



Insurance and Insolvency

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July 2011

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This article considers insurance issues which arise on the insolvency of an insured. In particular, we look at the obligation of trustees in bankruptcy to maintain existing coverage, and the competing concern which some insurers have, that the insolvency of the insured constitutes a material change of the risk.

Section 24(1) of the *Bankruptcy & Insolvency Act* obliges a trustee in bankruptcy insure all of the insurable property of the bankrupt. The most significant case interpreting this section remains the Supreme Court of Canada decision in *A. Marquette & Fils Inv. v. Mercure*, [1977] 1 S.C.R. 547. Among other things, the Supreme Court found that the trustee had an obligation to insure all insurable property of the bankrupt and that the trustee was required to “do his utmost” to keep in force any pre-existing coverage and replace any cancelled insurance.

Indeed, where the bankrupt has existing insurance in place, section 24(2) of the *Bankruptcy and Insolvency Act* provides that the existing policy automatically becomes payable to the trustee in the event of a loss:

24(2) All insurance covering property of the bankrupt in force at the date of the bankruptcy shall in the event of loss suffered, 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 payable immediately to the trustee 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.

As a counter-point to s. 24(2), Fire Statutory Condition 3 specifically provides that the insurer remains liable for loss or damage occurring after an assignment under the *Bankruptcy Act*. The effect of s. 24(2) was summarized by the Supreme Court in *A. Marquette* as follows:

10 From the time of the bankruptcy onward, all insurance policies should read as if the trustee's name appeared in place of that of the debtor: nothing more. Other entries in the insurance contracts remain unchanged, from which it follows that the beneficiaries of insurance policies continue to enjoy their privileged position except, obviously, for exceptional cases such as undue preference.

Because the trustee stands in the place of the bankrupt vis-à-vis any existing coverage, the insurer can raise any defence to a trustee's claim for indemnity that it had against the bankrupt. So for example, if prior to the bankruptcy the debtor made a material misrepresentation or omission in its insurance application, the trustee may be barred from recovering under the policy as a result.

A related concern is Statutory Condition 4 – material change of risk. Many insurers take the position that the insolvency of the insured is itself a material change of the risk. This creates complications for trustees in bankruptcy who have a duty to maintain existing coverage if possible.

On a common sense basis, the mere fact that the insured has become insolvent and a trustee/receiver appointed, without more, would not likely be found to constitute a material change to the risk. However, there are frequently issues associated with insolvency which may constitute a material change to the risk. Change of occupancy or use of the insured premises may be a material change. Also, so-called ‘moral hazards’ may arise in particular situations which can constitute a material change to the risk.

There are few reported cases in which the issue arises in an insolvency context. One such case is, *Yorkshire Trust Co. v. Laurentian Pacific Insurance*, (1987), 28 C.C.L.I. 368 (BCSC) in which the argument that the insolvency constituted a material change in risk was successful.

In *Yorkshire*, a mortgagee had received notice that the insurance coverage on the mortgaged property had lapsed due to non-payment of premiums. The mortgagee therefore arranged its own policy to protect its interest. When the property burned down, the mortgagee’s insurer denied coverage on the basis that various facts material to the risk were not disclosed to it in the initial application. The insurer argued that the mortgagee had fraudulently failed to disclose certain material facts in the original application for the policy, including the insolvency of the property owner which, in the insurer’s submission, created a “moral risk” – that the property owner may be motivated to torch the premises.

The court basically agreed that the insolvency of the property owner, as one fact among many, would have been material to the decision to insure the risk. This finding supports the position that, in the right case, insolvency can constitute a material change to the risk:

34 The existence of substantial vacancies, and of areas in the process of conversion, exposed the premises to the danger of fires started by intruders or by poor maintenance...The lack of daily business activity in these areas exposed the premises to the danger of unobserved development of fire hazards, as well as the danger of fire caused by intruders. The fact that so much of the floor space was producing no revenue, and that the former and present owners had not renewed the fire insurance, suggested a further danger — that insolvency might result in poor maintenance and housekeeping. These indications of likelihood of insolvency were warning signs also of the existence of the so-called "moral hazard" — a euphemism used in the fire insurance business of risk of arson, induced by a desire to defraud the insurer in order to escape financial ruin or, less commonly, a desire for "vengeance" against foreclosing creditors.

...

36 While the defendant insurer was sometimes willing to accept foreclosure risks, and was shortly to do so in another instance for the same agency, Mr. Hebden had no reason to assume that the company regarded high vacancy rates or insolvency as matters irrelevant to its decision whether or not to grant coverage.

...

38 I am satisfied that Mr. Hebden also knew that the owner was a company whose affairs appeared to be managed by a man of doubtful reputation — a matter which an insurer would certainly wish to look into in the light of all other obvious factors relating to the risk.

By comparison, a case in which the insolvency of the insured was essentially found not to be a material change to the risk is called *Re: Village Green Lifestyle Community Corp.*, (2007), 45 C.C.L.I. (4th) 302 (OSCJ). A Receiver had been appointed by Court Order to manage the affairs of the insolvent insured. The Receivership Order provided that no party could terminate a contract with Village Green without leave of the Court or consent of the Receiver. A further provision of the Order required that all parties with contracts with the Insured were restrained from discontinuing, altering or interfering with the contract provided that the Receiver continued to make payments, subject to further order of the court.

Prior to the receivership, Village Green (which was a retirement community) had recently renewed its policy of liability and property insurance with Economical Mutual. After the Receivership Order was granted (without notice to Economical), Economical sought to cancel the policy and requested the Receiver's consent. Economical's position was that it did not underwrite insurance for a risk in receivership and that its corporate policy was not to insure, renew or maintain insurance policies for any insured that is in receivership or bankrupt.

The Receiver refused to consent. It had tested the insurance market and received only one quotation for replacement coverage, with a premium 5 times higher than that charged by Economical. Simply put, the Receiver did not have access to sufficient funds. As such, Economical applied for an Order granting leave to terminate the policy.

In the application, the parties took the following positions:

8 Economical states that it seeks leave to cancel the policy because it does not "underwrite the risk of insuring risk that has been put into receivership". As a matter of customary practice, it does not insure risks that have gone into receivership. Economical states that a receivership triggers a change in the assessment of the moral risk for the insurer and it has neither the underwriting

expertise nor the rating basis to adequately assess the exposure to loss and to adequately price receivership business. It states that there are appropriate specialty markets to underwrite this class of business. It states that the prejudice caused to Economical in continuing with the risk of insuring the Facility is contrary to its ordinary business plan and practices.

9 In contrast, the Receiver states that it is unaware of any change in circumstances other than the appointment of the Receiver. It states that the fact that management has passed to the Receiver does not in and of itself alter the risk to Economical. Indeed, it is the Receiver's view that the risk borne by Economical under the policy decreased with the appointment of the Receiver. The Receiver has substantially improved the operating condition of the Facility and has worked with government agencies to achieve compliance with legal and regulatory requirements thereby decreasing any risk associated with the Facility. The Receiver is of the view that Village Green will be prejudiced if the insurance services currently provided by Economical are not continued.

The court acknowledged that Economical had a right to terminate the policy on 15 days notice as a policy condition. However, because of the terms of the Receivership Order, the court found itself to have discretion to determine whether to allow Economical to terminate the policy. The court refused to do so holding that Economical had not demonstrated any material change to the risk as a result of the receivership. In fact, the court accepted that if anything the risk had *diminished* as a result of the appointment and involvement of the Receiver. As a result, Economical would suffer no material prejudice by refusing the relief sought.

At the end of the day, these cases demonstrate that there is no cut and dry answer to whether the insolvency of the insured will constitute a material change to the risk. Where the insurer only becomes aware of the insolvency after a loss, the full circumstances of the matter will have to be investigated to determine whether in fact the insolvency constituted a material change to the risk.

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