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Whither Direct Physical Loss or Damage in Canada


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Introduction

The level of disruption unleashed by the COVID-19 pandemic on commerce worldwide has been, indisputably, unprecedented. Canada is no exception. The Canadian Federation of Independent Businesses recently estimated that more than "200,000 Canadian Business could close permanently during the COVID-19 crisis",[1] a figure which could grow in the event that restrictive shutdown orders continue to be issued by Canada's provincial and municipal governments.

There is no doubt that, by design, the insurance industry is better placed than many other business sectors to weather major loss events, including a pandemic such as COVID-19. That being said, insurers face varying levels of exposure from jurisdiction to jurisdiction depending on the legal framework underlying property and casualty insurance. Unfortunately, some of the most critical legal issues which will help define that exposure have yet to be finally determined by Canadian courts, leaving insurers, and the insurance bar generally, attempting to anticipate how the bench will respond.

With an onslaught of both individual and class actions stemming from the COVID-19 pandemic, this chapter aims to provide some insight into how Canadian courts may interpret certain insuring agreements in relation to COVID-19 losses. Specifically, we have analysed one of the recent decisions from the trial court in Ontario which has been and continues to be cited by policyholder counsel as representing a significant extension of coverage: *MDS Inc. v. Factory Mutual Insurance Company (FM Global)* (hereinafter, "*MDS*").[2]

The Concept of Direct Physical Loss or Damage

One of the most prominent issues facing insurers with Canadian risks is whether or not a property policy, which is commonly triggered upon the occurrence of direct physical loss or damage, ought to respond to a claim of losses due to COVID-19. In approaching this question, insurers need to understand what facts the claim for coverage arises out of – what is the "loss" complained of?

At the outset, a distinction must be drawn between those insureds who have presented claims due to the presence of the virus that causes COVID-19 (SARS-CoV-2) itself on their premises and those who have presented claims based on the indirect effects of the pandemic generally. The majority of claims being presented are on the basis that the insured's premises were closed, often in response to a government order, for the purpose of stemming community transmissions and enforcing social distancing protocols. These claims do not arise out of an actual incident involving the presence of the SARS-CoV-2 virus on insured premises.

The closing of businesses because of an event occurring off-premises, or for reasons based in social responsibility, have traditionally been accepted as pure economic losses that do not fulfil the "direct physical loss or damage" requirement. These scenarios are more appropriately classified as simple "loss of use" cases, which are also frequently excluded out of an abundance of caution, rather than cases of "physical loss or damage".

For example, in *Source Food Technology, Inc. v. United States Fidelity & Guaranty Co.*,[3] a decision from the US Court of Appeals, Eighth Circuit, the insured could not import beef products from a Canadian supplier due to the general scare regarding mad cow disease. The insured argued that the product had lost its utility and was therefore physically useless. The Court disagreed, suggesting that this proposition went too far and conflated "loss of use" with "physical loss". The majority of recent American jurisprudence which has been generated in the past year has similarly concluded there is no access to coverage in relation to general shutdown orders or the corresponding economic downturn.

Adopting this reasoning, and while always deferring to the wording of the specific policy at issue, Canadian insurers have generally denied claims for simple loss of use where the policy at issue requires a physical element to trigger coverage.

The question therefore remains: what coverage is there when a case of COVID-19 occurs on the insured's premises? Setting aside any unique civil authority or disease extensions which may eliminate the need for physical loss or damage, the traditional answer has been very little.

The guiding principle of contractual interpretation in the Canadian insurance context is that "when the language of the policy is unambiguous, the court should give effect to clear language, reading the contract as a whole".[4]

As a general proposition, most courts in Canada have recognised that the words "physical loss or damage" reflect a narrow concept. The British Columbia Court of Appeal, in *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Co.*,[5] held that "physical" means "an alteration in the appearance, shape, colour or other material dimension of the property insured". The Canadian approach in *Acciona* seemingly accords with the conclusions arising out of other Commonwealth jurisdictions such as England in *Pilkington UK Ltd v. CGU Insurance plc*,[6] Australia in *R & B Directional Drilling Pty Ltd (in liq) v. CGU Insurance Ltd (No 2)*,[7] and New Zealand in *Kraal v. Earthquake Commission*.[8]

In this regard, while "viral presence" might perhaps qualify as something "physical" in and of itself, the SARS-CoV-2 virus does not in any way alter the physical surfaces with which it comes into contact. It does not, for example, degrade wood causing it to splinter or erode steel resulting in cracks. It does not penetrate surfaces or stick to them permanently. While it can be removed with basic disinfection using readily available cleaning

products, SARS-CoV-2 will, if left alone, simply become inert and generally harmless.

Canadian insurance practitioners have noted that there is a specific line of American jurisprudence that accepts there has been a "physical loss" of property when that property is "uninhabitable" due to the fact that something present at the premises poses a danger to human health. This is despite the fact that there is no physical alteration of the property. For example:

- where asbestos existed in toxic levels, such as being "friable";
- where there were toxic levels of carbon monoxide;
- where there were toxic levels of ammonia;
- where inorganic lead, stemming from lead-based paint, had turned to dust and had contaminated the physical contents of a home;
- where toxic elemental sulphur was effusing from Chinese drywall; or
- where gasoline fumes were "highly dangerous" to humans.

As highlighted in *Acciona*, Canadian courts have not endorsed such a broad definition of "physical". That being said, the March 30, 2020 decision of *MDS*,[9] which has been the subject to significant criticism, recently signalled a potential shift in interpretation.

The Ontario Superior Court's Decision in *MDS*

In *MDS*, Factory Mutual Insurance Company ("FM") had issued a worldwide all-risks policy to the plaintiffs, MDS Inc. and MDS (CANADA) Inc. c.o.b. MDS Nordion ("MDS Inc"). In that case, a leak of heavy water containing radioactive Tritium occurred at the Nuclear Research Universal Reactor ("NRU") located in Chalk River, Ontario. At that facility, Atomic Energy of Canada Limited ("AECL") conducted research and produced radioisotopes. The plaintiffs, MDS Inc., purchased the radioisotopes that were produced at NRU and processed them for sale worldwide. As a result of the aforementioned leak, NRU was shut down for 15 months by the Canadian Nuclear Safety Commission ("CNSC") to conduct an investigation to identify the cause of the leak, conduct repairs, and to meet the CNSC protocol which contained conditions before NRU could restart. MDS lost profits, in excess of $100M, because it was unable to purchase said radioisotopes. As a result, MDS submitted a claim for lost profits to FM pursuant to FM's Contingent Time Element coverage.

Among those coverage issues to be determined was whether the corrosion or nuclear radiation exclusions in the policy applied, and if so, whether an exception for "resulting physical damage" nevertheless restored coverage.

From a factual perspective, the Court noted that there had been longstanding leakage of "light water" from an area known as "the reflector" into what was referred to as the "J-rod annulus". This had been caused by nitric acid that was produced by the radiation of the carbon dioxide in the J-rod annulus. However, this corrosion had been known to AECL, and monitored accordingly, since 1974. It was, therefore, "non-fortuitous".

However, the light water had been treated with chlorine. The Court found that microscopic traces of that chlorine had remained in the light water, and had become an aggressive agent. The agent precipitated a second form of corrosion ("pitting corrosion") in the J-rod annulus which was "unanticipated". The Court held that the loss stemmed from that "unanticipated corrosion … that caused the leak of heavy water" from the calandria into the J-rod annulus.

It was not disputed by the parties that the presence of the leaking heavy water in the J-rod annulus did not cause actual tangible damage in the interior of the J-rod annulus, but did require a 15-month shutdown.

The policy was an all-risks policy which insured losses "directly resulting from physical loss or damage of the type insured by this Policy". There was no dispute that corrosion constituted physical loss or damage and that the NRU constituted property "of the type insured" at a Contingent Time Element Location as that term was defined.

Therefore, the corrosion in the calandria wall which caused the leak of heavy water was held to be covered by the FM All-Risks Policy unless an exclusion applied. The analysis, therefore, turned to the relevant exclusions. The exclusion for "corrosion" was excerpted by the Court (emphasis in original):

> [234] The Policy states:
>
> C. This Policy excludes the following, but, if physical damage not excluded by this Policy results, then only that resulting damage is insured: …
>
> 3) deterioration, depletion, rust, corrosion or erosion, wear and tear, inherent vice or latent defect.

Much of the Court's analysis turned on the definition and interpretation of "corrosion". The Court ultimately concluded that the exclusion did not apply and, even if it did, MDS Inc. was entitled to recover pursuant to the exception for "physical damage not excluded by this Policy results".

Problematically, the Court decided to undertake an analysis in the alternative based on the exception to the corrosion exclusion, which nevertheless restored coverage for "physical damage" that results from the excluded corrosion. Again, the exception only needed to be considered by the Court if excluded corrosion was found. This was not the case.

The Court rejected the insurer's argument that physical damage requires "corporeal, tangible damage". The Court did accept that "[a] review of the US case law confirms generally a narrow view of physical damage" (para. 507); however, despite these cases, the Court rejected this interpretation because there was an actual "leak of heavy water [which] required the shutdown of the NRU rendering it unusable".

There are a number of issues to consider before extrapolating too broadly from *MDS*.

Most importantly, *MDS* is not a case considering COVID-19. This fact has been underemphasised by some policyholders' counsel; the decision is arguably based on the particular facts of that case. Whether it has broader application has yet to be seen.

The Court's analysis on the exception which restores coverage for resulting physical damage is, most importantly, *obiter dictum* in that it is an opinion expressed by a judge, in giving judgment, which was unnecessary for the determination of the case and on which such determination did not rest.[10] Although a judgment issued by a judge of the Superior Court is not binding on any other judge of the same court, *obiter* comments are even less persuasive because they are, by definition, unnecessary. Based on the foregoing, the Court's comments respecting the meaning of direct physical damage are of less weight than they might otherwise have been.

Further, *MDS* concerned actual physical damage caused by corrosion, and the resulting heavy water which contaminated the J-rod annulus thereby preventing its operation. In the case of a COVID-19 outbreak on an insured's premises, there would not be this clear precipitating physical damage.

MDS has reportedly been appealed to the Court of Appeal for Ontario. This further weakens the ability of any party at this point in time to rely on the analysis in the decision given it will be subject to appellate review in due course.

MDS was subsequently referred to by Justice Fitzpatrick of the British Columbia Supreme Court in *Prosperity Electric v. Aviva Insurance Company of Canada*,[11] where its impact was minimised.

Prosperity involved an insured who operated a proprietorship selling electrical equipment. Following a fire which occurred on property adjacent to the insured's premises, a claim was advanced against the first-party property policy issued by Aviva. The fire did not spread to the premises; however, the insured sought "reimbursement for damage to the Premises, damage to the stock on the first floor of the Premises and damage to all of the Second Floor Stock", as a result of smoke deposits which allegedly resulted in chloride contamination.

Investigations were carried out by the insurer. There was no evidence of the contamination complained of in the majority of cases, and in some cases, the damage was so minor that the reconditioning of said stock was feasible. Nevertheless, the insured maintained that the stock was unsaleable. Aviva denied coverage for the Second Floor Stock on the basis that it had not sustained any direct physical loss or damage.

In holding that coverage was not available to the insured, Justice Fitzpatrick held that there was either no evidence of the contamination complained of, or the contamination could be easily remediated. As such, in referring to *Acciona*, which was binding in that jurisdiction, there was no "physical loss or damage" as outlined by the Court in that case. Justice Fitzpatrick also referred to *Transfield* from the New South Wales Court of Appeal and *Pilkington* from the English and Wales Court of Appeal in support of the traditional conclusion.

Lastly, and perhaps most importantly, the Court highlighted the issues inherent in the analysis put forward by *MDS*:

> 62 At paras. 515-519, the Court in *MDS* applied a broad definition of resulting "physical damage" as including, under the all-risk property insurance, "impairment of function or use of tangible property" caused by the unexpected leak of heavy water.
>
> 63 I do not consider *MDS* useful in resolving this matter. The case involved a different kind of policy, a different type of claim and very different facts. With respect, the authorities cited in support of the Court's reasoning (a Nova Scotia Small Claims court decision and various US decisions) are hardly compelling. The reasoning and result are not binding on me. Further, I am advised that the decision is under appeal.
>
> […]
>
> 65 Most importantly, the reasoning in *MDS* and *General Mills* (as with the other American cases) is contrary to that in *Acciona* (BCCA), a decision that is binding on me. At para. 36 of *Acciona* (BCCA), Willcock J. confirmed that the concrete slabs met applicable standards and design requirements and were safe. He further stated however, citing *Pilkington* and *Transfield* in particular:
>
> > The fact that the slabs did not meet the serviceability standard does not mean they had suffered physical loss or damage. The building merely became less useful. The Contractor suffered an economic loss but no property damage.
>
> 66 On that basis, the Court of Appeal in *Acciona* formulated the applicable and more restrictive test for "physical loss or damage". That test does not include, as Mr. Sidhu alleges (but has not proved), loss of function or loss of marketability in its current state.

We also note that, even if there were direct physical loss or damage, the *Prosperity* Court would have applied the contamination exclusion, holding it to be plain and unambiguous on its face.

The *Prosperity* Court reflects the conclusion that would have generally been anticipated under Canadian law and is one which closely resembles the outcomes which have been reached in other Commonwealth jurisdictions. While every claim for coverage must be viewed in its own factual and policy wording matrix, the decision in *Prosperity* reflects the traditional Canadian approach to "physical loss or damage".

Conclusion

The insurance industry continues to grapple with the unique challenges which have been posed by the COVID-19 pandemic. Part of that challenge, in Canada specifically but no doubt in other jurisdictions globally, is contending with the uncertainty which remains in the case law when addressing novel scenarios.

Nevertheless, on a principled interpretation of Canadian case law, property and casualty insurers, absent specific clauses extending coverage, can be expected to continue to resist coverage based on the requirement of "direct physical loss or damage", *MDS* notwithstanding.

Endnotes

1. See "Covid-19 could shutter more than 200,000 Canadian businesses forever, CFIB says", CBC News, January 21, 2021: https://www.cbc.ca/news/business/cfib-survey-1.5882059.
2. *MDS Inc. v. Factory Mutual Insurance Company (FM Global)*, 2020 ONSC 1924.
3. *Source Food Technology, Inc. v. United States Fidelity & Guaranty Co.*, 465 F.3d 834 (US Court of Appeals, Eighth Circuit (October 13, 2006)).
4. *Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada*, 2010 SCC 33 at para. 22.
5. *Acciona Infrastructure Canada Inc. v. Allianz Global Risks US Insurance Co.*, 2015 BCCA 347.
6. *Pilkington UK Ltd v. CGU Insurance plc*, [2004] EWCA Civ 23.
7. *R & B Directional Drilling Pty Ltd (in liq) v. CGU Insurance Ltd (No 2)*, [2019] FCA 458.
8. *Kraal v. Earthquake Commission*, [2015] NZCA 13 (New Zealand Court of Appeal (February 13, 2015)).
9. *MDS Inc. v. Factory Mutual Insurance Company (FM Global)*, 2020 ONSC 1924.
10. *Abbott Laboratories v. Canada (Minister of Health)*, 2006 CarswellNat 185 (F.C.), affirmed 2007 CarswellNat 592 (F.C.A.).
11. *Prosperity Electric v. Aviva Insurance Company of Canada*, 2020 BCSC 1171.

Dominic T. Clarke practises principally in the area of insurance litigation encompassing both coverage and defence matters. A "go-to" counsel for insurers both nationally and internationally, Dominic's expertise is sought out on large and complex coverage claims. He specialises in advising and representing insurers with respect to commercial general liability, directors' and officers' liability and commercial property policies. He has significant experience in the defence of products liability and sexual abuse litigation. A force in the courtroom, he has appeared in the Ontario Superior Court of Justice and the Ontario Court of Appeal. A leading expert in insurance coverage and reinsurance matters, Dominic is a frequent lecturer and is hailed as "very experienced, very agreeable and highly competent" by *Who's Who Legal*, with respondents drawing praise for his litigation practice, especially in coverage disputes. He has published numerous thought leadership pieces in his nearly three decades of practice.

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Anthony maintains a deep and extensive knowledge of insurance law. By keeping himself on the forefront of the most challenging issues facing both the insurance industry and its consumers, he is continually consulting on particularly complex matters, including issues related to COVID-19.

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