THE BUILDERS RISK POLICY

by

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I. Introduction

The Builders Risk Policy, also known as a Course of Construction policy, is one of the cornerstones of the construction industry. It is the primary form of property coverage,[1] insuring the project throughout construction.

Builders Risk policies are found in various forms,[2] and may be classified in two ways. The first is in respect of the perils insured. All Risks coverage is the most common, although Fire and Extended Coverages is also available.

Policies may also be classified according to who is insured. Formerly, Builders Risk policies in the names of the owner and contractor alone were common, with subcontractors insuring their property through an Installation Floater Policy. Today larger projects are usually insured under a Wrap-up policy, which covers almost everyone involved in the work.

The owner, general contractor, engineer or architect assumes responsibility for obtaining Wrap-up coverage on behalf of named and sometimes unnamed insureds.[3] The named insureds are usually the owner and contractor, and often subcontractors and consultants, who are sometimes also described as "additional insureds". Unnamed insureds arise under

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1 There are several other forms of property coverage available, which complement many of the standard exclusions in the Builders Risk policy. These include installation floater insurance, marine and transportation insurance, contractors' equipment insurance and employees' tools insurance.

2 While generalisations will be made throughout this article concerning Builders Risk coverage, it is important to remember that coverage depends on the wording of the policy in question.

3 GC 11.1.1.4(1) of the CCDC 2 1994 Stipulated Price Contract places this responsibility on the general contractor, as follows:

> "`All risks' property insurance shall be in the joint names of the Contractor, the Owner and the Consultant, insuring not less than the sum of the amount of the Contract Price and the full value, as stated in the Supplementary Conditions, of Products that are specified to be provided by the Owner for incorporation into the Work, with a deductible not exceeding $2,500.... The coverage shall be maintained continuously until 10 days after the date of the final certificate for payment."

In addition, the contractor is required to obtain boiler and machinery insurance, and all risks contractors' equipment insurance.

policies which extend coverage to any person for whom the insured has agreed to obtain Builders Risk coverage, or policies which insure property owned by others.[4]

There are several advantages to Wrap-up coverage:

1. Disputes among insurers are avoided.

2. The risk of gaps or duplication in coverage is decreased.

3. Processing of claims is centralised and simpler.

4. Smaller contractors and subcontractors enjoy the benefit of higher limits than they would be able to obtain on their own.

Regardless of their name or form, all Builders Risk policies share a common purpose:[5]

> ... to provide the owner the promise that the contractors will have the funds to rebuild in case of loss and to the contractors the protection against the crippling cost of starting afresh in such an event, the whole without resort to litigation in case of negligence by anyone connected with the construction, a risk accepted by the insurers at the outset.

II. What is Insured

While coverage depends on policy wording, Builders Risk policies generally insure property forming part of the construction project (subject to certain exclusions). This usually includes:

1. Permanent structures, such as buildings and other works, which are the end result of the construction process;

2. Temporary structures, such as scaffolding, forms or falsework, employed during the construction process; and

3. Supplies and materials expended during the construction process.

Coverage extends to property owned by an insured and often to property owned by others, provided that its value is included in the amount insured. In addition, most policies cover expenses incurred to remove debris from the site after a loss.

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4 The latter type of policy was considered in *Sylvan Industries Ltd. v. Fairview Sheet Metal Works Ltd.*, below.

5 *Commonwealth Construction Co. Ltd. v. Imperial Oil Co. Ltd.* (1977), 69 D.L.R. (3d) 558, at p.566.

The standard exclusions are contractor's equipment and tools, motor vehicles, aircraft, watercraft, air and ocean cargo, money and securities. In addition, coverage will usually be lost for property at any location known to the insured to have been vacant or unoccupied for more than 30 consecutive days.

III. Who is Insured

The question of who is insured under a Builders Risk Policy is important not only from the point of view of defining an insurer's obligations, but also because it determines the insurer's ability to subrogate. The common law prohibits an insurer from subrogating against its insured,[6] a limitation which is expressly recognised in the waivers of subrogation found in many Builders Risk policies.[7]

The answer to the question of who is insured lies primarily in the wording of the policy, which is the principal reference for any coverage issue. As is often the case in the field of insurance, the Courts have developed principles to guide our analysis.

A. Judicial Philosophy

The Courts have expressed a strong preference for interpreting policy language in a manner that extends coverage to all builders and subtrades involved in the project. The starting point for this judicial trend is the 1978 Supreme Court of Canada decision in *Commonwealth Construction Co. Ltd. v. Imperial Oil Ltd.*[8]

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6 *Simpson & Co. et al. v. Thompson, Burrell et al.* (1877), 3 App. Cas. 279.

7 An example of typical wording is the following:

> "The insurer(s) upon making any payment or assuming liability therefor under this policy shall be subrogated to all rights of recovery of the insured against others and may bring action in the name of the insured to enforce such rights, except that:
>
> (a) any release from liability entered into by the insured prior to the loss shall not affect the right of the insured to recover, except as stipulated [above];
> (b) notwithstanding the provisions of paragraph (a) hereof, all rights of subrogation are hereby waived against any corporation, firm individual or other interest with respect to which insurance is provided by this policy ...."

8 (1978), 69 D.L.R. (3d) 558 (S.C.C.).

The decision involved a fertilizer plant built for Imperial Oil in Edmonton. Commonwealth Construction was a subcontractor charged with installation of certain piping. During the course of its work, Commonwealth caused a fire which resulted in minor damage to its property on the site, and major damage to the rest of the project. The insurer paid both of these losses to the Owner, and sought to subrogate against Commonwealth for the loss to the rest of the project. The policy described the insured as "Imperial Oil Ltd. and its Subsidiary Companies and any Subsidiaries thereof and any of their Contractors or Subcontractors."

The insurer rested its right of subrogation on the argument that Commonwealth's insurable interest in the project was limited to its own work. The Court rejected this submission, noting that in certain areas of the law, such as bailment, an insurable interest has been extended to parties who do not own property but stand in a special relationship to it. The Court went on to make the following statement of principle, which has set the course for this area of law:[9]

> On any construction site, and especially when the building being erected is a complex chemical plant, there is ever present the possibility of damage by one tradesman to the property of another and to the construction as a whole. Should this possibility become a reality the question of negligence in the absence of complete property coverage would have to be debated in Court. By recognising in all tradesmen an insurable interest based on that very real possibility, which itself has its source in the contractual arrangements opening the doors of the job site to the tradesmen, the Courts would apply to the construction field the principle expressed long ago in the area of bailment. Thus all parties whose joint efforts have one common goal, e.g. the completion of the construction, would be spared the necessity of fighting between themselves should an accident occur involving the possible responsibility of one of them.

The Court went on to observe that subrogation is inconsistent with the underlying purpose of Builders Risk coverage:[10]

> This purpose recognises the importance of keeping to a minimum the difficulties that are bound to be created by the large number of participants in a major construction project, the complexity of which needs no demonstration.

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9 At pp. 562-63.

10 At p. 566.

B. Subcontractors

In *Sylvan Industries Ltd. v. Fairview Sheet Metal Works Ltd.*[11] our Court of Appeal established that subcontractors will be covered as unnamed insureds under wrap-up policies, regardless of the subjective intentions of the parties. Zenith Mechanical entered into an agreement to construct a mushroom barn for Sylvan Industries. Zenith entered into a subcontract with Fairview Sheet Metal Works for part of this work. A fire occurred during Fairview's work which was allegedly caused by one of its employees. The insurer paid out this claim and sought to subrogate against Zenith, Fairview and its employee.

Sylvan was the only named insured under the Builders Risk policy issued by Gerling Global. The policy defined the property insured as:

> (a) property in the course of construction, installation, reconstruction or repair
>
> (i) owned by the insured;
>
> (ii) owned by others, provided that the value of the property is included in the amount insured.

The insurer endeavoured to get around *Commonwealth Construction* in a number of ways, all of which were rejected by the Court. It conceded that *Commonwealth Construction* established that subcontractors had an insurable interest in the entire project. However, it maintained that something more than an insurable interest was required for a party to benefit from builders risk insurance: the parties who obtained the insurance must have *intended* that subcontractors be covered under the policy. The insurer argued that neither the owner, Zenith nor Fairview intended that Zenith and Fairview would be an insured.

The Court declined to accept this argument. It observed that the principles governing the definition of insured and insurable interest are the same.[12] On the question of the subjective intent of the parties, the Court found it was not entirely clear from the evidence what the parties intended. Moreover, no evidence had been presented on what Gerling Global intended.

The Court concluded by endorsing the judicial philosophy originating in the *Commonwealth Construction* decision:[13]

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11 (1994), 14 C.L.R. (2d) 22 ((B.C.C.A.). The Court endorsed the reasoning of the Alberta Queen's Bench in *Timcon Construction Ltd. v. Riddle, McCann, Rattenbury & Associates Ltd.*, a decision on similar policy wording.

12 *Sylvan Industries*, at p. 29.

13 At p. 31.

> Sylvan argues for an interpretation of a policy entitled `Builders' Risk Comprehensive Form' that would not cover builders. Given the special nature of builders risk policies, the judicial pronouncements on the commercial necessity for inclusiveness, and the language of this policy, I am of the opinion that the trial judge reached the right conclusion when he found that contractors and subcontractors were unnamed insureds by necessary implication.

The principles articulated in *Commonwealth Construction* have also been held to require that unnamed insured status be extended to sub-subcontractors in a policy insuring "all contractors and subcontractors".[14]

C. Suppliers

Unlike subcontractors, material and equipment suppliers usually do not provide labour or services to the construction site. Do they enjoy the same status as subcontractors? Recent decisions indicate that the law is not settled in this area.

A helpful decision for suppliers is *Esagonal Construction Ltd. v. Traina et al.*[15], which considered a subrogated claim by a general contractor against a steel supplier. One of the supplier's employees ignited some straw bales while cutting some steel beams with a torch. The resulting fire destroyed part of the project, and killed the president of the general contractor. The wording of the Travellers Indemnity Company policy under consideration is similar to that found in many Builders Risk policies:[16]

> 1. This policy, except as herein provided, insures:
>
> (a) ... building materials and supplies,
>
> (i) owned by the insured;
>
> (ii) owned by others, provided that the value of such property is included in the amount insured;
>
> 14.(b) ... all rights of subrogation are hereby waived against any corporation, firm, individual, or other interest with respect to which insurance is provided by this policy.

The Court accepted the supplier's evidence that its practice, which was known to the general contractor, was to retain title to materials delivered to the construction site until payment is received in full. Since the supplier had not been fully paid, the steel beams were

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14 *Lester Archibald Drilling and Blasting v. Commercial Union Assurance Co.* (1987), 25 C.C.L.I. 145 (N.S.S.C.).

15 [1994] I.L.R. 1-3091 (Ont. Gen. Div.).

16 At p. 2966. The wording is similar to that under consideration in the *Sylvan Industries* and *Timcon Construction* decisions.

insured under clause 1 of the policy as "building materials and supplies ... owned by others".[17] The Court dismissed the insurer's argument that the waiver of subrogation under the policy applied only to the supplier's property. It observed that under clause 14 "*all* rights of subrogation are ... waived against any ... other interest with respect to which insurance is provided."[18] The subrogated claim was therefore dismissed.

In contrast to this decision, a few recent cases have allowed subrogated claims against suppliers.

In *Stuart Olson Construction Ltd. v. Allan Forrest Sales Ltd.*[19] the Alberta Queen's Bench held that a supplier of a water cooler which caused water damage was not an unnamed insured. The supplier (Watrous Sales Inc.) delivered the water coolers to another supplier (Allan Forest Sales), and had no contract with the owner or the general contractor (Stuart Olson). Watrous took no part in installing the defective coolers or performing any other work on the site.

The named insureds under the policy were Stuart Olson, the owner "and all Sub-contractors engaged in the construction of the Property insured by this Policy". The Court held that Watrous did not qualify as a subcontractor under the policy since it was "merely a remote supplier of material."[20] There was no reason to presume that the parties intended to confer coverage on material suppliers, and such an exclusion would result in a commercially sensible solution.[21]

Of particular interest was the Court's treatment of the argument that the supplier had an insurable interest in the project. Paragraph 1 of the policy provided:

> (d) ... Sub-contractors may, at the request of the Insured, be included in the name of the Insured *but only as regards property of the aforesaid Sub-contractors*, the value of which shall have been included in the estimated completed value shown in the schedule.]emphasis added]

The Court held:

> The answer to this submission is that Watrous did not at the time of the loss have an interest in the water coolers. It is doubtful that it retained an insurable interest after the units were shipped to the site. Under the ordinary law relating to the sale of goods, the property in the water coolers, and the risk of their loss or damage, passed to Allan Forrest or to Stuart Olson

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17 At p.2970.

18 At p.2970-71.

19 (1994), 17 C.L.R. (2d) 318 (Alta. Q.B.).

20 At p. 323.

21 At p. 325.

> no later than the moment they arrived at the construction site. Thereafter Watrous had only a claim for the price of the water coolers ....

Even if one assumes Watrous qualified as a subcontractor under paragraph 1(d), upon delivery to the site the water coolers ceased to be its property. Once they became Allan Forrest's or Stuart Olson's property, Watrous ceased to have an insurable interest in the project.

The Alberta Queen's Bench has also ruled that suppliers are not ordinarily entitled to coverage in two decisions arising out of the same loss. Sherritt Gordon entered into an agreement with the Kellogg Group of Companies to design and build an expansion to an ammonia plant. Kellogg, as the agent for the owner, entered into an agreement with Dresser Canada Inc. to supply a gas compressor. This agreement provided that Dresser would have responsibility for installing and testing the compressor. Dresser obtained the diaphragms required for this compressor from Bovar Inc.

The compressor malfunctioned owing to problems with the diaphragms. Sherritt suffered property damage and business interruption losses as a result. The insurer paid part of these losses and sought to subrogate against Dresser and Bovar.

The expansion was insured under an All Risks Builders Risk insuring Sherritt, Kellogg and "all contractors, sub-contractors and trades." The policy also stated that it did not include "suppliers whose sole function is material delivery."

Sherritt Gordon Ltd. v. Dresser Canada Ltd. (No. 1)[22] addressed the insurer's rights against Dresser. Dresser argued it was insured under the policy and therefore immune to subrogation. The insurer replied that Dresser was a supplier whose sole function was material delivery. It submitted that as a matter of principle a distinction had to be drawn between subcontractors and vendors of equipment. As a general contractor, Kellogg issued invitations to tender to subcontractors, and entered into agreements with successful bidders. In the case of vendors of equipment and other suppliers, Kellogg issued a request for quotation. This resulted in a purchase order and an agreement directly between the owner and the supplier.

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22 (1994), 16 C.L.R. (2d) 121 (Alta. Q.B.).

The Court dismissed the insurer's arguments.[23] Dresser's role was not limited to supplying materials. Its agreement with Kellogg and Sherritt required it to install the compressor and ensure that it met its performance guarantees. But the Court went on to observe:[24]

> In general usage the term `contractor' encompasses a person to one [sic] who contracts to provide work or labour, but not a vendor of a chattel.

The significance of this distinction was made clear in *Sherritt Gordon Ltd. v. Dresser Canada Ltd. (No. 2)*[25], a ruling on the subrogated claim against Bovar, the manufacturer of the faulty diaphragm. Unlike Dresser, Bovar was never on the site. Bovar also resisted the subrogated claim on the basis that it was a subcontractor or trade under the policy. The Court replied:[26]

> Bovar may well be a subcontractor or a trade for many purposes. However, it is not a subcontractor or a trade for the purposes intended by the Endorsements. The Endorsements cover the kinds of accidents discussed by de Grandpré J. [in *Commonwealth Construction*, such as fires or chemical leaks], not defective products or design.

Consequently, the insurer's claim against Bovar was allowed to proceed to trial.

While the policy in the *Sherritt Gordon* decisions expressly excluded "suppliers whose sole function is material delivery" a reasonable argument can be made that the distinction between suppliers and subcontractors is one of general application.

D. Collateral Activities

In *Canadian Pacific Ltd. v. Base-Fort Security Services (B.C.) Ltd.*[27] our Court of Appeal allowed a subrogated claim against Base-Fort Security, which was hired by Canadian

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23 The Court went on to allow the subrogated claim, however. It held that the policy was not intended to insure the type of loss resulting from Dresser's actions. It concluded, at p.139:

> "Here, the project was virtually complete. The facility had been operating for a significant period of time. A major portion of the damages involves loss due to business disruption. The negligence was not something that arose as a result of construction, or as part of the construction process. Both the peril and the damage at issue here are of an operating nature, and therefore come within the operating portion of the policy. I do not think that Dresser can come within that coverage."

24 At p.132.

25 (Unreported, July 21, 1994, Alta Q.B.)

26 At para. 34.

27 (1991), 52 B.C.L.R. 393 (C.A.).

Pacific to provide security services at one of its construction camps. An explosion occurred and American Home brought a subrogated claim alleging negligence on the part of Base-Fort. The policy insured:

> Canadian Pacific Limited ... Architects and/or Engineers and/or Consultants and/or General Contractors and/or Sub-Contractors and their various trades.

The Court concluded that Base-Fort was not an insured. It developed the following test, which examines a party's role in the construction process:[28]

> ... the `insureds' are *those persons without whose contribution to the project in its entirety the project itself could not be completed. That will be for the most part trades*. I think that is what the trial judge was saying when he referred to the insurers' risk as not `including a party whose services are *parallel to but not within the mainstream of the construction activities*....
>
> I conclude that those persons whose contributions are an *integral and necessary part of the construction process itself* are within the definition of `insured' in the policy and *not those whose contributions are collateral to that process*. [emphasis added]

The Court concluded that while Base-Fort's security services:

> ... ran parallel to the project, those services cannot be said to be an *integral and necessary part of the construction process* itself. In my opinion, those services were no more than *collateral to the construction process*, and that being so, Base-Fort was not an `insured' within the insuring agreement.

The distinction between those parties who are "integral and necessary" to the construction process and those who are "collateral" is not always clear. For example, a company hired to do maintenance work on a project would arguably be collateral, and subject to subrogation. However, an argument could also be made that the project could not be completed without maintenance, security and other ancillary services.

E. Covenants to Insure

Construction contracts sometimes contain a covenant by the owner or contractor to obtain insurance. Such covenants are an additional basis for preventing subrogation against a party for whom insurance is to be obtained.

Where insurance is obtained in accordance with the covenant, a subrogated claim will be dismissed on the basis that there is no legal basis for indemnity. *Weldwood of Canada Ltd. v. Gisborne Construction (Alberta) Ltd.*,[29] is an illustration of this principle. A subrogated

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28 At p.399-400.

29 (Unreported, May 26, 1995, Alberta Queen's Bench)

claim was brought against a subcontractor alleged to have commenced a fire that damaged a lumber bleach plant. The agreement between the owner and the general contractor stated:

> [The owner] shall maintain insurance ... upon [the owner's] real and personal property.... Coverage shall protect [the owner and contractor] and his subcontractors.

The Court ruled:[30]

> Rights of subrogation ... can be based only on the ... agreement and by covenanting specifically to place fire insurance coverage, [the owner] has deprived its insurer of any subrogated position and itself of any claim over against the [contractor or subcontractor].

If insurance is not arranged, the party responsible for obtaining coverage may find its breach of covenant raised as a defence to its claim for indemnity. In *Quintette Coal Ltd. v. Bow Valley Resource Services Ltd.*[31] the owner sued a contractor for damage caused by a faulty conveyor belt. The contractor sought to have the action dismissed at the commencement of trial on the basis that the owner breached its covenant to obtain Wrap-up Builders Risk and Liability coverage.

The Court dismissed the contractor's application, partly on the basis that the insurance which the owner agreed to procure would not "cover the cost of putting right what the defendant did wrongly in the first place".[32] This implies that if the owner had sued the contractor for an insured loss, the breach of covenant might have presented the contractor with a successful defence.

F. Enforcing the Waiver of Subrogation

It is a fundamental principle of contract law that, subject to certain exceptions, only parties to an agreement are able to take advantage of its terms. Such parties are described as being in a relationship of contractual privity.

The parties to a contract of insurance are the insured and its insurer. It has been widely assumed that unnamed or additional insureds are entitled to take advantage of the waiver of subrogation clauses in these contracts even though, strictly speaking, they are not parties to the policy.

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30 At para. 26.

31 (1988), 21 B.C.L.R. (2d) 203 (S.C.).

32 At p. 208.

This assumption has recently been questioned by the Supreme Court of British Columbia in *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.*[33], a decision involving a maritime Hull Subscription Policy. Fraser River chartered a barge and crane to Can-Dive for the purpose of installing concrete mats across the ocean floor. Can-Dive agreed to tow the barge and crane to safety in the event of adverse weather. The parties did not discuss insurance. Fraser River's Hull Subscription Policy provided that the charterer of an insured vessel was an "additional insured" against whom the insurer waived any rights of subrogation.

The barge sank as a result of being unattended at anchor during adverse weather. Fraser River waived its rights under the waiver of subrogation clause, and the insurer brought a subrogated claim against Can-Dive.

Mr. Justice Warren held that "only a party to the contract of insurance may enforce the waiver of subrogation clause."[34] Two potential exceptions are where the named insured intended to act as trustee or agent on behalf of unnamed insureds. The policy did not constitute Fraser River as a trustee, but stated that Fraser River acted "as agent for the others insured hereby".[35]

The Court held that the agency exception did not permit Can-Dive to enforce the waiver of subrogation clause. Fraser River had not been authorised to act as Can-Dive's agent when it purported to obtain insurance for Can-Dive. This unauthorised act could be ratified by Can-Dive, but only after Can-Dive became aware that Fraser River had obtained insurance on its behalf. By the time Can-Dive became aware of the insurance, however, Fraser River had nullified Can-Dive's coverage by forfeiting any rights under the waiver of subrogation.[36]

The *Fraser-River* decision focussed on Can-Dive's lack of contractual privity, and did not squarely address the reasoning that has allowed unnamed insureds to benefit from waiver of subrogation clauses in Builders Risk cases. In *Sherritt Gordon Ltd. v. Dresser Canada Inc. (No. 1)*[37] the insurer relied on English decisions concerning unnamed insureds. The Court observed:

> It is interesting that the two English cases attempted to ensure that there is privity of contract between the parties. That is not stressed in the Canadian cases. The Canadian cases rest less on technical requirements, and more on the practical, legal and policy contexts.

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33 [1995] 9 W.W.R. 376 (B.C.S.C.)

34 At p. 421.

35 At p. 423.

36 At p. 436.

37 (1994), 16 C.L.R. (2d) 121, at pp. 138 - 39.

The *Fraser River* decision's preoccupation with privity is inconsistent with the approach to Builders Risk insurance in Canada, and it is therefore questionable that its effect will be felt in this area. The decision is under appeal.

G. Summary

Base-Fort and the supplier decisions demonstrate that with the passage of time the Courts have found it necessary to place limits on the judicial policy of inclusion articulated in the *Commonwealth Construction* case. A simple principle underlies these limitations: Builders Risk coverage provides insurance against property damage arising out of *construction* activities. Parties whose services are collateral to the construction process (i.e. *Base-Fort*), or who are not involved in the work on the site (i.e. suppliers) are not truly engaged in construction activities, and may be the subject of a subrogated claim.

The existence of a covenant to insure in the construction contract may afford another basis for resisting a subrogated claim, whether or not insurance is obtained pursuant to the covenant.

IV. Which Risks are Insured

The perils insured by Builders Risk coverage are limited in two ways.

First, they are limited in respect of time. Builders Risk policies insure losses arising out of *construction* activities. In the absence of a specific endorsement, they do not insure operational losses.

Second, a number of construction-related perils are usually excluded by most underwriters. Some exclusions recognise that a risk may be addressed by an endorsement (i.e. earthquake and flood) or another type of insurance (i.e. faulty design, covered by Professional E & O insurance). Others acknowledge that a risk is not suitable for insurance coverage at all (i.e. faulty work, covered by Performance Bonds).

A. Construction v. Operation

Sherritt Gordon Ltd. Dresser Canada Inc. (No. 1)[38] illustrates the fundamental principle that Builders Risk and other types of construction insurance do not ordinarily cover operational

38 (1994), 16 C.L.R. (2d) 121, at p. 139.

losses. One of the issues was whether the damage caused by the failure of the compressor fell within the Builders Risk or operating part of the owner's policy.

> Here the project was virtually complete. The facility had been operating for a significant period of time. A major portion of the damages involves loss due to business disruption. The negligence was not something that arose as a result of construction, or as part of the construction process. Both the peril and the damage at issue here are of an operating nature, and therefore come within the operating portion of the policy.

B. Insured Perils

The standard exclusions from All Risks coverage are:

1. faulty or improper material, workmanship or design (but not resultant damage to other insured property);

2. mechanical or electrical breakdown (but not resultant damage to other insured property);

3. electrical or magnetic injury;

4. latent defect, inherent vice, or wear and tear;

5. rust, corrosion, frost and freezing;

6. earthquake and flood;

7. employee dishonesty;

8. inventory shortage;

9. delay, interruption, loss of use;

10. loss resulting from laws which prevent a property from being restored to its original condition;

11. nuclear energy hazards;

12. war and other hostilities.

This paper will examine the first two exclusions, which have received the most judicial attention, and the definition of "resulting damage" under these exclusions.

C. Faulty or Improper Material, Workmanship or Design

1. *"Faulty or Improper"*

Is material, workmanship or design "faulty or improper" if it is merely inadequate, or must it fall below a standard of reasonable care?

The authority most often referred to is the Australian High Court decision in *Queensland Government Railway v. Manufacturers' Mutual Insurance Ltd.*[39] Railway bridge piers erected in a river bed were swept away by flood waters higher than any previously recorded. The piers were designed in accordance engineering standards prevalent at the time. The contractor's policy excluded losses attributable to faulty design.

The Court held that the loss was excluded:[40]

> To design something that will not work simply because at the time of its designing insufficient is known about the problems involved and their solution to achieve a successful outcome is a common enough instance of faulty design. The distinction which is relevant is that between `faulty' i.e., defective, design and design free from defect.... The exclusion is not against loss from `negligent designing'; it is against loss from `faulty design', and the latter is more comprehensive than the former.

There is some support in Canada for the principle that negligence is not a factor in determining whether materials, workmanship or design are faulty. In *B.C. Rail Ltd. v. American Home Assurance*[41] our Court of Appeal considered whether B.C. Rail was entitled to recover the costs of building a bridge and re-routing traffic after a slide damaged one of its tracks. The slide occurred after B.C. Rail created a new grade for its track under the direction of one of its engineers, placing new fill over the existing fill. The engineer mistakenly assumed that the existing soil could support the additional fill. The policy excluded losses arising from any "error in design".

Mr. Justice Cumming (MacDonald J.A. concurring) concluded:

> ... here the design itself was `flawed'. It was based on Mr. Leighton's assumption that the substratum was on the colluvium and not on lacustrine soils. That assumption was a `mistake in judgment' based on an `incorrect belief as to the existence of matters of fact,' and *even though he may not have been negligent*, a question which I do not find it necessary to decide, *it was an `error in design'* within the meaning of the policy. [emphasis added]

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39 (1969), 1 Lloyds Rep. 214 (Aust. H.C.).

40 At p. 217.

41 (1991), 54 B.C.L.R. (2d) 228 (C.A.).

Mr. Justice Lambert, dissenting, disagreed with Mr. Justice Cumming's interpretation of "error in design", but also indirectly supported the conclusion in *Queensland Government Railway* concerning the meaning of "faulty design":[42]

> ... `error' does not have two well recognised meanings, as the word `faulty' does.... [T]here is no error without a mistake or shortcoming on someone's part. *A defective or imperfect design may be a faulty design*. But unless someone has made a mistake there is no error, and so no error in design.

In *CIC Mining Corp. v. Saskatchewan Government Insurance*,[43] the Saskatchewan Queen's Bench lent further support to this argument by concluding that faulty workmanship should not be equated with negligence.

There is, however, some uncertainty over whether negligence is ever relevant. For example, in *B.C. Rail* Mr. Justice Cumming observed that a reference to an "error in design*ing*" or "faulty workmanship" may require the Court to consider negligence.[44]

Moreover, in a number of cases involving walls which have collapsed as a result of excessive winds, the Courts have considered evidence on whether the wind speeds at the time of the loss were excessive. The underlying reasoning is that workmanship or design are faulty only if the wind speeds are within the range that should reasonably have been expected.

For instance, in *Applecrest Investments Ltd. Guardian Insurance Co.*[45] the Court held that the collapse was due to faulty workmanship and design because a properly designed wall should have withstood the winds on the day of the loss. In *Lakeland Development Co. v. Anglo Gibraltar Insurance Group*[46] the collapse was not attributed to faulty workmanship or design because of insufficient evidence that the bracing was inadequate. The Court added that the evidence of the insurer's expert fell "far short of proving negligence ... on a balance of probabilities."[47]

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42 At p. 254.

43 [1993] I.L.R. 1-2962 (Sask. Q.B.).

44 At p. 244.

45 (1993), 1 C.L.R. (2d) 259, at p.262 (Ont. Gen Div.).

46 (1994), 10 C.L.R. (2d) 17 (Ont. Gen. Div.).

47 At p. 20.

2. *Workmanship*

The leading decision on the meaning of faulty workmanship is *Pentagon Construction (1969) Co. v. U.S. Fidelity & Guaranty Co.*,[48] a decision of our Court of Appeal. A tank collapsed during testing, owing to the contractor's failure to weld certain struts into place beforehand. In a passage concurred in by the rest of the Court, Mr. Justice Robertson reasoned that the failure to follow the correct sequence in testing the tank was faulty workmanship:[49]

> The achievement of the result called for by the Contract required a number of steps to be taken in a particular sequence; failure to take them in that sequence could constitute faulty or improper workmanship; all too obviously it did so here. It is of no consequence why the proper sequence was not observed, or what individual was to blame for the failure to observe it, or whether he was employed by Pentagon, or that one cannot fix the blame on any particular person. Whatever the reason may have been, there was improper workmanship and it caused damage to the tank.

A few decisions have considered whether walls which have collapsed under high winds fall under the faulty workmanship exclusion, with inconsistent results. In *Todd's Mens and Boys Wear Ltd. v. Diamond Masonry (Calgary) Ltd.*[50] the Court concluded that the collapse was due to the project manager's failure to have the walls tied into the steel frame of the building. This constituted "faulty construction" which, unlike faulty workmanship, was not excluded under the policy.

The *Todd's Mens and Boys Wear* decision was disapproved of by the Newfoundland Supreme Court in *Greene v. Canadian General Insurance Co.*[51] The collapse was due in part to the failure to install temporary bracing. The Court found that the builder's neglect in providing temporary bracing was faulty workmanship. The omission of temporary bracing from the plans was not faulty design, since temporary bracing was within the competence of a prudent builder.

Lastly, in *Lakeland Development Co. v. Anglo Gibraltar Insurance Group*[52] the Court held that the collapse was not attributable to faulty workmanship because there was no clear evidence on what constituted adequate bracing, nor were there any regulatory requirements. This case may be compared to *Applecrest Investments Ltd. Guardian*

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48 (1977), 77 D.L.R. (3d) 189 (B.C.C.A.).

49 At p. 197.

50 (1985), 12 C.C.L.I. 301 (Alta. Q.B.).

51 (1992), 46 C.L.R. 290 (Nfld S.C.).

52 (1994), 10 C.L.R. (2d) 17 (Ont. Gen. Div.).

Insurance Co.,[53] where the loss was due to faulty workmanship since the evidence established that a properly braced wall should have withstood the winds on the day of the loss.

3. *Design*

Pentagon Construction (1969) Co. v. U.S. Fidelity & Guaranty Co.,[54] also considered the meaning of faulty design. The plans and specifications indicated that the struts had to be welded, but were silent on whether this had to be done prior to testing. Mr. Justice Bull found that the error was the result of faulty design because of the omission in the plans and specifications:[55]

> it was ... clear and uncontradicted that the drawings or specifications should have required, or made it clear, that the welding of the cross beams should take place before testing.

Mr. Justice Robertson disagreed:

> My view is that the word `design' as it is used in the policy expresses a concept of the finished product of the work to be done by Pentagon under the contract and that that concept finds its expression in the plans and specifications; those plans and specifications are not, however, the design. It follows that detailed instructions of how the work of construction is to be carried out are not part of the design of the tank.

Both definitions have found their supporters.[56]

In *Maclab Enterprises Ltd. v. Commonwealth Insurance Co.*[57] the insured owned an apartment building from which a number of bricks fell. The owners sought indemnity under a policy containing a number of exclusions, but which did not specifically exclude faulty design. Inspections revealed the brick wall panels were loose because of under-designed supports, inadequate mortar, and an inappropriate anchoring system, all of which were specified or authorised by the architect. The Court followed Bull J.A. in *Pentagon* and found these to be design errors.

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53 (1993), 1 C.L.R. (2d) 259, at p.262 (Ont. Gen Div.).

54 (1977), 77 D.L.R. (3d) 189 (B.C.C.A.).

55 At p. 191.

56 Mr. Justice Robertson's definition was followed by the Saskatchewan Court of Appeal in *Bird Construction v. U.S. Fire Insurance Co.*(1985), 18 C.L.R. 115. Mr. Justice Bull was followed in *Simcoe & Erie v. Willowbrook Homes*, [1980] I.L.R. 1-1236, at p.881 and in *Maclab Enterprises Ltd. v. Commonwealth Insurance Co.* (1983), 2 C.C.L.I. 267, at p. 270 (Alta. Q.B.).

57 (1984), 2 C.C.L.I. 267 (Alta. Q.B.).

Since faulty design was not specifically excluded, the policy responded to the loss. Mr. Justice MacNaughton rejected some exclusions categorically as a matter of legal principle. The mechanical breakdown exclusion did not apply "because in law design errors are not mechanical breakdowns or derangements."[58] Similarly, His Lordship endorsed the axiom in *Jackson v. Mumford*[59] that design errors are not latent defects.

The faulty design exclusion was recently considered by the Alberta Queen's Bench in *Triple Five Corp. v. Simcoe & Erie Group*[60]. The issue in *Triple Five* was whether business interruption losses resulting from the derailment of the rollercoaster at the West Edmonton Mall were covered in the owners' business interruption coverage. The Court held that the cause of the accident was a design error, namely, a failure to narrow the track width at certain sharp turns. This caused certain cap screws to vibrate loose and allowed the wheel carrier assembly to disengage.[61] The policy did not specifically exclude faulty design. Paragraph 10 read:

> 10. This policy does not insure against:
>
> (j) mechanical breakdown or derangement, latent defect, faulty material, faulty workmanship, inherent vice, gradual deterioration or wear and tear ....

The insured asked the Court to follow *Maclab Enterprises* and rule that as a matter of law the design error could not constitute one of the specifically excluded perils. Wilson J. declined the invitation:[62]

> I am not prepared to hold as a proposition of law that design error is not or never can be encompassed in the exclusion of `mechanical breakdown or derangement.' The fact that the internal problem was caused by a design error should not prevent the mechanical breakdown or derangement exclusion from operating. To hold to the contrary would be to give the exclusion a very narrow ambit.

Similarly, the Court disapproved of the finding in *Maclab* that design errors could not be latent defects:[63]

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58 At p. 271. His Lordship cites *Brown Fraser & Co. v. Indemnity Marine Assurance* as authority for this proposition, a conclusion which was correctly questioned by Wilson J. in *Triple Five Corp. v. Simcoe & Erie Group* (1995), 29 C.C.L.I. 219, at p. 280.

59 (1902), 8 Com. Cas. 61, 19 T.L.R. 18 (K.B.).

60 (1995), 29 C.C.L.I. 219 (Alta. Q.B.).

61 At p. 274.

62 At p. 282.

63 At pp. 285 - 86.

> The notion that `latent defects in machinery' do not include design errors is not compelling. I agree that an ordinary business person would not draw a distinction between latent defects founded upon design and any other reason for the latent defect. The reason for the latent defect is immaterial - the question is whether there is a latent defect....
>
> In the case before me I hold that the casualty was caused by latent defect....

The Court also found that the loss was excluded under the inherent vice exclusion.[64]

The scope of the faulty design exclusion has also been considered in decisions involving walls which collapsed during high winds, again with inconsistent results. In *Simcoe & Erie Insurance Co. v. Willowbrook Homes (1964) Ltd.*[65] concrete block walls collapsed during a severe windstorms. The insurer argued the losses were excluded under faulty workmanship and design. The Alberta Court of Appeal held that the temporary bracing required while the building was under construction was part of the design of the building. The design was faulty because the bracing was not "reasonably adequate for its purpose."[66] Similarly, in *Applecrest Investments Ltd. Guardian Insurance Co.*[67] the Court found that the collapse was due to inadequate design.

Simcoe & Erie v. Willowbrook was distinguished in *Todd's Mens and Boys Wear Ltd. v. Diamond Masonry (Calgary) Ltd.*[68] where the Court found that the collapse of the wall was not due to faulty design since there was no design person involved in supervising construction.

D. Mechanical Breakdown

There is not a great deal of jurisprudence on the mechanical breakdown exclusion. One of the more instructive decisions is *Brown Fraser & Co. Ltd. v. Indemnity Marine Assurance Co.*[69] The British Columbia Court of Appeal considered whether damage caused by the collapse of a crane was covered under the insured's policy. The loss occurred while the insured's employees were assembling the crane, and was apparently due to their failure to install certain anchor pins in the cab frame. The policy insured:

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64 At p. 286.

65 [1980] I.L.R. 1-1236 (Alta. C.A.).

66 At p. 882.

67 (1993), 1 C.L.R. (2d) 259, at p.262 (Ont. Gen Div.).

68 (1985), 12 C.C.L.I. 301, at p. 308 (Alta. Q.B.).

69 (1958-59), 27 W.W.R. 31, at p. 35 (B.C.C.A.).

> Against physical loss or damage from any direct cause whatsoever, excepting:
>
> (a) ... inherent vice or defect, mechanical breakdown ....

The majority of the Court held that the loss was due to neither of these exclusions, but was instead attributable to the negligence of the insured's employees.[70] Such negligence was an "adventitious cause" that was not encompassed by either of the excluded perils. Chief Justice DesBrisay, writing for the majority of the Court of Appeal, described mechanical breakdown as:

> a failure in operation due to some mechanical defect in some part or parts of the equipment when properly assembled as a crane. *Here the failure to operate was due to negligence in assembling the machine* so that it could function as an operating unit. In other words, there was a failure to function, not due to any mechanical defect, but due to a failure to insert a part or parts in the machine which ought to have been inserted to make it a complete operating unit.

Brown Fraser & Co. was considered in *Triple Five Corp v. Simcoe & Erie Group*.[71] As noted above, the Court ruled that the cause of the rollercoaster accident was a design error, namely, a failure to narrow the track width. This did not preclude a ruling that the loss resulted from a mechanical breakdown:[72]

> [Mechanical breakdown or derangement] is an expression that defines a happening that may occur for a number of reasons, and until the reason is determined, the exception cannot be applied. For example, a worker might carelessly fail to check the oil in a machine, or some other fluid level, or fail to add oil as it is needed. That could cause the machine to seize up, and that would certainly cause mechanical breakdown.... *But it would be external, resulting from negligence in the operation of the machine, an `adventitious cause,' and would not fall within the exclusion*. This is the ratio of *Brown Fraser & Co. v. Indemnity*. [emphasis added]

Wilson J. asked:[73]

> ... why may it not be said that in the case before me, the mechanical breakdown, in the circumstances and the context, was a failure caused by wide track [sic] that caused the cap screws to vibrate loose, allowing the wheel carrier to fall due to mechanical defect in part of the equipment (the track) when properly assembled to constitute a roller coaster assembly

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70 Mr. Justice Davey, dissenting, concluded the loss was excluded, at page 37:

> "In my opinion, a defect that is caused by faulty design, flaw in material, or fault in workmanship in the fabrication or assembly of a machine is an inherent defect, within the meaning of this policy because it is built into the machine."

71 (1995), 29 C.C.L.I. 219 (Alta. Q.B.).

72 At p. 283.

73 At p. 283.

> and train, *properly assembled in the manner in which it was designed*, the design being defective? I think it can be, and should be. [emphasis added]

The *Brown Fraser & Co.* and *Triple Five Corp.* decisions suggest that a loss resulting from improper assembly does not qualify as a mechanical breakdown. A distinction is also drawn in these decisions between mechanical breakdown and external or adventitious causes.

E. Resultant Damage

There have been numerous cases interpreting the resultant damage exception to exclusions for faulty materials, workmanship or design and mechanical breakdown. It is difficult to find a unifying principle among these decisions, and many of them are difficult to reconcile with one another.

Fortunately, in *British Columbia v. Royal Insurance Co. of Canada*[74] the British Columbia Court of Appeal brought order to this chaos. The case involved a loss which arose when the Crown hired a contractor to reshape the banks of a creek. The work required the contractor to place a corrugated pipe along the bed of the creek to channel the water of the creek while the work was underway. After the work was complete the pipe would be filled with concrete and have no continuing function. The contractor built a temporary dam to cope with heavy rains during the work. This dam gave way, and the resulting water flow damaged the pipe and other work in progress.

The Crown brought a claim under its Builders Risk policy for the cost of restoring the damaged work, but not the cost of replacing the diversion pipe. The policy excluded "faulty or improper design ... provided, however, to the extent otherwise insured and not otherwise excluded under this policy, resultant damage to the property shall be insured."

Mr. Justice Lambert's analysis of resultant damage was concurred in by the balance of the Court:[75]

> Damage for faulty or improper design encompasses all the *damage to the very thing that was designed faultily or improperly*. Resultant damage is *damage to some part of the insured property other than the part of the property that was faultily designed*.

His Lordship reviewed the leading decisions on the meaning of resultant damage and added:

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74 [1992] I.L.R. 1-2816 (B.C.C.A.).

75 At p. 1761.

> In each of those cases the decision was that the damage was damage to *an integral part of the very property that was subject to the faulty design*.
>
> In this case it is my opinion that the piped channel diversion system which was part of the work that was alleged to be the subject of faulty design was not an integral part of the work being constructed, or, perhaps more accurately, the work being constructed was not an integral part of the diversion system. The diversion system was a *necessary but conceptually separate construction device*. There are two principal reasons that support my opinion. The first is that the diversion system had no continuing function in the completed channelisation works and was not a designed part of them. The second is that the construction contract treated the diversion system as a construction device separate from, and not a part of, the designed project.

Since the faulty diversion works were not an integral part of the project, the Crown was able to recover for the damage done to the other work in progress.

V. Policy Limits

How much insurance is enough? A natural choice is to tie policy limits to the contract price. This practice is encouraged by GC 11.1.4(1) of the CCDC 2 (1994) Stipulated Price Contract:

> `All Risks' property insurance shall be in the joint names of the Contractor, the Owner, and the Consultant, *insuring not less than the sum of the amount of the Contract Price* and the full value, as stated in the Supplementary Conditions, of Products that are specified to be supplied by the Owner for incorporation into the Work, with a deductible not exceeding $2,500. [emphasis added]

However, setting policy limits by the contract price may result in under-insurance. For example:

1. In the case of the CCDC 2 (1994) Contract, Article A-4 excludes the GST from the contract price.

2. The contract price does not cover the cost of demolition and debris removal in the event of a loss.

3. In projects incorporating existing structures the contract price will understate the actual value of the work. As these structures are under the care and control of the contractor, they will not be covered under a liability policy.

If policy limits are set by the Contract Price, they should be reviewed when there are changes or extras that increase the value of the project.

January 10, 1996