

June 12, 2007

“FAULTY OR IMPROPER DESIGN” EXCLUSION IN BUILDERS ALL RISK POLICY



BACKGROUND

The recent decision of the Ontario Court of Appeal in *CN Railway v. Royal Sun Alliance*¹ serves to highlight the differing approaches taken by the BC and Ontario courts in interpreting the “Faulty or Improper Design” Exclusion in a Builders All Risk policy.

The facts of the case are relatively straightforward. CN undertook to construct a tunnel under a river using a highly specialised tunnel boring machine. During the course of boring the tunnel, the machine broke down and was damaged. The damage to the machine delayed construction by some 229 days.

CN held a subscription builders all risk policy which insured for “*all risk of direct physical loss or damage ...to all real and personal property*”, including the machine that was to undertake the boring. CN sought indemnity under the policy and the insurers relied on the exclusion in the policy which exempted coverage for the “*cost of making good...faulty or improper design*”. At trial, the court decided that the exclusion did not apply and the insurers were obligated to pay the claim of CN. The insurers appealed the trial decision. The insurers successfully argued on appeal that the faulty or improper design exclusion applied and the loss was not covered by the policy.

THE RULING

This case is of interest primarily because the Court of Appeal outlined the standard applied for the purpose of determining, in any given case, whether the faulty design of the insured property was established. Three separate standards were considered by the court:

- (i) the “prima facie” standard which contemplates that the fact of the failure of the property in question establishes that the design of the property was flawed;

¹ *Canadian National Railway v. Royal & SunAlliance Insurance Co. of Canada*, 2007 WL 902425 (Ont. C.A.), 2007 CarswellOnt 1706

- (ii) the “reasonable foreseeability” or tort standard which requires an inquiry into whether all reasonably foreseeable risks were taken into account in the preparation of the design; and
- (iii) the “foreseeability” standard which requires that the design in question provide for all foreseeable risks.

In BC, our courts have adopted the “prima facie” standard which is akin to strict liability. That is, in BC, if the property fails to perform as intended then the exclusion is demonstrated. Obviously, the standard in BC is the most favourable from the standpoint of insurers.

However, in this case, the Ontario Court of Appeal adopted the “foreseeability” standard which required proof that all foreseeable risks had been identified and addressed in the design in question. Mere recognition of a foreseeable risk was insufficient. The court stipulated that the foreseeability standard mandated that the relevant design “take into account”, “accommodate”, “provide for” and “withstand” all foreseeable risks. The foreseeability standard is very stringent because it requires that all known and foreseeable risks of failure be addressed in the design. On the facts of this case, it was decided that the design of the boring machine failed to accommodate a foreseeable and foreseen risk and therefore the improper design exclusion applied.

PRACTICAL IMPLICATIONS FOR INSURERS

It is important to recognise that differing standards apply in BC and Ontario with respect to the standard of proof required to invoke the faulty design exclusion. In BC, the standard is the most favourable to insurers relying on the exclusion. In Ontario, the standard required is more stringent and therefore more difficult for insurers to prove. We will continue to follow the case law in BC to determine if the decision in the CN Rail case is adopted in BC.

AUTHOR Lorne P.S. Folick
Direct Line: 604-891-0352 E-mail: lfolick@dolden.com

EDITOR Alex L. Eged
Direct Line: 604-891-0357 E-mail: aeged@dolden.com