THE INS AND OUTS OF

THE "IMPAIRED PROPERTY" EXCLUSION

IN

COMMERCIAL GENERAL LIABILITY POLICIES

SANDRA L. HAWES
&
DEBRA CURCIO LISTER

JULY 2016

TABLE OF CONTENTS

THE INS AND OUTS OF THE "IMPAIRED PROPERTY" EXCLUSION UNDER COMMERCIAL GENERAL LIABILITY POLICIES

I. INTRODUCTION

Contractors generally bear two main types of risks. First, the risk of being liable for providing deficient, shoddy or incomplete work or products, and second, the risk of being liable for bodily injury or property damage resulting from providing shoddy work or products.[1] Broadly speaking, Commercial General Liability (CGL) insurance only protects against the second type of risk, as the first is a "business risk" within the control and responsibility of the contractor.

Modern CGL policies exclude coverage for these "business risks" in many ways, including by the impaired property exclusion. This particular exclusion clause is notoriously complex, spawning a body of case law, mostly in the United States, dealing with its interpretation and exclusion.

II. AN OVERVIEW OF CGL POLICIES

A. *A Brief History*

Commercial liability insurance is a creature of the 21st century. Developed in the 1930's, Comprehensive General Liability Insurance – later renamed Commercial General Liability insurance - responded to North America's rapid post-war industrialization and manufacturers' increased liability beyond their factory floors.[2]

While liability insurance is recognized as a type of insurance under the Insurance Acts of the respective provinces and territories in Canada, CGL policies are not subject to the same level of statutory regulation as the other recognized forms of insurance.[3] As such, there is no mandatory uniform CGL policy for Canadian insurers and brokers. The same is true in the United States. Practically speaking, this means each insurance company providing CGL coverage is free to issue its own policy wording, subject only to approval of the Superintendent of Insurance for the province.[4] It bears emphasizing then, that each CGL policy should be carefully read, as its interpretation will ultimately turn on its own, unique wording.

That being said, insurance industry organizations in Canada and the US create standard form CGL contracts as model policies, and update them from time to time.[5] The standard form language is commonly adopted by insurers and brokers. The Insurance Services Office (ISO) in the US published the first standard form CGL in 1955, which was revised in 1966 and 1973.[6] The Insurance Bureau of Canada (IBC) followed suit by producing standard 'Form 2100' in 1978, which largely adopted the wording of the 1973 ISO policy.[7]

---

[1] Heather A Sanderson *et al., Commercial General Liability Insurance,* (Markham & Vancouver: Butterworths Canada, 2000) at 141 [Sanderson].

[2] Sanderson at 3.

[3] Sanderson at 5.

[4] Sanderson at 6. See for e.g. Alberta's *Insurance Act*, RSA 1980, c I-5, s 537, which provides: "The Superintendent may require an insurer to file with him a copy of any form of policy or of the form of application for any policy or of any endorsement or rider or advertising material issued or used by the insurer".

[5] Sanderson at 6.

[6] Sanderson at 6, 148.

[7] Sanderson at 148.

The ISO overhauled its standard form CGL in 1986 to add a number of new exclusions, including the impaired property exclusion.[8] The standard form's most recent modernization occurred in 2013.[9] Once again, the IBC played copycat by making similar changes to its standard form in 1987 (Form 2001). The most recent standard form CGL policy in Canada is Form 2100, updated and issued by the IBC in 2005.[10]

B. *What is Covered?*

CGL policies are only intended to protect the insured in the event its performed work or provided products accidentally cause damage to someone else's person or property. The contractor's liability for its deficient, shoddy or incomplete work is generally not covered by CGL insurance. This risk allocation and cost sharing between the insured and the insurer is an underlying or organizing principle of CGL policies, oft-cited by courts when tasked with interpreting these particular contracts of insurance.[11]

In order to claim indemnification under a CGL policy, an insured must generally establish the following elements on a probability basis:[12]

1. The claim must be with respect to the named insured or an entity coming within the definition of "persons insured";

2. The claim must have occurred during the policy period and within the coverage territory;

3. The claim must be due to an "occurrence" as defined;

4. The insured's liability must constitute a legal obligation to pay compensatory damages with respect to "property damage" or "bodily injury" as defined.

C. *What is Excluded?*

Once an insured has brought itself within the policy's scope of coverage, it falls to the insurer to establish the applicability of an exclusion.

The essence of an insurance contract is to protect the insured from liability and costs that are fortuitous and outside of the insured's control. The competence of service provided and the quality of goods supplied are factors within the insured's control. Furthermore, the risk of incompetence is inherent, normal and foreseeable, and can be controlled through the insured's own preventative measures or product and safety controls. Put simply, the losses a contractor becomes liable for as a result of failing to uphold his side of the bargain is simply the anticipated

---

[8] Caroline B Newcombe, "The Impaired Property Exclusion" (2002) 52:3 FDCC Quarterly 365, online: < http://www.thefederation.org/documents/Newcombe-Sp02.htm> [Newcombe].

[9] "ISO General Liability Form Revisions – Effective April 1, 2013" online: <https://www.marsh.com/us/insights/research/iso-general-liability-form-revisions.html>.

[10] Gordon G Hilliker, *Liability Insurance Law in Canada,* 6th ed (Toronto: LexisNexis, 2016) at 247 and 417 [Hilliker].

[11] See for e.g. *Weedo v Stone-E-Brick Inc,* 405 A.2d 788 at p 791 (NJ 1979), cited as the leading authority in *Cansulex v Reed Stenhouse* (1986), 70 BCLR 273, 18 CCLI 24 (BCSC), where the Court delineated the drastic difference in the contractor's responsibilities for bearing losses depending on the nature of the risk at issue:

> The accidental injury to property or persons substantially caused by his unworkmanlike performance exposes the contractor to almost limitless liabilities. While it may be true that the same neglectful craftsmanship can be the cause of both a business expense of repair and a loss represented by damage to persons and property, the two consequences are vastly different in relation to sharing the cost of such risks as a matter of insurance underwriting.

[12] Sanderson at 151. See *Trafalgar Insurance Co v Imperial Oil Ltd* (2001), 57 OR (3d) 425, 154 OAC 7 at para 18 for the onus on the insured to establish that the claim falls within the policy's scope of coverage.

cost of doing business; it is a "business risk". Accordingly, business risks are not properly passed off to an insurer; rather, it should be reflected in the cost of the good or service being rendered or ultimately borne by the provider. For these reasons, CGL insurers are not and should not be guarantors or warrantees of the insured's work or product quality, nor should CGL policies be treated as performance bonds.[13]

The intention and foundational principle behind the "business risk" exclusion clauses is to prevent the insured from receiving coverage for the costs associated with making good its work or product where the work or product is defective or not what was bargained for.[14] Courts are very aware of this underlying limit on CGL coverage and it informs and guides coverage analysis. They have also affirmed the general exclusion of these types of business risks from CGL coverage:[15]

> No matter how diligently and how assiduously a contractor attempts to control the workmanship and materials used on the project, when, in spite of those efforts, the projects fall short, the consequences of the failure is endemic in a commercial undertaking … claims for damage to the product itself… [are] … not covered under the contractor's comprehensive general liability policy…this type [of risk is] "business risk". … Even though an examination of the CGL policies in this case … will reveal no exclusions specifically designated as "business risk", in insurance law the scope of the phrase is well understood.

Business risk exclusions also serve the public policy goal of encouraging and incentivizing good workmanship. The rationale for these exclusions is best illustrated by the following passage:[16]

> I am hesitant to think that a comprehensive general liability policy covers a contractor for the cost of having to repair or replace his own negligently done work as opposed to the cost of redressing damages caused to others through the contractor's carelessness. Were that the case a contractor could bid a job for $1 million, do it carelessly at minimal cost to itself, and then claim from the insurer the cost of redoing the work as it should have been done in the first place for $1 million.

D. *The Principal Exclusions in Brief*

The most common exclusion clauses discussed and applied in insurance litigation are as follows: 1) the contractual liability exclusion, 2) the "Your Work" exclusion, 3) the "Your Product" exclusion, 4) the recall or sistership exclusion, and 5) the impaired property exclusion.

The contractual liability exclusion prevents the insured from receiving coverage for liability it assumes under any contract or agreement with two exceptions. First, coverage will not be excluded if the insured becomes liable for property damage or bodily injury to a third party resulting from a breach of warranty. Second, coverage will not be excluded for liability the

---

[13] Hilliker at 142.

[14] Hilliker at 271.

[15] *Knutson Construction Co v St Paul Fire & Marine Insurance Co,* 396 N.W.2d 229, 233-34 at p 235 (Minn. 1986), cited with approval in *Privest Properties v Foundation Co of Canada Ltd* (1991), 57 BCLR (2d) 88, 6 CCLI (2d) 23 (BCSC)

[16] *Quintette Coal Ltd v Bow Valley Resource Services Ltd* (1987), 21 BCLR (2d) 203, 1987 CanLII 2410 at para 5 (BCSC).

insured assumes under an "incidental contract" as defined, which is generally an assumption of the tortious liability of a third party.[17]

The "Your Work" or "work performed" clause excludes from coverage the risk that the insured may be required to correct a deficiency in the work performed by it or on its behalf under the contract. This exclusion applies if: (i) the insured's work is represented by tangible property, (ii) property damage occurs to the tangible work performed by or on behalf of the insured, and (iii) that property damage arises or results from the insured's work.[18] Put simply, if the insured's negligent or deficient work under a contract results in property damage to the very work performed, the "Your Work" exclusion operates to deny the insured's recovery for any claim made against it in that respect.

The "Your Product" clause is a counterpart to the "Your Work" exclusion. This clause operates to deny coverage for the insured's liability for replacing or repairing the defective goods or products sold by it or on its behalf. The definition of an insured's product notably includes the warranties, representations, warnings and instructions that accompany the product as well. Thus, whenever the insured faces a claim related to its defective product or stemming from its representations concerning that product, this exclusion may be applicable. When the insured supplies a product of many components, and only one component fails or is damaged, the exclusion nonetheless applies to the entire product. However, where the insured's product is only one component incorporated into someone else's larger product, the exclusion only applies to property damage to the insured's component.[19]

The recall or "sistership" exclusion clause removes from the scope of coverage the costs associated with recalling the insured's defective product from the market and taking preventative action against similar defects occurring in the future.[20]

III. AN IN-DEPTH EXAMINATION OF THE IMPAIRED PROPERTY EXCLUSION

A. *Standard Form Impaired Property Exclusion Clauses and Related Definitions*

The following is the advisory or model wording for the impaired property exclusion clause found in the 2005 IBC standard form CGL policy (Form 2100):[21]

> **j. Damage to Impaired Property or Property Not Physically Injured**
>
> "Property damage" to "impaired property" or property that has not been physically injured, arising out of:
>
> **(1)** A defect, deficiency, inadequacy or dangerous condition in "your product" or "your work"; or
>
> **(2)** A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

[17] Hiliker at 248-249.

[18] Hilliker at 274-275.

[19] Hilliker at 272-273.

[20] Hilliker at 279.

[21] See Hilliker Appendix E at 417-438 for a full copy of the 2005 IBC standard form CGL (Form 2100).

> This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to "your product" or "your work" after it has been put to its intended use".

The wording of the impaired property exclusion in the IBC standard form CGL policy is identical to that contained in the 1986 American ISO standard form.[22]

Below are excerpts of the relevant defined terms contained in the impaired property exclusion, also found in the 2005 IBC standard form CGL policy (Form 2100):

> **13.** "Impaired Property" means tangible property, other than "your product" or "your work", that cannot be used or is less useful because:
>
> > **a.** It incorporates "your product" or "your work" that is known or thought to be defective, deficient, inadequate or dangerous; or
> >
> > **b.** You have failed to fulfill the terms of a contract or agreement;
>
> if such property can be restored to use by:
>
> > **a.** The repair, replacement, adjustment or removal of "your product" or "your work"; or
> >
> > **b.** Your fulfilling the terms of the contract or agreement.
>
> …
>
> **25.** "Property Damage" means:
>
> > **a.** Physical injury to tangible property, including all resulting loss of use of that property; or
> >
> > **b.** Loss of use of tangible property that is not physically injured.
>
> …
>
> **31.** "Your Product":
>
> **a.** Means:
>
> > **(1)** Any goods or products, other than real property, manufactured, sold, handled, distributed or disposed of by:
> >
> > > **(a)** You
> > >
> > > **(b)** Others trading under your name; or
> > >
> > > **(c)** A person or organization whose business or assets you have acquired; and
> >
> > **(2)** Containers (other than vehicles), materials, parts or equipment furnished in connection with such goods or products.
>
> **b.** Includes

[22] See Newcombe at 365-366 for an excerpt of the exclusion clause in the 1986 ISO standard form.

> **(1)** Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your product"; and
>
> **(2)** The providing of or failure to provide warnings or instructions
>
> **c.** Does not include vending machines or other property rented to or located for the use of others but not sold.
>
> **32.** "Your Work":
>
> **a.** Means:
>
> **(1)** Work or operations performed by you or on your behalf; and
>
> **(2)** Materials, parts or equipment furnished in connection with such work or operations.
>
> **b.** Includes
>
> **(1)** Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your work", and
>
> **(2)** The providing of or failure to provide warnings or instructions.

Some policies or insurers may still be utilizing the language contained in the older 1987 IBC standard form (Form 2001). Accordingly, the impaired property exclusion clause contained in that standard form CGL policy is appended below for comparison sake:[23]

> This insurance does not apply to:
>
> (k) to loss of use of tangible property which has not been physically injured or destroyed resulting from
>
> (1) a delay in or lack of performance by or on behalf of the Named Insured of any contract or agreement, or
>
> (2) the failure of the Named Insured's products or work performed by or on behalf of the Named Insured to meet the level of performance, quality, fitness or durability warranted or represented by the Named Insured;
>
> but this exclusion does not apply to loss of use of other tangible property resulting from the sudden and accidental physical injury to or destruction of the Named Insured's products or work performed by or on behalf of the Named Insured after such products or work have been put to use by any person or organization other than an Insured;

B. *Components of the Impaired Property Exclusion*

The impaired property clause contemplates a situation where the insured's faulty work or product is incorporated into another person's larger product and thereby causes that larger product to become unusable or less usable. It is clearly aimed at narrowing the insured's scope

[23] See Hilliker Appendix B at 409-411 for a copy of the 1987 IBC standard form CGL (Form 2001).

of coverage for one type of "property damage" it causes to a third party - defined as "loss of use but not physical injury" – from the incorporation of its work or products. The general purpose of the impaired property exclusion is to prevent the insured from recovering the cost of repairing or replacing the defective product, redoing the shoddy work, or being responsible for the claimant's economic losses resulting from the lost use of its product.

In summary, the following are the components that the insurer must establish in order for the exclusion to apply and deny coverage:

1. The insured's work or product is incorporated into tangible property belonging to a third party that is not the insured.

2. As a result of either (i) the insured's deficient product or work, or (ii) the insured's failure or delay in performing its contractual obligations,

3. The tangible property is rendered less or not useful, but is not physically injured.

4. The tangible property can be restored to use by either (i) replacing or repairing the insured's defective component product, or (ii) fulfilling the terms of the contract.

If those elements are proven by the insurer to the appropriate standard, the onus shifts back to the insured to establish the applicability of the following exception to the exclusion:

> If the loss of use of the tangible property was attributed to a sudden and accidental physical injury to the insured's component work or product after being put to its intended use, coverage is not excluded.

One academic commentator provided the following general summary about the application of the impaired property exclusion:[24]

> 1. If the larger product is physically damaged from the defective component, the component manufacturer is covered for resulting liability (unless another exclusion applies).
>
> 2. If the larger product is made less useful by the defective component, though not physically damaged, there should be no coverage.
>
> 3. If the larger product is not physically damaged nor made less useful, but has less market value than it would have if the defective component were repaired or replaced, there should again be no coverage.

C. *Common Issues in Interpreting and Applying the Impaired Property Exclusion*

(i) Loss of Use Requirement

The courts have made it clear that the impaired property exclusion only applies to tangible property that has been rendered unusable or less usable as a result of the insured's defective work or product being incorporated into it. It does not apply to claims of physical damage to the larger property caused by the insured's defective work or product. Put another way, if the incorporation of the insured's work or product results in physical damage to the larger

[24] Mark G Lichty & Marcus B Snowden, *Annotated Commercial General Liability Policy,* looseleaf (consulted on June 20, 2016), (Toronto: Carswell, 2013) at 23-3 [Lichty & Snowden].

product, the exclusion does not apply and coverage will be provided subject to some other exclusion. Broadly speaking, this component of the exclusion ensures that economic losses suffered by the insured's customers as a direct result of incorporating the insured's faulty work are not recoverable by the insured under its CGL policy.

The following is a discussion of some Canadian and American jurisprudence elaborating on the "lost use" requirement and demonstrating its application to the facts of a claim.

In *Modern Agro Systems Ltd v Wellington Insurance Co*,[25] a dairy farmer purchased a milk tank and volume gauge from the insured who improperly calibrated the gauge upon installation. As a result of the faulty gauge, the farmer delivered a greater volume of milk than intended for the price charged and sought damages from the insured for its lost profits.[26] The Court upheld the insurer's denial of coverage under the impaired property exclusion. The farmer lost the use of his milk (the impaired property) as a result of the defective gauge supplied by the insured. Since no physical damage occurred to the tank or the milk, and this was simply an economic loss claim from lost use of a product, the exclusion applied.[27]

In *March Elevator Co v Canadian General Insurance Co*,[28] the insured failed to perform its obligations under an elevator maintenance contract with the plaintiff. As a result, the insured was sued for: (1) the costs of repair to the elevators (the property damage caused by failure to perform maintenance work), and (2) the lost income caused by the rent reduction granted for the reduced elevator services (the economic losses suffered from the lost use of the elevators).[29] The Court held that the insurer was not obligated to defend or provide coverage to the insured for these heads of damages as the impaired property exclusion applied.

The elevators were "impaired property": tangible property rendered less useful because they incorporated the insured's defective repair/maintenance work or the insured failed to fulfill its agreement to perform maintenance on them.[30] The Court held that CGL policies were never intended to cover the insured's costs of correcting its own work where proven to be defective or not what was bargained for. Furthermore, the impaired property exclusion rightfully applied to deny the insured's recovery of the plaintiff's economic losses related to the unusable elevators, as they directly resulted from the insured's deficient contractual performance.[31]

The insured in *Alie v Bertrand & Frere Construction Co*[32] was a concrete manufacturer that provided defective concrete for use in residential foundations. The deficiencies in the insured's product resulted in massive structural defects requiring total replacement of the homes. The Ontario Court of Appeal upheld the trial judge's finding that the impaired property exclusion had no application. Although the insured's product (concrete) was incorporated into a larger product (residential homes), its deficiencies resulted in serious physical injury to the foundation and most of the affixed property, not merely lost use of the homes. Furthermore, the property could not be restored simply by replacing the insured's faulty component (the

---

[25] (1986), 21 CCLI 143, 1986 CarswellOnt 746 (Ont H Ct J)

[26] *Ibid* at para 1.

[27] Hilliker at 277.

[28] [1995] ILR 1-3227, 1995 CarswellOnt 1237 (Ont Ct Gen Div)

[29] *Ibid* at para 1.

[30] Lichty & Snowden 23-5 – 23-6.

[31] Lichty & Snowden 23-5 - 23.6.

[32] 30 CCLI (3d) 166, [2000] OJ No 1360, (Ont Sup Ct J) varied on other grounds by 62 OR (3d) 345, 222 DLR (4th) 687 (Ont CA).

concrete); rather, restoration required replacement of the entire structure.[33] As such, the claim was not excluded from coverage under the impaired property clause.

The American case of *Oxford Aviation Inc. v Global Aerospace Inc.*[34] involved an allegation that Oxford's negligent repair and installation work on Airlarr's airplanes resulted in the cracking of one plane's side window and a loss of use of that airplane. The Court held that the CGL policy did not deny coverage for the physical injury to Airlarr's property caused by Oxford's negligent work, but did bar recovery for Airlarr's loss of use claims arising from the insured's deficient work.[35] The airplane became "impaired property" when it was out of commission as a result of Oxford's negligent work and could be restored to use by fulfillment of Oxford's contract. Accordingly, Airlarr's economic losses from the lost use of the plane were not recoverable by the insured under the impaired property clause.

In *Transcontinental Insurance Co v Ice Systems of America Co*,[36] the insured provided a promoter of an ice hockey game with a faulty portable ice rink that failed to properly allow the ice to freeze. The promoter suffered lost profits when forced to cancel the game as a result of the defective ice rink. The insured then sought indemnification from its CGL insurer for the promoter's economic losses it was held liable for as a result of its defective product. In summary: as a result of the insured's defective rink, the promoter suffered a loss of use of its intended venue for the hockey game and economic losses from foregone ticket sales that could have been rectified by replacement of the insured's defective product. The Court concluded that this claim for economic loss fell squarely within the impaired property exclusion and upheld the insurer's denial of coverage.[37]

In *Aetna Casualty and Surety Co of America v Deluxe Systems Inc*. of Florida,[38] the insured supplied faulty shelving components used by one if its customers in the business of storing business records. The shelving units were structurally inadequate when eventually put to use by the customer. The customer had to temporarily shut down its business, remove the defective shelving units, and replace them with better product from a different manufacturer. The insured was sued for the cost of replacing its shelving product, and the lost profits from the temporary shut-down of its storage facility necessitated by the insured's defective shelves. No physical damage befell any other person or their property from the shelving, only economic loss from the lost use of the customer's facility. Accordingly the Court held that the insured's liability to its customer for its lost profits were excluded under the impaired property clause.[39]

(ii) Property Capable of Restoration by Replacement or Repair of Insured's Component Product

Both Canadian and American courts have examined and interpreted the "restoration" requirement of the impaired exclusion clause. Generally speaking, this element of the exclusion is unambiguous: the larger product that incorporates the insured's defective work must be capable of becoming usable once again by simply repairing or replacing the insured's

[33] Lichty & Snowden at 23-6.

[34] 680 F.3d 85 (5th Cir 2012).

[35] Lichty & Snowden at 23-12.

[36] 847 F.Supp 947 (D. Fla 1994).

[37] Newcombe at 377.

[38] 711 So.2d 1293 (Fla Dist Crt of App 4th District).

[39] Sanderson at 179-180.

component. This element makes clear that the exclusion was only meant to limit coverage for damages stemming from property rendered less useful as long as that property was capable of becoming usable again simply by fixing the insured's component.

In *Danric Construction Ltd v Canadian Surety Co*,[40] the insured was sued under a contract it held with Tavistock Properties for the performance of blasting work. Tavistock contracted with the insured for work on the steep slopes of land above Okanagan Lake that it was developing into residential properties. Tavistock sued the insured for over-blasting and failing to carry out the work appropriately, which caused the land to be irremediably and physically damaged. The Court's concluding remarks on the inapplicability of the impaired property exclusion bear repeating:[41]

> This is not a case where the repair of [the contractor's] work will restore the damaged real property. The property beyond the design line cannot be remedied by correcting [the contractor's] work. Indeed, the loss of such property may very well never be remedied, as this may be a physical impossibility. I agree with Mr. Twinning that this is not a case of "impaired property" as defined in the policy. It follows that the exclusion does not apply.

In *Carwald Concrete & Gravel Co v General Security Insurance Co of Canada*[42] Phoenix was the general contractor under a contract for the construction of a gas processing plant for Amoco Canada. The plant was to be constructed on a pad comprised of concrete poured over rebar, reinforcing steel, plumbing, writing and other materials. Phoenix purchased the concrete component for this pad from Carwald, which proved to be of insufficient strength and not in accordance with the contract specifications. Once Carwald's concrete was poured, it rendered the entire pad defective and necessitated the replacement and removal of not only the concrete element, but also the rebars, ducting, wire, plumbing and other pad components. The Court held that the insured's defective product (Carwald's concrete) resulted in physical injury to other tangible property (all the components of the concrete pad). Additionally, the pad to which the insured's defective concrete was added could not be remedied simply by replacing the insured's component; the other pad components had to be replaced as well.[43] As a result, the impaired property exclusion had no application and coverage was not denied.

Sokol and Co v Atlantic Mutual Insurance Co[44] is another good example of the application of the impaired property exclusion, and in particular, the restoration requirement and the bar on recovery for loss of use claims. In that case, Sokol (the insured) manufactured sealed peanut butter paste packets for inclusion as a component in Continental Mills' cookie mix boxes. Before the boxes were sold, Continental discovered the paste was rancid and sued Sokol for the cost of replacing its defective paste with the product of a different manufacturer. The Court upheld the insurer's denial of coverage under the impaired exclusion clause. The cookie boxes were "impaired property", as they incorporated the defective product of the insured (the rancid paste) and were rendered unusable as a result. However, since the paste was an isolated component in the box, the cookie box mix could be restored by simply replacing the insured's

---

[40] 2000 BCSC 1663, 24 CLR (3d) 220 at paras 1-2.

[41] *Ibid* at para 25.

[42] 1985 ABCA 288, 24 DLR (4th) 58 at para

[43] Licthy & Snowden at 23-5.

[44] 430 F.3d 417 (7th Cir 2005)

defective packet. Accordingly, the economic losses arising from the restoration of the impaired property were not recoverable by the insured by virtue of the impaired property exclusion.[45]

Cytosol Laboratories Inc. v Federal Insurance Co[46] is another defective product case where the impaired property exclusion applied. The insured, AMO, was a pharmaceutical manufacturer of saline solution that was purchased by Cytosol for inclusion in its eye irrigation product box. AMO's product turned out to be defective and dangerous, thereby rendering Cytosol's product box unusable with its incorporation. However, Cytosol's product could be restored to use by replacing AMO's defective product with safe solution. Further, there was no physical injury to Cytosol's product as a result of AMO's product being included in the box. Accordingly, AMO was denied indemnification by its CGL insurer for the business losses of Cytosol resulting having to replace AMO's faulty component.[47]

Mullins Whey Inc v McShares Inc.[48] is a defective product case where the component was physically mingled with other products and not easily separated and replaced. This case involved a claim for losses stemming from the incorporation of Mullins' defective whey protein powder into Next Proteins' food product. The protein powder was contaminated with chemicals that rendered it unfit for human consumption. The Court held that the impaired property exclusion had no application in this case. The incorporation of the insured's defective product (Mullins' protein powder) into Next's food product rendered it inedible and unusable. However, Next's product could not be restored to use by simply removing Mullins' product, as it had become an inextricable part of the mixture. Put simply, Next's product was irrevocably ruined once contaminated with the whey powder. Thus, the impaired property exclusion did not apply to deny coverage.

The case of *Shade Foods Inc. v Innovative Prods Sales 7 Mktg Inc.*[49] provides another good example of the restoration requirement in the exclusion. In that case, the insured provided the diced almond component for the nut clusters used in General Mills' cereal. It turned out that the insured's product was contaminated with wood splinters, which rendered the nut clusters inedible. The insurer unsuccessfully attempted to argue that coverage should be denied under the impaired property exclusion, because the nut clusters could be restored to use by removal of the insured's contaminated food component. [50] The Court disagreed, finding that it was "fanciful to suppose that the nut clusters composed of congealed syrups and diced nuts or the boxed cereal product containing the nut clusters could be somehow deconstructed to remove the injurious splinters and then recombined for their original use".[51] In the result, the impaired property exclusion was not applied to deny coverage.

The Court in *Label Corp v Northbrook Property & Casualty Insurance Co*,[52] made clear that in order for the exclusion to apply, the unusable product need only be capable of restoration, not actually restored. In that case, the insured manufactured labels for feminine hygiene products sold by retailers. As a result of the insured's mislabelling of the product's

---

[45] Litchy & Snowden at 23-11.

[46] 536 F.Supp.2d 80 (D. Mass 2008)

[47] Lichty & Snowden at 23-11 – 23-12.

[48] 2005 US Dist LEXIS 39289 (ED Wis 2005).

[49] 93 Cal.Rptr.2d 364 (Ct. App 2000) [*Shade Foods*].

[50] Newcombe at 373.

[51] *Shade Foods* at 377.

[52] 607 NW.2d 276 at 281 (Wis 2000)

price, Wal-Mart undercharged for the product and sued the manufacturer for its resultant lost profits. The Court denied coverage on several grounds, including the impaired property exclusion. The insured argued that the packages sold at the wrong price were not impaired property because they could no longer be repaired, as they had been sold and could not be recovered to change the label. The Court rejected this premise, finding that the product was clearly impaired because it could have been restored to full use by replacing the defective labels before they were sold.[53]

(iii) Deficient Work or Unfulfilled Performance

Another fact pattern that engages the impaired property exclusion involves an insured providing defective or delayed construction work on a building and being sued for the resultant economic losses.

In *Merchandise Building Inc. v Aviva Insurance Co of Canada*,[54] San-Mar was hired by Merchandise to demolish the interior structure of a warehouse building in order to convert the space into a mixed residential and commercial complex. As a result of San-Mar's negligence, a fire occurred during the demolition work, causing physical damage to the structure and delay to the project. San-Mar became insolvent shortly after the accident and was unable to complete its demolition contract. As such, Merchandise commenced an action against San-Mar's insurer, Aviva, claiming property damage from the fire, the cost of removal of debris, and the economic losses from project delay. The parties agreed to proceed by way of arbitration. The liability of San-Mar/Aviva for the physical damage to Merchandise's property as a result of the fire was not contested. The cost of debris removal was held to be excluded under the "your work" exclusion in Aviva's policy; since San-Mar's contractual obligation was to demolish and remove debris, Aviva was not responsible for indemnifying Merchandise for the cost of redoing or repairing the exact demolition and debris removal work not fulfilled by San-Mar.[55]

The arbitrator concluded that the impaired property exclusion applied to prevent Aviva from having to reimburse Merchandise for its loss of use claim. Merchandise's building was "impaired property": it was rendered useless for a period of time because of a dangerous condition in the insured's work and a delay or failure of the insured to complete performance under the demolition agreement. Further, it could be restored to intended use by simply completing the insured's demolition work under the contract.[56] He rejected Merchandise's argument that the property could not be restored because San-Mar had abandoned the work or was no longer able to fulfill its agreement. Instead, he held that the restoration requirement only required the property be capable of being resorted to use by fulfilling the insured's contractual obligations, not that the insured be the one to finish the job.[57] The Ontario Superior Court upheld the arbitrator's decision in its entirety.[58]

Auto-Owners Insurance Co v Essex Homes Southeast Inc.[59] is a case of an insured property developer attempting to transfer business risks to its CGL insurer for incomplete

---

[53] Newcombe at 373-374.

[54] (2006), 51 CLR (3d) 141, 35 CCLI (4th) 241 (Ont Sup Ct J).

[55] *Ibid* at para 22.

[56] *Ibid* at paras 24-25.

[57] *Ibid* at para 24.

[58] *Ibid* at para 27.

[59] 136 Fed Appx 590 (4th Cir 2005).

development work and flawed product representations. The insured home developers failed to properly survey the land and clear it of ordinance and explosive waste before developing it into residential homes. Further, they failed to properly warn the homebuyers about the toxic waste on the land at the time of sale. The homeowners sued the developer for the loss of use of their homes.

This case emphasizes that part of the "impaired property" definition that includes loss of use caused by the insured's defective work, or the insured's misrepresentations about the quality of the work or failure to provide adequate warnings. It is a good reminder of the CGL policy's definition of "your work", which includes the work itself and warranties and representations concerning the work. The homes were not physically injured, but rendered unusable and less valuable as a result of the insured's deficient work. Further, they could be restored to use by proper performance of the insured's obligations to the homeowners. As such, the Court concluded that the insurer had no duty to defend the insured home developers by virtue of the impaired property exclusion.

(iv) Contractual vs Tort Damages

There is a line of authority in Canada and the United States that suggests the impaired property clause only applies to exclude from coverage the insured's liability for loss of use claims framed in contract, not tort. Thus, when an insured's liability for loss of use damages is purely a product of deficient contractual performance or breach of warranty, the exclusion will apply. But when the liability for economic losses or lost use damages is a result of tortious liability, the impaired property exclusion will not apply.

In *Romlight Inc. v AXA Insurance (Canada)*,[60] the insured manufactured and supplied lighting components for use in the plaintiff's chicken hatchery. The plaintiff claimed that the lighting system was defective and caused its chickens to have abnormally low egg production. The Court refused to apply the impaired property exclusion because: (i) any damage to the chickens would be considered "physical injury", not merely loss of use, (ii) the chickens did not "incorporate" the insured's product, and (iii) the claim against the insured was in negligence, not breach of contract.[61] The impaired property clause in the contract in dispute contained the following language: "'Property damage' to 'impaired property' or property that has not been physically injured arising out of: 1) A defect, deficiency, inadequacy or dangerous condition in 'your product' or 'your work' or 2) a delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms"[62]. The Court held that the wording of this exclusion did not clearly exclude coverage for the insured's tort liability, only for failing to fulfill the terms of the contract that results in loss of use of another's property.

A similar distinction in coverage between contract and tort damages in the context of the impaired property exclusion was made by the Court in *Ellett Industries Ltd. v Laurentian P & C Ins Co.*[63] In that case, the insured was contracted to design, manufacture and install a cooler condenser in the plaintiff's plant as an integral part of the equipment line making nitric acid. When the condenser failed, the plant was forced to shut down. The plaintiff sued the insured for the replacement costs and the financial losses from the shut-down of the plaintiff's operations.

---

[60] (2004), 70 OR (3d) 751, 11 CCLI (4th) 306 (Ont Sup Ct J) [*Romlight*].

[61] *Ibid* at para 25.

[62] *Ibid* at para 23.

[63] (1996), 17 BCLR (3d) 201, 73 BCAC 72 [*Ellett*].

The issue before the Court was whether the CGL insurer had a duty to defend the insured for the loss of use claim it faced as a result of the plaintiff's incorporation of its defective product.

The BC Court of Appeal determined, and the parties agreed, that the only relevant exclusion in this case was the impaired property exclusion. The relevant portions of that clause read: "7. This insurance does not apply … to claims arising from loss of use of tangible property which has not been physically injured or destroyed resulting from … (b) the failure of the Insured's products… to meet the level of performance, quality, fitness or durability warranted or represented by the insured[64] …". The Court notably concluded:[65]

> In the paragraph quoted at the beginning of these reasons the trial judge correctly identified the claims [against the insured] ... as sounding in negligence, breach of warranty and breach of a written agreement. When those kinds of claims are matched against the exclusionary words of clause 7(b) it is immediately apparent that negligence claims are not excluded. When the damages flow from equipment failure to meet the warranties or representations of the insured coverage is excluded. But when the equipment failure is due to negligent design, analysis, fabrication or supply … a different result obtains. There are no excluding words. There is instead a claim which falls within the policy...

In the end, the Court held that only the alternative claim in negligence was not excluded under the policy and the duty to defend arose.

Both *Romlight* and *Ellett* suggest that when an insured's shoddy workmanship or defective product is incorporated into a claimant's product resulting in that product's restorable loss of use, the impaired property clause will only apply to exclude coverage if the insured's liability is framed in contract. Put another way, if the claim against the insured is in tort or the insured is liable for damages in tort, even if all the other elements of the impaired exclusion clause are met, the exclusion will not apply.

Similar reasoning was applied in the American case of *Glen Falls Insurance Co v Donmac Golf Shaping Co Inc.*[66] The insured was contracted by a land developer to construct a golf course. The insured built the golf course on federally protected wetlands without the appropriate permits. This mistake caused the developer to incur substantial extra losses and costs relating to: (i) the defence of an action brought against it by the federal government for the illegal construction, (ii) the diminished market value of the property, (iii) increased financing costs from delay of the project, (iv) remediation of the property, and (v) replacing the wetlands. The developer sued the contractor for these economic losses, alleging negligent construction rather than contractual breach or failure to perform under the contract. As a result, the Georgia Court of Appeal held that coverage was not excluded under the impaired property clause, as it did not clearly exclude coverage for an insured's tort liability, only defective construction as per the contract.[67]

This narrow construal of the impaired property exclusion as only applying when the loss of use claims are framed in contract as opposed to tort is not without criticism. Some academic commentators argue that rather than focus on how the insured's liability is framed or plead,

---

[64] *Ibid* at para 7.

[65] *Ibid* at para 13 (emphasis added).

[66] 417 SE 2d 197 (Ga App 1992).

[67] Lichty & Snowden at 23-7.

courts should focus on the source of the claim.[68] Economic losses suffered as a result of incorporating the insured's defective product or work are rightfully excluded under the impaired property clause, whether framed in negligence or breach of contract or warranty, because the losses ultimately arise from the parties' contractual relationship. One commentator argues that these negligent performance claims are, in pith and substance, derivative contract claims: "By allowing a claim for negligent breach of contract, the Court ignores the source of the claim to which this [exclusion] is directed, namely failure to perform a contract. That it was done negligently as opposed to deliberately should be of no consequence".[69]

There is some American jurisprudence to support a broader, alternative interpretation of the impaired property exclusion. For example, in *Stein-Brief Group Inc. v Home Indemnity Co*,[70] the Court refused to analyze the application of the contractual liability exclusion solely on the premise of whether the claim against the insured was framed in tort or contract:

> The issue is not whether a claim is framed in tort or in contract. The key issue is whether the duty that gives rise to liability is independent of the contract or rests upon it. If liability stems from the contract, the policy will not cover any award even if some of the damages are based on tort claims arising from a contractual relationship.

Although this reasoning was in the context of the contractual liability exclusion clause, it could be applied in the impaired property exclusion clause. Another example is found in the case of *Unifoil Corp v CNA Insurance Cos*.[71] In that case, the insured attempted to get around the impaired property clause by arguing it was seeking coverage for a claim for negligent manufacture rather than breach of warranty. The Court held that even if performance was negligent, those actions are "intimately connected" with the insured's contractual obligations. In other words, artful pleading in tort cannot mask a derivative contract claim.[72]

In conclusion, it appears that the weight of Canadian authority has adopted or endorsed the narrower reading of the impaired property exclusion clause. Once again, this reading holds that the clause does not apply (and conversely, coverage is available) when the loss of use or impaired property claim faced by the insured is framed in tort or the result of tortious action. However, there may be an argument for a broader reading of the exclusion to apply to all loss of use claims, whether framed in tort or contract, when the insured's liability stems from its underlying contractual relationship with the claimant.

(v) Sudden and Accidental Exception

In Canada, there appears to be no reported cases elaborating on the "sudden and accidental" exception in the context of the impaired property clause. However, the same phrase is found in the exception to the environmental exclusion clause contained in the standard form CGL policy. The case of *BP Canada Inc. v ComCo Service Station Construction & Maintenance Ltd*.[73] interpreted sudden to mean abrupt, and accidental to mean fortuitous in the environmental exclusion clause context. Academic commentators suggest that the meaning

---

[68] See commentary in Lichty & Snowden at 23-13.

[69] Lichty & Snowden at 23-13.

[70] 65 Cal.App.4th 364 (1998)

[71] 528 A.2d 47 (NJ Super Ct 1987)

[72] Newcombe at 379.

[73] (1990), 73 OR (2d) 317, 49 CCLI 298.

given to the phrase “sudden and accidental” in the environmental exclusion clause should apply to the same words in the impaired property exclusion clause.[74] Therefore, if the insured can establish proof of: (i) a sudden, abrupt event or external force (ii) causing fortuitous physical injury to its component product or work once put to its intended use (iii) that results in the loss of use of the larger tangible property it is part of, then the exception applies.[75]

However, given that Canadian courts frequently refer to American jurisprudence interpreting CGL policy exclusions, it is advisable to examine how American courts have approached this exclusion.

In *Baldt Inc v American Universal Co*,[76] the insured supplied an anchor chain that was incorporated into an off-shore oil rig. The anchor chain suddenly and accidentally failed, resulting in the loss of use of that rig. The Court held that the CGL policy provided coverage for the claim against the insured arising from this loss of use because the exception to the impaired property exclusion was operable on these facts. The outcome of this case has been criticized by some Canadian commentators, who believe this was simply the supply of a faulty product to the market that caused loss of use of another’s property once incorporated.[77] While the failure of the chain was certainly “sudden” and “accidental” from the perspective of the rig owner, there was no indication that a sudden and fortuitous external force physically injured the chain and caused its abrupt failure, leading to the lost use of the rig.[78]

Another Court contemplated this exception in the case of *United Steel Fabricators Inc. v Fidelity & Guaranty Insurance Underwriters Inc.*[79] In that case, the insured contracted to supply modular steel expansion joints for repairs to a bridge owned by the government. Two years after the bridge work was completed, the expansion joints cracked and the general contractor was forced to replace them. The insured was sued for the cost of replacing its defective joints and the lost use of the bridge as a result of their failure. The Court held that the impaired property exclusion applied, but coverage was nonetheless available by virtue of the sudden and accidental exception. The Court interpreted the phrase to mean abrupt, “unexpected and unintended”. Since the cracking of the joints could be characterized as “sudden and unexpected”, the exception applied.[80] This case is also criticized for containing an overly broad interpretation of the phrase “sudden and accidental”, which caused the exception to effectively swallow the exclusion.[81] There was no abrupt and accidental force causing physical injury to the joints; rather, they were simply deficient for the purposes for which they were installed and failed under the normal and expected stresses on the bridge. In other words, this was the precise situation where the impaired property clause was intended to exclude coverage.

The case of *St. Paul Fire & Marine Insurance v Futura Coatings Inc*.[82] represents a more restrictive application of the exception to the exclusion clause. The insured provided a sealant coating for a power company’s concrete basins designed to hold waste water generated by

[74] Sanderson at 177.

[75] Sanderson at 177.

[76] 599 F.Supp. 955 (E.D. Pa 1985)

[77] Lichty & Snowden at 23-16.

[78] Lichty & Snowden at 23-16.

[79] 1993 Ohio App LEXIS 1422.

[80] Lichty & Snowden at 23-17.

[81] Lichty & Snowden at 23-17.

[82] 993 F Supp 1258 (D.Minn 1998).

power plants at its facilities. The insured represented that its product would meet the power company's specifications and instructed them how to apply it. The defects in the coating became apparent upon application, and the sealant had to be removed and replaced at great expense to the power company. The Court held that the insured could not be indemnified for its liability for the costs of removing and replacing its coating and the corresponding loss of use of the basins under the impaired property exclusion. It rejected the insured's argument that the sudden and accidental exception applied because the failure of the coating only became apparent as time passed.[83] In other words, the failure was not sudden to satisfy the exception.

In summary, there appears to be some controversy in American jurisprudence about the proper application of the exception to the impaired property exclusion. However, Canadian academic commentary suggests that the focus of the court when applying the exception clause should be on the physical injury and the nature of damage to the insured's work or product. If, upon incorporation into the larger product, the insured's product or work abruptly fails from an unexpected force causing physical injury, the exception should apply. This interpretation ensures only those "fortuitous" risks are covered by the CGL insurer.[84]

IV. CONCLUSION

Once again, the following are the components for the application of the impaired property exclusion:

1. The insured's work or product is incorporated into the tangible property belonging to a third party that is not the insured.

2. As a result of either (i) the insured's deficient product or work, or (ii) the insured's failure or delay in performing its contractual obligations,

3. The tangible property is rendered less or not useful, but is not physically injured.

4. The tangible property can be restored to use by either (i) replacing or repairing the insured's defective component product, or (ii) fulfilling the terms of the contract.

5. The loss of use of the tangible property is not attributed to any sudden and accidental physical injury to the insured's component work or product after it is put to its intended use.

Whenever Canadian and American courts are tasked with interpreting and applying the impaired property exclusion under CGL policies, they appear to be mindful of the underlying principle that "business risks" ought not to be insured against.

However, as a general matter, all Canadian courts faced with interpreting an insurance contract of any kind are bound by the principles of contractual interpretation as recently enunciated by the Supreme Court of Canada in *Progressive Homes Ltd. v Lombard General Insurance Co of Canada*.[85] These principles include:

1. Where the policy language is unambiguous, courts should give effect to the plain meaning of the words in the context of the entire contract;

---

[83] Sanderson at 179; Newcombe at 15-16.

[84] See discussion in Lichty & Snowden at 23-16 - 23-17.

[85] 2010 SCC 33, [2010] 2 SCR 245 at paras 22-24.

2. Where the policy language is ambiguous, the following canons of construction should apply:

   - Courts should prefer interpretations consistent with the reasonable expectations of the parties that are supported by the text,
   - Courts should avoid interpretations that would give rise to an unrealistic result or that would not have been contemplated by the parties at the time the contract was executed,
   - Courts should strive to interpret similar insurance policies consistently, and
   - Courts should not create ambiguity where none exists to begin with.

3. When these canons fail to resolve the ambiguity, the court will construe the policy against the insurer, with coverage provisions interpreted broadly and exclusion clauses interpreted narrowly.

Finally, although not on the particular topic of the "impaired property exclusion", the Supreme Court of Canada recently heard a commercial insurance case called *Ledcor v Northbridge Indemnity Insurance Company*. Those in the insurance industry should be on the lookout for the release of this pending decision, which will clarify the appropriate test for distinguishing the concepts of "faulty workmanship" and "resulting damage" under comprehensive builders' risk policies.[86][87]

[86] For a summary of this case and its related issues, see Mark E. Alexander, "Looking Through a Dirty Window: Builders' Risk Policies and the "Faulty Workmanship" Exclusion" (April 7, 2016) *Lloyd's Brief: Canadian Legal Perspectives,* online: <http://www.millerthomson.com/en/publications/newsletters/lloyds-brief-canadian-legal-perspectives/april-7-2016>.

[87] Thank you to Adrienne Funk, Articling Student at Miller Thomson LLP, for her assistance with preparation of this paper.