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November 26, 2008

"FAULTY DESIGN" EXCLUSION IN BUILDERS ALL RISK POLICY DOES NOT APPLY WHERE DESIGN IS "STATE OF THE ART": *CNR V. ROYAL AND SUN ALLIANCE*. 2008 SCC 66

BACKGROUND

In June, 2007, we reported on the Ontario Court of Appeal decision in *CN Railway v. Royal and Sun Alliance*[1], which highlighted the differing approaches taken by the BC and Ontario courts in interpreting the "Faulty or Improper Design" Exclusion in a Builders All Risk policy.

However, the Supreme Court of Canada has reversed that decision, and held that the exclusion can only apply to claims resulting from design that falls below the "state of the art" in the applicable industry. The mere fact that a product or building fails due to design flaws does not by itself bring the exclusion into play. The Supreme Court has in the process endorsed an analytical approach more favourable to insureds than has historically been used in either Ontario or BC.

The facts of the case are relatively straightforward. CN undertook to construct a tunnel under a river using a massive, 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, causing economic losses.

CN held a subscription builders' all risk policy which insured "*all risk of direct physical loss or damage ...to all real and personal property*", including to the boring machine itself. 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 that the insurers were obliged to pay the claim of CN. The insurers successfully appealed the trial decision, arguing that the faulty or improper design exclusion applied and the loss was *not* covered by the policy.

THE RULING

The Court of Appeal had considered three standards for determining whether faulty design by the insured property was established:

[1] *Canadian National Railway v. Royal & SunAlliance Insurance Co. of Canada*, (2007), 48 C.C.L.I. (4th) 161, 2007 ONCA 209

(i) the "*prima facie*" standard, akin to strict liability, in which the fact that the designed property failed establishes that the design must have been faulty;

(ii) the "foreseeability" standard, in which a design is faulty if it fails to foresee *and* withstand all foreseeable risks; and

(iii) the "reasonable foreseeability" or tort standard, in which a design will *not* be faulty for the purpose of the exclusion if the designer had taken into account all reasonably foreseeable risks; the design need not have withstood those risks.

BC courts have historically adopted the *prima facie* standard – if the property failed to perform as intended then the exclusion applies. Obviously, this standard favours insurers. The Ontario Court of Appeal in this case adopted the "foreseeability" standard, which is only slightly less favourable to insurers. On the facts of this case, it was decided that the boring machine's design failed to accommodate a foreseeable and foreseen risk and therefore the improper design exclusion applied.

However, in a 4-3 decision, the majority of the Supreme Court of Canada held that designs which meet the "state of the art" will avoid the exclusion. The exclusion does not require insureds to guarantee that their designs will not fail; to hold otherwise would reverse the onus on the insurer to demonstrate that the claim is caught by the exclusion. The exclusion only catches *faulty* design, not all designs which fail to perform as expected. In this case, the engineering behind this uniquely complex and vast machine had been of a very high standard, and the exclusion was thus held not to apply, and the insurers were ordered to pay an indemnity of more than $30,000,000.

PRACTICAL IMPLICATIONS FOR INSURERS

This case should standardize the analysis used in each Province to interpret the "faulty design" exclusion, potentially leading to greater interpretive consistency across the country. However, the bar has been raised for insurers wishing to rely on the exclusion. They will have to prove what the "state of the art" standard means in each case, and then demonstrate that the insured fell below that standard.

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