Newsletter

IN THIS ISSUE

SUPREME COURT AFFIRMS DUTY OF GOOD FAITH IN CONTRACTS

In a decision released this month, *Bhasin v. Hrynew*, the Supreme Court of Canada affirmed a new duty on parties to perform contractual obligations honestly and in good faith.

The Court recognized that Canadian common law in relation to good faith performance of contracts is piecemeal, unsettled and unclear. Justice Cromwell, writing for an unanimous Court, stated that "finding that there is a duty to perform contracts honestly will make the law more certain, more just and more in tune with reasonable commercial expectations." Justice Cromwell added(*1):

> The notion of good faith has deep roots in contract law and permeates many of its rules. Nonetheless, Anglo-Canadian common law has resisted acknowledging any generalized and independent doctrine of good faith performance of contracts. The result is an "unsettled and incoherent body of law" that has developed "piecemeal" and which is "difficult to analyze": Ontario Law Reform Commission ("OLRC"), *Report on Amendment of the Law of Contract* (1987), at p. 169. This approach is out of step with the civil law of Quebec and most jurisdictions in the United States and produces results that are not consistent with the reasonable expectations of commercial parties.

The Court stated that it was time to take two incremental steps in order to make the common law more coherent and more just. The first step is to acknowledge that good faith contractual performance is a general organizing principle of the common law of contract that underpins and informs the various rules in which the common law, in various situations and types of relationships, recognizes obligations of good faith contractual performance.

FIRM AND INDUSTRY NEWS

- The **Canadian Board of Marine Underwriters** will be holding its fall conference at the Royal York Hotel on December 2nd 2014.

- The **Transportation Club of Toronto** will be holding its annual dinner at the Royal York Hotel in Toronto on December 4th 2014.

- **Gordon Hearn** has co-authored an article entitled "Shipping Between the United States and Canada: Conflicts of Law Considerations" which will be published in the December edition of "For The Defense" published by the Defense Research Institute.

- **Gordon Hearn** will be representing the firm at the Conference of Freight Counsel meeting being held in Captiva, Florida on January 10 and 11, 2015

- The **Fernandes Hearn LLP Annual Seminar** will be held in Toronto on January 15th 2015.

- **Gordon Hearn** will be representing the firm at the Chicago Regional Seminar meeting of the Transportation Lawyers Association being held on January 16, 2015

- The **Marine Club Annual Dinner** will be held in Toronto on January 16th, 2015 at the Royal York Hotel.

- **Rui Fernandes** will be speaking at the **Cargo Logistics Canada Conference** taking place January 28 & 29, 2015 in Vancouver BC. He will be speaking on “Risk & Liability in Global Shipping”.

FIRM AND INDUSTRY NEWS

Fernandes Hearn LLP 15th Annual Maritime and Transportation Conference

Date: **Thursday January 15th, 2015**
Location: The Advocates' Society Education Centre
250 Yonge Street, Suite 2700 Toronto
Cost: $65.00 - Includes light lunch and materials on USB Drive
Registration: Sharifa Green, Fernandes Hearn LLP 416-203-9500
Send cheques to: Fernandes Hearn LLP,
155 University Ave. Suite 700, ON M5H 3B7
Limited to 120 attendees 5.5 RIBO Credits (Technical Category)

Topics and Speakers:

8:00-8:30	**Registration & Coffee**	
8:30-8:45	Welcome	Rui Fernandes
8:45-9:15	Arising Issues in Cross Border Trucking	Gordon Hearn
9:15-9:45	Arising Insurance Coverage Issues: Drones, Cyber Attacks	Rui Fernandes
9:45 – 10:15	Casualty Investigations in Transportation	Kim Stoll
10:15 – 10:30	**Coffee Break**	
10:30-11:15	Mapping Emotional Claims in the Brain	Dr. D. Kumbhare, University Health Network
11:15-11:45	Quantification of Transportation / Cargo Claims	Matson Driscoll & Damico Ltd.
11:45-12:30	Personal Injury Claims in Transportation: Air & Marine	Kimberly Newton Mark Glynn
12:30-1:15	**Lunch**	Conference Centre
1:15-2:00	Panel: Accident Claim Panel	James Manson, David Huard
2:00 – 3:45	Mini Trial and Argument: Trucking Accident involving personal injuries, loss of perishable cargo, and load brokers. [Casualty Investigation, Sleep Apnea, Personal Injury, Loss Transfer, Cargo Loss Perishable Goods]	Firm Members: Rui Fernandes, Kim Stoll, James Manson, Tara Cassidy, Martin Abadi, Mark Glynn, Kimberly Newton

The second step is to recognize, as a further manifestation of this organizing principle of good faith, that there is a common law duty that applies to all contracts to act honestly in the performance of contractual obligations. Taking these two steps will put in place a duty that is just, that accords with the reasonable expectations of commercial parties and that is sufficiently precise that it will enhance rather than detract from commercial certainty.(*2)

In essence, the organizing principle is simply that parties generally must perform their contractual duties honestly and reasonably and not capriciously or arbitrarily.(*3)

It is important that the Court noted that the duty of good faith is not a duty of loyalty or a duty to put the interests of the other contracting party first. It is not intended to significantly displace the freedom of parties to pursue their own economic interests. Nor is it intended to be a basis for a court to scrutinize the motives of contracting parties or to impose its own sense of morality. It is not a fiduciary duty.

> The organizing principle of good faith exemplifies the notion that, in carrying out his or her own performance of the contract, a contracting party should have appropriate regard to the legitimate contractual interests of the contracting partner. While "appropriate regard" for the other party's interests will vary depending on the context of the contractual relationship, it does not require acting to serve those interests in all cases. It merely requires that a party not seek to undermine those interests in bad faith. This general principle has strong conceptual differences from the much higher obligations of a fiduciary. Unlike fiduciary duties, good faith performance does not engage duties of loyalty to the other contracting party or a duty to put the interests of the other contracting party first.
>
> This organizing principle of good faith manifests itself through the existing doctrines about the types of situations and relationships in which the law requires, in certain respects, honest, candid, forthright or reasonable contractual performance. Generally, claims of good faith will not succeed if they do not fall within these existing doctrines. But we should also recognize that this list is not closed. The application of the organizing principle of good faith to particular situations should be developed where the existing law is found to be wanting and where the development may occur incrementally in a way that is consistent with the structure of the common law of contract and gives due weight to the importance of private ordering and certainty in commercial affairs. (*4)

The Supreme Court recognized and affirmed that the principle of good faith must be applied in a manner that is consistent with the fundamental commitments of the common law of contract which places great weight on the freedom of the contracting parties to pursue their individual self interest.

This decision follows earlier Supreme Court of Canada decisions confirming the principle of freedom of contract in Canada and contract interpretation which this firm has commented on.(*5) In *Tercon Contractors Ltd. v. B.C.* [2010] 1 SCR 69 the Court set out the principle of freedom of contract in relation to exclusion clauses in contracts. In *Sattva Capital Corp. v. Creston Moly Corp.*, 2014 SCC 53 the court clarified the rules to be applied in the interpretation of contracts.

The Court in this newest decision also cautioned that the development of the principle of good faith in contracts must be clear not to veer into a form of *ad hoc* judicial moralism or "palm tree" justice. As a warning to judges, the Court stated that the organizing principle of good faith should not be used as a pretext for scrutinizing the motives of contracting parties. A party to a contract has no general duty to subordinate his

or her interest to that of the other party. However, contracting parties must be able to rely on a minimum standard of honesty from their contracting partner in relation to performing the contract as a reassurance that if the contract does not work out, they will have a fair opportunity to protect their interests. The duty of honesty does not require a party to disclose material information to the other contracting party; however, a party cannot "actively mislead" or deceive the other contracting party in relation to performance of the contract.

The duty of honest contractual performance applies to all contracts and cannot be excluded by contractual language. However, in some circumstances, parties may establish their own standards for satisfying the duty, as long as they respect the core requirements of the duty.

The Court did not address the existence of a duty to negotiate in good faith. It may be implied, however. Where the parties have agreed to negotiate future rights in good faith, a key issue that remains to be determined is how the duty of honest contractual performance can be reconciled with the adversarial nature of such negotiations. Parties likely would not be expected to disclose their negotiating positions, but they will certainly be required to avoid any steps that could be viewed as actively misleading, dishonest, or deceptive.

The application of this decision by lower courts will be interesting to follow. Will it lead to renewed intervention by judges into contracts on the basis of "fairness" and "equity"? Will it lead to uncertainty and erosion of freedom of contract? Hopefully it will not. There is a clear warning that the principle must not veer into a form of *ad hoc* judicial moralism. Time will tell.

Rui Fernandes

Endnotes
(*1) 2014 SCC 71 at paragraph 32
(*2) At paragraph 33
(*3) At paragraph 63
(*4) At paragraphs 65, 66
(*5) See the Fernandes Hearn newsletters of February 2010 and August 2014.[2014] UKSC 15

2. *The Boat that Fell Over During the Night*: Some Important Lessons in Reducing your Claims Exposure with a Proper Contract and in Litigation Management

The case of *Forsey v. Burin Peninsula Marine Service Centre* (*1) concerns the sad tale of the vessel "EASTERN GAMBLER". This vessel fell from it's on-land "cradle" on July 10, 2011 during on-land storage at the Burin Peninsula Marine Service Centre in Fortune, Newfoundland. Forsey, the owner, brought a civil action against the marina for damages suffered to the boat and fuel clean and containment costs necessitated by the collapse of the cradle structure. The plaintiff alleged that the defendant marina facility used deficient materials in the construction of certain "cribbing" used in the boat cradle.

The case offers a neat review of some basic legal principles and concepts:

1. The law of "bailment": what is expected on the part of someone who is possession of goods owned by another?
2. Is a mere "Notice" that "*Boats Are Stored at the Owner's Risk*" posted at a facility enough to protect a marina in respect of what is said to be a negligently (i.e. deficient materials being employed for the purpose) constructed cradle structure?
3. How detailed should work order language be, intended for signature by a customer, purporting to relieve a business from the consequences of its own negligence in accidents occurring to stored property (such as the negligent construction of a cradle structure)?
4. What is the consequence of a party disposing of important evidence without a 'good faith' basis or explanation for having done so? (the defendant in this case disposed of the collapsed cribbing materials that were alleged to have been deficient prior to the plaintiff's marine surveyor representative having had a chance to inspect the same)
5. Can a defendant be held liable for the payment of the costs of an investigation into a loss and the nature and extent of damage? (In addition to his claims for the boat damage and clean up expenses incurred, the plaintiff also claimed for the costs of his marine surveyor who attended the scene and investigated the loss)

Discussion

Following a trial of the claims and the various issues, the Court made various findings. For the reasons set forth below, the defendant was held liable for all of the damages claimed by the plaintiff.

1. There Was a Contract of Bailment Between the Plaintiff and the Defendant

The Court revisited the law of bailment, noting that:

> Bailment is the legal relationship that arises when the property of one person is in the possession of another.

The facts of the case clearly suggested to the Court that there was a bailment relationship, and with this, there were the related duties expected of the marina concerning the care over the boat as discussed below. The vessel was clearly in the possession of the defendant at the time of the fall. It had been removed from the water and "cradled" in the wooden structure that was built by the defendant.

2. What was the Cause of the Loss? Did the Defendant Breach its Duties as a "Bailee"

Having found that a bailment relationship existed, the court noted that the civil burden shifted to the defendant to show that it was not negligent in the manner in which it dealt with the plaintiff's property.

The Court found that the wood used to build the cradle was the property of the defendant and that it was the defendant's employees who selected the material for use and built the structure. There was a factual issue as to who actually constructed the cradle, as certain representatives of the plaintiff had some involvement in its erection. On the facts of the case the Court found that this involvement was only peripheral to the exercise and that the defendant's employees were always in 'control'. Accordingly, the defendant was a "bailee" in the eyes of the law and it had the burden of showing that it met the related duty of care.

The Court cited case law precedent (*2) to expand on this point as follows:

> The duty of a bailee to provide suitable premises in which to store the bailors goods was in issue before the Court of Appeal of the province of Nova Scotia in the case of *Furness-Whitey and Co. Ltd. v. Ahlin* (1917), 35 DLR 150 (N.S.C.A.). There the collapse of a wharf due to the defective condition of the supporting piles resulted in damage to a cargo stored thereon. The trial judge found that the defects could have been discovered by the exercise of reasonable diligence by the defendant/owner even though the superstructure was intact, it held that the owner was liable for damages sustained. In dismissing the defendants appeal, Graham, C.J. of the Court of Appeal stated at page 156 as follows:
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> > … The obligation to take reasonable care of the thing entrusted to the bailee of this class (warehousemen, etc.) involves in it an obligation to take reasonable care that any building in which it is deposited is a proper state so that the thing therein deposited may be reasonably safe in it… the owner or occupant of a dock is liable in damages to a person who by his invitation, expressed or implied, makes use of it, for an injury caused by any defect or unsafe condition of the dock which the occupant negligently causes or permits to exist, if such person, was himself in the exercise of due care. Such occupant is not an insurer of the safety of his dock, but is required to use reasonable care to keep his dock in such a state as to be reasonably safe for use by vessels which he invites to enter it or for which he holds it out as fit and ready. If he fails to use such due care: if there is a defect which is known to him, or which by use of ordinary care and diligence should be known to him, he is guilty of negligence and liable to the person who, using due care, is injured thereby.

The analysis naturally turned to the fitness of the cribbing materials used to construct the cradle upon which the boat was placed. This was the obvious "failure mechanism". Unfortunately, the cribbing material was disposed of by someone related to the defendant *prior* to the plaintiff's marine surveyor having had an opportunity to inspect the same. The Court found that the cribbing had been removed "*with an intention that it not be available for an inspection*".

The Court had to address the situation caused by the disposal of such evidence in the cribbing material.

3. The Defendant's Disposal of the Failed Cribbing Material Constituted "Spoliation" of Evidence.

The court noted that the disposition of the cribbing raised an issue of spoliation; that is, the intentional destruction of evidence relevant to ongoing or contemplated litigation. In such cases, a reasonable inference can be drawn that the evidence was destroyed to affect the litigation: *McDougall v. Black & Decker Canada Inc.* (*3) Spoliation gives rise to a rebuttable

presumption that the evidence would be unfavourable to the party who destroyed the evidence. The presumption could be rebutted by the "spoliator" proving that it did not intend to destroy evidence relevant to existing or contemplated litigation. In *Nova Growth Corp. v. Kapinski* (*4) the Ontario Superior Court recently interpreted the *McDougall* decision to hold that a conclusion that there was spoliation requires the following four elements to be established on balance of probabilities:

1. The missing evidence is relevant;
2. The missing evidence must have been destroyed intentionally;
3. At the time of destruction, litigation must have been ongoing or contemplated; and
4. It must be reasonable to infer that the evidence was destroyed in order to affect the outcome of the litigation.

The Court found that the cribbing materials that were disposed of was relevant physical evidence relating directly to the issue of proving negligence; that is, whether the cradle was negligently constructed because the cribbing materials that were used to build the cradle were unfit for that purpose.

The Court found that the cribbing was disposed of within a 48-hour period following the incident, prior to the plaintiff's marine surveyor having an opportunity to inspect same. The Court found that the defendant ought to have known when it disposed of the cribbing that litigation would be contemplated by the plaintiff to recover for the damage to the vessel and that any disposition of the cribbing would affect any future claim made by the plaintiff.

The Court noted case law precedent that it is not necessary that the party accused of disposing of evidence had actually received actual notice of litigation (*5), but that litigation need only have been contemplated or reasonably foreseeable. (*6) The Court found that, in this case, it was reasonable to conclude that litigation was reasonably foreseeable at the time when the evidence was destroyed. The Court accordingly drew the adverse inference that the evidence was intentionally destroyed to affect the litigation. This raised a rebuttable presumption that the evidence was unfavourable to the defendants, in that the cribbing materials used to construct the cradle were unsound and unfit, unless the defendant could provide an innocent explanation for what happened. As the defendant did not lead any evidence to this effect, the Court drew this adverse inference against it.

Accordingly, on the basis of the case law authorities cited above, the Court drew the inference that the materials were inadequate for their use in the construction of the cradle. The Court accordingly found that the defendant was liable as a bailee.

On the basis of the foregoing, the Court found that the defendant was liable for breach of its bailment obligations.

4. The Effect of the "Notice" on the Premises, and the Contract signed by the Parties.

Having found that there was a contract of bailment and that the defendant breached its duty of care and mandate in failing to take reasonable steps to safeguard the boat, the Court turned its mind to the question as to whether there was a contract term that insulated the defendant from liability from its own negligence.

As noted above, there was basic signage on the premises to the effect that "Boats are Stored at Owners Risk".

In addition, the plaintiff had prior to the on-land storage of the boat signed a contract form containing the following language:

Statement of Acceptance of Responsibility

I understand and agree that the securing and locking of my boat is my

> *responsibility, and not that of the said Marine Service Centre, or of its agents, servants, employees or otherwise. Furthermore I agree to indemnify and save harmless the said Marine Service Centre and its officers, agents, employees, servants or otherwise from any claims on my part with respect to the same.*

In ruling that this language was *insufficient* to protect the defendant from liability (and, as a corollary, the signage "Notice" also being insufficient for the purpose), the Court summarized governing contract law principles taken from pages 561-600 of Fridman's *The Law of Contract Canada* (3rd ed. 1994) as follows:

> a. An exempting clause will not be enforced if an innocent misrepresentation by one party has misled the other to enter into the contract as set to clause (p.571).
>
> b. An exempting clause will not be enforced if the party seeking protection did not bring its existence and inclusion in the contract sufficiently to the notice of the other party at the time of, or prior to the making of the contract (p.573). Normally notice would be ensured where the clause is in a written agreement, the party signing can read, and that party is not in a rush to signing (pp. 573-578).
>
> c. Once the Courts accept that an exempting clause is included in a contract, the Courts still regard it with a critical or jaundiced eye, approaching the interpretation of such a clause strictly, applying the ordinary rules of construction, including the *contra proferentem* rule, which says the clause, particularly in a standard form contract, is to be strictly construed against the party who drafted it (p. 578). A clause will not exclude liability for the drafter's own negligence unless it does so expressly or by necessary implication. The latter case arises only where the words could not reasonably apply to some other ground other than the drafter's negligence (p. 580).

Item (c) above reflects the principle seized on by the judge, which affected the outcome of this issue: the language simply did not go far enough to protect the defendant from its own negligence. Citing recent case law from the Supreme Court of Canada (*7), the Court noted that the question falls to be determined on a "construction" of the contract language: exactly what did the parties agree to? The problem ultimately for the defendant was twofold: the signage was too brief, so as to not cover 'negligence'. Further, there was an ambiguity in the contract language that had to be resolved in favour of the plaintiff, it also being problematic for the defendant that the contract language did not expressly address losses caused by the defendant's own negligence. The ambiguity concerned the meaning of the word "securing" as it appeared in the above contract language. Wanting to limit the scope of application of the clause, the plaintiff argued that "securing" meant that the plaintiff was responsible only for lifting lines and securing buoys etc., while the boat was afloat. The defendant opted for a broader interpretation – that this word meant that the plaintiff was responsible for the safety of the vessel while it sat on the cradle. The Court noted that, where there is an ambiguity in a standard form contract, the ambiguity is resolved by applying doctrine of contractual interpretation of *contra proferentem* or reading the contract against the drafter, in this case being the defendant. Applying this rule of construction, the Court rejected the defendants' submissions that the plaintiffs' acceptance of responsibility for "securing" the vessel meant that the plaintiff would be responsible for the safety of the vessel while she was on the cradle.

The Court accordingly found the defendant could not rely on the contract language or the notice on the premises to exclude liability for negligence in connection with the construction of the cradle. The defendant was accordingly liable for the loss of the boat and the clean up expenses caused by the incident.

5. Could the Plaintiff Recover the Costs Spent on the Marine Surveyor's Investigation?

One question that remained was whether the plaintiff was entitled to recover the costs of the survey undertaken to inspect the nature and extent of the losses and clean up requirements. The Court cited the rule from *Hadley v. Baxendale* (*8) as authority for the extent in which a party may claim damages from an alleged breach of contract. The Court applied this decision in ruling that damages are recoverable that "flow directly from the injury". The case has also been cited for a different articulation that damages are recoverable if they were "reasonably foreseeable to the parties at the time of the making of the contract had they then turned their minds to what damages would logically flow from a breach of the contract". The Court also cited modern case law precedent (*9) as a basis for the recovery of investigation or survey costs as being a "natural consequence". The Court applied this rule in finding that the expenses charged by the plaintiff's marine surveyor were both foreseeable and a "natural and probable consequence" of the loss. Accordingly the plaintiff was able to recover this amount in addition to the other compensation awarded.

Conclusion

Accordingly the defendant was held liable for the plaintiffs losses.

The "take away" items from this case are as follows:

1. There is always a premium on clear and deliberate language in any contractual arrangement.
2. Whether litigation be in progress or simply contemplated as a possibility, any evidence that may be relevant should be safeguarded. Should this not be practical for any extended period (for example, perhaps the article in question continues to draw storage charges) then fair notice should be given to any potential adverse interest of the intent to relocate or dispose of the evidence (not to mention any desire by the party in possession to do any destructive testing of the article).
3. It should be noted that appraisal or survey charges might be items that can be claimed by a plaintiff in an appropriate case.

Gordon Hearn

Endnotes

(*1) 2014 FC 974 (CanLII)
(*2) *Howell v. Newfoundland (Attorney General*) 1987 CanLII 5161 (NL SCTD)
(*3) [2009] 1 W.W.R. 257.
(*4) 2014 ONSC 2763 (CanLII)
(*5) *Leon v. Toronto Transit Commission* 2014 ONSC 1600 (CanLII)
(*6) *Blais v. The Toronto Area Transit Operating Authority* (2011) 105 O.R. (3d) 575
(*7)*Tercon Contractors Ltd. v. British Colombia (Minister of Transportation and Highways* 2010 SCC 4 (CanLII)
(*8) (1854) 156 E.R. 145
(*9) *Laichkwiltech Enterprise Ltd. v. "Pacific Faith" (The)* [2009] 8 W.W.R. 681

3. Forfeiture of Vessel Due to Drunkenness and not Criminal Activity: *Ontario (Attorney General) v. Kittiwake Sailboat (Registration #50E83594),* 2014 ONSC 4866 (CanLII)

The issue on this application was the proposed forfeiture of a leisure-use sailboat under the *Civil Remedies Act* S.O 2001, ("the Act") as amended. The Act's purpose is to provide civil remedies that will assist in,

> (a) compensating persons who suffer pecuniary or non-pecuniary losses as a result of unlawful activities;
>
> (b) preventing persons who engage in unlawful activities and others from keeping property that was acquired as a result of unlawful activities;
>
> (c) preventing property, including vehicles as defined in Part III.1, from being used to engage in certain unlawful activities; and
>
> (d) preventing injury to the public that may result from conspiracies to engage in unlawful activities. 2001, c. 28, s. 1; 2007, c. 13, s. 26.

In this case, it was not alleged that the boat was illegally acquired or that it was used to commit crimes; however, the basis for forfeiture was that Mr. Chygyrynskyy operated his sailboat while he was impaired by alcohol or drugs. This would be an unusual application of the Act in that there is no element of use in a criminal enterprise regarding the use of the vessel but rather as a punishment for operating while impaired. Such punishment is potentially more appropriately incorporated in a criminal statute not a statute of general application.

Mr. Chygyrynskyy testified that he was not the operator of the vessel. The Court considered whether the *Civil Remedies Act* can and does extend to forfeiture of property in such circumstances.

Mr. Chygyrynskyy was unrepresented, did not speak English and did not have access to Legal Aid and the Court even suggested to the A.G. Ontario that this should not be a case to pursue. Despite this caution from the Court, the A.G. Ontario moved forward regarding the forfeiture.

The Court said,

> [3] Assuming without deciding that the facts are as alleged by the A.G. Ontario, there is a significant legal question as to whether the *Civil Remedies Act* can and does extend to forfeiture of property in these circumstances.
>
> [4] These are important issues that could have significant implications for a great many people.
>
> [7] The potential impact of this case on forfeiture practices generally, and thus on the general public, is a matter of concern, however.

To ensure that there was proper argument, the Court appointed an *amicus curiae* (*1) to assist the Court with legal issues raised by the A.G. Ontario's proposed recourse to the *Civil Remedies Act* to effect forfeiture of the sailboat in this case. The appointment of the *amicus curiae* is a very unusual step and shows the Court's level of concern.

The case has not yet proceeded to trial or full hearing. We will keep our readers posted.

Kim E. Stoll

Endnotes

(*1) "Friend of the Court", a lawyer is appointed to provide legal advice to assist the court.

4. A 'Bankrupt' Defence: *Douglas v. Stan Ferguson Fuels Ltd.*

Ontario Superior Court allows insurer's subrogation action to proceed despite insureds' undischarged bankruptcy status

Recently, in *Douglas v. Stan Ferguson Fuels Ltd.*, 2014 ONSC 4709 (S.C.J.), Justice Brian Abrams of the Ontario Superior Court of Justice ruled that Canada's federal *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 ("*BIA*") does not trump or extinguish an insurer's right to bring a subrogated action in the insureds' name, against a third party, in circumstances where one of the insureds was an undischarged bankrupt when the action was commenced.

This decision is important in that it provides a simple and fair answer to a narrow issue concerning the interplay between an insurer's equitable subrogation rights on the one hand, and the orderly disposition of a bankrupt's property (including any causes of action that the bankrupt may have against a third party) under the *BIA* on the other. Although in the normal course, a bankrupt's cause of action would vest in the trustee in bankruptcy pursuant to the *BIA*, the Court's ruling makes it clear that such is not the case in the context of a subrogated action brought not by the *bankrupt*, but rather by the *insurer* in the bankrupt's name.

Facts

In January 2008, there was a fuel oil leak at the plaintiffs' home in Kingston, Ontario. Some 622 litres of fuel oil escaped from an external fuel tank and contaminated the plaintiffs' premises. The plaintiffs, Art and Wendy Douglas, immediately notified their fuel oil provider and servicer, the defendant, Stan Ferguson Fuels Ltd. ("Stan Ferguson"). This triggered the involvement of an emergency response service retained by Stan Ferguson. Another remediation firm, Scott Environmental, was also retained.

The following day, the Douglases notified their insurer, State Farm, of the loss. State Farm accepted the claim and ultimately paid out approximately $800,000 under the Douglases' policy, which included a reimbursement of over $140,000 to Stan Ferguson and Scott Environmental for their remediation services.

In March 2008, State Farm notified Stan Ferguson, amongst others, that it intended to pursue its subrogated rights with respect to the loss.

In the course of the ongoing loss adjustment, it came to light that the Douglases had, in fact, separated prior to the oil leak. Ms. Douglas had not been living at the plaintiffs' home for some time.

In February 2007, Ms. Douglas had filed for bankruptcy. She was discharged some 9 months later, in November 2007. Then in June 2009, Mr. Douglas also filed for bankruptcy, related to issues arising out of the breakdown of the Douglases' marriage.

Ultimately, the property was remediated and sold by the trustee in bankruptcy in October 2009.

In January 2010, State Farm commenced a subrogated action, in the Douglases' name, naming Stan Ferguson and others as defendants. At the time the Statement of Claim was issued, Mr. Douglas remained an undischarged bankrupt.

The Issue

An issue arose in the course of the litigation as to whether State Farm had the right to bring subrogated proceedings against Stan Ferguson *at all*, given the fact that the Douglases had each declared bankruptcy before the Statement of Claim had been issued. Stan Ferguson argued that pursuant to the *BIA*, any causes of action that the Douglases may have had against it vested in the trustee in bankruptcy, and were therefore not the Douglases' (and, by extension, State Farm's) to bring.

The Parties' Positions

This resulted in the motion before Justice Abrams. State Farm took the basic position before that the equitable doctrine of subrogation entitled it to bring the action. State Farm had fully indemnified the plaintiffs, and had brought the action in the Douglases' name, as it was required to do.

State Farm relied on the Supreme Court of Canada's decision in *Somersall v. Friedman*, [2002] 3 S.C.R. 109 (S.C.C.) at paragraph 50, where Justice Iacobucci stated that the underlying objectives of the doctrine of subrogation are to ensure: *(i) that the insured receives no more and no less than a full indemnity; and (ii) that the loss falls on the person who is legally responsible for causing it.*

State Farm further pointed out that its subrogation rights would obviously be in jeopardy if State Farm were obligated to rely on the insureds or the trustee in bankruptcy to advance an action in order to protect State Farm's interest. Since the plaintiffs had already been fully indemnified for the loss, they would not be motivated to bring such an action, nor were they obligated to as a matter of law.

Stan Ferguson, on the other hand, argued that the plaintiffs simply had no capacity to bring the action because they had become bankrupt prior to the commencement of the action. Accordingly, both the property itself, as well as the causes of action against Stan Ferguson, vested in the plaintiffs' trustee in bankruptcy. Stan Ferguson argued that if the action were allowed to proceed, the fundamental tenet of the bankruptcy scheme (i.e that a bankupt's property vests in the trustee upon bankruptcy) would be subverted.

Further, Stan Ferguson argued that State Farm, in bringing the subrogated action, only stood in the insureds' shoes, and thus had no better claim than the Douglases themselves. Accordingly, Stan Ferguson argued that the plaintiffs lacked capacity to bring the action at all.

The Decision

The Court had little difficulty in finding for State Farm on the motion. The action was allowed to proceed, and State Farm retained the right to continue and control the subrogated action against Stan Ferguson.

Justice Abrams' decision was based largely on the perceived unfairness that would result if State Farm was denied the right to recover against Stan Ferguson. After citing s. 152(1) of the *Insurance Act*, R.S.O. 1990, c. I.8 (which provides the insurer with its right of subrogation), Abrams J. observed that Stan Ferguson (who, after allegedly causing the loss and retaining the remediators, was then *reimbursed* for its services by State Farm) now sought to avoid a trial on the grounds that the *BIA* extinguished State Farm's right of recovery from a potential tortfeasor. As Abrams J. stated at paragraph 53, "In short, to grant the order requested by the Defendants would be to allow the potential wrong-doer to profit from the fact that the Plaintiffs were insured."

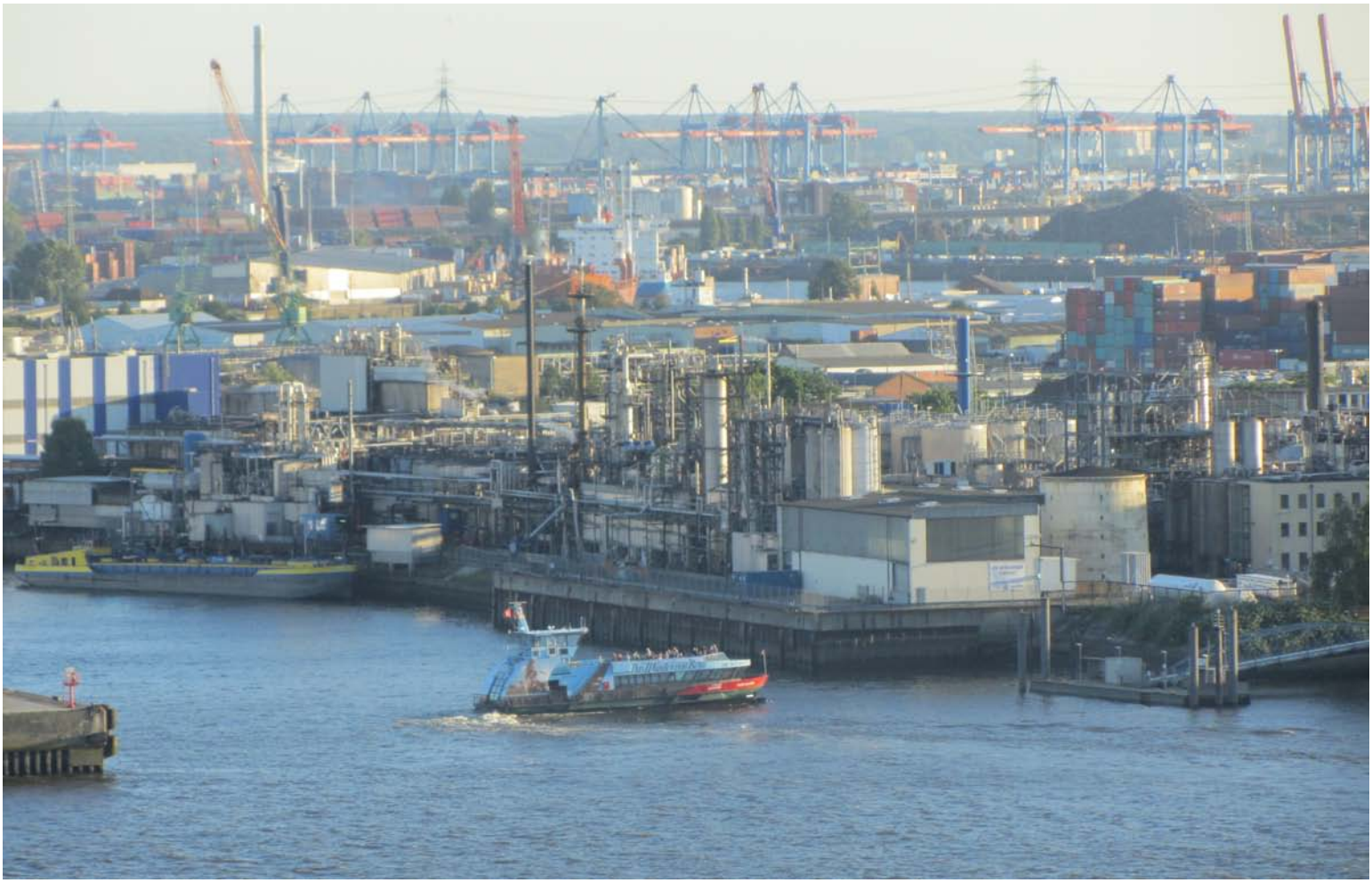
Justice Abrams went on, at paragraph 54, to hold that to grant the relief requested by Stan Ferguson "would be to incorrectly emphasize form over substance, which is the opposite of the substantive principle articulated by the Supreme Court in Somersall v. Friedman." His Honour also held at paragraph 55 that such an outcome would offend the second of the two underlying objectives (listed above) of the doctrine of subrogation, as described by Iacobucci J., that the loss falls on the person who is legally responsible for causing it.

In the result, Abrams J. was not persuaded that the *BIA* extinguished State Farm's subrogation rights. His Honour held that the subrogation rights vested with State Farm *at the time the policy was entered into*, and remained in place at the date of loss.

The Court was also not persuaded that the fundamental purpose of the *BIA* would be subverted if the action were permitted to proceed, since the plaintiffs were fully indemnified and the trustee had satisfied the creditors through the sale of the property - *property which could not have been sold in the first place had it not been for the remediation payments made by State Farm*.

Thus, the Court concluded that no subversion would result if the action were to proceed. On the contrary, if State Farm was precluded from pressing its subrogated claim, then there may be an inequitable result, since the plaintiffs themselves (and the trustee in bankruptcy) had no motivation or obligation to maintain or preserve viability of the action to protect State Farm's interests.

James Manson



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CONTEST

This month we are giving away a prize - a ticket to attend the Fernandes Hearn LLP Annual Seminar being held January 15th 2015 - for the first individual to email us the name of the city in the photographs on page 5 and 14. Email your answer to info@fernandeshearn.com with a subject line "Newsletter contest". First response with the correct answer wins.