, HAD NO DUTY TO DEFEND THE GENERAL CONTRACTOR PROGRESSIVE HOMES, AGAINST A CLAIM FOR DEFECTS AND DAMAGES CAUSED BY WATER INFILTRATION IN FOUR BUILDINGS BUILT BY IT.

The Supreme Court of Canada ruled:
(1) that the expression "property damage" includes all types of damages, including those caused to the work of the insured and not only those caused to the property of others; (2) that the notion of "accident" may include faulty workmanship insofar as the property damage was neither expected nor intended and, lastly, (3) that the insurer did not discharge its burden of proving that the "Work Performed" exclusion unambiguously applies as there is a possibility of coverage for damage caused to work completed by a subcontractor, as well as for damage resulting from the specific part of Progressive Homes Ltd's work that was allegedly defective. Therefore, the Court concluded that the insurer had a duty to defend.

The Court put an end to a jurisprudential controversy and adopted the position advanced by the Court of Appeal of Ontario in the *Bridgewood*[2] case and of the Court of Appeal of Saskatchewan in the *Westridge*[3] case.

1. THE FACTS

British Columbia Housing Management Commission ("BC Housing") hired Progressive Homes Ltd. ("Progressive") as a general contractor to build several housing complexes. After completion, BC Housing initiated four actions against Progressive alleging significant defects and damage caused by water infiltration in four buildings. BC Housing alleged breach of contract and negligence and that the water infiltration caused significant property damage such as rot, infestation and deterioration to the buildings to the point where they were unsafe and posed a serious health and safety risk to the occupants.

Over the years, Progressive had secured five successive policies with Lombard. These policies were in force from the time of construction until the time the actions were brought. The policies were "occurrence basis policies" and over the years, there had been three versions of the policy: the first version was used for the first policy; the second version for the second, third and fourth policies; and the third version for the fifth policy.

The pleadings also contained allegations of breach of contract, as well as negligence in the construction of the project as a whole. It further alleged that the structure of the roof, the drains and the ventilation were improperly or incompletely installed, that caulking was improperly used and that windows were poorly assembled and installed.

[1] 2010 CSC 33.

[2] 269 Sask. R.1.

[3] 211 O.A.C. 4.

Secondly, BC Housing alleged that it had suffered various damages, mainly the cost of remedial work, both permanent and temporary, the cost of relocation and alternate housing of tenants during the remedial work, reduction in the value of the project and, lastly, expenses and inconvenience.

For its part, Progressive maintained that the inadequate construction work had been completed by subcontractors who were identified in the pleadings.

2. THE INSURANCE POLICY

Under each policy, Lombard was required to defend Progressive in the context of any civil action instituted against its insured for "property damage": :

> "COVERAGE B – Property Damage Liability
>
> To pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay as damages because of property damage caused by accident."

The Court reviewed the definition of "property damage" and "accident" as used in the insurance policies:

"[10] "Property damage" is a defined term in the policies. The first policy defines "property damage" as:

> "Property damage" means (1) physical injury to or destruction of tangible property which occurs during the policy period, including the loss of use thereof at any time resulting therefrom, or (2) loss of use of tangible property which has not been physically injured or destroyed provided such loss of use is caused by an accident occurring during the policy period.

[11] "Accident" is a defined term in the first policy:

> "Accident" includes continuous or repeated exposure to conditions which result in property damage neither expected nor intended from the standpoint of the Insured.

In subsequent policies, the term "occurrence" is used. It is defined in the second and third versions of the policy as:

> "Occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

Even if property damage caused by an accident is proved, coverage may still be denied if the insurer shows that an exclusion clause is applicable. In this case, Lombard relied on the "Work Performed" exclusion.

3. THE JUDGMENT OF THE SUPREME COURT OF CANADA

THE DUTY TO DEFEND

The Court gave a brief overview of the principles applicable to the duty to defend without modifying them. What is material is the true nature or the substance of the claim.

GENERAL PRINCIPLES APPLICABLE TO THE INTERPRETATION OF INSURANCE POLICIES

Again, the Court briefly reviewed the relevant well-known principles of interpretation:

(1) when the text is unambiguous, the Court should give effect to clear language, reading it as a whole; (2) where the language of the insurance policy is ambiguous, the Court must give precedence to interpretations that are consistent with the reasonable expectations of the insured and avoid any interpretation that would give rise to unrealistic results or would not have been in the contemplation of the parties; (3) when these rules of construction fail to resolve the ambiguity, the Court will construe the policy against the insurer (contra proferentem).

ANALYSIS

Lombard's main argument was that "property damage" within the meaning of the policy does not include damage to one part of a building caused by another part of the same building; damage to other parts of the same building is considered pure economic loss. In short, "property damage" must be limited to third party property.

The Court noted that this argument arises from the distinction in tort between property damage and pure economic loss in common law and refused to apply such reasoning to the interpretation of an insurance policy:

> "[35] I cannot agree with Lombard's interpretation of "property damage". The focus of insurance policy interpretation should first and foremost be on the language of the policy at issue. General principles of tort law are no substitute for the language of the policy. I see no limitation to third party property in the definition of "property damage". Nor is the plain and ordinary meaning of the phrase "property damage" limited to damage to another person's property. Indeed, the Ontario and Saskatchewan Courts of Appeal reached the same conclusion with respect to similar definitions of "property damage" in CGL policies."

This interpretation dovetails with the ones adopted by the Court of Appeal of Ontario and the Court of Appeal of Saskatchewan in previous decisions[4].

[4] *Alie* c. *Bertrand & Frère Construction Co.* (2002), 222 D.L.R. (4th) 687 (C.A. Ont.) and *Bridgewood Building Corp. (Riverfield)* c. *Lombard General Insurance Co. of Canada* (2006), 266 D.L.R. (4th) 182 (C.A. Ont.), par. 6 and 7; *Westridge Construction Ltd.* c. *Zurich Insurance Co.*, 2005 SKCA 81, 269 Sask R.1, par. 38.

According to the Court, the plain meaning of "property damage" as used in the policy, contained no such restriction. Restricting the meaning of "property damage" to "third party property" would leave little or no work for the "Work Performed" exclusion.

To be indemnified under the policy, the insured Progressive was also required to show that the property damage described above was caused by an accident.

Progressive argued that "accident" includes the negligent act that caused damage that was neither expected nor intended by it.

On the basis of a rather significant case law trend[5], Lombard maintained that when a building is constructed in a defective manner, the end result is a defective building, not an "accident" and that, accordingly, faulty workmanship cannot be considered to be an accident.

Lombard also argued that interpreting "accident" to include faulty workmanship would convert CGL policies into performance bonds.

According to the Court, whether faulty workmanship is considered an accident is necessarily a case specific determination. It will depend both on the circumstances of the faulty workmanship alleged in the pleadings and the way in which "accident" is defined in the policy. Therefore, the Court refused to conclude that faulty workmanship is *never*[6] an accident.

Secondly, the Court analyzed the argument whereby faulty workmanship may not constitute a fortuitous contingent risk. Agreeing that fortuity is built into the definition of "accident", the Court defined accident as follows:

> "an unlooked-for mishap or an untoward event which is not expected or designed."

Lastly, the argument that coverage for faulty workmanship as an accident will convert CGL policies into performance bonds failed to convince the Court. According to the Court a performance bond ensures that work is brought to completion whereas a CGL policy only covers damage to the insured's own work once completed. The Court added: *"In other words, the CGL policy picks up where the performance bond leaves off and provides coverage once the work is completed*[7]."

The Court concludes that the pleadings contained sufficient allegations an "accident" occurred since there was no reference to any intentional conduct by Progressive which would suggest that the property damage was neither expected nor intended. The pleadings also alleged negligence, which also suggests that the damage was fortuitous.

THE APPLICATION OF THE "WORK PERFORMED" EXCLUSION

The insured having discharged its burden of having to prove that the allegations in the pleadings concerned property damage covered under the policy and that such damage could have been caused by an accident within the meaning of the policy, the insurer then had the burden to prove that an exclusion clearly and unequivocally applied to all of the claims made against Progressive and relieved it of its duty to defend.

According to the Court, the first version of the exclusion clause is limited to work performed by the insured. However, Progressive did not perform the work by itself and the clause was therefore inapplicable.

Based on the fact that Progressive had purchased a Commercial General Liability Broad Form Extension Endorsement, the Court held that in conformity with the contra proferentem rule, this exclusion should be interpreted restrictively and limited the exclusion only to damage caused by Progressive to its own work.

The second version of the "Work Performed" exclusion read as follows:

> "'Property damage' to 'that particular part of your work' arising out of it or any part of it and included in the 'products - completed operations hazard.'"

The Court acknowledged that Lombard was correct in alleging that there was no exception for subcontractors in this version, but added that this did not resolve the issue since this version expressly contemplated the division of the insured's work into its component parts by the use of the expression "that particular part of your work". According to the Court, the exclusion could have read:

> "'Property damage' to 'the window' arising out of 'the window' or any part of 'the window' and included in the 'products completed operations hazard'."

The Court concluded that only coverage for repairing the defective component was excluded while coverage for all other resulting damage was not.

[5] *Celestica Inc.* c. *ACE INA Insurance* (2003), 229 D.L.R. (4th) 392 (C.A. Ont.); *Erie Concrete Products Ltd.* c. *Canadian General Insurance Co.*, [1969] 2 O.R. 372 (H.C.J.); *Harbour Machine Ltd.* c. *Guardian Insurance Co. of Canada* (1985), 60 B.C.L.R. 360 (C.A.); *Supercrete Precast Ltd.* c. *Kansa General Insurance Co.* (1990), 45 C.C.L.I. 248 (C.S. C.-B.)).

[6] Italics are the Court's.

[7] Par. [48].

Finding that there was a possibility of coverage under the second version of the policy, the Court stated it will have to be determined at trial which "particular parts" of the work caused the damage. Repairs to those defective parts will be excluded from coverage under this version, regardless of whether they were the result of Progressive's own work or of the work of subcontractors. If, as Lombard argued, the buildings are wholly defective, then the exclusion may apply and Lombard may not have to indemnify Progressive.

Lastly, the Court reviewed the third and final version of the "Work Performed" exclusion and concluded that it was a mere combination of the first and second versions. The "exclusion" part of this clause was identical to the second version, thus it only excluded coverage for defective property, and therefore coverage remained for resulting damage. In addition, this version also expressly incorporated the "subcontractor exception", which was previously implicit in the broad form extension endorsement. This exception extended coverage to the general contractor and the faulty workmanship was covered when work was performed by a subcontractor.

OTHER EXCLUSIONS

Lombard had initially relied upon the exclusion clauses respecting liability assumed under a contract and the insured's product exclusion clause but apparently did not offer arguments on these points before the Court, which did not rule on them.

CONCLUSION

This decision of the Supreme Court of Canada constitutes a significant change in the interpretation of CGL policies covering the "products completed operations hazard" exclusion. It did away with an important case law trend which required that property damage be caused to a third party and not to the insured's own work. It further set aside any reference to the notion of pure economic loss in the interpretation of insurance contract when physical property damage affects the insured's work.

The Court has chosen to distinguish the interpretation of commercial general liability insurance policies from concepts of tort liability law.

Lastly, the notion of "accident" may include a construction defect or faulty workmanship if, according to the wording used in the pleadings, they appear to result from the negligence of the insured rather than an intentional act. Faulty workmanship may, according to the Court, be a fortuitous event. Finally, this decision sheds more light on the concept of divisibility of the insured's work by giving meaning to the expression "particular part of your work"; the exclusion would only apply to the defective part and not to damages which that defective part may have caused to the entire work of the insured.

Insurers may wish to review the wording of their contracts in the wake of this decision.

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