THE GRADUAL (AND ILLOGICAL) DEMISE OF SUBROGATION RIGHTS

CHARLES R. HUBAND*

> "This right of 'subrogation' rests upon the ground that the insurer's contract is in the nature of a contract of indemnity and that he is therefore entitled, upon paying a sum for which others are primarily liable to the assured, to be proportionately subrogated to the right of action of the assured against them."[1]

This quotation from *The Law of Insurance* by Colinvaux is an accurate description of subrogation. Once an insurer makes a payment, the insurer stands in the shoes of the insured, and is entitled to exercise whatever rights the insured might exercise against third parties, in either tort or contract.

If, for example, my house is destroyed by fire, and I am paid for the loss by my insurer, the insurance company then has the option to bring an action, in my name, against any party who may be responsible for causing the fire, deliberately or as a result of negligence.

The subrogation rights which the insurer may wish to exercise can be expanded or diminished by contract. If the insured has acquired additional rights by contract which would not normally be available, those rights can be exercised by the subrogated insurers. But more often the subrogated rights are diminished by contract.

Once a loss has occurred, it is improper for an insured to limit the rights of the insurer. The classic case of *Castellain* v. *Preston*[2] is an example. A house burned down which was insured, resulting in a payment by the insurer to the house owner. At the time of the loss, the owner was party to a contract under which the property was to be sold. The contract was framed in a manner which required the purchaser to pay the purchase price in full, in spite of the destruction of the house by fire. The purchase price was in fact paid to the insured, which meant that he had recovered the value of the property twice — once from his insurer and once from the purchaser.

The insurer should have had the benefit of standing in the shoes of its insured and exercising the rights under the contract of sale to diminish its loss, an unexpected bonus for the insurer. But the benefits of the contract had been exercised by the insured and were no longer available to the insurer. This improper interference with the exercise of subrogation rights by the insured was remedied by allowing judgment in favour of the insurer against the insured.

Prior to the occurrence of the loss, however, the insured is entitled to enter into any contracts and agreements, and the insurer can

---

* Of the Manitoba Bar. Partner with Richardson and Company, Winnipeg.

1. R. Colinveaux, *The Law of Insurance* (3rd ed. 1970) 129.
2. (1883), 11 Q.B.D. 380.

only hope that the contractual arrangements will not erode potential subrogation rights.

There have been several cases of considerable interest and importance involving leasing arrangements in which the landlord has entered into a lease which contains terms which have a bearing on the subsequent exercise of subrogation rights by the insurer against the tenant.

The *Hutson* Case and Its Progeny

The starting point for a review of the case law in this area is *United Motors Service* v. *Hutson,*[3] and in particular, the judgment of Kerwin J. at the Supreme Court level. The judgment is not startling or remarkable. A building owned by J. T. and H. Hutson was leased to United Motors Service Inc. A fire occurred which damaged the building. The fire was caused by the negligence of an employee of the tenant, United Motors Service. The building was insured. After having paid for the damage the insurers brought an action in the name of the landlord, against the tenant to recover the damages. The subrogated action succeeded.

Kerwin J. points out that under the common law, there was a period when lessees were not answerable to their landlords for the accidental or negligent destruction of the demised premises by fire. By statute, this was changed in mid-nineteenth century, and thereafter a tenant has been held responsible for negligently damaging the premises on the basis of responsibility for waste.[4]

The operation of this law can be displaced by a stipulation in the lease itself between landlord and tenant, but the standard form of leases almost invariably contain a covenant on the part of the lessee to repair, in keeping with the obligation to indemnify the landlord for waste. The standard form of lease, the type considered by Kerwin J., which has not altered appreciably through the years, also contains clauses which limit the lessee's obligation to repair. "Reasonable wear and tear and damage by fire, lightning and tempest, riot or public disorder or act on the part of any governmental authority" are exceptions to the obligation of the tenant to repair. However, Kerwin J. held that the word "fire" in this phrase was not intended to include a fire loss occasioned by the tenant's own negligence.[5] The standard form of lease also contains a provision for the abatement of rent while the premises are being repaired after a fire. Again, Kerwin J. makes it clear that the existence of such a clause in the lease does

3. [1937] S.C.R. 294 (hereinafter referred to as the *Hutson* case).
4. *Id.*, at 301.
5. *Id.*, at 302.

not diminish the lessee's obligation to pay for fire damage negligently caused.[6]

> The effect of these various clauses is to leave the appellant [tenant] liable for damage by a fire caused through its negligence. . .[T]he appellant could not be relieved from such liability under the exception in the covenant to repair. It would require much stronger language to permit the appellant to escape payment for damages caused by its negligence. . . .[7]

Hence, in the *Hutson* case the insurers of the landlord succeeded in their subrogated claim against the negligent tenant. But fire insurance underwriters can find little comfort in the language of Kerwin J. Ever since this decision the courts have been dissecting leases with great care to determine whether it contains that "much stronger language" which releases the tenant from liability to repair, and thus destroys the subrogated claim of the landlord's fire insurers.

Shell Oil Co. v. *White Motor Co.*,[8] a judgment of Kelly J. of the Ontario High Court is the next important case in chronological order. The facts relative to liability corresponded to the *Hutson* case in that there was a fire in the demised premises caused by the negligence of the tenant, which led to a subrogated claim being advanced by the landlord's insurers against the tenant. The terms of the lease between landlord and tenant were slightly different.

One such difference favoured the position of the landlord and, in turn, its subrogated insurers. The covenant to repair did not contain the usual exception for "wear and tear and damage by fire, lightning and tempest. . . ." Kerwin J. had held, however, that this exception did not include in its ambit damage by fire negligently caused by the tenant, so the omission of the exemption was of no great significance. It merely made the unassailable position of the landlord even more unassailable.

The outer variation in the wording of the lease related to responsibility for payment of insurance premiums. In the *Hutson* case the lease stated that the landlord was responsible for payment of taxes and "all premiums of insurance upon the buildings." In the *Shell Oil* case the lease contained a similar provision, but also contained this additional term:

> [I]n the event any business conducted on the said premises which will cause the rate of insurance to be raised on the said premises, the Lessee will compensate the Lessor for any extra premium of insurance thereby required.[9]

One assumes that the rent exacted by the landlord will cover costs, including taxes and insurance premiums, and yield a profit besides. But

6. *Id.*, at 303.
7. *Ibid.*
8. (1957), 8 D.L.R. (2d) 753 (Ont. H.C.) (hereinafter referred to as the *Shell Oil* case).
9. *Id.*, at 755.

this clause might be interpreted as more than that. Could it not be said that this phrase constitutes an undertaking by the landlord to insure, using the tenant's money? And if this be so, surely there is an implication that the tenant is entitled to the benefits of the insurance for which it is paying. Consequently, the subrogation rights of the landlord's insurers are extinguished.

That was not the way it was seen by Kelly J. who concludes his judgment in these terms:

> [I]t is evident that the lessor's covenant 'to pay all premiums of insurance upon the building erected on the demised premises' does not include premiums of insurance against fires caused by negligence of the tenant occupant of the building so as to absolve the tenant from repairing the consequent damage to the building under the tenant's covenant to repair.[10]

Surpassing the *Hutson* Case

In *Agnew-Surpass Shoe Stores Ltd.* v. *Cummer-Yonge Investments Ltd.*[11] the lease did more than say that the lessee would pay any increase in insurance rates. The lease in question was a shopping centre lease. The landlord, Cummer-Yonge Investments, undertook to insure the shopping centre, including that portion occupied by the tenant Agnew-Surpass Shoe Stores, "against all risk of loss or damage caused or resulting from fire." The lease required the tenant to take good and proper care of the leased premises, "except for reasonable wear and tear. . .and damage to the building caused by perils against which the lessor is obligated to insure hereunder."

This case ultimately found its way to the Supreme Court where it was heard by a full Court. Seven of the nine Judges concluded that the terms of the lease precluded a claim by the landlord or its subrogated insurer against the tenant for fire damage to the building caused by the negligence of the tenant's employees. Three of the seven, including Laskin C.J., held that the landlord was also prevented from asserting a claim for loss of rentals against the tenant while four members of the seven were of the view that the landlord's claim was extinguished only insofar as it related to property damage. For our purposes this difference of opinion among the majority is of no significance. The judgment of Laskin C.J., Judson and Spence JJ. was written by the Chief Justice. Pigeon J. wrote the second majority judgment on behalf of himself, Ritchie, Dickson and Beetz JJ. A dissenting judgment was presented by deGrandpré J. for himself and Martland J.

Laskin C.J. was able to distinguish the judgment of Kerwin J. in the *Hutson*[12] case on the basis of the terms of the lease. In the

10. *Id.*, at 761-62.
11. [1976] 2 S.C.R. 221 (hereinafter referred to as the *Agnew-Surpass* case).
12. *Id.*, at 233-34.

Hutson case, the lease contained a clause obliging the tenant to repair, except for "wear and tear and damage by fire. . . ." In the *Agnew-Surpass* case the tenant's obligation to repair had an exception for "damage caused by perils against which the lessor is obliged to insure," and the lease imposed the obligation on the lessor to insure against the risk of fire. The Chief Justice wrote:

> [T]he lease does not contain the usual tenant's repairing clause which associates a covenant to repair with an exception of damage by fire. Rather, the lessor is obliged to insure against all risks of loss by fire, and the tenant's obligation to repair excepts damage caused by perils against which the lessor is obliged to insure. The tenant would not, ordinarily, be liable for an accidental fire where it was not caused by negligence. The lease in this case recites that it is made pursuant to *The Short Forms of Leases Act*. Under that Act. . .the standard tenant's repairing covenant reads 'to repair, reasonable wear and tear and damage by fire, lightning and tempest only excepted'. Variations are permitted, and it appears to me that the parties in the present case, in replacing the usual tenant's covenant to repair, which excludes liability for accidental fire, with a provision excluding liability for all risks of damage by fire, made it clear that the only subject matter which can be assigned to this exception so far as the tenant is concerned is coverage for fire arising from its negligence.[13]

While seven of nine Judges of the Supreme Court found cause to distinguish the *Hutson* case, two members of the Court did not. Regrettably they did not set forth their reasons in sufficient detail to allow us to follow their reasoning. Laskin C.J. is surely right: if "much stronger language" is required than in the *Hutson* case to negate the landlord's right to claim against a negligent tenant for fire damage, that much stronger language is to be found in the *Agnew-Surpass* lease.

Pyrotechnics in The Supreme Court

But if the *Agnew-Surpass* case seems to afford the opportunity to move counter to the *Hutson* case, the decision of the Supreme Court in *Ross Southward Tire Limited* v. *Pyrotech Products Limited*[14] is more difficult to justify.

It is noteworthy that both the *Agnew-Surpass* case and the *Pyrotech Products* case came before the Supreme Court at almost the same time, and dealt with similar issues. The *Pyrotech Products* case was argued first, but judgment was delivered shortly after the *Agnew-Surpass* judgment. The *Pyrotech Products* case was argued before a five-man Court consisting of Laskin C.J., Judson, and Spence JJ. for the majority and DeGrandpré and Beetz JJ. in dissent. The *Angew-Surpass* case was considered by a full Court. While the division in *Agnew-Surpass* was seven to two to disallow the subrogated insurer of the landlord claiming fire damage against the

13. *Id.*, at 232.
14. [1976] 2 S.C.R. 35 (hereinafter referred to as the *Pyrotech Products* case).

negligent tenant, in the *Pyrotech Products* case the division was three to two, and one of the Judges, Beetz J., formed part of the majority in *Agnew-Surpass* but part of the minority in the *Pyrotech Products* case.

In the *Pyrotech Products* case the lease between landlord and tenant specified that the tenant would pay the "insurance rates immediately when due." The insurance coverage was actually arranged by the landlord. The bill for the premium was sent to the tenant and the tenant paid the premium in conformity with the provisions of the lease. The tenant did not know, and did not inquire of the landlord, the kind of insurance coverage being obtained. Suffice it to say that after a loss negligently caused by the tenant's employees it became evident that the policy insured only the landlord, and after payment of the fire loss the insurers then brought a subrogated action in the name of the landlord against the tenant.

The terms of the lease between landlord and tenant were almost identical to the form in the *Hutson* case except that in the *Hutson* case the lessor was responsible for payment of insurance premiums. In the *Pyrotech Products* case the standard printed form of lease was amended by adding a paragraph making it the lessee's responsibility to pay the "insurance rates." The documentation was not dissimilar to the situation which faced Kelly J. in the *Shell Oil* case except in that case the lessee undertook to pay any increase in insurance premiums occasioned by the tenancy where in the *Pyrotech Products* case the lessee was responsible for the total insurance premium.

DeGrandpré and Beetz JJ. did not consider the responsibility on the lessee to pay insurance premiums of itself sufficient to distinguish the unanimous decision of a five member panel of the Supreme Court in the *Hutson* case. DeGrandpré's judgment makes the point:

> [N]o importance from the point of view of the tenant's liability should be attached to the fact that one or the other of the parties to the lease pays the insurance rates. In the *Hutson* case, they were to be paid by the lessor and this stipulation did not bar recovery (by way of subrogated action by the landlord's insurer). Yet it certainly could not have escaped the members of this Court that, in actual fact, such an expense would be added to the carrying charges of the leased premises and would eventually find its way into the amount of the rent. If in the *Hutson* case the assumption by the lessor of the obligation to pay the insurance premiums did not constitute the lessee an additional insured although obviously he would eventually bear that amount, the result must be the same in the case at bar where the direct rather than the indirect route has been taken to spell out that the lessee must pay a rent that will bring the lessor an equitable rate on his capital.[15]

15. *Id.*, at 44.

DeGrandpré J. distinguished the *Agnew-Surpass* case as being a case which turned on interpretation of the particular lease under consideration in that case. In the *Pyrotech Products* case itself the terms of the lease were almost on the model of the *Hutson* case except that the lessee was to pay insurance rates. DeGrandpré J. wrote that in the *Agnew-Surpass* case,

> [T]he tenant was relieved of liability because its exoneration had been defined by reference to the landlord's obligation to insure the building. No such reference is contained in the lease under consideration and no such obligation is imposed upon the landlord; on the contrary, the relevant clauses in the case at bar are substantially similar to the terms of the lease in *Hutson* . . . .[16]

To the Chief Justice and the other members of the majority however, the *Pyrotech Products* case turned on the simple proposition that if the lessee is to be responsible for payment of the insurance premiums he is entitled to the benefits of coverage:

> [U]nder the provision of the lease respecting payment of insurance rates by the tenant, the risk of loss by fire passed to the landlord, at least upon the presentation by the landlord of the insurance bill, and that the matter thereafter was between the landlord and its insurer.[17]

Laskin C.J., regarded the *Pyrotech Products* case as a simple "assertion of a claim by a tenant to benefit from its payment for insurance pursuant to the terms of its lease."[18] On the other hand, he saw the previous cases, *Hutson* and *Shell Oil,* in a distinctly different light. These cases he distinguished as being concerned "with an attempt to shelter under a landlord's undertaking to pay insurance premiums. . . ."[19]

The *Eaton* Case

The last case which ends this strange eventful history is *T. Eaton Co.* v. *Albert E. Smith.*[20] Again we have fire damage to a building due to the negligence of the tenant's employees. Again the Court is called upon to adjudicate the right of the subrogated insurer of the landlord to press a claim against the tenant. Once again the Supreme Court pondered the provisions of the specific lease between the parties in order to arrive at a conclusion. And once again the majority judgment is written by the Chief Justice and the dissenting opinion by DeGrandpré J. The hearing was before the full Court and the only variation from the alignment of judges in the *Agnew-Surpass* case is that Ritchie J. leaves the camp of the majority and joins deGrandpré J. in the minority.

---

16. *Id.*, at 44-45.
17. *Id., at* 39.
18. *Id.,* at 40.
19. *Ibid.*
20. (1977), Unreported (S.C.C.) (hereinafter referred to as the *Eaton* case).

The lease contained a specific clause requiring the landlord to insure: the direct opposite to the *Pyrotech Products* case where the full responsibility to pay the insurance premiums was the obligation of the tenant. The specific clause reads:

> AND THE LESSOR covenants with the Lessee that he will, throughout the currency of this lease and any extension thereof, hereunder keep the buildings upon the said premises insured against loss by fire in an amount not less than One Hundred and Ten Thousand Dollars.[21]

The lease also contained the usual covenant on the part of the tenant, "wear and tear and damage by fire, lightning and tempest only excepted." As we have seen, this phrase does not include fire damage negligently caused by the tenant or its employees. Thus, the Chief Justice correctly postulates that the tenant can only escape liability "on the basis that the landlord's covenant to insure is a covenant that runs to the benefit of the tenant, lifting from it the risk of liability for fire arising from its negligence and bringing that risk under insurance coverage."[22]

The Chief Justice then proceeds to conclude that the landlord's undertaking to insure does precisely that: it brings the tenant under the umbrella of insurance coverage to be provided by the landlord and thus defeats a potential subrogated claim by the landlord's insurers against the negligent tenant. Laskin C.J. refers to the fact that in the *Eaton* case, the tenant was given an option to purchase under the terms of the lease, and "if anything" the existence of the option re-enforced his view that the tenant should have the benefit of the insurance which the landlord contracted to provide. The Chief Justice also noted that his decision was consistent with three American decisions in recent decades.[23]

As to the decision of his own Court some forty years earlier in the *Hutson* case, Chief Justice Laskin concludes that Kerwin J. wrote "nothing. . .from which any conclusion could be drawn as to the effect of the covenant to pay insurance premiums."[24]

Conclusion

Let us now take stock of this legerdemain to see where we have gone in forty years. The *Hutson* case tells us that the normal subrogation rights will exist and persist unless taken away by clear and decisive language. A covenant by the lessor to pay the cost of insurance is not enough. The *Shell Oil* case confirms the *Hutson* case,

21. *Id.*, at 2.
22. *Id.*, at 4.
23. *Id.*, at 9. The decisions mentioned are *General Accident Fire & Life Assurance Corp.* v. *Traders Furniture Co.* (1965), 401 P. 2d 157 (Ariz. C.A.), *New Hampshire Insurance Co.* v. *Fox Midwest Theatres, Inc.* (1969), 457 P. 2d 133 (Kan. S.C.) and *Winkler* v. *Appalachian Amusement Co.* (1953), 79 S.E. 2d 185 (N.C.S.C.)
24. *Id.*, at 11.

and goes further. A covenant by the tenant to pay any increased insurance premiums caused by the nature of its activities, is not that "much stronger language" required by Kerwin J., to displace normal subrogation rights.

The *Agnew-Surpass* case, in which the lease does not contain the usual covenant on the part of the tenant to repair, is an example of the kind of wording in a lease which will displace the normal subrogation rights. The *Pyrotech Products* case, which begins to strain our credulity, then tells us that where the lessee has assumed the responsibility to pay the full cost of insurance as one of the covenants of the lease, as opposed to increased costs of insurance as in the *Shell Oil* case, again there is language sufficiently strong to set aside normal subrogation rights.

Finally we come full circle, and in the *Eaton* case, a covenant on the part of the landlord to insure, as distinct from paying the insurance premiums as in the *Hutson* case, will be sufficient to cancel the subrogation rights of the landlord's insurers.

One might well ask: when are subrogation rights left intact? When there is a covenant on the part of the lessee to pay the insurance costs, subrogation rights vanish. When there is a covenant on the part of the lessor to insure, subrogation rights disappear. It would seem that subrogation rights will survive only if there is no written lease, or if the written lease does not contain a covenant imposing the obligation to insure on the landlord or the obligation of paying for insurance upon the tenant.

In point of fact the standard written leases, for a residential house, apartment, or store, do not contain a covenant relative to insurance. But there is ample space to add a clause if the parties wish to do so. It is not surprising that the recent plethora of cases in the Supreme Court relate to more sophisticated commercial leases where covenants pertaining to fire insurance have been specifically added.

It goes without saying that even under the standard leasing form it is wise for a solicitor who is representing a tenant to include a clause which will destroy potential subrogation against his client. The landlord is not likely to object, because the real effect is felt by the landlord's insurer rather than the landlord itself. The most recent decisions of the Supreme Court are simply examples of where subrogation rights have been displaced by accident rather than design.

But one should not become overly concerned over the plight of the landlord's insurer. The removal of its potential subrogation rights, even by accident, is probably not a significant underwriting factor. What will be lost in one instance will be made up the next

time, when as liability insurer of the negligent tenant, the same insurer finds that it has a sound defence.

What is troublesome is the manner in which the current Supreme Court eviscerated the decision in the *Hutson* case. Flimsy excuses were advanced to confine the *Hutson* case to its own limited facts. The impulse of the Laskin Court is to place limitations on unnecessary litigation. It is a public cost, and thus a public waste of time for two insurers (the landlord's fire insurer and the tenant's liability insurer) to be fighting between themselves. So the Court has taken it upon itself to limit such litigation by curtailing normal subrogation rights. In doing so the Court has strained our credulity and stifled the opportunity for litigation. It is better to determine liability and damages as between landlord and tenant through litigation, rather than dispose of these matters by the tortured logic of a Court that dislikes subrogation rights on social grounds.