PART 1

INTRODUCTION

On September 15, 2016 the Supreme Court of Canada issued its decision in Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co. [Ledcor].

The decision deals with two issues: (a) the standard of review applicable to policy interpretation; and (b) the scope of the faulty workmanship exclusion on “cost of making good” wording.

On the first issue, the Court clarified the scope of its 2014 decision in Sattva Capital Corp. v. Creston Moly Corp. [Sattva]. In Sattva, the SCC held that contractual interpretation is generally a question of mixed fact and law, reviewable only on a palpable and overriding error standard, subject to narrow exceptions. In Ledcor the Court held that interpretation of standard form policy language is an exception to Sattva and should generally be treated as a question of law, reviewable on a standard of correctness. In the period between Sattva and Ledcor this was a controversial issue and gave rise to conflicting appellate decisions. Ledcor puts the standard of review issue to rest, and is of general interest for that reason.

On the second issue, the Court held that the faulty design and workmanship exclusion, on “cost of making good” wording, is generally restricted cost of repair of physical damage to that part of the project which is within the contractual scope of the party who caused the damage, described by the Court as the “cost of redoing the work”. One result
of this approach is that the faulty workmanship aspect of the exclusion will not apply where the contractor whose fault caused the damage had a scope restricted to post-installation work. While the decision on this issue is restricted to construction insurance, and largely to the “cost of making good” wording, the decision is significant in defining the scope of one of the most commonly considered policy exclusions. The Court also reiterated the general principles of interpretation and underlying commercial considerations applicable to course of construction policies.

FACTS AND POLICY WORDING

Ledcor arose out of construction of the Epcor Tower, an office tower in Edmonton. Station Lands Ltd. (“Station Lands”) was the project owner, and Ledcor Construction Limited (“Ledcor Construction”) was the construction manager. One of the last steps in the construction process was a “construction clean” of the exterior glass. The construction clean would remove dirt and debris that had accumulated during the construction process and was required as a condition of substantial completion. A firm by the name of Bristol Cleaning (“Bristol”) was retained to carry out the construction clean. Significantly, as it turned out, Bristol had not been involved in installation of the glass, or any other pre-cleaning work. The contract with Bristol included broad warranties, requiring Bristol to correct and repair any defective work and to repair any damage to the exterior glass caused by Bristol.

Bristol, in short, botched the cleaning job. The contract contained various written specifications as to how the work should be carried out, intended to ensure that the glass was not scratched. Bristol failed to follow the specifications in several ways. As a result, the exterior glass was scratched at various locations. Station Lands made a claim under the course of construction policy issued in connection with the project (the “Policy”). Insurers denied cover on the basis of the faulty workmanship exclusion. The exclusion provided:
This policy section does not insure:

...  

(b) The cost of making good faulty workmanship, construction materials or design unless physical damage not otherwise excluded by this policy results, in which event this policy shall insure such resulting damage.

Insurers took the position that the poor cleaning constituted faulty workmanship and that cost of repair of the glass constituted “cost of making good” that faulty workmanship. Because the only damage was to the very part of the building on which the faulty work was carried out, there was no “resulting damage”. Station Lands took the position that the “cost of making good” was restricted to cost of a proper cleaning, and that cost of repair of scratching to the exterior glass would constitute “resulting damage”. Initially, Station Lands also asserted that the poor cleaning did not constitute faulty workmanship, although that position was withdrawn at the SCC.

Prior Caselaw and Context

To understand the SCC decision, on both standard of review and interpretation of the exclusion, it is helpful to consider the prior case law on the exclusion. Most construction projects are insured under some form of course of construction policy. Larger projects, like construction of the Epcor tower, are generally insured under a project specific course of construction policy. The policy, very generally, provides cover for cost of repair of physical damage to the project during construction. The policy will sometimes provide additional coverages, including cover for certain financial costs (“soft costs” or “delayed opening” costs) arising from physical damage. While the policy is generally taken out by the project owner, all parties engaged in the construction project are insured under the policy and, subject to certain exceptions, are protected from subrogation.

Virtually all course of construction policies include some form of faulty design and workmanship exclusion. The underlying purpose of the exclusion has been referred to in a number of cases. At a very high level, the exclusion ensures that, while the policy covers unanticipated physical damage at the project site, those involved do not have carte blanche to utilize faulty design, materials or workmanship. The “cost of making good” form of the exclusion is common, and has been considered by Canadian Courts on many occasions. Certain other versions of exclusion are also commonly used and have been considered in many cases. There are also some versions of the exclusion, such as the “DE” and “LEG” wordings, which have been considered in only a few cases, but which are nonetheless based on “standard” forms, created by industry groups for use in course of construction and similar policies.

Prior caselaw considers both the design and workmanship aspects of the exclusion. Most cases providing a detailed analysis of the scope of the exclusion have considered the design aspect was in connection with the design aspect. However, several cases have considered the faulty workmanship aspect of the exclusion in circumstances not dissimilar to those in Ledcor. In Bird Construction Co. v. United States Fire Insurance Co. [Bird], a contractor dropped a truss in the course of installation, due to faulty procedures. The insured argued that the “cost of making good” the faulty workmanship was restricted to the cost of proper installation of the truss, and did not include cost of repair of the truss. The Court rejected that argument and held that the “cost of making good” was the cost of repair of the truss. In Sayers & Associates Ltd. v. Insurance Corp. of Ireland Ltd. [Sayers], a contractor failed to protect electrical equipment from the elements while the equipment was awaiting installation, and, as a result, the equipment was damaged. The insured argued that the exclusion was restricted to the cost that would have been incurred to properly protect the equipment. The Court rejected that argument and held that the “cost of making good” the failure to properly protect the equipment was the cost of repair of the equipment. Ontario Hydro v. Royal Insurance [Ontario Hydro], the case
closest to Ledcor on the facts, involved supply and installation of a boiler. Following installation, but prior to final acceptance, the owner carried out an “ill-advised” acid wash, which damaged the boiler tubes. The insured argued that the exclusion should be restricted to the cost of a proper acid wash. The Court rejected that argument and held that the cost of repair of the boiler tubes was the “cost of making good” the faulty acid wash.

**Trial and Court of Appeal Decisions**

Ledcor was dealt with as a trial of an issue, on a short agreed statement of facts. The trial judge, Clackson J., issued a fairly brief decision. Clackson J. referred to only one case considering the exclusion; *Ontario Hydro*. Clackson J. held that the “cost of making good” could be either the cost of repair of that part of the insured property damaged by the faulty workmanship, or cost of redoing the work. Clackson J. adopted the latter interpretation, largely on the basis of *contra preferentum*.

The Court of Appeal overturned the trial decision. The Court of Appeal first considered standard of review, in light of *Sattva*. The Court of Appeal pointed out that insurance policies are a “highly specialized form of contract” commonly on standard wording, and generally entered into without any negotiation of the terms. Terms are often set, or heavily influenced by statutory provisions. Decisions interpreting insurance policies often have “great precedential value” and the “primary objective should be certainty”. For those reasons, the Court of Appeal held, it would be untenable for the same policy wording to be interpreted differently by two trial judges. While underlying questions of fact would be reviewed on a palpable and overriding error standard, “the standard of review for interpretation of insurance policies is correctness”.

The Court of Appeal then considered the purpose and intent of the exclusion. The Court noted the observation, from prior cases that an overly narrow interpretation of the exclusion would be inappropriate as it would give the insured *carte blanche* to cut corners by utilizing faulty workmanship, materials or design, and require the insurers to pay for any repairs. Having said that, the Court of Appeal pointed out that the cardinal rule of interpretation was to look first to the words of the policy and that “truisms” could be of limited assistance in interpreting the words of the policy.

The Court then turned to the central issue in terms of application of the exclusion to the facts; whether and how the exclusion would apply where the contractor who caused the damage was working on a part of the project supplied and installed by others. The Court termed this the “multiple contractors” issue. The Court rejected Station Lands’ position that application of the exclusion turned on whether the contractor who caused the damage had been responsible for other work on the item in issue at earlier stages of the project. The Court cited several matters in rejecting this argument. This is the key issue on which the Court of Appeal and the Supreme Court of Canada disagreed, and is referred to in further detail below.

After rejecting the “multiple contractors” approach to the exclusion the Court of Appeal proposed a new test, which the Court referred to as the “physical or systemic connectedness” test. That test, in summary, is based on the degree to which the damage was to the specific part of the project being worked on, and whether the damage was the likely result of the failure to properly carry out the work. The Court then applied the physical and systemic connectedness test to the facts. The damage here was restricted to the windows, the very part of the project being worked upon, and scratching was highly likely, even, perhaps, inevitable, if the work was done in a faulty way. On that basis the exclusion applied.

**Supreme Court of Canada Decision**

The SCC allowed the appeal and restored the trial decision. The majority judgment was written by Wagner J. for all members of the Court except Moldaver J. Justice Moldaver dissented on the reasoning, but not on the result.
Standard of Review

The first issue dealt with was standard of review.16 The standard of review issue, as noted above, arose out of the Court’s decision in Sattva. In Sattva, the SCC explicitly abandoned what it referred to as the “historical approach”, under which contractual interpretation is generally treated as a question of law. That approach is followed in England.17 It is also the approach followed in the United States, at the federal level.18 In Canada, however, different approaches to the standard of review had developed across the provinces. In some provinces, contractual interpretation largely remained a question of law, reviewable on a correctness standard;19 in others, it was treated as a question of mixed fact and law, reviewable depending on the nature of the specific issue, on a palpable and overriding error or correctness standard.20 In Sattva, the SCC held that contractual interpretation was generally a question of mixed law and fact, subject to the palpable and overriding error standard. While this was the general rule, the correctness standard of review would continue to apply to “rare” extricable questions of law that might arise in the interpretation process, such as “application of an incorrect principle, the failure to consider a required element of a legal test, or the failure to consider a relevant factor”.21

Application of Sattva to insurance policies and other contracts involving “standard form” wording was, to say the least, controversial. Following Sattva, several appellate decisions declined to apply the palpable and overriding error standard to interpretation of insurance policies. These cases included22 Portage LaPrairie Mutual Insurance Co. v. Sabean [Portage];23 Precision Plating Ltd. v. Axa Pacific Insurance Co. [Precision];24 MacDonald v. Chicago Title Insurance Co. of Canada [MacDonald];25 and Monk v. Farmers’ Mutual Insurance Co. [Monk].26 On the other hand, appellate courts applied Sattva in a number of cases which, to some degree, involved interpretation of policy language.27 Those decisions include: Kassburg v. Sun Life Assurance Co. of Canada [Kassburg];28 Industrial Alliance Insurance and Financial Services Inc. v. Brine [Industrial];29 Ontario Society for the Prevention of Cruelty to Animals v. Sovereign General Insurance Co. [Ontario Society];30 Acciona Infrastructure Canada Inc. v. Allianz Global Risks U.S. Insurance Co. [Acciona];31 and GCAN Insurance Co. v. Univar Canada Ltd. [GCAN].32 More generally, there was a marked level of disagreement by some appellate courts with the Sattva approach, at least insofar as it might apply to interpretation of standard form contract language. In Association des parents ayants droit de Yellowknife v. Northwest Territories (Attorney General)[Association],33 the Court of Appeal described Sattva as “unnecessarily derogatory” of the role of appellate courts.34

Justice Wagner pointed out that the agreement at issue in Sattva (a fully negotiated finder’s fee contract in connection with a corporate transaction) involved a commercial agreement between sophisticated parties. The Court in Sattva referred to the importance of the factual matrix to interpretation of the contract. The factual matrix is of limited importance where standard form contracts, such as insurance policies, are concerned. Certain aspects of an insurance policy such as premiums will be negotiated, but the wording itself is generally on standard form language. This does not mean that the factual matrix plays no role in policy interpretation. But it plays a lesser role than with regard to fully negotiated contracts. In addition, to the extent surrounding circumstances are relevant, those circumstances “will usually be the same for everyone who may be a party to a particular standard form contract”35 making this a less relevant factor.

Justice Wagner then turned to the definitions of “question of law” and “question of mixed law and fact”. While contractual interpretation is generally a question of mixed law and fact, interpretation “is more appropriately classified as a question of law in most circumstances” involving standard form contracts.36 In this context, the Court referred to the “division of labour” between trial and appellate Courts in accordance with their respective roles.
The primary function of a trial Court is to resolve the specific dispute before it, while appellate Courts “operate at a higher level of legal generality” citing Association. Appellate Courts can properly discharge that role without second-guessing trial Courts’ factual determination, but must have the ability to review errors of law on a standard of correctness. 

In many cases, the appellate Courts need not review contractual interpretation to properly perform their role, as interpretation of a contract often has no impact beyond the parties to the dispute. Where a standard form contract is involved, review on a standard of correctness may be necessary for appellate Courts to fulfill their function. Where particular contractual wording is in use by a major institution, or is standard across an industry, the interpretation of that contract could affect many, because “precedent is more likely to be controlling.” It would be undesirable for Courts to interpret identical or similar standard form provisions inconsistently, without good reason. The appellate Courts’ mandate of ensuring consistency in the law is advanced by review on a standard of correctness.

Justice Wagner noted that consistency is particularly important in the interpretation of standard form insurance contracts, quoting Co-operators Life Insurance Co. v. Gibbens. As Binnie J. noted in that case, the Courts will normally be reluctant to depart from precedent interpreting policy language in a particular way and should “strive to ensure that similar insurance policies are construed consistently.”

Justice Wagner held that there was no “bright-line distinction” between questions of law and those of mixed fact and law. Rather, the degree of generality or precedential value was the key difference between the two types of questions. While contractual interpretation is often application of principles to a unique set of circumstances, in the case of standard form contracts the interpretation may have precedential value and becomes a pure question of law. In summary:

Sattva should not be read as holding that contractual interpretation is always a question of mixed fact and law, and always owed deference on appeal. I would recognize an exception to Sattva’s holding on the standard of review of contractual interpretation. Where, like here, 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 specific to the particular parties to assist the interpretation process, this interpretation is better characterized as a question of law subject to correctness review.

Justice Wagner noted that, depending on the circumstances, interpretation of a standard form contract may be a question mixed fact and law, subject to deferential review. For example, deference will be warranted if there is a specific factual matrix, or if the parties negotiated and modified what was initially a standard form contract.

Justice Cromwell, in separate reasons, disagreed with the majority’s creation of an exception from Sattva for insurance policies and other standard form contracts. Justice Cromwell was of the view that standard form contracts should be subject to palpable and overriding error standard. Justice Cromwell held that, while standard form contracts generally do not have relevant surrounding circumstances relating to the negotiation, those contracts have other surrounding circumstances relating to the purpose of the contract and nature of the industry, among other things. In terms of precedential importance, Cromwell J. held that, simply because a matter involves a standard form contract, it does not necessarily mean that it is an issue of general importance, or one with precedential value. In summary, Cromwell J. would have applied a palpable and overriding error standard to the interpretation of the policy adopted by the trial judge.

Significance of Ledcor on Standard of Review and Future Issues

The Court’s clarification in Ledcor that a correctness standard of review applies to interpretation of standard form policy language is, in the author’s view, a positive development. Canadian Courts, including the Supreme Court of Canada, have previously recognized the particular importance, in insurance law, of consistency in interpretation. Were
policy interpretation issues subject to review only on a palpable and overriding error standard this would create the potential for inconsistent decisions and unnecessary litigation.

Notwithstanding the clarity brought by Ledcor there are some difficult questions that remain and that will have to be considered on a case-by-case basis.

The Impact of Negotiation on Standard of Review

Possibly the most difficult remaining question is the role that any negotiation of the policy language will play in determining the applicable standard of review. Certain language from Sattva and Ledcor might suggest that, to the extent the policy wording was negotiated, this lends greater importance to the individual factual matrix, and favours a palpable and overriding error standard. It is certainly true that, where there has been negotiation, determining the relevant and admissible factual matrix will involve issues of fact. However, once those facts are determined, the correctness standard of review should nonetheless apply to the interpretation of “standard form” language.

In considering this issue, it is important to keep in mind that the process by which insurance policies are created is far from uniform. At one end of the spectrum are consumer type policies held by individuals or smaller entities. Those policies generally involve no true negotiation. Wordings and premiums are fixed, and the only choice generally available to the policy holder is whether to add optional coverages. Wordings, if not actually dictated by statute (as in the case of motor vehicle policies) are generally based on industry forms, such as those created by the Insurance Services Office and Insurance Bureau of Canada, or long standing precedents. At the other end of the spectrum are more complex policies held by larger businesses or institutions. In many of those situations the policy wordings are drafted by the insured, not the insurer, in that the wording will be on a broker form. There will often be detailed negotiation of policy terms. That negotiation will generally involve matters such as premium and additional coverages. But that negotiation will also often involve choice of wordings. The faulty design and workmanship wording at issue in Ledcor is a good example. There is a broad range of faulty design and workmanship wordings available and many insurers, depending on the nature of the project, premium and wishes of the insured, will offer or accept more than one version of the exclusion. However, at the end of the day, all of the wordings are “standard”, in that they are taken from a menu of existing available wordings. In that scenario, a correctness standard of review should presumably apply, notwithstanding the fact that the policy term was, to some extent, the product of negotiation. Of course, there may be cases in which the wording was truly a one-off negotiated wording, not based on an industry form. In that case, a palpable and overriding error standard would likely apply to all interpretation issues. There will also be occasional cases in which, on what is ostensibly standard wording, there was specific discussion between the insurer and broker sufficient to essentially amount to an agreed interpretation of the policy term in question. Again, in that scenario, palpable and overriding error is likely the correct standard of review on all interpretation questions.

When Does a “Standard Form” Interpretation Issue Arise?

Not every case that, at first glance seems to involve interpretation of a standard form clause, will be subject to a correctness standard of review. In some cases application of a correctness will be fairly straightforward. For example, in MacDonald, the issue was interpretation of the term “marketable” in a title insurance policy. The term “marketable” is commonly used in such policies and there is substantial caselaw on its meaning. Application of a correctness standard would be a simple matter under the Ledcor test. In Precision, the issue involved interpretation of the pollution exclusion in a commercial general liability policy. The wording is standard and is subject to substantial prior case
law. In fact, proper interpretation of the exclusion cannot be determined without reference to the caselaw, as the exclusion, purely on its words, would have a substantially broader scope than Courts have given it.\(^5\) Again, in this scenario, a correctness standard would clearly apply under Ledcor.

In other situations however, on close examination, it becomes apparent that the real issue does not involve interpretation of the “standard form” parts of the policy. Take the facts in *Tien Lung Taekwon-Do Club v. Lloyd’s Underwriters (c.o.b. Sutton Sportscover).*\(^5\) In that case a liability policy held by a martial arts studio excluded liability for injury sustained during sparring, except as referred to in the declarations. The declarations referred to martial arts generally, but did not specifically refer to sparring. The insurer argued that the exclusion therefore applied. The trial judge found that the policy wording was ambiguous and declined to apply the exclusion. The Court of Appeal held that the standard of review was palpable and overriding error, on the basis of *Sattva.* The standard of review analysis would likely be the same under Ledcor. Quite apart from the question of whether the sparring exclusion could be considered “standard” (the Court pointed out that no prior caselaw on the exclusion had been cited), the real issue was not interpretation of the exclusion at all. The real issue was how to interpret the reference to martial arts in the declarations, relative to the exception in the exclusion. The declarations were obviously negotiated, and could not be considered “standard form” wording. Therefore, a palpable and overriding error standard would likely apply, post-Ledcor.

Another situation not involving a true standard form interpretation arose in *Ontario Society.* In that case the issue was whether allegations made in multiple lawsuits against the insured alleging, among other things, malicious prosecution and improper investigation, triggered cover. The Court of Appeal applied *Sattva* on standard of review. The policy was clearly on standard form language, and likely not negotiated, suggesting that, post-Ledcor, a correctness standard should apply. However, the issue was not restricted to interpretation of the policy language. The issue was, in large part, the scope of the allegations made in the pleadings, and whether, depending on how broadly those allegations were interpreted, cover was triggered. Interpretation of the pleadings would constitute an issue of mixed law and fact. Separating that issue from a pure policy interpretation issue would not be straightforward. Therefore, post-Ledcor, a palpable and overriding error standard may well apply in this scenario.

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id.
Sattva, paras. 53 and 55.
Ledcor, para. 22.
Ledcor, para. 23.
2015 BCCA 347, 77 B.C.L.R. (5th) 223.
2015 QCCA 500.
Association, para. 24.
Ledcor, paras. 31-32.
Ledcor, para. 34.
Ledcor, para. 36.
Ledcor, para. 37.
Ledcor, para. 39.
Ledcor, para. 39, quoting Geoff R. Hall, Canadian Contractual Interpretation Law, 3rd ed (Markham, Ont.: Lexis Nexis, 2016) at 131.

Ledcor, para. 41.
Ledcor, paras. 42-43.
Ledcor, para. 46.
Ledcor, para. 106.
Ledcor, paras. 116-117.
Of course, in some cases, smaller entities will be insured under program type policies, written for an industry, business or institutional group and negotiated at a level that does not involve the individual insured.
See, for an example of such a clause in the faulty design and workmanship context, Seele Austria GmbH v. Tokio Marine Ins. Ltd., [2008] EWCA Civ 441.
See, for example, Versacold Corp. v. Zurich Insurance Co., [2010] B.C.J. No. 30, 2010 BCSC 23, in which the underwriter and broker discussed, in writing, in advance, how the policy language should respond to an occurrence of the type that followed.
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