The Insurer's Duty to Defend After Swagger

I. Introduction

On September 9, 2005, the Supreme Court of British Columbia delivered Reasons for Judgment in *Swagger Construction Ltd. v. ING Insurance Company* 2005 BCSC 169. *Swagger* represents the first comprehensive decision from our Supreme Court on the duty to defend in a construction context since its Reasons in *AXA Pacific Insurance Co. v. Guildford Marquis Towers Ltd.* (2000) 74 B.C.L.R. 194 and *F.W. Hearn/Actes – A Joint Venture Ltd. v. Commonwealth Insurance Co.* (2000), 75 B.C.L.R. (3d) 272. Just as those two cases had a significant impact on the positioning of insurers respecting their duty to defend, *Swagger* is bound to reignite the debate.

A. Background

Swagger acted as the general contractor for the UBC, on a project known as the Forest Sciences Center. In 1999 Swagger commenced an action against UBC for construction delays and extras under the contract. UBC counterclaimed for construction defects. Specifically, UBC claimed that Swagger was negligent and in breach of its construction contract resulting in the provision of faulty workmanship and materials. The breaches, UBC alleged, lead to water ingress and damage to the building components. UBC claimed against Swagger for the costs or remedying these deficiencies and resulting damage.

Swagger tendered defence of the counterclaim to its insurers. Swagger's insurers denied coverage and refused to defend the claim. Swagger commenced a petition seeking a declaration from the Court that one or more of its insurers had a duty to defend the counterclaim.

B. Reasons for Judgment

The Court held that there was no duty on the part of Swagger's insurers to defend the action. The Court made two important findings in reaching its decision. First, it held that there was no "property damage", as that term was so defined within the insurance policy. Second, the damage was not caused by an "occurrence" or "accident".

(a) Property Damage

Each of the three policies in question had similarly worded insuring agreements:

> We will pay those sums that the insured becomes legally obligated to pay as compensatory damages because of "bodily injury" or "property damage".
> "Property damage" must be caused by an "occurrence."
> "Occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.
> "Property damage" means:

a. Physical injury to tangible property, including all resulting loss of use of that property; or

b. Loss of use of tangible property that is not physically injured.

Swagger argued that the underlying allegations of negligence and breaches of contract caused "physical injury to or destruction of tangible property" and therefore coverage was triggered subject to policy exclusions. It relied on *Guildford Marquis* and *F.W. Hearn/Actes.*

Both *Guildford Marquis* and *F.W. Hearn/Actes* were cases involving alleged damages arising from building envelope failures. In both cases, the Court found that the liability insurers had a duty to defend.

With respect to the two cases, the Court first observed that the policy before the Court in *Guildford Marquis* involved wording different from that found in the policies before it. Particularly, the Court noted, the insurer in *Guildford Marquis* agreed to provide coverage for "injury to or destruction" of property, rather than "physical injury to or destruction of tangible property". The Court reasoned that the difference in wording was not inconsequential. In the case of *Guildford Marquis*, it was arguable that the insurer contemplated coverage for economic loss claims. However, in *Swagger* the insuring agreements clearly restricted coverage to physical injury to tangible property, which did not encompass economic loss claims.

The *F.W. Hearn/Actes* case presented a greater challenge to the Court because the insuring agreement in that matter was similar to the three agreements before it. Following a comprehensive review of the reasons in *F.W. Hearn/Actes,* the Court concluded that the case was wrongly decided and pursuant to the principles set out in *Re Hansard Spruce Mills Ltd*., [1954] 4 D.L.R. (B.C.S.C.), did not feel bound by the decision.

(b) "Accident" or "Occurrence"

The Court correctly noted that even if there was property damage as so contemplated under the three policies, it would next become necessary to consider whether that property damage was the result of an occurrence.

The policies defined an occurrence as an "accident". The Court turned to the Supreme Court of Canada's decision in *Canadian Indemnity Co. v. Walkem Machinery & Equipment Ltd.* [1976] 1 S.C.R. 309 for consideration of the term "accident".

In *Walkem*, the insured manufactured what proved to be a defective crane that was installed on a barge. The crane collapsed and the insured was held liable to the owner of the barge. The Supreme Court of Canada held that the collapse of the crane was an "accident" within the meaning of the policy. It accepted the definition of accident as "any unlooked for mishap or occurrence".

The Court in *Swagger* asked whether the result would have been different in *Walkem* if the only claim was for damage to the defective product itself. Following a review of Canadian case law, including the Ontario case of *A.R.G. Construction Corp. v. Allstate Insurance Company of Canada et al*. (2004), 38 C.L.R. (3d) 221, the Court answered its own question in the affirmative.

In *A.R.G*. an action was brought against the insured contractor for damages resulting from alleged defects in the design and construction of a building. The Court in *A.R.G*. concluded that the alleged damage to property or loss of use of property was not caused by accident. It held that there were good policy reasons for refusing to find that defective design or construction can constitute an accident. The Court made reference to the often quoted edict that a liability policy is not akin to a performance bond for and on behalf of the insured.

In the end, the Court in *Swagger* distinguished *Walkem* on the basis that there was no damage to third party property.

C. Swagger's Detractors

Not surprisingly, not everyone has embraced the Reasons of the Court in *Swagger*. Some suggest the Court confused tort concepts, such as economic loss, with insurance coverage issues. Others are critical of the Court's willingness to decide the case on perceived policy grounds and not on an interpretation of the policy itself.

(a) The Court erred in concluding that damage to the insured work product could never constitute an occurrence.

The principle that a CGL policy does not generally cover costs to repair the insured's defective construction or damaged work is commonly known as the "business risk" doctrine. The doctrine recognizes that a CGL policy is not meant to act as a warranty of the insured's work and protect the insured from liability in contract when the work was not that for which the damaged party bargained.

It is generally accepted that insurers ordinarily eliminate coverage for "business risks" through exclusions, not through the insuring agreement. In particular, the standard CGL policy contains certain "business risk" exclusions. Notably, the "your work" exclusion precludes coverage for "property damage" to "your work" arising out of it or any part of it and included in the "products completed operations hazard".

The point is well made in *American Family Mutual Insurance Co. v. American Girl, Inc*. 673 N.W. 2d at 82, a leading American case on "occurrence":

> If...losses actionable in contract are never CGL "occurrences" for purposes of the initial coverage grant, then the business risk exclusions are entirely unnecessary. The business risk exclusions eliminate coverage for liability for property damage to the insured's own work or product – liability that is typically actionable between the parties pursuant to the terms of their contract, not in tort. If the insuring agreement never confers coverage for this type of liability as an original definitional matter, then there is no need to specifically exclude it. Why would the insurance exclude damage to the insured's own work or product if the damage could never be considered to have arisen from a covered "occurrence" in the first place?

Moreover, it is arguable that the Court in *Swagger* wrongly focused on the consequence, rather than the event, when it asked "Would the result in those cases have been the same if the only claim was for damage to the defective product itself?

Clearly, had Swagger's actions caused third party property damage, say to an adjacent building, the Court would have followed *Walkem,* and concluded that there had been an occurrence under the policies. But is the event, that is the actions of Swagger at the time of construction, not same under either scenario? Why should the consequence of the event have any bearing on the question of whether or not there was an accident or an occurrence? Policies reasons aside, it is suggested that the only relevant question when considering whether there is an occurrence under the policy is - was the result intended or reasonably foreseeable? The following passage from the Ontario Court of Appeal decision in *Alie v. Bertrand & Frere Construction Co.* 222 D.L.R. (4th) 687 is instructive:

> On the facts here, I do not think there can be any doubt that what took place was an occurrence within the meaning of the policy. The product that was inserted into Bertrand's concrete was not inherently bad. I have already made a finding that Lafarge and Bertrand were both negligent, but I could hardly conclude that they deliberately sold an inferior product to the plaintiffs. The damage that took place to the plaintiffs' foundations was certainly not expected or intended by the defendants. My earlier findings on the evidence leads me to conclude that the damage caused to the plaintiffs' property was the result of an occurrence within the meaning of the policies.

(b) The Court failed to consider the policy as a whole.

Most CGL policies contain some variation of the following exclusion:

> This insurance does not apply to:
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> "Property damage" to "your work" arising out of it or any part of it and included in the "products –completed operations hazard".
>
> This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

The subcontractor's exception to the exclusion has its roots in an endorsement to the CGL policy known as the Broad Form Property Damage endorsement ("BFPD"). The BFPD was a response from the insurance industry to demands made by general contractors for expanded coverage on projects constructed primarily by subcontractors. The Texas Court of Appeal, in *Lennar Corp. v. Great Am. Ins. Co.* 2005 Tex. App. Lexis 4214 offers the following background:

> Our disposition of this issue may be explained through an understanding of the evolution of the subcontractor exception to the "your work" exclusion. In the past, the "business risk" exclusions in a CGL policy operated collectively to preclude coverage for any damage to construction projects, including damage to the work of subcontractors, or damage arising out of work of subcontractors... Many contractors were unhappy with this situation because more projects were being completed using subcontractors... In 1976, the insurance industry began to offer, for an additional premium, an endorsement to the CGL policy known as the Broad Form Property Damage Endorsement ("BFPD")... The BFPD deleted several portions from the "business risk" exclusions and replaced them with more specific exclusions that effectively broadened coverage.... Among other changes, the BFPD narrowed the "your work" exclusion of a subcontractor. In 1986, the insurance industry incorporated this aspect of the BFPD directly into the CGL policy by inserting the subcontractor exception in the "your work" exclusion.

In other words, it may be argued that when read as a whole, the insuring agreement specifically contemplates coverage for work performed by a subcontractor, otherwise the subcontractor exception to the "your work" exclusion would be rendered meaningless. The point is well made in *Lennar*:

> Finding no "occurrence" when the insured's defective construction damaged its own work would render the "your work" exclusion, particularly the subcontractors exception, superfluous and meaningless.

On elevating the CGL policy to a performance bond, the Court had this to say:

> We see no reason insurers would include the subcontractor exception in the "your work" exclusion if they did not intend to cover property damage from defective construction. As one court explained:
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> > The [insurance] industry chose to add the [subcontractor] exception to the ["your work"] exclusion in 1986... We realize that under our holding a general contractor who contracts out all work to subcontractors...can insure complete coverage for faulty workmanship. However, it is not our holding that creates this result: it is the addition of the new language to the policy. We have not made the policy that creates this result: it is the addition of the new language to the policy. We have not made the policy closer to a performance bond for general contractors, the insurance industry has.

(c) The Court confused tort concepts with insurance coverage issues

"Property Damage" is not qualified to mean physical injury to property other than the insured's own work product. Nowhere in any of the three policies was such a limitation articulated, at least, not within the insuring agreement (such qualifications are clearly contemplated under the business risk exclusions).

The Saskatchewan Court of Appeal, in *Westridge Construction Ltd. v. Zurich Insurance Co*. [2005] S.J. No. 396, offered the following comments regarding the pure economic loss "defence":

> [26] Traditionally the courts have characterized the cost of repairing or replacing defective work and products as "economic loss" on the ground that such cost does not arise from injury to persons or damage to property, apart from the defective work or product itself. La Forest J., in writing for the court in Winnipeg Condominium Corporation No. 36 v. Bird Construction Co., [1995] 1 S.C.R. 85 at 97, 121 D.L.R. (4th) 193, makes reference to this usual classification. Winnipeg Condominium was not an insurance case but one dealing with a contractor's tortious liability for negligence in the absence of privity of contract with the plaintiff. In that context, La Forest J. noted at para. 13, with respect to this traditional distinction between property damage and economic loss, that he "would find it more congenial to deal directly with the policy considerations underlying that classification". More will be said about the decision in Winnipeg Condominium later in this judgment. At this point, however, we note that we share La Forest J.'s view and find, in this context as well, that the classification of the insured's own work or product as economic loss is not particularly instructive. Rather, the focus should be on the language of the insuring agreements and their interpretation.

D. Conclusion

The Court in *Swagger* reasoned that "insurers and contractors, many of whom carry on business across the country, should be able to expect reasonable consistency in the law." This, of course, is a laudable objective. However, within the boundaries of this province, the courts have not addressed "property damage" and "occurrence" under the insuring agreement in a consistent manner. Nor is there a better track record nationwide. The time has come for the BC Court of Appeal to weigh in on this important issue.