FOCUS
ON INSURANCE LAW

Alberta broadens scope of its *Insurance Act*

CRAIG BROWN

SIGNIFICANT CHANGES to legislation governing contracts of insurance in Alberta will mean greater clarity in the law relating to property and liability insurance. Similar amendments will soon follow in B.C., and the other common law provinces will likely emulate the revisions as well.

The new measures have been under consideration since *KP Pacific Holdings v. Guardian Insurance,* [2003] S.C.J. No. 24, which involved a claim for fire damage. The policy covered "all-risks," but included the statutory conditions mandated for contracts to which the fire insurance part of the *Insurance Act* apply.

In *KP Pacific*, the major issue was which limitation period applied: the one-year period included in the statutory conditions, or the longer period applicable to insurance to which the fire insurance part of the Act does not apply. The court held that all-risk or multiple peril contracts were not covered by the fire insurance part, even for fire loss.

Since very few policies are now written where either fire is the only peril covered or where other designated perils are clearly incidental to the fire coverage, *KP Pacific* rendered the fire insurance part of the Act practically inoperative in most cases. That part of the Act, more or less identical in all the common law jurisdictions in Canada, contains several provisions that modify the common law of insurance contracts in important ways.

For example, the duty to disclose facts material to the risk is moderated in that only a fraudulent omission voids the policy. As well, unreasonable or unjust terms in the contract may be nullified by a court, and an insurer gains a right of subrogation on accepting responsibility for only a partial, as opposed to a full, indemnity. Statutory conditions on disclosure, termination, claims procedures and other things are mandated for all "fire" policies.

The effect of *KP Pacific* is that these provisions now apply to very few insurance contracts. If the rules or conditions contained in the fire part are to apply, to the extent they can be, they have to be included in the contract as ordinary terms or conditions. But that is not possible for perhaps the most consumer-friendly section — the one giving courts the discretion to strike out unjust or unreasonable terms.

In *KP Pacific* the court strongly suggested that legislatures tidy all this up. As it happened, there were other issues relating to property insurance already

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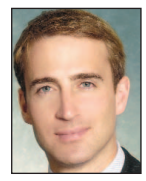
MATCHES BY ANDREW BUCKIN, FIREFIGHTER BY CRYSTALCRAIG / DREAMSTIME.COM

SCC narrows 'faulty design' exclusion

DOUG MCINNIS



& RORY BARNABLE

A long-standing insurance dispute over the failure of a massive tunnel boring machine ("TBM") ended in late November 2008 with a ruling by the Supreme Court of Canada awarding nearly $40 million to the insured. The decision addresses the "faulty or improper design" exclusion common to most "all-risks" property policies. Much to the insurance industry's surprise, Canada's top court both constricted the exclusion's scope, and enlarged the evidentiary burden for insurers relying on it.

In *CN Rail et al. v. Royal and Sun Alliance et al.*, [2008] S.C.J. No. 67, CN had constructed a rail tunnel in the early 1990s under the St. Clair River from Sarnia, Ont. to Port Huron, Mich. using the world's largest TBM (nicknamed "Excalibore"). Well into tunneling, but before the TBM was under the river, project engineers discovered that soil had contaminated the main bearing chamber for the 32-foot diameter rotating steel cuttinghead attached to the forward bulkhead. Although it was unclear how the soil had breached the 26 independent seals in the narrow gap between the cuttinghead and bulkhead, the initiating cause was determined to be excessive differential deflection (or bending) of the cuttinghead beyond its miniscule design tolerances.

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INSURANCE LAW

Courts differed on method for determining foreseeable risk

Excalibore
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The seal failure brought the project to a standstill. As the TBM was effectively stuck in the tunnel, a large vertical shaft was drilled from above to implement repairs. Once the problems were fixed, tunnelling continued without further incident. However, CN sustained significant losses due to the eight-month delay in the machine's return to operation.

Prior to commencing the project, CN arranged a "Builders' Risk" policy with the defendants to protect against "all risks of direct physical loss or damage...to ...all real and personal property of every kind", but not "the cost of making good...faulty or improper design". When CN claimed under the policy, the insurers declined coverage on the basis that the excessive differential deflection was the result of "faulty design".

CN obtained judgment at trial, but the insurers succeeded on appeal. On further appeal, a bare majority (4 to 3) of the SCC disregarded the Ontario Court of Appeal's findings that applied the exclusion in favour of the defendant insurers.

All three courts rejected the perennial insurer argument that the failure of a design to achieve its intended purpose stands as prima facie proof of a "faulty design". Neither did they accept the insured's opposing contention that negligence must be proven by the insurer to establish fault on the part of the designer. Instead, all levels of court endorsed an intermediate ground requiring the design to account for all foreseeable risks, failing which it would

ANDREW VAUGHAN / CP PHOTO

CN Rail built a railway tunnel under the St. Clair River in the 1990s. Litigation ensued over the tunnel boring machine.

be "faulty" and the exclusion would trigger. However, while they agreed in principle on this standard, they differed significantly on the method for determining foreseeable risk.

At the SCC, Justice Ian Binnie (writing for the majority) expressly confirmed that a designer must consider and accommodate all foreseeable risks in the development of the design. However, he went further to hold that the exclusion's use of the phrase "faulty or improper" invites a comparative analysis. In determining the appropriate comparison standard, he rejected the notion that a design must perfectly accommodate all risks, thereby allowing that a design can fail without being "faulty or improper".

Justice Binnie also rejected ordinary negligence (the prevailing industry standard applicable to the prudent designer addressing reasonably foreseeable risks). Instead, he set the comparative bar at a higher "state of the art" level, thereby limiting the exclusion's application to circumstances in which an insurer can prove that the risk would be foreseen by the most knowledgeable individuals using the highest standards of the day at the leading edge of the relevant speciality.

> "The battle lines will be drawn between 'uber-experts' opining on nuanced facts..."

Applying this test to the facts at hand, Justice Binnie concluded that CN's designers met the "state of the art", and the exclusion did not apply.

CN Rail has already been the subject of much legal and insurance industry commentary. It immediately affects insurers that are currently contesting claims in reliance on the exclusion. They must re-evaluate their cases with the aid of leading experts to assess whether the impugned designs fell below the "state of the art" at the material time. These assessments are critical as the outcome is now likely to turn on a combination of the quality and thoroughness of the upfront investigation and the expert's qualifications and opinion.

While the basic methodology for developing expert opinions will be similar to that employed in typical professional liability cases involving design issues, the process of establishing what is foreseeable under the "state of the art" test is likely to be much more complex and expensive. The initial weight of this difficult task will fall on the insurer's shoulders in light of its onus to prove the exclusion. However, the insured will also have to retain top experts to fully engage in a "state of the art" assessment in order to counter the insurer's position. In the result, the battle lines will be drawn between "uber-experts" opining on nuanced facts, the industry's leading edge developments and whether the parties have accommodated them.

The SCC decision has the two-fold effect of narrowing the circumstances in which the faulty design exclusion applies *and* increasing the evidentiary burden to bring it to bear. Although the majority reasons are couched in self-described circumstance-specific language, they clearly impact the utility of the exclusion at large and consolidate divergent case law across the country. In this sense, the legal outcome is as "groundbreaking" as the underlying facts.

Canadian insurers have yet to give a unified response to the decision. However, at least some insurers are changing the exclusion's phrasing to "design failure" (taking up the implicit invitation in Justice Binnie's reasons). By doing so, insurers hope to avoid the ruling's potential "warranty" effect as noted by both the SCC minority and the Ontario Court of Appeal (i.e. the policy warrants soundness, performance or fitness for purpose if it is not proven that the designers did not meet the state of the art).

A smaller number have refined this by adding a "state of the art" exception to the exclusion to shift the onus to the insured to prove the design meets standard. Others are likely to leave the wording untouched, instead favouring the tried and true certainty inherent in a national precedent and more selective underwriting. As always, however, competitive pressures in the marketplace will have the greatest influence on the insurance industry's ultimate stance. ■

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Duty to defend, indemnify may not coincide: *Hoyos*

Decision by Quebec Court of Appeal could be 'an insurer's worst nightmare'

LUIS MILLAN MONTREAL

Insurance companies who conclude that they have no duty to defend an insured facing an action, and by extension no obligation to indemnify, risk being surprised with a hefty bill, following a recent ruling by the Quebec Court of Appeal.

In a ruling that repeatedly hammers the distinction between a liability insurer's duty to defend with its obligation to indemnify, the appeal court warns insurance companies that they cannot come to the hasty conclusion that they have no duty to indemnify simply because they have no duty to defend.

"What strikes me about this case is that in most cases the duty to defend is broader than the duty to indemnify," said Domenic Naud, a partner with Nicholl Paskell-Mede. "Normally it is understood that when there is no obligation to defend there is necessarily no obligation to indemnify. But in this exceptional case, there was no duty to defend, which is normally broader, but the insurer may find itself with an obligation to indemnify."

Informed by several Supreme Court of Canada rulings, including *Nichols v. American Home Assurance Co.*, [1990] 1 S.C.R. 801, and its own rulings, notably *Boréal assurances inc. c. Réno-dépôt inc.*, [1996] R.J.Q. 46, the appeal court notes that the duty to defend is based on an analysis of the nature of the claims made by the third party, while the obligation to indemnify is determined following the facts proven at a trial.

"I recognize that the outcome

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