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Appeal Allowed – *MDS Inc. v. Factory Mutual Insurance Company:* Ambiguity in Insurance Contracts and the Meaning of "Physical Damage"

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On September 3, 2021, the Court of Appeal for Ontario released its widely anticipated decision in *MDS Inc. v. Factory Mutual Insurance Company*[1] (the "**Appeal Decision**"). Counsel for both insurers and insured parties were no doubt eagerly awaiting the release of the Appeal Decision ever since the release of the decision below[2] (the "**Trial Decision**", and together with the Appeal Decision, the "**MDS Decisions**") – and for good reason. The timing of the release of the MDS Decisions and the legal analyses contained therein, coupled with the unprecedented impacts on both insurers and insured parties arising from the global COVID-19 pandemic, made them highly relevant to the insurance industry for three reasons: (i) the Decisions reaffirm and thoroughly canvass cardinal principles of insurance policy interpretation; (ii) the Decisions guide what types of evidence will be relevant to the interpretation of an insurance policy; and (iii) the Decisions may be persuasive in interpreting the term "physical loss or damage" in future COVID-19-related insurance litigation in Canada.

The Trial Decision arose from a claim under an all-risks insurance policy by the insured, MDS Inc. ("**MDS**"), against its insurer, Factory Mutual Insurance Company ("**Factory Mutual**"), for lost profits arising from the shutdown of a nuclear reactor belonging to MDS' principal supplier, Atomic Energy of Canada Limited ("**AECL**"). The nuclear reactor was shut down due to unexpected corrosion on the wall of the reactor, which resulted in leakage of radioactive water. As a result of the shutdown, MDS suffered a loss of profits because it was deprived of the radioisotopes that it normally purchased from AECL, which it would process and sell for medical application.

At trial, MDS and Factory Mutual agreed that coverage had been triggered under the policy. The principal disputed issues were whether the claim for loss of profits was excluded under the policy, and whether an exception to the exclusion clause brought the claim back within coverage under the policy. Among other things, the Trial Judge held that the "Corrosion Exclusion" was inapplicable because only non-fortuitous (*i.e.*, expected) corrosion was excluded under the policy, and that fortuitous corrosion was not excluded.[3] The Trial Judge further held that, in any event, the loss of use of the nuclear reactor was "physical damage" within the meaning of the exception to the Corrosion Exclusion.[4] As such, she held that even if

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1 *MDS Inc. v. Factory Mutual Insurance Company*, 2021 ONCA 594 [*MDS Appeal*].
2 *MDS Inc. v. Factory Mutual Insurance Company*, 2020 ONSC 1924 [*MDS Trial*].
3 *MDS Trial*, *supra* note 2 at paras. 416-17.
4 *MDS Trial*, *supra* note 2 at paras. 516 and 520.

the Corrosion Exclusion applied to fortuitous corrosion, the loss of profits claimed would still be covered under the policy as an exception to the exclusion.[5]

Following its release, the Trial Decision was subjected to intense scrutiny. Could it be right that the Corrosion Exclusion applies only to non-fortuitous corrosion? Put more broadly, does it make sense that an exclusion clause in an insurance policy excludes coverage for events that were never insured to begin with? And, is it correct that "physical damage" can be sustained where an insured only loses the ability to use property?

The Court of Appeal answered both of these critical questions decidedly in favour of the insurer, Factory Mutual. Writing for the Court, Thorburn J.A. held that the Corrosion Exclusion in the insurance policy must apply to fortuitous corrosion because non-fortuitous events do not fall within the scope of coverage under an all-risks insurance policy.[6] The exclusion would therefore be meaningless if it did not apply to fortuitous corrosion.[7] Justice Thorburn further held that economic loss is not a form of "physical damage".[8] The Court held that MDS could not claim for lost profits arising from the shutdown of the nuclear reactor, which was brought about by the need to repair the corrosion.[9]

Given the complex claim at issue in the MDS Decisions, care should be taken in analyzing the conclusions set out in the Decisions, as well as in applying the Decisions to future proceedings that raise similar issues. A deeper dive into the reasoning underpinning these Decisions is set out below.

Facts

One important fact underpinning the claim at issue in the MDS Decisions is that the nuclear reactor that suffered the corrosion was not owned by MDS.[10] The nuclear reactor belonged to AECL – an entity that was not an insured party under the policy between MDS and Factory Mutual.[11] The loss claimed by MDS was therefore not advanced under the general property coverage provisions of its policy with Factory Mutual. It was advanced pursuant to a Contingent Time Element coverage provision (the "**Clause**").[12] That Clause provided coverage for up to US $25 million in lost profits in the event of physical loss or damage to property at a Contingent Time Element Location (*i.e.*, a location other than MDS' premises).[13] MDS and Factory Mutual

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[5] *MDS Trial*, *supra* note 2 at para. 616.
[6] *MDS Appeal*, *supra* note 1 at para. 77.
[7] *MDS Appeal*, *supra* note 1 at para. 77(9).
[8] *MDS Appeal*, *supra* note 1 at para. 93(1).
[9] *MDS Appeal*, *supra* note 1 at paras. 83 and 96.
[10] *MDS Trial*, *supra* note 2 at para. 1.
[11] *MDS Trial*, *supra* note 2 at para. 2.
[12] *MDS Trial*, *supra* note 2 at paras. 4-5.
[13] *MDS Appeal*, *supra* note 1 at para. 34.

agreed that the nuclear reactor was insured property covered under the Clause.[14] As such, there was no dispute as to whether coverage itself had been triggered under the policy.[15]

At trial, the dispute between MDS and Factory Mutual concerned the interpretation and applicability of the following three coverage exclusion clauses:

1. the Corrosion Exclusion, including the exception to the exclusion embedded within the clause;
2. the Idle Period Exclusion; and
3. the Nuclear Radiation Exclusion.[16]

The Trial Judge rejected Factory Mutual's interpretation of all three exclusion clauses, including the embedded exception to exclusion.

Factory Mutual did not appeal the Trial Judge's conclusions on the Idle Period and Nuclear Radiation Exclusions. The central issues on appeal concerned the interpretation of the Corrosion Exclusion and its embedded exception.

The Corrosion Exclusion states as follows:

> This Policy excludes the following, <u>but, if physical damage not excluded by this Policy results, then only that resulting damage is insured</u>:
>
> […]
>
> 3) deterioration, depletion, rust, corrosion or erosion, wear and tear, inherent vice or latent defect.[17] [emphasis added]

The underlined portion of the above clause is the embedded exception to the Corrosion Exclusion. Neither the word "corrosion" nor the term "physical damage" are defined in the policy.[18]

The evidence at trial demonstrated that the walls of the nuclear reactor suffered two types of corrosion resulting from exposure to water. The first type of corrosion was expected, or "non-fortuitous". This type of corrosion was expected to affect the outer wall of the nuclear reactor. Unfortunately, this expected corrosion also caused the second type of unexpected, or "fortuitous", corrosion on the inner wall of the nuclear reactor. This was so because the water

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[14] *MDS Trial*, *supra* note 2 at para. 4.
[15] *MDS Trial*, *supra* note 2 at para. 185. There was also no dispute as to quantum of loss. The parties agreed that MDS had suffered well lost profits well in excess of the policy limit of US $25 million: see *MDS Trial*, *supra* note 2 at para. 4.
[16] An additional dispute concerning whether MDS should be awarded interest on damages above the rates set out in the *Courts of Justice Act*, R.S.O. 1990, c. C.43 was litigated (see, *e.g.*, *MDS Inc. v. Factory Mutual Insurance Company (FM Global)*, 2020 ONSC 4464), but it is not the focus of this article. Similarly, this article does not address the Trial Judge's analysis of the Idle Period and Nuclear Radiation Exclusions.
[17] *MDS Trial*, *supra* note 2 at para. 234.
[18] *MDS Trial*, *supra* note 2 at paras. 235 and 442.

that corroded and seeped through the outer wall had the effect of corroding the inner wall of the nuclear reactor.[19]

Over time, the unexpected corrosion of the inner wall of the nuclear reactor caused a leak of the radioactive contents of the nuclear reactor.[20] This leak was detected in May 2009 and the nuclear reactor was shut down.[21] MDS submitted a claim for coverage that same month.[22] Factory Mutual delivered a denial of coverage in August 2009.[23] The nuclear reactor was not reopened until August 2010.[24]

It was undisputed that the leak "did not cause actual tangible damage in the interior of the [nuclear reactor]".[25] The nuclear reactor was not shut down because of damage to the functioning of the reactor. It was shut down in order to investigate the leak and to repair the leak.[26]

The Trial Decision

The Trial Judge first held that the meaning of the word "corrosion" as used in the policy was ambiguous.[27] The Trial Judge's conclusion in this regard was based largely upon her view that Factory Mutual's witnesses had conceded in cross-examination that damage resulting from some types of corrosion would be covered under the policy.[28] The Trial Judge then applied the *noscitur a sociis*[29] and *contra proferentum*[30] canons of interpretation to find that "corrosion" as used in the policy must mean non-fortuitous corrosion, instead of fortuitous corrosion.[31] Consequently, she held that the Corrosion Exclusion was inapplicable.

With regard to the exception to the Corrosion Exclusion, the Trial Judge held that the term "physical damage" must be interpreted in light of other provisions in the policy.[32] She found that other provisions of the policy exclude losses for business interruption or loss of use "except to the extent provided by [the policy]".[33] As such, in her view, it would not make sense to include such a proviso unless there were circumstances in which loss of use would be covered under the policy.[34] The Trial Judge also preferred a "broad definition" of the term "physical

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[19] *MDS Trial*, *supra* note 2 at paras. 242-245.
[20] *MDS Trial*, *supra* note 2 at paras. 60-66.
[21] *MDS Appeal*, *supra* note 1 at para. 7.
[22] *MDS Appeal*, *supra* note 1 at para. 8.
[23] *MDS Appeal*, *supra* note 1 at para. 8.
[24] *MDS Trial*, *supra* note 2 at para. 18.
[25] *MDS Trial*, *supra* note 2 at para. 447.
[26] *MDS Appeal*, *supra* note 1 at para. 83.
[27] *MDS Trial*, *supra* note 2 at para. 304.
[28] *MDS Trial*, *supra* note 2 at para. 304.
[29] The meaning of an unclear word or phrase, especially one in a list, should be determined by the words immediately surrounding it: *MDS Trial*, *supra* note 2 at para. 424.
[30] An ambiguity in an agreement should be construed against the party that drafted the agreement: *MDS Trial*, *supra* note 2 at para. 431.
[31] *MDS Trial*, *supra* note 2 at paras. 430 and 434.
[32] *MDS Trial*, *supra* note 2 at para. 452.
[33] *MDS Trial*, *supra* note 2 at para. 454.
[34] *MDS Trial*, *supra* note 2 at para. 462.

damage" because she concluded that to do otherwise would deprive MDS of a significant aspect of the coverage that it purchased.[35]

The Appeal Decision

As stated above, the Court of Appeal reversed the Trial Decision. Justice Thorburn held that the Trial Judge had erred with regard to her interpretation of the Corrosion Exclusion and its embedded exception.

On the meaning of "corrosion", the Court of Appeal reiterated that American authorities may be particularly persuasive where there are few Canadian authorities on point, and where the underlying insurance contract is used in both jurisdictions. The Court held that there was a consistent line of authority from American appellate courts that the meaning of "corrosion" in insurance policies includes both fortuitous and non-fortuitous corrosion.[36]

The Court of Appeal also held that the Trial Judge had erred in concluding that the word "corrosion" as used in the policy was ambiguous.[37] In this regard, the Court held that the Trial Judge had misinterpreted the evidence of Factory Mutual's witnesses. Those witnesses did not concede that some losses from corrosion would fall within the scope of coverage (as the Trial Judge interpreted). Rather, the evidence given by those witnesses indicated that losses flowing from corrosion might be covered if the corrosion itself was caused by some non-excluded physical loss or damage to property. The Court held that these witnesses did not concede that corrosion itself was an insured peril.[38] Moreover, the Court confirmed that the subjective evidence of Factory Mutual's witnesses given years after the policy was entered into was not proper or relevant evidence of the factual matrix that existed at the time the contract was executed.[39]

Ultimately, the Court held that the Trial Judge erred in her interpretation of the word "corrosion" for ten reasons,[40] an important one of which was the fact that the Corrosion Exclusion would be meaningless if it applied only to non-fortuitous corrosion because non-fortuitous events do not fall within the scope of coverage under an all-risks insurance policy.[41]

With regard to the meaning of "physical damage" as used in the exception to the Corrosion Exclusion, the Court held that there is a long line of authority for the proposition that "exclusions for physical damage do *not* include loss of use or pure economic loss" unless otherwise provided.[42] The Court distinguished the cases relied upon by the Trial Judge on the basis that those cases dealt with the issue of "whether loss of *use* was covered by a policy of

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[35] *MDS Trial*, *supra* note 2 at para. 519.
[36] *MDS Appeal*, *supra* note 1 at para. 62.
[37] *MDS Appeal*, *supra* note 1 at para. 78.
[38] *MDS Appeal*, *supra* note 1 at para. 74.
[39] *MDS Appeal*, *supra* note 1 at para. 75.
[40] *MDS Appeal*, *supra* note 1 at para. 77.
[41] *MDS Appeal*, *supra* note 1 at para. 77(9).
[42] *MDS Appeal*, *supra* note 1 at para. 86.

insurance that insured against all risks of 'direct physical loss'".[43] By contrast, the Court held that in the instant case, the loss of profit claimed arose from the need to repair the corrosion, and not from property damage.[44]

The Court therefore distinguished between: (i) coverage for losses flowing from an insured peril in an all-risks insurance policy that causes a loss of use; and (ii) coverage for losses that are themselves "physical damage" in nature. Because the loss of use of the nuclear reactor was not itself "physical damage", it did not fall within the exception to the Corrosion Exclusion.[45]

The Court held that the language of the exception – "but, if physical damage not excluded by this Policy results, then only that resulting damage is insured" – covers the costs of repairing physical damage to insured property.[46] Consequently, the costs to repair the leak in the inner wall of the nuclear reactor would be covered under the policy, but MDS had no claim to such damages because the nuclear reactor belonged to AECL.

Points of Note

The MDS Decisions are important for practitioners of insurance law for at least three reasons.

First, the MDS Decisions reaffirm and thoroughly canvass cardinal principles of insurance policy interpretation. As the Court of Appeal held in the Appeal Decision:

> Standard form contracts of insurance should be interpreted consistently…
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> Where the language of the disputed clause is unambiguous, effect should be given to the clear language of the policy read in the context of the policy as a whole […] It is unnecessary to consider extrinsic evidence in order to interpret its terms […] However, like all contracts, the policy is examined in light of the surrounding circumstances…
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> […]
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> …where a policy provision is ambiguous, the rules of contract construction may be employed to resolve the ambiguity. A contractual provision is ambiguous if it is reasonably susceptible of more than one meaning […] The goal is to reach a sensible commercial result that reflects the intentions of the parties at the time the agreement was entered into…[47]

The Appeal Decision reminds insurance law practitioners that an ambiguity in policy language should not be manufactured when the plain language of the policy is clear. To attempt to

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[43] *MDS Appeal*, *supra* note 1 at para. 82.
[44] *MDS Appeal*, *supra* note 1 at para. 83.
[45] *MDS Appeal*, *supra* note 1 at para. 96.
[46] *MDS Appeal*, *supra* note 1 at para. 93(2)(c) and 94.
[47] *MDS Appeal*, *supra* note 1 at paras. 39-43.

manufacture an ambiguity based on extrinsic evidence would invite the same error reflected in the Trial Decision's interpretation of the otherwise unambiguous word "corrosion".

Second, the MDS Decisions emphasize that the objective factual matrix that is relevant to interpreting a contract is that which existed at the time of contract formation. The Decisions are a warning against calling subjective evidence of the meaning of an insurance contract, as well as evidence that post-dates the formation of the contract (in this case by many years). As the Court of Appeal held, "the subjective belief of a party long after the standard form policy was entered into, absent other circumstances, is not evidence of the reasonable intention of the parties at the time the contract was entered into".[48]

Indeed, the general principle that a contract be interpreted pursuant to the objective intent of the parties at the time of contract formation – rather than based on evidence that post-dates the formation of the contract – is an important safeguard against ends-based reasoning. As noted above, the Trial Judge effectively concluded that it would be inequitable to interpret the term "physical damage" restrictively because doing so would deprive MDS from coverage it had purchased for corrosion. But this conclusion was premised upon knowledge that corrosion had occurred, and then reasoning back to assume that MDS purchased coverage for the very event that transpired. The Trial Judge did not analyze what circumstances were known to the parties at the time of contract, and whether, objectively, the insurance policy that MDS purchased was intended to cover insured perils other than corrosion.

Third, the precedential value of the Appeal Decision is affected by the issues that were actually in dispute. It is important to recognize (and re-emphasize) that the issue of whether the initial grant of coverage was triggered under the policy was not disputed in the MDS Decisions. Factory Mutual accepted that there had been loss of profit "directly resulting from physical loss or damage" to insured property. The issues in dispute were whether the insured peril (*i.e.*, corrosion) was excluded, and whether the nature of the *loss* was a type of loss covered by the policy (*i.e.*, "physical damage").

Notwithstanding the above limitations, the Appeal Decision may have significant persuasive value in future COVID-19-related litigation given the Court's explicit conclusion that specific and explicit language is required to bring claims for economic losses within the scope of coverage of an all-risks insurance policy that is premised upon physical loss or damage as an insured peril.[49]

Conclusion

The Appeal Decision corrects the significant departure in law reflected in the Trial Decision and restores the *status quo* applicable to the interpretation of insurance contracts in Ontario. Although the strict precedential value of the Appeal Decision might be limited given the concession that the initial grant of coverage had been triggered in the circumstances, the Court

[48] *MDS Appeal*, *supra* note 1 at para. 75.
[49] *MDS Appeal*, *supra* note 1 at paras. 85-89.

of Appeal's conclusion that specific and express language is required to bring claims for loss of use within the scope of coverage of an all-risks insurance policy premised upon physical loss or damage may be helpful for parties in future cases.