FILLMORE RILEY
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Punitive Damages For Bad Faith: The Supreme Court Speaks

◆ *Dean G. Giles*

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FILLMORE RILEY

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In the winter 2000 edition of the Fillmore Riley Report, we reviewed the decision of the Ontario Court of Appeal in Whiten v. Pilot Insurance Company, undoubtedly the most celebrated Canadian case arising out of a first party bad faith claim.

The court unanimously agreed that the insurer had acted in bad faith and that an award of punitive damages was appropriate in the circumstances. The majority of the court concluded, however, that the sum of $1 million awarded as punitive damages by the jury at trial was excessive and ought to be reduced to $100,000.

An appeal and cross-appeal of this result were taken to the Supreme Court of Canada and leave granted with respect to both. On February 22, 2002, that court released its reasons for judgment allowing Ms. Whiten's appeal and restoring the jury award of $1 million. The insurer's cross-appeal against the award of punitive damages was dismissed.

The facts of the case have been widely publicized. In January of 1994, the Whiten's home and its contents were destroyed in a fire. The insurer retained an experienced adjuster to investigate the loss. After inspecting the site, interviewing the Whitens and speaking with the fire fighters who had attended at the scene, the adjuster concluded that the fire was accidental and recommended to the insurer that the loss be paid.

Notwithstanding this advice, the insurer denied the claim based on a suspicion of arson, a position which it maintained through to the completion of the trial. The adjuster was instructed to investigate further the possibility that the Whitens had burned down their own home. When the adjuster found no evidence of arson and continued to recommend that the loss be paid, he was replaced and his reports withheld from the experts later retained by the insurer. The results of an investigation undertaken by the Insurance Crime Prevention Bureau were ignored when its representative expressed the view that an arson defence was untenable. Experts retained by the insurer were pressured to provide opinions supporting the arson theory and were provided with misleading information.

The majority of the Supreme Court confirmed that, quite apart from its contractual duty to pay the loss, an insurer has a distinct and separate obligation to deal with its policyholder in good faith. The breach of that duty constitutes an independent actionable wrong sufficient to give rise to an award of punitive damages.

In the course of his reasons, Mr. Justice Binnie outlined the points that should be conveyed to a jury contemplating an award of punitive damages. These comments serve as a useful overview of the circumstances that justify such an award and the factors to be considered in determining an amount:

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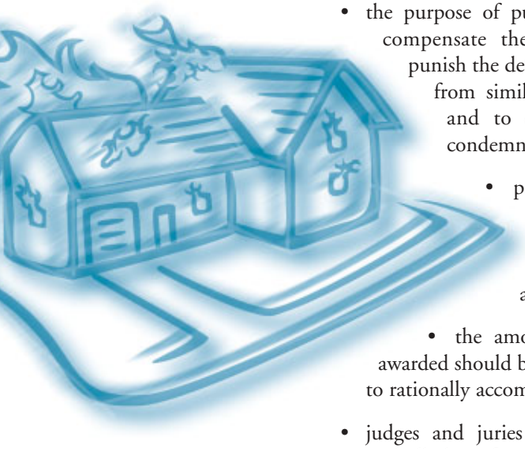
- punitive damages are very much the exception rather than the rule;
- such damages should be awarded only if there has been high-handed, malicious, arbitrary or highly reprehensible misconduct that departs to a marked degree from ordinary standards of decent behaviour;
- where awarded, punitive damages should be assessed in an amount reasonably proportionate to such factors as the harm caused, the degree of the misconduct, the relative vulnerability of the plaintiff and any advantage or profit gained by the defendant, taking into account other fines and penalties suffered by the defendant for the misconduct in question;
- punitive damages generally should be awarded only where the misconduct would otherwise go unpunished or where other penalties are likely to prove inadequate for achieving the objectives of retribution, deterrence and denunciation;
- the purpose of punitive damages is not to compensate the plaintiff but rather to punish the defendant, deter it and others from similar conduct in the future, and to express the community's condemnation of what has occurred;
- punitive damages should be awarded only where compensatory damages are insufficient to accomplish these objectives;
- the amount of punitive damages awarded should be no greater than necessary to rationally accomplish their purpose;
- judges and juries in the Canadian system typically have found that moderate awards of punitive damages, which carry a stigma in the community, are generally sufficient.



It is easy to view this decision as throwing open the doors to larger and more frequent punitive damage awards, particularly in cases involving an alleged breach of the duty of good faith by an insurer. Certainly, there is little doubt that allegations of bad faith on the part of insurers will become more common, at least in part because of this ruling.

At the same time, over-reaction should be avoided. While the *Whiten* case may make substantial punitive damage awards more common, the Supreme Court has reiterated that such a remedy will be granted only in the most exceptional circumstances, where reprehensible conduct might otherwise go unpunished. The court further noted that, unless punitive damages can be applied rationally, they should not be awarded at all.

Most observers will concede that the behaviour of the insurer in *Whiten* was sufficiently egregious to justify a finding of bad faith and an award of punitive damages. In the words of the court, the conduct of the insurer was planned and deliberate, and its arson defence contrived and unsustainable. The insurer maintained this position through to the completion of the trial, over which time the Whitens' financial situation became increasingly desperate. The amount of the award, which was more than the majority of the Supreme Court would have awarded, nevertheless was held to be within the high end of the range where such damages may be assessed.

The issue is likely to prove more difficult in those cases where the actions of an insurer during the claims handling process, while arguably inappropriate, do not rise to this level of misconduct. To date, there have been relatively few such cases in Canada. It will be interesting to see how courts in the future choose to treat allegations of bad faith and claims for punitive damages in view of the guidelines outlined by the Supreme Court in the *Whiten* case.

To locate the article on the Court of Appeal decision, readers can find the Winter 2000 edition of the Fillmore Riley Report on the internet at: www.fillmoreriley.com/ne/nena.html.

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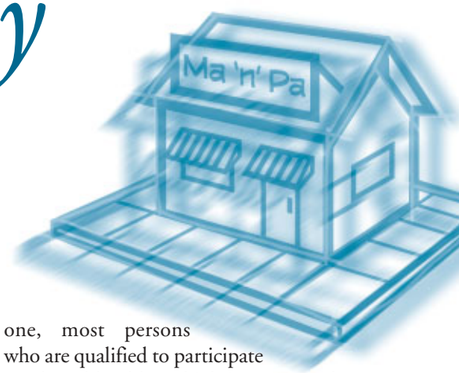
All in the Family



◆ *Ron Ade*

As reported in a recent issue of Canadian Business, family-run businesses in Canada employ directly and indirectly six million persons, and generate approximately $1.3 trillion in revenue each year.

Obviously these businesses constitute a key component in our country's economy. However, a startling fact is that almost half of the founders of those businesses intend to retire within the next 8 years.

The question that comes to mind is "who will succeed the current owners who have created the success and wealth of these businesses?" Outside interests will purchase some of those businesses, providing one answer to that question. Certainly many families of the founders will have their own answer. By birthright they expect to, and in many cases will, succeed their parent by taking control and carrying on the family business. While some will have the training and skills to perpetuate the success of their predecessors, some may not. What happens to the employees and revenue of those businesses which fall into the hands of the children who have good intentions, but inadequate skills?

Often, the success of the company is heavily dependent on the ambition, knowledge and intuition of the founder. Unless outside investors have participated in the business, it is often the case that no formal business plan has been created and kept current. Decision-making has been concentrated, with the only accountability being to institutional lenders and the founder's own satisfaction as to success.

Well in advance of retirement, the owner should evaluate the likelihood of passing on the business to family members. If it is a probable scenario, the owners should, in addition to having the family members work in the business, impose a discipline and regimentation to the operations that would be expected in businesses that are not family-controlled, allowing the next generation of family members to participate in that new regimentation. Such an approach would certainly involve formalized business plan preparation, led by experienced persons, in which the founder and the family members can participate. This process would assist in documenting what the founding parent has learned over the years and knows intuitively, but may not have committed to writing or transferred to the children.

In addition, a strategy of setting up a board of directors in which experienced business leaders join the board is an effective way of assisting in the transition from one generation of a family to the next. Directors need not be shareholders. Not only does the family get the benefit of having a broader scope of experience brought to the boardroom table by outsiders, this process requires the development of a discipline regarding operating and reporting which will only benefit the family members who will replace the founder at some point in the near future. There are a large number of experienced business persons and professionals in the Manitoba business community who would be willing and are capable of lending assistance to Manitoba firms that may seek outside assistance in their operations. While our business community is seen as a "close" one, most persons who are qualified to participate at a board level have high integrity and will exercise the discretion necessary to keep the family business private.

Such a strategy is not without cost. Outside directors expect, and should receive, adequate compensation for their participation. In addition, given that all directors assume potential liabilities, care must be taken to obtain directors' and officers' insurance to mitigate risks – a good practice for all businesses that is all too often not implemented by family owned businesses. By far the greatest "cost" may be the recognition by the directors and the founder that the next generation may not be capable of taking control of the business. Good directors, in fulfilling their obligations to act in the best interests of the corporation, should not hesitate to provide direction to management, notwithstanding that the message may not be welcome. While the shareholders always have the option to remove directors in whom they have lost confidence, before doing so, a founding owner should consider the advice given.

No matter what the outcome of allowing outsiders into the "family," the act of doing so can only strengthen the possibilities of success for a business facing the transition from one generation to the next.

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"Staying the Hand of the Paymaster?"

◆ *Shayne D. Berthaudin*

What are the nature and extent of an owner's obligations when a builders' lien is registered against its property?

This question is of interest to owners of both commercial and residential property who are contemplating or in the process of having construction work undertaken on their property. While the careful owner may resort to *The Builders' Liens Act*, this legislation is notoriously convoluted and inconsistent. However, a recent decision of the Manitoba Court of Appeal provides some useful guidance to assist owners in assessing their obligations.

In the case of *South Westman Regional Health Authority Inc.* v. *Accurate Dorwin Co. et al.,* South Westman retained a general contractor to perform two construction projects on separate pieces of its property. As construction progressed, South Westman made progress payments to the general contractor, subject to the 7.5 per cent statutory holdback. During the course of construction, to South Westman's knowledge, a builders' lien in the sum of $2,678 was registered by one of the sub-contractors ("the first lien"). Five days after the first lien was registered, South Westman made a progress payment of $128,864 to the general contractor. The general contractor abandoned the projects shortly thereafter, following which other sub-contractors registered builders' liens in the total amount of $623,390.

South Westman applied to the court for an order under *The Builders' Liens Act* vacating all builders' liens on payment into court of the statutory holdback plus the amount of the first lien (given that it had knowledge of this lien prior to making the last progress payment). The lien claimants opposed the application and took the position that, in order to vacate the liens, South Westman was required to pay the statutory holdback, the amount of the first lien, *plus the full amount of the progress payment made by South Westman after knowledge of the first lien* ($128,864).

Essentially, the lien claimants' position was that the registration of the first lien protected the rights of all unregistered lien claimants and, on registration of the first lien, South Westman was required to cease making any further payments, determine the value of the registered and unregistered lien claims, and pay the holdback together with such amounts determined to be owing. In other words, their position was that the registration of a single lien "stayed the hand of the paymaster," and failure to take those steps should result in the owner having to make double payment. Only after the required steps had been taken, according to the lien claimants, could further progress payments be safely made.

The Court of Appeal first noted that there is no provision in *The Builders' Liens Act* which specifically addresses the consequence to an owner of making payment after registration of a lien. Therefore, it looked at the legislation as a whole to determine the question. The Court ruled that there was no support in law for the theory put forth by the lien claimants and that it was not consistent with commercial reality. It ruled that when an owner proceeds to make payments in good faith after liens have been registered against its property, its liability is restricted to the amount of the registered liens. The registered liens do not operate to protect the rights of those sub-contractors who had not registered liens as at the date of that payment.

Notwithstanding the result in this case, owners finding themselves in a situation where a builders' lien has been registered would be well served to be cautious in making further payments. An owner may put itself in a vulnerable position by disregarding the warning signs raised by the registration of a lien. In this case, there was no evidence that South Westman had prior knowledge of any other lien claimants – thus it was assumed that the last progress payment was made in good faith. As such, the Court of Appeal did not address the issue of the consequences faced by an owner if such payments were made in bad faith. Given the potential $128,000 problem narrowly avoided by South Westman in this case, caution is advised.

On the other side of the coin, the message sent by this decision to those who act as sub-contractors on construction projects is that lien registration is paramount. Sub-contractors must be diligent in protecting their rights, not only by registering a lien where appropriate, but doing so in a timely way.

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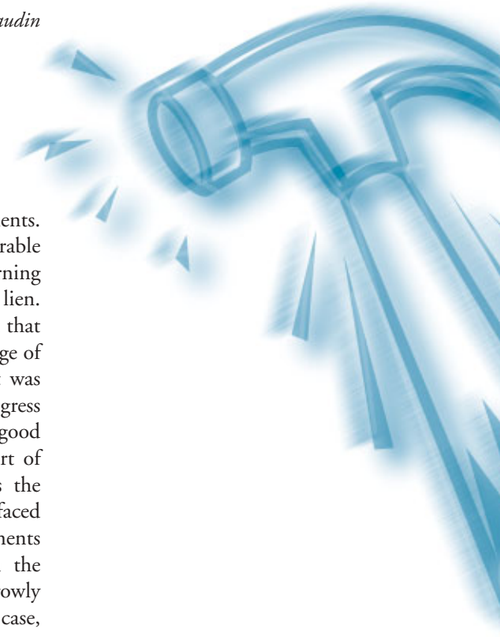


builders' lien

What's NEW in Federal Legislation

On June 14, 2001, the ability of smaller political parties to participate in the electoral system was enhanced with the granting of Royal Assent to the Act to Amend the Canada Elections Act and the Electoral Boundaries Readjustment Act.

Parts of this Act resulted from the 2000 decision of the Ontario Court of Appeal in *Figueroa* v. *Canada (Attorney General)*.

Prior to these amendments, a party needed to nominate at least 50 candidates (out of 301 federal ridings) in a federal election to become a registered political party. Only registered political parties are entitled to issue tax receipts, receive reimbursements of certain election expenses, receive airtime on television and radio and receive lists of electors. In addition, candidates belonging to a registered party may have their party affiliation shown on the ballot.

The appellant in the *Figueroa* case argued these restrictions violated his rights under the *Canadian Charter of Rights and Freedoms,* in particular section 3 which states:

> Every citizen of Canada has the right to vote in an election of members of the House of Commons or of a legislative assembly and to be qualified for membership therein.

The Ontario Court of Appeal found the 50 candidate rule did not infringe the *Charter* rights of Canadians, because section 3 of the *Charter* enshrines the right to effective representation. Members of the political parties could nominate a candidate at the constituency level and, therefore, support the party at the national level. However, the court found that a political party only becomes effective when it can have a meaningful participation in the national electoral process. Because of this, a limit of 50 candidates was reasonable in order for the party to be recognized as a national party.

The Court did find the limit on displaying party affiliation was an unjustified violation of section 3 of the *Charter*. The Court found the display of party affiliation provided voters with additional and useful information about the candidate so that they could vote rationally and in an informed manner. This information is particularly important for smaller parties who often have limited resources for reaching the voters. By being made aware of a candidate's party affiliation, a voter is better informed of the candidate's views and policies based on those of his or her party.

Due to this decision, the Federal Government amended the *Canada Elections Act* to allow political parties that have nominated at least 12 candidates to have their party affiliation identified on the ballot.

Can Crime Pay?

◆ *Stuart J. Blake*

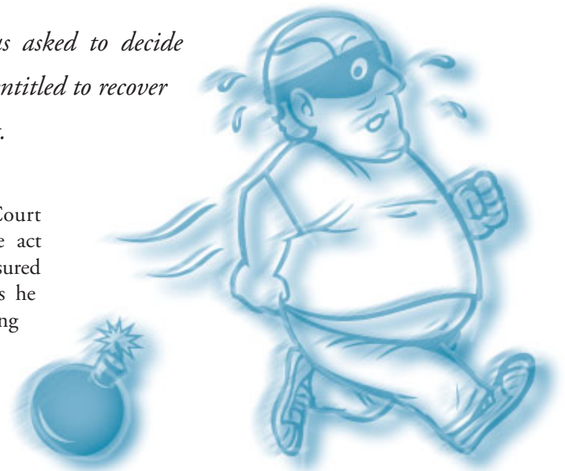
The Supreme Court of Canada in two recent decisions was asked to decide whether an innocent beneficiary to a life insurance policy was entitled to recover where the death of the life insured occurred by his criminal act.

Should the beneficiary profit from the crime, albeit indirectly? Alternatively, should the recovery be precluded by public policy?

In *Oldfield* v. *Transamerica Life Insurance Co. of Canada,* the insured, Oldfield, died in Bolivia when one of thirty cocaine-filled condoms which he had ingested burst in his stomach. It was agreed that his activity was contrary to Bolivian and Canadian law. Following Oldfield's death, his spouse, as beneficiary, claimed entitlement under the $250,000 life policy. The insurer refused to pay, saying her claim was barred by the public policy principle that a person should not be allowed to insure against his criminal act, regardless of who the ultimate beneficiary of the policy is.

The Supreme Court unanimously permitted recovery by the innocent spouse. Although the Court recognized the existence of a public policy rule that prevented criminals from profiting from crime, it stated that the rule was inapplicable on the facts before it because an innocent beneficiary is not a criminal. The Court confirmed it was consistent with justice that innocent beneficiaries not be disentitled to insurance proceeds merely because an insured accidentally dies while committing a criminal act.

Similarly, in *Goulet* v. *Transamerica Life Insurance Co. of Canada,* the policyholder was killed when a bomb he was attempting to plant in a car at Dorval Airport exploded. His spouse claimed the $50,000 insurance indemnity in her capacity as beneficiary. Once again, the insurer refused to pay notwithstanding the fact that there was no exclusionary clause precluding payment of the indemnity if the insured died while committing a crime.



The Supreme Court determined that the act committed by the insured was unintentional as he did not intend to bring about his own death. The Court agreed that the principle of public order exists in Quebec insurance law, but said its application is not absolute. It further held that the purpose of the public order rule is to prevent the insured or the person entitled to receive the insurance indemnity from profiting from his own crime. Insurance law does not, however, preclude the protection of innocent third persons or beneficiaries from the consequences of criminal activity. The spouse was, therefore, entitled to the life insurance proceeds.

In summary, the Supreme Court has confirmed that although the principle of public order does exist, the principle does not extend to an innocent beneficiary. In light of these recent decisions, an insurer may want to revise its policy language to include a clause specifically providing that the insurer is not required to pay the indemnity if the insured should die during the commission of an offence.

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NEWS

Ross Yarnell has been elected Chairman of the Board of the Manitoba Cardiac Institute [Reh-Fit] Foundation Inc. The purpose of the Foundation is to secure financial resources for the continued well being of the Reh-Fit Centre, which is a health and fitness facility, as well as a post-cardiac treatment centre.

Bill Ryall and **Dean Giles** participated in an Educational Program Innovations Centre seminar entitled "Understanding Environmental Regulations." Bill presented a variety of topics including liability and legal defences in environmental law, contaminated sites, and enforcement and inspection. Dean presented an overview of federal environmental law and policy.

Eleanor Wiebe lectured at the Law Society of Manitoba Bar Admissions Course on two occasions. In the Wills and Estates segment, Eleanor spoke on the topic of will drafting. And in the Corporate and Commercial segment, she spoke about the purchase and sale of a business.

Cary Reiss also participated in the Corporate and Commercial segment of the Law Society of Manitoba Bar Admissions Course, lecturing on debt and equity financing, and tax considerations.

Bernice Bowley gave her third annual lecture to the University of Manitoba's Faculty of Dentistry on the prevention of and protection from liability claims and other insurance issues. In addition, Bernice spoke in Winnipeg and in Brandon to the Association of Manitoba Municipalities on the Walkerton Report and the liability issues for municipalities regarding water supply.

Anita Southall lectured on estate litigation in the Wills and Estates segment of the Law Society of Manitoba Bar Admissions Course. In addition, Anita provided a workshop on director's liability through the Volunteer Centre of Winnipeg.

Norman Yusim participated as an instructor and seminar leader in the Ethics segment of the Law Society of Manitoba Bar Admissions Course. At a Continuing Legal Education course, Norman presented a lecture on family law to police officers and social workers.

Tim Dewart presented a lecture and paper to commercial lawyers at a Continuing Legal Education course on assisting clients who are experiencing financial problems.

Fillmore Riley sponsored the Service Excellence Award at the Tenth Anniversary of the Manitoba Women Entrepreneur of the Year Awards held in Winnipeg. This year marks the fifth year of our sponsorship of the award which recognizes the outstanding achievements of many of Manitoba's dynamic and successful business women.

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