Toronto Law Journal

Subrogated Claims and Bankrupt Insureds: *Douglas v. Stan Fergusson Fuels Ltd.*, 2018 ONCA 192

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Is an insurer entitled to commence a subrogated claim in the name of its bankrupt insured? Short answer — no.

Background

Art Douglas (“**Art**”) and Wendy Douglas (“**Wendy**”, together with Art, the “**Douglases**”) owned a home in Kingston, Ontario (“**Property**”). They used an external oil tank to heat their home (“**Oil Tank**”). On January 9, 2008, Stan Fergusson Fuel Ltd. (“**Fergusson Fuel**”) delivered fuel oil to the Douglases’ Oil Tank. The fuel oil leaked and contaminated the Property. The Douglases’ Homeowners Policy (“**Policy**”) with State Farm Fire and Casualty Company (“**State Farm**”) provided coverage for the losses associated with contamination. Pursuant to the Policy, State Farm was subrogated to the rights of the Douglases’ to recover against Fergusson Fuel.

A few months before loss, on November 14, 2007, Wendy was discharged from bankruptcy on the condition that her proprietary interest in the Property remain vested in her trustee in bankruptcy (“**Trustee**”). Accordingly, the Trustee and Art remained on title to the Property.

On June 4, 2009, Art filed an assignment into bankruptcy. The Trustee also became Art’s trustee in bankruptcy and replaced him on title to the Property. State Farm was put on notice of Art’s assignment on June 5, 2009.

The Trustee informed State Farm by way of the Trustee’s Limited Disclaimer, that the Trustee intended to sell the Property once it was remediated, and that the Trustee disclaimed interest in any insurance claims by the Douglases “*for loss or damage in the oil spill to matrimonial household contents not affixed or enjoyed with the residential property or proceeds of personal property except under the Execution Act (Ontario) which would not vest in their Trustee in Bankruptcy*”.

In October 2009, the Trustee sold the remediated Property.

In November 2009, State Farm made its final payments, pursuant to the Policy, spending over $800,000 to remediate the Property.

On January 7, 2010, State Farm commenced a legal proceeding, in the Douglases’ names, against Fergusson Fuel. Art was absolutely discharged from bankruptcy on March 5, 2010, and the Trustee was discharged on August 24, 2012.

Fergusson Fuel brought a motion for summary judgment arguing that the Douglases do not have capacity to commence the action because of their bankruptcies, and that State Farm's subrogated action in their names was void. State Farm cross-motioned seeking, *inter alia*, a declaration that it is the *dominus litis* and therefore had the right to continue and control the lawsuit.

Motion Judge's Reasons

The Motion Judge agreed with State Farm and dismissed Ferguson Fuel's summary judgment motion. The court held that the right of subrogation is a "contingent right" that vested at the time the Policy was entered into. The motion judge was not persuaded that the *Bankruptcy and Insolvency Act* ("**BIA**") extinguished State Farm's subrogation rights.

Ontario Divisional Court's Reasons

The Divisional Court emphasized that subrogated claims are derivative in nature. Accordingly, an insurer of an undischarged bankrupt who is unable to bring an action to enforce property rights is barred from commencing a derivative subrogated claim. Nevertheless, the Divisional Court dismissed Fergusson Fuel's appeal holding that State Farm had a "vested contingent right to assume [Art's] right to recover and to bring an action [which] crystalized before [Art's] assignment into bankruptcy."

With respect to Wendy, the Divisional Court reasoned that she had no right to recover for damages to the Property as she had made her assignment in bankruptcy prior to the effective commencement date of the Policy. In addition, after Wendy's discharge, the Property remained vested in the Trustee.

The Divisional Court held that State Farm was within its right to commence the action in Art's name.

Ontario Court of Appeal's Reasons

State Farm did not dispute that Wendy had no right to recovery for damages. Accordingly, the central issue on the appeal was whether State Farm was entitled to commence the subrogated claim in Art's name.

The Court of Appeal provided a useful overview of the doctrine of subrogation, specifically:

1. the objectives of subrogation are to ensure that the insured is fully indemnified, and the loss is borne by the person who is legally responsible for causing it;
2. at common law, the right of subrogation arises only on full indemnification of the insured;

3. at common law, once the insured is fully indemnified, the insurer becomes the *dominus litis*;
4. the right of subrogation is derivative;
5. any recovery in excess of the indemnified loss is paid to the insured; and
6. recovered indemnified losses by the insured are held in trust for the insurer.

State Farm argued that the cause of action vested in State Farm prior to Art's assignment into bankruptcy. The Court of Appeal disagreed. Although an insurer's subrogated claim is brought in the name of the insured, the claim remains that of the insured and is subject to the insured having the capacity to advance the same. The doctrine of subrogation does not assign the rights of the insured to the insurer; despite having assignment like qualities, subrogation is not the equivalent of assignment.

State Farm further argued that Art's cause of action was assigned to State Farm by way of the Policy. Again, the Court of Appeal disagreed. There are differences between an assignment and subrogation. One such difference is, on assignment, the insurer is able to recover and keep damages suffered by the insured in excess of the insurance proceeds. Accordingly, subrogation and assignment are different and if State Farm wished to include an assignment clause in the Policy, it ought to have done so.

Having found that State Farm was not assigned Art's cause of action by way of the doctrine of subrogation, or by way of the Policy, the Court of Appeal held that Art's cause of action vested in the Trustee at the time of Art's assignment into bankruptcy. In this regard, State Farm was entitled to commence a subrogated claim only in the Trustee's name, as Trustee of the Estate of Art, a bankrupt.

Accordingly, an insurer is not able to commence a subrogated claim in the name of its bankrupt insured, as the insured, pursuant to the BIA, ceases to have any capacity to deal with their property upon an assignment into bankruptcy. Consequently, the capacity to deal with Art's Property, which includes his cause of action, vested in the Trustee; as such, the court held that State Farm ought to have commenced its subrogated claim in the name of the Trustee.

The decision in *Douglas* was recently applied by the Ontario Court of Appeal in *Thistle v. Schumilas*, 2020 ONCA 88.[1] In about December 2012, approximately one and one half years after being discharged from bankruptcy, Jason Michael Thistle (**"Thistle"**) commenced an action against his spouse's insurance agent (**"Agent"**). The Agent brought a motion for summary judgment arguing that Thistle did not have standing to bring the action, as the cause of action arose while Thistle was an undischarged bankrupt. Thistle cross-motioned seeking an order *nunc*

[1] *Jason Michael Thistle v. James Schumilas, Jr.*, 2020 CanLII 50444 (SCC), leave to appeal to the Supreme Court was denied.

pro tunc granting him standing to bring the action in his own name, despite his assignment in bankruptcy, and subsequent discharge.

The Court of Appeal emphasized the following:

1. upon an assignment into bankruptcy being filed, the bankrupt ceases to have any capacity to deal with their property, and the bankrupt's property immediately passes to and vests in their trustee in bankruptcy;
2. a 'cause of action' is captured by the definition of 'property' under the BIA; and
3. there is no automatic re-vesting of the property of the bankrupt in the bankrupt either on their discharge or on the discharge of their trustee; accordingly, the trustee is obligated to return the property pursuant to the BIA.

The Court of Appeal found the *Thistle* case analogous to the *Douglas* case, except that in the former case, Thistle commenced his action after being discharged from bankruptcy, while in *Douglas*, State Farm commenced its subrogated action prior to Art's discharge from bankruptcy.

Importantly, it was held in *Thistle* that if a cause of action arose during the time in which a person is an undischarged bankrupt, that cause of action vests in that person's trustee in bankruptcy. In other words, even if the cause of action was discovered, and an action commenced, after a person's discharge from bankruptcy, the cause of action nevertheless vests in the person's trustee in bankruptcy because the cause of action arose while the person was an undischarged bankrupt.

Consequently, despite Thistle being a discharged bankrupt at the time of commencing the action, the cause of action arose while Thistle was an undischarged bankrupt, and in that regard, Thistle had no standing to bring the action as the cause of action still vested in his trustee in bankruptcy.

The *Thistle* decision sets out the following key principles:

1. a cause of action will vest in an undischarged bankrupt's trustee in bankruptcy if it arose during an assignment into bankruptcy, or prior to discharge from bankruptcy; and
2. the cause of action will remain vested in an undischarged bankrupt's trustee in bankruptcy until the undischarged bankrupt is absolutely discharged, and the trustee returns the cause of action, pursuant to the BIA, to the discharged bankrupt.

In summary, when dealing with a bankrupt insured, if a cause of action arose during the bankrupt insured's assignment into bankruptcy, and it still remains vested in the trustee, a subrogation clause must be read as if it is the trustee's name in place of the bankrupt insured. Therefore, an insurer's subrogated claim must be brought in the name of the trustee, not in the name of the bankrupt insured.