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# **PRACTICAL AND SUBSTANTIVE ASPECTS OF SUBROGATION**

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## I. INTRODUCTORY COMMENTS

The main purpose of this paper is to consider the procedural and substantive aspects of the doctrine of subrogation, from the point of view of an insurer. This inquiry into an insurer's legal rights of subrogation will examine the numerous statutory, contractual and judicially created rules which limit, or abolish altogether, common law and statutory rights of subrogation. The second purpose of this paper is to review some of the significant procedural issues which are likely to confront the subrogating insurer.

"Subrogation" is a word with a Latin root and is derived from the word "subrogate", which means to "put in place of another or to substitute".<sup>1</sup> For this reason text writers often refer to subrogation as the doctrine of "substitution". It is important to appreciate that the doctrine has broad scope, including "... every instance in which one part, pays a debt for which another is primarily answerable, and which in equity and good conscience, should have been discharged by the latter".<sup>2</sup>

The essential premise of subrogation is that an insured person, as the holder of a policy of insurance giving a right to indemnity in respect of covered risks, should not be entitled to recover anything more than the actual amount of any loss suffered. If insured persons were entitled to recover under their contracts of insurance, as well as recover compensation in ordinary legal proceedings from the person who caused the covered loss, an event of loss would represent a potential for windfall gain. The law of insurance, subject to the extensive limitations which are discussed in this paper, does not allow for such a windfall. Rather, the law provides an insurer who covers an insured loss with the right to sue and recover damages from the third party who has actually caused the loss or who is legally liable for it. Assuming that the insurer has reimbursed the insured, the insurer is entitled to "... compel an assured to allow his name to be used by the insurer for the purpose of enforcing the assured's remedies against third parties in respect of the subject matter of the loss."<sup>3</sup> This right is the insurer's right of subrogation.

Subrogation has been an essential feature of the law of insurance since insurance contracts were first written. One of the earliest recorded cases involving subrogation dates back to 1748.<sup>4</sup> Since that time the right to be subrogated to the insured's cause of action against the person or persons legally liable for causing a covered loss has been an important feature of an insurer's legal rights. This is so because the right to subrogation can be, and often is, of very significant economic importance to an insurer, particularly in circumstances where the person liable for the covered loss is himself protected by liability insurance.

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<sup>1</sup> Horn, R., *Subrogation in Insurance Theory and Practice*, (University of Pennsylvania, 1964), at 11-12

<sup>2</sup> *Home Owners' Loan Corp. v. Sears, Roebuck & Co.* 123 Conn. 232; 193 A. 769, 772 (1937).

<sup>3</sup> *Yorkshire Insurance Co. Ltd. v. Nisbet Shipping Co. Ltd.* (1962), 2 Q.B. 330 at p. 339.

<sup>4</sup> *Randell v. Cockron* (1748), 1 Ves. Sen. 98; 27 E.R. 916.

Legal proceedings founded on a right of subrogation are not undertaken in every case. In other words, the incidence of subrogated proceedings does not necessarily correspond with the incidence of legal liability. There is a paucity of data available as to the extent to which insurers use subrogated proceedings to recover for losses they have covered. In one of the few reported studies ever undertaken, the Senior Vice-President of a major U.S. property and casualty insurer<sup>5</sup> reviewed his own company's book of business for the policy year 1972, and determined that less than 1% of amounts paid for fire losses was recovered through subrogation proceedings.<sup>6</sup> Figures for other classes of business revealed that less than 1% of non-fire personal lines claims, 8.5% of auto physical damage claims and 14% of ocean marine claims were ever recovered. Naturally there are many covered losses which have been caused by persons who do not possess the resources to make litigation against them worthwhile, and who are not covered by insurance. However, there are several other factors which constitute significant barriers to the pursuit of subrogated claims against tortfeasors. It is submitted that the rather modest recovery figures revealed in the American study referred to above are attributable to the following factors:

- (a) A clear lack of judicial enthusiasm for 'loss shifting' exercises by insurers, which has led to the development of a wide variety of "judge made" limitations on subrogation rights;
- (b) Procedural impediments, mainly established by the various general insurance statutes of the common law provinces of Canada i.e. the provincial Insurance Acts, which limit the ability of an insurer to commence subrogated lawsuits without regard for the wishes or interests of the insured; and
- (c) The creation by the insurance industry itself of a wide variety of self-imposed contractual limits on rights of subrogation, which to a significant extent eliminate the potential for subrogated claims in several key sectors of the economy, such as the construction industry.

This paper will now turn to an examination of the common legislative and contractual formulations of the modern right to subrogate.

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<sup>5</sup> James M. Meyers of Crum & Forster Insurance Companies.

<sup>6</sup> Meyers, J.M. "Subrogation rights and recoveries arising out of first party contracts" (1973), 9 *Forum* 83.

## II. STATUTORY AND CONTRACTUAL PROVISIONS RECOGNIZING THE RIGHT OF SUBROGATION

### 1. STATUTORY RIGHT OF SUBROGATION

All of the provinces and territories of Canada have Insurance Acts that regulate the insurer's right of subrogation. Some provinces have relatively "old" Insurance Acts, and others, such as British Columbia, Alberta and Saskatchewan, have recently enacted new legislation. A significant change in the "new" legislation is that fire insurance and general insurance divisions have been merged. This is significant because the subrogation provisions of the new legislation apply to a broad class of insurance contracts, rather than being limited to particular classes of insurance, such as fire and auto. As such, in the provinces with new Insurance Acts, this change will eliminate many of the difficulties caused by multi-peril policies under the old legislation.

As of summer, 2015, British Columbia, Alberta, Saskatchewan and Manitoba have all enacted new legislation. The remaining provinces and territories are subject to old legislation which generally distinguishes between various classes of insurance contracts. In those provinces and territories that rely on the old legislation, insurers will continue to rely on contractual and common law rights of subrogation, which are discussed below.

An example of the subrogation provisions of the "new" Insurance Acts can be found in section 36 of British Columbia's *Insurance Act*, which provides as follows:

*(1) The insurer, on making a payment or assuming liability under a contract, is subrogated to all rights of recovery of the insured against any person, and may bring an action in the name of the insured to enforce those rights.*

*(2) If the net amount recovered after deducting the costs of recovery is not sufficient to provide a complete indemnity for the loss or damage suffered, that amount must be divided between the insurer and the insured in the proportions in which the loss or damage has been borne by them respectively.*

Subsection (1) provides that if the insurer makes a payment under the insurance contract to the insured for a loss, the insurer is "subrogated" the rights to commence a lawsuit (*i.e.*, the insurer is given the rights to bring an action against the wrongdoer) in the insured's name against the responsible third party. Subsection (2) provides for the division of any proceeds recovered, where the recovery is insufficient to indemnify the full amount sought (either through settlement or judgment), where the action includes both the insured "subrogated" claim and additional uninsured claims brought by or on behalf of the insured (*i.e.*, any loss or damage suffered by the insured which was not covered by any payment by the insurer to the insured pursuant to the insurance policy). The division of

the recovered proceeds must be divided between the insurer and the insured based on the values of their respective claims.

The new legislation in Alberta and Manitoba contains provisions which address who controls the litigation process when both the insurer and the insured are seeking to recover for the loss (i.e. there is both a subrogated action and an action for the uninsured loss).

Alberta's *Insurance Act*, section 546(3) – 546(6) states as follows:<sup>7</sup>

(3) When the interest of an insured in any recovery is limited to the amount provided under a deductible or co-insurance clause, the insurer has control of the action.

(4) When the interest of an insured in any recovery exceeds that referred to in subsection (3) and the insured and the insurer cannot agree as to:

- (a) the solicitors to be instructed to bring the action in the name of the insured,
- (b) the conduct and carriage of the action or any related matters,
- (c) any offer of settlement or the apportionment of an offer of settlement, whether an action has been commenced or not,
- (d) the acceptance or the apportionment of any money paid into Court,
- (e) the apportionment of costs, or
- (f) the launching or prosecution of an appeal, either party may apply to the Court for the determination of the matters in question, and the Court may make any order it considers reasonable having regard to the interests of the insured and the insurer in any recovery in the action or proposed action or in any offer of settlement.

(5) On an application under subsection (4), the only parties entitled to notice and to be heard on the application are the insured and the insurer, and no material or evidence used or taken on the application is admissible on the trial of an action brought by or against the insured or the insurer.

(6) A settlement or release given before or after an action is brought does not bar the rights of the insured or the insurer unless they have concurred in the settlement or release.

Subsection (3) provides that where the insured is seeking to recover their deductible or an amount provided for under a “co-insured” clause, the insurer will have control of the

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<sup>7</sup> RSA 2000, c. I-3.



litigation. However, when the amount sought by the insured is more than that provided for under subsection (3), and there is no agreement as to who should control the litigation, subsection (4) provides that either the insurer or the insured may apply to Court for a determination as to who should have control of the litigation process. The Court can also decide on matters of conduct of the litigation, settlement, apportionment of costs and any subsequent appeal.

Subsection (5) provides that during an application to the Court only submissions by the insured and the insurer will be heard (and no other party can make submissions). It also provides that any evidence and materials used by the parties in such an application are not to be relied on in any subsequent action brought against either the insured or the insurer. Finally, subsection (6) provides that any release or settlement prior to commencing a subrogated action does not bar the rights of the insurer to commence a subrogated action against the wrongdoer, unless the insurer has concurred to that settlement or release.

These sections help reduce some of the difficulties and uncertainty faced by insurers in determining who controls the litigation in a claim concerning both insured and uninsured losses. These challenges are discussed in further detail below, in the Procedural Aspects of Subrogation section.

## **2. CONTRACTUAL RIGHT OF SUBROGATION**

For policies not regulated by statutory subrogation provisions, such as "All Risk" policies that are subject to "old" insurance legislation, the insurers' right to subrogate is very frequently based on Insurance Bureau of Canada (hereafter "IBC") standard wordings, together with a variety of "manuscript" wordings used by the Canadian property and casualty insurance industry. Common forms include the following examples:

The Insurer, upon making any payment or assuming liability therefor under this policy, shall be subrogated to all rights of recovery of the Insured against others and may bring action to enforce such rights. Notwithstanding the foregoing, all rights of subrogation are hereby waived against any corporation, firm, individual, or other interest with respect to which insurance is provided by this policy.<sup>8</sup>

or:

The Insurer(s), upon making any payment or assuming liability therefor under this Policy, shall be subrogated to all rights of recovery of the Insured against others and may bring action in the name of the Insured to enforce such rights, except that (a) any "lease from liability entered into by the Insured prior to loss shall not affect

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<sup>8</sup> IBC Form No. 51222 - "Commercial Building Broad Form".

the right of the Insured to recover; (b) notwithstanding the provisions of paragraph (a) hereof all rights of subrogation are hereby waived against any corporation, firm, individual, or other interest with respect to which insurance is provided by this Policy.<sup>9</sup>

The following is a "manuscript" wording which is tailored so as to recognize and protect the shared economic interest of affiliated corporate entities (*e.g.*, parent/subsidiary), and accommodates the distinct economic realities of the different participants in the construction industry:

Any release from liability entered into by the Insured prior to a loss, shall not affect the right of the Insured to "cover hereunder".

The Insurer, upon making any payment or assuming liability therefore under this policy, shall be subrogated to all rights of recovery of the Insured against any person, and may bring action in the name of the Insured to enforce such rights.

The Insurer hereby waives right to a transfer of such rights: (a) of the Insured against any individual or organization affiliated or associated with, parent of or subsidiary to, the Named Insured or their employees (b) of any Insured against a general or subcontractor, including their employees, but this waiver shall be limited to loss or damage to the work being performed by said contractors and their employees in connection with the premises described herein.

Lloyds of London syndicates, through the insured's North American broker, will accept risks on "manuscript" property wordings which state:

The insurers shall be entitled at any time, either in their own names or in the name of the Insured, to take steps for the recovery of any part of the property lost or damaged or for securing "reimbursement in respect of any loss or damage. The Insured shall give the Insurers all information and assistance required in so doing and the Insurers shall indemnify the Insured for any costs or expenses which the Insured may incur or be compelled to pay as a result of providing such information and assistance.

Upon the payment of any claim under this policy the Insurers shall be subrogated to all the rights and remedies of the Insured arising out of such claim against any person or corporation whatsoever; it is agreed that any release from liability entered into by the Insured prior to loss shall not affect the Insured's rights of recovery under this policy.

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<sup>9</sup> IBC Form No. 5121 0 - "Builders" Risk Comprehensive Form".

Any recovery obtained by the Insurers through subrogation will be shared with the Insured in the ratio that the uninsured portion of the loss bears to the total amount of the loss.

Another version of a Lloyds of London policy provides:

The Insured may, prior to the happening of a loss without prejudice release any persons or corporations from liability for loss arising to the within described property; and it is agreed by the Insurers that all right of subrogation is waived under this policy if it is claimed that the loss was occasioned or caused by the act or neglect of any corporation or corporations whose capital stock is owned or controlled by the Insured at the time of such loss, or any corporation, parent or subsidiary to or affiliated with the Insured or any of their or either of their affiliated, proprietary or subsidiary companies. Specific rights of subrogation against any Named Insured or Additional Named Insured are released.

Liability policies also frequently contain subrogation provisions. At first glance it may seem illogical that there could be a right of subrogation in relation to a loss *caused* by the insured, not *suffered* by the insured, but it is often the case that an insured will be legally liable to a claimant, but is at the same time entitled to look to a third or fourth party to ultimately bear all or part of its legal liability for the loss. If an insurer provides indemnity for the liability, then the insurer will, on the general principles of subrogation, be entitled to claim over against the third or fourth party for contribution and indemnity for the covered loss. While subrogation in this context occurs less frequently than in the context of property insurance, differing forms of subrogation provisions commonly appear in liability policies. Examples used by Canadian property and casualty companies include:

In the event of any payment under this Policy the Insurer shall be subrogated to the extent of such payment to all the Insured's rights of recovery against any third party except where the amount of settlement exceeds the amount provided in the aggregate by this Policy and any other valid and collectible insurance in which case the Insured shall be entitled to all recovery until such excess has been made good to the Insured. The Insured shall execute all papers required and shall do everything necessary within his power to secure such rights.

or:

In the event of any payment under this policy, the Insurer shall be subrogated to all the Insured's rights of recovery therefor against any person or organization and the Insured shall execute and deliver instruments and papers and do whatever is necessary to secure such rights. The Insured shall do nothing after loss to prejudice such rights.

The functional distinctions between, on the one hand, the statutory subrogation provisions contained in the Insurance Acts, and, on the other hand, the contractual and "manuscript" wordings, will be outlined in the following passages of this paper, together with the implications of such distinctions from the standpoint of the insurer's procedural and substantive rights.

### **III. PROHIBITIONS ON SUBROGATION**

The general effect of the contemporary law has been to discourage the assertion or exercise of rights of subrogation. This result has been reached in a number of ways:

- (a) By barring the insurer's right to proceed if the insurer can be characterized as a "volunteer", i.e. in the absence of a clear contractual obligation on the insurer to pay under the policy;
- (b) By barring subrogated proceedings if the potential defendant in the subrogated claim is a party to a "covenant to insure";
- (c) By allowing "legal strangers" to a contract of insurance to raise a "waiver of subrogation" clause in the insurance contract clause as a substantive defence; and
- (d) By dismissing, in a more or less discretionary manner, subrogated claims against employees or agents of the insured, who are so closely connected with the corporate insured that litigation by the insurer against the employee or agent is considered to be "unfair".

The following section of this paper is intended to trace the emergence of these four separate developments, and outline their practical importance for property insurers contemplating the initiation of subrogated proceedings.

#### **1. THE INSURER AS "VOLUNTEER"**

One important obstacle to subrogation is the concept of an insurer as a "volunteer", that is, a person who gratuitously and without legal obligation has indemnified the insured for the loss caused by the intended defendant in a subrogated lawsuit. The concept of the insurer as a "volunteer" is significant because there is considerable judicial authority for the proposition that subrogated legal proceedings can be undertaken only by those who have covered the victims' loss as a matter of legal obligation.

Property insurers settle claims for a variety of reasons. Insured persons are often paid if there is some doubt as to whether the claim falls within coverage. Still other claims may be

paid as a "compromised sum", simply to avoid the complex, time consuming and expensive litigation that would likely result if no amount were paid to the insured. In many cases it is unclear whether and to what extent the claim is covered, or whether there has been a policy breach by the insured. Nevertheless, there have recently been situations where an insurer has been debarred from pursuing the person who actually caused a covered loss because the insurer is regarded as a "volunteer", even though the insurer had good, practical reasons for making payment to its insured.

Property policy claims which do not fall within coverage are not eligible for subrogation. This was not always the law. Historically, the U.S. Courts took the position that for an insurer to pay a claim when there was no coverage did not compromise that insurer's right to subrogate.<sup>10</sup> This traditional American view became subject to doubt in 1980 by the decision in *Commercial Union Insurance Company v. Postin et al.*<sup>11</sup> The facts in *Postin* merit careful review. The insured had suffered a roof collapse. The property policy in question excluded "latent" defects; the adjuster's view was that the claim was not covered, the roof collapse being attributable to a "latent" defect. Notwithstanding the adjuster's opinion, the insurer paid the claim.

After paying the claim and commencing litigation against the architects and engineers alleged to be at fault, the defence was that the insurer lacked standing to bring the action, being a "mere volunteer". In refusing the insurer the right to maintain the subrogated litigation, the Wyoming court accepted the following definition of the "volunteer rule" outlined in *Couch on Insurance* (2d) v. 16 para. 61:55 at page 137-138:

While the right of subrogation is not dependent upon legal assignment, or upon contract, agreement, stipulation or privity between the parties to be affected by it, the person who pays the debt must not be a mere volunteer, for the payment must have been made under compulsion, or for the protection of interest of the person making it in discharge of an existing liability which must be fully satisfied. Hence, an insurer which pays a loss for which it is not liable thereby becomes a mere volunteer, and is not entitled to subrogation, in the absence of an agreement therefor.

Until recently in Anglo-Canadian jurisprudence there was no clear statement as to whether the "volunteer" principle applied in *Commercial Union v. Postin* was a reliable guide as to when an insurer will forfeit its right to subrogate. Historically, English courts

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<sup>10</sup> *Firemen's Fund Ins. Co. v. Rowland Lumber Co.*, 186 N.C. 269. 119 S.E. 362 (1923); *Firestone Service Stores, Inc.* 131 Fla. 94. 194 So. 175 (1938); *Jamestown Mut. Ins. Co. v. Nationwide Mut. Ins. Co.*, 277 N.C. 216, 176 S.E. 2d 751 (1970); *Transamerica Ins. Co. v. Barnes* 29 Utah 2d. 101. 505 P.2d 783 (1972).

<sup>11</sup> 610 P.2d 984 (Wyo. 1980).

had questioned the correctness of the position exemplified by *Postin*. For example, in *King v. Victoria Insurance Company Limited*,<sup>12</sup> Lord Hobhouse speaking for the Judicial Committee of the Privy Council (the Imperial counterpart of the domestic House of Lords) stated:

To their Lordships it seems a very startling proposition to say that when insurers and insured have settled a claim of loss between themselves, a third party who caused the loss may insist on ripping up the settlement, and on putting in a plea for the insurers which they did not think it right to put in for themselves; and all for the purpose of availing himself of a highly technical rule of law which has no bearing upon his own wrongful act.<sup>13</sup>

Despite the high authority of this relatively old case it would appear that the result in *Postin* more accurately reflects the law in British Columbia, at least by implication. That much is clear from the decision of the British Columbia Court of Appeal in *Wellington Insurance Company Limited v. Armac Diving Services Ltd.*<sup>14</sup> Here, the insured was the owner of a vessel which had capsized and sunk. A claim was submitted for indemnity in an amount slightly less than \$27,000.00. After initially denying liability, and being sued on the policy by the insured, the insurers agreed to settle the claim for \$17,500 on the following terms:

.... in order to conclude this matter without any further legal costs accruing and as a public relations gesture our client has instructed us that they would be prepared to pay the sum of \$17,500.00 in full settlement of your client's claim all inclusive of interest and costs.

That sum was accepted. The insured's action on the policy was concluded by means of a Consent Dismissal Order, dismissing the lawsuit as if "... evidence had been heard and Judgment pronounced on the merits therein." Consistent with the proposition that insurers had no liability under the policy, the accompanying Release provided that "... neither the payment of the aforesaid sum of money or anything contained therein shall constitute or be construed as an admission of liability by the Releasee...". In all respects the settlement was concluded on the basis that the insured had no legally enforceable right to payment under the property policy.

Following settlement of the dispute with its insurer, the insured proceeded to trial against the surveyor whose negligence was the actual cause of the loss. The insured successfully recovered in excess of \$65,000.00 from the tortfeasor, which left funds sufficient to

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<sup>12</sup> (1896), A.C. 250

<sup>13</sup> *Ibid.* at 254.

<sup>14</sup> [1987] ILR 1-2196; trial reasons at (1987), 18 CCLI 221 (BCSC).

reimburse the insurer for the full amount of the settlement of its action on the policy. The insurer claimed the right to a share of this recovery.

The judgment in *Armac Diving* addressed whether the insured had to reimburse the insurer for amounts recovered in subsequent tort litigation. Accordingly, the British Columbia Court of Appeal had to squarely confront the issue of whether a "volunteer", given the language of the release, had a right of subrogation. McLachlin J.A. (now Chief Justice of the Supreme Court of Canada), speaking for a unanimous Court of Appeal, concluded that the insurer had no right of subrogation. That conclusion was reached on the basis of Her Ladyship's opinion that the settlement monies had not been paid by reason of the terms of the policy, but rather, to bring the matter to an end without further expense and as a "public relations gesture".<sup>15</sup> In accepting that there must be an amount paid pursuant to the terms of the policy as a necessary precondition to subrogation, the Court stated:

None of the authorities deviate from the principle that before the right to subrogation arises, the insurer must have made a payment pursuant to its contract of indemnity with the insured. The only qualification, if it can be called that, is the rule that where, with the benefit of hindsight it emerges that the payment made may not have been legally required under the policy, the right to subrogation remains if the payment was honestly intended to be in satisfaction of a loss under the policy. .... a right of subrogation does not arise unless the insurer has made a payment indemnifying the insured for loss under the policy.<sup>16</sup>

The decision in *Armac Driving* was considered in the 2006 Ontario Superior Court of Justice decision, *Rio Algom v. Liberty Mutual Insurance Co. (c.o.b. Liberty International Canada)*.<sup>17</sup> In that case two property insurers provided Rio Algom with umbrella coverage. Rio Algom was sued for damages by one of its employees as a result of an accident during the course of his employment. The action was settled prior to trial. The settlement was funded by one insurer, who paid the claim on a reservation of rights basis and upon the agreement that Rio Algom would attempt to recover the funds from the other insurer.

The other insurer attempted to rely on *Armac Driving* in arguing that the paying insurer did not have a right of subrogation as it had not acknowledged any obligation to Rio Algom pursuant to its policy.

The Court determined that *Armac Driving* did not on the basis that:

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<sup>15</sup> *Ibid.* at 8510.

<sup>16</sup> *Ibid.* at 8510.

<sup>17</sup> [2006] OJ No. 329

[the insurer's] payment was on behalf of the insured and with the agreement that should it be determined that its policy is the one that must respond to the claim, the payment already made will have had the effect of meeting [the insurer's] obligations to its insured

The Court went on to state, at paragraph 23, as follows:

In my opinion, [the non-paying insurer's] position represents too narrow an interpretation of the doctrine of subrogation and is inconsistent with long established principles. The fact the payment by [the paying insurer] was voluntary does not preclude access to the courts by way of subrogation so long as the payment, as is the case here, "has been made honestly purporting to be in satisfaction of a potential liability under a policy" (MacGillivray on Insurance Law, 9th ed. (London: Sweet and Maxwell, 1997) at p. 544, referred to in *Pacific Forest Products Ltd. v. AXA Pacific Insurance Company*, [2003] BCJ No. 973, 2003 BCCA 241 at para. 17).

In the *Pacific Forest* case, referenced in *Rio Algom*, the Court of Appeal determined that where there is more than one insurer for a risk, and one of the insurers has fully indemnified the insured, the paying insurer's claim cannot be advanced in a subrogated action in the name of the insured, but has to be pursued in the name of the paying insurer as a claim for contribution. This "double insurance" topic is discussed in further detail in the Procedural Aspects of Subrogation section of this paper.

The distinguishing factor between both the *Rio Algom* and *Pacific Forest* cases on one hand, and *Armac Driving* on the other, is that in the former cases, the property insurer who paid the claim did so in recognition of a potential liability under a policy – the real issue in dispute being which policy should respond to the loss, and to what extent.

The Supreme Court of Canada confirmed the rule in its 2007 decision, *ABB Inc. v. Domtar Inc.*<sup>18</sup> when it agreed with the Quebec Court of Appeal's statement that:

...for a payment to result in subrogation of an insurer to the rights of the insured, it must be made to the insured on account of an obligation arising from the insurance contract or by operation of law.

What is of great practical concern to insurers is the possibility that a right to subrogation may be lost if payment pursuant to the policy is made "honestly" but wrongly. In what circumstances can an insurer settle a doubtful claim under a policy without jeopardizing its right to legally proceed against the author of the loss? In the United States the answer is

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<sup>18</sup> 2007 SCC 50



provided by the "reasonableness" test which has been developed by the courts. In English law the test, or governing standard, is one of "good faith". Under either set of legal criteria if in the circumstances of a particular case a reasonable person would conclude that the loss was covered, then the insurer need not fear that paying the claim would lead to a successful plea of the "volunteer defence".

In the U.S. context the test of "reasonableness" is best illustrated by the decision in *Northern Utilities v. Evansville*.<sup>19</sup> A gas utility was sued following a natural gas explosion at a customer's home. The utility company, through its insurer, paid \$90,000.00 in compensation for both property damage to the insured's home and for personal injury. Subsequently the utility company brought action against the various contractors alleged to be responsible for the loss. The defendants raised the "volunteer" defence; it was rejected by the Court. The following statement of principle appearing in 73 Am. Jur. 2d, Subrogation, 25 at page 614 was adopted by the Court as an accurate summary of the relevant law:

The right of subrogation is not necessarily confined to those who are legally bound to make the payment, but extends as well to persons who pay the debt in self-protection, since they might suffer loss if the obligation is not discharged. A person who has an interest to protect by making the payment is not regarded as a volunteer. .... The extent or quantity of the subrogee's interest which is in jeopardy is not material. .... It would seem that one acting in good faith in making his payment, and under a reasonable belief that it is necessary to his protection, is entitled to subrogation, even though it turns out that he had no interest to protect."<sup>20</sup>

The English cases establish a similar test for the identification of a "volunteer", albeit in somewhat different terms. For example, in *King v. Victoria Insurance Company*<sup>21</sup> the Judicial Committee of the Privy Council concluded that the "volunteer defence" was not available as:

... there is nothing to suggest that the claim was not one which the insured might not honestly and reasonably make, or to which the insurers might not honestly and reasonably accede.<sup>22</sup>

What practical advice can be given to insurers, in view of the potential loss of a right to be subrogated to the insured's claim against those ultimately liable for the loss?

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<sup>19</sup> 822 P.2d 829 (Wyo. 1991).

<sup>20</sup> *Ibid.* at 835.

<sup>21</sup> (1986), A.C. 250.

<sup>22</sup> *Ibid.* at 255.

Given the strictness of the rule in *Commercial Union v. Postin*, and the obvious implications of the B.C. Court of Appeal's decision in *Armac Diving*, it is clear that if insurers wish to preserve their rights of subrogation, it is essential that certain basic steps be taken in the management of claims made under a policy. It is necessary to identify cogent reasons for which payment is being made to an insured, and these reasons must relate to the terms of the policy. This will serve to ensure that the right of subrogation is not blocked by the defence that the insurer is really a "volunteer". In settling first party property claims an insurer would be well advised to undertake the following precautions:

- (a) Ensure that communications with the insured contain an outline of all *bona fide* reasons for paying the claim;
- (b) The preamble to any release documents should specify why the insurer reasonably believes the claims, as identified in the Proof of Loss, are within coverage;
- (c) Any payment should be specifically attributed to the specific provision of the policy which is the precise basis of the claim for coverage (for example, if there is a "design exclusion" in the All Risk and yet an exception to the exclusion for "resultant damage" the insurer should stipulate that the sum was properly paid under the latter as opposed to the former); and
- (d) Insurers should, in the context of coverage litigation, carefully avoid the use of a Consent Dismissal Order which treats the claim for coverage as being dismissed as if it were heard on the merits, and instead, enter a Consent to Judgment for the amount of the payment.

In "double insurance" cases, where more than one insurer has undertaken to indemnify the same risk, a paying insurer should not proceed to recover from non-paying insurers by way of subrogation. Instead, the insurer has a claim for contribution in its own right. This issue is discussed in further detail below in the Procedural Aspects of Subrogation section of this paper.

Another point to keep in mind in every case where subrogated recovery is desired, is to ensure that the underlying contract which prompted the payment or settlement is in fact a contract of *indemnity* sufficient to support a claim of subrogation. If there is no contract compelling payment or founding a liability, the question of "amount" will not even come up; the dispute will be on whether any payment at all was required. For example, in the

case of *Qureshi (Guardian ad litem) v. Nickerson*,<sup>23</sup> the plaintiff Qureshi appealed Nickerson's right to a costs order, even though Nickerson was the successful litigant in the medical malpractice claim. The basis for Qureshi's challenge was an allegation that Nickerson, a doctor, had been defended by the Canadian Medical Protective Association, on a "voluntary" basis, and that he had not incurred any costs.

Nickerson conceded that while in fact his defence had been borne by the CMPA, nonetheless the payment of the costs of his defence amounted to an indemnification and therefore, the CMPA had a subrogated right to pursue the plaintiff for costs in Nickerson's name.

Interestingly, the B.C. Court of Appeal agreed with Qureshi. The court examined the objects of the CMPA and its by-laws, and discovered that while the CMPA's role could be likened to an insurer, the by-laws in fact precluded any member from having a contractual entitlement to a defence. The by-laws were carefully worded to allow the CMPA the discretion, in each case, to refuse a member assistance or advice. To this the court stated:

It seems clear from the by-laws that the Association has a discretion to decide whether or not it will respond affirmatively to a request for assistance, and if it does, the extent of any such assistance granted. This flows from the use of the discretionary term "may" in by-law 7.01, and from the specific provisions of by-laws 7.03, 7.04.01, and in particular 7.04.03 which gives the Association the "absolute discretion" to limit, restrict, or terminate any assistance without assigning any reason.

Thus to the extent that the terms of any contractual indemnification between a member and the Association are to be found in the by-laws, there does not appear to be any obligation on the former to indemnify, even though there has been full performance of all of the obligations required of the former. In that sense there appears to be no mutuality of obligation in the relationship created by the by-laws, a circumstance which casts doubt on the existence of a contract.<sup>24</sup>

The court went on to find that even Nickerson's letter requesting assistance from the CMPA, and the CMPA's agreement to defend him, were made "subject to the By-laws of the Association", and therefore, "...any promise to "indemnify", which might be read into the terms of that letter, is no less discretionary than any that might be found or read into the by-laws themselves." In the result, since the court found there was no contract of indemnification, there was no right to subrogate. The court concluded:

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<sup>23</sup> (1991), 53 BCLR (2d) 379 (CA).

<sup>24</sup> *Ibid.*, at 386.

A payment can only be made “pursuant” to a contract of indemnity if, before the payment is made, such a contract exists which either requires that the payment be made, or leads the insurer honestly to believe that the payment is required to be made. I take the Wellington Insurance case to have decided that absent such a contract, no right of subrogation can arise, even though a payment in the form of indemnification is made.<sup>25</sup>

A similar question was examined in *Society of Notaries of British Columbia v. Dowson*.<sup>26</sup> On the facts, the Society had made payments to claimant members of the public who had had their funds absconded by a notary public. The Society maintained a special fund for such situations. The Society sought reimbursement from the notary public’s accountant/auditor, arguing that the auditor owed a duty of care to the Society to ensure that the notary’s accounts were properly reconciled. The Society submitted that the auditor, by negligently failing to notice irregularities in the accounting, had failed to “present a proper picture” to the Society, which allowed the notary to make further misappropriations. The auditor, Dowson, demurred to the question of liability but defended, arguing that the Society’s payments were “voluntary” and therefore, the Society had no right to bring the claim, which was essentially one of subrogation.

In the result, the court agreed that there was no underlying contract of indemnity and therefore, the Society had no right of subrogation. In dismissing the claim, the court commented:

What forcibly strikes me about all of the cases I have read, going back in time as far as a case cited in the Brook’s Wharf case, *Exall v. Partridge* (1799), 8 Term Rep 308, is that generally where liability has been found in any case to exist to require a party to reimburse or indemnify, there has usually existed a legally enforceable obligation or financial penalty that could have been enforced against the plaintiff who seeks to be indemnified. The sum sought usually is not in the nature of damages but is really in the nature of a reimbursement for a sum expended by the plaintiff to satisfy a legal liability relating to another party from whom indemnity is sought. This case at bar is in some respects rather different because the plaintiff here, in effect, seeks damages for harm asserted to have occurred through the alleged negligent conduct of the defendant. The sum sought in this action is quantified by the amount of money paid out by the plaintiff to the client claimants.

However, in law, these claimants could not have demanded payment from the plaintiff Society as a matter of right. Section 17 of the statute clearly reserves a discretion to the Society to decide whether or not any claim will be honoured. I do not doubt that there were important policy and public relations reasons why the

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<sup>25</sup> *Ibid.*, at 389.

<sup>26</sup> (1995), 4 BCLR (3d) 97 (SC).

payments were made by this plaintiff. It was and is important for the plaintiff Society to be able to assure members of the public that their funds are not at risk in the hands of the notary members of the Society.....

I am of the view that the principles enunciated in the cases of Qureshi and Wellington Insurance cited supra. strongly militate in favour of the legal position of the defendant herein. I am unable to perceive how the voluntary payment of claims by the plaintiff can found a liability on the part of this defendant to this plaintiff.....<sup>27</sup>

As an alternative approach, the insurer's risk of being labelled a "volunteer" may be avoided by obtaining a valid legal assignment of the insured's cause of action. Assignment is a different form of "substitution" than the doctrine of subrogation. An assignment, in which the insurer pays a separate sum for the right to bring the insured's legal action, may entirely avoid the "volunteer" defence. Canadian property insurers may find themselves in a more advantageous position than their American counterparts, because in Canada it is easier to transfer a right to sue in this way than it is in the United States.

In many American states an assignment of a cause of action in tort is void as against public policy, and cannot be the subject matter of a valid transfer of rights.<sup>28</sup> The concern is that the assignment of a cause of action in tort offends "public policy"; put bluntly, the concern is that no one should be able to buy or sell a right to litigate in the courts. That policy concern is not enforced with nearly the same strictness in Canada. The Supreme Court of Canada has approved the view that a cause of action in tort for property damage is capable of assignment.<sup>29</sup> As McLachlin, J. (as she was then) stated, in referring to the assignment of causes of action in tort:

An assignment of a cause of action for non-personal tort is generally valid if the assignee has a sufficient pre-existing interest in the litigation to negate any taint of champerty or maintenance. In determining if this test is met, the court should look at the totality of the transaction... A genuine pre-existing commercial interest will suffice.<sup>30</sup>

In light of the more liberal approach taken by Canadian courts it is plainly arguable that an insurer, having made a payment under a property policy, notwithstanding that the

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<sup>27</sup> *Ibid.*, at 108

<sup>28</sup> *Allstate Insurance Co. v. Druke*, 118 Ariz. 301, 576 P.2d 489 (1978); *Block v. California Physicians' Service*, 244 Cal. App. 2d 266, 53 Col. Rptr. 51 (1966); *Northern Utilities*, supra, at p. 837.

<sup>29</sup> *Frederickson v. ICBC* (1986), 3 BCLR (2d) 145 at p.153, affirmed by SCC at (1988), 1 SCR 1089.

<sup>30</sup> *Supra*, at 156

claim was outside coverage, could effectively subrogate against the wrongdoer simply by ensuring that it obtained, for valuable consideration, a proper legal assignment of the insured's cause of action.

To summarize, the Canadian property insurer might avoid the loss of its right to subrogate by either:

- (a) Assuming there is a good arguable case that the claim falls within coverage, ensuring that the release specifically acknowledges the basis for payment, or
- (b) Assuming there is no genuine belief that there is coverage when paying a compromised sum to avoid coverage litigation, by obtaining a legal assignment of the insured's tort claim upon payment of new or separate consideration.

## **2. COVENANTS TO INSURE - THE "DOCTRINE OF LEGAL IMMUNITY"**

This section of the paper concerns the effect of contractual agreements to provide or pay for insurance coverage. Such agreements, common to many commercial tenancies, can affect both the civil liability of the contracting parties to each other and their insurer's right to subrogate if one of the parties has a civil claim against the other. For all practical purposes the covenant to insure has become a shield for the deflection of tort liability. This has important implications for insurers.

This section of the paper is not concerned with whether and to what extent one person may contract to provide an indemnity to another. That is the subject matter of a "hold harmless" clause. Neither is this discussion concerned with the extent to which an insurer may "waive" or release its right of subrogation in respect of that insured's claim against those whose wrongful acts have caused a loss; that topic will be covered in the next section. Rather, this section will address the general question of whether, by assuming the obligation of a covenant to insure or a covenant to pay for insurance, a party may be relieved of the risk associated with an event of loss, and thereby avoid its own liability for causing that very same loss. We shall see that it is possible for the contracting parties to accomplish such a result, at the expense of their insurer's right to pursue a subrogated claim, merely by utilizing appropriate language in a commercial agreement. This possibility has arisen from legal developments that have taken place in Canada since approximately the late 1970's.

Our analysis will begin with an examination of covenants to insure entered into by landlords and tenants. It is this particular relationship which has spawned the most

significant lawsuits. Therefore, the basic points which ought to be kept in mind by insurers and their insureds are demonstrated by consideration of the issues which have arisen in disputes involving commercial tenancies.

The analysis will then consider the scope of the protection afforded by a covenant to insure, both in terms of the type of loss which can be covered by such covenants, and the type of commercial or contractual relationship, in which such covenants may be given.

The next area of inquiry will deal with a covenant to insure and a contractual promise of indemnity. In some circumstances the two distinct obligations can conflict with each other. What happens when one party is the beneficiary of a covenant to provide or purchase insurance and, at the same time, is itself obliged to provide an indemnity to the covenantor in respect of a similar risk?

The discussion will then focus on the problems associated with employees, agents and independent contractors. Assuming that a corporate employer is immune from suit because it is the beneficiary of a covenant to insure, does the benefit of the employer's protection extend to its employees and other agents? If not, and employees are personally liable for damages caused by their negligence, what are the consequences for the employer?

**(a) Commercial tenancies**

It is difficult to imagine many commercial enterprises not involved in a lease of real property. It is highly unusual for corporations to own and control all the facilities they use. Covenants to insure are therefore relevant to almost all business enterprises.

The relationship between landlord and tenant, is, of course, primarily regulated by a lease agreement. Typically, commercial leases provide that the tenant has a duty to maintain the lease premises in good repair. In the event of damage to the leased premises caused by the negligence of either the landlord or the tenant (usually acting through their respective employees), one would normally have the right to sue the other for the losses resulting from that negligence. However, it has become commonplace for leases to stipulate that insurance coverage will be taken out or paid for by either the landlord or tenant on the assumption that the coverage will protect both parties' economic interests. Generally speaking, such stipulations can take one of four differing forms:

- (i) the landlord covenanting to pay for insurance;
- (ii) the landlord covenanting to insure;
- (iii) the tenant covenanting to pay for insurance; and

- (iv) the tenant covenanting to insure.

Assuming the existence of one of these covenants, are the parties entitled to assume that no further insurance coverage need be purchased, even in respect of losses caused not by third parties but by the negligence of one causing damage to the interests of the other? The answer varies depending on which of the four situations exists. Each will be considered in turn.

- (i) Landlord's covenant to pay the cost of insurance

Consider the situation where a landlord has entered into a covenant to simply pay for insurance, without more. Is this factor sufficient to bar a landlord's right of action against the tenant for negligently causing an insured loss, and thus prevent the insurer from proceeding with a subrogated action? The question has usually arisen in circumstances where the tenant's employees have negligently caused a fire resulting in property damage.

The question was first confronted in a case which reached the Supreme Court of Canada in 1937.<sup>31</sup> The landlord sued the tenant in the aftermath of a fire loss, the circumstances of which pointed to negligent conduct on the part of the tenant's employees. The lease between the parties provided that the landlord was to pay all premiums of insurance and contained the "standard" repair covenant. The covenants stated:

And the said Lessor covenants to pay all taxes in connection with the demised premises and all premiums of insurance upon the buildings erected thereon.

And that the said Lessee will repair, according to notice in writing, reasonable wear and tear and damage by fire, lightning and tempest, riot or public disorder or act on the part of any governmental authority only excepted...

And that it will leave the premises in good repair, reasonable wear and tear and damage by fire, lightning and tempest only excepted.<sup>32</sup>

Clearly the landlord had a duty to pay for the premiums of insurance, while the tenant had a corresponding duty to return to the landlord a building undamaged by fire at the expiration of the lease.

The repair covenant was not unlike the repair covenant contained in British Columbia's *Land Transfer Form Act*, RSBC 1996, c. 252, which provides, in Schedule 4 to the Act, that any provision in a lease obligating the tenant to leave the premises in good repair imports the following words:

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<sup>31</sup> *United Motors Service Inc. v. J.T. Hutson et al*, [1937] SCR 294

<sup>32</sup> *Supra*, at 298-99



.... the said lessee .... will yield up ... the said premises ... in good and substantial repair and condition in all respects, reasonable wear and tear and damage by fire only excepted.

The Supreme Court of Canada indicated that in its view a landlord's contractual undertaking to simply pay for insurance, without more, was not sufficient to bar a lawsuit against the tenant for the latter's negligence. The tenant was not generally responsible for the financial consequences of an accidental fire, but it was responsible if that accidental fire was attributable to its own negligent conduct.

The same result was reached in a British Columbia decision, *Leung v. Takatsu*.<sup>33</sup> The lease provided that the "owner [was] to pay property taxes and building insurance". The premises were damaged by a fire and the landlord's insurer, having indemnified the landlord, sought to advance a subrogated claim against the tenant. The Court of Appeal concluded that the owner's mere contractual obligation to pay insurance, without more, was not sufficient to bar the insurer's claim.

This view was re-confirmed in the 1991 B.C. Supreme Court decision, *Ruge v. Kennedy*.<sup>34</sup> There the covenant in question provided that the landlords were "to pay all mobile home insurance and property taxes." On the facts, the landlords had obtained insurance and were the only named insureds on the policy, although the policy did acknowledge the premises were rental premises. The Supreme Court found that the policy language was similar to that in *Leung v. Takatsu*, and held that the covenant did not amount to a covenant to insure "in such a manner as to exculpate the tenant" from fire liability.

Another B.C. Supreme Court decision, *Perlitz v. Nan*,<sup>35</sup> upholds this view. There the covenant provided: "Real property taxes, fire insurance and agricultural land fees are to be paid by the Lessor." After a review of the *Leung v. Takatsu* and the *Ruge v. Kennedy* decisions, the Court concluded that the wording "[fell] far short...of a covenant on the part of Mr. Perlitz to insure against the risk of his tenant's negligence, for their benefit, as well as his own."<sup>36</sup>

More recently, in the 2004 B.C Supreme Court decision, *North Newton Warehouses Ltd. v. Alliance Woodcraft Manufacturing Inc.*<sup>37</sup>, the Court suggested that *Perlitz*, *Leung* and *Ruge* establish a basic proposition that: "a covenant given by the landlord to pay for insurance is

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<sup>33</sup> (1980), [1992] 3 WWR 129 (BCCA)

<sup>34</sup> (1991), 6 CCLI (2d) 156 (BCSC).

<sup>35</sup> (1997), 51 BCLR (3d) 130 (SC).

<sup>36</sup> *Ibid.*, at 138.

<sup>37</sup> 2004 BCSC 230

not a covenant to insure in such a manner as to protect the tenant from liability for fire loss.”

In summary, the overwhelming judicial opinion seems to be that a tenant's attempt to "shelter" under a landlord's undertaking to pay insurance is not by itself sufficient to prevent the landlord from pursuing a lawsuit against his tenant in respect of a covered loss, nor to prevent the insurer's right to maintain a subrogated cause of action.

(ii) Landlord's covenant to insure

The question arises whether a landlord's covenant to actually obtain insurance covering the leased premises (as opposed to simply paying the premiums on a contract of insurance obtained by the tenant) is sufficient to prevent the landlord from suing the tenant in the event of the latter's negligence. This precise issue has been given careful analysis in two decisions of the Supreme Court of Canada: *Agnew-Surpass Shoe Stores Limited v. Cummer-Yonge Investments Ltd.*<sup>38</sup> and *The T. Eaton Company Limited v. Albert E. Smith et al.*<sup>39</sup> (those two cases, along with the *Ross Southward* case, discussed below, are frequently referred to in the subrogation context as “the trilogy” of cases).

In *Agnew-Surpass*, the negligent conduct of the tenant's employee had caused a fire. The landlord's insurer had indemnified the insured for the resulting loss, and then sought to exercise its right of subrogation by suing the tenant - and its employee - for damages. The terms of the lease between the landlord and tenant were significant in three respects:

- (a) there was the "usual" tenant's covenant to repair;
- (b) the landlord had covenanted to insure against any risk or loss due to fire, including both its interests and those of the tenant, in the following terms:

"The Lessor covenants to insure the Shopping Centre including the said Building, excluding foundations in each case, against all risk or damage caused by or resulting from fire, lightning or tempest or any additional peril defined in a standard fire insurance additional perils supplemental contract. All such insurance shall to the best of the ability of the Lessor be to the full insurable value of the property insured."

- (c) the tenant's obligation to insure excluded damage caused by perils that the landlord was obligated to insure against.

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<sup>38</sup> [1976] 2 SCR 221 at 228.

<sup>39</sup> [1978] 2 SCR 749.

It should be reiterated at this point that the covenant in this case, in contrast to that in the first situation already discussed, required the landlord to actually enter into a contract of insurance covering the leased premises, not simply to finance the premiums of insurance purchased by the tenant.

The question before the Supreme Court of Canada was whether the landlord's covenant to insure protected the tenant in the event of fire loss attributable to the negligence of the tenant's own employee. The landlord argued that its covenant to insure did not bar recovery for the tenant's negligence, and merely amounted to a covenant to rebuild the premises in the event of a loss due to fire. The Supreme Court held that the combined effect of the three provisions amounted to a bargain in which the tenant was intended to have the benefit of fire insurance in the event of loss regardless of whose negligence caused a loss. When viewed in that light, the Court treated the existence of the landlord's covenant to insure as a bar to any claim in negligence against the tenant by or on behalf of the landlord.

From a practical perspective, the Court was clearly ruling that where parties enter into a contract in which one party covenants to insure for the benefit of both, the parties can look only to the insurance policy for recovery. There is no related right to shift the ultimate loss to the other through subrogated proceedings, even assuming that otherwise such other party was in law responsible for the loss.

I will refer to the principle established by the Court's main ruling in this case as the "doctrine of immunity".

There is one further feature of the decision reached in this case which has wide practical significance. It concerns the nature of the risk agreed to be covered by insurance.

Apart from the landlord's claim for property loss, the tenant also faced a claim for loss of rental revenue during the rebuilding period following the fire. The landlord's insurer, unable to recover the loss associated with physical damage, contended that it was entitled to recover any loss in rental income covered by business interruption coverage because the covenant to insure only extended to loss caused by fire. The Court agreed with that view. In so doing, it made clear that the doctrine of immunity can be no wider than the extent of the relevant contractual undertaking in the lease.

What is particularly interesting about *Agnew-Surpass* is the Supreme Court's apparent willingness to ignore principles of insurance law. There exist recognized limits on an insured's ability to waive its right of subrogation. Those limits were seemingly

disregarded by the Court, which preferred the view that the lease itself should determine whether there could ultimately be tort liability.

It is necessary to consider the other especially significant decision involving commercial tenancies. In *T. Eaton*, a landlord's insurer again sought to recover in respect of a fire caused by a negligent tenant. The lease provided the landlord would "... throughout the currency of this lease... keep the buildings ... insured against loss by fire". The lease contained the three "customary" repair clauses that exist in many commercial leases:

- (i) the tenant's covenant to repair;
- (ii) the tenant's covenant to repair on notice; and
- (iii) the tenant's covenant to yield up the premises in good repair.

As in the *Agnew-Surpass* case there was also a covenant by the landlord which provided:

And the Lessor covenants with the Lessee that he will, throughout the currency of this lease and any extension thereof hereunder keep the buildings upon the said premises insured against loss by fire in an amount not less than their full insurable value.

Notwithstanding that the sole obligation to repair rested upon the tenant the Supreme Court concluded that the landlord and tenant had entered into a contract in which the landlord had agreed to provide fire insurance in lieu of its right to sue, and that in the aftermath of a fire caused by the tenant's negligence, the insurance money was the only source of compensation that the landlord could look to in the event of loss. The landlord and its insurer could not shift the loss to the actual wrongdoer. What is required to immunize a tenant from a lawsuit for damages for negligence is an explicit contractual duty obligating the landlord to insure against the specific loss caused by the negligence.

There have been a number of decisions out of B.C. and Ontario which have followed the *Agnew-Surpass* and *T. Eaton* decisions, but have considered other wordings involving landlord covenants to insure and their impact on the insurer's right to subrogate.

In the 1995 Ontario Court of Justice (General Division) decision in *Imperial Crown Investments Corp. v. Canada Custom Shutters*,<sup>40</sup> the lease in question provided:

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<sup>40</sup> (1995), 33 CCLI (2d) 80 (Ont. Gen. Div.)

That the lessee shall not be required to insure the building on the demised premises from loss or damage by fire. IN the event the policy for insurance provided and paid for by the Lessor herein for the building should have its premium increased due to the nature of the business being carried on by the Lessee herein, any such increase or increases shall be reimbursed to the Lessor by the Lessee.

The Court found that the words “provided and paid for by the Lessor” were sufficient to create a covenant by the lessor to provide the requisite insurance for the property. The lessor therefore assumed the risk of loss and could not proceed against the tenant in negligence and further, its insurer was precluded from asserting a subrogated claim. The court noted that if there was any ambiguity, the principle of *contra proferentem* would dictate an interpretation in favour of the tenant.

A similarly worded covenant was contained in the lease which was under consideration in the 1997 B.C. Supreme Court decision in *Rebello v. Nugget Equipment Ltd.*<sup>41</sup> The important paragraph was:

The Lessee acknowledges that this is a “net net lease” and that all expenses in relation to the demised premises shall be borne by the Lessee, except structural and paving repairs and exterior painting. Provided however that notwithstanding anything else herein contained, the Lessor will be responsible for paying the land taxes for year 1981 and the Lessor will further be responsible for placing and paying the premiums for replacement cost insurance on the building, which amounts as additional rent as defined in paragraph 1 hereof are included in the rental of \$4,000.00 per month herein.

Additional provisions in the lease provided that the lessee was responsible for plate glass and public liability insurance; and the lessor was responsible for repairing and restoring the premises, in the event of partial destruction, unless such destruction was due to the wilful act or neglect of the lessee.

At issue was a fire loss allegedly caused by the tenant’s negligence. After considering the lease as a whole, the court determined that the “scheme” of the lease was that the risk of damage to the building was allocated to the owner, and the risk of damage to leasehold improvements, plate glass and liability arising from the tenant’s operations, were allocated to the tenant. The court found that even though “loss by fire” was not specifically mentioned, “replacement cost insurance must surely embrace loss by fire which is the most common hazard for buildings”. Notably, the court accepted that “placing and paying” for “replacement cost insurance” was effectively a covenant to insure the premises.

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<sup>41</sup> (1997), 32 BCLR (3d) 326 (SC)

Two Ontario decisions are worthy of note. In *Amexon Realty Inc. v. Comcheq Services Ltd.*,<sup>42</sup> the court noted the following lease provisions:

- (a) the landlord covenants with the tenant that the landlord will insure the building against damage by fire (article 11.04);
- (b) the tenant agrees to pay to the landlord its proportionate share of the landlord's cost of insuring the building against both damage and lost rent (article 6.01);
- (c) notwithstanding the tenant's obligation to pay its proportionate share of the cost of insurance, no insurable interest is conferred on the tenant under any policies of insurance carried by the landlord (article 11.04);
- (d) the tenant covenants with the landlord to repair the leased premises, except for damage caused by fire against which the landlord is insured (article 7.01);
- (e) the tenant agrees to take out and pay for insurance in its own name and that of the landlord on property owned by the tenant against the perils of fire. Such insurance must provide for a waiver of any subrogation rights which the tenant's insurer might have against the landlord (article 11.01)

Given the landlord's covenant to insure, the fact that the tenant's covenant to repair specifically excepted damage by fire, and the fact that the tenant was obliged to pay its proportionate share of the insurance, the main argument in the insurer's favour seemed to be the article providing that the tenant had "no insurable interest" under the policy. Nonetheless, on the basis of the first three factors and the established case law, the Court of Appeal concluded that this was not an obstacle and that the tenant had "bargained for the right to be free of the risk of liability for fire arising from its negligence". In upholding the trial court's dismissal of the claim, the Court of Appeal stated:

It is true that the lease provides that the tenant has no insurable interest under the landlord's policy. While this provision would presumably preclude the tenant from asserting a claim for his own loss under that policy, it does not speak to the claim asserted by the appellant in this case. It is the bargain I have referred to rather than the tenant having an insurable interest under the landlord's policy that is the basis upon which this action is precluded.<sup>43</sup>

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<sup>42</sup> (1998), 37 OR (3d) 573, [1998] ILR 1-3533 (CA)

<sup>43</sup> *Ibid.*, at 4928

In *Economical Mutual Insurance Co. v. 1072871 Ontario Ltd.*,<sup>44</sup> the court was asked to consider the overall effect of several lease provisions. These were:

1. The landlord shall maintain insurance coverage on the premise for fire lightning, storm and other perils (Para 8(1))
2. The tenant shall carry fire and other peril insurance in his own name to protect the tenant's stock in trade, equipment, trade fixtures, etc. (Para. 8(4))
3. The tenant covenants to indemnify the landlord with respect to any damage to the premises occasioned by the negligence of the tenant, its officers or agents (Para. 8(2))
4. The tenant covenants to make all needed repairs as would a prudent owner but shall not be liable to effect repairs attributable to damage cause by fire, lightning or storm (Para. 6(1))
5. The landlord and tenant agree that the rent shall include realty taxes, heating and fire insurance premiums. (Para. 2(4))

The tenant argued that the provision stipulating that "the landlord shall maintain insurance coverage for fire..." was a covenant to insure by the landlord, and that such covenant enured to the benefit of the tenant, precluding any subrogated recovery. The landlord, in answer, argued that without the key words of "covenant" there was nothing to suggest a benefit of the tenant. The motions Court judge disagreed, stating:

In my view, the provision in a lease of an obligation on the landlord to insure should be seen as benefitting the tenant since its inclusion would be unnecessary if it were meant solely to benefit the landlord.<sup>45</sup>

The landlord also argued that the tenant's covenant to indemnify distinguished it from the *T. Eaton* case. Again, the court disagreed, noting that even without a covenant to indemnify a tenant would be liable for fire caused by negligence, and so the covenant did not change the impact of the insurance provision, which shifted the risk of fire to the landlord.

In the result, the court found that the lease provided a landlord's covenant to insure for the benefit of both the landlord and tenant, and the landlord was therefore precluded from claiming against the tenants for liability for fire arising from its negligence. The Court dismissed the action. The landlord's appeal was dismissed.

In a 2005 decision, *North Newton Warehouses Ltd. v. Alliance Woodcraft Manufacturing Inc.*<sup>46</sup>, the British Columbia Court of Appeal held that a subrogated claim commenced by a

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<sup>44</sup> (1998), 20 RPR (3d) 154 (Ont. Gen. Div.), aff'd (May 20, 1999), Docket CA C30945 (ONCA)

<sup>45</sup> (1998), 20 RPR(3d) 154 (Ont. Gen. Div.) at 160-61

landlord's property insurer against a tenant whose employees had negligently caused a fire was barred. In that case, the landlord had covenanted to take out "all risks" insurance and to repair the premises in the event of damage, including by fire. The tenant paid for the insurance premiums as part of "additional rent". The decision is notable for the Court of Appeal's summary of the policy rule concerning the doctrine of immunity in this context, as stated by the Honourable Madam Justice Newbury at para. 45:

Ultimately, the policy rule underpinning the proposition that the insurer cannot pursue a tenant for damages in circumstances such as those present in the instant case is based on the proposition that it makes little business sense for a landlord to covenant to insure and for a tenant to pay the premiums if the tenant is not to derive some benefit from the insurance. One might properly say that there is something approaching a presumption in favour of a tenant benefiting from a landlord's covenant to insure. That is the legal principle that I take to be established from the trilogy of cases decided by the Supreme Court of Canada.

In summary, recent caselaw suggests that in the ordinary course, a landlord's property insurer will not be permitted to pursue a subrogated claim against a tenant when the lease includes a landlord's covenant to insure. As a practical step, subrogating insurers should obtain and review their insured's lease agreements at an early stage, prior to expending time and money on pursuing a claim that may ultimately be barred by a landlord's covenant to insure.

(iii) The tenant's covenant to pay for insurance

Thus far, we have been examining whether and to what extent the landlord's covenant to insure may bar his right to maintain a cause of action for negligence against the tenant. The converse of this problem is whether and to what extent a similar tenant's covenant can bar the right to maintain a negligence lawsuit.

In *Ross Southward Tire Limited, et al. v. Pyrotech Products Limited, et al.*,<sup>47</sup> another decision of the Supreme Court of Canada (one of "the trilogy" of cases referred to above), the question arose whether a tenant's covenant to simply pay insurance purchased by the landlord was sufficient (without more) to extinguish the landlord's right to maintain an action in negligence against the tenant. The tenant had covenanted to:

... pay all realty taxes including local improvements and school taxes, electric power and water rates and insurance rates immediately when due.<sup>48</sup>

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<sup>46</sup> 2005 BCCA 309

<sup>47</sup> [1976] 2 SCR 35.

<sup>48</sup> *Ibid.* at 43.



The lease was accompanied by the standard covenant on the part of the tenant to repair. In this case, as in the previous cases, the premises were destroyed because of the negligence of the tenant's employees. The landlord's insurer, having indemnified the landlord, sought to maintain a subrogated claim against the tenant.

It was held that the tenant's undertaking to pay the cost of the insurance amounted to an agreement between landlord and tenant that the risk of accidental fires, however caused, would pass to the landlord and cease to be the tenant's concern. The Court concluded that upon presentation to the tenant of the bill for payment of the premium, the risk of loss due to fire had passed to the landlord. By shifting the risk in this manner neither the landlord nor its insurer could proceed with a lawsuit against the tenant or its employees. The rationale for the Court's decision was its view that the tenant, by having covenanted to pay the insurance, had in effect paid for an "expected benefit". The expected benefit was that the landlord would resort solely to the fire insurance in the event of loss. The tenant could not be expected to pay for insurance coverage which did not protect the tenant. As in the *T. Eaton* case which has already been discussed, the Supreme Court indicated that its decision depended not on general insurance law considerations but rather on specific contractual obligations undertaken between the landlord and the tenant.

In *Northwestern Metal & Salvage Ltd. v. Alltar Roofing Ltd.*,<sup>49</sup> the Alberta Court of Appeal was asked to try a preliminary issue as to whether certain provisions in the lease gave a defence to the tenant. There were two clauses. The first stated that the tenant would contribute a certain sum per year toward the premiums on the fire insurance; and the other clause stated that any damage to the building would be the responsibility of the tenant. The Court of Appeal divided on the issue. Mr. Justice Cote for the majority, ruled in favour of the tenant, reasoning:

Since the principles involved are undoubted, the question is applying them to the particular drafting here, and obviously the first task is to see what to do about the apparent clash between the two clauses. The first principle of interpretation is that, if possible, the words of a lease or contract should all be read together and reconciled. While there may be more than one way to reconcile these two clauses, it seems to me that the best way to do so is as follows.

The covenant about damages is of course broader than fire, let alone fire insurance. The clause respecting insurance is narrower. This being a lease between two business people, doubtless their focus with respect to liability was on losses coming out of the pocket of one of them, not losses to be borne out of the pocket of a non-party insurance company. Therefore, it seems to me that the best way to reconcile the two clauses is to say that the clause about insurance deals with those

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<sup>49</sup> (1994), 19 Alta. L.R. (3d) 439, 25 CCLI (2d) 116 (CA)

losses which are or can reasonably be covered by insurance such as fire insurance. The sentence about damages should be read as speaking about those losses not covered or readily coverable by fire insurance.

Therefore, it seems to me that in substance the defendant was right, and in substance the order given in Queen's Bench about the preliminary issue was right. [T]here [sic] is one qualification however. If there is any part of this loss which is not covered by the fire insurance, because there is an exception or deduction which is standard in insurance policies, then the defendant should not have the benefit of that. [sic] For example, some fire insurance policies will have a deductible of \$100.00. If there is anything like that here, and it was standard, then to that very limited extent, the defendant would be liable.<sup>50</sup>

McClung J.A., in the minority, disagreed, stating:

While the landlord charged the tenant for a portion of the cost of the premises fire insurance and now seeks to deny the tenant any return for his stated contribution by bringing this action, it is still clear to me that the lease provision, which I quote, is determinative.

“Any damages to the building caused by the lessees or their clientele is the responsibility of the lessee.”

To my mind that ends the landlord's responsibility and commissions the liability of the tenant. There is no inflexible rule that contractual contribution by a tenant toward the cost of insurance coverage entitles the tenant to its benefit if the parties have contracted otherwise. Here there was no exculpatory clause favouring the tenant in anything approaching clear terms, and the damage clause, as comprehensive as it is, by the use of the term “any damage”, to my mind must prevail.

As I have said, I would have allowed the appeal and issued a declaration that the damages here, admittedly caused by the lessee's negligence are to be borne by the lessee.<sup>51</sup>

In *Lee-Mar Developments Ltd. v. Monto Industries Ltd.*,<sup>52</sup> the court considered a situation where the lease in question was a “net lease” in which the tenant was responsible for all charges and expenses, including the cost of the landlord obtaining insurance. The lease required the tenant to take out insurance in its own name and the landlord's name, but crucially, did not contain a covenant requiring the landlord to insure the premises.

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<sup>50</sup> *Ibid.*, at 117-18 [CCLI].

<sup>51</sup> *Ibid.*, at 118 [CCLI].

<sup>52</sup> (2002), 18 CCLI (3d) 224 (Ont. SCJ.) *aff'd* [2002] ILR I-4066 (ONCA)

The court concluded that the intention of the parties to the lease was that the risk of fire was to be allocated to the tenant as opposed to the landlord. As such, the landlord's property insurer was allowed to maintain a subrogated action against the tenant. The court pointed out the particular provisions in the lease which had the effect of allocating the risk to the tenant:

- (1) there is no covenant obligating the landlord to take out insurance on the property; and the reference to the landlord's insurance does not appear in the section dealing with insurance on the property. Rather, it appears in Part II of the lease under the heading, "Lease, Term, Rent, Additional Rent and Taxes";
- (2) although there is an express bar against subrogation by the tenant's insurers, there is no similar provision in respect of the landlord or its insurers;
- (3) the lease contains an "entire argument" clause; and
- (4) it is a "completely carefree" net lease to the landlord.

The decision in *Lee-Mar* was considered by the B.C. Court of Appeal in *North Newton Warehouses*,<sup>53</sup> in which the landlord cited *Lee-Mar* in support of its submission that a net lease will shift the risk of fire to the tenant. The Court of Appeal distinguished *Lee Mar* from the case at bar on the basis that in *Lee Mar*, the lease did not contain a covenant by the landlord to obtain fire insurance.

The decision in *Lee-Mar* was followed by a 2006 Manitoba decision, *Sooter Studios Ltd. v. 74963 Manitoba Ltd. (c.o.b. Sooter Bridal Salon)*,<sup>54</sup> in which the lease in question did not contain an express covenant by the landlord to insure.

Generally, where a tenant has paid for insurance, the tenant will benefit from those payments and will be immune from a subrogated claim by the landlord's property insurer, provided the landlord has covenanted to insure. However, insurers should be aware that in the absence of a landlord's covenant to insure, and with clear language allocating the risk to the tenant, it is possible to maintain a subrogated action against a tenant who pays for insurance.

(iv) The tenant's covenant to insure

What remained unclear in the aftermath of the cases already discussed was whether the same rationale would be applied if the tenant, as opposed to the landlord, covenanted to

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<sup>53</sup> *Supra*

<sup>54</sup> [2006] MJ No. 11

actually take out insurance. This latter situation came before the courts in Canada for the first time in 1987 in *Jarski c.o.b. Jarski's Shoe Repair v. Schmidt et al.*<sup>55</sup> The tenant had covenanted to:

.... have his own insurance policy to cover the rental Premises and to give a copy to the Lessor at the starting of this Lease Agreement and thereafter until the expiration of this Lease.<sup>56</sup>

The tenant's goods were damaged by a fire which was caused by the negligence of the landlord's employees. The tenant's insurer sought to maintain a subrogated claim against the landlord. The Court indicated that the tenant's lawsuit would be barred on the same principle of immunity which decided the *T. Eaton* and *Agnew-Surpass* cases, and that neither the tenant nor the tenant's insurer could maintain a negligence action.

The reasoning in *Jarski* was referred to by the B.C. Court of Appeal in *Orange Julius et al v. Surrey et al.*<sup>57</sup> In *Orange Julius* a fire occurred at a mall. The landlord leased the retail premises in the mall to various tenants, under leases which required the tenant to obtain property insurance in the joint names of the landlord and tenant.

The Court of Appeal stated as follows at paras. 22 and 26:

[22]...It is well established that a covenant to obtain fire insurance will relieve the beneficiary of the covenant from any liability for the fire losses that may be suffered by the covenantor.

...

[26] The same principle has been held to apply where it is the tenant, rather than the landlord, who has covenanted to insure.

Similar reasoning was applied in the 2007 Ontario decision, *Lincoln Canada Services LP v. First Gulf Design Build Inc.*,<sup>58</sup> in which the Superior Court of Justice states as follows at para. 28:

The principle arising from these cases is that the insuring party has, by agreeing to insure against a specific loss for which the other party would otherwise be liable in negligence, relieved the other party from the risk of liability for the loss caused by its own negligence. The insuring party must deal with its own insurer for the loss.

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<sup>55</sup> (1987), 26 CCLI 94.

<sup>56</sup> *Ibid.* at 95.

<sup>57</sup> 2000 BCCA 467

<sup>58</sup> [2007] OJ No. 4167

This principle has broad commercial importance. It clearly suggests that a landlord can insulate itself from any litigation commenced by its tenant simply by insisting upon a tenant's covenant to insure for the benefit of both parties to the lease.

(v) Implied covenant to insure

As a direct consequence of the preceding cases, parties to commercial tenancy agreements began to carefully examine the terms of their leases and consider whether something short of a tenant's covenant to pay for insurance, or a covenant to insure, might be sufficient to establish the same doctrine of immunity.

A decision in British Columbia, *Matthews v. Andrew et al*,<sup>59</sup> provides a clear example of an attempt to base immunity from a landlord's insurer's negligence lawsuit on something less than an express covenant to insure. Legal action had been commenced against the tenant because of its negligence in causing a fire. The lease contained a provision requiring the tenant to keep the premises in repair. The evidence disclosed that the landlord customarily paid the insurance premium but was under no legal obligation to do so. The tenant contended that there was an implied covenant to insure on the part of the landlord, by reason of three provisions in the lease, namely:

- (a) the tenant's obligation to undertake leasehold improvements;
- (b) the fact that the rent was used to pay the insurance premiums; and
- (c) the fact that the tenant had a right of first refusal to purchase the leased premises;

The Court rejected that argument and indicated that without an expressly clear covenant by the landlord to insure, or an obligation on the part of the tenant to pay the insurance premium, there were no grounds for barring the lawsuit.

Similarly in *Yale Properties Ltd. v. Pianta*,<sup>60</sup> the tenant attempted to argue that a covenant by the landlord to insure could be inferred from the following provision in a lease:

- 23. In the event of a fire starting in the tenant's suite, all damages to the building not covered by the owner's fire insurance policy, shall be paid by the tenant immediately upon demand.

A fire resulted from the tenant's alleged negligence in falling asleep while smoking a

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<sup>59</sup> (1986), 1 BCLR (2d) 114.

<sup>60</sup> (1987), 13 BCLR (2d) 242 (SC)

cigarette. The landlord's insurer paid the landlord's claim, less a \$250 deductible, and then brought the present subrogated claim.

Counsel for the tenant argued that the provision was for the benefit of the tenant. The Court disagreed. The Court found that as in *Matthews v. Andrew*<sup>61</sup> and in *Leung v. Takatsu*,<sup>62</sup> there was no covenant to insure, and no obligation on the part of the tenant to pay for the insurance either. The Court also agreed with the Plaintiff's submission that if the provision were construed so as to allow the tenant to escape liability for her negligent act, this provision would be void under the *Residential Tenancy Act* [B.C.] because the Act provided a tenant duty to repair in respect of damage caused by negligent act or omission, and stipulated that the Act should prevail in the event of a conflict.

However, in *Independent Tank Cleaning v. Zabokrzycki*,<sup>63</sup> there were the standard covenants of the tenant to repair, and additionally, there was a clause providing that the tenant would not conduct his business so as to increase the insurance risk, but in case the tenant did, the tenant would pay any increase in insurance premiums. The court noted that there was "no clear covenant by the landlord to (1) pay insurance premiums or (2) insure for the risk of fire." The court was asked by the tenant to infer that the lease provisions amounted to a covenant to insure for fire. The tenant presented evidence that it had obtained liability insurance but had not obtained any coverage for fire risk separate from the landlord's.

After reviewing a number of cases, mostly cases in which the landlord covenanted to insure, and where covenants making the tenant responsible for increased insurance premiums were weighed positively in the balance, the Court found that a covenant to insure could be inferred under the circumstances and that the benefit of such insurance was for both the tenant and the landlord.

In the 1999 Alberta Queen's Bench decision of *Cilento-Gallance v. Mufata*,<sup>64</sup> the tenant asked the Court to infer a covenant to insure on the part of the landlord from the following clause in the lease: "8. The Tenant must insure his or her own property against damage or loss." There was nothing else in the lease about insurance. The landlord did insure the premises, but not out of any obligation to the tenant to do so. The tenant asked the court to rely on *Independent Tank Cleaning* and find immunity for the tenant.

The Court disagreed with the tenant and found that the *Independent Tank Cleaning* case was distinguishable, in that there were *no* facts in the present case on which a covenant to insure

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<sup>61</sup> *Supra.*

<sup>62</sup> (1980), [1992] 3 WWR 129 (BCCA)

<sup>63</sup> [1997] ILR 1.3418 (Ont. Gen. Div.).

<sup>64</sup> (January 28, 1999), Action No. 9803-18382 (ABQB)

the premises could be inferred.

(vi) Summary

The decisions analyzed support the following propositions:

- (a) a landlord's covenant merely to pay for insurance does not prevent the landlord or the landlord's insurer from maintaining an action in the event of the tenant's negligence;
- (b) a landlord's covenant to actually insure can prevent either the landlord or the landlord's insurer from maintaining a negligence lawsuit against the tenant;
- (c) a tenant's covenant to pay for insurance may similarly bar either the landlord or the landlord's insurer's right of action against the tenant;
- (d) a tenant's covenant to insure may bar either the landlord or the tenant, or, the insurer of the landlord or tenant, from maintaining a claim against the other party; and
- (e) lease covenants amounting to less than a covenant to insure or pay for insurance will usually be insufficient, taken either alone or collectively, to achieve these results.

**(b) The scope of a covenant to insure**

What was unclear in the aftermath of the *Agnew-Surpass* and *T. Eaton* cases was, first, whether a covenant to insure could be effectively utilized to bar liability in legal relationships other than that of landlord and tenant.

In *Bow Helicopters Ltd. v. Bell Helicopter Textron and Avco Lycoming Engine Group*,<sup>65</sup> the Alberta Court of Appeal established that a covenant to insure, when intended for use as a mechanism to reallocate the risk of loss, can be effectively utilized in commercial relationships outside the landlord and tenant setting. Moreover, the case suggests that it is possible to formulate a covenant to insure which will be effective to bar all types of subrogated claims.

In this case, the plaintiff had leased a helicopter from the defendant Bell Helicopter Textron. The helicopter was damaged, not by an operational failure, but by reason of a defect which

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<sup>65</sup> (1981), 16 Alta.L.R. (2d) 149 (CA).

was attributable to the defendant's negligence in its manufacture. The lease between the parties provided:

#### Insurance

In consideration of the monthly rental payments to be paid hereunder, Lessee agrees to provide insurance coverage against loss or damage to the helicopter as equipped at the time of delivery to the Lessee, naming both Lessor and Lessee.

In the event of any loss or damage to the helicopter ... whether total or partial not covered by the insurance, the Lessee shall pay to the Lessor the total ascertained amount of loss or damage up to the value of the helicopter.

The Lessee agrees to furnish Lessor evidence Lessee has obtained Public Liability and Property Damage Insurance ... and agrees to obtain from its insurance carrier a Waiver of Subrogation as to the Lessor.

In spite of this latter covenant a Waiver of Subrogation was not in fact obtained, and after paying for the repairs Bow's insurer commenced a lawsuit against Bell for compensation. Its claim was based upon the allegation of Bell's negligence in the manufacture of the helicopter.

Confronted with the principle of immunity developed in the *Agnew-Surpass* and *T. Eaton* cases, the plaintiff Bow argued that a mere covenant to insure only provided immunity from suit if the loss arose from the negligent operation of the helicopter, and did not bar suit for negligent manufacture of the helicopter. Put another way, Bow was contending that although it had covenanted to insure, it had not agreed to become a product liability insurer for Bell. Its contractual obligation was confined merely to third party liability and property damage covering the operation of the helicopter.

This submission was rejected both at trial and on appeal. The Alberta Court of Appeal took note of the fact that the insuring covenant purported to cover "loss or damage", without exception or qualification, and in that sense was all-embracing in its scope. In the Court's view, in order for Bow to "escape" from the covenant to insure, and thereby become entitled to pursue and maintain its subrogated claim, clear language excluding liability for negligent manufacture would have been required. In repudiating the validity of the insurer's claim the Court stated:

The Alberta Queen's Bench decision in *Western Drill-Dredging Mfg. Ltd. v. Suncor Inc.*<sup>66</sup> is yet another example of a Court extending the covenant to insure bar to action to a setting other

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<sup>66</sup> (1994), [1995] 4 WWR 69 (ABQB)



than landlord and tenant. The facts involved the lease of a pump. The pump was destroyed by fire, and after the lessor's fire insurer paid the claim, it brought a subrogated action against the lessee, claiming that the loss had arisen from the actions of the lessee's employees. The employees were not sued, but lessee employer was.

The lease for the pump provided simply, "Vendor to be responsible for insurance." While the court acknowledged that the statement was ambiguous, in that it did not state whose interest was to be insured, the court concluded, following *dicta* in *T. Eaton, Seig (Zuik) Estate v. Alberta (Public Trustee)*,<sup>67</sup> and *Northwestern Metal & Salvage Ltd. v. Alltar Roofing Ltd.*,<sup>68</sup> that without any other explanation for the inclusion of the contractual provision, there could be no other reason for its inclusion other than that the insurance coverage was intended to benefit both contracting parties; and therefore, the court implied a covenant by the lessor to insure for the benefit of both and ruled that subrogation was therefore barred.

These decisions out of Alberta are instructive in two respects:

- (a) the doctrine of immunity, originally developed in the context of commercial tenancies, can be extended to other commercial relationships founded on contract. Examples would include rental agreements, bailment, and, presumably, contracts for the carriage of good;
- (b) the covenant to insure, if properly worded, can create "legal immunity" effective against all types of legal liability without regard to the cause or nature of the loss. The practical significance can be dramatic in many commercial relationships where parties wish to totally shift risk. Examples include contracts for the sale of goods, lease arrangements and occupiers' liability situations.

**(c) Covenants to insure in other commercial settings**

Thus far we have been examining a covenant to insure in commercial relationships of some defined duration - typically a long term. We have seen that in the Alberta decision involving *Bow Helicopters* the Court was willing to apply the doctrine of immunity in circumstances not involving a lease of land. There have been a number of recent cases that have extended the doctrine to other contractual relationships where one party agrees to obtain insurance.

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<sup>67</sup> [1990] 3 WWR 191 (ABCA)

<sup>68</sup> (1994), 19 Alta. L.R. (3d) 493 (CA)

An indicator of the trend in this direction was illustrated by the decision in *L & B Construction Ltd. v. Northern Canada Power Commission, et al.*<sup>69</sup> The facts in this case are worth reviewing in some detail. Northern Canada Power Commission (hereafter "NCPC"), the Crown agency responsible for supplying electricity in northern regions, had purchased a 50 ton transformer that it wished to transport from the United States to Yellowknife. NCPC hired a local contractor, L & B Construction Ltd. (hereafter "L & B") to be responsible for unloading the transformer from a truck trailer onto the hydro substation site at its final destination. The \$500,000 transformer was totally destroyed because it was dropped while being unloaded. The underlying cause was L & B's failure to utilize adequate support straps. Could L & B be made liable for what plainly was the negligence of its employees?

In the negotiations leading to issuance of a work order authorizing L & B to perform the service, NCPC had verbally agreed that it would obtain insurance. The verbal discussions contemplated a "wrap up" policy. The verbal agreement was later confirmed by telex to L & B which stated:

Re [Purchase Order] L & B Construction this is to confirm insurance coverage by N.C.P.C. Edmonton relative to the above.

L & B, exposed to vicarious liability for negligence in its capacity as the ultimate employer of the workers who dropped the transformer, argued that NCPC was barred by its undertaking to insure from suing for L & B's negligence. The Court agreed. In refusing N.C.P.C.'s claim the Court stated that the clear intent upon examining the pre-contractual negotiations was that NCPC would insure to protect both its own interest in the transformer and the interests of the contractor. The covenant to insure provided a complete defence to the claim.

It did not matter whether NCPC had insurance, or whether L & B ensured that coverage was in fact obtained. The claim in negligence was barred by the simple promise of NCPC to provide insurance. This promise amounted to its voluntary acceptance of the risk of damage or loss, even if caused by negligence for which the contractor was responsible.

In *Lafarge Canada Inc. v. JJM Construction*,<sup>70</sup> the British Columbia Court of Appeal considered the doctrine of immunity in the context of a charter agreement. The parties had agreed that Lafarge would charter four barges owned by JJM. The agreement included provisions stating that Lafarge would obtain and pay for insurance on the barges, and JJM would be named as an additional insured. The barges were returned to JJM in a damaged condition and litigation ensued. Lafarge attempted to argue that the trilogy of cases stood for the

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<sup>69</sup> (1984), 6 WWR 598 (N.W.T.CA).

<sup>70</sup> 2011 BCCA 453

proposition that a party who pays for insurance is entitled to tort immunity regardless of which party covenanted to take out insurance. The Court of Appeal rejected Lafarge's argument and noted that although the trilogy of cases involved tenants contributing towards insurance, the insurance was taken out by the landlord. The Court confirmed that the party that covenanted to insure (in this case, Lafarge) could not obtain the benefit of that covenant and was therefore unable to rely on the doctrine of immunity.

In *Kruger Products Limited v. First Choice Logistics Inc.*,<sup>71</sup> the British Columbia Court of Appeal considered the doctrine in the context of a warehouse agreement. In *Kruger*, a fire destroyed the defendant's warehouse, which contained paper products being stored by the defendant pursuant to a warehouse agreement. The agreement required the plaintiff to obtain insurance of its property and inventory within the warehouse, and to name the defendant as an additional insured. The Court of Appeal, in overturning the trial decision, determined that the defendant was entitled to the benefit of the covenant to insure and the doctrine of tort immunity should apply.

Even more recently, in *Sanofi Pasteur Ltd. v. UPS SCS Inc.*,<sup>72</sup> the plaintiff entered into an agreement with one of the defendants, UPS, pursuant to which UPS agreed to store vaccines owned by the plaintiff in a temperature controlled warehouse. Under the agreement, the plaintiff agreed to obtain all-risk property insurance against damage to the stored goods. The Court of Appeal held that the covenant to insure protected UPS from a subrogated claim by the plaintiff's property insurer.

Interestingly, in *Sanofi*, the motion judge and the Court of Appeal decided that the defendants other than UPS, who were not parties to the storage agreement, were also entitled to rely on the plaintiff's covenant to insure to provide immunity against the plaintiff's subrogated claim. The Court of Appeal adopted the principled approach set out by the Supreme Court of Canada in *Fraser River* and *London Drugs* (discussed in further detail below and in the Waiver of Subrogation section of this paper) to relax the doctrine of privity of contract. The Court of Appeal determined that a failure to extend the benefit of the covenant to insure to the defendants other than UPS would nullify the protection the covenant was intended to provide to UPS or risk an injustice to the other defendants.

In a 2012 Ontario decision, *Castonguay Construction (2000) Ltd. v. Commonwealth Plywood Co. Ltd.*,<sup>73</sup> the third parties to an action sought to take advantage of a covenant to insure in a contract to which it was not a party.

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<sup>71</sup> 2013 BCCA 3

<sup>72</sup> 2015 ONCA 88 (application for leave to appeal to the Supreme Court of Canada filed April 10, 2015)

<sup>73</sup> 2012 ONSC 3487

In *Castonguay*, the plaintiff was the general contractor for a warehouse expansion project in Ottawa. The contract between the plaintiff and the defendant, Commonwealth Plywood, required the plaintiff to obtain liability insurance in favour of the parties and unnamed insureds defined by the contract (in the event, the plaintiff did not obtain the insurance required by the contract).

Following completion of the project, the defendant denied the plaintiff's holdback claim. The plaintiff filed an action claiming the holdback funds and the defendant counterclaimed, alleging various deficiencies with the project. The plaintiff filed a third party notice against Zenix Engineering Limited in relation to engineering consulting services provided on the project.

Zenix argued that it was a third party beneficiary of the plaintiff's covenant to insure and that the law of privity should be relaxed to extend to it the benefits of coverage from the plaintiff's property insurer.

The Court determined that a principled exception to the law of privity did not extend to the circumstances of the case. The Court suggested that the services provided by Zenix were not within the scope of services in the main contract between the plaintiff and defendant. In addition, the Court was also unable to find that the parties to the main contract intended the benefit of the insurance to be conferred on Zenix. As a result, Zenix was unable to meet the requirements set out in *London Drugs* and its application to dismiss the third party claim against it was dismissed.

These cases illustrate that the doctrine of immunity traditionally found in landlord-tenant agreements now applies to a wide range of commercial contracts. In most situations in which a party covenants to obtain insurance for the benefit of another party, the benefitting party will be able to rely on the doctrine of immunity as a shield to a property damage claim made against it by the covenanting party. Furthermore, non-parties to the contract may also be able to rely on the doctrine if they meet the requirements set out in *Fraser River* and *London Drugs* (discussed in further detail below).

As such, it is crucial that in property damage cases which involve commercial agreements between the parties, property insurers obtain and review the agreement in order to determine whether the doctrine of immunity may be of application.

#### **(d) Covenants to insure and indemnification**

Many commercial arrangements contemplate that Party A to an agreement will indemnify Party B in the event of loss. Interesting problems arise if those same agreements also stipulate that Party A is obligated to insure against similar risks.

Assuming the coexistence of both such contractual obligations, may an indemnity be enforced?

In *Atlantic Shopping Centres Ltd. v. Canadian National Railway et al.*,<sup>74</sup> a decision of the New Brunswick Court of Appeal, the CNR had granted a long term ground lease to Atlantic Shopping Centre Ltd. (hereafter "Atlantic") and Atlantic had in turn constructed an office tower which was sublet back to the CNR. A fire broke out while workers were installing a computer in the CNR's office facilities, which ultimately destroyed much of the building. Atlantic sued the CNR claiming that the loss was attributable to the negligence of CNR's agent, a local contractor, hired by the CNR to install its computer equipment. The original ground lease between the CNR and Atlantic provided:

... the Lessee shall insure and keep the same, together with the buildings previously erected on the Leased Premises, insured to their full insurable value against loss or damage by fire or other casualty ...

Although Atlantic was under a contractual duty to insure against fire loss, Atlantic argued that the CNR was liable for the loss because the CNR had agreed to indemnify Atlantic for loss arising out of the installation of the computer equipment. The indemnity given by the CNR to Atlantic was contained in an exchange of correspondence in which it was stated that:

... [CNR] will assume responsibility for any and all damages to the roof and/or building which may occur as a result of the installation and/or operation of ... equipment.

Atlantic argued that indemnity superseded the immunity from liability which the CNR otherwise enjoyed by reason of Atlantic's covenant to insure.

The New Brunswick Court of Appeal rejected this argument. The Court held that the indemnity should be read as intended to guard against risks intrinsic to the operation of the computer system, not to negate the legal consequences of the covenant to insure. As a result, the litigation against the CNR was not permitted to proceed. Since the intent of the parties at the outset of the commercial arrangement was to provide that Atlantic would bear the risk of a fire loss, it and its insurer should continue to assume that risk.

As already noted above in discussing a landlords' covenants to insure, a similar result was reached in the decision in *Economical Mutual Insurance Co. v. 1072871 Ontario Ltd.*,<sup>75</sup> where

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<sup>74</sup> (1985), 60 NBR (2d) 9 (CA).

<sup>75</sup> (1998), 20 RPR (3d) 154 (Ont. Gen. Div.), aff'd (May 20, 1999), Docket CA C30945 (ONCA)

there was both a landlord covenant to insure *and* a tenant covenant to repair and indemnify any damage. It is interesting that in this decision, the court based its decision in part upon the fact that even without the covenant to indemnify, the tenant would have had a repair/indemnification obligation, simply pursuant to its statutory obligations as a tenant. Since the Court found the clause to be in this sense superfluous, the Court had no trouble finding that the insurance clause was more representative of the parties' decision on how to allocate risks at the property.

These decisions suggest that the Courts will not lightly displace the broad immunity from tort liability afforded by a covenant to insure. If the risk of loss is to be allocated in any manner inconsistent with that arising from a covenant to insure, the language of the indemnity - or other provision - which reallocates the risk may have to make it explicitly clear that the covenant to insure will not prevail.

**(e) "Legal immunity" in the statutory setting**

The legal immunity principles evident in the contractual setting have been applied with equal vigour when prevailing legislation mandates the same policy result. For example, in the British Columbia *Strata Property Act*<sup>76</sup> and *Strata Property Regulation*,<sup>77</sup> the strata corporation has a "statutory covenant" to obtain property insurance for the benefit of both itself and the strata lot owners.

The creation of a covenant to insure has led at least one Court to conclude that the principles evident in *Agnew Surpass* and *The T. Eaton Company* cases should be applied with equal vigour when the covenant is imposed by statute. In *Lalji-Samji v. The Owners, Strata Plan VR 2135*,<sup>78</sup> the Court took the view that "legal immunity" could be applied in the statutory condominium setting.

The "covenant to insure" principle should lead to the conclusion that one party has entirely assumed the risk of loss and that the covenantor with the burden of that covenant cannot seek, through its subrogating insurer, to sue in the event that a beneficiary of the covenant, in this case the lot owner, has in fact been negligent or at fault in causing the loss.

The potential application of that latter argument seems particularly fitting in the context of legislation such as the *Strata Property Act*, in view of the "statutory contract" created by the Act. There being a legislative mandate for the strata corporation to insure the common property and common facilities it could be argued that the strata corporation should look

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<sup>76</sup> SBC 1998, c. 43

<sup>77</sup> B.C. Reg. 43/2000

<sup>78</sup> Unreported, BCSC Action #A913001, Jan. 13, 1992.

only to the property policy, and not tort proceedings, as the sole means of recovery in the event of a loss.

On appeal in the *Samji* action the strata corporation failed to recover the cost of repairing damage to the common property when caused by a strata lot owner. The facts in the *Samji* action are quite simple. When the strata lot owner moved into the building his moving company damaged the carpeting in the common area. That property constituted part of the common property. The strata corporation did not file a Proof of Loss and the claim for recovery on the strata corporation's All Risk property policy was not commenced within the requisite one year period following the occurrence of the loss. Being without recovery on the strata corporation's policy, the Strata Council voted to commence action against the allegedly negligent strata lot owner.

The strata lot owner resisted the claim arguing that Section 54 of the *Condominium Act* (the predecessor to Section 149 of the *Strata Property Act*) creates an implied bargain whereby the common property is insured to benefit the strata corporation and the lot owner, so that the party obliged to insure will look exclusively to insurance in the event of a loss. Section 54, it was submitted, set up a legislative form of "legal immunity". The strata lot owner sought by analogy to demonstrate that this type of loss is identical to the situation in *Agnew Surpass* and *The T. Eaton Company* case and that if a tenant causes a loss, subrogated proceedings are barred. The strata lot owner argued that since the Act commands that the common property be insured, the strata corporation has, in effect, covenanted to seek indemnification for any loss caused by a strata lot owner from the insurer and not the owner.

Mr. Justice Meredith took note of Section 54(1)(a) and indicated that the protection afforded by this section was intended to shield a lot owner against subrogated claims which result from losses that are "... usually the subject of insurance in respect of similar properties". In the Court's view damage to common area carpeting fell within the range of risks that are "...usually the subject of insurance".

The strata lot owners expected the strata corporation to ensure that the claim would be adequately insured and the strata council or its professional managers act diligently in ensuring that any claim is filed in a timely manner. In view of this case, strata lot liability insurers, many of whom traditionally assumed that there was virtually no prospect of a subrogated claim by the strata corporation, are fortified in the belief that the prospect of tort suits which arise from either a time delayed claim, or a claim which falls within the confines of an exclusion under the strata corporation policy, are not maintainable. Given the paucity of decided Canadian cases arising in the context of the appropriate condominium legislation, the *Samji* decision is significant for property insurers seeking to subrogate.

Strata and condominium property insurers should be aware of other limitations of subrogation rights involving claims against unit owners. For example, it is not open to an insurer to subrogate against its own named or unnamed insured. Since the unit owners constitute an unnamed insured on the strata/condo corporation's property policy, one would think that subrogated proceedings against a unit owner are prohibited.

This question was addressed by the Alberta Court of Appeal decision, *Condominium Corp No. 9813678 v. Statesman Corp.*<sup>79</sup> In *Condominium Corp. No. 9813678*, a fire was negligently started during the construction of a condominium development by the developer's subcontractor. The property insurer paid out the claim and brought subrogated proceedings against the developer (who was also an owner). This case is discussed in more detail below, under the Actions Against a Developer heading. In brief, *Condominium Corp. No. 9813678* confirms that a strata corporation's property insurer cannot maintain a subrogated action against a strata unit owner even if the unit owner's liability arises solely by reason of conduct unrelated to the ownership of the unit. In other words, mere ownership provides full tort immunity regardless of the precise role exercised by the unit owner that ultimately gives rise to legal liability provided that the ensuing damage is to the common property.

However, it is important for property insurers of strata corporations to note that a strata corporation can sue an owner for recovery of the deductible portion of the claim (subject to the bylaws, rules and regulations of the strata corporation).

**(f) The liability of employees: *Greenwood Shopping Plaza and London Drugs***

Simmering in the background for several years was the question of whether employees, or other third parties having some connection to a corporate party might be entitled to the protection of a covenant to insure, or whether rules of privity of contract would preclude such a benefit. This question was first given serious consideration in 1980 in the Supreme Court of Canada's decision in *Greenwood Shopping Plaza Ltd. v. Beattie*.<sup>80</sup>

The action arose out of a fire loss originating in a Canadian Tire store located in a shopping mall in Nova Scotia. It was alleged, and the finding was made at trial, that the negligent conduct of the store's employees caused the loss. A lease between the shopping mall owner and the store owner tenant provided that the mall owner would provide insurance coverage.<sup>81</sup> Flowing from this covenant to insure, based on prior authority of

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<sup>79</sup> [2007] ILR I-4610 (ABCA).

<sup>80</sup> [1980] 2 SCR 228.

<sup>81</sup> The lease provided specifically:

"14. The Lessor shall insure the buildings on the Entire Premises against fire and supplemental risks on the basis of replacement cost to the extent obtainable and shall furnish copies of all policies to the Lessee. The Lessor, if itself unable to procure insurance on this basis, and before



the Supreme Court of Canada, the store tenant was exonerated from liability. The outstanding issue concerned the personal liability of the store's employees.

The action against the employees was dismissed at both the trial and the appellate levels, on reasoning that the parties must have intended the insurance to cover the employees' liability, since the tenant company's negligence could only arise vicariously as a result of the acts or omissions of the employees. However, in the final appeal, the landlord mall owner was successful in persuading the Supreme Court of Canada that the doctrine of privity of contract precluded the employees from relying on the lease provision, and that no known exception to the privity doctrine assisted the employees on the facts of the case. The Court stated:

Paragraphs 14 and 15 of the lease are part of a valid contract between Greenwood and the company which confers rights and liabilities upon each of them and for which there was the necessary consideration. It is clear as well that in entering into that contract the parties were fully aware of the use to which the employer would put the demised premises and that the company would engage employees. There was at least some awareness of the risk of fire attendant upon such use because the parties agreed to guard against it by insurance arrangements. Whatever may have been in the minds of the contracting parties, however, the employees who seek the protection of paras. 14 and 15 were not parties to the contract and, according to the common law of contract, may neither sue to enforce nor benefit from it. We have here at most a contract where "A" and "B" entered into certain covenants for their mutual protection, from which it is said benefits were to flow to "C" and "D". There are many authorities for the proposition that save for certain exceptions, of which agency and trust afford examples, "C" and "D" in the illustration above can take no benefit under the contract.<sup>82</sup>

The Court found that there was insufficient evidence before it from which to give effect to the agency exception; and the Court found further that there was no evidence that the company had acted as a trustee for the employees in negotiating the covenant. The Court's judgment against the employees served as a reminder that privity doctrine was alive and well in Canada.

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insuring on a depreciated cost basis, undertakes to give notice to the Lessee of its inability to procure such insurance and to permit the Lessee to acquire insurance on the basis of replacement cost on behalf of the Lessor and for which the Lessor agrees to pay.

15. Both the Lessor and the Lessee will arrange, provided such arrangement is not contrary to the wishes of any existing or future mortgagee of the Entire Premises, with their respective insurers not to grant subrogation rights for the recovery of any loss through fire or supplemental perils occasioned by acts of the other, provided such loss is covered by insurance and to the extent only that payment of such loss is made by the insurer."

<sup>82</sup> *Ibid.*, at 237

Since the release of the judgment, the *Greenwood Shopping Plaza* decision has been available as a precedent for astute insurers and their counsel willing to pursue a subrogated claim against individual employee tortfeasors. However, courts are now unable to deal with questions of employee liability without some consideration as well of the landmark decision of the Supreme Court of Canada in *London Drugs Ltd. v. Kuehne & Nagel International Ltd.*<sup>83</sup>

The *London Drugs* decision has had such far-reaching impact that it is worthy of a detailed discussion. In the *London Drugs* case, what was at issue was not a covenant to insure in a lease agreement, but rather, a limitation of liability set out in a standard form storage contract between the warehouseman, Kuehne & Nagel, and the owner of the goods, London Drugs. The contract limited the “warehouseman’s” liability on any one package to \$40. While a transformer owned by London Drugs was in storage with the Defendant, it was damaged when it fell over as a result of the negligent conduct of Kuehne & Nagel’s employees. London Drugs was indemnified for the loss by its insurer and the insurer commenced a subrogated recovery action against both Kuehne & Nagel and the employees involved in the loss.

While it was determined that the limitation of liability protected Kuehne & Nagel, one of the key issues before the Supreme Court of Canada was whether Kuehne & Nagel’s employees could be held personally liable for the damages, or whether they too were entitled to rely on the limitation of liability set out in the storage contract. The employees were unable to rely on the traditional exceptions of trust or agency. In allowing the employees to raise the limitation of liability in their defence, despite the privity of contract problem, the Court reviewed judicial history in the area and concluded that the time had come to revisit such doctrines. Iacobucci J. for the majority of the Court stated:

These comments and others reveal many concerns about the doctrine of privity as it relates to third party beneficiaries. For our purposes, I think it sufficient to make the following observations. Many have noted that an application of the doctrine so as to prevent a third party beneficiary from relying on a limitation of liability clause which was intended to benefit him or her frustrates sound commercial practice and justice. It does not respect allocations and assumptions of risk made by the parties to the contract and it ignores the practical realities of insurance coverage. In essence, it permits one party to make a unilateral modification to the contract by circumventing its provisions and the express or implied intention of the parties. In addition, it is inconsistent with the reasonable expectations of all the parties to the transaction, including the third party beneficiary who is made to support the entire burden of liability. The doctrine has also been criticized for

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<sup>83</sup> [1992] 3 SCR 299

creating uncertainty in the law. While most commentators welcome, at least in principle, the various judicial exceptions to privity of contract, concerns about the predictability of their use have been raised. Moreover, it is said, in cases where the recognized exceptions do not appear to apply, the underlying concerns of commercial reality and justice still militate for the recognition of a third party beneficiary right.<sup>84</sup>

The Court went on to establish a two-prong test for deciding whether the doctrine of privity should be relaxed for a third party, in circumstances where the traditional exceptions do not apply. The Court referred to the new exception as an “incremental change to the doctrine of privity of contract”. What must be fulfilled under the new exception is:

1. Did the parties to the contract intend to confer a benefit on the third party seeking to rely upon the contract? i.e., is the beneficiary a mere stranger to the contract, or a true beneficiary?
2. Did the actions in question come within the scope of the agreement between the initial parties?

Applying the test to the facts of *London Drugs*, the Court determined that the parties to the storage contract did intend to confer a benefit on the employees as third party beneficiaries to the contract, in that:

- (a) when the contract was signed, the appellant knew that it contained a clause limiting the liability of the “warehouseman” to \$40;
- (b) it also knew, or can be assumed to have known, that Kuehne & Nagel employed many individuals and that they would be directly involved in the storing of the transformer;
- (c) the appellant chose not to obtain additional insurance from Kuehne & Nagel but instead arranged for its own all-risks coverage;
- (d) when the damages occurred, the respondents were acting in the course of their employment and were performing services related to the contract of storage;

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<sup>84</sup> *Ibid.*, at 423

- (e) this was a contract for services and given that Kuehne & Nagel was a corporation, the services of necessity are performed by the employees, which creates an identity of interest;
- (f) the language of “warehouseman”, without definition, impliedly included the employees engaged in the role of a warehouseman.

The Court also noted that applying the doctrine of privity strictly in the case would allow the appellant to circumvent the limitation of liability clause to which it had expressly consented. Finally, the Court observed that sound policy reasons supported relaxing the doctrine, in that it made good commercial sense to allow the contracting parties to allocate the risk of damage to the goods and to procure insurance accordingly. As stated succinctly by Iacobucci J.:

It stretches commercial credulity to suggest that a customer, acting prudently, will not obtain insurance because he or she is looking to the employees for recovery when generally little or nothing is known about the financial capacity and professional skills of the employees involved. That does not make sense in the modern world.<sup>85</sup>

In considering the second prong of the test, the Court found that the damage to the transformer did occur at a time when the employees were performing the very services provided for in the contract. The conclusion was that in the circumstances, privity could be relaxed and the action dismissed.

It is critical to note that the Court in *London Drugs* made some observations about the *Greenwood Shopping Plaza* case, in effect distinguishing it from the facts then before the Court. Iacobucci J. for the majority stated:

I should like to make four observations concerning this decision. First, the contract involved in *Greenwood Shopping Plaza* was a lease of premises rather than a contract for services such as a contract of storage. The contract was between a lessor (the owner of the shopping centre) and the lessee (the company) and the intervention of the lessee’s employees was not at all necessary for the execution of this agreement. It was irrelevant to any aspect of this agreement, especially to paragraphs 14 and 15 [the covenants to insure], whether the lessee had any employees and whether they would be present on the leased premises. Second, the provisions of the contract which the employees were seeking to obtain a benefit

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<sup>85</sup> Iacobucci J. also observed from a policy perspective that employees do not expect to be subject to unlimited liability for damages that occur in the course of a contract, when the contract specifically limits the liability of the “warehouseman” to a fixed amount; and holding employees liable in such circumstances could lead to serious injustice

from in Greenwood Shopping Plaza were not general limitation of liability clauses. Rather they were stipulations containing material undertakings by the lessor and the lessee with respect to insurance of the premises and the granting of subrogation rights. Third, it was inferentially observed that there was little, if any evidence supporting a finding that the parties to the contract intended to confer a benefit on the employees by the provisions of the lease relied on. This appears from the comments made by McIntyre J. in the context of his analysis of both the agency exception (at pp. 238-39) and the trust exception (at p. 240) and, more clearly, in the following closing observations (at pp. 240-41):

It must also be observed that the clear and precise words of paras. 14 and 15 limit the application of the insurance provisions to the parties to the lease, the appellant and the company. Courts must, in cases of this sort, be wary against drawing inferences upon vague and scanty evidence, where the result would be to contradict the clear words of a written agreement and where rectification is not sought or may not be had.

Finally, and closely related to the preceding comment, there is the fact that, as in *Canadian General Electric*, supra, the parties seeking to obtain benefits from the contract in Greenwood Shopping Plaza were viewed as complete strangers and not third party beneficiaries. This appears clearly from the wording of the provisions in question as noted by McIntyre J. in the underlined passage reproduced above.<sup>86</sup>

Since *London Drugs*, a number of courts in Canada have considered the impact of lease covenants on the liability of employees. The first decision was out of Nova Scotia, in *Sobey's Inc. v. MacLellan*.<sup>87</sup> The facts arose out of a fire in leased premises. The lease terms did not require the tenant to carry all-risk insurance but the tenant was told that he would be responsible to pay for the all-risk insurance carried by the landlord. In fact, the tenant was never billed for that insurance. At the request of the landlord, the lease was made out in the tenant principal's name and not in the name of the tenant company.

A fire at the leased premises caused damage and the landlord instituted proceedings against both the tenant principal and the tenant's employee. The Court applied *T. Eaton, Agnew-Surpass* and *Ross Southward* to find that there was no liability to the tenant's principal. With respect to the tenant's employee, the defendants argued that *London Drugs* had changed the law since *Greenwood Shopping Plaza*, "tempering" the impact of privity. However, the Court disagreed. The Court found that the case fell

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<sup>86</sup> [1992] 3 SCR 299 at 431-32.

<sup>87</sup> (1994), 139 NSR (2d) 1 (SC).

“squarely within the perimeters of the *Greenwood Shopping Plaza* decision” and noted that Iacobucci J. had in fact commented directly on the *Greenwood Shopping Plaza* decision. The Claim was allowed against the tenant.

The 1997 Ontario Court of Appeal decision in *Madison Developments Limited at al. v. Plan Electric Co. et al.*<sup>88</sup> involved a subrogated action by a property insurer in relation to a fire loss caused by the negligence of a subcontractor’s employees. The agreement between the contractor and subcontractor required the contractor to obtain comprehensive fire insurance in relation to the building project. The Court of Appeal concluded that the covenant to insure protected the subcontractor from a subrogated claim for losses caused by fire resulting from the subcontractor’s negligence. In determining the liability of the subcontractor’s employees, the Court of Appeal relied heavily on the reasoning set out in *London Drugs* to conclude that the contractor’s claim against the subcontractor’s employees was barred. In doing so, the Court of Appeal made the following comments regarding the intention of the contracting parties to extend the benefit of the fire insurance to the subcontractor’s employees:

The business reality which flows directly from the terms of the subcontract is that the contractor was to obtain comprehensive insurance covering the events which occurred and it did so. Those events were unlikely to be caused by the corporate entity, the subcontractor, but rather were most likely to arise from the conduct of employees acting in the course of their employment. That is what happened.

The issue of employee liability in the context of a lease of premises was considered in the Ontario decision in *Tony & Jim’s Holdings Ltd. v. Silva*.<sup>89</sup> The action arose out of a fire in a pizza parlour. The pizza parlour, a business known as Mamma Mia Pizza (Kingston) Ltd. was a small business owned and run by its president and directing mind, the Defendant Silva. Mamma Mia rented the building from the Plaintiff pursuant to a lease, and under the lease, was responsible for payment of insurance premiums. There was no express covenant to insure and the lease contained the usual obligations upon the tenant to repair “reasonable wear and tear, and damage by fire, lightning and tempest only excepted”.

The owners conceded that on the authorities, they had no right to sue the corporate tenant for negligence, given the insurance arrangements referred to in the lease.

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<sup>88</sup> [1997] OJ No. 4249

<sup>89</sup> (March 10, 1999), Docket CA C28170 (ONCA), aff’g (1997), [1998] ILR 1-3497, 50 CCLI (2d) 332 (Ont. Gen.).

However, the owners maintained their right to sue Silva personally. They relied on *Greenwood Shopping Plaza* in support of their position. Silva relied on *London Drugs*, arguing that the rationale of that case was not restricted to its facts and could apply to other fact situations, such as the case at hand.

Both the motions court and the Ontario Court of Appeal were persuaded that on facts and law, *Greenwood Shopping Plaza* was distinguishable under the circumstances, and that the *dicta* set out in *London Drugs* applied to render the action against Silva not maintainable in law. The Court was mainly persuaded by the “identity of interest” it saw existing between Silva and the operations of the tenant, which in its view, created special exception to the doctrine of privity. Silva had presented evidence that the business was a family business which started out as a sole proprietorship; it was run by he and his wife; he and his wife were sole shareholders; and any dealings between the owner and the corporate tenant were made through Silva.

The Court of Appeal also noted that the lease contained provisions giving rise to a contractual obligation on the landlord to insure for losses extending to those occasioned by the tenant’s negligence, and “[w]hether Silva is regarded as an employee acting within the scope of his employment or as one of the directors and the operating mind of the corporate tenant, his alleged negligent conduct can only be regarded as that of the corporation in this context.” Additionally, the policy of insurance contained the following clause:

The Insurer, upon making any payment or assuming liability therefore under this form shall be subrogated to all rights of recovery of the Insured against others and may bring action to enforce such rights. *Notwithstanding the foregoing, all rights of subrogation are hereby waived against any corporation, firm, individual, or other interest with respect to which insurance is provided by this policy.* [Emphasis added.]

On the basis of these two provisions, the Court of Appeal found:

While the language used in this clause is certainly not the clearest, it would seem to me that, in a case such as this where fire coverage is extended to leased premises for fire caused by the negligence of anyone, the scope of this waiver can reasonably be expected to extend to the tenant who, in the words of the clause, has “an interest with respect to which insurance is provided” by the policy. Indeed, the insurer does not assert the right to make a subrogated claim against the tenant. It is my view that the words used are also wide enough to include those individuals through which the corporate tenant, of necessity, must act.

As a final clincher, the Court stated its view that the parties had intended to allocate risk in a certain way, and that it made “no commercial sense to expect in these circumstances that Silva would understand he was obligated to procure separate insurance to cover the act of those individuals through which the corporation would act”. The Court concluded that to adopt the owner’s interpretation would defeat the parties’ allocation of risk and their reasonable expectations; in the result, the action against Silva was dismissed.

The British Columbia court considered the issue of employees in a lease context, in the decision in *Laing Property Corporation v. All Seasons Display Inc. et al.*<sup>90</sup> The facts involved a fire in the Guildford Shopping Mall, in which it was alleged that the damages sustained by the owner and tenants exceeded \$8 million. The issue presented for a summary trial was whether the lease, which contained tenant covenants to insure the premises against fire, precluded any third party claim being made against the owner and its employees.

The Court of Appeal concluded that the action against the owner could not be sustained. Similarly, if it were assumed that the actions of the owners’ employees arose out of and in the course of employment, no action could be sustained against the employees for the same reason.

With respect to the action against the employees, the Court of Appeal reversed the trial judge’s decision and held that the claim against the employees could not proceed. The Court of Appeal held that the “new exception” to privity set out in *London Drugs* assisted the defendant employees. In coming to its decision the Court considered at length the two pronged test in *London Drugs* for extending a contractual benefit so as to include a contracting party’s employees.

In considering the first prong of the test, the Court discussed a number of factors which assist in the determination of whether an intention to benefit a third party should be implied. The first factor that must be considered is whether there is an identity of interest between the employer and the employee as to the performance of the employer’s contractual obligations. The Court held that in circumstances where the employer provides services to the other party pursuant to a contract and the employees of the employer have the primary responsibility for carrying out those contractual obligations, the interests of the employees are identical to those of the employer.

The second factor the Court considered is whether a contracting party would know that the services to be provided under the contract would be undertaken by the employees

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<sup>90</sup> [2000] BCJ No. 1655 (C.A), rev’g in part (1998), 53 BCLR (3d) 142 (SC)



of the other contracting party. The Court held that an intention to extend the benefit of any contractual protection to the employees will be implied where there is an identity of interest between the employer and the employees, the other party is aware of that identity of interest and would normally expect the services to be performed by the employees. As noted by the Court, if this intention was not implied, the result would be absurd as the plaintiff would be able to circumvent the employer's contractual protection by suing the employees.

After considering the second prong of the test in *London Drugs* the Court of Appeal concluded that the negligent conduct alleged against the employees was performed in the course and scope of their employment and in the discharge of the services the landlord was obligated to provide under the lease. The Court noted that it does not matter that the alleged negligent conduct of the employees does not include all of the services for which the employer contracted, nor that the services provided by the employer were discretionary. The Court held that the two prong test in *London Drugs* had been satisfied and that employees were "third party beneficiaries" to the contract. It directed that the third party proceedings against the employees be struck out.

The Court of Appeal stated that the correct approach to determining whether a contractual benefit can be extended to include the contracting party's employees is to apply the new principles with respect to the law of privity enunciated in *London Drugs*; it is not necessary to compare the facts of the case to those in *Greenwood Shopping Plaza*.

In *Read v. HMTQ et al*,<sup>91</sup> the plaintiff sued for losses arising from a fire at her home, which was caused by a child who had been placed in care at her home pursuant to a care contract with St. Leonard's, a youth and family services society. The plaintiff's action named an employee of the society, Mr. Hagger. In the care contract, the plaintiff covenanted to obtain insurance relating to a child's willful acts which result in damage to her home. The defendants successfully argued that the covenant to insure relieved St. Leonard's from any liability to the plaintiff. The defendants further argued that *London Drugs* applied to relieve Mr. Hagger from liability. The Court agreed, citing the rationale in *Laing*.

It is awkward using the device of "privity" to allow or disallow employees to take advantage of lease covenants or other contractual arrangements made by their corporate employers, and it has far-reaching economic implications for both insurers

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<sup>91</sup> 2004 BCSC 1207

and employees. It is submitted that this is one area which is ripe for clarification, given the trend of uncertainty.<sup>92</sup>

**(g) Summary**

At the outset of this section of the paper it was suggested that the notion of a covenant to insure differed in concept from a waiver of subrogation. By waiver of subrogation an insurer expressly relinquishes its right to pursue a subrogated claim against a wrongdoer in the event of loss. However, a covenant to insure operates to exclude subrogated claims without the involvement of the insurer, who in fact may not even be aware of the precise contractual obligations entered into by the insured.

In conclusion, it may safely be said that the policy of the law in recent years has been to discourage subrogation litigation between parties who have contracted for a risk to be covered by property insurance. This development has found favour in statutory settings where the legislation mandates that one party insure for the benefit of both parties. Whether in a purely contractual setting or the statutory setting the Courts seem to favour the view that all parties look only to the property insurance coverage which they have agreed will be obtained by one or the other of them. The simple contractual device of a covenant to insure has become an instrument by which substantive civil liability is limited and controlled in a theoretically infinite variety of commercial relationships. The full extent of the doctrine of immunity, and the parties entitled to rely on it, remains to be seen.

**3. WAIVER OF SUBROGATION**

A very significant aspect of the doctrine of subrogation, one which has practical significance for both insurers and insureds, concerns express contractual "waivers" by insurers of their right to pursue subrogated claims. It is only logical that an insurer cannot claim over against the insured itself, since the possibility of such litigation would render meaningless the coverage paid for by the insured. By definition, the doctrine of subrogation cannot involve the insured as a defendant in litigation initiated by the insurer, but only some person other than the insured.<sup>93</sup>

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<sup>92</sup> See the comments of Jeffrey W. Lem and Chantale Blais in their Annotation to *Economic Mutual Insurance Co. v. 1072871 Ontario Ltd.* (1998), 20 RPR (3d) 154 (Ont. Gen. Div.).

<sup>93</sup> In *Blakemore v. Blakemore* (1994), 25 CCLI (2d) 234 (BCSC), the insurer tried unsuccessfully to do just this. Mr. and Mrs. Blakemore were insured under a policy of travel insurance; both were in a car accident while travelling in B.C. Mrs. Blakemore was injured, allegedly as result of her husband's negligent driving. The policy provided for subrogation rights against any "third party". The court held that the "ordinary, plain commonly understood meaning" of "third party" was "a party who is not a party to the contract". Since Mr. Blakemore was one of the parties, the action was dismissed.

There are, however, several common situations where the same practical concerns which would arise if the insured itself were sued would also arise if the insurer exercised, in a strictly literal sense, its right to subrogate. A homeowner would consider his property policy to provide only hollow protection if his insurer could sue his or her spouse for damage to the family home.<sup>94</sup> If a wholly owned operating subsidiary of an insured corporation were sued for causing covered losses to its parent's property, the parent's economic interests would be adversely affected, for all practical purposes, to the same extent as if the parent itself had been sued by the insurer in a subrogated action. Likewise, the numerous participants in a construction project - owner, contractor, subcontractors, material suppliers " all look to the coverage provided by one policy as protection against mishaps. They do not consider the owner's policy to be the source of litigation fixing one or another of them with the manifold tort and contractual liabilities which can arise from an accident on a construction site. In these situations, the individual or corporation who caused the loss might not be the same individual or corporation who is the insured, and so the insurer has a right of subrogation. Nevertheless, if the right were exercised the practical utility of the coverage to the insured would be seriously compromised.

These potential concerns are addressed by express "waivers" of the right to subrogate contained in standard form insurance policies. Customarily, insurers provide for a waiver of their right to subrogate in circumstances where there is such close personal or business proximity between potentially adverse parties, that to allow a subrogated claim to proceed would irreparably harm an existing business or family relationship. Our inquiry will now proceed to examine typical examples of "Waiver of Subrogation" clauses, as well as the legal principles which are relevant to their actual interpretation and application.

In addition, this discussion will include recent cases that relax the doctrine of privity of contract with respect to waivers, extending the benefit of waivers to third parties who are "legal strangers" to the insurance policy.

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<sup>94</sup> But note that the policy wording may limit coverage. In *Wade v. Canadian Northern Shield Insurance Co.*, the court allowed a claim to proceed against the insured's son, finding that he was not a "resident of the insured's household" as defined by the policy, in that he was only house/pet sitting for the insureds while they were away on vacation. See also the court's reasoning in *National Trust Co. v. Allan*, (August 20, 1999), Winnipeg Ctre. CI 97-01-01626 (Man. Q.B.), where an insurer was allowed to proceed with its subrogated action against the wife of the trust beneficiary, where the trustee was the named insured, and the trust beneficiary and his wife were residents of the insured trust property which was the subject of a fire loss. The court concluded that the defendant wife was a true "stranger" to the both the trust settlement and to the insurance contract and thus was not entitled to the benefit of the trustee's obligation to insure.

**(a) Action against a named or unnamed insured**

A typical wording may state:

... all rights of subrogation are hereby waived against any corporation, firm, individual or other interest with respect to which insurance is provided by this policy.

This provision is superfluous, and should have no practical significance,<sup>95</sup> because the law does not allow subrogated proceedings against the insured itself, as a matter of principle. This principle will be considered more fully in the later passages of this paper.

**(b) Action against affiliated or related corporate entities**

Typically the member companies of a corporate group are each specified as "named insureds" in one property policy which provides coverage to them all. Even if not so specifically identified, such companies are immune from subrogated claims. To permit an insurer to recover simply because the insured conducts business through a subsidiary or a non arm's-length company is regarded as antithetical to the overriding relationship which should exist between insurer and a corporate insured. Thus, one common waiver clause provides:

... and it is agreed by the Insurers that all right of subrogation is waived under this policy if it is claimed that loss was occasioned or caused by the act or negligence of any corporation or corporations whose capital stock is owned or controlled by the Insured at the time of such loss, or any corporation, parent, or subsidiary to or affiliated with the Insured or any of their or either of their affiliated, proprietary or subsidiary companies.

For reasons which will soon be addressed, the phrase "... if it is claimed that loss was occasioned or caused..." broadens the scope of the waiver in ways which most insurers do not readily appreciate.

**(c) Actions against the insured's contractors, subcontractors and design professionals**

In the context of a new construction project, the owner or general contractor will ordinarily obtain an "All Risks" property policy, customarily referred to as a "Course of Construction" or "COC" policy, in which all of the construction site participants are included as named or unnamed insureds. The inclusion of construction site participants as named or unnamed

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<sup>95</sup> But see the Ontario Court of Appeal's decision in *Tony & Jim's Holdings Ltd. v. Silva*, (March 10, 1999), Docket CA C28170 (ONCA), aff'g (1997), [1998] ILR 1-3497, 50 CCLI (2d) 332 (Ont.Gen.Div.), discussed *supra*, where such a wording was weighed in the balance to find that a covenant to insure embraced not only the corporate tenant but the corporate tenant's principal and directing mind owner-operator.

insureds virtually excludes the possibility of subrogation against the only likely tortfeasors if an accident occurs on the site. Almost all construction claims arise from the default of contractors, suppliers, or their employees.

A new set of problems arise after the completion of construction, when the building owner no longer carries a COC policy but instead carries a Broad Form Commercial Policy which no longer includes the construction site participants as insured parties. When periodic repairs or improvements are being made to the insured structure, the magnitude of the work may not justify participants in the renovation project being added to the Broad Form Commercial Policy as additional insureds. Often, in the aftermath of an accident occurring in the course of repairs or renovations, the owner's insurer will contemplate subrogated legal action against the responsible contractor or subcontractor. In many cases such proceedings cannot be maintained, despite the intended defendants not being unnamed insureds, because of the broad scope of a standard form waiver of subrogation clause.

Counsel for the construction site participants, not being privy to the terms of the Broad Form Commercial Policy, may fail to appreciate the significance of the "waiver of subrogation" provision as a potentially complete defence to the insurer's subrogated action. Yet many commercial Broad Form Commercial property policies in place during renovations and repairs state:

The Insurer hereby waives right to a transfer of such rights ... (b) of any Insured against a general or subcontractor, including their employees, but this waiver shall be limited to loss or damage to the work being performed by said contractors and their employees in connection with the premises described herein.

Counsel for such defendants are well advised to inform themselves of the limitations which may have been placed by prior agreement on an insurer's right to sue their clients; as well, issuers of Broad Form Commercial policies should not lose sight of the economic significance of a waiver of subrogation clause which extends protection to all the persons most likely to be responsible for a loss on a construction site.

**(d) Condominium and housing cooperative losses**

The common broad form "all risks" property policy wording for condominiums widely utilized throughout Canada provides that:

... all right of subrogation is waived under this policy if it is claimed that the loss was occasioned by or caused by the act of neglect of the Strata Corporation, the Strata Council, any Management Corporation engaged to manage its affairs, the individual Strata Lot Owners, and if residents of a Strata Lot Owners household, his spouse, the "relatives of either, any other person under the age of twenty-one in

the care of a Strata Lot Owner, and any agents or employees of the Strata Corporation.

In the 1996 Ontario General Division decision in *Peel Condominium Corporation #16 v. Vaughan*,<sup>96</sup> the Court was asked to consider whether the waiver which was extended to owners of the condominium units was also intended to provide a waiver against non-owning tenants of the units. The Ontario *Condominium Act* provided, at section 27:

The corporation shall obtain and maintain insurance on its own behalf and on behalf of the owners of the units and common elements...against major perils to the replacement cost thereof, and against such other perils as may be specified by the declaration or by-laws, and for this purpose the corporation shall be deemed to have an insurable interest in the units and common elements.

On the facts, the tenant had started a fire while repairing his car in the garage and caused damage to two other condo units. Negligence was admitted. The insurer for the condominium corporation paid the cost of repairs and sought to subrogate against the tenant.

There was no written lease between the registered unit owner and the tenant; the tenancy was month to month. The unit owner paid a condo fee of \$110 to the condominium corporation Plaintiff each month, a portion of which covered the cost of insurance.

In making its decision, the Court reviewed the Ontario *Condominium Act*, the *Landlord and Tenant Act*, and the condominium corporation's declaration, by-laws and regulations. The Court observed that the *Landlord and Tenant Act* allocated responsibility for damage caused by the tenant's negligence to the tenant, and that unless the other sources could be interpreted to alter the risk, that was where the responsibility ought to lie. None of the Acts, the declaration, the by-laws or regulations contained any basis upon which to extend the definition of "owner" to include tenants, and none contained words specifically stating that a tenant was covered by the insurance.<sup>97</sup> Moreover, the tenant was unable to show that he had an insurable interest in the unit to qualify as an unnamed insured. In the result, the Court found it would be improper to judicially extend the meaning of "owner" to include a "tenant" of the unit, even though it observed that "...it would seem equitable and efficient to include tenants in the coverage scheme..."

With respect to housing cooperatives established and managed under the authority of the *Cooperative Association Act*, SBC 1999, c.28 (hereafter the "*Cooperative Act*"), insurers

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<sup>96</sup> [1996] ILR 1-3335, 34 CCLI (2d) 245 (Ont. Gen. Div.)

<sup>97</sup> Note that the wording of the Ontario Act differs from that of B.C., excerpted *supra*, which specifically includes "tenants" in its definition of "named insureds".

ordinarily agree to a waiver of subrogation. The usual "All Risks" property policy issued to housing cooperatives extends this waiver to the shareholders of the cooperative. This is significant, as often the resident shareholder is the one responsible for property damage covered by the policy. The relevant provision customarily consists of the waiver provided in condominium policies reproduced above, to which is added the following language:

If the subject matter of this policy of insurance is a Cooperative Housing Society, it is understood and agreed that the words "Cooperative" and "Shareholder" are substituted respectively for the words "Strata Corporation" and "Unit Holder" wherever such latter words appear herein.

This provision eliminates all rights of subrogation should the property insurer allege that the loss was occasioned or caused by the act or negligence of the housing cooperative, including the members of the board of the directors of the cooperative; any corporation engaged to manage the housing cooperative's affairs; the individual shareholders as well as permanent residents in the shareholder's living quarters; spouses, and the relatives of either; or any other person under the age of twenty-one in the care of a shareholder; and any agents or employees of the housing cooperative.

**(e) The scope of the waiver of subrogation**

The use of a comprehensive waiver clause which provides that "*all* right of subrogation is waived ... if it is claimed that loss was occasioned by or caused by the act of neglect..." can preclude a subrogated action in ways not contemplated by the property insurer.

Canadian courts have concluded that the protection provided by such a waiver of subrogation clause should enure to the benefit of persons who are outside the limited category of persons specified in the clause. Subrogation rights against any person are precluded if a party favoured by the waiver is responsible for the loss. Stated differently, a waiver protecting a limited class of persons will effectively bar subrogated claims against all potential wrongdoers if the facts or the pleadings suggest that a person among them, enjoying the benefit of the waiver, was even partially at fault. Where one of the persons who is within the class entitled to the benefit of the protection of the waiver is alleged to be even a minor contributor to a covered loss, the insurer must face the loss of its right to claim against anyone at all.

This principle is illustrated by the condominiums case of *Owners, Strata Plan No. NW 651 v. Beck's Mechanical Ltd. et al and Beck's Mechanical et al*,<sup>98</sup> a decision of the Supreme Court of British Columbia. An owner-occupied condominium development had been severely damaged by fire. The strata corporation's property insurer had commenced subrogated

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<sup>98</sup> (1980), 20 BCLR 12.

proceedings against several defendants, including a strata lot owner alleged to have been personally responsible for the fire loss. In the property policy the definition of "insured" included individual strata lot owners. After determining that it would be futile to proceed against the individual owner, the insured discontinued the action only in respect of that individual owner. However, the owner was added as a third party by the other named defendants; they claimed contribution and indemnity from the owner in the event that they were found liable to the strata corporation.

The policy contained a "waiver of subrogation" clause which stipulated:

...all right of subrogation... [was] waived if it is claimed... that the loss [was] ... occasioned by or caused by... an act of neglect by ... the Individual Strata Lot Owners.

This clause is identical in terms to the condominium and construction project waiver clauses referred to above.

The defendants other than the individual strata lot owner claimed that because the insured had originally sued that individual, and because the individual owner had been brought back into the litigation as a third party, the waiver of subrogation clause effectively foreclosed any subrogated litigation by the insurer in respect of the fire loss. The defendants were unsuccessful on the first of these arguments, but were successful on the second. It was concluded that the insurer had waived all subrogation rights against any defendants, in view of the third party proceedings taken against the individual strata lot owner.

What is noteworthy about this case is the court's willingness to conclude that the waiver clause should enure to the benefit of persons outside the limited category of persons in favour of whom it had been granted. The Court reasoned that "all" rights of subrogation were precluded because of the involvement in the litigation of one person within the protected class.

Counsel for the insurer argued that it would be absurd to interpret the waiver of subrogation clause so as to preclude any litigation at all, but Esson J. reasoned that the prospect of someone entitled to the benefit of an insurance policy becoming "embroiled" as a third party in litigation commenced by the insurer was a danger against which the waiver of subrogation clause could reasonably be interpreted to guard.

Insured persons, for good business reasons, may wish to avoid being embroiled in litigation resulting from the loss which their property insurance is intended to protect them against. They may well, to that end, stipulate for a broad restriction



upon subrogation rights or, more likely, see the existence of that broad restriction as an attractive feature of this particular "package" of insurance. It is, presumably, reflected in the premium. The reality of the benefit to the insured is exemplified by the facts of this case. If the insurers can proceed with the subrogated claim in the circumstances which have arisen here, [the unit holder] will have to defend the claim of the third parties and thus sustain, at a minimum, the expense of retaining solicitors plus the expense involved to it as a business organization in being involved in litigation. If the proceedings go against it, it will also be responsible for the party-and-party costs and the amount of any judgment recovered by the plaintiff - the real plaintiff being its own insurers.<sup>99</sup>

Not all waiver of subrogation provisions necessarily lead to the result of cases such as *Beck's Mechanical*. For example, immunity from subrogated claims is not enjoyed by persons outside the protected class if the property insurer uses policy wording contained in an IBC Form 51220. This form of wording does not abrogate all rights of subrogation in the event a protected class of persons is responsible for part or all of the loss; it simply disclaims subrogation rights only against the class of persons enumerated in the waiver. This result is accomplished by policy language which states:

Except with respect to arson, fraud or vehicle impact, the Insurer agrees with the Insured to waive its right of subrogation as to any claim against:

- (a) the "Condominium Corporation", its Directors, Property Manager, agents and employees, and
- (b) the "unit" owners, and if residents of a "unit" owner's household, his or her "spouse", the relatives of either and any other person under the age of 21 in the care of a "unit" owner or his or her "spouse".

**(f) Actions against a developer**

The decision of the *Alberta Court of Appeal in Condominium Corp. No. 9813678 v. Statesman Corp.*,<sup>100</sup> serves to highlight the common law underlying the waiver of subrogation clause that is commonly found in all-risk insurance policies. It also emphasizes the reluctance of the courts to restrict or limit the scope of such waivers.

In this case, the insurer for the Condominium Corporation brought a subrogated claim against the condominium's developer, after two of the four condominium buildings were destroyed by a fire allegedly caused by the negligence of the developer's contractor during the course of construction.

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<sup>99</sup> *Ibid.* at 16.

<sup>100</sup> 2007 ABCA 216

The developer was also the owner of two condominium units in the buildings that had been destroyed, and was thereby a named insured in an all-risk insurance policy taken out by the Condominium Corporation. That policy contained an express waiver of subrogation for losses caused by the negligence of individual unit owners.

The Alberta Court of Queen's Bench determined that the developer was not entitled to the benefit of the waiver of subrogation contained in the insurance policy because the subrogation clause applied to the developer in its capacity as a unit owner, but not in its capacity as a developer/contractor engaged in the construction of the condominium buildings.

The developer appealed. The Alberta Court of Appeal allowed the appeal, finding that the developer was entitled to the benefit of the waiver.

The Court of Appeal began its consideration of the issue by acknowledging the well settled law that an insurer is not permitted to sue any of its insureds for losses paid out under the same policy no matter how negligent the insureds were in causing the loss. The insurer argued that the Court should find a controversial exception to that well settled law.

The essence of the insurer's submission was that the all-risk insurance in place was taken out for the benefit of the condominium residents and not taken out as construction risk insurance by the developer. Because the developer was not acting in its capacity as a resident when it allegedly caused the loss, the insurer should be allowed to subrogate. The insurer also argued that it was more or less a coincidence that the developer happened to be both a named insured as well as the person who was building the adjacent condominium where the fire started.

The Court noted that the traditional rule barring an insurer from suing its own insured occasionally yielded unpredictable results (such as the one in this case) but also recognized that insurers are free to negotiate exceptions to coverage or subrogation waiver clauses before they issue policies. The insurer was found to have no right to subrogate against its insured for several reasons:

- 1) while there may be individual fact situations where the anti-subrogation rule would be unfair, as a whole, insurers and insureds would be better off without the exception to the rule;
- 2) potential for bad faith against an insured during the claims handling process;

- 3) an insurer gets no right of subrogation until it has fully indemnified its insured. The Court wryly asked, "How can a cheque stapled to a bigger statement of claim ever be full indemnity?"; and
- 4) to allow an insurer to sue a co-insured by way of subrogation would likely be futile and circular and would fly in the face of the fact that the insurer has contracted to take the risk in question onto itself and from the insureds.

This decision demonstrates that courts will be very reluctant to allow exceptions to waivers of subrogation unless such exceptions are consistent with the principles behind subrogation. It also highlights the real constraints on the ability of a property insurer to subrogate against any named insured even where that insured's liability arises in an entirely different context than the basis on which the insurance was placed.

**(g) How "legal strangers" to an insurance contract may take advantage of a waiver of subrogation**

The "waiver of subrogation" is legally effective because it forms a term in a contract entered into between the insurer, and the insured. The insurer and the insured are the only parties; it is a basic principle of the law of contract [i.e. the rule of privity] that only the parties to a contract are entitled to enforce a contract, or to claim the benefit of its provisions. Yet in many cases the benefit of the protection of a waiver of subrogation clause is intended to protect persons not party to the contract in which it appears. Does the rule of privity prevent "legal strangers" from relying upon the protection afforded by a "waiver of subrogation" provision? It turns out that the rules relating to "waiver of subrogation" clause constitute an exception to the principle of privity of contract. A waiver of subrogation provision can be relied on in defence of a subrogated claim by a defendant who is a "stranger" to the contract of insurance. In the view of a leading English text this is so for the following reason:

... [the stranger] is entitled to treat the insurers as being in fact the real plaintiffs, and to raise a defence which is available only against them and not against the nominal plaintiff. Thus, he may rely upon a term in the policy by which the insurers have relinquished their rights against himself, (citing *Thomas & Co. v. Brown* (1899) 4 Com. Cas. 186)<sup>101</sup>

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<sup>101</sup> E.R. Hardy Ivamy, *General Principles of Insurance Law* (1966) p.406

The seminal case comes from England. In *Thomas & Co. v. Brown* the insurers subrogated in the insured's name in respect of a cargo claim, despite a waiver in favour of "lightermen". In holding that the action was not maintainable, the Court stated:

There is a further difficulty in the way of the underwriters. They are endeavouring to get out of the contract contained in their policy, they have agreed to surrender the right or proceeding against the lighterman, and I cannot understand how they can now come forward and say that that right which they have relinquished has been subrogated to them. It seems to be the effect of the contract entered into in this case, that the assured is at liberty, if he likes, to sue on his own account, if he is entitled to do so under his contract with the lighterman, or he may relinquish his claim against the lighterman or refuse to prosecute any proceedings against him.<sup>102</sup>

This approach has been adopted in contemporary Canadian cases,<sup>103</sup> and has firmly established the proposition that although a person may not be a party to an insurance contract, he or she is free to raise a "waiver of subrogation" clause in defence to a subrogated claim, provided that person is within the class of persons against whom the insurer's right of subrogation has expressly been waived.

Canada's highest court, re-confirmed its approval of this trend in the 1999 decision, *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.*,<sup>104</sup>. In *Fraser River Pile & Dredge Ltd.*, the Court not surprisingly applied the "principled exception to the common law doctrine of privity of contract" set out in the *London Drugs* decision to find that a waiver of subrogation clause could be relied on by a "third party beneficiary" to the insurance contract in complete answer to the insurer's subrogated action against it.

The facts of *Fraser River Pile & Dredge Ltd.* merit close attention. The action arose out of the sinking of a vessel owned by the Plaintiff, Fraser River Pile & Dredge Ltd. ("Fraser River") which, at the time of the sinking, was under charter to the Defendant, Can-Dive Services Ltd. ("Can-Dive"). Fraser River was indemnified for the loss by its insurer, and the insurer in turn brought a subrogated action against Can-Dive.

The basis for Can-Dive's defence were some clauses in Fraser River's insurance policy with the subrogated insurer, which provided:

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<sup>102</sup> *Thomas & Co. v. Brown* (1899) 4 Com.Cas. 186 at 192.

<sup>103</sup> *J. Clark & Son Ltd. v. Finnamore*, [1973] ILR 1-503, 32 DLR (3d) 236; *Owners Strata Plan No. NW651 v. Beck's Mechanical et al.*, *supra*.

<sup>104</sup> (September 10, 1999), unreported (SCC), *aff'g* (1997), 39 BCLR (3d) 187 (CA); *rev'g* (1995), 9 BCLR (3d) 260 (SC)

## **General Conditions**

### **1. Additional Insureds Clause**

It is agreed that this policy also covers the Insured, associated and affiliated companies of the Insured, be they owners, subsidiaries or interrelated companies and as bareboat charterers and/or charterers and/or sub-charterers and /or operators and in whatever capacity and shall so continue to cover notwithstanding any provisions of this policy with respect to change of ownership or management. Provided, however, that in the event of any claim being made by associated , affiliated, subsidiary or interrelated companies under this clause, it shall not be entitled to recover in respect of any liability to which it would be subject if it were the owner, nor to a greater extent than an owner would be entitled in such event to recover.

...

Notwithstanding anything contained in the Additional Insureds Clause above, it is hereby understood and agreed that permission is hereby granted for these vessels to be chartered and the charterer to be considered an Additional Insured hereunder.

### **Trustee Clause**

It is understood and agreed that the Named Insured who obtained this Policy did so on his own behalf and as agent for the others insured hereby including those referred to by general description.

Can-Dive was unaware of the provisions of the insurance policy until after it had filed its Statement of Defence. On discovering the clauses, it then amended its defence to plead an immunity from suit on the basis that the Plaintiff had waived its right to sue.

One wrinkle to the facts was that before commencing the action against Can-Dive, the insurer and Fraser River entered into an agreement which purported to remove any rights flowing to Can-Dive under the policy. The preamble of their agreement stipulated:

C) The Underwriters have agreed to pay the claims (the claims) of F.R.P.D. for the loss of the barge and crane and the Underwriters wish to proceed with legal action against Can-Dive Services Ltd. and possibly recover part or all of their payments.

D) F.R.P.D. has agreed to waive any right it may have pursuant to the waiver of subrogation clause in the aforesaid policy with respect to Can-Dive Services Ltd....

Although the principle of agency was argued as a basis for allowing Can-Dive's defence to succeed, the Supreme Court of Canada chose to refrain from comment on that particular argument and preferred to adopt the approach set out in *London Drugs*.

At the outset, the Court in *Fraser River Dredge & Pile* noted that it was not the intention of the Court in *London Drugs* to limit application of the principled approach to situations involving only an employer-employee relationship. In considering the first part of the test, the Court then found that due to the specific words of the contract with the express reference to "charterer(s)", it was obvious that from the outset, the insurance contract was intended to benefit a charterer like the Defendant, Can-Dive. The Supreme Court of Canada stated:

In my opinion, the case in favour of relaxing the doctrine of privity is even stronger in the circumstances of this appeal than was the case in *London Drugs*, supra., wherein the parties did not expressly extend the benefit of a limitation of liability clause covering "warehouseman" to employees. Instead, it was necessary to support an implicit extension of the benefit on the basis of the relationship between the employers and its employees, that is to say, the identity of interest between the employer and its employees in terms of performing the contractual obligations. In contrast, given the express reference to "charterer(s)" in the waiver of subrogation clause in the policy, there is no need to look for any additional factors to justify characterizing Can-Dive as a third-party beneficiary rather than a mere stranger to the contract.

The Court also addressed the insurer's argument that any benefit which might have accrued to Can-Dive under the insurance policy was extinguished by the subsequent agreement entered into between Fraser River and the insurer. The Court stated:

....A significant concern with relaxing the doctrine of privity is the potential restrictions on freedom of contract which could result if the interests of a third-party beneficiary must be taken into account by the parties to the initial agreement before any adjustment to the contract could occur. It is important to note, however, that the agreement in question was concluded subsequent to the point at which what might be termed Can-Dive's inchoate right under the contract crystallized into an actual benefit in the form of a defence against an action in negligence by Fraser River's insurers. Having contracted in favour of Can-Dive as within the class of potential third-party beneficiaries, Fraser River and the insurers cannot revoke unilaterally Can-Dive's rights once they have developed into an actual benefit. At the point at which Can-Dive's rights crystallized, it became for all intents and purposes a party to the initial contract for the limited purpose of relying on the waiver of subrogation clause. Any subsequent alteration of the waiver provision is subject to further negotiation and agreement among all parties involved, including Can-Dive.

I am mindful, however, that the principle of freedom of contract must not be dismissed lightly. Accordingly, nothing in these reasons concerning the ability of the initial parties to amend contractual provisions subsequently should be taken as applying other than to the limited situation of a third-party's seeking to rely on a benefit conferred by the contract to defend against an action initiated by one of the parties, and only then in circumstances where the inchoate right has crystallized prior to any purported amendment. Within this narrow exception, however, the doctrine of privity presents no obstacle to contractual benefits conferred on third parties.

In considering the second part of the test, the Court found that the activities causing the loss arose in the context of the relationship of Can-Dive to Fraser River as a charterer, and therefore, it was the very activity contemplated in the policy pursuant to the waiver of subrogation clause, and the test was satisfied.

The Court also acknowledged that sound policy reasons underlay the Court's decision to relax privity in the circumstances. The Court noted that the parties were sophisticated commercial actors, and that "...relaxing the doctrine of privity in these circumstances establishes a default rule that most closely corresponds to commercial reality as is evidenced by the inclusion of the waiver of subrogation clause within the contract itself."<sup>105</sup>

The test set out in *Fraser River Pile & Dredge Ltd.* has been cited in a number of subsequent decisions. For example, in *Kingsway General Insurance Co. v. Canada Life Assurance Co.*,<sup>106</sup> a 2001 decision of the Ontario Court of Appeal, the defendant in a personal injury action sought to rely on a waiver of subrogation in a travel insurance policy. The brief facts are as follows: two residents of Ontario were involved in a motorcycle accident in Florida. The rider was killed and his passenger (and wife) was seriously injured. Both husband and wife were insured by a travel insurance company, which paid for medical treatment administered to the injured party. The travel insurer notified the rider's auto insurer of its intention to pursue a subrogated claim with respect to the medical expenses incurred. The

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<sup>105</sup> The "new exception" created by the *London Drugs* decision has had considerable impact: see e.g., *M.A.N. & W. Diesel v. Kingsway Transports Ltd.* (1997), 33 OR (3d) 355 (CA). However, in the *Haldane Products Inc. v. United Parcel Service Canada Ltd.* (May 14, 1999), Court File No. 23258 (Ont. Sup. Ct. J.), the court found that if it was implicit in *London Drugs* that a contracting party would act through its employees, the identity of interest which arises when an employee discharges that party's duty is lost when an unanticipated, independent non-employee third party sub-contractor is injected to carry out the duties of the contracting party. In such cases, the allocation of risk decided on by the contracting parties is unrelated to the third party sub-contractor and "commercial reality" does not dictate extending a limitation of liability to encompass that party's negligence.

<sup>106</sup> (2001), 149 OAC 303

rider and his insurer argued that they were entitled to rely on the waiver of subrogation clause in the travel insurance policy.

The Court of Appeal summarised the two requirements set out in *Fraser River Pile & Dredge*, namely that:

1. the contracting parties intended to extend the benefit to the third party seeking to rely on the waiver; and
2. the activities of the third party are those contemplated as coming within the scope of that clause.

In the *Kingsway* case, the Court of Appeal found that under the travel insurance policy, there was no right of subrogation with respect to health care expenses arising from the use of an automobile. The Court determined that the parties to the travel insurance policy must have intended to extend the benefit of the waiver to third party tortfeasors such as the defendant. As a result, they were permitted to rely on the waiver and the claim was dismissed.

A more recent example of the application of the principles set out in *Fraser River Pile & Dredge* is a 2009 Federal Court of Appeal decision, *Timberwest Forest Corp. v. Pacific Link Ocean Services Corporation*.<sup>107</sup> In *Timberwest*, the plaintiff, a British Columbia corporation, contracted to supply approximately \$1,000,000 worth of Douglas Fir logs to Harwood Products Inc., a customer based in California. At the time of the loss, the logs were being shipped on a barge under a contract of carriage between Harwood and Pacific Link Ocean Services Corporation.

Timberwest's property insurer paid the claim and commenced a subrogated action against a number of parties, including the owners and time charterers of the tug and barge in question, the captain of the tug and two other individuals.

The policy issued by Timberwest's insurer contained a clause waiving their rights of subrogation against any person or corporation in respect of whom the insured had waived any right of recovery prior to loss or damage. The defendants relied on a bill of lading provided by Pacific Link to Harwood that provided that "in no event shall the Carrier be liable for any loss or damage in respect of cargo carried on deck". The term "Carrier" was found to include all the named defendants. In addition, it was not in dispute that the logs were carried on deck. As a result, the Court concluded that Timberwest had waived its right to make a claim against all of the named respondents for the loss of the logs, which

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<sup>107</sup> 2009 FCA 119



brought them within the waiver of subrogation in the insurance policy. Interestingly, this was the outcome even though neither Timberwest, nor its insurer, were provided with a copy of the Pacific Link bill of lading, which contained the waiver. The Court was content that because Timberwest agreed that Harwood would choose the shipper and arrange shipping, Harwood was acting as agent for Timberwest when agreeing to the terms of the bill of lading.

The exception to the rule of privity is of considerable importance, particularly in the context of construction litigation. One need only pose a simple example to illustrate the potentially broad impact of the exception. Assume that a subrogating insurer, having paid for a property loss on a partially constructed building, undertakes proceedings in the name of the insured against a negligent contractor. The property policy on which the loss has been paid contains a "construction related" waiver of subrogation provision in favour of all construction site participants, although these same persons are neither named or unnamed insureds, and therefore are in no sense parties to the contract of insurance. Assume further that the general contractor issues third party proceedings against the sub-contractor alleging that the ultimate legal responsibility for the loss is for the account of the sub-contractors. Both the contractor and the subcontractor can rely on the waiver of subrogation provisions in the policy, despite both being "legal strangers" to the insurance contract.

As a practical consideration, insurers should be aware that it may not be readily apparent that a third party can rely on a waiver of subrogation until after an action has been commenced. As such, it is worth obtaining relevant documents and considering this issue early in the litigation process, to avoid the prospect of spending a significant amount of time and money on a claim that is ultimately doomed to fail due to a waiver of subrogation.

#### **4. LIMITS PLACED ON SUBROGATION AGAINST UNNAMED INSURED AND TRADESMEN WHO CONTRIBUTE LABOUR AND MATERIALS TO THE CONSTRUCTION SITE**

The insurance industry, by utilizing standard policy wordings, has effectively placed additional limits on subrogation in the construction setting. Customarily a Course of Construction policy ("COC") will contain a waiver of subrogation which extends beyond the parties to the insuring arrangements. It is instructive to examine what the Builders' All Risk insures. IBC Form 51208 (Builders' Risk Broad Form) actually provides:

Property Insured

This policy, except as herein provided, insures

- (a) buildings, structures, foundations, piers or other supports, building materials and supplies ....

- (I) owned by the Insured;
- (II) owned by others;

provided that the value of such property is included in the amount insured; all to enter into and form part of the completed project including expendable materials and supplies not otherwise excluded, necessary to complete the project.

("the omnibus provision")

For example at least one manuscript wording commonly used in Western Canada provides:

Upon the payment of any claim under this Policy the insurers shall be subrogated to all the rights and remedies of the insured arising out of such claim against any person or corporation whatsoever.... It is further understood and agreed that the insurers on paying a loss, hereby waive their right to a transfer of such rights:

- (a) Of any Insured(s) named herein against any other insured named herein by whose fault or negligence the loss or damage was caused
- (b) Of the Insured(s) against any Sub-contractor (including their directors, officers, employees, servants or agents) engaged in performing the work herein, by whose fault or negligence the loss or damage was caused;

This waiver of subrogation provision, read with the provision which insures material supplied to the subject matter of the contract, has led the courts to conclude that this immunity from subrogation should be extended to anyone that supplies materials to the project. This is so even if the parties to the All Risk policy had not actually intended to include these suppliers as unnamed insureds.

This is illustrated by the decision of the Alberta Court of Queen's Bench in *Timcon Construction Ltd. v. Riddle, McCann, Rattenbury & Associates Ltd., Rattenbury and Halifax Insurance Company*.<sup>108</sup> The general contractor had been hired to construct a condominium project and obtained a Builders' All Risk policy. During construction a fire occurred and an action was commenced by the insurer, alleging that a subcontractor on the job was at fault in having caused the fire. The evidence was clear that it had not been the intent of either the owner or the contractor that the subcontractor constitute either a named or an unnamed insured under the policy. Nonetheless, the insurer was barred from maintaining the action.

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<sup>108</sup> (1981), 16 Alta.L.R. (2d) 134 (QB)

Mr. Justice Foisey, after reviewing the nature of the coverage under a Builders' All Risk policy, including the waiver of subrogation clause, described some of the evidence at trial as follows:

While it is always the function of the court to interpret contracts, it is nonetheless interesting to note that Rattenbury and Rambaut, both persons who have a great deal of experience in the insurance business and particularly in the builders' risk area, and Power, a highly qualified expert in the field of insurance, were collectively of the view that the builders' risk broad form contained in the policy covered all those connected with the project in question that were not named insureds and it was their view that the interpretation being placed on this form by the industry was of a like effect.<sup>109</sup>

His Lordship also cited supporting American authority, including *General Insurance Co. of America v. Stoddard Wendle Ford Motors*, which held:

The courts have consistently held, in the builder's risk cases, that the insurance company -having paid a loss to one insured - cannot, as subrogee, recover from another of the parties for whose benefit the insurance was written even though his negligence may have occasioned the loss, there being no design or fraud on his part.<sup>110</sup>

*Timcon* was followed in a 1994 decision of the B.C. Court of Appeal, with the same result: see *Sylvan Industries Ltd. v. Fairview Sheet Metal*.<sup>111</sup> Notably, that Court rejected the insurer's submission to the effect that a party cannot attain the status of an unnamed insured simply by holding an insurable interest in the property, but rather, an *intention* to insure that party must be proved. The Court in rejecting this argument, considered the fact that the evidence of intention was equivocal and the sub-contractors in question had in fact been indemnified through the head contractor for their own losses. However, the Court upheld the view that a builder's risk policy is a special kind of policy in Canadian law which has as its primary purpose the simplification of insurance coverage for the construction process, and includes all of the trades and sub-trades "integral and necessary" to the construction process.<sup>112</sup>

The trend was followed more recently in an Alberta Court of Queen's Bench decision, *529198 Alberta Ltd. v. Thibeault Masonry Ltd.*<sup>113</sup> The Court found that the subcontractor

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<sup>109</sup> *Ibid.*, at 139

<sup>110</sup> (1966), 410 P. 2d 904 at 908.

<sup>111</sup> (1994), 89 BCLR (2d) 18 (CA).

<sup>112</sup> See also *Esagonal Const. Ltd. v. Traina*, [1994] ILR 1-3091 (Ont. Gen. Div.) Notably, the Court allowed an unnamed insured "immunity" status not only for the sub-contractor defendant, but also, consistent with the reasoning in *London Drugs*, for the sub-contractor's employee.

<sup>113</sup> [2001] AJ No. 1684

Thibeault was an unnamed insured under the builder's risk policy, despite the fact that the policy did not specifically list contractors or subcontractors as unnamed insureds. The Court noted that the value of a construction project necessarily includes the sum of materials, supplies and labour of the subcontractors working on the project. Therefore, by implication, the subcontractor Thibeault was an unnamed insured.

In *Medicine Hat College v. Starks Plumbing & Heating Ltd.*,<sup>114</sup> another decision of the Alberta Court of Queen's Bench, the Court considered a situation where the property insurer of the owner of a property brought a subrogated action against consultants and contractors who performed work in relation to the renovation of the owner's property, which included construction of an addition to an existing building (in this case the owner obtained a builder's risk policy, rather than the contractor).

During the construction work, a gas explosion occurred in the existing building, which caused damage to the existing structure and not to the new work being undertaken, although it was likely that the explosion was caused by faulty installation of new piping.

The owner's property insurer argued that the builder's risk policy did not cover damage to the existing building and it was therefore permitted to seek recovery from the contractors who were allegedly responsible for the explosion.

At paragraph 46, the Court noted that:

...in a case where there is an addition to an existing structure (as opposed to when a new stand-alone building is being constructed on the same property), it is not difficult to envisage a situation where the negligence of a trade or sub-trade employed to do the new work, could easily have the effect of causing damage to all or at least a portion of the existing structure.

The Court continued, at paragraph 49, as follows:

It seems that in a situation where there is an expansion or addition to an existing structure - as opposed to where there is an entirely new and separate building being constructed in proximity to the existing structure - that it is a logical extension to recognize that the trades and sub-trades involved in the expansion work have an insurable interest in the entire interconnected structure and not merely the new addition that they are working on.

In rejecting the owner's argument, the Court held that:

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<sup>114</sup> [2007] AJ No. 1337

...all parties involved in the construction of this project had an insurable interest not only in the addition being undertaken to the existing structure but the existing structure itself. To hold otherwise would be to defeat the reasonable expectations of the parties and would require clear language of exclusion, which is absent in this case.

These cases further serve to illustrate the modern view that all suppliers of labour and materials to a construction project have an insurable interest under a builder's risk policy and are "protected parties" with respect to a subrogated claim by the insurer who issued the policy.

This view has generally been adopted in various of the American states, e.g., *Louisiana Fire Ins Co. v. Royal Indemnity Co.*,<sup>115</sup> *New Amsterdam Casualty Co. v. Homans-Kohler, Inc.*,<sup>116</sup> and *Transamerica Ins. Co. v. Gage Plumbing and Heating Co.*<sup>117</sup> Still, this view has not met with universal acceptance.

In *Janeland Developments Inc. v. Michelin Masonry Inc.*,<sup>118</sup> the Ontario General Division considered whether a clause in the contract requiring the sub-contractor defendant to obtain its own insurance coverage was enough to negate the language of the policy, which (like the wording in the cases above) covered property "in the course of construction". The Court ruled that this was insufficient to negate coverage, concluding:

...I find that the wording in the Continental policy, as in the policies in *Sylvan*, supra., and *Esagonal*, supra., extends coverage to the defendants as unnamed insureds. I have considered the expression of intention contained in the agreement and the fact that the defendants' negligence may have occasioned the damage. However, in my view, the insurance provision in the construction agreement does not provide sufficient evidence of intention to negate the language of the insurance policy, particularly in light of prior judicial pronouncements on the effect of the policy's language. This determination is in keeping with the court's desire to reduce litigation which flows from losses of this type. It recognizes the reality of

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<sup>115</sup> (1949), 38 So. 2d 807.

<sup>116</sup> (1969), 305 F. Supp. 1017.

<sup>117</sup> (1970), 305 F. 2d 1051.

<sup>118</sup> [1996] ILR 1-3298 (Ont. Gen. Div.). Note that the Court refers to the trial level decision in *Madison Developments Ltd. v. Plan Electric Co.* (1993), 18 CCLI (2d) 142 (Ont. Gen. Div.), which was in fact overturned on this point on appeal: see (1997), 36 OR (3d) 80, [1998] ILR 1-3493 (ONCA), leave to appeal to SCC refused, May 7, 1998. In *Madison*, the "property insured" clause included property of others; only the owner and the contractor were named insureds; and there was no clause stating that the contractor was obtaining the insurance as "trustee" for the others. *Madison* is also notable in that on the basis of *London Drugs*, it extended the protection of the course of construction policy to employees of the subcontractor, finding that the insurance provisions would be "thwarted" otherwise.

complex industrial life and provides comfort and security to owners, builders and subcontractors involved in commercial projects.<sup>119</sup>

The modern trend has been to limit the subrogation rights of the All Risk insurer and to extend an immunity to the class of persons who supply materials to the subject matter of the policy, whether or not the party procuring the policy intended to include them as unnamed insureds. The Courts have clearly signalled that a property insurer having issued an All Risk policy cannot maintain a subrogated claim against a subtrade if the latter contributed materials or labour to the project. The underlying theory is that the parties to the construction project, having expressly agreed that one of the parties must obtain a Builders' All Risk, have also implicitly agreed that in the event of a loss all of the parties would look to the Builders' All Risk as the sole remedy in the event of loss and would not as between themselves, seek to shift that loss. The insurer is bound by this implied agreement and is thus unable to use subrogation to shift the loss to other parties.

## 5. ACTIONS AGAINST AN INSURED ON THE SAME POLICY

As emphasized in the preceding passages of this paper, it has long been recognized that an insurer is not entitled through the exercise of any right of subrogation to be indemnified by its own insured. The fundamental principle is that it is the insurer, not the insured, who is to provide indemnity. This principle is simple enough, but matters can become complex when it is remembered that this rule against subrogation extends to any unnamed insured. The coverage which is typically written in relation to construction projects extends protection to numerous unnamed insureds, because there are numerous large and small business operations which are involved in a given project.

Typically, in a Builders' "All Risk" policy (or COC) both the owner and the general contractor will be expressly included as insureds. Plainly, in an event of loss the insurer cannot maintain subrogated proceedings against the general contractor alleging that its fault caused the loss.<sup>120</sup> The unnamed insured is similarly protected if identified as being within the class of persons intended to be protected by the insurance coverage. An example of construction policy language which encompasses a potentially large number of insured parties would be a description of the "Named Insured" as "ABC Holdings Ltd., John Smith Contracting Ltd. and all subcontractors carrying on work in respect of the project".

In *Commonwealth Construction Co. Ltd. v. Imperial Oil Ltd. et al.*,<sup>121</sup> the Supreme Court of Canada ruled that unnamed insureds of this description are protected from subrogated

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<sup>119</sup> [1996] ILR 1-3928 (Ont. Gen. Div.) at 3925

<sup>120</sup> *Lester Archibald Drilling & Blasting Ltd. et al. v. Commercial Union Assurance Co. of Canada* (1987), 25 CCLI 145

<sup>121</sup> (1977), 69 DLR (3d) 559.

proceedings. This outcome results from the unique structure of a Builders' All Risk or COC policy. By its very terms, the An Risk policy contemplates that any person who supplies labour or material to a construction project has an insurable interest in the project to the extent of such tradesman's or supplier's contribution.

The omnibus provision makes clear that persons who supply materials for the construction of the project are intended to have and do have an insurable interest in the property protected by the policy. In this respect All Risk coverage is unique in relation to other types of property insurance. The legal character of an "insured" extends far beyond those persons owning the land and structure; it extends to all other persons who contribute to its construction, i.e. those who add value to the property. "All Risk" policies give effect to that intent, firstly, by excluding the insurer's subrogation rights against the class of person supplying materials and, secondly, by prohibiting subrogated claims against those who fall within the class of protected persons (an example being subrogated proceedings in respect of a cause of action which the general contractor may have against one of the subcontractors).

As the Supreme Court of Canada stated in *Commonwealth Construction*:

On any construction site, and especially when the building being erected is a complex chemical plant, there is ever present the possibility of damage by one tradesman to the property of another and to the construction as a whole. Should this possibility become reality, the question of negligence in the absence of complete property coverage would have to be debated in Court. By recognizing in all tradesmen an insurable interest based on that very real possibility, which itself has its source in the contractual arrangements opening the doors of the job site to the tradesmen, the Courts would apply to the construction field the principle expressed so long ago in the area of bailment. Thus all the parties whose joint efforts have one common goal, e.g., the completion of the construction, would be spared the necessity of fighting between themselves should an accident occur involving the possible responsibility of one of them.<sup>122</sup>

So, for example, in *Commonwealth Construction* the Court concluded that a subcontractor had an insurable interest in the project which extended to the entire undertaking, with the consequence that the insurer had no right to subrogate against that subcontractor notwithstanding the latter's actionable negligence.

It is important to emphasize that this effective barrier to virtually any right of subrogation (because almost all construction losses are the fault of one or another of the participants in the project) is a special feature of Builder's "All Risk" policies. If the nature of coverage is

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<sup>122</sup> *Ibid.* at 109

different there are likely to be fewer limits on an insurer's right to subrogate. For example, if a general contractor working on a home renovation project were to damage the homeowners premises by causing a fire, an ordinary fire insurer would, after compensating the homeowner for the damage, ordinarily be entitled to make a subrogated claim against the general contractor.

Another limitation on the foregoing principles arises from the rule which allows a property insurer to subrogate against an unnamed insured if the claim entails the loss of property other than property in which the unnamed insured has an insurable interest. Immunity from subrogated claims because the proposed defendant is an insured does not extend to claims which relate to something other than the insured property itself.<sup>123</sup> If the subject matter of the subrogated claim is property in which an unnamed insured has no insurable interest, then the ordinary right of subrogation is unimpaired.

The principle is best illustrated by the decision of the Ontario Court of Appeal in *Morawetz v. Morawetz*.<sup>124</sup> The subrogating insurer, having provided indemnity for a fire loss to a private residence caused by the son of the insured, brought action against the insured's son. The son's interest in the policy was limited to his personal effects; what the insurer sought to recover was the cost of damage to other property - in this case the dwelling itself. In concluding that the action could be brought the Court stated that..... "[the son] did not have an insurable interest in and was not the insured in the part of the policy covering the property damaged by his negligence".<sup>125</sup> Since the loss entailed that portion of the property in which the son had no insurable interest, a right of subrogation was available to the insurer.

The decision has been criticized as being inconsistent with the principle enforced by the Supreme Court in *Commonwealth Construction*.<sup>126</sup> The case can properly be understood as one in which the son did not have an interest in the entire property, unlike the situation regarding subcontractors and tradesmen on a construction site, in which their interests are treated as extending to the entire construction project if there exists a Builders' All Risk policy.

Apart from the example of *Morawetz v. Morawetz*, the Courts are concerned to limit rights of subrogation when parties to a group enterprise, particularly construction site

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<sup>123</sup> A recent example of this principle in action is *Sin v. Mascioli* (1999), 8 CCLI (3d) 39, [1999] ILR 1-3658 (ONCA), where the court allowed the subrogated action against an unnamed insured mortgagee to proceed in respect of the personalty loss only, where the mortgagee was a loss payee in respect of the building loss.

<sup>124</sup> (1986), 18 CCLI 108.

<sup>125</sup> *Ibid.* at 109.

<sup>126</sup> "Insurance Law", *Law Society of Upper Canada Special Lectures*, 1987, page 210-217.



participants, utilize a property policy to insure the entire project in the names of all of them. In creating a "zone of legal immunity" the legal premise is that by purchasing a property policy, typically an "All Risks" policy, the parties have agreed to look solely to the property insurance in the event of a loss, and the insurer cannot ignore that agreement.

## **6. SUBROGATED ACTIONS AGAINST ONE'S OWN INSURED ON A DIFFERENT POLICY**

The focus in the preceding passages has been on the legal rights and obligations which arise under a single insurance policy. The basic logical formulation is that "A" is the insured who has been indemnified under a policy, and the issuer of the policy claims against "B" as the party ultimately responsible for the loss. The fundamental principle that an insurer cannot subrogate against its own insured is relevant in situations in which both "A" and "B" are co-insureds, either named or unnamed, under the same policy of insurance, and in respect of the same insurable interest. What has not yet arisen for consideration by the Courts in Canada is whether the same prohibition against suing one's own insured applies if the subrogating property insurer of "A" is also the liability insurer for "B".

This very question has been considered at least once by an American court. The principle which has emerged is that a property insurer cannot subrogate against someone who is its own insured under a separate liability policy. It may be asked why an insurer would take the trouble to subrogate against its own insured, since no obvious economic advantage would thereby be gained, but the practical motivation for an insurer to do so is real enough; there are subrogation rights pursuant to liability policies, and the liable insured may have a right to claim over against a third or fourth party, who itself may be protected by liability insurance. If the insurer pays itself "out of its own pocket", the potentially valuable right to claim over against other parties is triggered, but not otherwise. This situation commonly occurs in the context of construction and products liability litigation, where there is a procedural and substantive "chain" of liability, commencing with the ultimate consumer and culminating with the original manufacturer of the products supplied. The possibility that an insurer is at risk of losing its right to be subrogated to any one of these successive legal claims has potentially serious economic consequences for an insurer who has the misfortune to be on more than one risk in the "chain" of liability. Yet this possibility is a very real one.

In *Home Insurance Company v. Pinski Bros. Inc.*,<sup>127</sup> the insurer of a hospital sought to exercise its ordinary right of subrogation in the aftermath of a construction loss. The insurer brought action against the architect who designed the hospital. Coincidentally, the architect was covered by a liability policy issued by the same insurer. The architect was not an insured on the property policy. Counsel for the architect disputed the insurer's right to

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<sup>127</sup> 160 Mont. 249, 500 P. 2d 945 (1972)

claim against its own policyholder. In refusing to allow the insurer to subrogate against someone who was an insured on a different policy the Court cited five policy concerns:

Such action, if permitted, would (1) allow the insurer to expend premiums collected from its insured to secure a judgment against the same insured on a risk insured against; (2) give judicial sanction to the breach of the insurance policy by the insurer; (3) permit the insurer to secure information from its insured under the guise of policy provisions available for later use in the insurer's subrogation action against its own insured; (4) allow the insurer to take advantage of its conduct and conflict of interest with its insured; and (5) constitute judicial approval of a breach of the insurer's relationship with its own insured.<sup>128</sup>

In the writer's view the decision in *Home Insurance* can be seen as a reflection of heightened American judicial concern over "bad faith" claims which will be analyzed in more detail in a subsequent section of this paper, as well as the spectre of property insurers refusing a co-insured the benefit of a defence on the separate liability policy simply to "squeeze" settlement funds from the then "uninsured" insured. Given the more moderate approach to "bad faith" claims seen in Canada, it is not clear that Canadian courts will necessarily arrive at the same conclusion as in *Home Insurance*.<sup>129</sup>

## **7. SUBROGATED ACTIONS AGAINST A PARTY BENEFITING FROM THE "AS THEIR INTERESTS MAY APPEAR" CLAUSE**

In the setting of construction coverage it is not uncommon for the "All Risks" or Course of Construction policy to contain "benefit of insurance" clauses, which typically provide as follows:

It is specifically understood and agreed that this policy covers both the interest Of the Insured and contractor(s) and subcontractor(s) as additional insureds hereunder, as their interests may appear.

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<sup>128</sup> *Ibid.* at 949.

<sup>129</sup> In *Earl A. Redmond Inc. v. Blaire LaPierre Inc.* (1995), 127 Nfld. & P.E.I.R. 329 (PEISC) the Court referred to a passage from *Home Insurance* with approval, in the context of avoiding the "conflict of interest" created by an insurer suing its own "unnamed insured" subcontractor under a course of construction policy, after having already indemnified the subcontractor for a property loss. The case was also referred to in *Sylvan, supra*. It is interesting however, to compare those decisions with the very recent decision in *Sin v. Mascioli*, [1999] ILR 1-3658 (ONCA), where the Ontario Court of Appeal had no apparent qualms about allowing the insurer to subrogate in respect of a *contents* loss against the mortgagee, who was responsible for the negligent construction of the premises which led to a fire, but who was also a loss payee in respect of the *building* loss. The Court found that this was permissible, since the mortgagee had no insurable interest in the contents, and the covenant to insure in the mortgage was directed only to insuring the real property and did not include personality.

or:

It is hereby understood and agreed that the Insurers grant permission to complete construction and that Contractors and/or Consultants, Architects, Engineers and Sub-Contractors are added as Additional Insurers as their interest may appear.

In the United States debate continues as to whether the words "as their interests may appear" completely protects a contractor or subcontractor from subrogated litigation by the owner's insurer in the event of a loss in the course of construction. The limiting effect of this language may be contrasted with the type of construction coverage which was considered by the Supreme Court in *Commonwealth Construction*, which was interpreted to endow every project participant with an insurable interest in the entire project.

Interestingly, the same wording arises in the context of a homeowners' policy in which the mortgagee's interest is stated in similar words "as its interests may appear". However, in the insured-mortgagee context those words have not been interpreted as conferring an interest in the property, but rather, in the amount of the debt owed to the mortgagee as secured by the mortgage.<sup>130</sup>

In the United States there are divergent lines of authority as to whether the use of the phrase "...as their interests may appear" effectively grants complete immunity from subrogated proceedings to all project participants. Several judgments have conferred a wide immunity from subrogated proceedings.<sup>131</sup>

Other U.S. courts have considered the same phrase and concluded that the words were intended to denote the bailed property interest a construction participant possesses (i.e. - its own tools and equipment and materials supplied) and have held that the subcontractor is not a co-insured for all purposes, including immunity from subrogated proceedings. So, for example, in *Turner Construction Company v. John B. Kelly Company*,<sup>132</sup> the court, relying upon the fact that the subcontract required the subcontractor obtain its own liability policy, concluded that the parties' intention was that the subcontractor not be insulated from its own negligence.

The significant English case of *Petrofina v. Magnaload* arose from a comprehensive construction policy issued in respect of an oil refinery construction project.<sup>133</sup> One subcontractor severely damaged the finished refinery by mishandling certain heavy

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<sup>130</sup> *Couch on Insurance*, 2d ed, 42:696.

<sup>131</sup> *Harvey's Wagon Wheel, Inc. v. McSween*, 96 Nev. 215, 606 p. 2d 1095 (1980); *Barigh-Belande Construction Co. v. College Utilities Corp.*, 561 p. 2d 1211 (Alaska, 1977).

<sup>132</sup> 442 F. Supp. 551 (DC Pa. 1976).

<sup>133</sup> (1983), 3 All E.R. 35.

equipment. The owner's insurer commenced subrogated proceedings in the name of the owner against that subcontractor, alleging negligence in the handling of the equipment. The terms of the policy in issue "mirrored" the conventional Builders' "All Risks" policy, and extended coverage to the entire project including the materials used in the project. The subrogating insurer, in its claim that the action was not prohibited, argued that the extent of the subcontractor's interest in the project and consequently the extent of its immunity from subrogated claims was no more than the value of the subcontractor's own property. In rejecting that argument, Lloyd J. stated:

It seems to me that on the ordinary meaning of the words which I have quoted, each of the named insured, including all of the subcontractors, are insured in respect of the whole of the contract works. There are no words of severance, if I may use that term in this connection, to require me to hold that each of the named insured is insured only in respect of his own property. Nor is there any business necessity to imply words of severance. On the contrary, as I shall mention later, business convenience, if not business necessity, would require me to reach the opposite conclusion.<sup>134</sup>

Since the subcontractor who was engaged on the construction site was held to be insured in respect of the entire contract works, as well as its own property, the insurer's right of subrogation was refused.

In Canada, the Court in *Weldwood of Canada Ltd. v. Gisborne Construction (Alberta) Ltd.*,<sup>135</sup> considered the meaning of a clause in the construction contract which provided that the owner would maintain fire insurance, with coverage to "protect [the owner] and Contractor and his subcontractors as their respective interests may appear."

Relying on the leading Canadian authorities decided in the context of commercial lease agreements and course of construction policies, the Court concluded that the clause amounted to a covenant to insure for the benefit of all parties, and therefore ruled that the subrogated action against the subcontractor was barred. The Court commented:

I cannot accept that Champion by its covenant to insure in cl. 6 of its Agreement with Mocoat agreed to insure Mocoat and its subcontractor Gisborne only to the extent of their respective interests in completed work for which they remained unpaid. Further, the idea that Mocoat's fire insurance protection is to be found separately in its broad indemnity obligations under cl. 3 and its covenants under cl. 4 to obtain comprehensive general public liability coverage of the CMA agreement as a whole, makes little sense in the context when set out in the agreement is the

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<sup>134</sup> *Ibid.* at 40.

<sup>135</sup> [1995] ILR 1-3233 (ABQB)

obligation by Champion to specifically insure the total property at risk for fire and supplemental perils. See *Simcoe & Erie General Insurance Co. v. Royal Insurance Co. of Canada*, [1982] 3 WWR 628 [Caselaw\_11502119 Alta. L.R. (2d) 133] (ABQB).<sup>136</sup>

Given this expansive approach to the definition of the extent of the insured's interest, it is suggested that construction site participants will be treated as full co-insureds even where the relevant policy language contains the phrase "as their interests may appear", and that being so, all rights of subrogation will be blocked.

## **8. FIDELITY INSURER'S SUBROGATED ACTION AGAINST THE CORPORATE INSURED'S DIRECTORS**

We now focus on the exposure faced by the directors and officers of an insured corporation to subrogated claims for the corporation's losses suffered due to the directors and officers' alleged negligence. This is a very contemporary phenomenon because the traditional legal conception of the position of directors and officers has been that they are identified more or less absolutely with the corporation with which they are associated. It is only recently that Canadian courts have been asked to consider, for example, whether a fidelity bond covering a corporation for the dishonest or fraudulent acts of its employees provides the insurer with the right to maintain subrogated proceedings against the insured's officers and directors, founded on allegations of the latter's failure to properly supervise the dishonest employee. This is an issue that has given rise to considerable debate in American courts for the past five years; it will undoubtedly spawn further litigation in Canada.

Most fidelity or financial institution bond losses are, in an important sense, attributable to the failures of supervisory personnel. It is not at all uncommon for dishonest employees to succeed in a fraud or embezzlement because honest but inattentive officers and directors negligently fail to apprehend their activity. Often the question is not whether both are at fault, but rather their relative degrees of culpability. This in turn has led to a dramatic expansion in the demand for directors' and officers' liability coverage for complex bond claims. Frequently, a change in company ownership or the appointment of an insolvency receiver has led to litigation against former directors and officers. New decision makers, particularly those appointed by creditors, often regard previous directors' potential legal liability to their former corporation as a lucrative source of recovery.

Invariably, in situations involving employee dishonesty attributable to director/officer negligence, the fidelity insurer will be obligated to pay the company's claim. Negligence in allowing a loss to occur, or, in failing to discover the loss, has not been an acceptable defence to the surety (except perhaps in cases of virtual collusion or the actual involvement of some of the directors in the fraud). The cost of covering fidelity claims can be

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<sup>136</sup> *Ibid.*, at 3615

astronomical, and opportunities to refuse coverage are few. Accordingly, the fidelity surety is acutely concerned to examine any and all potential avenues of recovery, including every possible variety of subrogated claim.

In the American law of insurance there is more than one view as to whether a fidelity surety can subrogate against negligent officers and directors. Most of the case rulings permit subrogation. For example, in *Federal Deposit Insurance Corp. v. National Surety Corp.*,<sup>137</sup> a fidelity surety sought to sue the directors of the insured as a consequence of claims being brought by the FDIC on various bankers' blanket bonds in the aftermath of the Franklin National Bank failure. The Court allowed the action to proceed on a preliminary motion. Implicit in the decision was the Court's view that, although an insurer cannot subrogate against its own insured, corporate directors are legal persons distinct from the company itself and therefore do not enjoy this traditional immunity.

In a 1988 decision of the United States Court of Appeals, *Home Indemnity Company v. Shaffer et al.*,<sup>138</sup> a fidelity surety brought an action against the members of the board of directors for their alleged negligence in permitting the chief executive officer of a savings and loan company to make unauthorized loans to personal friends. Interestingly, while willing to accept that the directors and officers together with the company should be treated as a single entity for the purpose of this issue, the Court did recognize that there are some situations where a claim would nevertheless be permitted. The Court denied the right of the fidelity bonding company to subrogate if the claim was predicated upon negligence alone, citing the following principle:

The insurer accepts not only the risk that some third party may cause the casualty but also that its own insured may negligently cause the loss. The insurer, however, has consented to this latter risk in exchange for the premiums received for his compensation obligation.<sup>139</sup>

Acknowledging that the doctrine of subrogation is an equitable doctrine, the court held that the only circumstances in which it would be equitable to allow an action to be commenced against directors and/or officers were situations wherein the fidelity insurer could demonstrate fraud, bad faith or dishonesty on the part of the officers and directors. This ruling is consistent with a basic principle of Anglo-Canadian company law, to the effect that the knowledge and actions of any directors are the knowledge and actions of the company itself, except where the directors are acting consciously against the company's interests.

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<sup>137</sup> 434 F. Supp. 61 D.C.N.Y. (1977).

<sup>138</sup> (1988) 660 F.2d 186

<sup>139</sup> *Ibid.* p. 187.

A 1990 decision of Chief Justice Esson of the Supreme Court of British Columbia, *Columbia Trust Company v. American Home Assurance Co. et al.*,<sup>140</sup> is of considerable interest in regard to the issue of a fidelity insurer's right to subrogate a negligence claim against a person traditionally regarded as the alter ego of the corporation, but who as a legal person is separate and distinct from the corporation. The fidelity surety's claim of subrogation was not advanced against the directors or officers, but rather, against the receiver of the insured corporation. The insurer faced fidelity losses stemming from an employee's fraudulent conversion of more than \$1,000,000.00. It was alleged that the loss arose after the receiver had been appointed, and that, had the receiver been more vigilant, the loss could have been prevented. The two fidelity companies sought to commence subrogated third party proceedings against the receiver on the fidelity bond claim just three months before trial.

Although Esson C.J.S.C. ruled that the subrogated claim ought not to proceed, the decision was based primarily on the proposition that the receiver, upon its appointment, was for all intents and purposes the insured corporation itself. Its status was not analogous to other company agents including the directors and officers. The Court stated:

"The receiver was appointed under statute on terms that, in relation to any third parties dealing with Columbia Trust, it was to stand in all respects in the shoes of Columbia Trust. In a very complete sense, its actions were the actions of Columbia Trust to such an extent that it would be unrealistic to separate the position of the "receiver and the company in relation to the fidelity insurance."<sup>141</sup>

It is clear in the aftermath of *Columbia Trust* that the legal position with respect to subrogation in Canada is undecided. Undoubtedly fidelity surety companies will continue to be vigilant in asserting subrogated claims against the insured's directors and officers, providing another reminder of the need for directors' and officers' liability coverage.

#### **IV. SUBSTANTIVE ASPECTS OF SUBROGATION**

##### **1. WHO RETAINS THE RIGHT TO ANY SURPLUS FROM A SUBROGATED ACTION**

The rule in Canada is that an insurer, having fully indemnified the insured, cannot retain any net surplus which may be obtained from the successful prosecution of a subrogated action.<sup>142</sup> The rule appears to be the same in the United States. As was said by Justice Brown in *The St. Johns*:<sup>143</sup>

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<sup>140</sup> (1990), 50 BCLR (2d) 379 (SC)

<sup>141</sup> *Ibid.* at 389.

<sup>142</sup> *Yorkshire Insurance Co. Ltd. v. Nisbet Shipping Co.* (1961), 2 All E.R. 487.

<sup>143</sup> 101F. 469 (1900).

If the amount, recoverable from the wrongdoer, after payment of the damage claims of third parties were in excess of the amount paid by the underwriters to the assured no doubt that excess would belong to the latter since the insurer's right of subrogation in equity could not extend beyond recoupment or indemnity for the actual payments to the assured.

The converse of this principle is that if the insured, prior to payment by the property insurer, recovers in the litigation process a sum in excess of its actual loss then the insurer is not obligated to indemnify the insured.<sup>144</sup> If the insurer does pay the claim and later learns that the insured is fully compensated through other means, then the insurer can seek the return of the insurance proceeds as monies "had and received" to its use.<sup>145</sup> For this reason it is essential that any insurer who has reason to believe its insured may benefit from tort proceedings should be wary of granting any Release which extinguishes its right to cut for the return of insurance money.

## **2. THE EXCESS INSURER'S RIGHT TO SUBROGATE AGAINST THE PRIMARY INSURER**

A legal issue which liability insurers and their counsel must confront all too frequently arises in situations where the claim against the insured is for an amount substantially in excess of the insurance policy limits. Since primary liability insurers have conduct of the defence of any case against the insured, it is within their power to settle claims for an amount greater than the policy limits. Such settlements are sometimes made. Insured persons [which often effectively means their excess insurer] are thereby left exposed to considerable financial liability. This situation has led to a series of cases in the United States and Canada in which insurers have been sued for "bad faith" in settling a case on terms which favour their own interests rather than the interests of the insured.

It is worthwhile to consider the legal question of whether a primary liability insurer's failure to reasonably settle a case, i.e. within policy limits, creates a situation which permits an excess insurer to pay the entire claim on behalf of the insured, and thereby be subrogated to the insured's cause of action for "bad faith" against the primary insurer.

That was exactly the issue in *American Centennial Insurance Co. v. Canal Insurance Co.*<sup>146</sup> The insured in this case was a car rental agency. After one of its rental vehicles was involved in a fatal accident case, the agency was sued for several million dollars. There were three liability insurers: the primary insurer was only responsible for the first \$100,000.00 of any claim; the first excess insurer was liable for the value of claims above \$100,000.00 to a limit of \$1,000,000.00; while the second excess insurer was liable for claims with a value

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<sup>144</sup> *Yorkshire Insurance Co. Ltd. supra.* at p. 490.

<sup>145</sup> *Ibid.* at 491.

<sup>146</sup> 810 S.W. 2d 246 (Tex. App.-Houston (1st Dist.) 1991, writ granted).



exceeding \$1,000,000.00 to a maximum amount of \$3,000,000.00 in excess of that total. The primary insurer took an approach to the conduct of the defence of the fatal accident claim which clearly favoured its own interest over those of the insured and the excess insurers. Its counsel made very damaging admissions in the course of litigation, and afterward the primary insurer simply refused to seriously participate in settlement negotiations. It was clear that the primary insurer intended that the excess insurers would take full responsibility for settling and defending the case.

Ultimately, the excess insurers settled the case with their own money for \$3,700,000.00. They did, however, sue the primary insurers for "bad faith" in its original conduct of the defence of the fatal accident claim against the insured. Since the cause of action against the primary insurer for "bad faith" belonged to the insured, the main legal issue was whether the excess insurers were subrogated to this cause of action. The Texas Court of Appeals allowed the excess insurer to sue and recover for the primary carrier's failure to manage the litigation in a responsible way. The Court concluded that equitable subrogation was open to the excess insurer, upon proof that it had paid the entire settlement, and upon evidence that the primary carrier's misconduct was actionable by the insured.

It is not clear whether this principle of equitable subrogation will find judicial support in Canada. The ruling in *American Centennial Insurance* presents some potential problems including:

- (a) the concept of equitable subrogation does not easily accommodate the basic rule that the insured has no right to settle the case; that right is vested with the primary insurer. In this regard, it may be asked why should the excess insurer have rights paramount to the insured;
- (b) This example of judicial intervention undermines the freedom of the primary insurer to properly defend and settle the case, by raising the spectre of pre-emptive attacks by the excess insurer;
- (c) "Equitable" subrogation constitutes a less controversial basis of legal reasoning in the United States than in Canada. In Anglo-Canadian law there has been no final resolution of the question whether subrogation is an equitable right, or is based upon an implied term of the contract of insurance.<sup>147</sup>

At least one insurer in Canada has attempted this sort of subrogated claim for "bad faith", but with no success, due to the rather novel application of the doctrine. The context was

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<sup>147</sup> See Derham, *Subrogation in Insurance Law*, pages 4 - 12.

unusual, and ultimately held distinguishable, in that it was not a classic case of an excess insurer suing the primary insurer. Instead, the insurer of an underinsured motorist protection policy attempted to bring action against the tortfeasor's insurer for failing to settle within limits. The facts of *Hampton v. Traders General Insurance Co.* were straightforward.<sup>148</sup> Hampton was involved in a motor vehicle accident with one Chartrand. Chartrand was insured to a liability limit of \$500,000 with Cooperators; Hampton had underinsured motorist protection to limits of \$1 million with Traders. Hampton was injured and sued Chartrand, and also sued Traders for any excess which could not be covered by Chartrand's policy. Cooperators assumed the defence in Hampton's tort claim against Chartrand, and unbeknownst to Traders, agreed with Hampton that the limits would be paid out and it would continue to defend the claim. Judgment was rendered in favour of Hampton in the amount of approximately \$650,000.

Traders paid out the excess of \$150,000 to Hampton and then third partyed Cooperators, alleging that Cooperators had breached its duty of good faith by failing to explore the possibility of a settlement within the limits of the Cooperators policy.

In a summary motion for judgment, the Ontario motions court dismissed Traders' third party action on grounds that there was no reasonable cause of action. The dismissal was upheld on appeal to the Ontario Court of Appeal. The Court concluded that Traders had no cause of action against Cooperators, in that Traders was not subrogated to Chartrand's cause of action against Cooperators (in that it had not paid Chartrand anything); and Hampton did not have a cause of action against Cooperators. The Court also observed that there was no evidence to support Traders' allegation that Cooperators had breached its duty to Chartrand or otherwise acted improperly.

Traders built its argument upon American authorities in support of "equitable subrogation", including the *American Centennial* decision, discussed *supra*. In response, the Court stated:

My problem in this case, however, is not in extending this court's reliance upon American authorities on equitable subrogation. Rather, I have difficulty in understanding how these authorities can be of any assistance to Traders in founding its cause of action against Co-operators. Hampton has no cause of action against Co-operators to which Traders could become subrogated. Co-operators has fully complied with its obligations to Hampton pursuant to the agreement reached between them. Hampton has a claim against Chartrand in tort for the balance of her judgment and when Traders paid Hampton under her SEF 44 policy, it became subrogated to this tort action. On what basis can Traders argue that it is subrogated to a cause of action, if any, which Chartrand might have against its own insurer Co-

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<sup>148</sup> [1997] ILR 1-3416 (ONCA)

operators? In the American authorities cited above, equitable subrogation was applied to allow an excess insurer to pursue a subrogated claim against the primary insurer where the excess insurer had indemnified the insured. Traders did not indemnify Chartrand. Its payment of \$155,000 to Hampton did not relieve Chartrand of liability for this amount and in fact left him liable to its subrogated claim. Accordingly, even under the American authorities, Traders is not legally entitled to be subrogated to Chartrand's rights.<sup>149</sup>

Given the unusual circumstances of this case, it is unlikely that this decision will have any substantial impact on any subsequent attempt to forward this type of claim in Canada. In the writer's opinion, the issue remains open.

### 3. SUBROGATED ACTIONS AND THE DEFENCE OF SET-OFF

One potentially important obstacle in the path of a subrogating insurer concerns the rules of "set-off". The law of set-off enables, in some circumstances, the value of an obligation which "A" owes to "B" to be deducted from the value of an obligation which "B" owes to "A". There are two types of set-off: (1) legal set-off, which concerns liquidated cross-claims between owners of debt; and (2) the equitable set-off, under which the defendant must satisfy the following requirements:

1. There must be some distinct equitable ground for the defendant being protected from his adversary's demands;
2. The equitable cross-claim must go to the very root of the plaintiff's claim; and
3. The cross claim must be so clearly connected with the demand of the plaintiff that it would be manifestly unjust to allow the plaintiff to enforce payment without taking into consideration the cross claim.<sup>150</sup>

From the point of view of a subrogating insurer, the issue at hand is whether, assuming the defendant has a right of set-off against the insured, that could also be asserted against the subrogating insurer. The traditional view was that an insurer's claim should not be subject to any countervailing claim of set-off. The courts took the view that the insurer, as the "true plaintiff", did not sue "in the same right" as the insured, even though the lawsuit was commenced in the name of the insured.<sup>151</sup> However, at least in British Columbia, it is now open to the defendant in a subrogated action to invoke "equitable" set-off.<sup>152</sup>

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<sup>149</sup> *Ibid.*, at 4410

<sup>150</sup> *Coba v. Millie's Holdings (Canada) Ltd.* (1985), 65 BCLR 31 (CA)

<sup>151</sup> *Lewenza v. Ruszcak* (1960), O.W.N. 40. For more recent Ontario authority disallowing legal set-off involving an insurer's subrogated claim, see *378096 Ontario Ltd. v. Bond's Decor Ltd.* (1999), 11

Equitable set-off has one great advantage over legal set-off from the point of view of a defendant; the cross-claim need not be for a "liquidated", i.e. precisely certain, sum of money, but may be for an unquantified amount. Neither must the cross-claim arise from the same contract. For that reason insurers should be cautious in pursuing a subrogated action without giving careful consideration to the cost/benefit ratio, if the real value of any resulting judgment is liable to be reduced or eliminated by a suitably drawn defence of legal or equitable set-off. To avoid this potential problem, the insurer may wish to enter into an indemnity agreement with the insured whereby the insured indemnifies the insurer for the amount of the cross-claim and the costs of dealing with that cross-claim.

#### **4. DOES THE INSURED'S INSOLVENCY JEOPARDIZE RECOVERY OF FUNDS THROUGH A SUBROGATED ACTION**

If the insured becomes bankrupt during the currency of a subrogated action, any recovery is treated as being held in trust for the benefit of the insurer, and is not appropriated to the insured's estate for the benefit of the insured's creditors. The operation of this important rule is illustrated in *In the Matter of the Bankruptcy of Northward Airlines Limited*.<sup>153</sup> The insured had been indemnified on a property loss. Prior to recovery being effected by the insurer in a subrogated action, the insured's bank, holding a General Assignment of Book Debts, claimed to be entitled to any amount recovered in priority to the insurer. The insurer argued that upon payment of the property loss its subrogation right arose and from that point on any recovered funds became impressed with a trust in its favour. Citing *McGillivray & Parkington on Insurance Law*, the court commented:

If the insured makes a recovery from a third party, after the insurer has made a payment under the policy, the insured can retain what he has recovered until he is fully indemnified, but holds the rest on trust for the insurer up to the value of the insurers' payment.<sup>154</sup>

Until any insurer becomes vested with subrogation rights it should be very reluctant to engage in litigation only to see the fruits of any success retained by the insured or the insured's trustee in bankruptcy. When exactly an insurer's subrogation rights actually "vest" poses a difficult question in many cases: does the right crystallize as soon as the full payment has been made pursuant to the policy, even if the insured must bear part of his own loss, or does the right arise only after the insured has been fully indemnified for the loss? At common law, subrogation rights arise only when coverage provides full

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CCLI (3d) 188 (Ont. Gen. Div.). See also *Co-operators Insurance Association v. Brown*, [1989] ILR 1-2509 (Ont. Dist. Ct.) which disallowed a counterclaim.

<sup>152</sup> *Best Buy Carpets Ltd. v. 281856 B.C. Ltd.*, [1987] ILR 1-2197 (BCSC).

<sup>153</sup> [1981] ILR 1-1435 (ABQB)

<sup>154</sup> 6th ed., p. 780

indemnity, and after payment has been made. That will be the position unless the insurer has the benefit of a statutory or contractual subrogation provision such as section 130 of the Act,<sup>155</sup> which it will be remembered allows an insurer to exercise rights of subrogation in respect of only partial payment of a loss.

If full indemnity triggers subrogation rights, then even payment to the full extent of the policy hits places the insurer at serious risk in the event of an insolvency. To then proceed with subrogated proceedings exposes the insurer to the risk that the proceeds will enure to the benefit of the insured's creditors.

## **5. COMPENSATION ORDERS UNDER THE CRIMINAL CODE: A LIMITED ALTERNATIVE TO SUBROGATION PROCEEDINGS**

Sections 738 through 741.2 of the *Criminal Code* provide that a convicted or discharged offender may be ordered to make restitution to victims of offences. The order is made at the time of sentencing or discharge.

Generally, in exercising the discretion afforded by the *Criminal Code*, the court will consider four factors:<sup>156</sup>

1. Are the factual and legal issues of the case clear?
2. Is there satisfactory evidence as to the amount of the loss and the accused's financial circumstances?
3. Does the procedure prejudice the accused? and
4. Is the matter so complicated that a full civil lawsuit is really required in order for justice to be done?

Precedent suggests that insurers are not barred from applying as “persons aggrieved” by the crime; orders of restitution have in fact been made to insurers.<sup>157</sup>

However the *Criminal Code* provides that an aggrieved party’s civil remedies are not affected by reason only that a restitution order has been made; this is in some respects consistent with the case law which suggests that the restitution provisions were not

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<sup>155</sup> *Farrell Estates v. Canadian Indemnity Company* [1989] ILR 1-2478 at p. 9596-97 and 9598; concurred in by the Court of Appeal: [1990] ILR 1-2599 (BCCA) at p. 10,123

<sup>156</sup> *R. v. Dick*, [1984] ILR 1-1755.

<sup>157</sup> See for example *R. v. Horne* (1996), 34 OR (3d) 142 (Gen. Div.). Orders are also permitted, though perhaps more cautiously, under the *Young Offenders Act*: see e.g. *R. v. C.* (May 11, 1989), Q.B.Y.O. Nos. 1 and 2 of 1989 J.C.B., Judicial Centre of Battleford (SKQB).

intended to supplant civil remedies, and that such orders should only be made with “restraint and caution”.<sup>158</sup>

## V. PROCEDURAL ASPECTS OF SUBROGATION

### 1. WHO CONTROLS THE LITIGATION BEFORE THE INSURER HAS PROVIDED FULL INDEMNITY TO THE INSURED?

As noted above, several provinces across Canada have enacted new Insurance Acts, which do away with the distinction between policies of fire insurance and other policies. The new legislation contains language that alters the common law rule by permitting rights of subrogation after an insurer has provided only a partial rather than a complete indemnification of the insured's loss.

In addition, many policies of insurance will contain subrogation sections which “mirror” the language of the legislation.

#### (a) Cases beyond the scope of Insurance Acts’ subrogation sections

In the provinces that continue to rely on “old” Insurance Acts, there remains a distinction between different classes of insurance. For example, Ontario’s *Insurance Act* contains subrogation provisions only with respect to fire and automobile insurance. For property policies not governed by subrogation provisions in the Insurance Acts, the insured retains the right to sue the wrongdoer and control the litigation until the insurer has provided full indemnity for the loss and indemnified the insured for its legal costs.<sup>159</sup> However, once it has been partially indemnified, the insured must conduct the litigation for the benefit of the insurer and itself.<sup>160</sup> The New Zealand Court of Appeal adopted with approval the following passage from *MacGillivray and Parkington on Insurance Law*:

The assured is entitled to control any proceedings brought in his name until he has received complete indemnity, that is to say, if the insurer has not paid what is in fact a complete indemnity for all damages insured or uninsured arising from the same cause of action as the damage in respect of which payment has been made the assured remains *dominus litus* until he has recovered a complete indemnity, and if he undertakes to prosecute his claim for the whole damage the insurers cannot interfere. The assured must conduct the litigation with proper regard for the insurers' interest, and will be liable in damages for any misconduct or for any abandonment of rights. If the assured recovers judgment the insurers have a lien thereon for the amount to which they are entitled to be subrogated.<sup>161</sup>

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<sup>158</sup> The leading case of *R. v. Zelensky*, [1978] 2 SCR 940, as referred to in both *R. v. Horne*, *supra.*, and *R. v. C.*, *supra.*

<sup>159</sup> *Commercial Union Assurance Co. v. Lister* (1874), L.R. 9 Ch. 483.

<sup>160</sup> *Arthur Barnett v. National Insurance Co. of New Zealand* (1965), N.Z.L.R. 874 at p. 884.

<sup>161</sup> 5th ed., p. 921, para. 1898.

Frequently in liability policies the subrogation clause of the insurance contract will stipulate that the insured is obliged to cooperate as required in whatever is considered to be in the best interests of the insurer. One example, quoted at the outset of this paper, states:

In the event of any payment under this policy and to the extent of such payment, the Company shall be subrogated to all the Insured's rights of recovery therefore against any person or corporation and the Insured shall execute all papers necessary and shall cooperate with the Company to secure to the Company such rights.

The question may be asked, assuming the insured does undertake litigation, is the insurer obligated to pay a portion of the costs associated with obtaining recovery? This question commonly arises in cases where the maximum amount of available coverage is insufficient to cover the full amount of the actual loss suffered by the insured. Had the insurer initiated the litigation there would be no question that the costs were for the account of the insurer. If, however, the insured undertakes such proceedings it seems the insurer is not obligated to immediately contribute a share of the costs of making recovery. In *Arthur Barnett Ltd. v. National Insurance Co. of New Zealand*,<sup>162</sup> the insured had undertaken litigation on its own account. The policy stated:

The insured shall, at the expense of the company, do and concur in doing, and permit to be done, all such acts and things as may be necessary or reasonably required by the company for the purpose of enforcing any rights and remedies, or of obtaining relief or indemnity from other parties to which the company shall be or would become entitled or subrogated, upon its paying for or making good any loss or damage under this policy, whether such acts and things shall be or become necessary or required before or after his indemnification by the company.

If the insurer invokes the clause by caning upon the insured to act it will be obligated to pay a portion of the costs, but if the insured elects of its own accord to proceed with litigation, it cannot require the insurer to bear a portion of the costs.<sup>163</sup> However, as was outlined earlier, the insured is entitled then to deduct its full legal costs from the amount of any recovery to which the insurer has a subrogated claim. In the result, the insurer is not directly obligated to actually pay part of the costs of litigation, but the insured can deduct such costs from the gross amount which the principles of subrogation require it to pay over to the insurer.

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<sup>162</sup> (1965), N.Z.L.R. 874.

<sup>163</sup> *Supra*, at p. 884.

It is important to bear in mind that an insurer's right to the proceeds of litigation against the author of a covered loss is entirely dependent on its having paid for the insured's loss. A right to the proceeds of litigation is one aspect of the right of subrogation, and rights of subrogation do not arise unless an indemnity has been paid. This fundamental principle is well illustrated by the Saskatchewan case of *APM Operators Ltd. et al v. Allendale Mutual Insurance Co.*<sup>164</sup> The insured, a mine operator, suffered a property loss. A claim was made under the policy and denied by the insurer; an action on the policy was commenced. On the eve of the expiry of the limitation period which governed the cause of action against the person who caused the loss, the insurer's counsel wrote to the insured's counsel in the following terms:

We understand that, as of this date, the insureds have not commenced an action against any of the [wrongdoers].... It is the position of [the insurer] that ... the insureds are required to commence an action prior to the expiry of the limitation period .... Our clients have instructed us to advise you that if, prior to the expiration of the limitation period, the insureds have not commenced an action against [the wrongdoers] ... we are to seek an amendment to the [insured's action for recovery on the insurance policy] .... that the insureds have voided their right of recovery, by acting so as to impair the insurers' potential right of subrogation.<sup>165</sup>

The insured refused to sue the wrongdoer; the insurer then sought to amend its Statement of Defence to the insured's claim on the policy, asserting the insurer's right to reduce the amount payable under the policy by the amount which could potentially have been recovered against the potential defendants. The Court refused to allow the amendment to be made, ruling that until the insurer had indemnified the insured, no subrogation rights arose and until that point was reached there did not exist, on the part of the insured, an obligation to even commence litigation. The Court did leave open the question whether an insurer could expressly stipulate for such rights in the contract of insurance, but in the absence of clear wording to that effect the insurer could not assert any rights of subrogation without first providing coverage.<sup>166</sup>

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<sup>164</sup> (1984), 9 CCLI 136.

<sup>165</sup> *Ibid.*, at 138.

<sup>166</sup> See also the novel decision in *McMurachy v. Red River Valley Mutual Insurance Co.* (1994), 22 CCLI (2d) 1, [1994] ILR 1-3093 (Man. C.A), which decided that an insured who had had coverage denied in respect of liability in a tort claim was free to enter into a reasonable settlement with the tort claimant, and following settlement, to assign to that claimant its cause of action against the insurer in exchange for a release of personal liability. The Court noted that in the face of a wrongful denial of coverage, the insured was free to make a reasonable settlement and the insurer was *not* relieved of its obligation to indemnify under the policy. The Court further found that the terms of the release in favour of the insured did not render the insurer no longer "legally liable to pay" but rather, the insurer's liability "crystallized" at the latest, when the settlement was consummated (i.e. before the release document was drafted), and possibly earlier, on the happening of the



**(b) Cases subject to new Insurance Acts, and property policies which incorporate language of new Acts**

An example of the subrogation provisions that can be found in the new Insurance Acts is section 36 of British Columbia's *Insurance Act*, which provides as follows:

- (1) The insurer, on making a payment or assuming liability under a contract, is subrogated to all rights of recovery of the insured against any person, and may bring an action in the name of the insured to enforce those rights.
- (2) If the net amount recovered after deducting the costs of recovery is not sufficient to provide a complete indemnity for the loss or damage suffered, that amount must be divided between the insurer and the insured in the proportions in which the loss or damage has been borne by them respectively.

Clearly this legislation provides an additional advantage to insurers by permitting rights of subrogation after having provided only a partial rather than a complete indemnification of the insured's loss. In this regard these provisions change the common law. The question then becomes to what extent do these provisions alter the common law rules relating to an insurer's right to conduct any lawsuit against persons who may have caused the loss?

The British Columbia Court of Appeal examined this question in the context of section 130 of the Old Act (the predecessor of s. 36, which applied only to fire insurance policies) in *Farrell Estates Ltd. v. Canadian Indemnity Company et al.*<sup>167</sup> In light of the decisions in *Farrell Estates* and *Ison*, it appears clear that the insured does maintain control of any litigation unless and until it has been fully indemnified.

In *Farrell Estates* the insured had been partially indemnified. Both the insured and the insurer, having commenced their own lawsuits, were vying for the right to be in control of the litigation. In ruling that it is the insured who has the right to control the legal proceedings against a tortfeasor unless and until fully indemnified, the Court of Appeal seems to have implicitly accepted that Section 130 permitted an insurer, upon making a payment or assuming liability under the property policy, to have a right to share in the recovery from the tort proceedings, while the insured had the sole right to commence and maintain the action, including the right to settle the case.

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tortious incident. With an eye to American precedent in this area, the Court stated that in such cases, "In circumstances where an insured is obliged to protect herself as a result of an insurer's wrongful denial of coverage, it is plainly wrong in my view to determine whether rights in the policy continue to be effective based on the technical form of the documentation used as opposed to the intended consequences of the settlement and assignment." (at p. 2979)

<sup>167</sup> [1993] ILR 1-2970 (ABQB)

In the result, Section 130 of the old *Insurance Act* (and presumably, the subrogation provisions of the new *Insurance Acts*), while altering the common law rule as to when subrogation rights vest, does not alter the common law rule that the insured can maintain control of the legal proceedings until fully indemnified. As Mr. Justice Lambert stated, in comparing the common law position with the position under section 130 of Part 5 of the Old Act:

[I]t is, in my opinion, the sounder view, as well as the better view under the wording, to conclude that the common-law position as to entitlement to control of the action for recovery remains unchanged by s. 224. If the insurer wishes to control the litigation then the contract of insurance must provide for complete indemnity of the insured, and the complete indemnity must be paid. The result is that if the insurance contract provides for a deductible then the insured rather than the insurer will control the litigation. I suppose the insurer could gain control by waiving the deductible, if that seemed worthwhile.<sup>168</sup>

In 2011, the Ontario Supreme Court of Justice analysed this issue, and the decision in *Farrell Estates, in Zurich Insurance Company Ltd. v. Ison T. H. Auto Sales Inc.*<sup>169</sup> In *Ison*, the defendant, an automobile dealer trading as Toronto Honda, was insured under a policy of insurance issued by Zurich. Toronto Honda had stored 71 new cars in an underground parking lot, which were damaged by an explosion and fire.

Ison made a claim under its policy and was paid \$1.9m for its loss. Zurich subsequently recovered \$900,000 in salvage for the cars, leaving a “shortfall” of approximately \$1m. Ison initiated a subrogated claim for its “uninsured claim”, consisting of losses of profits and goodwill, in the amount of \$700,000. Zurich sought a declaration from the court for a declaration that it was entitled to have carriage and control of the subrogated action.

Following a “masterful” analysis and conclusion of the issues,<sup>170</sup> Mr. Justice Strathy dismissed Zurich’s application. The Court noted, at paragraph 70, as follows:

...the case law in Ontario, as well as the decision of the British Columbia Court of Appeal in *Farrell Estates*, confirms that the insured is in control of the litigation, or dominus litis, until it has been fully indemnified for its insured and uninsured losses.

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<sup>168</sup> *Ibid.* at 10124.

<sup>169</sup> 2011 ONSC 1870 (affirmed, *Zurich Insurance Company Ltd v. Ison T.H. Auto Sales Inc.*, 2011 ONCA 663).

<sup>170</sup> As described by the Court of Appeal in its decision

The Court confirmed the meaning of “fully indemnified” as paragraph 34 of its judgment:

"Fully indemnified" means not only indemnified for all losses covered by the policy, but also indemnified for uninsured losses, such as the insured's deductible, losses in excess of the policy limits and losses (such as business losses) that are not covered by the policy.

Despite the above, the Court left the door open to an insurer to argue that it should have control of the litigation if the insurer's interest *“is so vastly disproportionate to the insured's interest that it would be unreasonable to allow the latter to have control of the litigation”*.

The Court noted that there was nothing in the subrogation clause of the insurance policy in question to alter Ison's common law right to control the litigation. The Court commented:

it would be a simple matter for the insurers to amend the Subrogation Clause to alter the common law position and to give carriage to the insurers, if they wished to do.

An alternative option to the above was also discussed by the Court, namely a discussion and agreement with respect to subrogation at the time the insurance claim is paid out. We suggest that a useful subrogation agreement will address the following issues:

- who controls the litigation;
- choice of counsel;
- how the recovered proceeds are allocated between insured and insurer;
- payment of fees and expenses; and
- resolution of any dispute between insurer and insured.

In reality, it is rare to find an insured who has been “fully indemnified” as the term is described by the Court in *Ison*. Insureds will invariably claim to have incurred uninsured losses and almost all policies require payment of a deductible. It follows that, in almost all cases, an insured is legally entitled to control the subrogation litigation. However, as insurers are well aware, in practice, this rarely happens. In many cases, the insured (and sometimes, the insurer) is simply unaware they have the right to control the litigation. Even if they were aware, most insureds would likely be content to allow the insurer to control the litigation, especially if the insurer offered to fund the recovery of the insured's uninsured loss. Given this reality, insurers may ask: when is it worth entering into a subrogation agreement?

An insured is more likely to assert its right to control the litigation when the uninsured loss is substantial. In addition, a “sophisticated” insured is more likely to be aware of its right to

control the litigation. Another factor is the proportionate amount of the insured and uninsured loss. For example, if an insured only recovers 10% of its total loss, it is more likely to be interested in controlling the litigation. These factors are by no means exhaustive, but operate as "red flags" that should alert insurers to the need to address this issue as early in the process as possible (ideally at the time the claim is paid).

In situations where an insured has the right to settle an action, insurers are concerned to know whether they can participate in determining the terms of settlement, or the proper allocation of any proceeds. Some property policies deal with these questions by including a "concurrence clause" which states:

A settlement or release given before or after an action is brought does not bar the rights of the insured or insurer, as the case may be, unless they have concurred therein.

If the insurer makes a payment, or, assumes liability, in accordance with the terms of Section 130 of the Act, and the policy contains a "concurrence clause", the insured's act in unilaterally settling or abandoning the claim may afford the insurer a claim against the insured for damages.<sup>171</sup>

## **2. USING THE PROOF OF LOSS TO OBTAIN RIGHTS OF SUBROGATION**

The standard IBC Proof of Loss stipulates that:

All rights of recovery from any other person are hereby transferred to the Insurer which is authorized to bring action in the Insured's name to enforce such rights.

The practical issue is whether the subrogation clause in the IBC Proof of Loss overcomes the rigours of the common law doctrine, and the requirements of subrogation provisions of the Insurance Acts, as both require full indemnity as a condition precedent to the insurer's right to commence and maintain litigation. The answer to this question clearly is "no". This is so for two reasons: first, the filing of a Proof of Loss is not equivalent to the grant of a contractual right which amounts to good and valuable consideration. On basic principles of the law of contract, good consideration must be provided by the insurer as a precondition of being granted any additional rights of subrogation over and above those rights arising from the common law or by statute; second, the language of the IBC Proof of Loss subrogation clause is not materially different from the language used in the Insurance Acts,

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<sup>171</sup> *Toronto Hydro-Electric Commissioners et al. v. Budget Car Rental Ltd. et al.* (1983), 3 CCLI 49 (Ont. Ct. Ct.), cited with approval in *Daniele v. Johnson* (1997), 46 OTC 76 (Ont. Sup. Ct. J.); *Bates-Pasis Leasing Inc.* (1976), 11 OR (2d) 409.

which has been interpreted not to allow insurers to have control of litigation unless a full indemnity has been provided.

Insurers desire to know whether a Proof of Loss form can be effectively worded so as to vest an insurer with the right to commence subrogated proceedings upon partial payment or an assumption of liability. This is not legally possible, because of prohibitive language that accompanies the statutory conditions of insurance legislation, which provides that no variation or omission of or addition to a statutory condition is binding on the insured.

However, in the writer's view there is nothing preventing insurers from effectively achieving that desired business result in one of two ways:

- (a) the insurance policy could be amended to expressly provide that the insurer has the right to commence and maintain litigation on payment of only a partial indemnity;
- (b) In provinces that rely on the old legislation, certain classes of insurance are not limited by the prohibitive language noted above. As such, the insurer could modify the Proof of Loss in such cases, assuming there is good legal consideration, to confer a right to commence and maintain litigation simply upon making a payment or assuming liability.

### **3. THE INSURED WHO SETTLES THE ACTION WITHOUT PROTECTING THE INTERESTS OF THE INSURER**

In situations where an insured has the right to settle an action, and in the absence of an agreement to the contrary, insurers are concerned to know whether they can participate in determining the terms of settlement, or the proper allocation of any proceeds.

An insured is legally obligated to identify the insurer's interest when commencing proceedings for the recovery of a covered loss.<sup>172</sup> An extension of that general rule is that the insured, in settling a claim which includes both its interest and that of the insurer, must have reasonable regard to the interests of the insurer. If the true value of each claim cannot clearly be ascertained the insured is given considerable latitude in ascertaining the acceptability of any offer of settlement. This position is succinctly stated in *A. Barnett Ltd. v. National Insurance Company of New Zealand*:

The obligation of an insured towards his insurer if the insured does launch proceedings against third parties is, as I have said, to act bona fide and with proper

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<sup>172</sup> *Arthur Barnett v. National Ins. Co. of New Zealand, supra.*

regard to the insurer's rights. Where the act or omission alleged against the third party clearly caused the whole of the loss, I believe that an insured, if he does not sue for the whole of that loss, will be in danger of being held liable for abandoning rights to which the insurer is entitled. But where, as in this case, the amount of the loss can fairly be said to flow from the particular act or omission is incapable of precise estimation and is very much in dispute, all that an insured is obliged to do, when fixing the amount of his claim, is to state a sum which he believes can fairly and justly be sought, bearing in mind the insurer's rights to be reimbursed to the maximum extent reasonably possible.<sup>173</sup>

In *Ison, supra*, the insurance policy in question contained the following subrogation clause:

The Insurer, upon making any payment or assuming liability therefor under this Policy, shall be subrogated to all rights of recovery of the Insured against any person, and may bring action in the name of the Insured to enforce such rights.

. . . [This paragraph waives subrogation against affiliates or subsidiaries of the named insured and against other named insureds and dealers] . . .

Where the net amount recovered after deducting the costs of recovery is not sufficient to provide a complete indemnity for the loss or damage suffered, that amount shall be divided between the Insurer and the Insured in the proportion in which the loss or damage has been borne by them respectively.

Any release from liability entered into by the Insured prior to loss hereunder shall not affect this Policy or the right of the Insured to recover hereunder.

The Court noted that the effect of the clause, including the right of the insurer to share proportionately in recoveries, coupled with the duty of good faith:

...will require the insured, although in control of the litigation, to consider the insurer's interests, to keep the insurer informed concerning the status of the litigation and concerning major issues in the litigation, and to consult with the insurer with respect to the prosecution of the litigation.

As such, in most cases where the insured controls the litigation, the insurer can take a certain amount of comfort from the fact that the insured owes a duty to consider the insurer's interests during its conduct of the litigation. However, what happens if the insured ignores this duty and settles a subrogated action without properly considering the rights of the insurer?

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<sup>173</sup> *Ibid.* at 886.

Some property policies deal with this potential problem by including a "concurrence clause" which states:

A settlement or release given before or after an action is brought does not bar the rights of the insured or insurer, as the case may be, unless they have concurred therein.

As such, if the insurer makes a payment, or, assumes liability in accordance with the provisions of the applicable *Insurance Act*, and the policy contains a "concurrence clause", the insured's act in unilaterally settling or abandoning the claim may afford the insurer a claim against the insured for damages.<sup>174</sup>

If the insured's conduct in settling the insurer's claim amounts to "bad faith", or, its power of control is not exercised "fairly and justly",<sup>175</sup> then the insured can be held accountable to the insurer for the amount in which it has been unjustly enriched in the settlement process.<sup>176</sup>

If the third party settling with the insured is aware of the insurer's subrogated interest, there are circumstances in which the release may be void and of no effect in terms of the insurer's ability to subsequently maintain an action for its subrogated interest. There is mixed Canadian judicial support for the view that a release given to a third party by the insured will not bind a subrogated insurer if at the time the third party was aware that the insured previously had received a payment from the insurer.<sup>177</sup> There is U.S. jurisprudence to the same effect.<sup>178</sup>

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<sup>174</sup> *Toronto Hydro-Electric Commissioners et al. v. Budget Car Rental Ltd. et al.* (1983), 3 CCLI 49 (Ont. Ct. Ct.), cited with approval in *Daniele v. Johnson* (1997), 46 OTC 76 (Ont. Sup. Ct. J.); *Bates-Pasis Leasing Inc.* (1976), 11 OR (2d) 409.

<sup>175</sup> *Supra*, at 883-884.

<sup>176</sup> *West of England Fire Insurance Co. v. Isaacs* (1897), 1 Q.B. 226; *Phoenix Ass. Co. v. Spooner* (1905) 2 K.B.; *Law Fire Ass. Co.* (1888), 4 T.L.R. 309

<sup>177</sup> In support of same, see *Busgos v. Khamis et al.* (1990), 48 CCLI 233 (Ont. Dist. Ct.). However, the Court in *BH Shopping Centre Ltd. v. Marrazzo* (1993), 13 Alta. L.R. (3d) 304, [1994] ILR 1-3035 (Q.B.) specifically disapproved of *Busgos* and denied that this was the law in Alberta, finding instead that "in my view, the notice given to the defendants does not preserve a subrogated right to pursue the defendants. The notice should more properly have been given to the insured to alert him not to settle or dispose of the action until the insurers were satisfied that such was proper." See also *Tucker v. Tucker* (1997), 159 Nfld. & P.E.I.R. 269 (Nfld. SC), which considered the effect of a partial release which reserved the insurer's right of subrogation.

<sup>178</sup> *Home Insurance Co. v. Hertz Corp.* 71 Ill. 2d 210, 375 N.E 2d 115 (1978); *Leader National Insurance Co. v. Torres et al.* 779 P.2d 722 (Wash. 1989).

#### **4. WHAT HAPPENS IF THE INSURED OR INSURER CONCLUDE THEIR ACTION: CAN THE OTHER PARTY STILL MAINTAIN LEGAL ACTION?**

While, practically speaking, an insured and an insurer might consider themselves to have separate interests and separate claims to pursue against the author of a covered loss, the law in Canada is that there exists only one cause of action for one wrong.<sup>179</sup> So, for example, if an insurer settles or concludes an action for property damage to a vehicle, the insured's cause of action for bodily injury is extinguished.<sup>180</sup> For that reason insurers and insured must be cautious not to unfairly extinguish the other's cause of action, for to do so may result in exposure to a claim for damages.

#### **5. AVOIDING THE PROBLEMS OF SUBROGATION: USE OF THE 'LOAN RECEIPT' AND AN ASSIGNMENT**

In the United States the rules of procedure practically require that subrogated proceedings be brought in the name of the insurer, not the insured.<sup>181</sup> The rule is otherwise in Canada.<sup>182</sup> Often American insurers attempt to shield their interest in a lawsuit from juries resorting to the device of a "loan receipt", to avoid the appearance that the insurer is involved in the litigation.

The device of a "loan receipt" is a contract which contemplates that the insurer will provide a non-interest bearing loan to the insured for the full amount of the claim. The loan is repayable if and when the insured is able to recoup its full loss through tort proceedings. The agreement will normally provide that: (a) the insured agrees to commence and maintain litigation; and (b) the insured win appoint the insurer's counsel as its counsel to prosecute the claim. When the action is concluded the insurer repays itself from the proceeds of the lawsuit, with the insured retaining any balance. A sample loan receipt is appended to this paper as Schedule "A".

The practical advantage of the "loan receipt" in the Canadian legal context arises when the insurer is confronted with a property loss which is doubtfully within coverage. The insurer is properly concerned that there may be a judicial determination, long after the loss, that the property insurer is not obligated to indemnify under the policy. Equally, the insurer is concerned to preserve any potentially valuable rights of subrogation; i.e. when it is fairly

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<sup>179</sup> *Cahoon v. Franks*, [1967] SCR 455.

<sup>180</sup> *Fortino v. Rudolph* (1983), 32 CPC 315: application for leave to appeal dismissed on April 8, 1983 (Ont. Div. Ct.). See also *Trudel v. Seguin* (November 30, 1998), Court File No. 73497 (Ont. Gen. Div.), where the court dismissed the insured's action against the defendant, finding that it was *res judicata*, but noted that there was "little, if any" prejudice resulting to the insured, in that the insured had also named his insurer as a defendant in the action.

<sup>181</sup> Federal Rule of Civil Procedure 17(a) states: Every action shall be prosecuted in the name of the real party in interest

<sup>182</sup> *Sainas v. Sainas* (1968), 66 DLR (2d) 753 (BCSC); *USA v. Bulley, et al* (1991), 49 CCLI 257 (BCCA)



clear that there is a wrongdoer who will be obligated to ultimately meet the claim. For reasons discussed earlier, the insurer cannot compel the insured to commence proceedings nor can the insurer seek to deduct the benefit of any tort recovery from the amount obligated to be paid under the property policy. Assuming that tort recovery is reasonably certain the insurer might be well advised to advance the claim under a loan receipt agreement, and then seek to reimburse itself from the subsequent tort settlement or judgment. That allows the insurer to recover the proceeds where there is arguably no coverage, or, there is evidence of a policy breach. This solution is only viable if the insurer can be satisfied that there exists a worthwhile opportunity of recovery. However, in those circumstances the use of the loan receipt can avoid non-recoverable advances under the policy in circumstances where indemnity is truly in doubt.

Similarly, the use of an assignment can overcome many of the practical difficulties confronting insurers who do not possess a right to maintain subrogated proceedings. If the insurer alters the wording of the policy to provide for a right of assignment then the cause of action can be brought immediately in the name of the insurer. Assignment is quite distinct from subrogation and therefore not governed by Section 130(1) of the Act or the range of contractual subrogation provisions typically used by insurers.

In the United States, a bankers' blanket bond will customarily contain an assignment provision, in addition to a subrogation provision, which provides:

In the event of payment under this bond, the insured shall deliver, if so requested by the underwriter, an assignment of such of the insured's right, title and interest and causes of action as it has against any person or entity to the extent of the loss payment.

Theoretically, an assignment can be made contingent upon the fact of a loss. To ensure that the assignment is "perfected", i.e. fully enforceable in the insurer's own name, the insurer must provide notice in writing to the potential tortfeasor pursuant to Section 36 of the *Law and Equity Act*, RSBC 1996, c. 253, whereupon the insurer can sue on the cause of action in its own name, without the further cooperation of the assured.

Section 36 reads:

*Assignment of debts and choses in action*

- 36.(1) An absolute assignment, in writing signed by the assignor, not purporting to be by way of charge only, of a debt or other legal chose in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to receive or claim the debt or chose in action, is

and is deemed to have been effectual in law, subject to all equities that would have been entitled to priority over the right of the assignee if this Act had not been enacted, to pass and transfer the legal right to the debt or chose in action from the date of the notice, and all legal and other remedies for the debt or chose in action, and the power to give a good discharge for the debt or chose in action, without the concurrence of the assignor.

- (2) If the debtor, trustee or other person liable in respect of the debt or chose in action has had notice that the assignment is disputed by the assignor or anyone claiming under the assignor, or of any other opposing or conflicting claims to the debt or chose in action, the debtor, trustee or other person
  - (a) is entitled to call on the persons making the claim to interplead concerning the debt or chose in action, or
  - (b) may pay the debt or chose in action into court, under and in conformity with the Trustee Act.

## 6. SUING IN THE NAME OF THE INSURED

In Canada, the insurer is obligated to maintain subrogated proceedings in the name of the insured.<sup>183</sup> If the insured is a natural person and dies, the proper approach is not to substitute the insurer, but rather, the estate administrator or the administrator ad litem.<sup>184</sup> However, at a procedural level the Courts appear quite forgiving of departures from this rule. Even if the governing limitation period has expired, the Courts will permit the insured to be substituted as a plaintiff in place of the insurer.<sup>185</sup>

## 7. “DOUBLE” INSURANCE

It is not uncommon for an individual or corporation to hold more than one policy with respect to a given risk. The provincial *Insurance Acts* contain provisions that confirm that multiple insurers of the same risk are each liable to the insured for their rateable proportion of the loss.

As such, if only one of the insurers indemnifies the insured, the question may arise as to whether the paying insurer can maintain a subrogated action in the name of the insured against the non-paying insurer, for contribution towards the amount paid.

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<sup>183</sup> *Sainas v. Sainas* (1968), 66 DLR (2d) 753 (BCSC); *USA v. Bulley et al* (1991), 49 CCLI 257 (BCCA). Note, however, that certain statutes may allow the insurer to sue in its own name: see e.g., Ontario's *Health Insurance Act*, RSO 1990, c. H-6, s.30; see also *Mason (Litigation Guardian of) v. Ontario (Ministry of Community and Social Services)* (1998), 39 OR (3d) 225 (CA).

<sup>184</sup> *Arsenault v. Weber* (1985), 14 CCLI 192; Sections 65 and 66(2) of the *Estate Administration Act*.

<sup>185</sup> *Insurance Corporation of British Columbia v. Piche* (1983), 1 CCLI 155 (BCCA).

This question was considered by the B.C. Court of Appeal in 2003 in *Pacific Forest Products Ltd. v. AXA Pacific Insurance*,<sup>186</sup> and by the Saskatchewan Court of Appeal in 2010 in *Insurance Company of the State of Pennsylvania v. Cameco Corporation*.<sup>187</sup>

In *Pacific Forest*, the insured logging company was an insured under two liability policies. Following a forest fire the insured claimed under one policy and was fully indemnified. The paying insurer then issued a claim in the insured's name against the non-paying insurer for the amount of that insurer's policy limits.

The Court of Appeal confirmed that a paying insurer's claim for contribution from a non-paying insurer is not properly brought by way of a subrogated claim in the insured's name. Rather, the claim should be brought in the name of the property insurer seeking contribution and indemnity. The insured, once fully indemnified, had no cause of action against the non-paying insurer.

*Pacific Forests* was considered by the Saskatchewan Court of Appeal in *Insurance Company of the State of Pennsylvania v. Cameco Corporation*. The insured, Cameco, held three liability insurance policies. Several actions were commenced against the insured following the death of ten Canadians in a helicopter accident in Kyrgyzstan in 1995. One of the insurers defended and settled the claims, constituting a full indemnity to the insured. The paying insurer initially sought to issue a claim for equitable contribution against the non-paying insurers, but was advised that the claim was statute barred by limitation legislation. In an effort to overcome this problem the insurer took steps to convert the action into a subrogated action in name of the insured.

The Court of Appeal confirmed that once an insured has been fully indemnified by one insurer, its right to commence an action against other insurers of the same risk is extinguished. If the paying insurer seeks equitable contribution from a non-paying insurer, it must commence a contribution action in its own name, to determine the proportionate liability between the insurers.

We suggest that in order for insurers to avoid unnecessary legal expenses and potentially unwelcome results it is crucial to understand the difference between an equitable contribution action, which determines proportionate liability of multiple insurers, and subrogated actions, which concerns an insured's claim against a third party for the whole amount paid by way of the indemnity.

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<sup>186</sup> 2003 BCCA 241

<sup>187</sup> 2010 SKCA 95

## 8. PRODUCTION OF THE INSURER'S FILE AND EXAMINATION FOR DISCOVERY OF THE INSURER IN SUBROGATED PROCEEDINGS

The Rules of Court in many of the provinces contain a rule similar to British Columbia's Rule 7-2(6) which provides:

(6) Subject to subrule (9), a person for whose immediate benefit an action is brought or defended may be examined for discovery.<sup>188</sup>

While, generally speaking, much of the insurer's file will contain documents relevant to the matters in issue in a subrogation proceeding, there will always be a portion of the insurer's file which relates to its dealings with the insured under the terms of the policy. Attempts have been made by tortfeasors to gain full access to the insurer's file, or to conduct discoveries of the insurer, rather than the insured, on the basis of Rule 7-2(6) or its equivalent in other provinces.

Some courts, particularly in Alberta, have taken the view that even if the action is a subrogated one the insurer cannot be compelled to produce its file in the tort action.<sup>189</sup> That is so because the mere fact that the insurer is entitled to a portion of the proceeds is not sufficient to satisfy the rule; *i.e.*, fit within the definition: "for whose immediate benefit an action is brought". It has been suggested, by inference, that if the insurer has entirely directed the litigation and formulated the claims the result might be otherwise.<sup>190</sup> The Ontario Courts have taken a more liberal view of the matter and permitted discovery of the insurer's representative if the action is a subrogated one.<sup>191</sup>

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<sup>188</sup> The Ontario equivalent, Rule 333(1) provides:

"333(1) Where an action is prosecuted or defended for the immediate benefit of a person or a corporation, such person or any office or servant of such corporation may without order be examined for discovery."

<sup>189</sup> *Esso Resources Canada Ltd. et al v. Steams Catalytic Ltd. et al* (1990), 41 CPC (2d) 222 (ABQB).

<sup>190</sup> *Ibid.* at 226.

<sup>191</sup> *Consumers Glass Co. v. Farrel Lines Inc.* (1982); 39 OR (2d) 696; 30 CPC 293 (HC). Note that in *Alpha Leasing Ltd. v. Hodgson Machine & Equipment Ltd.* (1984), 41 CPC 137 (Ont. Master) the Court held that where an insurer brings a subrogated claim in the name of a nominal plaintiff, the defendant has a prima facie right to examine the nominal plaintiff. In an appropriate case, the insurer may substitute its own representative in place of the plaintiff, but such an order will not be made until the insurer has satisfied the onus on it to demonstrate that substitution is necessary under the circumstances; *i.e.* the insurer must offer persuasive evidence that it has exhausted "all reasonable efforts" to secure the cooperation and attendance of the plaintiff, who has a contractual duty to cooperate with the insurer. The court stated that such reasonable efforts "...would include sending the appropriate officer or servant of the insured a copy of the order contemplated by this judgment, and making it clear to the insured, in writing, of its obligation to co-operate through giving testimony and producing documents, and bringing home to it the consequences of such a default...and, failing all else, having the insurer attempt to obtain an attachment order from a Judge under [Ontario] R. 330..." (at p. 145).

*McRae v. Canada (Attorney General)* is interesting in that it supports the proposition that an insurer's file regarding a subrogated action is not privileged vis-à-vis its insured, or the "nominal plaintiff".<sup>192</sup> In *McRae*, the government employer had made income loss payments to an employee pursuant to a federal government employee compensation statute. The Court found that its position was analogous to that of an insurer. The government then brought a subrogated claim against the tortfeasor, and the employee cooperated in the government's furtherance of that action. However, the government settled the action without consulting with the employee, and the settlement included no payment for any general damages or other losses which had been sustained by the plaintiff. The plaintiff sued the government in negligence and for breach of fiduciary duty, alleging that the government's representative had assured her that her non-insured claims would be protected by the government in its action against the tortfeasor, and that they had unjustly compromised her rights. The plaintiff brought a motion for production of the file containing the government's instructions to the law firm in the subrogated action. The B.C. Court of Appeal allowed the plaintiff employee's motion, stating:

By reason of her personal interest in the claim against the wrongdoer the appellant must be viewed as a matter of law, and in particular the law as it relates to the discovery of documents, as a joint claimant along with the government.

...

Solicitor-client privilege is indispensable in the structure of our justice system. It is not to be lightly disregarded. Nevertheless, the defendant cannot claim privilege over communications in whose subject matter the plaintiff has a joint interest. If parties have a joint interest in the action there is no privilege between them at all: see *Hicks v. Rothermel*, [1949] 2 WWR 705 (Sask. K.B.); *Ontario (Attorney General) v. Ballard Estate* (1994), 20 OR (3d) 350 (Ont. Gen. Div. [Commercial List]); and *Sopinka et al.*, *Law of Evidence in Canada*, at 638-9.<sup>193</sup>

## 9. CAN A LIABILITY INSURER CHALLENGE A PROPERTY INSURER'S ASSESSMENT OF THE VALUE OF A GIVEN LOSS

Subrogating insurers are generally mindful of the possibility that in settling a property loss the payment of an unduly large sum might lead to disentitlement in the subsequent tort proceedings. It would be anomalous if an insurer, in good faith, valued a property loss only to be met by the argument that the sum paid was over inflated. However, it has been held that a subrogating insurer must nonetheless prove the plaintiff's damages as in the normal course and that a statement of the insurer's payments to the insured is insufficient.

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<sup>192</sup> (1997), 46 BCLR (3d) 137 (CA).

<sup>193</sup> *Ibid.*, at 148.

*Grosvenor Fine Furniture (1982) Ltd. v. Terrie's Plumbing & Heating Ltd. et al.* is instructive.<sup>194</sup> At the trial level, the Court made the following observations in coming to its valuation of the plaintiff's damages:

Unless there is evidence to the contrary, it should be assumed that the insurer who cannot count on being reimbursed for the amount it pays, has made every effort to minimize both the loss suffered by the insured and the payment in respect of that loss. So the amount actually paid by the insurer should be regarded as *prima facie* proof of the amount that should be paid by the wrongdoer.<sup>195</sup>

and that:

The insurer should simply be required to show that it acted reasonably in the circumstances and in good faith and if so, the measure of damages should be the amount actually paid by the insurer in settlement of the claim made against it. This appears to be particularly applicable where the defendant is also represented by an insurer and the action in reality is a battle between two insurance companies, being the plaintiff's property insurers and the defendant's liability carrier...<sup>196</sup>

However, on appeal, at least two of the three judges of the Alberta Court of Appeal viewed this statement as wrong in law.<sup>197</sup> In separate judgments, each of the judges on appeal stated that while the appropriate method of calculating damages must depend on the circumstances of each case, the proper approach to assessing damages *must* involve an independent assessment of the loss by the Court. Taking an insurer's estimate of the damages as *prima facie* proof does not fit within this paradigm. As stated by Lane J.A.:

I have a second concern with regard to the determination by the trial judge that "the amount actually paid by the insurer should be regarded as *prima facie* proof of the amount that should be paid by the wrongdoer." Taking this statement at face value means the assessment of damages has been delegated by the court to the insurer. The assessment of damages may be extremely complicated but the trial judge must do his or her best on the information available. The "evidence of accountants, while admissible and useful in many cases, cannot be conclusive. Assessment of damages is a task for the court, not for accountants" (Waddams,

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<sup>194</sup> (1991), 94 Sask R. 8 (SKQB), *aff'd* on other grounds (1993), 20 CCLI (2d) 215 (SKCA) (see discussion below)

<sup>195</sup> *Ibid.* at 10.

<sup>196</sup> *Ibid.* at 10-11.

<sup>197</sup> (1993), 20 CCLI (2d) 215, leave to appeal to SCC refused [1994] 1 SCR xi (note)

*The Law of Damages* (2nd ed.), p. 13-3) For these reasons I am of the view the trial judge committed an error in law.<sup>198</sup>

According to Lane J.A., taking the insurance payments as *prima facie* proof effectively “shifted the onus of proof from the plaintiff to the defendant”, and was a shift in the law of subrogation which ought not to be endorsed.

Wakeling J.A. expressed even stronger concerns with the trial judge’s approach. He started his discussion with a review of the fact that in Canadian law, the existence of insurance coverage has always been considered irrelevant, and in fact has been forbidden in civil jury trials. He found no historical support for the trial judge’s approach to damages, and noted that a subrogated action is at all times a derivative claim, no less and no more. He stated:

In my view, the damages in this trial should have been assessed as though neither insurer existed. The claim of the property insurer was based on subrogation which means it steps into the shoes of the insured. The claim for the cleaning loss should have been based on what was paid for and done by GFF and any consequent diminished value, the total of which would represent the damages proved irrespective of whatever sum was paid for clean-up by its insurer. In this case, it seems apparent that if the damages had been proven in this fashion they might well have been significantly less than the \$17,204.67 that was paid by the insurer. The same method of proof would apply to the merchandise loss. The loss would not be based on an insurance payout or a salvage purchase, but on the difference between what the furniture would have sold for if it had not been damaged as compared to what it did sell for in a damaged condition. In other words, the evidence would be directed to permit an assessment of what it would have taken to place the insured party in the same position as nearly as possible as it would have been in but for the damage which the furniture suffered. This is the normal and traditional approach to the proof of damages and I am not aware of any reason why that approach should be departed from when a claim of subrogation is involved.

Nor am I aware of any authority to suggest that damages ought to be proven differently if two insurance companies are involved. If I am not insured, I expect to pay for the damages that my negligence has caused, not that sum which some adjuster is prepared to recommend to an insurer of the damaged party. If I am insured, I expect my insurer to pay what I would have been required to pay had I not been insured and nothing more. That is not what has happened here.<sup>199</sup>

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<sup>198</sup> *Ibid.* at 267

<sup>199</sup> *Ibid.*, at 264-65

Despite the finding of error in law, the majority of the Saskatchewan Court of Appeal affirmed the trial judge's result, on the basis that the trial judge had heard and considered extensive expert evidence supporting the valuation, had independently assessed the credibility of such experts and the reasonableness of their findings, and in that sense, had not abdicated his responsibility to assess the loss and consequent damage. For that reason alone, the majority concluded that there had not been any substantial wrong or miscarriage of justice.

The Ontario Court of Appeal is apparently not so critical of accepting insurers' views on loss values when calculating damages. In the recent case of *Sin v. Mascioli*, the Ontario Court concluded:

The trial judge assessed the quantum of damages for the restaurant contents loss at the amount the insurer paid out under the contents insurance policy. The appellant argues that the insurer paid too much, and therefore the appellant's quantum of liability is too high.

The trial judge heard evidence as to how the insurer reached its decision on the quantum of its liability under the contents policy, and he heard evidence of quantum of loss on behalf of the appellant. The difference in the final figure was not great, and the trial judge was disposed to accept the figure arrived at by the insurer. There may be some cases where, because of carelessness of the adjuster, the amount paid by an adjuster could be shown to be too high. I expect that such cases would be extremely rare, and this is not one of them. The trial judge valued the loss on the basis of evidence before him which was adequate to decide this issue.<sup>200</sup>

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<sup>200</sup> [1999] ILR 1-3658 (ONCA)