Subrogating in the Name of Bankrupt Insureds

Christine Lau
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This time last year, a rare five-member panel of the Ontario Court of Appeal rendered a decision in *Douglas v. Stan Fergusson Fuels Ltd.*[1] The decision involved the intersection of subrogation and bankruptcy law. The issue was whether an insurer has the right to bring a subrogated action in the name of its insured when its insured is an undischarged bankrupt.

The Court of Appeal dismissed the insurer's subrogated action on the basis that, at the time the action was commenced, its insured's cause of action had already vested in his trustee in bankruptcy (whom the insurer had failed to name as a plaintiff to the action).

The right of subrogation is derivative in nature. Since the insureds were not entitled to bring an action for recovery of the property remediation costs, State Farm, in turn, could not bring a subrogated claim in the name of the insureds. Only the trustee could bring a claim.

On January 31, 2019, the Supreme Court of Canada denied leave to appeal.

Background

In *Douglas*, State Farm brought an action in the name of its insureds, the Douglases, against an oil company to recover the $800,000 that it had spent to remediate damage to the Douglases' home caused by an oil escape incident, pursuant to its right of subrogation under its homeowner's policy.

The Douglases had filed assignments in bankruptcy to the benefit of their creditors before State Farm issued its subrogated claim, which resulted in their property and causes of action vesting in their trustees.

State Farm did not consider naming the trustees as plaintiffs to its subrogated action until the opportunity had passed to amend its claim before the expiry of the limitation period.

The Right of Subrogation

Subrogation is a key aspect of insurance law. The doctrine relates to the principle of indemnification and ensures that the parties deemed responsible for a loss are held accountable.

An insurer, after indemnifying its insured for losses caused by third parties, is entitled to bring an action in the name of the insured to recover such payments from the third parties.

As the insurer has effectively stepped into the shoes of its insured in a subrogated action, the insurer also has the right to recover any losses incurred, which were not covered by the policy limits, from the third parties. This amount is payable to the insured.

Bankruptcy Law

Under the *Bankruptcy and Insolvency Act* ("*BIA*"), once an assignment in bankruptcy is filed, the bankrupt no longer has any capacity to deal with his/her property, which immediately vests in the bankrupt's trustee in bankruptcy.[2] The definition of "property" is broad and can be extended to causes of action.[3]

Analysis of the Law

The Court of Appeal focused on whether State Farm was entitled to commence the action in Mr. Douglas' name, only, as State Farm did not cross-appeal the Divisional Court's decision that Ms. Douglas had no right of recovery for damages caused to the property.

The Court refused to permit Mr. Douglas's cause of action to be assigned to State Farm.

The Court distinguished the vehicles of subrogation and assignment. While subrogation has assignment-like features to it, subrogation does not equate to assignment.

On this basis, the Court found that Mr. Douglas' cause of action did not vest in State Farm before his bankruptcy by virtue of the doctrine of subrogation. Importantly and moreover, State Farm's homeowner's insurance policy did not contain an assignment clause.

The Court found that State Farm was required to commence the action in the name of Mr. Douglas' trustee, not that of Mr. Douglas.

The subrogation clause in State Farm's homeowner's policy did not permit it to bring an action in the name of Mr. Douglas. The Court read the insurance policy as if Mr. Douglas' name was replaced with that of his trustee's for indemnification purposes, particularly as the trustee had taken the benefit of the policy.

The Court considered the interplay between the principles of the doctrine of subrogation and the established principles of bankruptcy law.

While subrogation is rooted in the idea of indemnification, bankruptcy law deems that only the trustee has the capacity to bring the action, as Mr. Douglas' property vested in the trustee immediately upon bankruptcy.

The Court refused to allow State Farm to substitute the trustee as the plaintiff to the action. It was found that it would not be just in the circumstances to grant such relief.

The appellant oil company had incurred four years worth of legal fees in responding to State Farm's flawed position that it could bring the action in Mr. Douglas' name, knowing that he had filed for bankruptcy.

Further, this issue was never raised in the lower courts, and it would be unfair to resolve such issue on appeal.

State Farm was not only denied its right to recover the $800,000 that it had indemnified, but had to pay the oil company $83,500 in costs, approximately 10% of its subrogated claim, for failing to name the correct plaintiff.

Practical Considerations

As subrogation is increasingly retrofit into business models, the more value add there is for insurers to understand this niche area of law.

Subrogation is an important way to minimize expenditures for insurers. While insurers have traditionally created large pools of money and assumed the risk for everyday losses that cannot be predicted (other than on a statistical level), subrogation has afforded insurers the opportunity to balance out its income statements with subrogated recoveries.

On a practical basis, it would be prudent for insurers to incorporate the following risk management strategies into their business practices before commencing litigation:

- Include an assignment clause in insurance policies, wherein the insurer is granted an assignment of their insured's cause of action (before the insured makes an assignment in bankruptcy);

- Conduct bankruptcy searches of the insured; and

- If the insured is an undischarged bankrupt, bring the subrogated action in the name of the insured's trustee in bankruptcy (*with notice*).

The courts look upon insurers as sophisticated parties and hold them to a higher standard.

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[1] 2018 ONCA 192.

[2] *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3 at s 71.

[3] *Ibid* at s 2.