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"Arising out of": Adding Another Definition to Your Contractual Terms Dictionary

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In *Sky Clean Energy Ltd. (Sky Solar (Canada) Ltd.) v. Economical Mutual Insurance Company*,[1] the Ontario Court of Appeal analysed a common feature of insurance arrangements in development projects – the extension of insurance coverage to additional insureds. The Court of Appeal provided clarity regarding the meaning of "arising out of the operations" as part of an additional insured clause, a common phrase in many commercial agreements and contracts.

Factual Background

The appellant, Sky Clean Energy Ltd. ("**Sky**"), is a solar energy project developer. Sky contracted with Marnoch Electrical Services ("**Marnoch**") to have Marnoch install Sky's solar power system in two construction projects. Under their contract, Marnoch was only responsible for installing the solar power system that Sky designed, but it did help Sky with sourcing a new transformer supplier, Marcus Transformers of Canada ("**Marcus**"), when Sky's original supplier delivered the wrong type of transformer.

In their contract, Marnoch agreed to name Sky as an insured under Marnoch's general liability insurance policy with the respondent, Economical Mutual Insurance Company ("**Economical**"), but "only with respect to liability, other than legal liability arising out of [Sky's] sole negligence, arising out of the operations of [Marnoch] with regard to the Work" (the "**Contract Provision**"). Marnoch's insurance broker then issued insurance certificates to Sky confirming that Sky was entitled to coverage "but only with respect to liability arising out of the operations of [Marnoch]" (the "**Insurance Provision**").

After the Marcus transformers were installed, fires that originated in the electrical transformers occurred at both Sky construction projects. One of the fires took place after Sky had transferred the ownership of the projects.

Sky commenced arbitration against Marnoch for indemnity under the construction contracts. The arbitrator found that the decision to use the Marcus transformers was solely that of Sky and Marnoch was not responsible or liable for the consequences of Sky's decisions. Therefore, the liability was not covered by Marnoch's insurance policy. An appeal to the Superior Court from the arbitration award was dismissed.

Sky subsequently commenced an action against Economical. In his consideration of whether the liability "arose out of the operations of Marnoch", per the Insurance Provision, the trial judge agreed that the failure of the Marcus transformer was not caused by any decision taken by Marnoch. The fact that the fire would not have occurred "but for" the installation of the Marcus transformer was not, in itself, sufficient to establish that Sky's liability arose out of Marnoch's operations. Sky appealed the trial judge's decision.

Central Issue

The central issue in the appeal was whether the trial judge erred in interpreting the insurance policy and in finding that Sky's liability

did not “arise out of the operations” of Marnoch.

Analysis

Writing for the court, Chief Justice Strathy noted that the phrase “arising out of the operations” is a common feature of insurance arrangements in construction and is usually included in the insurer’s standard form.[2] Furthermore, the Court noted that contractual insurance obligations and additional insured endorsements are a frequent source of litigation between owners, contractors, and their insurers. In particular, disputes commonly arise because of uncertainty regarding the necessary connection between the liability incurred by the owner and the contractor’s operations. As such, there is a wider industry interest in ensuring that similar insurance policies are construed consistently.

“Arising out of the operations”

On appeal, Sky argued that the trial judge adopted an unduly narrow construction of the words “arising out of the operations”. The Court disagreed, finding that “arising out of” requires more than an incidental connection between the owner’s liability and the contractor’s operations.

In its analysis, the Court specifically adopted the reasons of the late British Columbia Chief Justice Finch in *Vernon Vipers Hockey Club v. Canadian Recreation Excellence Corporation*.[3] In *Vernon*, Finch C.J.B.C. considered several Supreme Court of Canada cases which interpreted “arising out of” in the context of motor vehicle insurance cases, finding that “arising out of” requires more than a “but for” connection between the liability of the additional insured and the operations of the named insured. In those cases, the Supreme Court of Canada consistently found that for coverage to apply, there must be an unbroken chain of causation between the liability and the operations, which is more than incidental or fortuitous.[4] Given this consistency, in *Vernon*, Finch C.J.B.C. concluded that the phrase “arising out of” should have the same meaning regardless of whether it appears in a statute or a contract. The Ontario Court of Appeal agreed.

The Court in *Sky* also adopted Finch C.J.B.C.’s interpretation of the term “operations” in *Vernon*. “Operations” includes the creation of a situation, or circumstance, that is connected in some way to the alleged liability. “Operations” is broader than “activities” and can include the occupation and use of premises or other passive conduct.[5]

Altogether, the Court stated that the “arising out of the operations” issue can be addressed by answering the question: “why did the additional insured’s liability arise?”[6] In this case, the Court agreed with the trial judge’s conclusion that Marnoch’s connection to the failure of the Marcus transformer was “merely incidental”. While the fire would not have occurred but for Marnoch connecting Sky with the supplier Marcus and installing the transformers, a stronger connection was needed to attract coverage under Marnoch’s policy. Marnoch’s operations did not require it to select the transformers to be installed in the projects, that was solely Sky’s decision.[7] Therefore, the selection of the faulty transformers did not arise out of Marnoch’s operations.

Sky also argued that the trial judge erred in his interpretation of the insurance policy by failing to consider the broader language in the Contract Provision in the contract between Sky and Marnoch. The Court disagreed, finding that when a claim arises between the additional insured and the insurer, it is the language of the insurance policy that governs, not the language of the contract between the policyowner and the additional insured as the insurer is not privy to their contract.[8]

Conclusion

This case provides clarity on a common source of disputes in additional insured insurance policies, namely whether there is a sufficient connection between the liability incurred and the policy holder’s operations to attract coverage under the policy. This case also highlights the value courts place on ensuring certainty and predictability in the interpretation of common terms, whether those terms

appear in legislation or in private contracts. It is likely that the Court's interpretation of "arising out of" in this case will be persuasive in other contexts.

[1] *Sky Clean Energy Ltd. (Sky Solar (Canada) Ltd.) v. Economical Mutual Insurance Company*, 2020 ONCA 558. [***Sky***]

[2] *Sky*, at para. 52.

[3] *Vernon Vipers Hockey Club v. Canadian Recreation Excellence Corporation*, 2012 BCCA 291.

[4] *Sky,* at para. 83; see *Amos v. Insurance Corp. of British Columbia*, [1995] 3 S.C.R. 405; *Lumbermens Mutual Casualty Co. v. Herbison,* 2007 SCC 47, [2007] 3 S.C.R. 393; and *Citadel General Assurance Co. v. Vytlingam*, 2007 SCC 46, [2007] 3 S.C.R. 373.

[5] *Sky,* at paras. 88-89.

[6] *Sky*, at para. 99.

[7] *Sky*, at para. 102.

[8] *Sky*, at paras. 65-66.

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