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Noteworthy

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Dirty Windows Help to Clarify Appellate Review of Standard Form Contracts

Overview

Just when you thought the judicial approach to the appellate standard of review for Canadian contract interpretation had been addressed, the Supreme Court of Canada ("SCC") rendered its decision in Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co., 2016 SCC 37 ("Ledcor") on September 15, 2016. Ledcor has created an exception to the Court's significant decision in Sattva Capital Corp. v. Creston Moly Corp., 2014 SCC 53 ("Sattva"), which had held that the appropriate appellate standard of review for contract interpretation was the deferential one of palpable and overriding error.

The Court's 2014 decision in Sattva had changed the longstanding law that "correctness" was the applicable standard of review on appeal regarding the interpretation of contracts. Ledcor has now recognized an exception to the Sattva decision with respect to standard form contracts. Writing for the majority, Wagner J. stated that because a decision on the meaning of a standard form contract held significant precedential value, as it was likely to affect a wide range of individuals in the future and not just the contracting parties, and did not involve a meaningful factual matrix, correctness was the more appropriate appellate review standard. The case involved the interpretation of a faulty workmanship exclusion in a Builder's Risk policy which was important to the insurance and construction industries. In the result, the SCC held as follows:

Typically, the standard of appellate review for trial decisions involving standard form insurance contracts will be correctness; and

Faulty workmanship exclusion clauses in Builder's Risk policies should be narrowly construed to exclude only the cost of re-doing the faulty work itself and not the cost of remedying the property damage caused by the faulty work.

Of note, in his concurring reasons, Cromwell J dissented on the standard of review issue, holding it should still be palpable and overriding error, per Sattva, because factual issues still remain.

Background

Station Lands Ltd. retained Ledcor Construction Ltd. as the general contractor for the construction of an office building in Edmonton. Ledcor properly installed the windows of the office building. Over the course of construction, the exterior of these windows became dirty from concrete spatter and other debris. As a result, Station Lands and Ledcor ("the In-

(Continued on page 2)

IN THIS ISSUE

Dirty Windows Help to Clarify Appellate Review of Standard Form Contracts

Michael S. Teitelbaum

Tara Chown

Firm News

(Continued from page 1)

sureds") hired Bristol to clean the windows prior to completion of construction of the office building. In carrying out its cleaning, Bristol Cleaning used improper tools and cleaning methods, scratching the windows of the office building, which ultimately had to be replaced at a cost of approximately $2.5 million. The Insureds sought the cost of replacing the windows under the construction project's Builder's Risk insurance policy. The Insurers denied the claim on the basis of the "cost of making good faulty workmanship" exclusion clause ("the Exclusion Clause") contained within the policy.

The Exclusion Clause contained an exception for "resulting damage" so that it excluded coverage for the "cost of making good faulty workmanship unless physical damage not otherwise excluded by this policy results, in which event this policy shall insure such resulting damage"

The issue at trial and on appeal was whether the Builder's Risk insurance policy excluded the cost of the replacement of the windows due to the damage caused by Bristol or if the cost of the window replacement fell within the exception to the exclusion. The trial judge found Bristol's cleaning work constituted faulty workmanship and the Exclusion Clause was, therefore, applicable. However, the trial judge held that the Exclusion Clause was ambiguous and applied the rule of contra proferentem as against the Insurers, finding coverage for the Insureds.

On appeal, this decision was reversed and the Court of Appeal held that the damage to the windows was excluded from coverage. In its interpretation of the Builder's Risk insurance policy and Exclusion Clause, the Court of Appeal applied the correctness standard of review. The Court of Appeal held that the trial judge had improperly applied the rule of contra proferentem because the Exclusion Clause was not ambiguous. In order to determine whether physical damage was excluded as the "cost of making good faulty workmanship" or covered as "resulting damage", the Court of Appeal created the "physical or systemic connectedness" test. By applying this new test, the Court of Appeal concluded that the damage to the windows was excluded from coverage because the damage was not accidental or fortuitous, but was directly caused by the intentional scraping and wiping motions involved in the cleaners' work.

The Supreme Court of Canada Decision

The Appropriate Standard of Review: Mixed Question of Law and Fact vs. Question of Law

In interpreting the Exclusion Clause as excluding coverage of the cost of re-cleaning the windows, but covering the cost of replacing the windows, the SCC was given the opportunity to modify its decision in Sattva. The SCC rejected the Court of Appeal's "physical or systemic connectedness" test as unnecessary and concluded that the appropriate standard of review on appeal is correctness, where the appeal involves the interpretation of a standard form contract, the interpretation at issue is of precedential value, and there is no meaningful factual matrix that is specific to the particular parties to assist the interpretation process.

In Sattva, the SCC had held that contractual interpretation is a question of mixed fact and law subject to deferential review on appeal for the following two reasons: the importance of the factual matrix and that contractual interpretation does not fit within the definition of a pure question of law. The SCC has now held that these reasons were not applicable to standard form contracts.

In Sattva, Rothstein J. held that "[c]ontractual interpretation involves issues of mixed fact and law as it is an exercise in which the principles of contractual interpretation are applied to the words of the written contract, considered in light of the factual matrix". Therefore, the standard of review of palpable and overriding error applies to a trial court's interpretation of a contract. However, Wagner J distinguished the factual matrix in Sattva from the situation in Ledcor, as Sattva did not involve a standard form contract, but was instead a complex commercial agreement between two sophisticated parties. Wagner J. held that the importance of the factual matrix carries less weight in cases involving standard form contracts because there is typically no meaningful negotiation of terms between the contracting parties entering into Builder's Risk insurance policies, as the contract is typically presented to the potential Insured on a "take it or leave it" basis.

Wagner J. was of the view that the interpretation of a standard form contract has precedential value and, as a result, can fit under the definition of a pure question of law. In support of this proposition, Wagner J. referred to Rothstein J's acknowledgment in Sattva that correctness is the applicable standard of review

(Continued on page 3)

(Continued from page 2)

for the "'rare' extricable questions of law that arise in the interpretation process, such as 'the application of an incorrect principle, the failure to consider a required element of a legal test, or the failure to consider a relevant factor'"

Policy Interpretation: Broad Coverage

In its analysis, the SCC found that the Exclusion Clause was ambiguous and saw no reason to depart from the governing principles of general contract interpretation as summarized in the Court's decision in Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada, [2010] 2 SCR 245 ("Progressive Homes").

In applying the Progressive Homes principles, the SCC confirmed that the Insured has the onus of first establishing that there is coverage, at which point the onus shifts to the Insurer to establish that an exclusion applies, and finally, if necessary, the onus shifts back to the Insured to prove an applicable exception to the exclusion. In his interpretation, Wagner J. relied heavily on commentary with respect to the purpose of Builder's Risk insurance policies and the reasonable expectations of contracting parties in the construction industry that coverage under these types of policies will be broad in nature. In support of this proposition, Wagner J. stated that the overall purpose of Builder's Risk insurance policies was established by the Court in Commonwealth Construction Co. v. Imperial Oil Ltd., [1978] 1 S.C.R. 317 ("Commonwealth"); namely, to "provide certainty and stability by granting coverage that reduces the need for private law litigation… [and] also recognize[s] the complexity of industrial life and large-scale construction projects that involve many different individual contractors". The SCC concluded that interpreting the Exclusion Clause to only exclude from coverage the cost of redoing any faulty work, did not transform the Builder's Risk insurance policy into a construction warranty, and also aligned with the commercial reality of the construction industry and commercially sensible results, as well as the parties' reasonable expectations.

Of note, the SCC majority rejected the Insurer's argument that endorsing an interpretation which held that the exception to the Exclusion Clause applied would promote commercially unreasonable behaviour because it had the potential to influence how future work on construction sites is divided among various contractors and sub-contractors in an effort to maximize coverage. In rejecting this proposition, the SCC held that it would be unreasonable to expect an owner or general contractor to consider this a relevant factor in deciding how to allocate work tasks.

Having established that the Exclusion Clause served to exclude from coverage only the cost of redoing the faulty work; namely, the cost of re-cleaning, the windows, by applying the general principles of contractual interpretation, the SCC held that it was not necessary to turn to the contra proferentem rule.

Conclusion and Future Implications

The Ledcor decision creates an exception to Sattva for standard form contracts with respect to the appropriate appellate standard of review. Ledcor holds that when interpreting standard form contracts on appeal, correctness applies. Ledcor also settled in the affirmative the issue of whether or not the exception to the exclusion of faulty workmanship covering resultant damage can include damage to the part of the construction project that the Insured is working on.

The application of the standard of review of correctness when interpreting standard form contracts is also consistent with the mandate of appellate courts, namely to ensure consistency in the law. By confirming the precedential effect of the interpretation of a standard form contract, the SCC clearly had the intention of reducing the need for litigation. However, it remains to be seen whether Ledcor may have the opposite effect. First, the result of applying this interpretation in future cases remains uncertain as it will depend on the particular facts of those cases. Second, and somewhat ironically, the Ledcor decision may increase litigation for a number of reasons. For example, subject to revisions being made to the policy wordings, the seemingly potential increase in liability for Insurers under a Builder's Risk insurance policy this decision creates may increase litigation as the facts of each case are assessed. Further, the lack of deference to trial decisions by applying the correctness standard also lends itself to an increased frequency of appeals as well. Finally, in the weeks following the Ledcor decision, the SCC remanded two insurance-related cases, Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Co. and Deslaurier Custom Cabinets Inc. v. 1728106 Ontario

(Continued on page 4)

(Continued from page 3)

Inc. to Courts of Appeal for disposition in accordance with its Ledcor decision, i.e., to address what the appellate standard should have been and in Acciona, to also address the interpretation of the faulty workmanship exclusion in that policy. We understand that there is no standard form for Builder's Risk, or indeed Commercial General Liability policies, with the wording varying between insurers, unlike for example, a government-mandated automobile policy. Therefore, what is "standard" is not necessarily common across the board. This also raises the interesting question whether one can have a standard clause within a manuscript policy which should also be decided using the "correctness" test. Overall, Ledcor will likely reduce inconsistent holdings with respect to interpretations of the same or similar wording within standard form contracts, even if the frequency of appeals may not diminish.

Finally, the Court in Ledcor recognized that there may be circumstances where a standard form contract may still continue to attract the Sattva deferential standard of review. Arguably, a deferential standard may apply where parties to a standard form contract conduct some degree of negotiation and, as a result, change specific terms, or make amendments or additions to the standard form contract. Going forward, when considering an appeal on a question of contractual interpretation, it appears the main question will be: are the contractual provisions at issue "standard form"? When in doubt as to the answer, one should ask if one of the parties was offered the contract on a "take it or leave it" basis, as this is likely to indicate it is a standard form contract and, therefore, should be reviewed on the basis of correctness.

Firm News

Hughes Amys is pleased to announce that LexisNexis Butterworths has just released Ontario Insurance Law & Commentary 2017. This guide to insurance law in Ontario is now in its thirteenth year. Our Michael Teitelbaum is the Consulting Editor and co-author of the commentary which provides an overview of the principles and key issues in liability, property and life insurance, including an annotated review of key provisions of the Insurance Act, and a review of important recent insurance case law in both Ontario and Canada. Congratulations to Michael, and to Yulia Pesin, who assisted Michael with the preparation of this year's edition!

HA is pleased to welcome two new associates to the firm. Alex Reyes and Benjamin Tinholt were called to the bar in 2011 and 2013 respectively. Both have experience in handling a wide variety of insurance matters; they will both be practising in our Toronto Office.

HUGHES AMYS LLP
BARRISTERS & SOLICITORS

TORONTO
48 YONGE STREET
SUITE 200
TORONTO, ONTARIO
M5E 1G6
TELEPHONE (416) 367-1608
TOLL-FREE (800) 565-1713
FACSIMILE (416) 367-8821

HAMILTON
25 MAIN STREET WEST
SUITE 2100
HAMILTON, ONTARIO
L8P 1H1
TELEPHONE (905) 577-4050
TOLL-FREE (877) 858-8234
FACSIMILE (905) 577-6301

www.hughesamys.com