

## Defining the Scope of the "Faulty or Improper Design" Exclusion in an "All Risks" Policy

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By Michael Teitelbaum

In *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada*<sup>1</sup>, the Supreme Court of Canada divided 4 to 3 on the issue of what standard should be applied in interpreting the "faulty or improper design" exclusion in a builder's "all risks" insurance policy.

### Facts

The dispute arose from the design and construction of, what was in the early 1990's, the world's largest tunnel boring machine ("TBM"). The Canadian National Railway ("CNR") designed the TBM to bore a tunnel under a river. The project was insured pursuant to a builder's "all risks" policy that covered "all risks of direct physical loss or damage... to...[a]ll real and personal property of every kind and quality including the [TBM]"<sup>2</sup>, as well as economic loss occasioned by delay in opening the tunnel.

An experienced tunnel equipment manufacturer was selected to design, engineer and construct the TBM. A significant challenge in the design of the TBM was that it would need to withstand 6,000 metric tonnes of pressure. The main bearing of the TBM had to be protected from contaminants, and a system of 26 independent seals lubricated by constant injection of pressurized grease was designed to prevent the excavated material from getting into the main bearing.

The TBM was built and boring commenced. At completion of 14 percent of the tunnel, contamination was detected. Inspection revealed that some seals were destroyed and that dirt had penetrated. Operations were stopped, the main bearing was cleaned, and modifications were made to strengthen the TBM, after which the project was completed without further com-

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### Firm News

1. [2008] SCC 66.

2. *Ibid.* at para. 2.

## Noteworthy

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plication; however, the delay greatly increased costs.

Experts were unable to explain the precise mechanism of failure since the external conditions had not proven more severe than anticipated. The insurer denied coverage on the basis of the "faulty or improper design" exclusion and at trial the insurers were held liable.

### The Action and Appeal

Justice Ground, the trial judge, found that the failure was due to unforeseeable excess differential deflection<sup>3</sup>, which was not a foreseeable risk; therefore, the "faulty or improper design" exclusion did not apply.

The Ontario Court of Appeal set aside the trial judge's decision by a 2 to 1 majority. Their decision was based largely on the finding that excess differential deflection was a foreseeable risk. Justices Rosenberg and Cronk, speaking for the majority, found the design was faulty because it failed to meet the foreseeability standard, being "the relevant design must 'take into account', 'accommodate', 'provide for', and 'withstand' all

foreseeable risks"<sup>4</sup>, however unlikely or remote.

The standard applied by the trial judge was that the TBM must be designed to withstand all foreseeable risks, whereas the Court of Appeal held that the design must in fact, with the benefit of hindsight, succeed in withstanding all foreseeable risks<sup>5</sup>.

Analysis by the Supreme Court of Canada

The Supreme Court of Canada unanimously agreed that the wording of the "faulty or improper design" exclusion was unambiguous and was negotiated between sophisticated parties and, therefore, the *contra proferentem* rule did not apply<sup>6</sup>. Applying the rule of construction that exclusion clauses are to be interpreted narrowly, the majority held that a narrower interpretation of the exclusion best accorded with the intentions of the parties based on the plain meaning of the words "faulty or improper"<sup>7</sup>.

Justice Binnie, on behalf of the majority, found that the standard that should be applied in interpreting the exclusion was the one set out in *Foundation Co. of*

*Canada Ltd. v. American Home Assurance Co.*<sup>8</sup> The majority observed that the concept of a "faulty or improper design" implies a comparative standard against which the impugned design must fall short.

Justice Binnie agreed with Justice Lang (who dissented in the Court of Appeal), that

"[t]he words "faulty or improper", and in particular the word "improper", require the insurers to establish that the design fell below a "realistic" standard. Such a standard can require no more than that the design comply with the state of the art. A standard of perfection in relation to all foreseeable risks... was not required by the words used by the parties. It was for the insurers to demonstrate that the exclusion applies."<sup>9</sup>

With respect to the standard that should be applied, Justice Binnie stated that what is in issue is a faulty or improper "design", not an "at fault" de-

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3. Excess differential deflection describes the movement away or towards one another of different structures, (e.g., the moving cutting head and static bulkhead) beyond acceptable tolerances, leading to failure.

4. *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada* (2007), 48 C.C.L.I. (4th) 161, 2007 ONCA 209 at para. 62.

5. *Supra* note 1 at para. 23.

6. *Ibid.* at para. 33.

7. *Ibid.* at para. 56.

8. (1995), 25 O.R. (3d) 36 (Gen. Div.).

9. *Ibid.* at para. 53.

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signer.<sup>10</sup> His Honour explained that

"[i]t is quite possible to evaluate the design (as distinguished from the designer) as to whether it met the standard of an ordinary, reasonable, cautious and prudent design, having regard to what could be expected in the circumstances. However, a design that survives a negligence test is not, on that account, of a calibre sufficient to deny the insurers the benefit of the exception. The insurers are entitled to the benefit of the exemption unless the design met the very highest of standards of the day and failure occurred simply because engineering knowledge was inadequate to the task at hand."<sup>11</sup>

By the same token, a "faulty or improper design" is not established by the mere failure "to withstand"<sup>12</sup> all foreseeable risks, nor by the absence of unforeseeable "external" condi-

tions<sup>13</sup>. "[T]he loss may have been caused by the design, but unless the design is shown by the insurers to be 'faulty or improper', [because it failed to meet the "state of the art",] the exclusion does not apply to relieve the insurers of liability"<sup>14</sup>.

**The majority observed that the concept of a "faulty or improper design" implies a comparative standard against which the impugned decision must fall short.**

#### Dissenting Reasons

The Supreme Court of Canada's dissenting reasons were delivered by Justice Rothstein, who did not agree that the term "faulty or improper design" implied the introduction of a "state of the art" standard against which an impugned design should be compared, as held by the majority. His Honour preferred the approach endorsed by the High Court of Australia in *Queensland Government Railways v. Manufacturers' Mutual*

*Insurance, Ltd.*<sup>15</sup> and stated the test should be "whether or not the damage to the insured property was due to an inability of the design to fulfil its purpose in the foreseeable conditions of the property's use".<sup>16</sup> Justice Rothstein was of the view that in this case, the design was unable to cope with the excess differential deflection which was a foreseeable risk and, therefore, the design was faulty.

#### **Comment**

As can be seen, the outcome was far from certain. The views of the Supreme Court of Canada judges in the majority and minority differed honestly but profoundly as to how the exclusion should be interpreted. Illustrative of how close a call this was can be seen by the fact that in both appeals, the courts were divided as to what test should be applied. Taken together, in total, five judges had one view and approach while five judges had another.

The effect of the Supreme Court's decision is that each case will turn on its unique facts and evidence as to whether the

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10. *Supra* note 1 at para. 55.

11. *Ibid.*

12. *Ibid.* at para. 58.

13. *Ibid.* at para. 59.

14. *Ibid.* at para. 31.

15. [1996] 1 *Lloyd's Rep.* 214 (Aust. H.C.)

16. *Supra* note 1 at para. 70.

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design met the "state of the art" standard. The decision also highlights and re-emphasizes the importance of how policies are worded. If courts interpret

the wording used as representing a comparative standard then insurers must consider whether this is satisfactory and something they are prepared to accept, or if they wish to use

different wording, as suggested by the Supreme Court of Canada<sup>17</sup>, recognizing that there can never be absolute certainty in how a court will interpret that wording.

17. Ibid. para. 56.

#### FIRM NEWS

The partners are very pleased to welcome Linda Kiley, Bruce Cook, and Hershel Sahian into the partnership.

We are also pleased to announce that Gail Willoughby, Jason Arcuri, and Elizabeth Wilson have joined the firm as associates in our Toronto office.

On January 22, 2009, we celebrated the "official" opening of our new Hamilton office at an Open House; a fine time was had by all. Many thanks to Jennifer Malchuk for her hard work in organizing the event.

And . . . a special goodbye to Bill McCorrison, who has left the firm and is continuing his mediation practice on his own. We wish Bill well and know that he will continue to have great success as a mediator.

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