

Insurance & Reinsurance - Canada

In a pickle: the limitation of relying on insurance contract exclusions

Contributed by **McMillan LLP**

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A recent decision of the Ontario Court of Appeal demonstrates the limitations on insurers that attempt to use catch-all exclusions in insurance policies. The ruling suggests that insurers should ferment a little longer when drafting exclusions in their insurance policies to avoid costly payouts.

On August 14 2003 an electrical transmission problem created a power blackout in much of Ontario and a large portion of the northeastern United States. The power outage caused a large degree of spoilage at a pickle processing plant in Holland Landing, Ontario. Caneast Foods Limited made a claim of over C\$160,000 under its all-risks insurance policy for lost raw materials, clean-up expenses and the cost of equipment repair arising out of the blackout. The insurer, Lombard General Insurance Company of Canada, denied the claim on the basis that the losses incurred fell under the excluded peril provisions for "change of temperature" or "mechanical or electrical breakdown or derangement in or on the premises".

The court conceded that a 'change of temperature' provision, alone and without any qualifying language, would have been fatal to Caneast's claim for indemnity. Since the phrase itself is clear and unambiguous, any spoilage caused by a change in temperature, no matter what the cause, would be excluded from insurance coverage. However, since the provision was qualified and accompanied by language to provide coverage for "loss or damage caused directly by a peril otherwise insured and not otherwise excluded", a blackout, being otherwise insured and a direct or proximate cause of the spoilage, would negate the 'change of temperature' provision.

While Lombard conceded that the blackout was a proximate or direct cause of the loss, it took the position that the power failure was still excluded under the 'mechanical failure' provision. It argued that based on the dictionary definition of 'breakdown' - being to "suddenly cease to function" or "experience a sudden failure of function" - the equipment failure was not covered by the insurance policy. The Superior Court and the Ontario Court of Appeal each rejected this argument on the grounds that the dictionary definition examples of 'breakdown' suggest that a breakdown must be a consequence of internal failing, and that any other interpretation would be at odds with common sense. Specifically, the courts found that taking the dictionary definitions at face value would lead to an overly broad definition of the term. Furthermore, the courts pointed to previous case law in Ontario, which required that there be an internal problem or defect to the machine in order for a 'breakdown' to be deemed to have occurred. Accordingly, the insurer's argument that the 'mechanical...breakdown' exclusion applied failed.

Lombard also attempted to advance the theory that a failure to have access to the necessary electrical supply would constitute a 'derangement' of the equipment under the insurance policy. Lombard defined 'derangement' as a "disturb[ance of] the normal state, working, operation or functioning of" a machine. While the Superior Court judge struggled with the idea of applying a psychological concept such as 'derangement' to machinery, he ultimately found that a failure to receive power due to a lack of availability would not constitute a derangement. The Ontario Court of Appeal affirmed this view, stating that as with 'breakdown', 'derangement' refers to an internal problem or defect in the machine, and not to the machine's inability to operate due to a lack of access to a power supply resulting from a regional blackout.

With this decision in mind, insurers, insureds and their brokers are advised to:

- review the terms of insurance policies, particularly the exclusions, to ensure that coverages and exclusions are as intended;
- consider including a blackout provision as an excluded peril, since the ceased operations of machinery caused by an external power failure does not constitute a mechanical breakdown or a derangement;
- revisit the obligations of insureds to mitigate potential losses caused by power

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failures, such as the use of back-up generators during peak mechanical operation periods and how premiums would adjust for insureds that build in such redundancies;

- revisit the provisions in their policies to educate themselves as to plain language terms, such as 'change of temperature', which do not leave room for appeal based on an interference by external factors; and
- consult with legal counsel if in doubt about potential liability and policy terms.

For further information on this topic please contact [Hartley Lefton](#) at McMillan LLP by telephone (+1 416 865 7000), fax (+1 416 865 7048) or email (hartley.lefton@mcmillan.ca).

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