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Builder's Risk Insurance

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BUILDER'S RISK INSURANCE

WHAT IS IT?

Builder's Risk insurance, also known as "course of construction", "construction all risk", and "contractor's all risk insurance", is a specialized form of insurance designed to insure buildings or projects against repair or replacement costs while they are under construction and, in some cases, for a specified period afterwards. This insurance will usually also cover build materials, fixtures and appliances all of which are intended to become an integral part of the structure under construction.

The Supreme Court of Canada described the function of Builder's Risk insurance as follows:

> *"Whatever its label, its function is to provide to the owner the promise that the contractors will have the funds to rebuild in case of loss and to the contractors the protection against the crippling cost of starting afresh in such an event, the whole without resort to litigation in case of negligence by anyone connected with the construction, a risk accepted by the insurers at the outset.*[1]*"*

Although the Builder's Risk policy is designed to provide broad coverage, it does not cover all property connected to the construction project nor does it cover every risk. Instead, coverage is limited by specification of covered property types, locations and owners and further limited by an extensive list of exclusions. As such, a Builder's Risk policy is just one part of an overall scheme of insurance coverage for the construction industry. Additional coverage may be obtained either through endorsements (additional coverage added to a standard policy) or through other insurance policies specifically created to cover many of the risks and property types outside the coverage provided by the typical Builder's Risk policy. Some of these endorsements and policies include[2]:

- boiler and machinery;
- marine and transportation;
- contractor's equipment;
- contractor's leased and rented equipment;
- employees' tools;
- loss of use of contractor's equipment; and
- riggers/hook liability.

[1] *Commonwealth Construction Company v. Imperial Oil Limited* (1976), 69 D.L.R. (3d) 558 (S.C.C.) as per De Grandpre J. at p. 566.
[2] Jardine Insurance Services, *Construction Bonds & Insurance* (7th ed. 1998) ("Jardine"), at pp. 46-48.

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This paper will examine the standard Builder's Risk policy including such issues as who should obtain coverage, the proper amount of coverage, who is covered under the policy and what is actually included or excluded by the policy. Note that this paper will focus only on the coverage provided by the basic Builder's Risk policy. For a brief discussion of the endorsements and additional policies listed above, see *Construction Bonds & Insurance* published by Jardine Insurance Services.[3]

WHO OBTAINS THE POLICY?

A Builder's Risk policy often covers a number of parties. As such, the standard policy can usually be obtained by any of the owner, contractor, architect, engineer or project manager. Generally the industry expectation is that the general contractor or owner will obtain the Builder's Risk policy[4]. Whether this expectation is followed or not, there are a number of points that need to be considered by all parties involved in the project in order to properly determine exactly who should obtain the policy for the project in question.

The Construction Contract May Stipulate Who Obtains the Policy

It may be that the party who obtains the policy is contractually required to do so. Where the owner and contractor enter into a construction contract using the current version of the Standard Construction Document CCDC2 Stipulated Price Contract (1994) (the "CCDC2 Contract") then condition GC (general condition) 11.1.1 stipulates that the contractor shall obtain the necessary policy. The requirements of the policy are also set out under GC 11.1.1.4(1):

> *"All risks' property insurance shall be in the joint names of the Contractor, the Owner, and the Consultant, insuring not less than the sum of the amount of the Contract Price and the full value, as stated in the Supplementary Conditions, of Products that are specified to be provided by the Owner for incorporation into the Work, with a deductible not exceeding $2,500."*

The contractor should also be aware that condition GC 11.1.1 requires them to provide the owner with confirmation that such coverage has been obtained not only prior to the start of the project but at any time *"upon the placement, renewal, amendment, or extension of all or any part of the insurance …"*.

The owner may be required to provide or maintain the policy if the contractor fails to do so. However, if such is the case, the owner is then allowed to demand the costs of obtaining and maintaining the policy from the contractor or alternatively can deduct such amounts from its payments to the contractor (per condition GC 11.1.4).

Whoever Obtains the Policy Controls the Coverage

Each party may have its own agenda in terms of what it wants covered including which additional policies it may wish to obtain to provide an acceptable level of coverage.

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[3] *Ibid*.
[4] See *529198 Alberta Ltd. v. Thibeault Masonry Ltd.* 2001 ABQB 1108.

Accordingly, the party that obtains the insurance is in the best position to ensure that the policy provides for the precise coverage that it wants. This includes what risks to include and exclude.

The Possibility of Exposure to Liability and Additional Costs

A party that fails to meet its obligations to obtain insurance for others may be exposed to liability either in tort or through a claim for breach of contract. Getting less than the minimum required coverage or getting a larger than permitted deductible could make the obligated party liable for the difference.

Another cost consideration for the party obtaining coverage is responsibility for any additional costs associated with the policy. Additional costs could arise from increased or prolonged premiums if the project takes longer than scheduled to complete or from obtaining a replacement policy where necessary.

Other Considerations

Other points to be considered include the following[5]:

- Many contractors may be able to negotiate better terms and rates based on their insurance history and knowledge of the construction industry. Additionally some contractors carry Building Risk policies that automatically insure any project that they work on. Accordingly this could allow them to add a future project under their policy at a rate that may be lower than could otherwise be obtained for a separate project specific policy.

- Contractors and their bonding companies or architects and engineers may have specific insurance requirements not met by a policy supplied by an owner.

- Some policies may exclude perils that the other parties deem necessary or important enough to be included in the overall coverage.

- An owner obtained policy may not cover subcontractors or subtrades that the general contractor is obligated to protect through insurance.

THE AMOUNT OF COVERAGE

The amount of coverage should adequately cover the full value of the project in its finished state. Indeed most policy wordings often require coverage of the "full value" of the work however this term has not been strictly defined. Additionally, perceptions of what constitutes "full value" may differ depending on the views of each of the insured parties.

It is imperative that the policy purchaser be aware of any gaps in the amount of coverage that might result in a discrepancy once a claim is made. For example, condition GC 11.1.1.4(1) of the CCDC2 Contract states that the policy shall be for "*not less than the sum of the amount of the Contract Price.*" "Contract Price" is a defined term in the CCDC2 Contract and ultimately does not include any "Value Added Taxes" as per condition A-4. This means that the amount

[5] Per Jardine *supra* Note 1 at p. 43.

of coverage is the contract price minus taxes, which may ultimately lead to a reduction in repair costs paid out on the policy. This in turn would result in a shortfall to the insured who would have to look elsewhere for complete compensation.

In addition to the "Contract Price", the following factors should also be taken into account in order to assess what constitutes the proper "full value" amount to ensure adequate coverage[6]:

- The possibility of increased repair costs based on timing, inflation or economic situations such as wage increases. This would apply not only for contractor costs but subtrade costs as well.

- Any potential demolition and debris removal costs necessary for proper repair such as tearing down a weakened portion of the structure before rebuilding.

- The value of any labour, equipment or material that formed part of the project but was not covered under the contract price such as volunteered work or donated materials or anything supplied directly by the owner to defray the original contract price.

- Any consultant costs such as architectural, engineering and project management fees, which are not usually part of the direct contract cost. Such fees may increase because of extra work required by any of these consultants after a loss.

- The cost of temporary facilities such as barricades, hoardings, formwork and other site structures that will not be re-used and will have to be re-supplied.

- Any construction soft costs including insurance premiums and legal fees.

- The possibility of increased costs due to by-law or zoning changes that may occur after the start of the project.

THE POLICY'S COMPONENTS

A Builder's Risk policy, like most insurance policies, consists of two basic groups of statements. The first sets out the "who", "what" and "when" for matters inside coverage. The other group does the same for matters outside coverage. The former tend to be general in scope while statements in the latter group are usually more specific.

The policy components setting out the matters within coverage are the declaration pages and the insuring agreements. The declaration pages name the insured parties, the monetary limits, and the time period during which the insurance coverage will be in effect. In Builder's Risk polices, the declaration pages often specify a particular construction project but some policies may cover a party for all projects.

The insuring agreements describe the types of property and risk covered by the policy.

[6] Per Lawrence Bicknell, Construction Law – 2004 Update, "Construction Risks" (Vancouver, The Continuing Legal Education Society of British Columbia, Nov. 2004) ("Bicknell") at p. 2.1.4.

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If there is a coverage dispute between the insurer and the insured, the onus is on the insured to prove its claim falls within the parameters of the declarations and the insuring agreements[7].

The parts of the policy describing matters outside coverage are called exclusions. They remove specific types of property (e.g. tools) or causes of damage (e.g. freezing) from the broad coverage provided by the insuring agreements. In a coverage dispute, once an insured has proven a claim falls within the declarations and insuring agreements, the onus falls on the insurer to prove it falls into one of the exclusions[8].

WHO IS COVERED?

The Builder's Risk policy typically lists the owner/developer and general contractor by name as the insured parties. Because they are identified by their own names, they are known as "named insureds".

In addition, the Builder's Risk policy often covers most other persons involved with the construction project. This is either because the policy identifies them in a generic category of insured parties (e.g. all "subcontractors" or "persons for whom the named insured has contracted to obtain Builder's Risk insurance") or because the courts have traditionally deemed them to be insureds. Those included by generic identification or by the courts are known as "unnamed insureds".

In the context of a policy claim, it is important to determine whether a party is covered under the policy. There are two reasons for this. The first one is obvious. Parties with coverage will not have to pay for losses out of their own pockets. The policy, if adequate and not breached, should serve to make any included losses payable by the insurer. The second reason is to find out whether the party causing the loss can be sued by the party that suffered the loss (or the insurer that paid for it). Where the one causing the damage is not insured under the same policy as the victim, the insurer covering the loss usually gains the right to sue (in the name of the victim) the party responsible for the loss. This is referred to as the insurer's right of subrogation. However, if the party at fault is a named or unnamed insured under the victim's policy, the insurer will not be able to pursue them for recovery of the insurance funds. This is because of the generally recognized principle that an insurer cannot bring a subrogation action against someone covered by the same insurance policy[9]. Because of this principle, the practice of including all parties involved in a construction project under one policy can reduce lawsuits between them.

The Courts, in determining whether a party classifies as an "unnamed insured", will generally ask "*in the context of the construction contracts, did the various trades have, prior to the loss,*

[7] *British and Foreign Marine Insurance Co. v. Gaunt*, [1921] 2 A.C. 41 (H.L.) and see *B.C. Rail Ltd. v. American Home Assur. Co.* (1991), 54 B.C.L.R. (2d) 228 (C.A.).
[8] See *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada* [2004] O.J. No. 4086 (Ont. Sup. Ct.) for an affirmation of this principle.
[9] *Commonwealth Construction, supra*, note 1 at p. 561.

such a relationship with the entire works that their potential liability therefore constituted an insurable interest in the whole?[10]*"*

Based on numerous authorities, it is now widely held that all sub-contractors, whether named in the policy or not, have an insurable interest in the whole project. Because of this, they have the benefit of a Builder's Risk policy, regardless of whether the policy was taken out by the owner or the general contractor[11]. This is based on the rationale of necessary implication[12]. The underlying theory of this rationale is that the contracting parties to the project, having expressly agreed that the project was to be covered by a Builder's Risk policy, have also implicitly agreed that in the event of a loss, any party that was a member of the construction team would be able to look to the policy as the sole remedy in the event of a loss and would not, as between all the parties, seek to shift that loss.

Speaking of this concept, Mr. Justice DeGranpre said in the 1976 Supreme Court of Canada case, *Commonwealth Construction Co. Ltd., v Imperial Oil Ltd* .[13],

> *"On any construction site … there is ever present the possibility of damage by one tradesman to the property of another and to the construction as a whole. Should this possibility become reality, the question of negligence in the absence of complete property coverage would have to be debated in Court. By recognizing in all tradesmen an insurable interest based on that very possibility, which itself has its source in the contractual arrangements opening the doors of the job site to the tradesmen, the Courts would apply to the construction field the principle expressed so long ago in the area of bailment. Thus all parties whose joint efforts have one common goal, e.g., the completion of the construction, would be spared the necessity of fighting between themselves should an accident occur involving the possible responsibility of one of them.*[14]*"*

While it is now recognized that subcontractors who supply materials to a project fall under the category of unnamed insured, what of those that merely supply labour or services? The Courts have recognized that these subcontractors also qualify as unnamed insured[15]. However, the category of those covered under the Builder's Risk policy by implication of law might be restricted to only those whose products and services formed an integral part of the construction process. In the 1990 case of *Canadian Pacific Ltd. v. Base-Fort Security Services (B.C.,)*[16] the British Columbia Court of Appeal ruled that a security company at a construction site provided

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[10] *Commonwealth Construction, supra*, note 1 at p. 562 and see *Timcon Construction Ltd. v. Riddle, McCann, Rattenbury & Associates Ltd.* (1981) 16 Alta. L.R. (2d) 134 (Alta. Q.B.).
[11] See *Timcon Construction, supra* note 10, *Sylvan Industries Ltd. v. Fairview Sheet Metal Works Ltd.* [1994] B.C.J. No. 468 (C.A.), *Madison Developments Ltd. v. Plan Electric Co.* (1997), 152 D.L.R. (4th) 653 (Ont. C.A.) and *529198 Alberta Ltd., supra* note 4.
[12] *Sylvan Industries, supra* note 11.
[13] *Commonwealth Construction, supra* note 1.
[14] *Ibid* at p. 562.
[15] *Earl A. Redmond Inc. v. Blair LaPierre Inc.* [1995] P.E.I.J. No. 25 (P.E.I. T.D.) at para. 17 – "cannot maintain a subrogated claim against a subtrade if the latter contributed materials or labour to the project".
[16] (1990), 52 B.C.L.R. (2d) 393 (C.A.).

services that were parallel but not integral to the construction activities. The security company was therefore was not an insured within the meaning of the policy.

Sometimes, in order to avoid the problems of determining who is actually covered under the policy, coverage will be granted to all parties involved with the construction by way of a "wrap up" endorsement to the policy. The endorsement bears this name because it serves to "wrap up" a group of parties within the coverage of one insurance policy. By covering all members of the construction team, the wrap up endorsement reduces uncertainty concerning coverage and the potential for numerous subrogated claims.

Other advantages of extending Builder's Risk coverage to all construction participants can be lower overall premium cost, uniform broad coverage, and meeting any construction contract requirements that compel one party to obtain Builder's Risk insurance for another[17]. Some disadvantages are that claims caused by others may increase the future costs of whoever procured the policy and the policy may provide less coverage than the contractor's own policy and be subject to higher deductibles[18].

THE INSURING AGREEMENTS

As previously stated, the onus is on the insured to prove on a balance of probabilities that it has suffered a loss and that such a loss falls within the scope of the insuring agreement.

Property Insured

The description of property insured under a typical Builder's Risk policy might look like this:

> PROPERTY INSURED: This Form, except as provided, insures:
>
> (a) Property in the course of construction, installation, reconstruction or repair
>
> (i) owned by the Insured;
>
> (ii) owned by others, provided that the value of such property is included in the amount insured;
>
> all to enter into and form part of the completed project including expendable materials and supplies not otherwise excluded, necessary to complete the project described in the Declarations for this form as "Description of project".
>
> (b) temporary buildings, scaffolding, falsework, forms, hoardings, excavation, site preparation, landscaping and similar work, provided that the value thereof is included in the amount insured and then only to the extent that replacement or restoration is made necessary to complete the project;
>
> (c) expenses incurred in the removal from the construction site of debris of the property insured, occasioned by loss, destruction or damage to such property and in respect of which insurance is provided by this Form.

[17] Jardine *supra* note 2 at p. 44.
[18] *Ibid*.

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For any items not listed above, an insured can usually add coverage through endorsements or by obtaining additional policies.

Risks Insured – All Risks and Fortuity

Regarding the causes of loss, the typical Builder's Risk policy provides "all risk" coverage. An insuring agreement might look like this:

> PERILS INSURED: This Form, except as herein provided, insures against all risks of direct physical loss of or damage to the property insured.

As previously stated, coverage against "all risks" is misleading because it does not literally mean that coverage will extend to all risks that might cause the loss of or damage to the insured property. In some cases, coverage is usually limited by an extensive list of exclusions set out in the policy itself. In other cases, some risks have been found to fall outside coverage without need for a specific exclusion to take them out. In *British and Foreign Marine Insurance Co.*, Lord Birkenhead L.C. stated:

> *"In construing these policies it is important to bear in mind that they cover "all risk". These words cannot, of course, be held to cover all damage however caused, for such damage as is inevitable from ordinary wear and tear and inevitable depreciation is not within the policies. There is little authority on point, but the decision of Walton J. in* Schloss Brothers v. Stevens*, on a policy in similar terms, states the law accurately enough … Damage, in other words, if it is to be covered by policies such as these, must be due to some fortuitous circumstance or casualty.*[19]*"*

"Fortuitous circumstance or casualty" is a fancy way of saying "accident". This means that the loss is not covered if it was intended, inevitable or expected. Things such as wear and tear or gradual deterioration do not qualify as "accidents" because these are naturally and inevitably occurring events that happen to all property. Likewise, intentional damage to property is not included as an "accident". Rather the circumstances which caused the loss must be unintended and unexpected. In 1990, Madam Justice McLachlin of the Supreme Court of Canada put it this way,

> *"… in determining whether a loss falls within the policy, the cause of the loss should be determined by looking at all the events which gave rise to it and asking whether it is fortuitous in the sense that the accident would not have occurred "but for" or without an act or event which is fortuitous in the sense that it was not to be expected in the ordinary course of things.*[20]*"*

Loss arising out of negligence may also be considered an "accident". Indeed, negligence is the most common cause of accidents covered by insurance policies. The question arises, however, as to whether one can be so negligent that the result falls outside the category of "accident" and

[19] *Supra* note 7 quoted by Jardine, *supra* note 2 at pp. 46-47.
[20] *C.C.R. Fishing Ltd. v. British Reserve Insurance Co.* (1990) 69 D.L.R. (4th) 112 (S.C.C.) – McLachlin J. (as she was then) at p. 120 and see *Corp. of Dawson Creek (City) v. Zurich Insurance Co.* 2000 BCCA 158.

into the category of "expected". Just how probable a result must be before it is no longer accidental is a matter for debate. Taking calculated risks may bring the result just inside the "accident" category. In *Canadian Indemnity Company v. Walkem Machinery & Equipment Ltd.*[21], a case involving a liability insurance policy, the insured manufactured and sold a crane knowing there was a defect that could cause the crane to collapse. It did. The Court found that although the insured had taken a business risk, the loss was still the result of an accident. At the Court of Appeal, Robertson J. stated:

> *"The word 'accident' is not a technical legal term with a clearly defined meaning, and in the policy here it is to be read in its proper and ordinary sense. That sense is expressed in these definitions: 'any unintended and unexpected occurrence that produces hurt or loss' and 'an [undersigned], sudden and unexpected event'. Injuries are accidental or the opposite, for the purpose of indemnity, according to the quality of the results rather than the quality of the causes.*[22]*"*

The Court of Appeal's decision was upheld by the Supreme Court of Canada. In the latter court's decision, Pigeon J. stated:

> *"'Accident' covers ... any unlooked for mishap or untoward event which is not expected or designed or any unexpected personal injury resulting from any unlooked for mishap or occurrence. The test of what is unexpected is whether the ordinary reasonable man would not have expected the occurrence, it being irrelevant that a person with expert knowledge, for example of medicine, would have regarded it as inevitable.*[23]*"*

These extracts highlight two principles. First, the term "accident" will be examined from the point of view of the average person, not an expert in the field of insurance or law. This is consistent with the principle that the court must give a policy a meaning that meets the reasonable expectations of the insured. Second, the court will not look at whether the act was deliberate but whether the result was expected. In this case, the Courts found the supplier knew there was a risk of collapse but did not expect it to happen.

In the *Walkem Machinery* case, the supplier knew there was a risk of collapse but did not expect it to happen. However, if an insured person goes further, and deliberately courts the risk of damage, the loss will not be considered accidental and will fall outside coverage[24].

It is widely accepted by the courts that faulty work or design does not itself qualify as an accident, although resulting damage to other property may qualify. In *Harbour Machine Ltd. v. Guardian Insurance Co. of Canada,*[25] the British Columbia Court of Appeal ruled that faulty installation of new engines and propellers did not constitute an accident so as to trigger

[21] [1973] 5 W.W.R. 212 (B.C.C.A.), upheld [1975] 5 W.W.R. 510 (S.C.C.).
[22] *Ibid* at para. 26.
[23] [1975] 5 W.W.R. 510 (S.C.C.) at p. 514.
[24] See *Candler v. London & Lancashhire Guarantee & Accident Co. of Canada* [1663] I.L.R. para 1-110 (Ont. H.C.).
[25] (1985), 60 BCLR 360 (BCCA).

insurance coverage for the repair cost. In *Supercrete Precast Ltd. v. Kansa General Insurance Co.*,[26] the British Columbia Supreme Court found there was no accident within the meaning of an insurance policy when a contractor failed to properly tension the cables serving as an anchoring system during bridge construction and the only loss was the cost of fixing the problem.

Risks Insured - Direct Physical Loss

"All Risk" policies cover all risks unless they fall outside of the meaning of "occurrence" in the insuring agreements or are otherwise removed from coverage by the exclusions. Examples of typical risks covered by a Builder's Risk policy include[27]:

- Fire
- Lightning
- Explosion
- Impact by aircraft or vehicles
- Riot, vandalism and malicious acts
- Windstorm, hail and rain
- Burglary and theft
- Collapse
- Subsidence

This is a list of things that may cause a loss. The insuring agreement also requires there be a "direct" connection between the cause and the loss and requires the loss be a "physical" loss. "Direct" means a loss that was a proximate cause of the insured peril[28]. For example, say there was a fire which damaged the project. The question to determine proximate cause would be whether the loss was the reasonable and probable consequence, directly and naturally, of the fire. If there was an intervening act which caused the damage then the fire would not be the proximate cause. "Physical loss" only relates to actual physical damage[29]. Both these requirements are in place to ensure the insurer pays only the costs of repairing or replacing the loss or damaged item and is not obliged to pay for indirect or purely economic losses such as loss of income or financial penalties resulting from the physical damage.

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[26] 45 CCLI 248 (BCSC).
[27] Bicknell, *supra* note 6 at p. 2.1.2.
[28] *Filkow v. Gore Mutual Insurance Co. et. al.* (1965) 55 D.L.R. (2d) 258 (Man. C.A.) and see *Vanguard Realty Ltd. v. Royal & Sun Alliance Insurance Co. of Canada* 2002 BCSC 1426.
[29] *British Columbia Buildings Corp. v. Reed Stenhouse Ltd.* [1989] B.C.J. No. 391 (S.C.) – an economic loss is not a "direct physical loss".

Loss Occurring While the Policy is In Effect

The final significant requirement of the insuring agreement is that the loss happen while the policy is in effect. Determining this is not as simple as it seems.

A number of theories have been adopted by the Courts to determine if loss or damage occurred during the time the policy was in effect. The most notable of these are the

- "exposure" theory – coverage is triggered by the first exposure to the condition causing the loss or damage;
- the "manifestation" theory – the coverage is triggered when the damage first becomes noticeable;
- the "injury-in-fact" theory – coverage is triggered when the damage first occurs, whether or not it was noticeable at the time; and
- and the "continuous trigger" theory – coverage is triggered throughout the period from first exposure through to the time it was noticed.

No one theory has been definitively accepted by the Courts but the "injury-in-fact" theory may be coming to the fore in British Columbia[30].

As previously stated, the onus is on the insured to prove on a balance of probabilities that it has suffered a loss and that such a loss falls within the scope of the insuring agreement.

EXCLUSIONS

Once an insured has proven that a loss falls within the insuring agreement, the onus shifts to the insurer to prove the loss falls into one of the policy's exclusions[31].

An exclusion is basically a clause that serves to eliminate coverage that might otherwise exist. With "all risk" policies, a loss falling outside the exclusion clauses is usually covered. Remember, however, that the loss must still fall within the coverage provided by the insuring agreement. If the loss does not come within the insuring agreement, there is no coverage whether or not any exclusions apply.

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[30] It is trite law that in order to recover under the policy the loss must have occurred during the coverage period. However determining this may not be as simple as it seems. Accordingly, a number of theories have been adopted by the Courts to determine if the loss or damage occurred during the time of the policy – most notably the manifestation theory, the exposure theory, the injury-in-fact theory and the continuous trigger theory. See *Saskatchewan v. Fireman's Fund Insurance Co. of Canada* [1997] S.J. No. 642 (C.A.) where the Court rejected the manifestation theory but note *Corp. of Dawson Creek*, *supra* where the Court distinguished the ruling in *Saskatchewan*, *supra* and held that the loss occurred on the date the roof actually collapsed (injury-in-fact).

[31] For examples of this application see *Triple Five Corp. v. Simcoe & Erie Group* [1994] A.J. No. 760 (Alta. Q.B.), affirmed [1997] A.J. No. 248 (Alta. C.A.), leave to appeal dismissed [1997] S.C.C.A. No. 263 and *Canadian National Railway*, *supra* note 8. Also see *Reid Crowther & Partners Ltd. v. Simcoe & Erie General Insurance Co.* [1993] 1 S.C.R. 252 for the proper approach in determining coverage and interpreting the provisions of the policy.

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Based on the principles of insurance contract interpretation, the Courts must construe the insuring agreements broadly and exclusion clauses narrowly. Even where an exclusion clause may be clear and ambiguous, it will not be applied where: (1) it is inconsistent with the main purpose of the insurance coverage and where the result would be to virtually nullify the coverage provided by the policy; and (2) where to apply it would be contrary to the reasonable expectations of the ordinary person as to the coverage purchased[32].

Note that the Courts have held that where loss or damage caused by a peril is excluded then that peril itself is deemed to be excluded under the policy[33].

Excluded Property

Like the insuring agreements, exclusions are split into those dealing with types of property and those dealing with types of risk.

The property exclusions in a typical Builder's Risk policy might look like this:

> PROPERTY EXCLUDED: This Form does not insure loss of or damage to,
>
> (a) property,
>
> (i) while waterborne, from the commencement of loading until completion of discharge except while on a ferry, railway car or transfer barge, all in connection with land transportation;
>
> (ii) while insured under an Ocean Cargo Policy;
>
> (iii) while aboard or being transported by any aircraft;
>
> (b) contractor's tools and equipment including spare parts and accessories whether owned, loaned, hired or leased other than property specified in Clause 1(b);
>
> (c) money, books of account, securities for money, evidences of debt or title, automobiles, tractors, and other motor vehicles, aircraft or watercraft.

Remember it is important to review the policy and determine what items are excluded. This is to ensure that there are no unexpected coverage gaps. Where coverage gaps exist, endorsements or other insurance policies can sometimes be obtained by the insured to ensure additional coverage.

Excluded Risks

The major risks usually excluded under "all risk" policies are,

- faulty design, material or workmanship;
- latent defect;

[32] *Weston Ornamental Iron Works Limited v. The Continental Insurance Co.* [1981] I.L.R. 477 (Ont. C.A.) and *Algonquin Power v. Chubb Insurance Co. of Canada* [2003] O.J. No. 2019 (Ont. Sup. Ct.).
[33] Per *Triple Five Corp., supra* note 31 and *Canadian National Railway, supra* note 8.

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- inherent vice;
- breakdown or derangement; and
- wear and tear.

Each of these will be discussed below.

Faulty Design, Material, or Workmanship

A typical Builder's Risk exclusion for faulty design, material and workmanship looks like this:

> This Form does not insure:
>
> (a) the cost of making good
>
> (i) faulty or improper material;
>
> (ii) faulty or improper workmanship;
>
> (iii) faulty or improper design;
>
> provided, however, to the extent otherwise insured and not otherwise excluded under this Form, resultant damage to the property shall be insured.

A Builder's Risk policy is not a product warranty. The insurer has no desire to cover faulty design, material and workmanship because doing so would provide the builder with no incentive to do a good job in the first place. The insurer does, however, cover resultant damage to the property. As such, the main issues that arise in considering this exclusion clause are:

1. Was the loss or damage caused by workmanship, material or design?
2. If so, was the workmanship, material or design that caused the damage "faulty" or "improper"?
3. Does the loss or damage fall under the "resultant damage" exception?

As will be seen, separating the excluded faulty material, workmanship and design from the covered resultant damage can be difficult.

Faulty material and workmanship are relatively easy to understand. It does not appear to matter whether there was any negligence involved in producing the material or doing the work. The only concern is that the material or workmanship caused the product to fail within its normal operating limits. In *Pentagon Construction (1969), Co. v. U.S. Fidelity & Guaranty Co.*,[34] a water tank under construction collapsed because the subcontractors failed to weld steel support beams in place before testing the tank. The architect had not directed in the plans or specifications that the beams should be welded before testing and so the insured contractor argued there was no specific act of worker negligence that would bring the faulty workmanship

[34] [1977] 4 W.W.R. 351 (B.C.C.A.).

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exclusion into play. The British Columbia Court of Appeal rejected the suggestion it was necessary to show that some specific act or acts of a tradesperson were faulty or improper before a loss could be considered the result of faulty workmanship. Robertson J.A. stated:

> *"The workmanship referred to comprehended as well the combination, or conglomeration, of all the skills that were directed to the building of the tank.*
>
> …
>
> *The achievement of the result called for by the Contract required a number of steps to be taken in a particular sequence; failure to take them in that sequence could constitute faulty or improper workmanship; all too obviously it did so here. It is of no consequence why the proper sequence was not observed, or what individual was to blame for the failure to observe it, or whether he was employed by Pentagon, or that one cannot fix the blame on any particular person. Whatever the reason for it may have been, there was improper workmanship and it caused the damage to the tank."*

It has become evident through a series of judgments that the Courts will deny coverage under the faulty workmanship exclusion in a wide variety of circumstances[35], not merely in situations were there is a finding of negligence on behalf of the workers.

In considering the scope of "faulty design", the term "design" has been considered by the Courts to fall into the overall scheme of the construction project as follows:

> *"The courts have long distinguished between the workmanship involved in the construction of an object and the design of that object. The former term is generally restricted to the physical construction of the object, while the latter as discussed above, encompasses the mental concept and its translation into plans and specifications[36]."*

Similar to the requirements for faulty workmanship and materials, faulty design does not require negligence. In the Australian case, *Queensland Government Railway v. Manufacturers' Mutual Ins. Ltd.*[37], a flood destroyed three piers in a riverbed. The court found that the flood was greater than any previously experienced and ruled the pier designers had not been negligent. The judge writing for the majority stated at p. 217,

> *To design something that will not work simply because at the time of its designing insufficient is known about the problems involved and their solution to achieve a successful outcome is a common enough instance of faulty design. The distinction which is relevant is that between "faulty" i.e. defective, design and design free from defect … The exclusion is not against loss from "negligently*

[35] See *Mr. Elegant Ltd. v. Cdn. General Ins. So.* (1988) 31 C.C.L.I. 243 (N.B.C.A.), *Lake v. Commercial Union Ass. Co.* (1990) 72 D.L.R. (4th) 239 (Ont. H.C.) and *Greene v. Canadian General Ins. Co.* (1991) 46 C.L.R. 290 (Nfld. T.D.) or alternatively see *Bird Construction Co. v. United States Fire Insurance Co.* [1985] S.J. No. 902 (C.A.) where it was held that the damage did not fall under the exclusion.
[36] *Maclab Enterprises Ltd. v. Commonwealth Insurance Co.* [1983] A.J. No. 777 (Alta. Q.B.) at para. 12.
[37] (1969), 1 Lloyds Rep. 214 (Aust. H.C.).

> *designing"; it is against loss from "faulty design", and the latter is more comprehensive than the former.*[38]

In the *Foundation* case [39] Mr. Justice Wilson highlighted the difference between faulty design and negligent design when he said,

> *"The departure from the test of negligence as a prerequisite for faulty or more particularly defective design makes sense and I accept it … The onus is, however, upon the insurer to prove that the exclusion applies … All foreseeable risks must be taken into account in a design. It is not a test of "reasonably foreseeable risks" applicable in the law of negligence."*[40]

In *Algonquin Power*, Justice Lang stated,[41]

> *"Foundation stands for the principle that an insurer cannot rely on a faulty design exclusion where the causative event was not foreseeable. The insured or the project designer must do more than simply consider* ***reasonably*** *foreseeable risks and must go further to consider* ***all*** *foreseeable risks. As a result, a designer may not have been professionally negligent in the design because all reasonably foreseeable risks were considered, however, if the designer failed to consider all foreseeable risks coverage will not be provided."*[42]

This rationale was echoed by the Court in *Canadian National Railway,*[43] where it canvassed the three separate standards developed in the case authority which have been applied in determining whether the loss results from "faulty" or "defective" design.

1. Prima facie standard - If a product does not perform or fulfil the purpose for which it was designed, the design will be held to be faulty regardless of whether there was any failure to meet standards of a profession or any negligence on the part of the designer

2. The reasonably foreseeable or negligence standard - The product must be able to function for it's intended purpose after accounting for all reasonably foreseeable risks.

3. The "all foreseeable risks" standard - The product must be able to function for its intended purpose after accounting for all foreseeable risks not just those risks which would be reasonably foreseeable.

The Court concluded that the standard as it stood in Ontario fell under the third heading. Accordingly, the standard to be applied to determine whether a design was faulty or improper

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[38] *Queensland, supra* – note 37 at page 217.
[39] *Foundation Company of Canada Ltd. v. American Home Assurance Company (1995),* O.R. (3d) 36 (Gen. Div.) aff'd 71 A.C.W.S. (3d) 957 (C.A.).
[40] *Ibid* p. 97.
[41] *Algonquin Power v. Chubb Insurance of Canada (2003)* O.J. No. 2019 (Ont. Sup. Ct.).
[42] *Ibid*.
[43] *Supra* note 8.

was that the insured property must be designed so that it accommodates all foreseeable risks, even though such risks may be unlikely and remote.

The Resultant Damage Exception

> *"Resultant damage is damage to some part of the insured property other than the part of the property that was faultily designed."*[44]

Clauses excluding liability for faulty or improper workmanship, material or design normally provide that such exclusions do not apply to "resultant damage" to the property. Interpreting this "resultant damage" exception is far more difficult than understanding what constitutes faulty material, workmanship or design. How do we distinguish between the excluded faulty material, workmanship and design on the one hand and resultant damage to the property on the other? This is easy when the faulty item and the damaged item are physically separate and one is not essential to the function of the other. For example, if the wall of one building collapsed onto that of another, it is not too difficult to understand the cost of fixing the faulty collapsing wall would be excluded while the cost of fixing the receiving wall would be covered as resultant damage. What if, however, one part of a structure damages another part of the same structure?

The courts will first look at the scope of work for the supplier, contractor or designer providing the faulty item. For example, was the contractor hired to work on the entire structure or only a part of it? If the contractor was retained to work on only part of the structure and his or her fault causes damage to parts of the structure outside the scope of work, the resulting damage exception may apply.[45]

If the contractor is working on the entire structure, the exception will only apply if the faulty item is not integral to the damaged portions of the project. In such cases, though, the scope of coverage may only pertain to a small portion of the overall loss[46]. In *Triple Five Corp., supra*[47] excessively wide roller coaster tracks caused the cars to go off the track, resulting in damage to the cars, the tracks, and the track superstructure. The court ruled that the defective tracks were part of the entire roller coaster and so the cars, tracks, and superstructure were all excluded from coverage. The only covered resultant damage was to the walls of the mall that housed the roller coaster.

However, a B.C. court has suggested that a temporary service function between the faulty and damaged items is not enough to exclude both. In *British Columbia v. Royal Insurance Co. of Canada*[48], the insured plaintiff's project involved reconstruction of a road interchange and diversion of a creek. The plan called for temporary upstream interception and diversion of the creek. The diversion pipe failed because it was not adequate for the water flow and the creek bed was damaged. The plaintiff claimed for the cost of restoring the bed but not the faulty

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[44] *British Columbia v. Royal Insurance Co. of Canada*, [1992] I.L.R. 1-2816 (B.C.C.A.) at p. 1761.
[45] *Southwest Tank and Treater Manufacturing Company v. Mid-Continent Casualty Company*, 2003 U.S. Dist. LEXIS 1724.
[46] But see *Canada National Railway, supra* note 8 where the Court found a number of heads of damage fell within the resultant damage exception – at paras. 98 and 99.
[47] *Supra* note 31.
[48] *Supra* note 44.

diversion pipe. The insurer resisted on the grounds that the creek bed was not resultant damage but was instead part of the faulty design. The court ruled otherwise, saying the diversion system was not integral to the work under construction. It was a necessary but conceptually separate device. It was designed separately and did not have any permanent function.

Some insurers have tried to mitigate the effect of cases like *Triple Five Corp.*, by refining the policies to exclude only the cost of fixing the faulty material workmanship and design itself, whether or not other damaged parts of the project have an integral connection to the faulty component. Sometimes, policies incorporate wording that states only the "particular part" of the property found to be faulty or defective in material, workmanship or design. However, several cases have shown that even this wording may not be sufficient to bring damage to other parts of the project within the exception[49].

Latent Defect

A latent defect is a flaw in the original composition of a material or at least as it was acquired by the insured party. This means a latent defect exclusion does not attach to any defect created afterward. In addition, a latent defect is *"one that could not be discovered on such an examination as a reasonably skilled person would make."*[50] The purpose of this exclusion is to ensure that the insurer does not become a guarantor of the quality or fitness of the insured's property.

There is some difference in the case law as to whether a latent defect can result from faulty design or construction. In the Alberta case of *Triple Five Corp.*[51], the Court ruled that a design error could lead to an inherent vice or latent defect. However, in *Corp. of Dawson Creek, supra*[52], the Court of Appeal agreed with the trial judge who ruled that "latent defect" was limited in scope to any defects in the materials used for construction and did not include matters of design or construction.

Inherent Vice

Inherent vice is a problem which is necessarily part of the property rather than being the result of some negligent act or omission. That is the loss is brought about by internal decomposition or some quality inherent in the property which brings about its own loss or destruction[53].

> *"The peril of inherent vice has also been described by the courts as a situation where the cause of the loss to the insured property was something which was*

[49] See these cases involving liability policies: *Alverson v. Northwestern National Cas. Co.*,559 N.W. 2d 234 (S.D. 1997) and *Continental Stress Relieving Services Ltd. v. CGU Insurance Co. of Canada*, [2002] A.J. No. 1322 (Q.B.), aff'd [2004] ABQB 943. However, see also *Economy Lumber v. Ins. Co. of North America*, 204 Cal. Rptr. 135 (Ct. App. 1984).
[50] *Prudent Tankers Ltd. v. Dominion Insurance Co. (The "Caribbean Sea")* [1980] Lloyd's Rep. 338 (Eng. Q.B.), quoted and applied in *Triple Five Corp., supra* note 31 at para. 212.
[51] *Supra* note 31.
[52] *Supra* note 20. Also see *Maclab Enterprises Ltd., supra* note 36.
[53] *Essex House v. St. Paul Fire & Marine Insurance Co.* 404 F. Supp. 978 (S.D. Ohio 1975). note that per *Corp. of Dawson Creek, supra* note 20, inherent vice has a more limited scope under the Canadian authorities than the U.S. authorities.

> *necessarily incidental to the property itself rather than being occasioned by an adventitious cause or as something inherent in the insured property which causes it to be damaged when it is exposed to normal conditions.*[54]"

This distinction between an internal and external cause was first described in *Brown Fraser & Co. v. Indemnity Marine Assurance Co.*[55], a case involving a boom crane which collapsed due to the failure of the insured's employees to install two steel pins. The Court rejected the application of the inherent vice exclusion saying:

> *"The expression 'inherent vice' has been held to mean that which is necessarily incidental to the property rather than occasioned by an adventitious cause."*[56]

An example of an inherent vice claim was demonstrated in *Nelson Marketing International Inc. v. Royal & Sun Alliance Insurance Company of Canada*[57]. There the plaintiff claimed damages under its insurance policy for shipments of laminated boards sent from Malaysia to California which arrived with water stains, cracks and delaminated sections. The defendant argued that the wood shipped had a high shrinkage rate. In order to combat this it was fire dried in a kiln but the facts showed that the wood still had not been dried to an appropriate level. Accordingly, the defendant claimed that the hot temperature in the hold of the transport ships caused the wood to release water which then caused the wood to shrink and subsequently crack. The released water was subsequently kept in contact with the surface of the boards since the wood was wrapped in plastic sheeting. This combined with a defective application of the laminant glue caused water stains and delamination. As such, the defendant relied on the wood's moisture content and high shrinkage rate as an inherent vice contained within the product itself as the source of the loss. The Court however found in favour of the plaintiff's theory, outside water contamination and external factors, and held that the loss did not fall within the inherent vice exclusion.

This exclusion merely restates the need for the insured to show that the loss itself was caused by an external factor[58]. Where the property itself contains its own "seeds for destruction" then it may be excluded from coverage when a loss occurs.

<u>Mechanical Breakdown or Derangement</u>

> *"One meaning of mechanical breakdown is that it is a functional defect in moving parts or even in non-moving parts of machinery causing the machinery to operate improperly or cease operating; a failure in the working mechanism of a machine.*[59]"

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[54] *Canadian National Railway, supra* note 8 at para. 58.
[55] (1958), 27 W.W.R. 31 (B.C.C.A.).
[56] *Brown Fraser, supra* at p. 34.
[57] 2005 BCSC 772.
[58] note the onus is on the insurer to prove that the exclusion applies once the insured had demonstrated that the loss falls under the policy. Per *Canadian National Railway, supra* note 8 the insurer's position must be supported by evidence and not by mere implication.
[59] *Triple Five Corp., supra* note 31, – Wilson J. (trial judgment) at para. 206.

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Where the loss has been caused directly or indirectly by mechanical or electrical breakdown or derangement (a disturbance of the normal state, operation or functioning of the object[60]) then these exclusion clauses may serve to deny coverage. Note that just because the object does not function does not mean that this equates to mechanical breakdown or derangement within the ambit of these exclusion clauses. Similar to the exclusions of latent defect and inherent vice, these exclusions will only operate where the failure or loss was due to a reason internal to the object itself rather than from any external cause. An example of a mechanical breakdown could include a situation such as where a boom fell due to the breaking of its mounting bolts[61].

Conversely, say for example a worker failed to check the oil in a machine or failed to add oil and the machine seized up. This would cause a mechanical breakdown of the machine but the cause would be external as it was a result of the negligent operation of the machine by the worker. Accordingly in such a situation these clauses would not come into effect. Similarly, the Courts have held that these exclusions will also not apply in other situations where external factors governed, such as where the failure was due to negligent assembly by the insured's employees or was due to overloading[62]. In *Brown Fraser, supra*[63], the judge writing for the majority of the British Columbia Court of Appeal explained this rationale as follows:

> *"Mechanical breakdown, it seems to me, must be interpreted in the circumstances of this case and in its context as a failure in operation due to some mechanical defect in some part or parts of the equipment when properly assembled to constitute a crane. Here the failure to operate was due to negligence in assembling the machine so that it could function as an operating unit. In other words, there was a failure to function, not due to any mechanical defect, but due to a failure to insert a part or parts in the machine which ought to have been inserted to make it a complete operating unit. Without these parts the machine could not function. It was the absence of these necessary parts that caused the boom to fail. There was an operating failure not due to any mechanical defect but to negligence.*[64]"

Wear and Tear

Wear and tear refers to natural events likely to occur because of the inherent nature of the property. In a 1973 American case, *Cyclops Corp. v. Home Insurance Co.*[65], the judge stated:

> *"[C]onstruing the words "wear and tear" in their everyday common usage, we are convinced that the words "wear and tear" mean simply and solely that ordinary and natural deterioration or abrasion which an object experiences by its expected contacts between its component parts and outside objects during the period of its natural life expectancy."*

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[60] See *Cominco v. Commonwealth Ins. Co.* [1985] B.C.J. No. 174 (S.C.).
[61] See *Aable Crane & Trucking Limited v. The Canadian Surety Company* [1979] N.S.J. No. 614 (S.C.).
[62] See *Weldland Crane Rentals Ltd. v. Casualty Company of Canada* [1978] O.J. No. 1063 (Ont. H.C.).
[63] *Supra* note 55.
[64] *Brown Fraser, supra* note 55 at p. 35 but note *Triple Five Corp., supra* note 31 where it was held that design error could be and was encompassed in this exclusion.
[65] 352 F. Supp. 931 (W.D.Pa. 1973).

Wear and tear is not the result of faulty materials, workmanship or design. In *Edmonton (City) v. Protection Mutual Insurance Co.*[66], a turbine unit was damaged by high cycle fatigue, crack initiation and propagation under the influence of high means stress, and "fretting" (a wear phenomenon) caused by faulty design. In the relevant insurance policy, the word "accident" did not include "depletion, deterioration, corrosion, or erosion of materials or wear and tear". The Court held:

> *""Wear and tear" seems to me to refer to a gradual wear process related to the normal concept of "fretting", not the design-instigated problems that were in the machine from the beginning.*[67]*"*

Concurrent Causes

In many cases, a loss may be the result of more than one event where the sum of the events contributed to the loss but the events themselves did not necessarily start at the same time. This presents a problem when one or more of the causes are within the scope of the policy's coverage but the others are excluded. A question then arises as to whether the loss or damage is covered where the policy excludes only some of the multiple causes while the other causes fall under coverage.

The courts used to resolve this by looking for the dominant or "proximate" cause of the loss and determining whether or not it was covered. This approach was rejected in *Derksen v. 539938 Ontario Ltd.*,[68] a Supreme Court of Canada case involving a dispute between auto liability and general liability insurers. In the *Derksen* case, a contractor's employee loaded a steel plate onto the contractor's truck. He failed to properly secure the plate and it fell off while he was driving the truck down a highway. The plate flew through a school bus windshield, killing one child and injuring others. A dispute later erupted between the contractor's insurers over whether the dominant cause of the loss was (1) negligence on the work site which would attract coverage under the general liability policy or (2) negligent operation of a motor vehicle which would be covered under the auto policy.

The Supreme Court departed from the previous pattern of searching for a dominant cause. Mr. Justice Major, writing for the majority, stated:

> *"I decline to adopt the presumption that where there are concurrent causes, all coverage is ousted if one of the concurrent causes is an excluded peril. If an insurer wishes to oust coverage in all cases where covered perils operate concurrently with excluded perils, all it has to do is expressly state it in the insurance policy.*[69]*"*

The Supreme Court ruled that there were two contributing causes to the loss and there was coverage under both policies. In this case, each cause of the accident was covered under one

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[66] (1997), 42 C.C.L.I. (2d) 166 (Alta Q.B.), aff'd. 5 C.C.L.I. (3d) 268 (C.A.)., leave to appeal to S.C.C. refused 213 W.A.C. 400*n*.
[67] *Ibid* at para. 194.
[68] (2001), 205 D.L.R. (4th) 1 (S.C.C.).
[69] *Derksen*, *supra* note 55 at para. 48.

policy or the other. The Supreme Court did not expressly state what would happen if there were multiple causes, some of which were outside any coverage, however, the following passage from the case suggests full coverage would be granted:

> *"[T]here is no compelling reason to favour exclusion of coverage where there are two concurrent causes, one of which is excluded from coverage. A presumption that coverage is excluded is inconsistent with the well established principle in Canadian jurisprudence that exclusion clauses in insurance policies are to be interpreted narrowly and generally in favour of the insured in case of ambiguity in the wording* (contra proferentum)."[70]

In *B&B Optical Management Ltd. v. Bast*[71], damage was caused to the insured's electrical equipment because an electrical contractor had negligently mis-matched voltage in certain connections. The policy excluded damage to "electrical devices, appliances or wiring caused by artificially generated electrical currents". The Court ruled there were two causes of the loss, one of which (electricity) was excluded, the other of which (contractor's negligence) was not. In reaching its decision, the Court applied the principles from *Derksen, supra* and noted that there was *"no indication that concurrent perils were considered by the insurance company in drafting this exclusion clause. There is no mention in the policy of concurrent perils at all"*. Accordingly, since the insurer had not expressly provided for the exclusion of the concurrent perils, coverage was enforced.

What are the magic words necessary to exclude coverage in multiple cause situations? Is the phrase "directly or indirectly" within the exclusion good enough? Note that in *Derksen, supra* the Supreme Court of Canada referred to language along the following lines:

> *"We do not insure for such loss regardless of the cause of the excluded event, other causes of the loss, or whether other causes acted concurrently or in any sequence with the excluded event to produce the loss.*[72]"

Accordingly, in order to exclude coverage in multiple causation situations, the insurer may wish to consider inserting an exclusion clause such as the following:

> In this section of the policy, the words "caused by" mean "directly, indirectly or in any way caused by or resulting from" and exclude coverage for the specified loss or damage regardless of whether other causes, covered or not, acted concurrently or in any sequence to produce the loss.[73]

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[70] *Derksen, supra* note 55 at para. 46.
[71] 2003 SKQB 242.
[72] *Derksen, supra* at para. 47.
[73] note *Jordan v. CGU and Uegama* 2004 BCSC 402 where the exclusion clause was clearly worded and provided that there was no coverage for certain types of loss regardless of how that loss was caused.