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MDS Inc v Factory Mutual Insurance Company: Loss of Use is Not “Physical Damage” Under Exception to an Exclusion in an All-Risks Policy

On September 3, 2021, the Ontario Court of Appeal (“ONCA”) released its decision in *MDS Inc v Factory Mutual Insurance Company,* which considered the proper interpretation of corrosion exclusions and resulting damage exceptions in standard-form property and casualty insurance policies.

Although the ONCA’s reversal of the lower court’s decision likely puts to rest the debate as to whether loss of use constitutes “physical damage” in an all-risks policy, the lower court’s reasons for awarding compound prejudgment interest will continue to be relevant.

Factual Background

The case arose in the context of a denial of coverage by Factory Mutual Insurance Company (“FM Global”), after the insured MDS Inc. et al (“MDS”) sought to recover under an all-risks policy (the “Policy”) for business losses arising from a 16-month shutdown of a Nuclear Research Universal (“NRU”) reactor in Chalk River. The shutdown was required to investigate and repair a leak caused by corrosion, and interrupted the supply of radioisotopes to MDS, resulting in lost profits. There was no physical damage to the NRU other than the corrosion.

The Policy excluded coverage for losses caused by “corrosion”. The term “corrosion” was not defined. The Policy included an exception from this exclusion for resulting “physical damage not excluded by this Policy”.

Lower Court’s Decision

In March 2020, Wilson J. of the Ontario Superior Court of Justice ruled in favour of the insured and applied a broad interpretation of the exception to the corrosion exclusion for physical damage to include not just physical damage caused by the corrosion, but economic loss caused by the inability to use the insured property during the shutdown.

The trial judge therefore concluded that MDS' losses were covered under the Policy and, in addition to damages up to the Policy's limit, awarded MDS prejudgment interest at the rate of the company's actual cost of borrowing, including compound interest. Although there was no provision for compound interest in the policy, Wilson J. reasoned that this was "just compensation".

The lower court's decision garnered attention upon its release for its broad interpretation of these provisions, particularly in the context of business interruption claims arising from COVID-19. Corrosion exclusions and resulting damage exceptions appear in many commercial property all-risks policies. An even larger number of policies have a physical damage-based trigger. Many questioned whether the lower court's decision opened the door to the argument that the shutdown of a business due to COVID-19 could constitute "physical damage" under an all-risks policy.

Appeal Decision

The ONCA unanimously overturned the lower court's decision. The Court held that the exclusion for corrosion and the exception to the exclusion were unambiguous, the corrosion exclusion would cover non-fortuitous corrosion, and the trial judge's interpretation was inconsistent with prevailing authorities and commercially unreasonable.

In coming to this conclusion, the ONCA unanimously reaffirmed the prevailing authority and the reasonable objective expectations of insurers and policyholders with respect to these standard-form provisions. Specifically, it confirmed that: (i) the proper interpretation of a standard-form corrosion exclusion includes both anticipated and unanticipated corrosion unless specifically provided for in the policy; and (ii) the proper interpretation of a resulting damages exception to an exclusion in a standard-form property and casualty insurance policy, which is based on *physical* damage does not extend to mere "loss of use" of property. Apart from the specific corrosion damage, there was no other physical damage to property that resulted.

Although unnecessary, given its decision denying coverage, the ONCA also addressed the issue of prejudgment interest in *obiter*, stating that it would not have interfered with the trial judge's exercise of discretion awarding compound prejudgment interest. On this issue, the ONCA noted that the trial judge had broad discretion to award compound interest and found no error in principle with the trial judge's conclusion that it was reasonable to make such an award where an insurer, though losing the lawsuit on all fronts, has effectively won, in that it has benefitted from the use of the insured's funds over the years.