SOME EFFECTS OF AN INSURED'S BANKRUPTCY ON CERTAIN PRINCIPLES OF FIRE INSURANCE

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Insurance is basically a contract between two parties, an insurer and an insured, whereby the insurer, for valuable consideration, agrees to indemnify the insured against loss or liability arising from the occurrence of certain prescribed risks. Section 2(27) of *The Insurance Act* of Manitoba defines insurance as follows:

> '[I]nsurance' means the undertaking by one person to indemnify another person against loss or liability for loss in respect of a certain risk or peril to which the object of the insurance may be exposed, or to pay a sum of money or other thing of value upon the happening of a certain event; but does not include an agreement of the nature commonly described as an investment contract made by a person not licensed under this Act to undertake contracts of insurance.[1]

Although a policy of insurance is basically a contract, it is a very specialized form of contract and the subject of many unique legal principles and specific legislation. This paper will canvas some anomalies and difficulties that arise when an insured declares bankruptcy.

The Effect of an Assignment in Bankruptcy on Insurable Interest

One of the most basic principles of insurance law is that the insured, in order to enforce a contract of insurance, must have an insurable interest in the property insured.[2] What does or does not constitute an insurable interest is the subject of numerous decisions, but basically it can be said that a person has an insurable interest in property if he will suffer a direct and immediate loss[3] by the destruction of that property.[4] For example, if "A" owns a building, he will suffer direct and immediate loss if it is destroyed by fire; he has an insurable interest in the building. If he sells the building, the destruction of it would create no loss and "A" 's insurable interest in the building is lost. Even if "A" retained a policy of insurance, he would not be entitled to claim under the policy.

Similarly, "A" would lose title to all his insurable property, including the building, if a receiving order was made against him or if he filed an assignment in bankruptcy. Section 50(5) of the *Bankruptcy Act*[5] of Canada states:

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1. R.S.M. 1970, c. 140.
2. *Lynch* v. *Dalzell* (1729), 4 Bro. P.C. 431, 2 E.R. 292 (H.L.); *Sadlers Co.* v. *Badcock* (1743), 2 Atk. 554, 26 E.R. 733 (Ch.); *Williams* v. *Baltic Insurance Assn.* (1924), 2 K.B. 282.
3. *Keefer* v. *Phoenix Insurance Co.* (1901), 31 S.C.R. 144.
4. F. Laverty, *The Insurance Law of Canada* (2nd ed. 1936) 77.
5. *Bankruptcy Act*, R.S.C. 1970, c. B-3.

> On a receiving order being made or an assignment being filed with an official receiver, a bankrupt ceases to have any capacity to dispose of or otherwise deal with his property, which shall, subject to this Act and subject to the rights of secured creditors, forthwith pass to and vest in the trustee named in the receiving order or assignment, and in any case of change of trustee, the property shall pass from trustee to trustee without any conveyance, assignment or transfer.

A question arises as to whether an insured would retain an insurable interest in property if a receiving order was made against him, or if he filed an assignment in bankruptcy. The Courts, for the most part, have answered this question in the affirmative, finding an insurable interest from at least two different approaches. Both of these approaches are espoused in the case of *Wade* v. *Rochester German Fire Insurance Co.*[6]

In *Wade*, Middleton, J. at trial and Maclaren and Magee, JJ.A., on appeal, held that an insured,. on bankruptcy, retains an insurable beneficial interest in the property by virtue of his right to have the surplus property returned to him by the Trustee in Bankruptcy if all debts are discharged.[7] Moss, C.J.O., and Garrow, J.A., agreeing in the result at appeal, held that the insured, on bankruptcy, retains an insurable beneficial interest, since his financial position may improve and he could then discharge his debts and call on the Trustee in Bankruptcy to return his property.[8] These two approaches can be boiled down into the single basic principle, that an assignment to a Trustee in Bankruptcy is not a transfer of the whole interest; it is not an absolute assignment, transfer of the title, and determination of the interest.[9]

This common law right of the bankrupt to the remainder is codified by Section 115 of the *Bankruptcy Act* of Canada which states:

> The bankrupt or the legal personal representative of a deceased bankrupt is entitled to any surplus remaining after payment in full of his creditors with interest as by this Act provided and of the costs, charges and expenses of the bankrupt's proceedings.[10]

Following the reasoning in the *Wade* case, a bankrupt under the *Bankruptcy Act* would retain an insurable interest.

Given that a bankrupt retains an insurable interest in property passed to the trustee, it is still doubtful that he would be able to enforce payment under the policy. An insured must prove loss, and since a bankrupt's insurable interest is so tenuous he would be hard

6. (1911), 23 O.L.R. 635 (C.A.).
7. *Id.*, at 636-38, 640-43, *See also In re Dickie; Ex parte Trustee* (1925), 7 C.B.R. 196, at 199 (N.S.S.C.).
8. *Supra* n. 6, at 639-40.
9. *Id. See also McQueen* v. *The Phoenix Mutual Fire Insurance Co.* (1880), 4 S.C.R. 660; *Bull* v. *North British Canadian Investment Co.* (1888), 15 O.A.R. 421 (C.A.).
10. *Bankruptcy Act*, R.S.C. 1970, c. B-3.

pressed to prove more than nominal loss. The loss, if any, would be the difference between value of the property and the debts owing; or it could be the loss taking into account the unlikely possibility of the bankrupt's coming into money and being able to pay off all his debts and call for the return of the property. In most instances the loss would be theoretical as would be the chances of recovery.

To avoid the obvious risks inherent in these events, the common law position has been that, on bankruptcy, the insurable interest of the bankrupt, as owner, is assigned by operation of law to the trustee.[11] The name of the trustee is fictionally inserted in the policies in place of that of the debtor.[12] This means that the trustee can enforce the insurance policies and claim the full value of any property as if he were the full owner. This principle has been enacted in statutory provisions, notably Section 13(2) of the *Bankruptcy Act*:

> All insurance covering property of the bankrupt in force at the date of bankruptcy shall immediately, and without any notice to the insurer or other action on the part of the trustee, and notwithstanding any statute or rule of law or contract or provision to a contrary effect, become and be, in the event of loss suffered, payable to the trustee as fully and effectually as if the name of the trustee were written in the policy or contract of insurance as that of the insured or as if no change of title or ownership had come about and the trustee were the insured.[13]

Not only is loss made payable to the trustee, but it is payable as fully and effectually as if the name of the trustee were written in the policy as that of the insured, or as if no change of title or ownership had come about and the trustee were the insured.

Change of Insured Without Notice

Section 13(2) by codifying the common law principle of passing the insurable interest of the bankrupt to the Trustee in Bankruptcy, creates a problem for the insurer, in that the section clearly takes effect without any requirement of notice being served on the insurer. Consequently, an insurer takes a risk whenever it pays the claim of an insured without checking to see if the insured is bankrupt. A payment to the bankrupt cannot relieve the insurer from its obligation to the trustee created by the section. The only remedy available to the insurer would be against the insured who, of course, is bankrupt.

This right to proceed against a bankrupt insured is of little comfort to an insurer. Certainly, if there is any doubt about the solvency of the insured, it would be prudent to check the bankruptcy records prior to payment under a policy, because if such payment occurs

11. *In re Dickie, Supra* n. 7. *Manchester Fire Assurance Co.* v. *Wykes* (1875), 33 L.T. 142 (C.A.); *Re Carr and Sun Fire Insurance Co.* (1897), 13 T.L.R. 186 (C.A.); *Hood's Trustees* v. *Southern Union General Insurance Co.*, [1928] 1 Ch. 793 (C.A.).
12. *In re Dickie, Supra* n. 7.
13. *Bankruptcy Act*, R.S.C. 1970, c. B-3.

after the date of the bankruptcy, it must be made to the trustee and not the original insured.

Ascertaining the Date of Bankruptcy for Purposes of Section 13(2)

The problem with which the insurer is confronted as the result of Section 13(2) is compounded by the difficulty in ascertaining the "date of the bankruptcy." Bankruptcy is defined by Section 2 of the *Bankruptcy Act* as "the state of being bankrupt or the fact of becoming bankrupt."[14] Section 50(4) of the *Bankruptcy Act* provides that:

> The bankruptcy shall be deemed to have relation back to and to commence at the time of the filing of the petition on which a receiving order is made or of the filing of an assignment with the official receiver.

Further, Sections 39 and 44 of the *Bankruptcy Act*, under certain circumstances, may relate the date of the assignment and consequently the date of the bankruptcy, back to the date on which a copy of a proposal was filed.

In considering the difficulty created by the "relating back" sections, it must be remembered that the mere filing of a proposal does not by itself create a state of bankruptcy and depending upon the terms of the proposal, the insured might well be entitled to the proceeds of the policy. On the other hand, if during the period before the Court has approved the proposal the insured files an assignment or if the proposal is rejected, the date of the assignment and the bankruptcy is deemed by Sections 39 or 44 and Section 50(4) to be the date on which a copy of the proposal was so filed.

An insurer in the position of having paid the proceeds of the policy to an insured prior to the making of a receiving order but subsequent to the filing of a petition, could argue that the "date of the bankruptcy" was in fact the date the receiving order was made and that the "relating back" sections did not apply. In other words, he may argue that the payment of the insurance proceeds was a protected transaction within the meaning of Section 75(1) of the *Bankruptcy Act*, which states:

> Subject to the foregoing provisions of this Act with respect to the effect of bankruptcy on an execution, attachment or other process against property, and with respect to the avoidance of certain settlements and preferences, nothing in this Act invalidates, in the case of a bankruptcy
> (a) any payment by the bankrupt to any of his creditors,
> (b) any payment or delivery to the bankrupt,
> (c) any conveyance or transfer by the bankrupt for adequate valuable consideration, or
> (d) any contract, dealing, or transaction by or with the bankrupt for adequate valuable consideration,

14. *Bankruptcy Act*, R.S.C. 1970, c. B-3, s. 2.

if both the following conditions are complied with, namely:

(e) that the payment, delivery, conveyance, assignment, transfer, contract, dealing, or transaction, as the case may be, is in good faith and takes place before the date of the bankruptcy, and

(f) that the person, other than the debtor, to, by, or with whom the payment, delivery, conveyance, assignment, transfer, contract, dealing or transaction was made, executed or entered into, has not at the time of the payment, delivery, conveyance, assignment, transfer, contract, dealing or transaction, notice of any act of bankruptcy committed by the bankrupt.[15]

Prior to 1949, the predecessor to Section 75 had used the words "before the date of the receiving order or authorized assignment." These words, without doubt, provided protection to an insurer in the above circumstances. This phrase, however, has now been changed to read "before the date of the bankruptcy" which obviously does not provide as much protection, if any, to the insurer.

There appears to be a divergence in the case law as to the interpretation of the phrase "date of the bankruptcy" as it is used in Section 75. In *Freed* v. *Rioux*,[16] the Court held that the date of the bankruptcy was the date on which the petition was filed and not the date on which the receiving order was in fact issued. However, in *Re Pic-N-Save Ltd.*,[17] it was held that the date of bankruptcy was the date that the receiving order was made and not the date of the filing of the petition.[18]

Assignment Subject to the Equities

The rights of a trustee under an insurance policy arising due to the operation of Section 13(2) can be no greater than the rights of the bankrupt. A trustee takes the policy subject to all of the equities.

In the case of *In re Dickie; Ex parte Trustee*,[19] the bankrupt had before the bankruptcy made loss payable under his insurance policies on his building to the Canadian Bank of Commerce. After the bankruptcy, fire destroyed the property covered by the policies. The trustee claimed under the policy by virtue of the provisions of the Bankruptcy Act, but the Court held that the trustee could be in no better position than the bankrupt who would have had no right to the money had the bankruptcy not occurred. Consequently, the bank was entitled to the proceeds of the policy, even though the Trustee in Bankruptcy was the only party which had an insurable interest in the property.

15. *Bankruptcy Act*, R.S.C. 1970, c. B-3, s. 75(1).
16. (1964), 7 C.B.R. (N.S.) 55 (Que. Q.B.).
17. (1972), 32 D.L.R. (3d) 431 (Ont. S.C.).
18. *See also Re McAulay Bros. Ltd.*; *Broadhead* v. *Royal Bank of Canada* (1968), 12 C.B.R. (N.S.) 94 (Ont. S.C.) and *Re Stemec Ltd.*; *Goldberg* v. *Foxboro Co.* (1974), 18 C.B.R. (N.S.) 243 (Que. S.C.).
19. *Supra* n. 7.

In the case of *Central Mortgage and Housing Corp.* v. *Dixon*,[20] the insured prior to bankruptcy agreed to assign his policy on demand to a mortgagee. After the bankruptcy, the trustee, although he took the assets unaware of either the mortgage or the agreement to assign, was required to assign the policies or the proceeds of the policies on demand to the mortgagee in accordance with the agreement.[21]

The assignment of loss payable or the assignment of the insurance should not be confused with the transfer or conveyance of the property insured or an assignment of the insured's interest in the property. The transfer or conveyance of the property results in the insured losing his insurable interest. This renders the policy unenforceable and is a defence available to the insurer against both the bankrupt and the trustee.

Fraudulent Conveyances

There is one instance in which a policy that would be unenforceable in the hands of the insured could be enforced by the trustee. This is the result of the provisions of the *Bankruptcy Act* relating to fraudulent conveyances. If the conveyance of the property covered by the insurance is fraudulent, the trustee may attack the conveyance and have it set aside. Upon a successful application by the trustee to set aside the fraudulent conveyance and upon the reconveyance to the trustee of the property, there would be a valid insurable interest upon which a claim under the policy could be made.[22]

This is not the case where the transferee effects the policy in his own name and makes all premium payments himself. In such circumstances, even if the conveyance was fraudulent and set aside, the trustee would have no right to trace the insurance proceeds. This is so notwithstanding that the trustee would be entitled to retrieve the property transferred or the proceeds of sale of the property. In *Canadian Credit Men's Trust Assn. Ltd.* v. *Chow Luñ*,[23] a bankrupt fraudulently transferred his car to his wife who subsequently insured the car in her own name and paid the premium. Her husband became bankrupt and the car was destroyed by fire. The Court held that the

20. [1971] 2 W.W.R. 442 (Man. Q.B.).
21. *See also In re McGinnis* (No. 2 & 3) (1950), 30 C.B.R. 178, 264 (B.C.S.C.); *In re Burce* (1923), 4 C.B.R. 513 (Sask. K.B.) (right of conditional vendor when bankrupt failed to assign policy); *In re Wilner* (1928), 8 C.B.R. 616 (Ont. S.C.) (applicable where loss made payable to someone other than the insured by agreement. Amounts to an equitable estoppel and is valid as against the trustee).
22. *Turgeon* v. *Dominion Bank* (1929), 11 C.B.R. 205 (S.C.C.); *Canadian Credit Men's Trust Assn. Ltd.* v. *Winnipeg Fire Underwriters Agency* (1926), 7 C.B.R. 565 (Alta. S.C.); *In re Radowelsky* (1927), 8 C.B.R. 457 (Que. S.C.).
23. (1930), 13 C.B.R. 275 (Alta. S.C.). This case further decided that the transferee of property fraudulently conveyed has an insurable interest in that property sufficient to maintain a claim for the proceeds.

proceeds of insurance arose from a special contract and did not amount to a replacement of the property lost in the fire.[24]

Effect of Bankruptcy on the Right of Subrogation

Under *The Insurance Act* of Manitoba, with respect to fire insurance, the insurer has a right of subrogation. Section 146(1) of the *Act* states as follows:

> The insurer, upon making any payment or assuming liability therefor under a contract of fire insurance, shall be subrogated to all rights of recovery of the insured against any person and may bring action in the name of the insured to enforce such rights.[25]

The bankruptcy of an insured can create difficulties with respect to a subrogated action. The Section in *The Insurance Act* basically has the effect of assigning the right to the cause of action from the insured to the insurer. The assignment as such would be for valuable consideration and even if it occurred within a three month period of the bankruptcy would be a "protected transaction" within the meaning of the *Bankruptcy Act.* There can be little question that all rights of recovery will pass to the insurer even though the insured is insolvent at the time and subsequently becomes bankrupt. The difficulty arises for the insurer when it attempts to commence and maintain an action, based on the subrogated claim, in the name of the insured who has become a bankrupt.

Once the bankruptcy has occurred, all of the property of the bankrupt, by virtue of Section 50(5), including the right to bring an action with respect to a loss of property, vests in the trustee. The bankrupt no longer has any interest in the property and would be unable to maintain the action on his own behalf.[26]

In response to a claim filed in the name of a bankrupt with respect to property, the defendant could plead that the bankrupt has no cause of action and that the proceedings should have been taken by the trustee.[27] If such a claim were in fact a subrogated claim, the onus would then fall on the insurer to adduce evidence to prove that it was a subrogated claim being advanced by the insurer pursuant to *The Insurance Act.*

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24. The proposition discussed in the *Chow Lun* case *Id.*, that the proceeds of insurance do not represent the property insured is more fully discussed with respect to the position of secured creditors in the case of *In re Giguère, Moreau and Morin* (1924), 5 C.B.R. 756 (Que. C.A.).

25. *The Insurance Act*, R.S.M. 1970, c. 140.

26. This applies only to property affected by the bankruptcy and does not necessarily prevent a bankrupt from suing in his own name with respect to after-acquired property. The difficulty arises in determining what property the action concerns. *See Lewis* v. *St. Paul Fire & Marine Insurance Co.* (1966), 9 C.B.R. (N.S.) 63 (Man. Q.B.).

27. In *Lemoine* v. *Rol* (1966), 10 C.B.R. (N.S.) 115 (Que. S.C.) the Court held that the defendant could not successfully plead the plaintiff's lack of capacity because in so doing the defendant was really pleading the rights of a third party. However, in the *Lewis* case *Id.* the capacity of the plaintiff was questioned in interlocutory proceedings on the grounds that the plaintiff, being a bankrupt, had no cause of action.

Conclusion

An insured's declaring bankruptcy does create unique problems, particularly for the insurer. This paper has briefly reviewed a few of the interesting results bankruptcy has on insurance law. Although an exhaustive treatment has not been attempted here, it is hoped that lawyers will be alerted to the primary areas of controversy in this complex area.