

RISKY BUSINESS: SCC BROADENS THE SCOPE OF PROPERTY INSURANCE COVERAGE

By the slimmest of margins, the Supreme Court of Canada has broadened the scope of property insurance coverage in its most recent decision, *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada*.¹ In a 4-3 decision, the majority of the Court found in favour of the Canadian National Railway Co. (“CNR”) and adopted a narrow interpretation of the “faulty or improper design” exclusion common in many all-risks policies.

In the early 1990s, CNR established an intricate and sophisticated process to design and construct a customized tunnel boring machine (“TBM”), the purpose of which was to drill a tunnel under the St. Clair River between Sarnia, Ontario and Port Huron, Michigan. The TBM was a massive piece of machinery; the largest TBM of its kind in the world. To design and construct such an engineering marvel, CNR retained Lovat Tunnel Equipment Inc. (“Lovat”), an experienced tunnel equipment manufacturer. Lovat enlisted the services of Wardrop Engineering Inc. and, together, the three parties developed a state of the art TBM.

Despite all precautions, there was an inevitable inherent risk in developing such a innovative machine. In recognition of that risk, CNR purchased an all-risks insurance policy which insured “all risks of direct physical loss or damage...to all real and personal property

of every kind and quality including but not limited to the [TBM]” (the “Policy”). The Policy did not insure “the cost of making good...faulty or improper design”.

In November 1993, the TBM began boring the tunnel under the St. Clair River. Approximately two months later, after digging only 14 percent of the route, the TBM sustained significant damage and operations were halted. It was discovered that dirt had entered the main bearing chamber of the TBM causing over \$20,000,000.00 in repairs and economic losses. CNR sought indemnity under the Policy and Royal and Sun Alliance Insurance Co. of Canada (“Royal”) denied coverage based upon the aforementioned “faulty or improper design” exclusion.

At trial, Ground J. of the Ontario Superior Court of Justice found in favour of CNR and held that the loss fell within the coverage and was not excluded in the circumstances of the case. This decision was overturned on appeal, with Lang J.A. dissenting. CNR then appealed to the Supreme Court of Canada.

The central issue before the Supreme Court of Canada was the interpretation of the “faulty or improper design” exclusion within the context of an all-risks insurance policy and whether the design of the TBM fell within that exclusionary clause.

In the present circumstances, CNR acknowledged that it had foreseen the risk that dirt may enter the main bearing chamber of the TBM, but argued that it took its design to the boundaries of engineering knowledge.

¹ [2008] S.C.J. No. 67.

Even if it failed, such a design should not be considered “faulty or improper”. Royal, however, maintained that failure itself was *prima facie* evidence that the design was “faulty”.

In finding in favour of CNR, and allowing the appeal, Binnie J., for the majority, found that, “the policy did not exclude all loss attributable to ‘the design’, but only loss attributable to a ‘faulty or improper design’”.² The term “faulty or improper design” implied a comparative standard and that the appropriate standard was the state of the art. “A design is not faulty or improper simply because it does not meet a standard of perfection in relation to all foreseeable risks...If [Royal] wished to negotiate an exclusion of costs associated with simple ‘design failure’ or ‘design failure in conditions of foreseeable risk’, it was open to them to have tried to do so...but that is not the wording of the policy...[nor should it] be given that effect”.³

Rothstein J. strongly disagreed and would have dismissed the appeal. In writing on behalf of the minority, Rothstein J. stated, “the exclusion requires that the design of a property be fit for its intended purpose...Here, [the TBM] did not achieve its intended purpose because on an inability to cope with expected, foreseeable conditions of its use...This type of risk was excluded from coverage under the “faulty or

improper design” exclusion”.⁴

Further, Rothstein J. found no basis for introducing a comparative standard of the state of the art in the term “faulty or improper design”. In the minority’s opinion, “a comparative standard of the state of the art essentially turns a claim that must have its foundation in contractual terms into a claim in tort or something akin to a tort which is entirely foreign to the contract”.⁵ This was not the intention of the parties.

In the result, the *CNR* decision has likely widened the scope of coverage in all-risks insurance policies involving pioneering design. From a practical perspective, the cost of litigating such claims will increase as it will be necessary to adduce expert evidence as to the state of the art of engineering knowledge in order to establish that the exclusion applies. Whether this will persuade insurers to refuse coverage or increase premiums, is yet to be seen.

For more information on this decision and its impact, please contact Susan E. Remmer (sremmer@parlee.com), or any member of our Insurance Litigation Practice Group.

This legal alert is intended to provide general information concerning developments in the law and is not intended to provide legal advice in respect of any particular situation.

² *Ibid.* at para. 5.

³ *Ibid.* at paras. 51 and 56.

⁴ *Ibid.* at paras. 100 and 108.

⁵ *Ibid.* at para. 111.