CLARK WILSON LLP

EXCLUDING EXCLUSIONS:
The Role of Reasonableness in the Interpretation of Insurance Policies

by

Nigel P. Kent
Clark Wilson LLP
tel. 604.643.3135
npk@cwilson.com

CLARK WILSON LLP
Barristers & Solicitors
Patent & Trade-Mark Agents
900 – 885 West Georgia Street
Vancouver, BC V6C 3H1 Canada
T. 604.687.5700 **F.** 604.687.6314
cwilson.com

TABLE OF CONTENTS

Nigel P. Kent, T. 604.643.3135

EXCLUDING EXCLUSIONS:
The Role of Reasonableness in the Interpretation of Insurance Policies

I. Doctrine of Reasonable Expectation regarding the Interpretation of Insurance Provisions

Over the past 25 years, the doctrine of reasonable expectation of the parties regarding the interpretation of insurance provisions has undergone a dramatic shift in application by Canadian courts. What began as a limited and narrowly applied doctrine in 1984 in *Wigle et al. v. Allstate Insurance Co. of Canada*, (1984) 49 O.R. (2d) 101 (C.A.), has evolved into a tool for which insured parties may rely upon to avoid clearly stated contractual provisions in insurance policies. Three recent 2011 decisions in provincial superior courts in Ontario and British Columbia, demonstrate that this doctrine may have major ramifications for the future interpretation of insurance contract provisions. In this paper, the history of this doctrine, which has its roots in American case-law, will be traced up to the most recent application in Canadian jurisprudence.

A. Evolution from the American to the Canadian approach:

In the USA, some courts have applied a "reasonable expectations doctrine" which, in its broadest form, negates a clear and unambiguous exclusion clause if it conflicts with the reasonable coverage expectations of the policy holder. In *Wigle et al. v. Allstate Insurance Co. of Canada*, (1984) 49 O.R. (2d) 101 (C.A.) Justice Cory discusses the American approach at length. The following paragraphs set out how the "reasonable expectations doctrine" has been applied in American courts:

> "The American courts have adopted a policy with regard to the interpretation of standard forms of insurance contract known as the "reasonable expectations" doctrine. Following this doctrine, courts have consistently accepted the argument that they should honour the reasonable expectations of an insured in situations where the policy is ambiguous despite the presence of policy provisions which would appear to negate coverage.
>
> The first American case which led to the formulation of the doctrine was *Gaunt v. John Hancock Mutual Ins*. Co. (1947), 160 F. 2d 599 (2nd Cir.); certiorari denied, 331 U.S. 849. In that case Mr. Justice Learned Hand, in dealing with the standard of contractual interpretation, stated:
>
> > A man must indeed read what he signs, and he is charged, if he does not; but insurers who seek to impose upon words of common speech an esoteric significance intelligible only to the craft, must bear the burden of any resulting confusion ...[Although the underwriters might have understood this insurance contract], it was to go to persons utterly unacquainted with the niceties of life insurance, who would read it colloquially. It is the understanding of such persons that count.

Nigel P. Kent, T. 604.643.3135

The doctrine was extended to its present form in the case of *Steven v. Fidelity & Casualty Co.* (1962), 58 Cal. 2d 862. In that case Mr. Steven purchased a flight insurance policy from a machine at an airport. On his return flight, he was unexpectedly required to take an unscheduled flight and was killed when that aeroplane crashed. The insurance company sought to deny recovery by his widow because the policy only covered "scheduled air carriers". The court, by applying the doctrine of reasonable expectations to the policy, determined that Mr. Steven was covered under the policy of insurance which he had purchased at the airport.

By 1980 one author had counted well over 100 cases supporting the doctrine: see Abraham, "Judge-Made Law and Judge-Made Insurance: Honouring the Reasonable Expectations of the Insured'', 67 Va. L. Rev. 1151 (1981).

The basic rules of construction adopted by the American courts are as follows:

1. The court should look at the words of the contract to determine if there is ambiguity;

2. the court should ascertain the intention of the parties concerning specific provisions by reference to the language of the entire contract;

3. the court should construe ambiguities found in the insurance contract in favour of the insured, and

4. the court should limit the construction in favour of the insured by "reasonableness" and apply it only if it is impossible to give the contract a fair interpretation by using other rules.

The doctrine has been extended to give effect to the reasonable expectations of policyholders to cases which did not involve ambiguous provisions in the policy. For our purposes it is necessary only to consider situations where there is ambiguity in the contract. I am of the opinion that the first three rules of construction, above, are appropriate to the interpretation of standard form motor vehicle insurance contracts in Ontario. Their application is equitable for it is the insurer that has the only real opportunity to settle upon the wording of the coverage, whether it will offer such coverage and to explain it to their clients who can only accept or reject the coverage."

In *Wigle*, the doctrine was applied in contemplation of an ambiguous insurance policy and it was held that a reasonable person would suppose that the policy covered the circumstances of the accident that had occurred, thus the plaintiff was awarded coverage. The American application of the doctrine was discussed again in some detail in the dissenting judgement of Justice Cory in *Brissette Estate v. Westbury Life Insurance Co*. [1992] 3 S.C.R. 87 at pages 21-25.

In *Brissette*, Justice Cory explains how this doctrine has been applied in United States Courts in three variations. The most controversial application of the doctrine is as follows:

"37 The third application of the principle is even broader and more controversial than the second. It was originally advocated by Professor Keeton who stated:

> The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.
>
> (R. Keeton, "Insurance Law Rights at Variance with Policy Provisions" (1970), 83 Harv. L. Rev. 961, at p. 967.)

38 In a thoughtful article, "Insurance Law: The Doctrine of Reasonable Expectations" (1988), 37 Drake L. Rev. 741, at pp. 746-47, Holz sets out the pros and cons of this last approach:

> ... the reasonable expectations of a policyholder, having an ordinary degree of familiarity with the policy coverage, should be given effect for three reasons: (1) policy forms are long and complex and cannot be understood without detailed study; (2) rarely do policyholders read their policies carefully enough to acquire such [page104] understanding; (3) most insurance transactions are final before a policyholder has a chance to see the detailed policy terms. The Keeton doctrine has been criticized on the grounds that: (1) if there is to be any predictability and uniformity of decisions, the courts need to establish more precise guidelines for the doctrine; (2) the analysis fails to consider the well-established rule of adhering to express contract language; (3) it would allow recovery to insureds who fail to read and understand their policies despite clear and unambiguous policy language; (4) the insurer would no longer be able to rely on the terms of a written insurance policy."

However, in *Brissette*, Justice Cory explains that he is not intent on following the American approaches to the doctrine of the reasonable expectation of the parties, but provides them as "an indication of how far some jurisdictions have gone to give effect to the reasonable expectations of the insured and the reasoning that lead to the adoption of that approach."

B. The Doctrine of Reasonable Expectation of the Parties is applied in Canada to ambiguous policies:

In *Reid Crowther & Partners Ltd. v. Simcoe & Erie General*, [1993] 1 S.C.R. 252, Justice McLachlin (as she then was) relied on *Brissette* for the principle of interpretation of insurance policies that include "the desirability, at least where the policy is ambiguous, of giving effect to the reasonable expectations of the parties." Relying on *Wigle*, she states that "it is settled that where the policy is ambiguous, the courts should consider the reasonable expectations of the parties". Due to *Reid Crowther*, the American doctrine of the reasonable expectation of the parties was now implemented in the highest court in Canada. However, its reach had not yet been settled. The approach was subsequently adopted on numerous occasions by the Supreme of Canada, but in a limited capacity. It was applied with respect to the "reasonable expectations" in the interpretation exercise only in the context of resolving ambiguity;

and with regard to the expectations of both parties (insured and insurer), *Jesuit Fathers of Upper Canada v. Guardian Insurance Co*., 2006 SCC 21 at para. 29 and *Citadel General Insurance v. Vytlingham*, 2007 SCC 46 at para. 4.

C. The application of the American approach in Canada:

In 1995, Justice Carruthers from the Ontario Court (General Division) held, in the decision of *Sawhney v. Bempah*, 22 O.R. (3d) 306, that he did not "agree that absent its use to resolve an ambiguity the doctrine of reasonable expectation can be employed to extend the coverage provided by (the insurance contract) to losses occasioned by an unidentified driver". This reasoning was followed in the next case noted below.

In *Chilton v. Co-Operators General Insurance Co*., 32 O.R. (3d) 161 (C.A.) the plaintiffs argued that the broader, American conception of the reasonable expectations doctrine should be applied in their situation. In their case, the insurance clause relating to "underinsured motorist" coverage did not cover losses caused by an unidentified driver. Justice Laskin held that the clause was not ambiguous and the doctrine of reasonable expectations was not applicable. However, his following comments made in obiter regarding the applicability of this doctrine in situations where there is no ambiguity in the policy have been relied on in subsequent cases (discussed further in the paper) to support the proposition that the doctrine can be applied to situations with no ambiguity:

> "In considering whether to apply the reasonable expectations principle to cases in which there is no ambiguity in the policy, first the court should consider whether a reasonable insured could have expected coverage. An arguable case for coverage may exist, for example, if the policy is difficult to read or understand and if the insurer, either by its marketing practices or by giving its policy a misleading name, created or contributed to a reasonable expectation of coverage. Coverage may also be warranted where the insurer's interpretation of the relevant policy provision would virtually negate the coverage the insured expected by paying a premium. In these circumstances the court may be justified in looking beyond the words of the contract and holding the insurer responsible for the insured's reasonable expectation of coverage."

Justice Laskin found that this scenario was not applicable to the current case, as the terms of the insuring agreement were clear and understandable and a reasonably insured person who had read the definition would not be misled.

Up until this year, a court in Canada had not employed the doctrine of reasonable expectation of the parties against an insurer when the clause was not ambiguous. The first decision that does this is *Cabell v. Personal Insurance Co*., 2011 ONCA 105. In this case, the Cabells' pool was damaged as a result of hydrostatic uplift pressure. This pressure increased due to the build-up of groundwater, which caused the pool to lift out of the ground. The pool cracked and was significantly damaged.

The common exclusions portion of the policy stated that the insurer, Personal, did not cover cracking of the insured property. However, the Cabells also purchased Endorsement 33b which amended the policy to provide property coverage for damage to their pool caused by all risks other than flooding or water-borne objects. In the previous decision, the applications judge interpreted the policy and Endorsement 33b as excluding coverage for damage caused to the pool in the nature of moving and cracking. Justice

Rosenberg held that the application of the common exclusions to Endorsement 33b would virtually nullify coverage under the endorsement and that such a result could not have been within the reasonable expectations of the parties, thus applying the doctrine of the reasonable expectation of the parties for the first time in Canada to a policy that is not ambiguous. In his decision, Justice Rosenberg referenced the cases explained below regarding the nullification of exclusion and concluded that the application of the common exclusion would "virtually nullify coverage (and) such a result could not have been within the reasonable expectation of the parties".

Justice Rosenberg, in *Cabell* compounds the doctrines of nullification of coverage and the reasonable expectations of the parties. The doctrine of nullification of coverage originates in the reasons of Estey J in *Indemnity Insurance Co. of North America v. Excel Cleaning Service*, [1954] 1 S.C.R. 169 at pp. 177 - 80:

> "Such a construction would largely, if not completely, nullify the purpose for which the insurance was sold - a circumstance to be avoided, so far as the language used will permit. Cornish v. The Accident Insurance Co. [(1889) 23 Q.B.D. 453.], where at p. 456 Lindley L.J. stated:
>
> > The object of the contract is to insure against accidental death and injuries, and the contract must not be construed so as to defeat that object, nor so as to render it practically illusory.
>
> When regard is had to the possible meanings of the words "care," "custody" and "control" as they are here used as part of general provisions prepared without reference to the particular coverage purchased by the respondent, together with what is perhaps the more important consideration that, if construed as the appellant submits, these words would largely, if not entirely, nullify the usefulness of the insurance purchased, it is difficult to determine the precise meaning that ought to be attributed to these words.
>
> It is, in such a case, a general rule to construe that language used in a manner favourable to the insured. The basis for such being that the insurer, by such clauses, seeks to impose exceptions and limitations to the coverage he has already described and, therefore, should use language that clearly expresses the extent and scope of these exceptions and limitations and, in so far as he fails to do so, the language of the coverage should obtain. Lord Justice Lindley stated:
>
> > In a case on the line, in a case of real doubt, the policy ought to be construed most strongly against the insurers; they frame the policy and insert the exceptions. Cornish v. The Accident Insurance Co., supra, at p. 456."

In *Cabell*, Justice Rosenberg held that these passages indicate that the nullification of coverage is simply a particular application of the broader principle of interpretation of insurance contracts, ie in the case of an ambiguity of an exclusion clause, the ambiguity should be construed against the insurer. However, Justice Rosenberg goes on to explain that subsequent decisions regarding the nullification of coverage created ambiguity as to how the doctrine should be applied. He cites the well-quoted passage from *Consolidated Bathurst Export Ltd. v. Mutual Boiler and Machinery Insurance Co.*, [1980] 1 S.C.R. 888:

> "Even apart from the doctrine of *contra proferentem* as it may be applied in the construction of contracts, the normal rules of construction lead a court to search for an interpretation which, from the whole of the contract, would appear to promote or advance the true intent of the parties at the time of entry into the contract. *Consequently, literal meaning should not be applied where to do so would bring about an unrealistic result or a result which would not be contemplated in the commercial atmosphere in which the insurance was contracted. Where words may bear two constructions, the more reasonable one, that which produces a fair result, must certainly be taken as the interpretation which would promote the intention of the parties.* Similarly, an interpretation which defeats the intentions of the parties and their objective in entering into the commercial transaction in the first place should be discarded in favour of an interpretation of the policy which promotes a sensible commercial result. It is trite to *observe that an interpretation of an ambiguous contractual provision which would render the endeavour on the part of the insured to obtain insurance protection nugatory, should be avoided.* Said another way, the courts should be loath to support a construction which would either enable the insurer to pocket the premium without risk or the insured to achieve a recovery which could neither be sensibly sought nor anticipated at the time of the contract. [Emphasis added.]"

Justice Rosenberg contends that this passage, along with a subsequent interpretation by Justice Major in *Amos v. Insurance Corp. of British Columbia*, [1995] 3 S.C.R. 405 which held that "the construction given to a policy of insurance must not nullify the purpose for which the insurance was sold" suggest that the doctrine of nullification of coverage is an independent doctrine that applies even in the absence of ambiguity. He relied on *Weston Ornamental Iron Works Ltd. v. Continental Insurance Co.*, [1981] I.L.R. 477 (Ont. S.C.) and *Zurich Insurance Company v. 686234 Ontario Limited*, 62 O.R. (3d) 447 (C.A.) for this proposition:

> "[28] From Weston Ornamental Iron Works it is clear that this court has concluded that even though an exclusion clause may be clear and unambiguous, it will not be applied where: (1) it is inconsistent with the main purpose of the insurance coverage and where the result would be to virtually nullify the coverage provided by the policy; and (2) where to apply it would be contrary to the reasonable expectations of the ordinary person as to the coverage purchased. As I noted earlier in discussing the American authorities, these principles are used by American courts in interpreting the absolute pollution liability exclusion in CGL policies. See, also, Re Pettit v. Economical Mutual Ins. Co. (1982), 40 O.R. (2d) 344, 143 D.L.R. (3d) 752 (H.C.J.); Wigle v. Allstate Insurance Co. of Canada (1984), 49 O.R. (2d) 101, 14 D.L.R. (4th) 404 (C.A.), leave to appeal to S.C.C. refused (1985), 14 D.L.R. (4th) 404n; Brissette Estate v. Westbury Life Insurance Co., [1992] 3 S.C.R. 87, 96 D.L.R. (4th) 609."

Justice Rosenberg, in *Cabell*, thus concluded that the doctrine of nullification of coverage may be applied when an exclusion would go against the reasonable expectation of the parties in the circumstances and carved out the following test:

> "If the court is able to determine on an objective basis that the insurer's interpretation would render nugatory coverage for the most obvious risks for which the endorsement

> is issued, a tactical burden shifts to the insurer. It will be for the insurer to show that the effect of its interpretation would not virtually nullify the coverage and would not be contrary to the reasonable expectations of the ordinary person as to the coverage purchased."

Another recent decision applying the doctrine of reasonable expectations to an unambiguous exclusion comes from the Ontario Superior Court of Justice in *Perrault v. Encon Insurance Managers Inc.*, 2011 ONSC 4108. In this case, the insured applied for an order requiring the insurers to reimburse the costs incurred in the successful defence of criminal charges brought against an officer of the insured, Dr. Perrault who was the director of the blood transfusion service of the insured, the Canadian Red Cross, in the 1980's when Canada's blood supply became infected with HIV and Hepatitis C.

In 2002, Perrault was criminally charged with common nuisance and criminal negligence causing bodily harm arising out of his role with the Red Cross. After a lengthy trial, Perrault was found not guilty of all charges. Perrault, who could not afford the cost of funding his legal defence, sought the assistance of the Canadian Medical Protective Association, who agreed to assist him with his legal costs. After his innocence was determined, Perrault, who was an insured under the Red Cross' policy, claimed indemnity in respect of the costs of his defence, which totalled $1,623,945. The insurer denied coverage relying on the bodily injury exclusion in the policy. Justice Greer allowed the application and ordered the reimbursement of legal expenses from the insurer. She found that the idea that the administrative tasks undertaken by Dr. Perrault would have caused bodily injury to be against the reasonable expectations of the ordinary person. In her analysis, Justice Greer relied on the above noted passage from *Zurich* for the proposition that even when an exclusion clause is clear and unambiguous, it should not be applied when it would be found contrary to the reasonable expectations of the ordinary person. Justice Greer held:

> "40 In the case at bar, the main purpose the Red Cross purchased the insurance was to protect its Officers and Directors in cases where they were sued. The position taken by the Insurers is that somehow the "bodily injury" exclusion applied to Dr. Perrault and nullified the coverage provided by the policy. In my view, to find that Dr. Perrault's administrative tasks caused bodily injury to anyone, would be contrary to the reasonable expectations of the ordinary person as to the coverage purchased. The ordinary person would assume that in order to cause "bodily injury" there would need to be a real injury caused to the body, whether physical or mental. It follows that no administrative task could fall into that category."

In coming to this conclusion, Justice Greer relied upon (and adopted) the analysis of the Court of Special Appeals in Maryland *Philadelphia Indemnity Insurance Co. v. Maryland Yacht Club Inc. et al.*, 129 Md. Pp. 455 (1999) which examined a similar exclusionary clause and held that "the bodily injury exclusion was not ambiguous; and "... a reasonable person in the position of the parties could not conclude that the bodily injury exclusion applied to the facts attendant here. Indeed, only a tortured construction of the exclusion - one that ignores common sense - would lead to the result urged by appellant". The fact that Justice Greer relied on an American decision for her analysis further exemplifies how the broad American approach to this principle is being adopted into Canadian case-law.

The other decision in 2011, *Turpin v. Manufacturers Life Insurance Co.*, 2011 BCSC 1162, applies the doctrine of reasonable expectation of the parties to an unambiguous insurance policy. Relying on the

conclusion in *Cabell* and the passage noted above in *Chilton*, Justice Wilson finds that this is a proper case in which to apply the reasonable expectations principle, as:

> "56 On the construction I have applied to the exclusion clause in this case, Ms. Turpin was not eligible for medical coverage because she suffered an irregularity in her health, three days before the policy issued. the medical coverage is nullified. That is not what the parties expected. I find they expected that Ms. Turpin would be so covered.
>
> 57 Ms. Turpin applied to the defendants' agent for medical insurance, for a planned trip to Southern California. The defendants' agent presented a travel insurance policy, "off the shelf" as it were, without inquiry. Ms. Turpin paid the policy premium and left the agent's office, without reading the policy, notwithstanding the caution on the policy cover that she "PLEASE READ CAREFULLY".
>
> 58 I find however, that if she had read the policy, she would have found it difficult to understand, with its myriad of excluding conditions, variously applicable, or not applicable, to an infinite array of possible risks."

Due to these three recent decisions, the doctrine of reasonable expectation of the parties has evolved from being applicable only in cases of ambiguity to a doctrine that can be relied upon when insurance provisions are clear and straightforward. This American approach to the application of the doctrine of reasonable expectations may have major ramifications for insurers who, in the future, may not be able to rely upon their clearly stated contractual provisions in insurance policies. What began as a limited and defined doctrine has, in the past 25 years, transformed into one that is wide-reaching in its scope; its consequences, unknown.

II. "Unjust or unreasonable contracts" provision in the *Insurance Act*

In 2003 a lawyer's negligence case resulted in the Supreme Court of Canada declaring that B.C.'s Insurance Act was "outmoded", "incapable of coherently addressing the modern multi peril policy", and resulted in "unproductive, wasteful litigation about technicalities": *KP Pacific Holdings Ltd. v. Guardian Insurance* [2003] 1 S.C.R. 433 ("*KP Pacific*").

In *KP Pacific* the insured claimed for a fire loss under an all risk policy. The policy contained the standard statutory conditions mandated by the "Fire Part" of the BC Insurance Act which included the litigation limitation period of one year following occurrence of the loss. The question in the case was whether the limitation period was the one stipulated by the statutory condition or the longer limitation period stipulated in the "General Provisions" of the Act, namely, one year from the filing of a proof of loss. The more general issue was whether the modern all-risk policy was governed by the Fire Part of the Act (including the statutory conditions) or the General Provisions of the Act.

The Court ultimately held that an all-risk policy could not be "shoe-horned" into the Fire Part of the Act and instead applied the longer limitation period stipulated by the General Provisions (thereby saving the arguably negligent lawyer from liability for missing the limitation period). The Court noted the history of the legislation which was "built on the premise of discrete policies for discrete subject matters, with limited overlap" which was now an "outmoded paradigm incapable of coherently addressing the modern multi-peril policy". The Court urged,

> "It is our hope that legislatures will rectify this situation by amending the *Insurance Act* to provide specifically for comprehensive [all-risk] policies. In an insurance era dominated by comprehensive [all-risk] policies, it is imperative that Canada's Insurance Acts specifically and unambiguously address how these statutes are to operate and the rules by which comprehensive policies are to be governed.
>
> It would be highly salutary for the Legislature to revisit these provisions and indicate its intent with respect to all-risks and multiperil policies. In the meantime, the task of resolving disputes arising from this disjunction between insurance law and practice falls to the courts. Brown and Menezes lament: "Surely there can be little which is less productive, or more wasteful, than litigation about such technicalities": C. Brown and J. Menezes, *Insurance Law in Canada* (2nd ed. 1991), at p. 16. I whole-heartedly agree."

In this paper, British Columbia's response to the challenge posed in *KP Pacific*, ie amending the *Insurance Act* and the corresponding ramifications the amendments may present to the future of insurance law will be explored. First, the amendments in British Columbia and Alberta will be explained, next the concept of "material to the risk" will be analyzed and lastly, a review of the case-law of the current provisions will provide insight as to how the future amendments may be treated by the judiciary in BC and Alberta.

A. The amendments to the "unjust or unreasonable contract" provisions in BC and Alberta:

It took a long time but in due course the legislatures of both Alberta and British Columbia responded to the challenge presented in *KP Pacific*. Both provinces have passed legislation amending their respective Insurance Acts, however the changes are not yet in force in either jurisdiction. The unjust or unreasonable contract provision in BC currently reads as follows:

> Unjust exclusions
>
> 129 If a contract
>
> > (a) excludes any loss that would otherwise fall within the coverage prescribed by section 122, or
> >
> > (b) contains any stipulation, condition or warranty that is or may be material to the risk, including, but not restricted to, a provision in respect to the use, condition, location or maintenance of the insured property,
>
> the exclusion, stipulation, condition or warranty is not binding on the insured if it is held to be unjust or unreasonable by the court before which a question relating to it is tried.

The current Alberta Act states that:

> Special stipulations
>
> 552(1) When a contract

> (a) excludes any loss that would otherwise fall within the coverage described in section 544, or
>
> (b) contains any stipulation, condition or warranty that is or may be material to the risk including, but not restricted to, a provision in respect to the use, condition, location or maintenance of the insured property,
>
> the exclusion, stipulation, condition or warranty is not binding on the insured if it is held to be unjust or unreasonable by the court before which a question relating to it is tried.

Both of these provisions are contained in the Fire Part of their respective Insurance Acts.

The New BC Act, which now applies to all property and liability insurance in that Province, will state:

> Unjust contract provisions
>
> 28.3 If a contract contains any term or condition, other than an exclusion prescribed by regulation for the purposes of section 28.4 (1), that is or may be material to the risk, including, but not restricted to, a provision in respect to the use, condition, location or maintenance of the insured property, the term or condition is not binding on the insured if it is held to be unjust or unreasonable by the court before which a question relating to it is tried.

The New Alberta Act will state:

> Special Stipulations
>
> 545(1) If a contract contains a stipulation, condition, term, proviso, or warranty, other than a prescribed exclusions referred to in subsection (3)(a), that is or may be material to the risk, including but not restricted to, a provision in respect to the use, condition, location or maintenance of the insured property, the stipulation, condition, term, proviso, or warranty is not binding on the insured if it is held to be unjust or unreasonable by the court before which a question relating to it is tried.

At the time of writing this article, the amendments to both the British Columbia and Alberta *Insurance Acts* are not currently in force, however that will occur in the near future. Accordingly it is still unclear just how broadly the "unjust contract" provisions will be treated by the courts. In a review of the past 5 years of case-law in Canada, only a handful of cases contemplated similar provisions and every case was specific to a fire insurance policy. A review of the case-law is instructive as to possibilities.

B. "Material to the risk" and risk to insurers:

Section 13(2) of the Current Act provides (and after the proposed amendments will continue to provide) that "the question of materiality is one of fact". The courts have decided that "materiality" imports an objective test of whether any prudent insurer in the normal practice of the insurance business would be influenced whether to accept/decline the risk or to stipulate a higher premium or other limitations: e.g. Kehoe v. British Columbia Insurance Co. (1993) 79 B.C.L.R. (2d) 241 (CA); *Kruska v. Manufacturers Life*

Insurance Co. (1984) 54 B.C.L.R. 343 (SC), affirmed (1985) 63 B.C.L.R. 209 (CA); *Wells v. Canadian Northern Shield*, 2007 BCSC 1844.

It is difficult to conceive of any policy exclusion that would not be "material to the risk". After all, if the underwriter was prepared to assume the risk referred to in the exclusion, it would not have inserted the exclusion in the first place! Hence, once these new provisions come into force, it may be arguable that every policy exclusion is "material to the risk" and therefore is "not binding" on the insured should it be "unjust or unreasonable" in it's application. This in turn probably means that every denial of coverage an insurer may make in the future based on an exclusion is going to be countered by a wide variety of imaginative arguments why the denial is unjust or merely unreasonable in the circumstances. The role of the insured's reasonable expectations of coverage may loom large in that debate The proverbial flood gates may well be opening.

The new provision could also serve to strip insurers of the protection traditionally afforded by a warranty. In insurance law, the characterization of a policy term as a "warranty" imports a requirement of strict compliance by the insured the breach of which discharges the insurer from all liability under the policy even if the loss had no connection whatever to the breach (see *Automotive Products Company Ltd. v. Insurance Company of North America* [1969] S.C.R. 824). If the loss in any given case has no connection to the actual breach of the warranty, it is not difficult to see how a court might conclude a denial based on that warranty is "unreasonable" and therefore not available to the insurer by virtue of new Section 28.3 of the *Act*.

The "unjust or unreasonable" provision of the Current Act was considered by the Supreme Court of Canada in the seminal case of *Marche v. Halifax Insurance Co.* 2005 SCC 6. In that case, the insured's house, which had been converted into two apartments, remained vacant for a period of time before a tenant moved in. Such vacancy amounted to an unreported change material to the risk triggering Fire Statutory Condition 4 which provided that it "shall avoid the contract as to the part affected thereby". In other words, the unreported vacancy rendered coverage void.

The property was subsequently destroyed by fire after a tenant had in fact moved into the premises and therefore the property was no longer vacant. The court was then called upon to decide whether it would be "unjust or unreasonable" to uphold the voiding of the policy (and therefore the denial of coverage) even though the default (unreported vacancy) had in effect been cured by the time the fire occurred. The Supreme Court of Canada answered this question affirmatively observing that,

- the "unjust or unreasonable" relief provision in the *Act* applied not only to make unenforceable policy conditions that are unreasonable on their face but also to relieve against the results of applying policy conditions that, in the particular circumstances of the case, are unreasonable in their application or draconian in their consequences;

- the unjust or unreasonable provision applied to statutory conditions just as much as to other policy terms and conditions;

- such an interpretation avoids inequitable results and corresponds with the remedial objectives of the provision; and

- in the present case, because the vacancy (and the material change in risk) had been rectified prior to the loss, it was clearly unreasonable to enforce Statutory Condition 4 in the circumstances.

Because 1) the "unjust or unreasonable" provision is now contemplated to apply to all property and casualty policies not just fire policies and 2) because most policy conditions and exclusions are "material to the risk" in some fashion, it may now be possible to contest a wide variety of coverage denials on the grounds that applying policy provisions to that effect is either unjust or unreasonable in the circumstances of any given case.

C. Case-law regarding "unjust or unreasonable contracts":

As discussed, the amendments to the "unjust contract" provisions are not currently in force. A review of the case-law on similar provisions in *Insurance Acts* in Canada over the years, yielded a handful of cases that applied only to fire insurance policies. The case-law demonstrates that this provision (or similar provisions in other *Insurance Acts* across Canada) is at the current time applied rarely. Indeed, the courts have given effect to the reasonable and just stipulations as drafted by insurers, even in circumstances where the plaintiff is in an unfortunate circumstance due to no fault of his/her own or even when the stipulation makes it impractical, inconvenient or difficult to carry on business.

In *Abell v. Underwriters, Lloyd's, London*, 2005 BCSC 1715 the plaintiff/insured owned a floating home, which burned to the waterline. He had been mooring the boat temporarily and it was towed away. The insurer refused to pay the claim and argued that the policy was voided by failing to keep the home permanently moored and by failing to inform it of the material change in risk. The court agreed and held that the insured had failed to comply with the warranty contained in the policy and the insurer was not liable. The following paragraphs discuss the plaintiff's claim that the policy was unjust or unreasonable:

> "44 Mr. Abell also argues that his claim should be saved by application of the Insurance Act, s. 129:
>
> > 129. If a contract
> >
> > (a) excludes any loss that would otherwise fall within the coverage prescribed by section 122, or
> >
> > (b) contains any stipulation, condition or warranty that is or may be material to the risk, including, but not restricted to, a provision in respect to the use, condition, location or maintenance of the insured property, the exclusion, stipulation, condition or warranty is not binding on the insured if it is held to be unjust or unreasonable by the court before which a question relating to it is tried.
>
> 45 Mr. Abell asserts that the provision relating to the location and the warranty concerning permanent mooring are unjust or unreasonable. Mr. Abell's position is untenable. It was manifestly reasonable for the insurer to stipulate that its insured permanently moor the floating home - given the, well, fluid nature of a floating home's

> footing, anything other than permanent moorage would surely affect the insurer's risk. It was equally reasonable and just for the insurer to require that its insured stipulate where the home would be moored. Absent that information the insurer could not approximate its risk on the policy. This argument must fail."

In *Charles v. Peace Hills General Insurance Co.*, 2007 ABQB 515 the plaintiff's husband burned their home to the ground intentionally. The defendant insurer argued that the plaintiff was not entitled to indemnification because the co-insured set the fire that destroyed the home. The court held that although the plaintiff was innocent, no relief from forfeiture was granted under the *Insurance Act*. The following paragraphs discuss the plaintiff's claim that the contract is unjust or unreasonable:

> "36 Section 552(1) of the Insurance Act provides: When a contract
>
> (a) excludes any loss that would otherwise fall within the coverage described in section 544 (fire insurance included), or ...the exclusion, stipulation, condition or warranty is not binding on the insured if it is held to be unjust or unreasonable by the Court before which a question relating to it is tried.
>
> 37 Section 10 of the Judicature Act provides:
>
> ... the Court has power to relieve against all penalties and forfeitures and, in granting relief, to impose any terms as to cost, expenses, damages, compensation and all other matters that the Court sees fit.
>
> 38 Mrs. Charles asserts that she was blameless in the loss, that she cooperated with the investigators, that attempts were made to change the parties to the contract of insurance, that attempts were made to clarify the position of Mr. and Mrs. Charles vis a vis the ownership and possession of the house, and that those attempts were known to the agent of Peace Hills who did nothing to assist Mrs. Charles.
>
> 39 Mrs. Charles relies on the dissent in Scott v. Wawanesa Mutual Insurance Co. [1989] 1 S.C.R. 1445. In that dissent the Court declared that the exclusion from coverage caused by the wrongful act or omission of an insured applies only to the insured responsible for the act or omission and does not apply to an innocent insured. However the majority concluded that the terms of the insurance policy were clear and that the policy excluded coverage to all insured even if the intentional or criminal act was the result of only one insured.
>
> 40 Mrs. Charles is in the unenviable position of being victimized as the result of her husband's actions, actions which escalated over a period of time and which were predictable. He threatened her and her property. Her actions were a cautious reaction to the dangers presented by her husband. Unfortunately they were tentative and delayed. The dissent in Scott v. Wawanesa has not been followed. An insurer is entitled to assess the risk it faces when a policy of insurance is issued. To accept Mrs. Charles' position would be tantamount to asking insurance companies to enter into a lottery when a contract of insurance is issued. Each side is entitled to certainty in determining what is the nature of the risk and who is covered by the contract of insurance.

> 41 In my view the exclusion clause in this Contract is contained in the Notice of Renewal. It is one which was brought to the attention of Mrs. Charles and it is one which clearly sets out the parameters of coverage. While Mrs. Charles' circumstances are unfortunate and deserving of sympathy, the exclusionary clause in the Contract of Insurance is neither unjust nor unfair. Mrs. Charles is not entitled to relief against forfeiture.
>
> 42 In the result there is no genuine issue for trial with respect to this claim. It is plain and obvious that the action cannot succeed. The application for such Summary Judgment is granted and the Plaintiff's action is dismissed."

In *Pietrangelo v. Gore Mutual Insurance Co*., 2011 ONCA 162 the plaintiffs appealed the dismissal of their action to enforce the fire loss claim in their homeowner's insurance policy with the respondent. The appellants had rented a house to a tenant. The tenant caused an explosion which completely destroyed the house. The tenant had operated a marijuana grow operation on the property. The insurer relied on the exclusion clause which excluded damages to dwellings used in the manufacture of marijuana. The appeal was dismissed. The following paragraphs discuss the plaintiff's claim that the insurance contract was unjust or unreasonable:

> "9 Second, the appellants' fundamental argument here is that the exclusion clause is unjust and that it operates to create an unfairness on them primarily because of their innocence, or their inability to prevent the events that caused the loss. However, the trial judge correctly observed that the issue in this regard is not whether the clause creates unfairness to the insured, but whether there is a rational basis for its existence.
>
> 10 Indeed, it is in respect of this issue that the trial judge relied on the evidence of the draftsperson. That is, the draftsperson's evidence did not go to the interpretation of the clause; rather, it was in relation to the reason for the existence of such a clause.
>
> 11 The trial judge was of the view that s. 151 of the Insurance Act has no application in this case because the exclusion clause was neither unjust nor unreasonable and that its purpose was valid and legitimate. Thus, whether or not s. 151 applied in the circumstances of this case, it has no impact on the critical finding of the trial judge that the clause was not unjust or unreasonable.
>
> 12 We agree with the trial judge, the exclusion clause in the circumstances of this case is not "unjust or unreasonable". There are certain risks, which insurers are entitled not to cover for legitimate business reasons relating to the ability to assess risk and set premiums."

In *Rosam Enterprises Ltd. v. Zurich Insurance Co.*, [1993] B.C.J. No. 1265 Master Bishop allowed the application for summary dismissal as there was no triable issue. In the decision, Master Bishop stated that this part of the *Insurance Act* is limited to fire and since the policy at issue was an all risk policy, it did not apply to relieve application of the exclusion in the case before him..

In *Poast v. Royal Insurance Co. of Canada*, 21 Man.R. (2d) 67 the insurer denied coverage to the insured based on the "fire extinguisher warranty" which required the insured to carry a 30 pound extinguisher

with the insured tractor. The insured only had a 2 and 3/4 extinguisher and could not extinguish the fire which destroyed the tractor. The action was dismissed and in the following paragraphs, Justice Wilson describes the history of the "unjust or unreasonable" provision as found in insurance legislation:

> "34 In Kekarainen v. Oreland Movers Ltd. et al., [1981] 3 W.W.R. 534, I traced the introduction of s. 145 into Manitoba insurance legislation. Without repeating that exercise, I think it fair to say that certainly since 1925 and subject to the "just and reasonable" test written into s. 145, the insurer may introduce stipulations or conditions "in respect to the use ... of the insured property". And in my view, the requirement to carry a 30-lb. fire extinguisher while the equipment is in action is a condition in respect to the use of the insured property.
>
> 35 The "unjust or unreasonable" clause must itself be reasonably construed; and see Hogg, J.A., in Tarr v. Westchester Fire Ins. Co., [1953] O.R. 378, p. 387, adopted by Holland, J., in Rankin v. North Waterloo Farmers Ins. Co. (1979), 19 O.R. (2d) 517; at p. 520:
>
> > These words 'just and reasonable', as they stood in the Act dealing with insurance, were considered in former years by the Supreme Court of Canada in several appeals.
> >
> > In The City of London Fire Insurance Co. v. Smith (1888), 15 S.C.R. 69, Gwynne, J., said: 'I do not see that any rigid rule can be laid down applicable to all cases as a test adequate to determine whether a variation of any of the statutory conditions is just and reasonable or not. ... Every case must, as it appears to me, depend upon its own circumstances and the sound sense of those who are called upon to determine the question, and no rule can be laid down applicable to all cases.
> >
> > In The Anglo-American Fire Insurance Company v. Hendry et al.; The Montreal-Canada Fire Insurance Company v. Hendry et al. (1913), 48 S.C.R. 577, 15 D.L.R. 832, it was held that the justness and reasonableness of a variation of, or addition to, a statutory condition must be determined according to the circumstances of the case in which it was sought to be applied.
> >
> > In this Province the Courts have considered the words 'just and reasonable' in connection with a variation sought to be made to a statutory condition, and reference has been made to some of these decisions by Mr. Justice Judson.
> >
> > The rule is stated by a Divisional Court in McKay v. The Norwich Union Insurance Company (1895), 27 O.R. 251, to be that the reasonableness of a variation from the statutory conditions is to be decided with relation to the circumstances of each case at the time the policy is issued and not in the light of those existing at the time at which the condition is sought to be applied. There was evidence adduced in the present action to support the view that the clause now under consideration was just and reasonable at the inception of the policy and there is no doubt, in my view, that it is just and reasonable when the circumstances of

> the case are considered. As was said by Mr. Justice Gwynne in the Supreme Court of Canada in The City of London Fire Insurance Co. v. Smith, supra, 'no rule can be laid down applicable to all cases'.

36 In McKay v. Norwich Union, supra, p. 262, Street, J., observed that "an unreasonable condition is one which no sensible man would propose, expecting another man to accept it." And he went on to dismiss as unreasonable a condition which, of a row of tenement houses, required notice to the insurer and reconfirmation of coverage whenever a vacancy occurred, the insurer knowing from the start that, of such premises, tenancies are unpredictable. A condition, he thought, "manifestly more onerous than the statutory condition" of a "change material to the risk".

37 That may not be said of the Fire Extinguisher Warranty here which, although restricting the indemnity contemplated by s. 138 of the Act, does not conflict with the statutory conditions in the policy.

38 Plaintiffs protest the impracticality of carrying a 30-lb. extinguisher on their tractor, an argument gone by the boards in face of defendant's demonstration of the several ways in which the extinguisher might be carried; and see the photographs, Exhibits 14-20. Of the further argument that the presence of the extinguisher in any of those locations would interfere with the ability of the driver to operate the tractor, the seven pictures so exhibited suggest nothing of the kind, and one could expect the operator to accustom himself without difficulty to this extra passenger.

39 The inconvenience or added difficulty of carrying on business was not accepted as evidence of an unjust or unreasonable condition in Automotive Products Co. Ltd. v. Insurance Company of North America (1969), 6 D.L.R. (3d) 210, (the insured to report details of sales from the inventory covered by his insurance), or in Kallinikos Fur Company v. St. Paul Fire and Marine Insurance Company (unreported), Cromarty, J., Ontario Supreme Court June 19, 1978, (monthly reporting of inventory), or in Dunningham v. St. Paul Fire and Marine Insurance Company (1963), 45 W.W.R. (N.S.) 463, (half of the inventory, by value, of the insured jewelery stock to be kept in a safe when the premises were closed).

40 Indeed, the evidence of the witness Steele earlier referred to was that, for eight years past, the 30-lb. Fire Extinguisher Warranty was a standard feature of all policies written by this insurer to cover equipment akin to and when used in the circumstances here. While he could not give the number of such policies, for the three years 1979/81 defendant's premium income for such risks was $647,000, suggesting a significant number of policies, and countering the argument (from McKay, supra) that the persons who would accept such an endorsement must be few indeed.

41 Plaintiffs' witness Gordon Laidlaw, called as an expert, conceded that assuming the operator to understand the purpose and application of a chemical extinguisher, a 30-lb. unit would offer a better defence against fire than the smaller two-and-three-quarter or five-pound unit carried by the plaintiffs. Frank Poast agreed with this, with the caveat

that, whatever the size of the extinguisher, one must be able to reach the source of the fire.

42 Quite so; and one cannot expect the insurer to issue policies in the secure knowledge that there could never be a claim for indemnity. But the reasonableness of the condition here is to be tested by the circumstances at the time of issue of the policy, and not against an event which in fact later occurs, i.e., was it reasonable, and not an injustice, for the defendant to stipulate that, if it was going to accept the risk of fire, plaintiffs, for their part, would lessen the chance of loss by carrying the extinguisher called for?

43 On cross examination, Frank Poast agreed that it was not unreasonable for the defendant to ask for a fire extinguisher costing $97.00, the price of the 30-lb. unit, to protect equipment insured for $70,000.00.

44 Given the right of the insurer to hopefully limit its exposure by a "stipulation, condition or warranty ... in respect to the use ... of the insured property", and the evidence touching the incidence of fires where equipment such as that covered by the policy here is used in bush clearing operations, may I adopt the remarks of MacDonald, C.J.B.C., in Pratt v. Connecticut Fire Insurance Co. (1914), 6 W.W.R. 579, at p. 584:

> I am in entire accord with those who think that variations of statutory conditions should be jealously scrutinized by the court in order to guard against a reversion to the conditions which brought about the intervention of legislators and the enactment of laws for the protection of insurers against unjust contracts. But on the other hand, it must not be forgotten that insurance is a lawful business, highly beneficial to mankind, and that stipulations which would pass without criticism in ordinary commercial contracts are not necessarily to be condemned because they appear in an insurance contract. While the legislature intended to fetter insurance companies to some extent in the making of contracts of insurance, it left them the right to protect their own interests by reasonable restrictions on their liability.

45 In my view the Fire Extinguisher Warranty in defendant's policy is not unjust or unreasonable."

In *Morton v. Canadian Northern Shield Insurance Co.*, [1999] I.L.R. I-3662 the insurer appealed the decision that found a policy of fire insurance to be effective. The insured intended to demolish his building and redevelop, if he obtained the required permit. While waiting for the permit, he had his tenant vacate the building, although he intended to rent the building again if he could not redevelop. The building was destroyed by a fire that was caused by vandalism. The policy excluded coverage for damage caused by vandalism while the building was vacant. The chambers judge held that the premises had been unoccupied but not vacant, since the plaintiff intended to rent them if he did not receive the building permit. The vacancy exclusion, therefore, was not applicable. The appeal was allowed and the court found that the vacancy exclusion was applicable and the vandalism policy was not unjust or unreasonable. In the following paragraphs Justice Hollinrake discusses the "unjust or unreasonable" argument put forward by the respondent:

> "In my opinion, it cannot be demonstrated by the respondent, as it must be, that s. 129 of the Insurance Act permits the Court to conclude the vacancy condition under the "Vandalism" peril is not binding on the respondent as being unjust or unreasonable.
>
> There is necessarily a deliberateness on the part of an insured to the premises becoming vacant within the exclusion. That these premises would become vacant had to be known to the respondent or his agents. Everything done before the vacancy occurred was deliberate and with a view to demolishing the premises.
>
> In my opinion, while the submission of the respondent that coverage can be denied on the first day of vacancy is correct, it cannot be said that at the time of the insurance placement such an exclusion to coverage was "unjust or unreasonable". I reach this conclusion because in my opinion vacancy does not just happen. The state of vacancy is brought about by deliberate acts of the insured or his agents. I think it is reasonable for an insurer to exclude coverage under the "Vandalism" peril where the premises are vacant for however a short period of time."

In *Hirst v. Commercial Union Assurance Co. of Canada,* 70 B.C.L.R. (2d) 361 a real estate agent discovered a hairline crack in an upstairs toilet that had leaked and caused damage. The house had not been occupied yet by the purchasers. The insurance policy excluded loss for damage while the building is vacant for more than 30 consecutive days. Justice Carrothers contemplated the justness and reasonableness of the exclusion in the following paragraphs, but notably did not comment on the fact that this was not a fire insurance policy:

> "14 On the other issue regarding the application of the provisions of Section 212 which I have quoted, the test to be applied is the reasonableness and the justness of the operation of the exclusion provisions in the policy at the time the policy issued and this test is to be judged in the light of the circumstances of the particular case. Undoubtedly, this is a standard exclusion commonly found in similar policies. Increased risk or inherent risk in the premises being vacant is obvious and judicial notice can be taken of it. The obvious duration unobserved of the offending leak in this particular case is directly on point. It must have gone on for quite some time unnoticed to inflict damage as extensively as it did.
>
> 15 Under the policy the Appellant insurer is entitled to assume and to make it a condition of insurance coverage that the insured premises are to be kept under reasonably constant observation which is in effect to equate normal observation with habitation and to provide that a hiatus in this observation or habitation in excess of 30 days voids the coverage.
>
> 16 Reasonably constant observation for water leakage is only one of the circumstances of occupation affecting the risk in the sense the vacancy and the concomitant inattention for a protracted period would be an adverse change material to the risk. It so happens to be the circumstance that turned out to be the relevant one in this case and standing alone in my view confirms the reasonableness of the condition and the justness of it being exacted by the insurer. But it does not fall to the insurer to establish that the exclusion is just and reasonable. On the contrary, it is incumbent on

> the insured to show that at the time of the insurance placement it was unjust and unreasonable, and this in my view has not been done.
>
> 17 I am drawn to the conclusion that the policy provision which is challenged here is an eminently just and reasonable exclusion to appear in the policy and not to be avoided by the operation of Section 212 of the Insurance Act."

It remains to be seen whether these amendments will drastically change the interpretation of insurance contracts in the near future. The jurisprudence reviewing the former provisions, demonstrates that the court has been hesitant to apply such a provision to avoid denials of coverage. However, given the right fact scenario, it is possible that these new amendments, possibly reinforced by a reasonable expectation of coverage on the insured's part alone, may be used to circumvent exclusions or policy breaches which the insurer might reasonably have expected to apply.

Nigel P. Kent
T. 604.643.3135 / npk@cwilson.com

EXCLUDING EXCLUSIONS: The Role of Reasonableness in the Interpretation of Insurance Policies

CWA163575.1