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The insured is responsible for the cost of bringing its building up to construction standards

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On December 19, 2016, the Alberta Court of Appeal allowed the appeal[1] of the insurer which had excluded from its policy coverage the rebuilding costs associated with bringing the insured building up to by-law standards. The Court of Appeal unanimously maintained the exclusion for damages resulting from the latent defect or inherent vice (defects and deficiencies) in the building and rendered of no force or effect the exception extending the coverage to the rectification of building code deficiencies to bring the insured building into compliance with by-law requirements.

The facts

In March 2012, Economical Mutual Insurance Company issued a commercial policy to its insured, Inter-City, an auto body shop operating in a building which had been built in the 1950s. The relevant provisions of the policy were quoted as follows:

"[6] The Policy contained two relevant exclusions under section IV of form 6557 as follows:

2. Perils excluded

This Form does not insure against loss or damage caused directly or indirectly:
…

(M) proximately or remotely, arising in consequence of or contributed to by the enforcement of any by-law, regulation, ordinance or law regulating zoning or the demolition, repair or construction of buildings or structures, which by-law, regulation, ordinance or law makes it impossible to repair or reinstate the property as it was immediately prior to the loss or
…

This form does not provide insurance for:

(O) wear and tear, gradual deterioration, latent defect, inherent vice, or the cost of making good faulty or improper material, faulty or improper workmanship, faulty or improper design, provided, however, to the extent otherwise insured and not otherwise excluded under this Form, resultant damage to the property is insured;

[emphasis added]

[7] On the other hand, form 6558 provided in relevant part as follows:

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This form provides the following extensions of coverage in Commercial Building, Equipment and Stock Form 6557. The limit for these extensions shall be in addition to the limits of coverage provided in section 1 of Form 6557.
…

3. Contingent liability from enforcement of building by-laws:

This form shall, as a result of a peril insured against, extend to indemnify the insured for:

(a) loss occasioned by the demolition of any undamaged portion of the buildings or structures;

(b) cost of demolishing, and clearing the site of any undamaged portion of the buildings or structures; or

c) any increase in the cost of repairing, replacing, construction or reconstructing the buildings, or structures on the same site or on an adjacent site, of like height, floor area and style, and for the like occupancy; arising from the enforcement of the minimum requirements any by-law, regulation, ordinance or law which:

(i) regulates zoning or the demolition, repair or construction of damaged buildings or structures; and

(ii) is in force at the time of such loss or damage."

[emphasis added]

In July 2012, heavy rainfall caused a storm sewer overflow which resulted in limited water damage to the wood frame building. The insurer indemnified its insured for emergency work ($6,793.83) and the repairs of the damage to the building ($16,040.98).

During the investigation conducted after the loss, it was discovered that the structure of the building no longer complied with municipal by-laws in force as to construction standards. The municipality determined that the wood structure portion of the building had to be demolished and rebuilt according to the new construction standards in force. The rebuilding costs were assessed at $471,000.

Position of the insured

The policy covered the cost of replacing the non-compliant wood structure of the insured building. The insurance policy identified two separate insured risks, namely (1) the cost for repairing the damages caused by a storm sewer overflow, and (2) the rebuilding costs associated with rectifying the structural items which did not comply with the by-laws. The causal relationship between the damage caused by the overflow and the costs of rectifying the structural items which did not comply with the by-laws had no relevance as to their coverage.

Decision in the first instance

The court and the parties acknowledged that the non-compliant structural items of the building did not constitute damage resulting from the overflow and predated the issuance of the insurance policy.

Form 6557 of the policy excluded the costs associated with bringing up to construction standards the insured building (*gradual deterioration, latent defect, inherent vice*). However, Clause 3 (C) of Form 6558 of the policy contained exceptions covering the cost for rectifying by-law noncompliance

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(*enforcement of minimum requirements*).

The Court concluded that Form 6558 was not ambiguous and had to be interpreted according to the terms used. Accordingly, there was a coverage extension for damage resulting from a covered risk to include the cost of bringing the building up to by-law standards at the time of the loss. The damage resulting from an initially covered risk, said the Court, created an additional and independent covered risk, so that the costs of bringing the building up to the construction standards became an autonomous covered risk independent from the initial water overflow.

The judgment of the Court of appeal

The interpretation of a standardized insurance contract is an issue of law which allows a court of appeal to intervene (*Ledcor Construction Ltd.* v. *Northbridge Indemnity Insurance Co.*, 2016 SCC 37, para 21-24).

It was admitted that the building's non-compliance with the by-laws had not been caused by the storm sewer overflow. The overflow, although it was a covered risk, had only triggered the discovery of the structural non-compliance of the building.

To determine the scope of application of the exclusion and the exception, the Court of Appeal applied the reasonable expectations of the parties principle. It concluded that the parties could not reasonably expect that the costs for making good non-compliant structural items predating the loss would be included in the insurance coverage. The Court was of the view that the application of the reasonable expectations principle resolved the ambiguity of Clause 3 (C) of Form 6558.

Therefore, it was not necessary to rely on the other interpretation rules such as the broad interpretation of the insurance coverage, the restrictive interpretation of exclusions, nor the interpretation in favour of the insured. The intent of the parties, as established in Form 6558, was to cover the rectification of non-compliant structural items if caused, as opposed to simply discovered, by the occurence of a covered risk.

The latent defect or inherent vice (defects and deficiencies) of the insured building were specifically excluded by the clear language of Form 6557. To constitute an exception to this exclusion, the noncompliant structural items necessarily had to constitute a damage caused by the occurence of a covered risk. The Court thus refuted the conclusion of the trial judge according to which the rectification of noncompliant items of the building was an insured risk independent from the initial covered risk.

Our view

We note from the *Roth* judgment that the interpretation of a standardized insurance contract is an issue of law which allows a court of appeal to intervene using the correctness standard rule. In this respect, two contradictory lines of jurisprudence exist based on the nature of the question of the interpretation of a contract by an appellate court. According to the first, it is a mixed question of fact and law commanding deference from an appellate court. In such a case, the standard of review was that of palpable and overriding error. The second, considered an exception to the applicable principle for the interpretation of a standardized contract. This would thus constitute an issue of law for which the standard of review on appeal would be that of correctness. In the Ledcor case, the Supreme Court decided in favour of the correctness standard allowing an appellate court to review the interpretation of a standardized contract such as an insurance contract[2].

As to the interpretation of the insurance coverage of the policy at issue, the ambiguity of the scope

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of the exclusion and exception clauses must be resolved by taking into account the reasonable expectations of the parties. It seems fair, according to the Court, that an insurer would not be required to indemnify its insured for the cost of rebuilding a building and entirely bring it up to by-law standards following a minor loss which only uncovered pre-existing non-compliant items. To conclude otherwise would require the insurer to be responsible for any latent defect revealed by a loss, even if the loss is a covered risk. It would then be impossible for the insurer to assess the risk to be covered.

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1. *Roth* v. *Economical Mutual Insurance Company*, 2016 ABCA 399.
2. Also see *Fortier* c. *Société immobilière Bourg-Royal inc.*, 2017 QCCA 117; *Parkhill Excavating Limited* c. *Royal & SunAlliance Insurance Company of Canada*, 2016 ONCA 832, para. 19; *Carter* c. *Intact Insurance Company*, 2016 ONCA 917, para 32 in reference to the case of *Ledcor Construction Ltd.* c. *Société d'assurance d'indemnisation Northbridge*, above, on that point.

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