THE COVENANT TO INSURE IN A CONSTRUCTION CONTEXT

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As discussed in detail in a previous article, the Supreme Court of Canada has held in a trilogy of cases that a covenant to insure in a lease can operate as a bar to legal action to recover for property damage to the leased premises.

As with leases, construction contracts often contain covenants to insure as between owners, contractors, and sub-contractors. Unlike in the landlord-tenant context, the covenant to insure is rarely invoked as a defence to property damage claims as between the parties to a construction contract.

As an example of a covenant to insure in the construction context, General Condition 11.1 of the CCDC2 stipulated price contract requires the Contractor to obtain general liability insurance and broad form property insurance in the joint names of the Contractor, Owner, and Consultant, and to include as insureds all subcontractors.

While the language of these provisions may be modified by way of Supplemental Conditions, their essence usually remains intact. In short, one of the parties to the construction contract has covenanted to obtain liability and property insurance in the joint names of the Owner, Contractor, Consultant, and Sub-contractors.

These insurance policies are usually purchased in the form of commercially available Wrap-Up Liability and Builder's Risk insurance policies.

In cases where the contracted-for insurance coverage has been purchased (and responds in accordance with the policy language) there is usually no further issue as between the parties to the construction contract. These construction-specific policies will usually contain an express waiver of subrogation. In addition, subrogation is not available as between insureds under a single policy of insurance.

However, there are cases where the party who has covenanted to obtain insurance under the construction contract has failed to do so. This happens with surprising regularity, particularly on smaller construction projects. In these cases, there is no insurance policy to turn to in the event of a loss and the parties are left to their contractual and common-law remedies.

In these situations, close attention should be paid to whether the contract contains a covenant to insure, and whether that covenant to insure provides a full defence to the plaintiff's claim.

This situation was considered in the case of Active Fire Protection 2000 Ltd. v B.W.K. Construction Co., [2005] OJ No 2892 (Ont. C.A.). In that case, the Ontario Court of Appeal applied the reasoning from the trilogy to a claim brought by a general contractor against its sub-contractor relating to flood damage to a project.

In that case, B.W.K. Construction Company Ltd. ("BWK") was the general contractor for a renovation and addition to the Town of Whitby's centennial centre. Pursuant to the terms of the prime contract as between the Town and BWK, BWK was required to obtain a policy of "all-risks" property insurance in the joint names of the owner, the contractor, and the consultant. BWK was also obliged to incorporate the terms of the prime contract into any sub-contracts or supply contracts.

BWK entered into a sub-contract with Active Fire Protection 2000 Ltd. ("Active") to provide a fire protection system for the project. The terms of the prime contract, including the covenant to insure, were incorporated into the sub-contract by reference. Under the sub-contract, Active agreed that it would indemnify BWK against any damage caused by its work on the project.

In breach of its obligations under the prime contract, BWK failed to obtain the required insurance for the project. Active, however, did have a policy of liability insurance in place.

Prior to the completion of the project, the basement of the building flooded due to a failure in sprinkler system installed by Active. Active admitted that it was negligent and that its negligence was the cause of the loss.

BWK paid damages to the Town and sought to recover that amount from Active as compensatory damages. A summary judgment motion proceeded to determine the issue of liability as between BWK and Active. The contractor's claim was dismissed. The contractor appealed this finding.

The Court of Appeal wrote that:

[16] There is no dispute that the appellant was required by the general conditions of the Main Contract to acquire an all-risks property insurance policy on the entire construction project prior to the flood and that this policy, if in place in accordance with the appellant's contractual obligation, would have responded to the losses arising from the flood. It is also common ground that if the appellant had met its obligation under the Subcontract to acquire and maintain fire insurance, the fire insurance policy would also have responded to the losses occasioned by the flood.

[17] Accordingly, the question is upon whom the assumption of risk falls in this case and whether, in the absence of the policies of insurance that the appellant contracted to provide, the appellant is entitled to claim against the respondent for the losses caused by the flood, given the respondent's insurance and indemnification obligations under the Subcontract and its admitted negligence.

[18] In my view, the decision of this court in Madison Developments Ltd. v. Plan Electric Co. (1997), 152 D.L.R. (4th) 653 (Ont. C.A.), leave to appeal to S.C.C. refused (1998), [1997] S.C.C.A. No. 659 (S.C.C.), is dispositive of this appeal. In that case, this court held:

[9] Let me begin with an analogous circumstance. The law is now clear that in a landlord-tenant relationship, where the landlord covenants to obtain insurance against the damage to the premises by fire, the landlord cannot sue the tenant for a loss by fire caused by the tenant's negligence. A contractual undertaking by the one party to secure property insurance operates in effect as an assumption by that party of the risk of loss or damage caused by the peril to be insured against. This is so notwithstanding a covenant by the tenant to repair which, without the landlord's covenant to insure, would obligate the tenant to indemnify for such a loss. This is a matter of contractual law not insurance law, but, of course, the insurer can be in no better position than the landlord on a subrogated claim. The rationale for this conclusion is that the covenant to insure is a contractual benefit accorded to the tenant, which, on its face, covers fires with or without negligence by any person. There would be no benefit to the tenant from the covenant if it did not apply to a fire caused by the tenant's negligence.

. . . . .

[11] In my view, this interpretive reasoning as to the terms of a lease applies equally to this contract between contractor and subcontractor. This is a sizable building construction project in which the contractor has agreed with the owner to obtain comprehensive fire insurance covering losses arising from any cause. The anticipation was that a group of subcontractors would contribute their efforts to the overall project and it was undoubtedly expected that if a fire occurred it would most likely be caused by the negligence of one of those subcontractors. Given the contractor's obligation in favour of the owner to obtain comprehensive fire insurance it makes no business sense for each subcontractor to pay premiums to duplicate that coverage. There would be no purpose for Article VI in the subcontract if it was not to protect the subcontractor from claims for fire damage caused by its negligence; there could be no claim if the subcontractor was not negligent.

[12] The separate obligation of the subcontractor in Article V to obtain liability insurance is, in a way, akin to the separate obligation of the tenant to repair. The subcontractor's obligation to obtain liability insurance, which would cover many risks beyond that of fire, can be written with an eye to the respective obligations of the subcontractor and the contractor. In other words, the liability insurer should know in setting the premium that the subcontractor is protected against fire-related losses to the owner or general contractor caused by its negligence.

[19] This reasoning is apposite here. In this case, both in the Main Contract and in the Subcontract, the appellant contractually undertook to obtain insurance for the entire construction project that it admits would have responded to the losses in issue. In breach of its contractual obligations, the appellant failed to obtain such insurance coverage. But, its commitments to obtain the requisite insurance (all-risks property insurance under the Main Contract and fire insurance under the Subcontract) operated as a voluntary assumption by the appellant of the risk of loss or damage caused by the perils to be insured against. As a matter of contract, it assumed the risks.

In the result, despite the admission of negligence on the part of Active, the appeal was dismissed and BWK’s claim against Active was dismissed in its entirety. The Court of Appeal specifically noted that this finding was applicable even in the absence of a subrogated claim.

In short, the Court of Appeal relied upon the existence of BWK’s covenant to insure to defeat its claim for property damage against Active.

In summary, sub-contractors and other parties to a construction contract, and their liability insurers, would be well-served to carefully review the allocation of risk and the covenant to insure under the applicable contractual regime in responding to allegations that they have negligently caused damage to a building project. In certain circumstances, the covenant to insure may provide a complete defence to a property damage claim.

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