

LITIGATION NOTES

Legal Decisions and Developments in Canada

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University Fails But Gets 95%

The Ontario Court of Appeal recently considered the proper allocation of defence expense in litigation involving some claims that are covered by insurance and others that are not ("mixed claims")

The Ontario Court of Appeal recently considered the proper allocation of the costs of defending a lawsuit advancing two distinct claims where the defendant has insurance coverage for only one of the claims. In a case where almost all of the defence costs related to both claims, the Court held that the insurer had to pay 95% of the defence costs, leaving the defendant insured responsible for the remaining 5% only.

The University of Western Ontario fired the director of its computing laboratory, Edward Hanis, accusing him of misuse of the computer system. The University reported Hanis to the police and he was charged with, and later acquitted of, the offence. Hanis sued the University for wrongful dismissal, malicious prosecution, and a number of other things. The University had a commercial general liability policy with the Guardian Insurance Co. of Canada ("Guardian") which provided coverage for malicious prosecution claims, but not for the wrongful dismissal and other claims. Because coverage was disputed, the University retained its own counsel to conduct the defence and added Guardian as a third party. Hanis was unsuccessful at trial, but on appeal was awarded damages for wrongful dismissal. The University's costs of the defence were \$2 million. The trial judge accepted that most of the work done by defence counsel related both to the defence of the malicious prosecution claim, and the defence of the various other claims, including the wrongful dismissal claim. He found that only 5% of the defence costs related exclusively to the wrongful dismissal or other claims. He held

Guardian responsible for 95% of the costs of the defence on the basis that those costs related in part to the malicious prosecution claim.

Guardian appealed, complaining that the allocation was unfair in the circumstances. The trial judge's allocation of defence costs was upheld on appeal. The Court of Appeal considered Canadian, U.S. and Commonwealth authorities and found in the jurisprudence two different conceptual approaches taken to this issue. Which was the proper approach had yet to be decided under Ontario law.

Guardian argued that the costs associated with both covered and uncovered claims ("mixed claims") should be allocated between the University and Guardian on a "fair and equitable" basis, having regard to several factors, including the relative proportion and significance of the covered and uncovered claims. On this basis, Guardian sought to have 80% of the costs allocated to the University.

The court rejected that approach, preferring an allocation based on interpretation of the language used in the insurance policy. In this case, the policy stated that the insurer shall defend "at the cost of the insurer any civil action which at any time may be brought against the insured" on account of a loss covered under the policy. That covenant was unqualified under the policy, and the policy was silent as to what happens in the event of a mixed claim. The court concluded, on the basis of contractual interpretation that Guardian was responsible for all defence costs re-

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lating to the malicious prosecution claim regardless of whether the costs also arose from the defence of the other claims. Principles of fairness and equity do not lessen the obligations that Guardian assumed by contract, said the Court. The Court reasoned that requiring Guardian to pay all defence costs relating to a mixed claim would not increase its liability exposure compared to the cost of defending a covered claim in isolation. Neither would it grant the University anything more than what it bargained for.

The onus of proving entitlement to costs remained with the University, but the Court noted that Guardian likely undermined its position by having breached its contractual obligation to provide a defence for the insured. By not being directly involved in the conduct of the defence, Guardian missed the opportunity to examine and refute the university's assertion that virtually all defence costs related to mixed claims.

Hanis v. Teevan, 2008 ONCA 678 (CanLII)

Compliance With Standards No Defence

A railway company was found negligent for failure to make a crossing safe, despite the fact that it met standards set by the government regulator

The Ontario Court of Appeal recently considered the standard of care applicable to railway companies and whether or not compliance with industry standards is justification for conduct which would otherwise be negligent.

At about 9:15 on an August evening in 1994 the plaintiff, Jason Zsoldos, was riding his motorcycle home. He had been drinking beer with some friends and had a blood alcohol level slightly below the legal limit of 80 milligrams of alcohol per 100 millilitres of blood. He came to a railway level crossing near his home with which he was well familiar. He was travelling at about 80 km/hour and failed to see a train in the level crossing. He collided with the train and lost both arms and a leg.

The crossing was maintained by Canadian Pacific Railway Company (“CP”) and was similar to level crossings in rural municipalities across Canada. There were no gates or flashing lights. The only marker was a reflectorized cross buck with reflective tape on the front side only. 290 feet before the crossing there was a sign erected by the municipality, alerting motorists to the presence of the crossing and recommending that they reduce their speed to 20 km/hour. There were crops on either side of the roadway which had reached a height sufficient to obscure the view of the tracks.

At trial, the judge found CP liable to the ex-

tent of 75%. She found the plaintiff 25% liable by reason of having consumed alcohol and the speed at which he was travelling at the time of the accident. The trial judge reviewed the leading case on railway negligence, *Ryan v. Victoria (City)*, a 1999 decision of the Supreme Court of Canada which overruled the previously privileged position occupied by railways within the law of negligence. Prior to *Ryan* the rule was that so long as railway companies complied with government regulations and orders, they were under no further obligation to act in an objectively reasonable manner. After *Ryan*, railway companies were subjected to the same standard of care as other defendants.

In this case, the trial judge found that CP had been negligent because it had never inspected the railway crossing at night. Had it done so, it would have realized that there were a number of steps that could have been taken which would have reduced the likelihood of an accident. This might have included applying reflective tape to the backs and fronts of the cross bucks, because the reflective tape creates a strobe effect as it is illuminated by car headlights shining through the spaces between the rail cars as they pass through the level crossing. More ambient lighting and a more emphatic warning sign would also have been of assistance.

CP appealed on the basis that the trial judge had not adequately enunciated the standard of

care that CP should have met. CP argued that industry standards did not require anything more than passive measures for a rural crossing such as this one, which was one of 16,000 similar crossings throughout the country. CP pointed to the “cross product”, a term of art in the railway industry, which refers to the number of vehicles travelling over a crossing daily, multiplied by the number of trains. At this location, in 1994, the cross product was 300. At the time, Transport Canada did not recommend an active warning system where the cross product was less than 1,000.

The Court of Appeal upheld the decision of the trial judge. In the opinion of the Court of Appeal the so-called industry standard advanced by CP had to be approached with caution because CP effectively “was the industry”. The Court reviewed the authorities dealing with application of industry standards as a defence to negligence and pointed out that it is a factor to take into consideration but that “...even a common practice may itself be condemned as negligent if fraught with obvious risk”. In this case, the Court of Appeal considered that it was open to the trial judge to find that CP’s failure to carry out night-time inspections of the crossing was negligent.

Zsoldos v. Canadian Pacific Railway Company, 2009 ONCA 55

Blue Pencil is Not a Cure

The Supreme Court of Canada considers whether an unenforceable restrictive covenant can be saved by severing the offending portion of the clause

The Supreme Court of Canada recently considered whether severance can be used to render enforceable an otherwise unenforceable restrictive covenant. The case related to Mr. Shafron, who sold his insurance brokerage to KRG Insurance Brokers (Western) Inc. (“KRG”) in 1987. He remained on staff with KRG for a period of about 14 years, during which time he repeatedly executed employment contracts containing a restrictive covenant. The restrictive covenant provided that he would not carry on business in the “Metropolitan City of Vancouver” for a pe-

riod of 3 years after leaving his employment with KRG.

In 2001 Mr. Shafron left KRG and began working as an insurance broker in Richmond, a suburb of Vancouver. KRG commenced an action to enforce the restrictive covenant, but it was dismissed by the trial judge on the basis that the term “Metropolitan City of Vancouver” was ambiguous and therefore unenforceable. This decision was reversed by the British Columbia Court of Appeal which concluded that it could apply the doctrine of

severance to “read down” the provision. The Court of Appeal concluded that it was reasonable to conclude that “Metropolitan City of Vancouver” meant the “City of Vancouver, the University of British Columbia endowment lands, Richmond, and Burnaby”.

This decision was reversed by the Supreme Court of Canada. The Supreme Court began by reviewing the law relating to restrictive covenants which are *prima facie* unreasonable as being in restraint of trade. The burden

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Blue Pencil (continued)

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is on the person seeking to enforce the restrictive covenant to demonstrate its reasonableness. However, for a determination of reasonableness to be made, the terms of the restrictive covenant must be unambiguous. The Court points out that limits on geographic scope often give rise to issues of severance and questions whether a restrictive covenant that is unreasonably wide in its geographic scope can be severed in some manner so as to leave in place what the Court regards as reasonable.

The Court goes on to review the two types of severance, being “Blue Pencil” severance and “Notional” severance. Blue Pencil severance “...is effected when the part severed can be removed by running a blue pencil through it”. It can be applied “...if the judge can strike out, by drawing a line through, the portion of the contract they want to remove, leaving the portions that are not tainted by illegality, without affecting the meaning of the part remaining”.

Notional severance on the other hand involves “...reading down an illegal provision in a contract that would be unenforceable in order to make it legal and enforceable”. By

way of example the Court refers to a case in which the parties intended to enter into a contract in which the highest interest rate permitted by law would be charged. They made a mistake and charged an interest rate in excess of that permitted by the *Criminal Code* of Canada and the Court was able to use notional severance to apply the legal interest rate. This was possible because there was a clear “bright-line” test of illegality.

The Supreme Court goes on to conclude that notional severance has no place in the construction of restrictive covenants in employment contracts. There “...is no bright-line test for reasonableness”. While the Courts “...wish to uphold contractual rights and obligations between the parties, applying severance to an unreasonably wide restrictive covenant invites employers to draft overly broad restrictive covenants with the prospect that the Court will only sever the unreasonable parts or read down the covenant to what the Courts consider reasonable”. The court quotes from Lord Moulton in *Mason v. Provident Clothing and Supply Co.*, [1913] A.C., 724 where he stated: “It would in my opinion be *pessimi exempli* if, when an employer had exacted a covenant deliberately framed in unreasonably wide terms, the Courts were to come to his

assistance and, by applying their ingenuity and knowledge of the law, carve out of this void covenant the maximum of what he might validly have required. It must be remembered that the real sanction at the back of these covenants is the terror and expense of litigation, in which the servant is usually at a great disadvantage, in view of the longer purse of his master”.

The Court went on to say that in this case, blue pencil severance was not available because it was clear that the parties intended that the scope of the restrictive covenant should extend beyond the City of Vancouver and that to simply strike out the word “Metropolitan” would not be consistent with that intention.

The Court of Appeal had tried to resolve the ambiguity in the term “Metropolitan City of Vancouver” by reading down the covenant according to its notion of reasonableness and what it thought the parties might have intended. There was no basis for the solution reached and consequently the decision of the trial judge was restored and the action by KRG was dismissed.

Shafron v. KRG Insurance Brokers (Western) Inc., 2009 SCC 6 (CanLII)

Excess Insurer Must Contribute to Defence Expense

The Ontario Superior Court of Justice rules that an excess insurer must contribute to costs of defence and sees no material difference between Ontario and Quebec law on the issue

A Quebec company, Tidan Inc (“Tidan”) operated an oceanfront hotel in Florida. Tidan was insured by a commercial general liability policy issued by American Home Assurance Company (“American Home”) with a limit of \$1 million for claims involving bodily injury or death. It also had an umbrella policy issued by Temple Insurance Company (“Temple”) which provided an additional \$9 million of coverage for bodily injury or death claims. Both policies contained provisions requiring the insurer to defend the insured in respect of claims for which an indemnity was provided by the policy.

A guest of the hotel drowned as a result of being caught in a rip tide while swimming in the ocean off the hotel’s private beach. A

wrongful death action was commenced by the deceased’s widow and children and in November of 2003. American Home appointed Florida counsel to represent Tidan. In January of 2006 the plaintiffs presented Tidan’s counsel with a settlement demand of \$15 million. As this was in excess of the primary policy limits, Tidan was asked if additional insurance was available, at which point the existence of the umbrella policy was disclosed. At that point, Temple were put on notice of the settlement demand.

Following an unsuccessful mediation in March of 2007, American Home tendered its policy limits. The plaintiffs were unwilling to settle for less than \$15 million and the case went to trial, with American Home continuing to pay the defence expense. The first trial

resulted in a mistrial and prior to the second trial, the case was settled for \$2,273,000. American Home paid the first \$1 million and Temple paid the balance. Between April of 2006 when Temple was notified of the claim and the settlement of the action, American Home had paid \$515,000 in legal fees. Of that amount \$477,000 was referable to the time period subsequent to March 15, 2007. Despite repeated requests by American Home that Temple share in the cost of Tidan’s defence, Temple refused to do so and American Home brought an application in the Ontario Superior Court of Justice.

It was acknowledged by the parties that under Ontario law Temple would have had an equitable obligation to contribute to the costs of

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Excess Insurer (continued)

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defence. However, Temple argued that its policy was governed by Quebec law and that the law of Quebec was different from that of Ontario. Temple pointed to the wording of its policy which provided that its defence obligation existed only in respect of an occurrence “not covered by underlying insurance...”. Temple took the position that since American Home had provided coverage, Temple had no defence obligation. In Ontario, it is clear that an excess insurer’s duty to defend is triggered where the primary insurance may be exhausted. Temple took the position that the situation is different in Quebec and that the term “covered” is referable only to the nature of the claim and does not extend to the quantum of the claim.

The Ontario Superior Court of Justice was not impressed with Temple’s argument. In the first place, the Court considered that the proper law of the contract was the law of Ontario. Although Tidan was domiciled in Montreal, had applied to a broker in Montreal for the policy and the policy was prepared and delivered to the Insured’s broker in Montreal, the Insurer was prominently identified on the policy as “Temple Insurance Company, Toronto, Ontario”. Temple is

based in Toronto. It has no claims office in Montreal and all of the personnel who dealt with the claim were based in Toronto. Furthermore, the American Home policy was covered by Ontario law and it made sense that the parties would have expected that an excess policy intended to provide coverage over the layer provided by American Home, would be governed by the same law.

Furthermore, the Court felt that even if the Law of Quebec did apply, it was not different in any material respect from the law of Ontario. Temple had produced an expert witness on the law of Quebec, but the most that witness could state was that there was no case-law directly on point dealing with the meaning of “covered”. The expert suggested that to conclude that “covered” relates to quantum would require the re-writing of the contract to modify the word “covered” with the word “completely”. However, the Court pointed out that it could be equally said that to hold otherwise would involve re-writing the policy by modifying “covered” with “partly”.

The Court went on to consider whether or not Temple should have any duty to contribute to the defence costs incurred by American Home. The Court concluded that American Home was first in line when the claim arose

and accepted the risk that it might be solely responsible for funding the defence, even if the amount claimed exceeded the limits of its policy. Between November of 2003 and early 2006 it appeared that any recovery on the claim would not exceed American Home’s limits and Temple’s duty to defend remained dormant. However, in 2006 it became clear to Temple that there was a realistic risk of an award of damages that would exceed the limits of American Home’s policy. At that point Temple’s duty to defend became concurrent with that of American Home. After American Home tendered its policy limits Temple’s exposure became greater than that of American Home and Temple eventually became the only insurer with a continuing interest in reducing the settlement value of the case.

Consequently, the Court ordered Temple to pay American Home 50% of the costs billed to American Home for the defence of Tidan from the beginning of May 2006 forward, but reduced by 25% of the costs billed to Temple by its own counsel.

American Home Assurance Company v. Temple Insurance Company, 2009 CanLII 1648

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