DOLDEN WALLACE FOLICK LLP

WHEN A HOME WARRANTY PROVIDER SUES ITS MEMBER-BUILDER, IS THE CLAIM COVERED BY THE BUILDER'S CGL POLICY?

Brian D. Rhodes and Shelly M. Armstrong

May 2014

18th Floor - 609 Granville St.
Vancouver, BC
Canada, V7Y 1G5
Tel: 604.689.3222
Fax: 604.689.3777

308 - 3330 Richter Street
Kelowna, BC
Canada, V1W 4V5
Tel: 1.855.980.5580
Fax: 604.689.3777

850 - 355 4th Avenue SW
Calgary, AB
Canada, T2P 0J1
Tel: 1.587.480.4000
Fax: 1.587.475.2083

500 - 18 King Street East
Toronto, ON
Canada, M5C 1C4
Tel: 1.416.360.8331
Fax: 1.416.360.0146

CONTACT LAWYER

Brian Rhodes

604.891.0363
brhodes@dolden.com

Shelly Armstrong

604.891.0357
sarmstrong@dolden.com

TABLE OF CONTENTS

I. INTRODUCTION

This paper examines an issue which has become increasingly prevalent in Canada in the recent past as more jurisdictions move to implement statutory home warranty regimes. In particular, this paper examines whether a builder faced with a claim by his warranty insurance provider is entitled to coverage under his Commercial General Liability ("CGL") insurance policy. It is our view that the answer to this question depends on the structure of the home warranty scheme in place. For this reason, we begin our paper with a brief overview of home warranty programs across the country. We then examine two of the provincial schemes – those in BC and Ontario – in more detail and, with reference to wording in a typical CGL policy, explain how the subtle differences in these schemes lead us to conclude that, in general, a builder licensed in Ontario will be afforded coverage under his standard CGL policy, whereas a builder licensed in British Columbia will <u>not</u> be.

II. EXECUTIVE SUMMARY

Home warranty schemes in Canada can be classified as "mandatory" or "voluntary". Both Ontario and BC have "mandatory" home warranty schemes in place. However, the structure of these schemes differs in at least two key respects:

1. The Ontario scheme places primary responsibility to repair defective workmanship on the builder whereas the BC scheme places this responsibility on a private third party insurer; and

2. The Ontario scheme prescribes performance standards which a builder is required to ascribe to whereas the BC scheme does not.

As such, in Ontario, builders are "legally obligated" to repair defects thus bringing them within the language of a typical CGL's "insuring agreement". Further, Ontario builders' legal obligation to repair defects is mandated by statue and therefore is not caught by the "liability assumed by contract" exclusion found in a typical CGL policy. It follows that coverage will typically be afforded to an Ontario builder. In contrast, in BC, any legal obligation to repair defects arises by virtue of an indemnity agreement with the builder's warranty provider and not by reason of statute; any claim by the builder against its warranty provider would therefore by excluded from coverage under a typical CGL by virtue of the "liability assumed by contract" exclusion.

III. OVERVIEW OF HOME WARRANTY PROGRAMS IN CANADA

Home warranty programs are now common-place in the Canadian provinces. While there are as many models of Canadian warranty as there are programs, they all share common principles and features, including:

1. a statutory or voluntary warranty obligation;
2. a warranty scope that can include housing form, tenure, products, systems, appurtenances, coverage for economic loss, quality and compliance thresholds;
3. surety protection for delayed closing, deposits and deficiency completion;
4. a term during which an enrolled builder must respond to purchaser requests; and
5. the form of warranty whether public, private for-profit, private not-for-profit, self-supply or hybrid.

As of the date of this paper, five Canadian provinces have mandatory-statutory home warranty schemes in place: British Columbia, Quebec, Ontario, Manitoba and, effective February 1, 2014, Alberta. Saskatchewan and the Atlantic provinces have voluntary home warranty programs in place.

As this paper will illustrate with reference to the Ontario and British Columbia home warranty regimes, subtle but significant differences exist even among the mandatory statutory home warranty schemes.

IV. ONTARIO'S HOME WARRANTY MODEL

Ontario's home warranty model owes its form to decisions made in the mid-1970's that coincided with the failure of some builders, the introduction of rent control and the first Ontario building code.

Ontario's home warranty program is managed by Tarion Warranty Corporation ("Tarion"), a non-profit, private corporation. Tarion was established in 1976 to protect the rights of new home buyers and regulate new home builders. As part of its role, Tarion administers the *Ontario New Home Warranties Plan Act*, R.S.O. 1990, c. 0.31 (the "Ontario Act"), which outlines the warranty protection to which new home purchasers are entitled in Ontario. Anyone in the province of Ontario who plans to build and/or sell a new home must be registered with Tarion and enroll the home(s) as per the requirements in the Ontario Act.

Pursuant to the Ontario Act, builders in Ontario are deemed to provide certain statutory warranty coverage, including:

- Protection for deposits;
- Protection against financial loss for contract homes;
- Compensation for delays in closing or occupancy;
- Protection against unauthorized substitutions;
- One and two year warranties for certain defects in work and materials;
- A seven year warranty for major structural defects; and
- Coverage for condominium common elements.

The statutorily mandated warranties are backed by Tarion, which in addition to administering the Act, is responsible for managing a guarantee fund to ensure that builders honour the statutory warranties.

A builder's obligation to repair a warranted defect is triggered on the submission by a homeowner of a 30-Day, Year-End and/or Second-Year form. If the builder does not complete or otherwise resolve items that the homeowner believes are warranted within the prescribed time period (120 days), the homeowner then has 30 days to request a Tarion "conciliation inspection". This triggers the start of another 30 day period in which the builder may repair or otherwise resolve the warranted items. If the builder fails to do so, Tarion will schedule the requested "conciliation inspection" in the presence of both the builder and the homeowner and send both a report of the findings within 30 days. The builder is given 30 days from the day of the report to resolve the warranted items. If he does not do so, Tarion will work directly with the homeowner to resolve the items.

V. BRITISH COLUMBIA'S HOME WARRANTY MODEL

British Columbia's home warranty model is a product of the failure of the high-rise and mid-rise condominium construction practices of the 1990's, and the system of regulation and inspection that was supposed to take place.

British Columbia's home warranty scheme, including its governing legislation, the *Homeowners Protection Act*, SBC 1998 c. 31 (the "BC Act") is administered by the

Homeowners Protection Office ("HPO").[1] The BC Act requires that all new homes constructed with building permits applied for on or after July 1, 1999 be built by residential builders licensed with the HPO. It also makes third-party home warranty insurance mandatory on new home construction throughout the province. The mandatory home warranty insurance can only be obtained from companies that have been approved by the Financial Institutions Commission ("FICOM") and which meet the requirements of the BC Act.[2]

The BC Act requires, at a minimum, that coverage include:

- 2 years on labour and materials (some limits apply);
- 5 years on the building envelope; and
- 10 years on the structure.

The regulation under the BC Act – specifically, the *Homeowner Protection Act Regulation*, BC Reg 29/99 – sets requirements for how a warranty provider (as opposed to the builder) must respond to a properly filed claim. These include:

- On receipt of a notice of claim from an owner under home warranty insurance, promptly make reasonable attempts to contact the owner to arrange an evaluation of the claim.
- If, following evaluation of a claim under home warranty insurance, the warranty provider determines that the claim is not valid or not covered under the home warranty insurance, the warranty provider must notify the owner of the decision in writing, setting out the reasons for the decision.
- If the claim is found to be valid, repairs must be undertaken in a timely manner, with reasonable consideration given to weather conditions and the availability of materials and labour.

[1] Previously, the HPO had crown corporation status; however, in 2010, the HPO lost its crown corporation status and became a branch of BC Housing.

[2] The FICOM authorized home warranty insurance companies include: Aviva Insurance Company of Canada represented by National Home Warranty Group Inc. and Pacific Home Warranty Insurance Service Inc., Echelon General Insurance Company represented by Pacific Home Warranty Insurance Service Inc., RSA represented by WBI Home Warranty Ltd. and Travelers Insurance Company of Canada.

- All repairs and replacements made under home warranty insurance must be warranted against defects and labour for at least one year.

Pursuant to the BC Act, the warranty provider is ultimately responsible for repairing any construction defects covered by a home warranty insurance policy. That said, in many cases, the warranty provider will have an indemnity agreement with its member-builder (i.e. a contract which obligates the builder to correct defects that are deemed to be covered by home warranty insurance). This indemnity agreement will also often require the builder to provide financial security of some sort to their warranty provider. Wording typical of an indemnity agreement between a warranty provider and its member-builder is as follows:

> Indemnity
>
> The Builder agrees, that if it is in default of any obligation to a Purchaser, it shall and does hereby indemnify and save harmless The Program with respect to every cost, expense or payment incurred by The Program which the Program is required to make by reason of any obligation imposed by this Agreement or undertaken by The Program pursuant to the provisions hereof or under the provisions of the Limited Warranty or any assurance issued pursuant thereto including, without limitation, every and all costs which The Program may incur in investigating, negotiating, settling or litigating any claim or with respect to the fees of consultants, lawyers and others whom The Program may retain in connection with any claim made against The Program under this Agreement and the Limited Warranty.

Notably, the indemnity provision entitles the warranty provider to indemnification of its investigative and litigation fees incurred in pursuing indemnity from a rogue builder, in addition to the expenses incurred to remedy warranted defects which the builder failed to address.

VI. RELEVANT PROVISIONS IN THE CGL POLICY

In order to determine whether any given claim will trigger coverage under a CGL, it is necessary to consider the language of the CGL at issue. For the purposes of this paper, we have reproduced below the relevant portions of a typical CGL.

(a) Insuring Agreement

The "insuring agreement" in a typical CGL provides as follows:

*We will pay those sums that the Insured becomes legally obligated to pay as "**compensatory damages**" because of "bodily injury" or "**property damage**" to which this insurance applies. No other obligation or liability to pay sums or perform acts or services is covered unless explicitly provided for under SUPPLEMENTARY PAYMENTS – COVERAGES A, B AND D. This insurance applies only to "bodily injury" and "property damage" which occurs during the form period. The "bodily injury" or "property damage" must be caused by an "**occurrence**". The "occurrence" must take place in the "coverage territory". We will have the right and duty to defend any "action" seeking those "compensatory damages" but:*

1) *The amount we will pay for "compensatory damages" is limited as described in SECTION III – LIMITS OF INSURANCE;*

2) *We may investigate and settle any claim or "action" at our discretion; and*

3) *Our right and duty to defend end when we have used up the applicable limit of insurance in the payment of judgments or settlements under Coverages A, B or D or medical expenses under Coverage C.*

    a. *"Compensatory damages" because of "bodily injury" include "compensatory damages" claimed by any person or organization for care, loss or services or death resulting at any time from the "bodily injury".*

    b. *"Property damage" that is loss of use of tangible property that is not physically injured shall be deemed to occur at the time of the "occurrence" that caused it.*

"Compensatory damages" is typically defined in a CGL policy to mean:

> [D]*amage due or awarded in payment for actual injury or economic loss. "Compensatory damages" does not include punitive or exemplary damages or the multiple portion of any multiplied damage award.*

"Property damage" is typically defined in a CGL policy to mean:

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.*

"Occurrence" is commonly defined in a CGL policy to mean:

[A]n accident, including continuous or repeated exposure to substantially the same general harmful conditions. [3]

(b) Contractual liability exclusion

CGL policies often exclude coverage for liability assumed by contract or agreement. Typical wording for this exclusion is as follows:

> *This insurance does not apply to "bodily injury" or "property damage" for which the insured is obligated to pay "compensatory damages" by reason of the assumption of liability in a contract or agreement. This exclusion does not apply to liability for "compensatory damages":*
>
> *1) Assumed in a contract or agreement that is an "insured contract"; or*
>
> *2) That the insured would have in the absence of the contract or agreement".*

"Insured contract" may be defined in material part to mean:

> *… that part of any other contract or agreement pertaining to your business under which you assume the tort liability of another to pay "compensatory damages" because of bodily injury or "property damage" to a third person or organization, if the contract or agreement is made prior to the "bodily injury" or "property damage". Tort liability means a liability that would be imposed by law in the absence of any contract or agreement.*

VII. RELEVANT CASELAW

The applicability of a builder's CGL policy to a member-builder's claim for indemnification from its CGL provider was considered in the Ontario case, *Bridgewood Building Corp. (Riverfield) v. Lombard General Insurance Co. of Canada.*, 2005 CanLII 63763 (ONSC).

In *Lombard*, a number of homeowners made warranty claims against the residential builder, Bridgewood. Bridgewood funded the repairs and then submitted the claims to its CGL insurer, Lombard General Insurance Company of Canada ("Lombard") for indemnification. Lombard denied coverage to Bridgewood. Therefore, Bridgewood sought a determination from the Ontario Superior Court of Justice ("ONSC") as to whether coverage was available to him for the costs of the repairs under his CGL policy. The CGL policy at issue contained similar provisions to the "typical" CGL wordings set

[3] Canadian courts have held that the term "accident" is to be interpreted in its popular and ordinary sense as an "unlooked for mishap or an untoward event which is not expected or designed" (see *Mutual of Omaha Insurance v. Stats* [1978] 2 S.C.R. 1153).

out above. This gave rise to three issues for determination by the ONSC, two of which are relevant for our purposes.

The two relevant issues for determination in *Lombard* were:

1) Whether the builder was "*legally obligated to pay as damages*" the repair and associated costs resulting from the defects at issue so as to bring them within the meaning of policy's insuring agreement.

2) Whether the exclusion for liability "*assumed in a contract*" contained in the policy applied to the facts and thereby deprived the builder of coverage.

In respect of the first issue, Lombard argued that "*legally obligated to pay as damages*" requires a determination of liability beyond what had occurred in that case. In its view, "*legally obligated to pay as damages*" required that there be some demonstrated fault on the part of the prospective insured, or a determination that they are "*legally obligated to pay*" before liability can be brought to bear. The ONSC rejected this restrictive interpretation of the meaning of that provision, agreeing instead with the position of the builder, Bridgewood, that the plain meaning of "*legally obligated to pay as damages*", construed broadly, embraces the statutorily imposed warranty obligations which were the subject of the dispute (i.e. the warranties which the Ontario Act deems all builders to provide). In this regard, Stewart J. cited with approval the following passage from the text Commercial General Liability Insurance by Heather A. Sanderson (Toronto: Butterworths, 2000), at pp. 37-38 (at para. 33):

> *Despite some early controversy on this point there is now significant Canadian authority to the effect that the phrases "liability imposed by law" and "legally obligated to pay" include any liability imposed by a judgment of a court, whether the liability arises out of tort or contract or whether the relief claimed draws on an equitable remedy such as restitution. A direct statutory obligation to pay amounts to the government can also constitute a "legal obligation to pay" within the meaning of this phrase -- even if the liability is imposed directly and a court's only involvement would be in the case of non-payment. . . . Given that one is looking at unqualified words in a coverage agreement which a court is bound to interpret broadly in favour of the insured, it is appropriate to give the phrases "liability imposed by law" and "legally obligated to pay" a wide interpretation. These authorities and principles indicate that an argument that these phrases include all facets of an insured's civil liability has great weight.*

In response to Lombard's assertion that a CGL policy is not meant to be a performance bond and that the CGL policy in question did not extend to provide indemnity for

anything that was not the result of the fault of the insured, Stewart J. commented further as follows (at para. 36):

> *It is evident that the Act and the ONHWP are in the nature of consumer protection legislation, designed to assist and protect the purchasers of new homes. In my view, this no-fault remedial and protective legislative scheme is akin to environmental protection legislation which requires pollution clean-up and the costs thereof to be carried out and absorbed by persons regardless of proof of negligence or fault. Coverage for these attendant costs has often been considered by courts in the United States [cites omitted]. Since 1990, most courts that have considered costs of cleaning up environmental damage, costs connected with compliance with the Comprehensive Environmental Response, Compensation, and Liability Act, are covered by the standard language in CGL insuring agreements which pay "all sums which the insured shall become legally obligated to pay as damages" [cites omitted]. In my view, the same approach should be taken in this particular case. (our emphasis)*

In respect of the second issue, Lombard argued that because the Ontario home warranty legislative regime requires vendors and builders to extend warranty coverage to purchasers of new homes, this represents a liability "assumed in contract" by the builder and is therefore not covered by the CGL contract. Again, the ONSC rejected Lombard's position. Significantly, it found that that the obligations imposed on builders by the Ontario home warranty legislation were not "*assumed in a contract*", but rather were mandated by statute, and that "*failure to comply with those statutory requirements would require the builder to ignore their statutorily-imposed duties and jeopardize their continued registration to carry on business in Ontario*" (at para. 38).

In the end, the ONSC granted the builder Bridgewood a declaration that its statutory obligation pursuant to the Ontario Act to effect the repairs constituted a legal obligation to pay damages within the meaning of the applicable CGL policy and a declaration that Lombard was obligated to indemnify the builder for the repair costs and all reasonable expenses incurred or to be incurred to compensate the homeowners for losses and expenses arising from the defects. The ONSC decision was appealed, on different grounds. The coverage decision was upheld by the Ontario Court of Appeal, without reference to the warranty issue.

To our knowledge, the ONSC's core analysis in *Lombard* has not been revisited and we are unaware of any other Canadian decision in which a court has considered whether a member-builder subject to a claim from its warranty provider is entitled to coverage under his CGL policy. We are also unaware of any American decision which directly addresses this point.

VIII. CGL COVERAGE AVAILABLE TO A BUILDER: BC VERSUS ONTARIO

While every case must necessarily be determined on its facts with reference to the exact wording of the applicable policy provisions, it appears that, at least in Ontario, it is likely that a builder will be entitled to coverage under his CGL policy for costs incurred due to duties of repair imposed on him by the Ontario Act. The question is, does this extend to British Columbia builders operating under British Columbia's home warranty regime? In our view, it does not.

As set out above, the Ontario Act reposes builders with certain statutory obligations in respect of new home construction. In particular, the Ontario Act deems certain statutorily constituted warranties to be included in every contract of purchase and sale between a builder and the purchaser of a new home. Further, the Ontario Act prescribes standards which the builder is required to adhere to in order to become licensed to build new homes in Ontario. While Tarion backs the obligations and responsibilities of the builder and will step in if the builder fails to honour his obligations, primary responsibility to effect the repairs lies with the builder.[4]

In contrast, the BC Act is merely a legislative framework for mandating a homeowner's warranty. It does not prescribe performance standards that a builder is required to ascribe to. Rather, the BC Act prescribes the minimum requirements that must be covered by warranty and contains a general requirement that the form of private third party insurance be approved by the HPO then leaves the specifics to be determined by the FICOM-approved warranty providers (insurers). It is true that the warranty provider can (and often will) enter into an indemnity agreement with the builder entitling it to sue the builder to recover its costs if the builder's work turns out to be defective (including the costs it incurs in investigating, negotiating, settling or litigating its claim). However, unlike the situation in Ontario, under the applicable legislation, ultimate responsibility for ensuring the minimum warranty requirements are met resides with the warranty provider, not the builder. Any right of recovery on the part of the warranty provider arises by virtue of its contractual agreement with the builder; it is not a right prescribed by statute.

In our view, the indemnity agreement between warranty provider and its member-builder is an agreement assumed by contract and, as a result, a warranty provider's claim against a builder brought pursuant thereto would most likely be excluded from coverage under a typical CGL policy by virtue of the contractual liability exclusion.

[4] The Ontario Act does give Tarion the right, upon paying a homeowner's claim, to sue the builder alleging a breach of the statutorily mandated performance standards. Such a claim would be a breach of contract claim for failure to adhere to the prescriptive performance standards (not to recover on a contractual indemnity).

This conclusion stems at least in part from the fact that an indemnity agreement, by its very terms, obligates a builder to pay more than merely the cost of repairing a home but, as well, the private insurer's expenses in adjusting the loss and engaging in legal proceedings (i.e., unlike the statutory warranty in Ontario, it does not necessarily precisely "mirror" the exposure of the underlying warranties mandated by statute). Further, it is our view that an indemnity that seeks recovery of more than merely compensatory amounts (as do most builder indemnity agreements), is not, by its nature "compensatory" and, as such, may not even fall within the wording of a typical CGL policy's insuring agreement.

For these reasons, it is our view that, in most cases a BC member-builder will not be entitled to coverage under his CGL policy if he is sued by his warranty provider. We repeat, however, that this is a generalization and that every case will need to be decided with reference to the specific facts and the applicable policy wordings.

IX. CONCLUSION

As more Canadian jurisdictions move towards implementation of home warranty regimes, we expect that CGL insurance providers will encounter the issues raised in this paper with increasing frequency. When faced with a claim from a builder and the corresponding need to make a determination on coverage, it will be important for the CGL insurer to bear in mind that the coverage determination will be influenced by many factors, not the least of which is the structure of the home warranty program in the relevant jurisdiction. Even the most subtle differences in structure can change the outcome of the coverage determination.