



Problems with Property Policies:
Recent Developments Regarding
Commercial and Residential
Coverage

by

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1. A HORSE OF A DIFFERENT COLOUR: CLASSIFICATION OF MULTI-PERIL POLICIES FOLLOWING *KP PACIFIC* AND *CHURCHLAND*

(a) Outmoded Insurance Acts

Insurance Acts in Canada contain fairly standard wording and generally provide for separate sections devoted to auto, fire, accident and sickness insurance. These sections contain different rules, including limitation periods, based on the type of insurance issued.

Insurance practices however have changed since the enactment of the Insurance Acts and no longer are different and discrete categories of insurance common. Rather, the “multi-peril” or “all risk” policy has become the primary form of insurance for many consumers. The Courts thus face the difficult question of where to fit these types of policies in what Madam Justice McLachlin in *KP Pacific v. Guardian*, 2003 S.C.C. 25 called an “outmoded category based act”.

In at least British Columbia, and perhaps Alberta and Newfoundland, the Supreme Court of Canada has held in the concurrent decisions of *K.P. Pacific* and *Churchland v. Gore Mutual*, 2003 S.C.C. 26, that a multi-peril policy does not fall within the fire insurance provisions of the Insurance Act.

(b) *K.P. Pacific v. Guardian*, 2003 S.C.C. 25 and *Churchland v. Gore Mutual*, 2003 S.C.C. 26

K.P. Pacific v. Guardian, 2003 S.C.C. 25 and *Churchland v. Gore Mutual*, 2003 S.C.C. 26, were two cases which considered the provisions of the BC *Insurance Act*. One case involved fire and the other theft. Both required a determination whether the fire Statutory Conditions applied, or whether a more lenient limitation period found elsewhere in the Act had application.

In *K.P. Pacific* and *Churchland* the Supreme Court noted that the advent of a comprehensive ‘all-risk’ type of policy was “difficult if not impossible to fit into the old categories” of insurance contemplated by the “outmoded category-based *Insurance Act*”. The latter “is based on the paradigm of discrete categories of insurance policies and is incapable of coherently addressing the modern multi-peril policy.” The Court ruled that such a policy “cannot be shoehorned into the fire insurance part of the Act without contrived reconstruction and anomalous consequences. It simply does not fit. Consequently, it cannot be said that the legislature intended the Fire Insurance provisions to govern”.

The decisions in *KP Pacific* and *Churchland* involved the application of the BC *Insurance Act*. However, the Insurance Act wording is fairly consistent across the Provinces, leading to the question of whether the Supreme Court of Canada's decision is binding outside of BC. To date only Alberta, Newfoundland and Manitoba have considered this issue.

(c) *Fenrich v. Wawanesa Mutual Insurance Co.*, 2004 ABQB 310

Fenrich involved a claim for damage arising out of a broken water main located behind the Plaintiff's parent's house. The parents had a valid insurance policy with the Defendant insurer Wawanesa and the Plaintiff disputes the amount paid to him under the insurance policy. The Plaintiff was an adult child living at his parent's home at the time and it was accepted at trial that he was included within the definition of the term "Insured" in the policy of insurance but was not listed in the Declarations.

Wawanesa brought an application to strike the Statement of Claim relying upon the doctrine of privity of contract and a clause in the contract of insurance which requires that only the persons named in the 'Declaration' can bring suit against the insurer. In a separate motion, the Plaintiff sought a declaration that he was able to continue its action in his name or, alternatively, to amend the pleadings by substituting the father for the son as the Plaintiff. If s. 6 of Alberta's *Limitation Act* applied then such an amendment would be permissible. S. 6 however does not apply where there is a statutory limitation period and Wawanesa took the position that the statutory limitation period contained in the fire insurance section of the *Insurance Act* applied and had since expired.

Both the Plaintiff and Wawanesa agreed that Supreme Court of Canada decision of *KP Pacific* was "instructive" Wawanesa however argued that the case did not apply. The Plaintiff argued that s. 119 of the British Columbia Act is analogous to s. 543 of the Alberta Act and, if anything, the Alberta Act was more clear than the British Columbia legislation. The British Columbia Act says that the provision applies to contracts of fire insurance "whether or not a contract includes insurance against other risks", whereas s. 543 of the Alberta Act makes it plain that the section applies only to "the peril of fire". Thus they argued, since the Supreme Court of Canada determined that s. 119 of the British Columbia Act did not apply to all-risk policies such as the one at issue in *KP Pacific*, even though they were there dealing with a fire loss, s. 543 of the Alberta Act, by the same logic could not apply to all-risk policies where the loss is from flooding. The Court agreed and held that:

[o]n the reasoning of *KP Pacific*, statutory condition 14 does not apply because all-perils insurance is not included within the meaning of fire insurance in s. 543. The Alberta Act, like the British Columbia Act, sets out rules applicable to discrete types of insurance policies and seems ill-fitted to deal with the more modern convention of issuing all-risk policies such as the policy held by the Fenrichs. Thus, as I have concluded that the Subpart 3 of the Alberta Act applies only to fire insurance and not to all-risk policies, it follows that statutory condition 14 is not one of the conditions applicable to "the perils insured by this policy" and unless it has been specifically made a part of the agreement, it does not apply.

As a result of *Fenrich*, in Alberta multi-peril policies are not governed by the fire insurance subpart of Alberta's *Insurance Act*.

(d) *Burry v. Donahue*, 2003 NLSCTD 165

In *Burry v. Donahue*, the Plaintiffs property was completely destroyed by fire and they subsequently brought an action against their insurer, Co-operators under a multi-peril, all risk policy. At issue was the applicable limitation period for bringing the claim. Co-operators argued that the one-year limitation period under their Statutory Condition 14 applied to a multi-peril insurance policy by statutory prescription as the fire insurance legislation is contained in Newfoundland's *Fire Insurance Act* and the one year limitation period was a Statutory Conditions set out in that Act.

The Plaintiffs argued that the court should find that the fire peril is incidental to the full coverage provided by the insurance policy and as such the limitation provisions in the *Fire Insurance Act*, do not apply. Rather, they argued that the limitation period should be determined by the Newfoundland's *Limitations Act*. The Plaintiffs argued that the Newfoundland and British Columbia Acts were similar in content and in form and thus the Court was bound by the application of the doctrine of stare decisis to the decision of the Supreme Court of Canada in *KP Pacific Holdings Ltd. v. Guardian Insurance Co. of Canada*.

The Court agreed with the Plaintiff and held that there was "no compelling reason why our s. 3(1) should be treated any differently than the Supreme Court of Canada treated s. 119 of the British Columbia Act." The Court could find "no obvious reason why there should be a special regime for contracts of fire insurance" and as such the multi-peril policy did not fall within the *Fire Insurance Act*.

(e) *Casey v. Federated Insurance*, 2004 MBQB 99

While the Courts in Alberta and Newfoundland have held that the wordings of their Insurance Acts are similar enough to BC's for *KP Pacific* to be, if not binding then at least wholly persuasive, Manitoba has not. In *Casey*, the Manitoba Court of Queen's Bench has gone the opposite way.

There the Plaintiff, who coincidentally had been for some years Federated's claims manager, was claiming under an all risk policy for damage to his roof due to a severe hailstorm. In deciding whether the limitation period under the all risk policy was governed by the Part IV fire provisions of the Manitoba Insurance Act or not the Court considered and ultimately distinguished the decision of *KP Pacific* holding that "[w]hereas the Manitoba legislation leaves much to be desired and, like the BC legislation, does not address the fact of modern all-risks policies, to accept the respondent's argument would be to ignore the material differences between the two Acts "

Thus, in Manitoba, multi-peril policies are governed by the fire provisions of the *Insurance Act*.

2. WHAT A DIFFERENCE A YEAR MAKES: LIMITATION PERIODS FOLLOWING *KP PACIFIC* AND *CHURCHLAND*

In *K.P. Pacific* and *Churchland*, the S.C.C. held that sections 3 and 22 of the *Insurance Act* overrides the one year from date of loss limitation period imposed by either the wordings of property policies, or the “fire” Statutory Conditions. As a result, it is the one-year limitation in section 22 itself which applies, and that does not start to run until “the furnishing of reasonably sufficient proof of a loss or claim”. The problem, for insurers, is that they have no direct control over when an insured furnishes a proof of loss, and the *Act* does not include any deadline in this regard. This has opened the door to much uncertainty for insurers and more litigation concerning the one-year limitation period regarding claims under property policies.

This issue has since spread to disability claims, but the latest in a series of BC Court of Appeal decisions provides might help to clarify the law, and give back to insurers some degree of control over limitation periods under first party policies in general.

(a) *Gumpp v. Co-operators Life Insurance Co.*, 2004 BCCA 217

In *Gumpp v Co-operators* 2004 BCCA 217 and, previously *Balzer v. Sun Life* 2003 BCCA 306 and *Watterson v. Sun Life* 2003 BCCA 305, the B.C.C.A. has provided disability insurers with at least a partial solution: start the one-year limitation period running by clearly and unequivocally denying coverage. Whether the courts will extend the same reasoning to limitation periods under property policies remains to be seen, but the logic may well apply to both types of first party policies. Besides, nothing ventured, nothing gained.

Ruth Gumpp stopped working on September 30, 1994, and filed a Proof of Loss under her group life and disability policy on December 28, 1994. Co-operators paid Ms. Gumpp disability benefits for almost four years, until November 30, 1998. They terminated her benefits in a letter stating that “the medical information no longer supports that you are totally disabled from all types of employment. That decision was reiterated on October 20, 1999, after a review requested by the insured.

Ms. Gumpp did not commence proceedings until May 24, 2001, about two and a half years after her claim had been denied and monthly payments terminated.

In *Balzer*, Justice Huddart of the B.C.C.A. had stated:

“Read literally, the words of s. 22(1) create the absurd result that the limitation period in this case would have begun to run while the benefits were being paid [because it would be triggered by the Proof of Loss that was filed in order to obtain such benefits], or alternatively, would not begin to run until after a claim was made [if the insured decided, for whatever reason, to wait until later to do so]

... A clear and unequivocal denial of coverage precludes the need to furnish a claim (where the policy does not require the filing of a proof of claim) and triggers the commencement of the limitation period.... It avoids the absurd results

a literal reading of the words of s. 22(1) would otherwise produce in this and like cases.”

In *Gumpp*, Madam Justice Southin applied the same reasoning, even though Co-operators had been paying benefits for almost four years after the Proof of Loss. The claim was therefore dismissed, as being statute-barred.

(b) Application to Property Policies

With respect to property insurers, the above decisions obviously leave unanswered questions such as: What is reasonably sufficient proof of a loss? What is reasonably sufficient proof of a claim under a policy? and, Is there a difference between the two?

However, likely answers to other questions are beginning to emerge:

Q: If an insurer purports to reject a Proof of Loss document, does this postpone the limitation period?

A: Probably.

Q: How does the insurer force the issue if an insured delays in the presentation of a claim?

A: Demand a Proof of Loss within a fixed period of time, failing which the insurer will be compelled to proceed on the basis that the insured had furnished one, and the insurer had clearly and unequivocally denied any and all such claims as of that date.

Q: If an insured does not make a claim, when should the insurer close its file?

A: Not for at least one year after demanding a Proof, or the deadline it has set for doing so.

However, unless the Legislature amends the Insurance Act to deal with these and other issues, in the words of the S.C.C. more “unproductive and wasteful litigation about such technicalities” such as *Gumpp*, *Balzer* and *Watterson*, is still guaranteed.

3. TWO CAUSES ARE BETTER THAN ONE: CONCURRENT CAUSATION - DERKSEN AND BEYOND

Assessing coverage can be very difficult in cases where any particular loss has multiple causes. The situation may involve a “chain of causation” (consecutive causes) or it may involve separate but concurrent causes. In either case, the question will often arise whether the loss is covered if the policy excludes only one of these multiple causes.

(a) *Derksen v. 539938 Ontario Ltd.*, 2001 SCC 72

Until October 2001 the case law had almost universally ruled that if the policy excluded just one of the main causes of the loss, then there was no coverage at all. But then the Supreme Court of

Canada issued its judgement in *Derksen v. 539938 Ontario Ltd.* and completely reversed the old rule.

In *Derksen* a piece of equipment flew off the back of the Defendants truck hitting the bus following behind. There were two separate but concurrent causes of the accident: Negligent clean up of the work site (covered by the Defendants CGL policy) and negligent operation of the truck. (covered by the Defendants auto policy).

The issue was whether the CGL insurer could invoke the standard auto exclusion so as to avoid coverage or the claim. The Court ruled that the CGL insurer was on the hook and commented:

- “there is no compelling reason to favour exclusion of coverage where there are two concurrent causes, one of which is excluded from coverage” and,
- “If an insurer wishes to oust coverage in cases where covered perils operate concurrently with excluded perils, all it has to do is expressly state it in the policy”.

The *Derksen* ruling arguably means that the words “caused by” or “arising out of” in an exclusion clause are not good enough to oust coverage if there are both covered and excluded causes. However, some observes though the case might be a “one off” decision, restricted to its facts, and with no application outside of liability policies.

But this has proven not to be the case. Subsequent decision have made it clear that the *Derksen* principles apply not just to liability polices but also to other types of insurance polices as well, including multi-peril and property policies.

(b) *B&B Optical Management Ltd. v. Bast*, 2003 SKQB 242

The most recent application of *Derksen* in a property policy is the decision of the Saskatchewan Court of Queens Bench in *B&B Optical Management Ltd. v. Bast*, which involved a claim under a multi-peril property policy. Damage was caused to the insured’s electrical equipment because an electrical contractor had negligently mis-matched voltage in certain connections. The policy excluded damage to “electrical devices, appliances or wiring caused by artificially generated electrical currents”. The Court ruled there were two causes of the loss, one of which (Electricity) was excluded, the other which (contractor’s negligence) was not. Hence, applying *Dersken* principles, coverage was enforced.

In applying *Derksen* the Court noted that there was “no indication that concurrent perils were considered by the insurance company in drafting this exclusion clause. There is no mention in the policy of concurrent perils at all”.

By implication the Court was stating that coverage could have been avoided by properly drafted wording in the Policy addressing concurrent causation.

(c) Magic words – An effective *Derksen* clause

What are the magic words necessary to exclude coverage in multiple cause situations? Is the phrase “directly or indirectly” within the exclusion good enough? Note that in the *Derksen* case itself the Supreme Court of Canada referred to language along the following lines:

“We do not insure for such loss regardless of the cause of the excluded event, other causes of the loss, or whether other causes acted concurrently or in any sequence with the excluded event to produce the loss.”

But many insurers continue to ignore the *Derksen* ruling and do not insert the necessary language into their policy wording. In fact, we are aware of only one insurer utilizing the following “Derksen clause”:

In this section of the policy, the words “caused by” mean “directly, indirectly or in any way caused by or resulting from” and exclude coverage for the specified loss or damage regardless of whether other causes, covered or not, acted concurrently or in any sequence to produce the loss.

(d) *Jordan v. CGU and Uegama*, 2004 BCSC 402

A properly worded exclusion actually renders any *Derksen* analysis of multiple causation irrelevant. This is illustrated in *Jordan v. CGU and Uegama* where the exclusion clause provided that there was no coverage for certain types of loss regardless of how caused.

There, roots originating from the Plaintiff’s neighbour grew onto the Plaintiff’s property impeding the drainage system, clogging the sump pump and constraining water drainage from the property. This caused damage to the Plaintiff’s concrete slab foundations, swimming pool and drainage system.

The Plaintiffs were insured under an “all risk” policy with CGU who relied upon two exclusions to deny coverage:

We do not insure:

13. wear and tear, deterioration, defect, design fault or mechanical breakdown, rust or corrosion, extremes of temperature, wet or dry rot or mould, and contamination except that resulting damage by an insured peril is covered.

and

17. settling, expansion, contraction, moving, bulging or cracking of pavements, patios, foundations, walls, floors, roofs or ceilings, except resulting damage to building glass.

CGU took the position that the Plaintiff damages as pleaded, namely, settling, cracking, corrosion and deterioration were expressly covered by the exclusions.

The Plaintiff submitted that the exclusions did not apply by virtue of the sewer backup endorsement that covered “direct loss or damage caused by the backing up or escape of water from a sewer”. The endorsement however provided that it was “subject to all other terms and conditions” of the form. The Plaintiff argued that *Derksen* mandated a broad and not restrictive interpretation of the exclusions and that the sewer backup endorsement extended coverage for the loss in the circumstances.

The Court drew a distinction between provisions that exclude specific types of damage regardless of how caused, and from provisions that exclude damages from a specific type of cause. As such the Court found that the exclusions in this case referred to types of damage incurred, regardless of the cause and were unaffected by the endorsement, which related to loss or damage from a particular cause, namely sewer backup.

In spite of the Plaintiff’s reliance on *Derksen* to argue ambiguity and multiple causation to enforce coverage, the Court commented that a broad interpretation of the endorsement does not change its plain meaning and it was still subject to all the other terms and conditions of the policy, including the exclusion clauses. Further where there is no ambiguity the contra proferentem rule does not apply. The Court therefore enforced the exclusion and dismissed the action against CGU.

4. YOU LIGHT UP MY LIFE: ARSON AND INNOCENT CO-INSUREDS

- (a) *Torchia v. Royal & Sun Alliance Insurance Co.* [2004] O.J. No. 2316 (Ont. C.A.)
leave to appeal dismissed [2004] S.C.C.A. No. 458 (S.C.C.)

Does “for better or worse” inescapably bind one spouse to consequence of the other spouses’ criminal act? At issue in *Torchia* was with whether an innocent spouse could recover under an insurance policy when the loss has been caused by the other spouse intentionally burning down the house.

Mrs. Torchia was the sole owner of a house in Rockwood Ontario in which she resided with her husband. This house was substantially destroyed by fire on February 28, 1997 and Mr. Torchia subsequently charged and convicted of arson with intent to defraud the insurer in relation to the fire. The house was insured with Royal & Sun Alliance but with only Mrs. Torchia as a named insured. However, the policy contained a definition of “you and your” as including the “insured on the coverage summary page and, while living in the same household ... his or her wife or husband”.

In denying Mrs. Torchia’s claim under her policy, Royal relied upon the following exclusion clause:

We do not insure loss or damage:

...

3. resulting from the intentional or criminal acts of, or the failure to act by,
 - a) any person insured by this policy, or
 - b) any other person at the direction of any person insured by this policy[.]

Relying upon the early decision of *Snaak (Litigation Guardian of) v. Dominion of Canada General Insurance Co.* (2002), 61 O.R. (3d) 230 (C.A.) Mrs. Torchia argued that there was an ambiguity in the exclusion clause as it could be read to exclude either the loss of any insured resulting from the intentional or criminal act of a person insured by the policy or only a loss suffered by the person who committed the act. The Court of Appeal distinguished *Snaak* on the basis that the policy there, unlike the Royal Policy, contained a “separate cover” provision which provided that coverage was to apply separately to each person insured. Further the Court of Appeal held that the Royal exclusion clause was clear and unambiguous with no language to suggest that the exclusion was confined to a loss sustained by the person who committed the intentional or criminal act. As there was no ambiguity in the exclusion clause it must be given effect as written and thus the appeal was dismissed with the denial of coverage being upheld.

5. **SOMETIMES CHANGE IS NOT GOOD: MATERIAL CHANGE IN RISK**

(a) Statutory Wordings

An insurers obligation to pay out under a property policy is limited not only by exclusion clauses but also by the common statutory requirement under the policy that the insured advise of any material change in risk.

Most Provinces contain similarly worded material change in risk clauses in their statutory conditions. For instance British Columbia and Alberta contain identical statutory conditions which read:

Material change

4. Any change material to the risk and within the control and knowledge of the insured avoids the contract as to the part affected by the change, unless the change is promptly notified in writing to the insurer or its local agent; and the insurer when so notified may return the unearned portion, if any, of the premium paid and cancel the contract, or may notify the insured in writing that, if the insured desires the contract to continue in force, the insured must, within 15 days of the receipt of the notice, pay to the insurer an additional premium; and in default of such payment the contract is no longer in force and the insurer must return the unearned portion, if any, of the premium paid.

In addition, some Policies contain plain language versions of the material change in risk provision written directly into the policy.

The fire part of the *Insurance Act* also contains a provision relieving against “unjust or unreasonable” terms of the policy which might otherwise support a denial of coverage in any given case. For example, Section 171 of the *Nova Scotia Insurance Act* provides:

171. Where a contract,

(b) contains any stipulation, condition or warranty that is or may be material to the risk including, but not restricted to, a provision in respect to the use, condition, location or maintenance of the insured property,

the exclusion, stipulation, condition or warranty shall not be binding upon the insured if it is held to be unjust or unreasonable by the court before which a question relating thereto is tried.

The Supreme Court of Canada has recently held, in the 5 – 2 decision in *Marche v. Halifax Insurance Co.* 2005 SCC that a statutory condition which provides for the voiding of coverage can be circumvented on the grounds that it is “unjust or unreasonable”?

(b) *Marche v. Halifax Insurance Co.*, 2005 SCC 6

In the *Marche* case, a fire in February 1999 destroyed the insured’s rental property in Sydney, Nova Scotia. When the policy had last been renewed before the fire, the property had been rented. However by September 1998 the property was vacant and remained vacant for three to four months. In December 1998 the property again became occupied by a relative of the insured who remained there until the time of the fire.

The insurer denied coverage under the policy on the basis that the vacancy has been an unreported material change in risk, that the statutory condition had therefore been breached, that coverage was void from the date of the breach, and therefore was not in force at the time of the fire.

The trial court held that, while vacancy was a material change in the risk, the subsequent occupancy had cured the breach and therefore it would be “unjust and unreasonable” to void coverage in the circumstances. The Nova Scotia Court of Appeal reversed that decision, holding that the breach of the statutory condition had voided the policy and the subsequent occupancy could not restore coverage. On further appeal, the Supreme Court of Canada restored the trial decision, holding that Section 171 of the *Insurance Act* does indeed apply to statutory conditions and that the insured should be given relief in the circumstances on the ground that the vacancy had been rectified prior to the loss.

The Court noted that there were two possible alternative applications of the “unjust condition” section of the *Act*, namely that,

1. the section could only be used to delete those policy terms which are not mandated by the statute, i.e. the section did not apply to statutory conditions, (including the condition respecting an unreported material change in risk); or alternatively,

2. the section could be used not only to delete terms (including statutory conditions) that are unreasonable on their face but also to provide relief where, in the particular circumstances of the case, the terms would be unreasonable in their application.

The Court adopted the second approach. Hence, in the *Marche* case, because Section 171 of the *Act* did indeed apply to statutory conditions, and because the unreported vacancy had been cured before the actual loss, the court affirmed that voiding the policy in such circumstances would be an unreasonable application of the policy condition and therefore refused a denial of coverage.

This decision affirms that the “unjust condition” provision in the Fire Part of the *Insurance Act* does indeed apply to statutory conditions and also provides relief where the application of the policy condition would be unjust or unreasonable.

However, some questions remain unanswered in the face of *Marche*.

Still uncertain is whether an insurer is entitled to void coverage on the basis of an earlier but later rectified change to the risk. The decision of the Nova Scotia Court of Appeal in *Marche* applied a “Humpty Dumpty” approach, holding that once a material change in risk occurred the policy was void and could not be repaired by subsequent rectification of the change. The Supreme Court of Canada commented that policy cancellation in the face of a rectified change was a “draconian consequence” and that the material change in risk statutory condition was “not a model of clarity” in this regard. The Court ultimately deferred a determination of this question to be resolved either by legislative amendment or another case. Therefore, it may indeed be possible to put Humpty Dumpty back together again and it is not at all certain that an unreported material change, if rectified, constitutes sufficient grounds to invalidate coverage.

Further, the policy at issue in *Marche* was a specified perils policy rather than the usual and much broader “all-risk” homeowners coverage. As such, still unanswered is whether the saving provision of the *Act* even applies to the modern all-risk insurance policy. In two earlier cases in 2003 (*KP Pacific v. Guardian*, *Churchland v. Gore Mutual*), the Supreme Court of Canada had ruled that the “category-based” Insurance Acts across Canada were “outmoded”, that they did not “coherently address the modern multi-peril policy”, and that such policies were not governed by the Fire Part of the British Columbia *Insurance Act*. Subsequent decisions in Alberta and Newfoundland have applied this reasoning to their respective *Insurance Acts* (*Fenrich v. Wawanesa Mutual*, 2004 ABQB 310; *Burry v. Donahue*, 2003 NLSCTD 165). Manitoba, however, has gone the other way (*Casey v. Federated Insurance*, 2004 MBQB 99). Certainly, in British Columbia it is beyond doubt that the “unjust condition” provision in the Fire Part of its *Insurance Act* does not apply to all-risk policies and, indeed, there is at least one ruling exactly to that effect: *Rosam Enterprises Ltd. v. Zurich Insurance* (BCSC, 1993). Hence, if the *Marche* case had arisen in British Columbia, and the policy had contained a material change in risk condition which provided for voiding coverage upon breach, coverage may then have been successfully denied without any avenue for recourse to the saving provision.

However, an interesting (and potentially draconian for insurers) point remains: Whether in all-risk policies not affected by the Fire Part, but which have incorporated a material change in risk condition, can “automatic voiding” of the sort contemplated by the condition be relieved against,

if not by the savings provision (because the Fire Part doesn't apply), then by the broad "relief from forfeiture" language in the "Law and Equity" or "Judicature"-type acts? Certainly if the application of a statutory condition leads to what Supreme Court of Canada called an "inequitable result, otherwise inescapable" then the judicial trend, as evidenced in *Marche* may well be to grant such relief.

6. **YOU CAN TAKE THAT TO THE BANK: STANDARD MORTGAGE CLAUSES AND MATERIAL CHANGE IN RISK**

(a) Standard Mortgage Clause

It is common for property policies to contain a standard mortgage clause placed at the insistence of a mortgagee. The standard wording provides:

Mortgage Clause

This insurance and every documented renewal thereof - AS TO THE INTEREST OF THE MORTGAGEE ONLY THEREIN - is and shall be in force notwithstanding any act, neglect, omission or misrepresentation attributable to the mortgagor, owner or occupant of the property insured, including transfer of interest, any vacancy or non-occupancy, or the occupation of the property for purposes more hazardous than specified in the description of the risk; PROVIDED ALWAYS that the Mortgagee shall notify forthwith the Insurer (if known) of any vacancy or non-occupancy extending beyond thirty (30) consecutive days, or of any transfer of interest or increased hazard THAT SHALL COME TO HIS KNOWLEDGE; and that every increase of hazard (not permitted by the Policy) shall be paid for by the Mortgagee - on reasonable demand - from the date such hazard existed, according to the established scale of rates for the acceptance of such increased hazard, during the continuance of this insurance. ...

... The term of this mortgage clause coincides with the term of the Policy, PROVIDED ALWAYS that the Insurer reserves the right to cancel the Policy as provided by Statutory provision but agrees that the Insurer will neither terminate nor alter the Policy to the prejudice of the Mortgagee without the notice stipulated in such Statutory provision.

Should title or ownership to said property become vested in the Mortgagee and/or assigns as owner or purchaser under foreclosure or otherwise, this insurance shall continue until expiry or cancellation for the benefit of the said Mortgagee and/or assigns.

SUBJECT TO THE TERMS OF THIS MORTGAGE CLAUSE (and these shall supersede any policy provisions in conflict therewith BUT ONLY TO THE INTEREST OF THE MORTGAGEE), loss under this Policy is made payable to the Mortgagee

The effect of the standard mortgage clause is to protect the mortgagee from any acts or omissions the of the mortgagor that would affect coverage. Thus, if the mortgagor's acts triggered an exclusion clause the mortgagee would still be entitled to coverage. But what happens when the mortgagee is aware of the mortgagors breach of a policy condition?

The Supreme Court of Canada has recently considered the effect of a mortgagees knowledge of a property's vacancy and held that this does not operate to void coverage.

(b) *Royal Bank of Canada v. State Farm Fire and Casualty Co.*, 2005 SCC 34

The Plaintiffs Royal Bank and Alexander held mortgages on a home which was destroyed by a fire. The home was insured by State Farm and Alexander and the Royal Bank, as mortgagees were named insureds under that policy which contained both a vacancy exclusion and the statutory material change in risk provision (Statutory Condition 4).

A fire destroyed a house. By the time of the fire, the insured house had been vacated by the owners and was controlled by the mortgagees. The mortgagees were aware that the house was vacant. Following the fire, the mortgagees made a claim pursuant to the standard mortgage clause in the policy.

State Farm denied the claim because it had not been informed of the vacancy of the house. It asserted that the vacancy was a "change material to the risk and within the control and knowledge" of the mortgagees and that, under Statutory Condition 4, it was entitled to void coverage. The mortgagees sued alleging breach of the policy.

The Ontario Superior Court of Justice found that although Statutory Condition 4 did not conflict with the Mortgage Clause. The Mortgage Clause dealt with changes in risk brought about by the mortgagor and within a mortgagee's knowledge, whereas Statutory Condition Number 4 spoke to changes in risk within a mortgagee's knowledge and control. In his view, Statutory Condition Number 4 would allow the Insurer to void the coverage of a mortgagee who failed to notify the Insurer of a "change material to the risk" within its control and knowledge. However, it was held that Statutory Condition Number 4 was not applicable in the circumstances. The only "change material to the risk" occurred when the owners vacated their house and neither of the mortgagees were in a position to reverse that change as neither had title. Accordingly, neither could be said to have had control over the change.

The Ontario Court of Appeal agreed that Statutory Condition Number 4 did not conflict with the Mortgage Clause. However, the unanimous bench held that Statutory Condition Number 4 had been triggered by the mortgagees and that the Insurer could thus void the policy. In their view, the continued vacancy of the house after the mortgagees gained control of it was a "change material to the risk" within their control and knowledge. In the result, the court set aside the decision and granted judgment in favour of the insurer.

The Supreme Court of Canada in another unanimous decision, reversed the Court of Appeal judgement. Major J.J. writing for the majority held that Statutory Condition 4 could not be relied on by the insurer to void coverage.

Major J.J. started with the premise that it is the wording of the relevant Mortgage Clause which determines the scope of coverage granted to a mortgagee. The mortgage clause provides that its terms “shall supersede any policy provisions in conflict therewith BUT ONLY TO THE INTEREST OF THE MORTGAGEE”. This meant that terms of the policy which conflict with the Mortgage Clause, including exceptions to the mortgagor’s coverage, do not affect the mortgagees’ coverage. Therefore if Statutory Condition 4 conflicts with the Mortgage Clause it could not be relied upon by the insurer to void coverage.

Major J.J. reasoned that there is such a conflict. This conflict was apparent as Statutory Condition 4 would permit the insurer to void coverage on the basis of an unreported material change in risk within the control and knowledge of the “Insured”. Assuming that “Insured” means the mortgagor, this right could not be reconciled with paragraph one of the mortgage clause, which provides that the mortgagees’ coverage shall remain in force notwithstanding any act or omission of the mortgagor which would include causing and not reporting a material change in risk. This conflict remains even if it is assumed that the reference to “Insured” also includes a mortgagee. The only way to avoid such conflict is to read “Insured” to mean only a mortgagee and such a reading is untenable. First because the wording in the mortgage clause specifically distinguishes a mortgagee from the insured. Second, because defining “Insured” to mean only a mortgagee would lead to absurd results if used as the term appeared in other parts of the policy. For instance, it would allow a mortgagee to unilaterally terminate a policy taken out by the mortgagor at any time.

Major J.J. found a further conflict between the mortgage clause and Statutory Condition 4. On the facts here, the alleged material change in risk was the vacancy of the house but the Mortgage Clause specifically stated that the coverage shall remain in force “notwithstanding...any vacancy or non-occupancy” attributable to the mortgagor. To allow voiding the policy for vacancy would defeat the promise contained within the Mortgage Clause for continued coverage in event of a vacancy.

As a result, it was held that Statutory Condition Number 4 conflicts with the Mortgage Clause and is thus superseded in accordance with the latter’s final paragraph. Therefore, the Insurer could not rely on it to void the mortgagees coverage and deny the claims.

This decision, yet again, underscores the importance of policy drafting in both exclusion clauses and grants of coverage. An importance which is reflected in Mr. Justice Major’s comments that:

[30] If the Insurer wished to be able to void a mortgagee’s coverage in the event of a “change material to the risk” within that mortgagee’s control and knowledge of which it was not notified, it should have used clear language to that effect. It cannot expect this Court to contort the Mortgage Clause and Statutory Condition Number 4 in order to fulfill its unreflected, but professedly true, intention.

It remains open for insurers to incorporate clear and plain language which would operate to bind a mortgagee to any material change in risk, including a vacancy, which is within their knowledge and control.

7. IF IT'S BROKE, WHO PAYS TO FIX IT: THE FAULTY DESIGN EXCLUSION

(a) *Canadian National Railway v. Royal and Sun Alliance* [2004] O.J. No. 4086

The very recent decision of Mr. Justice Ground of the Ontario Superior Court of Justice in *Canadian National Railway v. Royal and Sun Alliance* [2004] O.J. No. 4086 thoroughly addressed the scope of the “faulty design” exclusion and the effect of resultant damage.

The action arose out of Royal’s denial of a claim made by CN pursuant to a builder’s all risk insurance policy issued with respect to the construction of a new larger railway tunnel under the St. Clair River. The claims arose out of the failure of a tunnel boring machine to perform as anticipated resulting in substantial loss and damage being incurred by CN to repair the machine and a delay of some 229 days in the opening of the new tunnel. CN’s claim with Royal was over \$ 22 million. Royal denied on the basis of the following exclusions:

SECTION I - BUILDERS RISK INSURANCE

3. **EXCLUSIONS:** This Policy does not insure:

(d) the cost of making good:

- (i) faulty or improper material
- (ii) faulty or improper construction or workmanship;
- (iii) faulty or improper design

provided, however, to the extent otherwise insured and not otherwise excluded under this Policy, resultant loss or damage under any Section of this Policy shall be insured, except that with respect to Architects and Engineers included as Additional Insureds hereunder, such resultant loss or damage shall not be insured and the Insurer(s) shall retain their rights of subrogation against such Architects and Engineers for such resultant loss or damage;

(a) wear, tear, inherent vice, normal upkeep and normal making good; but this exclusion shall not apply to resulting loss not otherwise excluded by this Policy;

...

SECTION II - DELAYED OPENING

9. **ADDITIONAL EXCLUSIONS:**

This Section of the Policy does not cover loss directly resulting from nor delay in completion directly or indirectly caused by:

(e) any alteration, addition or improvement or rectification of any defect or fault which is simultaneously or concurrently completed during the repair or replacement of any items damaged by an insured peril.

Two key issues were discussed and addressed by the Court:

- 1) What does “faulty or improper design” mean; and,
- 2) If faulty design is excluded is resultant damage covered?

(i) Faulty Design:

The Court canvassed the three separate standards developed in the case authority which have been applied in determining whether the loss results from faulty or defective design.

1. Prima facie standard - If a product does not perform or fulfil the purpose for which it was designed, the design will be held to be faulty regardless of whether there was any failure to meet standards of a profession or any negligence on the part of the designer
2. The reasonably foreseeable or negligence standard - The product must be able to function for it's intended purpose after accounting for all reasonably foreseeable risks.
3. The “all foreseeable risks” standard - The product must be able to function for it's intended purpose after accounting for all foreseeable risks not just those risks which would be reasonably foreseeable.

The Court concluded that the law in Ontario is that the standard to be applied to determine whether a design was faulty or improper is that insured property must be designed so that it accommodates all foreseeable risks, even though such risks may be unlikely and remote, and that the standard is not the *prima facie* standard nor a standard of reasonable foreseeability or negligence.

As a result, a designer may not have been professionally negligent in the design because all reasonably foreseeable risks were considered, however, if the designer failed to consider all foreseeable risks coverage will not be provided.

The Court held that the failure of the tunnel boring machine was due to an excess differential deflection sufficient to cause a narrowing of the seal gap beyond tolerance, thereby permitting soil and foreign material to enter the bearing chamber. The Court also went on to hold that such excess differential deflection was not foreseeable in the sense of being foreseeable even though unlikely or remote and therefore the design of the tunnel boring machine was such as to accommodate all foreseeable risks. Accordingly the failure of the tunnel boring machine was not caused by faulty or improper design so as to be excluded under the policy.

(ii) Resultant Damage:

The Court went onto consider, in the event it was incorrect in the conclusion that the failure of the tunnel boring machine was not foreseeable, the proper interpretation of the exception of “resultant loss or damage” to the exclusion of “the cost of making good faulty or improper design”.

The Court concluded that resultant damage referred to loss or damage to insured property other than the loss or damage to the property which was faultily or improperly designed resulting from such faulty or improper design.

8. AROUND THE MALL IN 180 DAYS: REPLACEMENT COST DEADLINES AND RELIEF FROM FORFEITURE(a) *Hua v. Optimum West Insurance Company*, 2005 BCCA 123

On March 4, 2005, the British Columbia Court of Appeal affirmed that “relief from forfeiture” is available to insureds to enforce replacement cost coverage even though the repairs were not made within the 180 day period required by the Policy.

Hua v. Optimum West Insurance Company 2005 BCCA 123 involved a fire claim under a homeowners policy which provided the option of replacement cost loss settlement if the repairs or replacement were carried out “within 180 days after the damage”.

The insured retained a public adjuster who dealt with the insurers adjuster respecting valuation of the loss. The coverage lawsuit was resolved by way of a summary trial based on affidavits from, among others, both adjusters, each of whom testified as to the negotiations between the parties and to different dates upon which the quantum of replacement cost was determined. Ultimately, the Trial Judge preferred the evidence of the insureds public adjuster and ruled it was reasonable for the insured to have held off starting repairs until he had the insurers agreement as to how much of that cost the insurer would cover stating that:

It is only common sense to suppose that an insured will want to know the level of coverage the insurer is prepared to provide before committing himself to a particular reconstruction process.

Section 10 of British Columbia’s *Insurance Act* provides:

If there has been imperfect compliance [in respect of any] matter or thing required to be done ... by the insured with respect to the loss and the Court deems it inequitable that the insurance should be forfeited or avoided on that ground ... the Court may, on terms it deems just, relieve against the forfeiture

In this case, the insurer advanced the ACV within 180 days of the loss but repairs were not carried out before the 180 days expired. The insurer therefore refused to settle the loss on a

replacement cost basis. When the insured sued to enforce coverage by invoking the above relief from forfeiture provision of the Act, the insurer responded that failure to rebuild within the 180 days did not constitute imperfect compliance but rather was non-compliance and Section 10 of the Act therefore did not apply. The Court of Appeal agreed this was the critical issue.

Ultimately, the Court of Appeal ruled that failing to repair/replace within 180 days constituted imperfect compliance with the Policy provision and therefore relief from forfeiture was indeed available under the Act in appropriate circumstances. The Court also ruled there was no basis for disturbing the trial Judges determination that it was reasonable for the insured to have held off starting the repairs or replacement of the property until he had the insurers agreement as to how much of that cost the insurer would pay. In light of the communication difficulties between the adjusters and the insureds acknowledged intention to reconstruct the property throughout, the Court upheld the relief from forfeiture which had been granted by the trial Judge.

This case exemplifies the rock and the hard place between which adjusters often find themselves. Theoretically, it is the insureds sole responsibility to carry out repairs and present the costs for reimbursement by way of the formal proof of loss procedures contemplated by the Policy. In practice, of course, insurers want their adjusters to play a significant role in that process to ensure the costs incurred, and therefore ultimate exposure under the Policy, are kept within reasonable limits. Should disagreements arise with respect to valuation issues, any debate between the parties may, as the *Hua* case demonstrates, result in any 180 day replacement period being waived, whether under the guise of relief from forfeiture or otherwise.

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Problems with Property Policies

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