Duty to Defend in Construction Damages Claims.

When does an insurer have a duty to defend or indemnify and insured construction company? That question has been the source of much debate in the insurance field as well as litigation before the courts.

There are myriad scenarios in which the duty to defend/indemnify have arisen in the courts. These include:

- Faulty concrete is supplied to a construction project by a third party supplier. The faulty concrete causes severe damage to the affected homes. The construction company had a comprehensive general liability (CGL) policy that excluded coverage for property damage that was the result of the insured's own work. However there was an exception to this exclusion related to damage resulting from the work performed by a subcontractor. The question is whether the cost of repairing the homes, by the construction company, is recoverable under the CGL policy of the construction company? The Ontario Court of Appeal thought that the cost for the damage was recoverable from the insurer, since the exception to the exclusion reinstated coverage for the faulty work of a subcontractor.[1]

- A company, which represented itself as having expertise in building barns, builds a barn, the roof of which later collapses because of the use of inappropriate material. The CGL policies excluded coverage for faulty workmanship but not damage caused by the work of a subcontractor. Do the insurers have a duty to defend the insured? The Saskatchewan Court of Appeal found that they did. Among the reasons, the court noted that though there was faulty workmanship, the exclusion was limited to the work done under contract. They agreed that there was a separate claim for negligent misrepresentation that was not excluded by the clause. Further the material for the roof was supplied by a subcontractor, and this was protected by the sub-contractor exception in one of the policies.[2]

- A construction company builds a building for a university. In a counterclaim after the university alleges that the company used defective material in the construction, had a faulty design and poor workmanship. The CGL insurer refuses the company's request that it defend the action. In this case did the insurer have a duty to defend and indemnify the insured? The court concluded that they did not. The court found that the damages suffered by the university related to deficiency in the work of the insured contractor, a scenario that was specifically excluded from the policy coverage.[3]

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[1] *Bridgewood Building Corp. (Riverfield) v. Lombard General Insurance Co. of Canada*, [2006] 79 OR (3d) 494; See also *AXA Insurance (Canada) v. Ani-Wall Concrete Forming Inc.*, 2008 ONCA 563[hereafter *Ani-wall*], another case a faulty concrete where the court also found that the subcontractor exception to the exclusion for "Your work" operated to reinstate coverage for the property damage suffered.

[2] *Westridge Construction Ltd. v. Zurich Insurance Co.* 2005 SKCA 81 [hereafter *Westridge*].

[3] *Swagger Construction Ltd v ING Insurance Co of Canada*, 2005 BCSC 1269 [hereafter *Swagger*]; See also *ARG Construction Corp. v. Allstate Insurance Co of Canada*, [2004] 73 OR (3d) 211 [hereafter *ARG*], where the

- A transformer manufactured by a subcontractor and incorporated into a module for a photocopier was defective. This created the risk of an electrical shock, which was remedied by replacing the power cord for the photocopiers in some cases and replacing the module containing the faulty transformer with another module with a different transformer. The company then tried to recover the cost of its remedial action from its insurer. Was the insurer required to provide coverage? The Ontario Court of Appeal found that there was no coverage for the remedial work. They suggested that coverage would only be available for damage suffered by a third party and such damage must be caused by an accident. They reasoned further that the company manufactured a product that with a part that did not meet the functional requirements that were intended and was therefore excluded from coverage from the "own work" exclusion.[4]

These are just a few illustrative examples of how courts have evaluated the duty to defend in construction and manufacturing defect cases. These results indicate that there appears to be some ambiguity surrounding the situations where the duty to defend will be upheld versus where the courts will find that there is no coverage. The following discussion will attempt to clarify some of this ambiguity by looking at some of the general principles underlying the duty to defend, as well as looking at two recent judicial decisions (one from the Texas Supreme Court[5] and the other from the Supreme Court of Canada[6]) and how the issue was handled in both decisions.

The law as it relate to duty to defend

For the purposes of this discussion when we refer to the duty to defend we will include in that concept the duty to indemnify.[7] Whether or not there is a duty to defend and/or indemnify is driven by what is contained in the policy and what is stated in the pleadings of the injured party. Courts in Texas have referred to this as the "eight corners rule", i.e. the four corners of the pleadings and the four corners of the policy.[8] Canadian courts have taken a similar approach though the reference to "eight corners" has not been used.[9]

There is a basic four step process to determining whether there is a duty to defend. First is there coverage based on an "eight corners" approach. Secondly is there an exclusion clause in the policy that would remove coverage. Third, is there and exception to the exclusion that would have the effect of reinstating coverage. Finally, what role if any does public policy play in the determination of the duty to defend.

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contractor was sued for defects in the design and construction of a commercial and retail building. The court found that ARG, the contractor, was only covered for loss or damage resulting from accidents, not for the costs of repairing defective work, which this claim was.

[4] *Celestica Inc v ACE INA Insurance*, [2003] OJ No 2820 (ONCA) [hereafter *Celestica*].

[5] *Lamar Homes Inc v Mid-Continental Casualty Company*, 2007 [hereafter *Lamar*]

[6] *Progressive Homes Ltd v Lombard General Insurance Co of Canada*, 2010 SCC 33 [hereafter *Progressive Homes*].

[7] See *Non-Marine Underwriters, Llody's of London v Scalera*, [2000] 1 SCR 551 at paras 73 – 76 [hereafter *Scalera*], where the Court noted that the duty to defend is not independent of the duty to indemnify. The duty to indemnify will trigger the duty to defend.

[8] See *Argonaut Sw Ins Co v Maupin*, 500 SW 2d 633 at 635 (Tex 1973).

[9] See Scalera *supra*.

Is there Coverage

As noted previously, the availability of coverage is governed by both the policy and the pleadings. From the perspective of the policy, liability insurance is intended to cover accidents. Often the decisions of the courts turn on whether or not a particular occurrence was in fact an accident. In *Canadian Indemnity Co. v Walkem Machinery & Equipment Ltd*,[10] the Supreme Court of Canada defined an accident as an "unlooked for mishap or occurrence",[11] noting that the very idea behind insurance is to protect against mishaps dangers and risks. The coverage clauses in *Celestica*, *Westridge*, *ARG*, *Swagger* (mentioned in the opening examples) all required that the damage sustained be caused by an accident. Further the court also noted that "a policy which would not cover liability due to negligence could not properly be called 'comprehensive'",[12] leading to the suggestion that even negligently caused accidents should be covered. This fits comfortably with the general principle that coverage clauses in insurance policies should be construed broadly.[13]

The second element in the determination of coverage is the pleadings itself. The Supreme Court of Canada in *Monenco Ltd v Commonwealth Insurance*,[14] voiced its approval of the "pleadings rule. As stated in *Monenco*, "if the pleadings allege facts which if true would require the insurer to indemnify the insured for the claim then the insurer is obliged to provide a defence."[15] Where the pleadings are not framed with sufficient precision to determine if there is coverage under the policy, the duty to defend is still triggered if on a reasonable reading of the pleading a claim falling within the coverage can be inferred.[16] Court may even resort to extrinsic evidence to determine if there is coverage providing this evidence is explicitly mentioned in the pleadings.[17]

Therefore in CGL policies the pleadings must allege a set of facts that identify an accident or occurrence sufficient to trigger coverage. The burden of establishing that the allegations meet this threshold rests with the insured.[18]

Is there an exclusion

Whereas the breadth of coverage clauses and the methods of interpretation adopted by the Courts usually mean that most things will fall within coverage, exclusion clauses are quite the opposite. The general rule is that exclusions clauses are construed narrowly.[19] Further, as noted in *ARG*,

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[10] [1976] 1 SCR 309.
[11] Ibid at para 12.
[12] Ibid at para 13.
[13] See Scalera *supra* at para 70.
[14] [2001] 2 SCR 699. [hereafter *Monenco*]
[15] Ibid at para 28.
[16] Ibid at para 31.
[17] Ibid at para 36.
[18] ARG *supra* at para 9.
[19] See Scalera *supra* at para 70.

once the insured can establish that there is coverage, the burden of proof shifts to the insurer to show that the claim falls outside the policy coverage because of an applicable exclusion clause.[20]

Is there an exception to the exclusion

Matters may even be further complicated where there is an exception to an exclusion. The result of that would be a reinstatement of the coverage for certain limited that may have been blocked by an exclusion clause that was too broad. The most common such exception to an exclusion in the context of construction defects is the 'subcontractor exception'.

Court decisions such as that in *ARG* supra, suggest that where there is an exception to and exclusion clause, the burden is on the insured to prove that the exception applies.[21] However, in one decision of the Ontario Court of Appeal, it appears that exception to exclusion clauses are regarded in the same light as coverage clauses, and therefore are construed broadly and in favour of the insured, in line with the principle of insurance contract interpretation.[22]

What role for public policy concerns

In cases of construction defects, the primary concern, usual raised by insurers, is that CGL policies should not be converted into performance bonds. It is a notion that was raised in *Bridgewood*, *ARG*,*Celestica*, *Swagger* and *Westridge*.[23] Public policy considerations while not a stand-alone consideration appear to hover over the coverage clauses providing a limit on the breadth of the interpretation of these clauses, but only where there is an ambiguity in the language. They are intended to be a last resort where the standard process of insurance contract interpretation may produce a result that may not have been in the contemplation of the parties.[24]

Two recent Cases on the issue

The two cases that will be discussed (one from the Supreme Court of Texas and the other from the Supreme Court of Canada) offer a very clear insight into the judicial reasoning that goes into deciding if a duty to defend does exist.

Lamar Homes Inc v Mid- Continental Casaulty Company

This case was a 2006 decision from the Supreme Court of Texas. The case was referred to the Supreme Court by the United States Court of Appeals for Fifth Circuit to determine whether an insurer under a CGL policy has a duty to defend its insured, a homebuilder, against a

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[20] ARG *supra* at para 9.
[21] Ibid.
[22] See Ani-wall *supra* at para 20 where the court noted that in the exception to the exclusion clause, "the word "subcontractor" should be construed broadly and…any ambiguity in its meaning must…be resolved in favour of Ani-wall…AXA has not met its burden of proving otherwise" [emphasis added].
[23] Bridgewood *supra* at paras 17-22; ARG *supra* at paras 45-54; Celestica *supra* at paras 30-31; Swagger *supra* at paras 4-5; Westridge *supra* at paras 33-34.
[24] See Westridge supra at paras 33-34.

homebuyer's claims of defective construction. Three certified questions were placed before the court for consideration:

1. When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege an "accident" or "occurrence" sufficient to trigger the duty to defend or indemnify under a CGL policy?

2. When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege "property damage" sufficient to trigger the duty to defend or indemnify under a CGL policy?

3. If the answers to certified questions 1 and 2 are answered in the affirmative, does Article 21.55 of the Texas Insurance Code apply to a CGL insurer's breach of the duty to defend?[25]

The facts are fairly unremarkable. A couple buys a new home from the appellant and several years later they discovered problems which they attributed to defects in the building's foundation. The couple sued the builder, Lamar and its subcontractor complaining of the defects. Lamar forwarded the claim to its CGL insurer seeking defence and indemnity, which the insurer denied. It is the result of the denial that Lamar seeks to get a declaration of its rights under the policy. The district court found in favour of the insurer and Lamar appeal, prompting the Circuit Court to ask the Texas Supreme court to resolve certain conflicts in the lower courts decisions in the state.

The language at issue in the case calls for the insurer to defend and indemnify if there is a claim for "property damage" or "bodily injury", caused by an "occurrence". "Property damage" was defined as physical injury to tangible property including all resulting loss of use of that property. "Occurrence" was defined as an accident including continuous or repeated exposure to substantially the same general harmful conditions.

Progressive Homes Ltd v Lombard General Insurance Co of Canada

The decision in this case revealed a very systematic approach to the interpretation of an insurance contract, one which could be easily applied to other fact scenarios. Again the facts are rather unremarkable. The British Columbia Housing Management Commission (BCHMC) hired the appellant, Progressive Homes, as a general contractor to build several housing complex. After the completion of the contract BCHMC initiated four actions against Progressive alleging significant damage caused by water leaking into the four buildings. The claims alleged both breach of contract and negligence. There were 3 versions of five policies involved. The first policy defined property damage as "physical injury to or destruction of tangible property...or loss of use of tangible property...caused by an accident". The subsequent policies used the word "occurrence" defined as an accident including continuous or repeated exposure to substantially

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the same general harmful conditions. The insurer won in both the British Columbia Supreme Court and the Court of Appeal, prompting the insured to take it to the Supreme Court of Canada (SCC).

The policies were typical CGL policies: they set out coverage, followed by specific exclusions to coverage and exceptions to the exclusion clauses. In relation to the first policy the insurer, Lombard, contended that the damage cause to one part of the building, by another part of the same building, was not property damage within the meaning of the policy and that property damage is limited to third party property. Further they argued that a building constructed in a defective manner is a defective building and not an accident.

The court did not agree with this position. In their view, following first principles (where there is no ambiguity the court should give effect to the plain meaning of the words, reading the policy as a whole), the language of the policy defined property damage as simply injury to, destruction of or loss of use of tangible property. It made no attempt to limit it to third party property. Further if it were limited to only third party property, then the 'own work' exclusion would have been redundant. In addition, the court noted that whether faulty workmanship can be an accident is driven by the fact of the case. To this end the court stated that when an event is unlooked for, unexpected or not intended by the insured it is fortuitous and therefore an accident. Quite what the circumstances would be that would lead to a decision that defective workmanship is an accident was not discussed by the court.

Some Recurrent Issues

Public Policy

As mentioned above, it appears that public policy considerations are generally raised as a last resort. The courts have accepted the premise that an insured should not be able to insure against it own defective work. However, how this principle is applied varies.

In *Celestica* for instance the Court of Appeal concluded that the motion judge had erred in by "extending the meaning of accident beyond its reasonable limits" thereby transforming the policy into something akin to a performance bond.[26] This provided a basis for the denial of the claim by the insured to be indemnified, though it was acknowledged that the defective transformer was made by a sub-contractor. However in *Bridgewood*, when a similar argument was raised by the insurer, the court upheld coverage for three reasons. First the court noted that where the defective work is performed on behalf of the general contractor by a subcontractor, then the performance bond argument is less persuasive as the insurer can pay and then claim against the

[26] Celestica *supra* at paras 30-31.

subcontractor.[27] Second, they suggested that market forces may be sufficient to "weed out" contractors who insist on using incompetent sub-contractors under the guise that their insurer will cover them.[28] The final rationale was that as authors of the contract if insurers would like to limit their exposure to sub-contractor defective work, they can do that in the contracts.[29]

Claims in Tort vs Claims in Contract

The cases discussed also reflect the attempt by insurers to avoid the duty to defend by claiming that the damages suffered are contractual. The upshot is that the injured party would seek recovery under contract, which the policy would not cover, instead of tort law, which is where CGL coverage is triggered. This has led to even sharper focus being placed on the pleadings to determine if the claims allegations are contractual or tortuous.

Whether or not a claim is a claim in tort or contract is not wholly dependent on the terminology used in the pleadings. As the court in *Swagger* noted, the court must look beyond the labels used in the pleadings to determine the true nature of the claim and whether it can be supported by the factual allegations.[30] In the case of *Swagger* the court found that even allowing for the broadest interpretation of the facts pleaded the claims arose only out of contract and were therefore not covered by the CGL policy. There are situations however where the same set of facts may give rise to a claim in both tort and contract. Citing the Supreme Court of Canada in Scalera supra, the Saskatchewan Court of Appeal, in *Westridge*, reiterated the three step process for determining if a claim is covered: 1) determine which of the plaintiff's allegations are properly pleaded; 2) determine if any of the claims are entirely derivative; and 3) determine if any of the properly pleaded non-derivative claims will trigger coverage. The pivotal point in this analysis is the determination if the claims are derivative in nature. The court noted that even where claims in both contract and tort arise from the same harm, the tort claim will not be determined as a derivative claim if on examination it clear that it is a stand-alone action and not simply the plaintiff trying to convert the contractual claim into a tort to involve the insurer. Though this issue was dealt with in *Westridge*, the court was clear that both actions (in contract and in tort) were independent. Several of the facts pleaded could only support the claim of negligent representation and had no bearing on the breach of contract claim. To the extent that the facts supported distinct claims, the court found that the tort claim was not derivative of the breach of contract claim.

Defective Workmanship vs Occurrence/accident

[27] Bridgewood supra at para 19.
[28] Ibid at para 20.
[29] Ibid at para 21
[30] Swagger *supra* at para 10.

CGL policies will generally exclude coverage for defective work performed by an insured. As note in *Alie v Bertrand & Frère Construction Co*.,[31] these policies are "generally intended to cover the insured's tortious liability to third parties, but not including the cost of replacing or repairing the insured's own defective work or product"[32]. While the CGL policies do not generally offer coverage for the defective work of the insured, there may be circumstances where the defective work will trigger coverage. In such situations, the defective work would have to come within the meaning of an accident or occurrence. The Supreme Court of Canada, in *Progressive Homes*, explained that this is a case specific determination, which hinges on the facts alleged in the pleadings and the definition of accident in the policy.[33] This was the approach that the Ontario Court of Appeal took in *Celestica*. The policy in that case defined an occurrence as an accident. The court then turned to the agreed statement of facts observing that the parties agreed that both the transformer/module that was defective was required to operate on global supply voltage and be double insulated; the transformers that were incorporated into the module were not double insulated. On that basis they concluded that the resulting failure could not be an unlooked for mishap. A similar analysis and result was reached by the court in *Swagger* supra. Likewise in *ARG* the court concluded on the basis of the claims for coverage and the wording of the policy that what the insured was asking to have covered was really redial work for its own faulty workmanship and that of its subcontractors. Where faulty workmanship may in fact give rise to coverage was however discussed briefly in this case. The court noted that alleged claims that the deterioration of the parking garage caused damage to the vehicles of occupant, if proved would have been covered, notwithstanding that the building was poorly constructed. In *Alie – ONCA*, the court also sided with the view that where there is damage to the property of a third party, coverage will arise. In that case the faulty concrete used in the foundations, led to major structural defects in the building, which would have led to their eventual collapse. Though the defective product, the concrete in the foundation, was not covered, the loss of the use of the homes by the occupants provided the basis for supporting coverage.

Who is a Sub-contractor?

In the absence of a definition in the policy of who is a sub-contractor, it is left to the courts to decide whether or not the defective work can be classified as the work of a sub-contractor and ultimately determine whether or not the sub-contractor exception to the "own work" exclusion clause, a staple in many CGL policies, applies.

The Ontario Court of Appeal seems reluctant to embrace any rigid formula for determining who is a subcontractor. In *Ani-wall*, the insurer suggested that the court accept a 3 criteria test from the United States. These criteria required that:

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[31] (2002) 62 OR (3d) 345 [hereafter *Alie - ONCA*]
[32] Ibid at para 27.
[33] Progressive Homes *supra* at para 46.

1. The product supplied should be custom made according to specifications identified in the prime contract;

2. The supplier should provide on-site installation of supervision services; and

3. The product supplied should form an integral or substantial part of the prime contract.[34]

The court rejected this formulaic approach, noting that it preferred to "retain some flexibility in the realm of insurance coverage",[35] especially where the insurer is relying on an exclusion clause. The court was particularly critical of the fact that the insurer did not attempt to define the term "sub-contractor" in the policy, and in such cases the term should be given its ordinary meaning with ambiguities resolved in favour of the insured.

[34] Ani-wall supra at para 13.
[35] Ibid at para 17