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Practice

Lawyers

Resources

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Welcome to the second volume of The Practical Edge on Insurance, Theall Group's newsletter on important developments in insurance law. In this issue, we analyze two recent Ontario Court of Appeal decisions where the Court decided that an insurer was responsible to pay all costs associated with the defence of covered claims even if those costs furthered the defence of uncovered claims, and where the Court rejected a technical definition of "subcontractor". We also review an important decision of the British Columbia Court of Appeal which found that an insurer acted in good faith when it rejected a settlement that would have reduced the insured's uninsured liability. Finally, we consider the Supreme Court of Canada's judgment that narrowly defined the "faulty or improper design" exclusion.

INSIDE THIS ISSUE:

- Page 2.** Insurer Required to Pay Defence Costs of Covered Claims Even if it Furthers the Defence of Uncovered Claims
- Page 3.** Court of Appeal Rejects Technical Definition of "Subcontractor"
- Page 4.** Insurer Acted in Good Faith When Rejecting Settlement That Would Have Reduced Uninsured Liability
- Page 5.** Supreme Court of Canada Narrowly Defines "Faulty or Improper Design" Exclusion



Theall Group LLP was formed in 2002 and has grown steadily as we enter into our seventh year. We are, first and foremost, a litigation firm that specializes in commercial insurance law acting for policy holders and brokers. We also have expertise in the automobile industry, product liability, risk management and transnational disputes. Our goal is to provide service-oriented expertise that focuses on finding the most effective and efficient way to reach our client's goals. Working with our clients, and leveraging the firm's information technology, we strive to deliver practical solutions to the most difficult and complex problems. This is how we do business at Theall Group LLP, your practical edge.

Insurer Required to Pay Defence Costs of Covered Claims Even if it Furthers the Defence of Uncovered Claims

Case Review: Hanis v. University of Western Ontario

The Ontario Court of Appeal recently held that the apportionment of costs of defending said lawsuit should be determined by the operative language of the policy.

More specifically, the Court of Appeal ruled that where there is an unqualified obligation to pay for the defence of claims covered by the policy, the insurer is required to pay all reasonable costs associated with the defence of those claims, even if those costs further the defence of uncovered claims.

In this case, an action was commenced against the University of Western Ontario by one of its employees for malicious prosecution and wrongful dismissal. The insurer conceded that malicious prosecution was covered under the policy but wrongful dismissal was deemed to be excluded.

The insurer argued that the costs associated with the defence of covered and uncovered claims (the "mixed claims") should be divided in a manner that is fair and equitable, which is determined by a variety of factors such as the proportion and significance of the covered and uncovered claims, the benefit derived by the insurer and insured in advancing the defence, the extent to which the work of the defence appears to be reasonably related to covered or uncovered claims, and the extent to which the defence effort would reasonably have been necessary if the only claims advanced were the covered claims.

The Court of Appeal favoured the contractual analysis over the fair and equitable approach for the division of costs stating that "the relationship between an insured and an insurer is contractual and must be governed primarily by the terms of the relevant policy of insurance." The Court refused to simply apply general principles of fairness.

The language of the policy provided that the insurer shall "defend in the name and on behalf of the Insured and at the costs of the Insurer any civil action..." The Court held that this policy wording provided for an unqualified responsibility to pay all reasonable costs associated with the defence of covered claims, even if they furthered the defence of the uncovered claims. There was nothing in the language of the policy that qualified the obligation to pay the costs or suggested that it did not apply to the "mixed claims". In other words, nothing in the policy exempted the insurer from paying the costs simply because they also assisted the insured in the defence of the uncovered wrongful dismissal claim.

Finally, the Court of Appeal had to determine what part of the defence costs related to the defence of the covered malicious prosecution claim and what part of the costs related to the defence of the uncovered wrongful dismissal claim. The Court of Appeal found that this was a factual question and deferred to the trial judge's finding that "because of the mixed claims, and because the factual foundation underlying all claims was the same, it is impractical, artificial, and next to impossible to allocate with any precision the legal expenses incurred with respect to covered, mixed, and uncovered claims."

Ultimately, the Court of Appeal affirmed the trial judge's finding that 95% of the defence costs related to the defence of a covered claim and were properly allocated to the insurer.

An equally important point that arises out of this decision comes from the Court's statement that an insurer who wrongfully denies coverage may have difficulty contesting the insured's position on allocation. The insurer will not escape its obligation to pay defence costs by arguing that the litigation could have been conducted differently or that certain costs were unnecessary. However, the Court also stated that by simply refusing to defend a covered claim, an insurer is not liable to assume all defence costs, including uncovered costs, as some sort of penalty. To impose a penalty would be at odds with the contractual interpretation approach that forms the basis of the Court's analysis in this case.

Court of Appeal Rejects Technical Definition of "Subcontractor"

Case Review: Axa Insurance (Canada) v. Ani-Wall Concrete Forming Inc.

The Ontario Court of Appeal has provided further guidance regarding the interpretation of the "Your Work" exclusion.

Ani-Wall Concrete Forming Inc. ("Ani-Wall"), a forming concrete contractor, contracted with Dominion Concrete Group Limited ("Dominion"), to supply ready-made concrete to the job site. The concrete was defective and Ani-Wall was sued by homebuilders who

alleged that it constructed defective concrete footings or foundations in homes, which resulted in substantial property damage. Axa Insurance (Canada) ("Axa") denied coverage and brought an application for a declaration that the policy's exclusions applied.

In the lower court decision, Perell, J. found the "Your Work", "Your Product" and "Rip and Tear" exclusions to be inapplicable. The insurer appealed based on the "Your Work" exclusion and on a portion of the "Rip and Tear" exclusion, but the "Your Work" exclusion merits particular discussion.

On appeal, the applicability of the "Your Work" exclusion turned on whether Dominion's role was that of a subcontractor or a mere supplier. A "subcontractor", which was not defined in the policy, was an exception to the "Your Work" exclusion. Axa argued that Dominion was a supplier, not a subcontractor, because Dominion supplied ready-made concrete to Ani-Wall. In its argument, Axa referenced American authorities which set out a test to determine whether a party is in fact a "subcontractor" in the insurance context. Those terms are: (1) the product supplied should be custom-made according to specifications identified in the prime contract; (2) the supplier should provide on-site installation or supervision services; and (3) the product supplied should form an integral or substantial part of the prime contract.

The Court of Appeal resisted applying the American test in order to retain a degree of flexibility where the insurer seeks to rely on exclusionary provisions to limit its scope in situations where coverage is acknowledged. The Court stated that insurers can limit the "subcontractor" exception by defining it in the Policy.

The Court of Appeal found that since “subcontractor” was not defined in the policy, it must be construed broadly and resolve ambiguities in favour of the insured. Although stating it was “close to the line”, the Court found that Ani-Wall subcontracted to Dominion its contractual obligation to supply concrete to the builders. In doing so, it triggered the “subcontractor” exception to the “Your Work” exclusion.

This case is notable because it resists the suggestion that courts should provide judicially created definitions with technical overlay. While the Court suggested a “mere supplier” would not be a subcontractor, it refused to adopt a technical or specialized analysis for determining who will in fact be a subcontractor. For example, the requirement that the product supplied by the subcontractor “should form an integral or substantial part of the prime contract” does not seem to flow from the simple word “subcontractor”, which could involve the subcontracting of a very small portion of the contract. In contrast, the approach adopted by the Court provides flexibility for future courts to determine cases on their own facts, using the ordinary meaning of subcontractor. This is consistent with established case law which says, when interpreting insurance policies, precise words should be given their ordinary meaning not a technical or specialized meaning. It is also interesting to note that the Court did not find it would never refer to the American approach as a guide, but simply refused to become limited by its overly technical analysis for what should be a common sense exercise.

Insurer Acted in Good Faith When Rejecting Settlement That Would Have Reduced Uninsured Liability

Case Review: McGee v. Insurance Corp. of British Columbia

The British Columbia Court of Appeal has ruled that an insurer did not breach its duties of good faith by failing to accept a structured settlement that would have reduced the uninsured liability against its insured, if doing so would conflict with the insurance policy’s provision that stipulates that it must obtain a full release in exchange for a structured settlement.

The insured, McGee, was insured by the Insurance Corporation of British Columbia (the “Insurer”), who defended the underlying action by an infant plaintiff. Two months prior to trial, the Insurer told McGee to obtain independent counsel because the potential liability exceeded the \$1 million policy limits. As it turned out, the insured was found liable for \$1.45 million, and the insured assigned his cause of action against the Insurer to the plaintiff in exchange for the plaintiff agreeing not to take execution proceedings.

Following judgment, the Insurer offered to pay the policy limits and to structure any portion of the funds in exchange for a full release from liability. The plaintiff made a structured settlement offer that would have reduced the judgment by \$80,000, but refused to provide a full release to McGee. The Insurer’s policy stipulated that it was to agree to a structured settlement only in return for a full release of its insured from any further liability from the judgment. McGee’s independent counsel wrote to the Insurer requesting that it accept the plaintiff’s offer, but the Insurer refused and paid out the policy limits. In the action against

the Insurer, McGee argued that the Insurer acted in bad faith by failing to accept a settlement offer that would have reduced his uninsured liability by \$80,000.

On appeal, McGee argued that the Insurer, as a statutory exclusive insurer with the exclusive right to settle a claim against its insured, is subject to duties of good faith and fair dealing and to consider the insured's interest at least equally with its own. However, the Court found that the Insurer was under no obligation to accept a post-judgment settlement offer that exposed it to a contingent liability (i.e. the structured settlement) in addition to the policy limits. The Court held that the Insurer was well within its rights to accept a structured settlement only where it could obtain a full release, and that it was not a breach of the duty of good faith to refuse to do so. The Insurer was doing no more than insisting on its contractual rights in furtherance of its policy to accept structured settlements (and the accompanying contingent liability) only where it could obtain a full release for its insured.

A secondary issue that arose in the case is the obligation of the Insured to pay for independent counsel because there was exposure beyond the policy's limits. Prior decisions had held that where there is a conflict between the insured and the insurer, the insurer should hire independent counsel for the insured. The issue in this case was whether the possibility that the judgment might exceed the policy's limits was an actual conflict that required the insurer to hire independent counsel. Although the Court agreed that exposure to a judgment in excess of limits could lead to a conflict between the insurer and the insured, there was no requirement to hire independent counsel.

Supreme Court of Canada Narrowly Defines "Faulty or Improper Design" Exclusion

Case Review: Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada

In its recent decision, *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada*, the Supreme Court of Canada significantly broadened the scope of property insurance coverage by narrowly interpreting the "faulty or improper design" exclusion commonly found in a builder's all-risks insurance policy. As a result, the defendant insurers were ordered to pay over \$30 million in damages to their policyholder, Canadian National Railway ("CNR"), in connection with the construction of a railway tunnel.

In the early 1990s, CNR sought to construct a tunnel under the St. Clair River between Sarnia, Ontario and Port Huron, Michigan. To do so, CNR hired an experienced tunnel equipment manufacturer to build an innovative, custom-designed tunnel boring machine ("TBM"). The TBM was the largest ever built and was described by leading experts as a state of the art machine. The project was insured under an all-risks insurance policy, which insured against "ALL RISKS of direct physical loss or damage ... to ... [a]ll real and personal property of every kind and quality including but not limited to the [TBM]", but excluding "the cost of making good ... faulty or improper design". During construction, problems with the TBM's seals allowed dirt to enter the main bearing chamber, resulting in significant damage to the TBM and a 229-day delay in the opening of the tunnel. CNR sought indemnity under the policy for damage to the TBM and economic losses. The

insurers denied coverage on the basis of the “faulty or improper design” exclusion.

CNR successfully sued the insurers at the Ontario Superior Court of Justice for recovery under the policy. Ground, J. found that despite its failure, the TBM had been designed in accordance with the state of the art at the time, and concluded that the design not only addressed all reasonably foreseeable risks but all foreseeable risks. The insurers successfully appealed, and a majority at the Court of Appeal found that the design of the TBM was faulty within the meaning of the exclusion, ruling that the foreseeability standard required the design to succeed in withstanding all foreseeable risks, however unlikely or remote. CNR then appealed to the Supreme Court, which allowed the appeal by a 4-3 majority.

The central issue before the Supreme Court was the interpretation of the “faulty or improper design” exclusion within the context of an all-risks policy, and whether the design of the TBM fell within that exclusion. Binnie, J., writing for the majority, held that the loss fell within the coverage, as “the policy did not exclude all loss attributable to ‘the design’, but only loss attributable to a ‘faulty or improper design’”. He stated that a design is not faulty or improper simply because it falls short of perfection in relation to all foreseeable risks. He also noted that failure is not the same thing as fault or impropriety.

Binnie, J. stressed that CNR purchased the all-risks policy in recognition of the fact that, despite all efforts to achieve a successful design in accordance with the state of the art in a new and challenging situation, there was an inevitable element of risk with an innovative design that it wished to insure against. In the policy, the risk

was broadly defined and the design addressed that risk with state of the art diligence and expertise. Under those circumstances, he concluded that the insurer was not entitled to rely on the “faulty or improper design” exclusion just because existing engineering knowledge and practice lacked a proper appreciation of the design problem. He pointed out that had the insurers wished to negotiate an exclusion for costs associated with “design failure” or “design failure in conditions of foreseeable risk”, it was open to them to have tried to do so.

The *CNR* decision has clearly widened the scope of coverage in all-risks insurance policies, particularly where an innovative or pioneering design is involved. There will undoubtedly be an increase in coverage litigation as both insurers and insureds try to clarify the types of design failures covered under such policies.
