DOLDEN WALLACE FOLICK LLP

INSURE UPDATES SEPTEMBER 2021

Canada's Specialty Insurance Law Firm

IN THIS ISSUE

"2021 Coverage Special"

In the past several months there have been a number of important Court of Appeal rulings from across the country dealing with common coverage issues. This quarter, our newsletter focusses on these decisions and the impact for insurers going forward.

Perhaps "Damage" Means "Damage" After All

By Michael Libby, DWF Vancouver, Email: mlibby@dolden.com

Introduction

Since at least 2015 when the British Columbia Court of Appeal released its decision in *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Company*, 2015 BCCA 347, the concept of "direct physical loss of or damage to the property insured" in a policy of property insurance has been interpreted in B.C. to mean that "physical loss" and "damage" denote an alteration in the appearance, shape, color or other material dimension of the property insured. This interpretation has generally been sufficient to resolve any coverage issues arising over whether or not insured property has sustained direct physical loss or damage.

The degrees of certainty and predictability offered by the *Acciona* decision appeared to fall into a degree of disarray with the onset of COVID-19, and more particularly, the impacts on business caused by various provincial restrictions on business operations that were imposed in attempts to limit the

18th FLOOR – 609 GRANVILLE ST
VANCOUVER, BC. V7Y 1G5
Tel: 604.689.3222
Fax: 604.689.3777
E-mail: info@dolden.com

302-590 KLO RD,
KELOWNA, BC. V1Y 7S2
Tel: 1.855.980.5580
Fax: 604.689.3777
E-mail: info@dolden.com

850 – 355 4th AVE SW
CALGARY, AB. T2P 0H9
Tel: 1.587.480.4000
Fax: 1.587.475.2083
E-mail: info@dolden.com

14th FLOOR –20 ADELAIDE ST E
TORONTO, ON. M5C 2T6
Tel: 1.416.360.8331
Fax: 1.416.360.0146
Toll Free: 1.855.360.8331
E-mail: info@dolden.com

spread of the virus. Numerous businesses - who were forced to shut down or limit their activities in different ways - sought coverage under the business interruption coverages in their property policies. In many of these cases, the coverage assessment turned on the presence or absence of direct physical loss or damage. Of particular relevance to these COVID-19 related claims were questions such as whether a loss of use (resulting from governmental restrictions) or the potential presence of the SARS CoV-2 virus (the virus which causes COVID-19) on insured property could constitute such damage. To date, these questions have not been definitively considered by any Canadian courts.

Earlier this month, however, the B.C. Court of Appeal released a decision which - although not directly addressing COVID-19 related claims - provides further clarity as to the circumstances an insured must show to establish direct physical loss or damage, and give helpful guidance for the assessment of COVID-19 business interruption claims going forward.

Background

The decision in *Prosperity Electric v. Aviva Insurance Company of Canada*, 2021 BCCA 237 arose following a property insurance claim by Prosperity Electric - an electrical and lighting supplies wholesaler. In November 2018, a fire broke out in an adjacent facility. While the fire itself did not spread to the Prosperity property, some of its stock was affected by the entry of smoke and the deposit of soot. Impacted lighting fixtures were found to be functioning properly, and forensic examination revealed that levels of chloride particles deposited onto the fixtures as a result of the fire were low enough so as not to be associated with any increased risk of failure. Put another way, the expert evidence (which was not disputed by Prosperity) was that the fixtures were very likely fully functional and free of hazardous levels of contamination, and could be used. On the basis of that evidence, Aviva concluded that there was no direct physical loss or damage to the fixtures. That decision was challenged, and the trial court upheld Aviva's denial of coverage. Prosperity appealed the trial decision.

The Appeal

Before the Court of Appeal, both parties relied upon *Acciona* in support of their respective positions: Prosperity argued that an increase in the surface concentration of chloride anions was "an alteration in a material dimension". Aviva asserted that the limited increase observed in this case was not such an alteration. The Court sided with Aviva, stating that:

> *"...in referring to a "material dimension" in Acciona, the Court meant only an alteration to a physical parameter. That, however, does not resolve the matter in issue in this case. While the discussion in Acciona is a valuable*

> *starting point for analysis, it must be recognized that the observation I have quoted did not purport to comprehensively or definitively set out the meaning of "damage" in an insurance context. In particular, Acciona did not abandon the well-established principle that "damage" refers to a harmful alteration to the insured property.... If an alteration does not result in a property becoming less functional, aesthetically pleasing, or valuable, it is difficult to understand how the alteration could properly be described as "damage".*

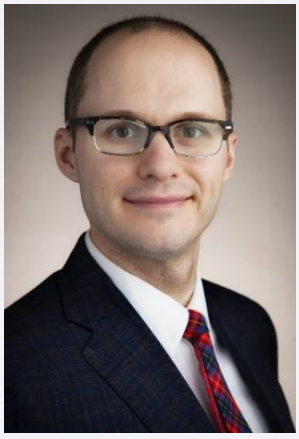
The Court went on to confirm that to constitute "direct physical loss of or damage to" insured property, the alteration to the property in question must be harmful. In this case, the evidence was clear that the deposition of a small amount of chloride on the lighting fixtures did not affect their appearance or function. The plaintiff provided no evidence that the fixtures were diminished in value. Accordingly, the trial judge made no error in finding that Prosperity had failed to show any "physical loss of or damage" to the property as there was no harmful alteration to the fixtures. The denial of coverage was upheld.

Takeaway

While this decision does not directly consider the potential for physical damage arising from the presence of SARS-CoV2, it does confirm that insured property must be shown to have sustained some "harmful" alteration before it will be seen to have sustained "direct physical loss or damage". So while not ultimately determinative of the issue, this case provides some clarity, and significant support in favor of the view that the mere presence of a virus on insured property will not amount to physical loss or damage necessary to engage coverage under most property policies.

Ontario Court of Appeal Overturns Trial Judge in *MDS Inc. v. Factory Mutual Insurance*: Mere Loss of Use Is Not "Resulting Physical Damage"

By Robert Smith, DWF Toronto, Email: rsmith@dolden.com



On September 3, 2021, the Ontario Court of Appeal released a decision that may have a significant impact on the recently-certified Ontario class action lawsuits against insurers for their denials of business interruption claims related to COVID-19.

In *MDS Inc. v. Factory Mutual insurance Company*, 2021 ONCA 594, the Court overturned the trial judge's finding that economic losses stemming from the loss of use of a nuclear reactor fit within the "resulting physical damage" exception to a corrosion exclusion under an all-risks policy. This decision

brings the law in Ontario in line with much of the British and American jurisprudence on whether loss of use constitutes "physical damage".

The facts of the underlying decision are rather complicated. MDS Inc. was a customer of the radioisotopes produced at the Chalk River nuclear facility. A government agency shut down that facility in 2009-2010 to allow the operator to repair a leak caused by corrosion in a component of the reactor. The water from this leak migrated into a J-rod annulus, which is not supposed to contain water. The presence of water in the J-rod caused the shutdown. During the shutdown, MDS could not buy isotopes. MDS therefore submitted a claim under its all-risks policy of insurance for resulting business losses. The insurer denied MDS' claim by relying on a corrosion exclusion in the policy, which itself contained an exception for "physical damage" resulting from corrosion that was not otherwise excluded. MDS commenced a claim against the insurer for coverage under the policy.

The central issues at trial were the interpretation of the corrosion exclusion in the policy and whether MDS' business losses arising from the shutdown of the reactor were payable pursuant to the exception to the exclusion for physical damage caused by corrosion. With respect to the latter issue, which is the one of significance for the business interruption claims stemming from COVID-19, the trial judge found that the leak did not damage the interior of the J-rod annulus and there was no physical damage to the reactor beyond the corrosion in its calandria wall. However, the trial judge held that loss of use of the reactor should be considered "physical damage" because, in her view, the term "physical damage" was ambiguous, an all-risks policy is designed to provide broad coverage, and the loss of use of insured property caused by the leak "would constitute resulting physical damage".

The Court of Appeal overturned the trial judge's decision on the application of the "physical damage" exception to the corrosion exclusion, holding that the exception to the corrosion exclusion for resulting physical damage includes physical damage, but not damage resulting from loss of use. Accordingly, while economic loss may result from physical damage, it is not in and of itself physical damage.

The Court of Appeal overturned this decision on a number of grounds. First, it held that Canadian law has long held that exclusions for physical damage do not include loss of use or pure economic loss unless the policy specifically allows for those. The Court held that where a policy is intended to include not only physical, but economic losses, such policies have specifically defined the term "property damage" to include "loss of use", which was not done in the policy in question. The Court also held that the plain meaning of physical damage did not include economic loss.

Second, the Court noted that appellate courts in the USA and the UK have held that physical damage exceptions to policy exclusions do not include loss of use absent a distinct, demonstrable physical alteration of the insured property. The Court held that such a physical alteration had not occurred and, accordingly, the exception did not apply

Takeaway

It was common during the early days of the COVID-19 Pandemic for counsel for insureds to use the trial judgment in MDS to argue that the loss of use of insured property caused by the presence of COVID-19 constituted physical damage to that property for the purposes of an all-risks business interruption policy. The argument was that "physical damage" may occur when a property is uninhabitable or unusable for its intended purpose, even without a physical alteration. The Court of Appeal's decision removed a significant part of the jurisprudential support for that argument.

We note that the Ontario Superior Court of Justice recently certified a class action lawsuit against a large number of insurers. One of the common issues that will be argued in that lawsuit is whether the presence of COVID-19 constitutes physical damage to property. The Court of Appeal's decision, which clarifies the law in Ontario and aligns it with the law in the UK and the USA, is therefore quite timely and will likely influence the outcome of aspects of that class action lawsuit.

Alternative Histories: The Hypothetical House

By Paul Dawson, DWF Vancouver, Email: pdawson@dolden.com and Ouran Li DWF Vancouver, Email: oli@dolden.com

What is the correct measure of damages, where a broker's negligence leads to a loss of coverage for a fire loss? If the policy provides replacement cost coverage, and the insured would have rebuilt, had his claim not been denied, damages will be awarded on a replacement basis – even though the house was never rebuilt at all.

In *Alvaro v. InsureBC (Lee & Porter) Insurance Services Inc.*, 2021 BCCA 96, the insureds owned a residential rental property. In 2013, they had to evict their tenant, and so decided to renovate before seeking new tenants. Unfortunately, seven weeks later, the house burned down. Even more unfortunately for the insureds, their insurance claim was denied because their insurance policy excluded coverage for property left vacant for more than 30 consecutive days.

The insureds had insured the property with the same broker for many years. As of the last renewal of the policy, the broker knew the property was rented to tenants. The trial judge held that the broker should have anticipated

that rental properties are periodically vacant, and so should have warned the insureds about the 30-day vacancy exclusion. The insureds could then have obtained vacancy coverage if required. The broker failed to warn about the exclusion, was thus liable to the insureds in negligence.

The policy allowed the insured to choose to be indemnified for actual cost value (ACV) or, if the property was rebuilt on the same location with similar materials within a reasonable time, to be reimbursed for replacement cost value (RCV). The policy did *not* require the insurer to fund the reconstruction in advance. At trial, the insureds testified that they would have rebuilt, if the policy would have covered the entire cost of rebuilding. The trial judge interpreted this evidence to mean that they would only have rebuilt if the insurance paid for the work up front, which would not have happened, on the policy's terms. Since the insureds never rebuilt (and by the date of trial, had sold the property), the trial judge only awarded ACV damages.

However, on appeal, the court stated that the fact that the insureds had not rebuilt did not prevent them from claiming RCV damages against the broker; the question was "*what position the insureds would have occupied had they obtained that for which they had bargained.*" The court concluded, based on the evidence at trial, that the insureds *would* have rebuilt, obtaining the necessary financing and then paying it back with the RCV proceeds after the project was done. They were thus entitled to damages from the broker equivalent to the RCV indemnity they would have received from the insurer.

This case demonstrates the subtle difference between calculating the *contractual indemnity* an insured would receive in accordance with policy terms, and assessing *tort damages* resulting from a broker's negligence. In the first case, had their claim not been excluded, the insureds would have had to rebuild within a reasonable time in order to choose RCV indemnity. In the second case, the court had to consider an alternative history, *i.e.*, what would have happened, if the appropriate cover had been in place, and then award damages sufficient to put the insured back in the position it would have been in had the negligence not occurred. If the evidence at trial had proven that the insureds would never have rebuilt, even given an assurance of coverage, they would only have been entitled to ACV.

The facts and reasoning in *Alvaro* are distinguishable from cases where an insured *can't* rebuild solely because of an insurer's wrongful denial of coverage. In such cases, the insured is entitled to defer until after trial its election on whether to claim ACV, or to proceed with reconstruction and so qualify for RCV: *Olynyk v. Advocate General Insurance of Canada*, (1985), 32 Man. R. (2d) 171 (QB); *Caesar's Palace Ltd. v. Elite Ins. Co.* (1987), 22 CCLI 120 (QB). In those cases, the insureds can claim RCV based on what it would cost to rebuild

as of the date of trial. Here, the insureds were awarded damages equal to the RCV that would have been paid had the house been rebuilt promptly (less $295, the amount they would have had to pay to obtain the vacancy coverage).

Takeaway

If insurance brokers provide negligent advice, their liability to the insureds might not be limited to what would have been payable under the policy given the circumstances existing as of the date of trial. The courts will instead consider an alternative history, reconstructing what the parties would have done and what would have happened, had the negligence never occurred.

What Does "Under Construction" Mean? It Depends

By Robert Smith, DWF Toronto, Email: rsmith@dolden.com, and Ouran Li DWF Vancouver, Email: oli@dolden.com

In the recent decision of *Tataryn v Axa Insurance Canada*, 2021 ONCA 413, the Ontario Court of Appeal declined to define what "under construction" means in a homeowner's policy. This commonly-used term is undefined in most policy wordings, which can lead to anomalous results. As this ruling demonstrates, courts take a highly fact-based approach to determining whether a particular situation falls within the "under construction" exclusion.

The Respondent, Tataryn, renovated the second and third floors of her home that was insured under a Homeowners Comprehensive policy with Axa. She did not renovate the first floor, where she continued to reside during the renovations.

Water damage occurred on two occasions during renovations carried out by the Respondent. Axa covered an initial loss due to water damage, but denied coverage for the second loss on the basis of an "under construction" exclusion clause, which read in part:

> *We do not insure loss or damages... [19.] caused by water unless loss or damage resulted from... [(b)] the sudden and accidental escape of water or steam from within a plumbing, heating, sprinkler or air conditioning system or domestic water container, which is located inside your dwelling ... but we do not insure loss or damage [viii.] occurring while the building is under construction, vacant, or unoccupied, even if we have given permission.*

The issue was whether the Respondent's renovations engaged the "under construction" exclusion found in the Policy. The Superior Court judge held that the term "under construction" did not apply to the facts of the case.

Specifically, he held that the term "construction" is defined as "the creation of something new, as opposed to the repair or improvement of something already existing". Therefore, the fact that a house is being worked on by a contractor does not necessarily mean that the house is "under construction". Axa appealed and asked the Court of Appeal to provide guidance on the common law definition of "under construction". The Court of Appeal refused to do so. It agreed with the Superior Court judge's reasoning and held that the question of whether a structure is "under construction" is one of fact that the judge must determine on the basis of all of the evidence. The Court of Appeal declined Axa's invitation to "furnish a definition of 'under construction' that the appellant could have included in its standard form contract".

The Respondent was awarded damages for the water damage.

Takeaway

This case is a reminder to insurers that exclusions will be interpreted narrowly. When courts interpret contracts, including insurance policies, they attempt to give effect to the reasonable interpretations of the parties. In the absence of definitions, the court will assume that the parties intended to make the exclusions narrow. In regards to the term "under construction", courts are likely to continue taking a highly fact-based approach to determining if it is applicable. Insurers may avoid this result by clearly defining the term "under construction" in their policies.

Storm Clouds Ahead: Broad Interpretation of Data Exclusions in Non-Cyber Policies

By Elka Dadmand, DWF Toronto, Email: edadmand@dolden.com

In April 2016, the Family and Children's Services of Lanark, Leeds and Greenville ("FCS") cloud based website was hacked. Hackers took confidential information relating to case files and investigations into 285 people and posted the information to Facebook.

A representative plaintiff commenced a $75 million class action against FCS alleging the leaked information contained defamatory information and that FCS was negligent in securing its website. In turn, FCS commenced a third party negligence claim against the operator of its communication platform, Laridae Communications Inc. ("Laridae").

Co-operators General Insurance Company ("Cooperators") insured FCS and Laridae under a Commercial General Liability Policy ("CGL Policy") and a Professional Liability Policy. Co-operators denied having to defend FCS or Laridae, relying on policy exclusions for claims arising from the distribution

or display of data by means of an internet website. This coverage dispute eventually made its way to the Ontario Court of Appeal and the decision was recently reported (*Family and Children's Services of Lanark, Leeds and Grenville v. Cooperators General Insurance Company*, 2021 ONCA 159).

The Policies' Exclusion and the Court of Appeal Decision

Both the CGL and Professional Liability Policies included similarly worded exclusions for claims arising from the "distribution, or display of 'data' by means of an Internet Website" or "similar device or system designed or intended for electronic communication of 'data'".

Based on the wording of the exclusion, the Court concluded that Co-operators did *not* have a duty to defend either FCS or Laridae.

The Court held that the wording of the exclusion in the Policies was clear and unambiguous, such that the Court need not consider the expectations of the parties in interpreting the exclusion provisions or make recourse to extraneous sources.

The Court further held that the exclusion covered all claims asserted in the proceedings that flowed from "*one chain of causation*", namely the wrongful appropriation and disclosure of confidential information.

Lastly, the denial of coverage did not nullify the policies. The Policies clearly articulated what was, and was not, covered. To hold the parties to its bargain was consistent with the provisions of the policies and the reasonable expectations of the parties.

Takeaway

This recent ruling from the Ontario Court of Appeal suggests a judicial shift towards broad interpretation of cyber-coverage exclusions in non-cyber policies such as Commercial General Liability Policies and Professional Liability Policies. As more businesses continue to develop remote and cloud based applications and processes, the decision reinforces the need to have stand-alone cyber-coverage tailored to business needs.

Intention Remains King When It Comes to the Vacancy Exclusion

By Robert Smith, DWF Toronto, Email: rsmith@dolden.com

In *Gregson v. CAA Insurance.*, 2021 ONSC 3041, the Ontario Superior Court of Justice dealt with the often-litigated boundaries of the "vacancy" exclusion

found in homeowner's policies. In this case, the policy contained an exclusion for damage that occurred to a property that had been left vacant for more than 30 days.

The matter arose when a house sustained water damage due to a pipe burst on March 17, 2017. At that time, the homeowner and policy holder, Ms. Gregson, had not lived in the house since the previous October.

Ms. Gregson left her house on October 20, 2016 to be admitted into the hospital because of various infirmaries. She was subsequently transferred to Chartwell Regency Retirement Home and was then re-admitted to hospital in February, April and May 2017. On March 27, 2017, Ms. Gregson was deemed incapable of personal care. Ms. Gregson passed away on September 7, 2019. She never returned to her house after she left in October 2016. Ms. Gregson's power of attorney would visit the house to check the mail and heat, but only on an inconsistent basis. No one was staying overnight in the house. Ms. Gregson and her power of attorney had not advised her insurer of this absence.

Under the policy, the word "vacant" referred to circumstances where, regardless of the presence of furnishings, "all occupants have moved out with no intention of returning and no new occupant has taken up residence." The court noted that the policy definition meant that the property would be vacant if the occupant moved out with no intent to return. The "intention test" was established by the court in the earlier case of *Maracle v. Bay of Quinte Mutual Insurance Co.*, 2010 ONSC 5217 and indicates that a property will be vacant if, objectively in all of the circumstances, the former occupant has moved out and does not intend to return.

The court applied the "intention test" and held that Ms. Gregson had likely lost the mental ability to form an intention to return to her house by the date of the damage and it was unlikely that she could ever return to her house because of her failing health. As a result, the court held that the house had been left vacant for more than 30 days.

Takeaway

This case is a good application of the law related to the vacancy exclusion and reiterates the objective nature of the intention test. The court held that Ms. Gregson could not form an intention to return to her property, regardless of what she may have been saying while she was at the hospital. The court also examined all of the circumstances related to her physical condition to gather further evidence of a lack of objective intent.

EDITOR

Cody Mann
Tel: 604 891 0366
Email: cmann@dolden.com

Please contact the editor if you would like others in your organization to receive this publication.