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Commercial General Liability Insurance Policies - The Duty to Defend Post-Progressive Homes

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This paper was included in the presentation materials by Dominic C. Clark[i] at the Osgoode Professional Development National Update on Commercial Insurance Law and Coverage Disputes, November 3, 2011, in Toronto.

This paper reviews key issues relating to CGL insurance policies and the latest case law respecting, the reasonable expectations doctrine, approaches to policy interpretation and the duty to defend in light of *Progressive Homes* and recent caselaw concerning pollution exclusions.

REVIEW AND UPDATE ON THE REASONABLE EXPECTATIONS DOCTRINE

At its simplest, the doctrine of "reasonable expectations" is a tool of construction whereby courts construe insurance contracts in a manner consistent with the reasonable expectations of the contracting parties. As this review and update on the law of reasonable expectations will suggest however, there is not much that is "simple" about it.

a) The American Experience

The doctrine of reasonable expectations originated in the United States. The concept of looking to the reasonable expectations of the parties to a contract was articulated as far back as the 1918 decision of *Bird v. St. Paul Fire and Marine Insurance,[ii]* but the doctrine did not achieve prominence in the insurance context until the 1960-1970's.

By 1976, Professor Robert Keeton, a leading scholar of U.S. insurance law, found that there was sufficient case law to credit it with having established a clear departure for American insurance law from the insurance law of the English legal system, stating it was "perhaps a

more striking departure than any that had occurred before this doctrine began to emerge in the 1960's".[iii]

Keeton is generally credited with creating the modern formulation of the reasonable expectations doctrine. In his seminal 1970 article, he noted the shift from the early days where insurance contracts were negotiated at Lloyd's Coffee House among persons of relatively equal bargaining power to the modern practice of offering mainly contracts of adhesion. Given the changes, Keeton argued that judicial regulation of these contracts was appropriate and set out the following principle:

The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.[iv]

Keeton reasoned that the principle was "too general to serve as a guide from which particularized decisions can be derived" and "too broad to be universally true",[v] but that it pointed in the direction insurance law appeared to be moving and, in his view, ought to be embraced.

Many U.S. jurisdictions did go on to adopt and develop this principle, but based on different approaches. Certainly Keeton's suggestion that courts should ignore clear contract language and honour the insured's reasonable expectations regardless was, and still is, controversial. A review of the case law and literature reveals that there is no real consensus on how doctrine is applied. Depending on the article, authorities suggest that there are two,[vi] three[vii] and even four[viii] different applications of the doctrine of reasonable expectations. In the absence of consensus and for our purposes, however, these various approaches can be categorized as adopting either a narrow or broad application of the doctrine.

The narrow application purports to apply the doctrine of reasonable expectations only when policy language is ambiguous. This approach is in line with the traditional contract interpretation canon of *contra proferentem* which construes ambiguity against the drafter. As the vast majority of insurance contracts are unilaterally drafted by the insurer, any ambiguity is construed in favour of the insured.[ix]

Courts adopting the broad application of the doctrine hold that it can be applied even in the absence of an ambiguity. These courts are willing to ignore clear policy language in order to ensure that they give effect to the reasonable expectations of the insured.

Various justifications have been put forth in support of a broad application, with the gist of them being that proponents believe insurance policies are essentially adhesion contracts over which insurers exercise extraordinary control. They argue that most insureds do not read, let alone understand, their policy[x] and in fact, many insurance transactions are final before a policyholder even has the chance to view the detailed policy terms.[xi] Accordingly, it is up to the doctrine of reasonable expectations to avoid an unfair or unconscionable result. The broad

approach upholds public policy and appears to be “part and parcel of the expanding emphasis on consumer protection”.[xii]

Of course, the broad application also has its detractors. It has been criticized for, among other things, being too imprecise to result in predictable court decisions, precluding insurers from relying on the written terms of their policies, and permitting recovery by insureds who do not bother to read their policies.[xiii]

Not all jurisdictions in the United States even accept the doctrine.[xiv] In the jurisdictions that do apply it, however, the courts generally consider one or more of the following factors in determining whether the doctrine is excluded by the policy terms:

1. The existence of ambiguity;
2. Hidden exclusions or technical language;
3. Unconscionable conduct by insurer or unfair result;
4. The physical appearance of the policy; and
5. Public policy considerations.

These factors are interrelated and courts will often cite to more than one factor as grounds for applying the reasonable expectations approach to an insurance coverage controversy.[xv]

In summary, the doctrine of reasonable expectations has grown out of, and evolved considerably within, the United States. Application of the doctrine varies widely depending on the particular jurisdiction, and care must be had to determine the state of the law in each jurisdiction when relying on American authorities or practising law across the border.

b) The Canadian Approach

The doctrine of reasonable expectations, as it has been applied in Canada, generally arises only where there is an ambiguity in the terms of the policy. However, case law does mention the possibility of broadening the doctrine so that, in certain circumstances, it would apply even in the absence of an ambiguity. To date, no appellate court has yet embraced the broader application of the principle.

Origins of the Doctrine

The basis for the doctrine of reasonable expectations in Canada is sometimes referred to as *Consolidated Bathurst Export Ltd. v. Mutual Boiler & Machinery Insurance Co.****[xvi]*** In particular,where Estey J. wrote:

[L]iteral meaning should not be applied where to do so would bring about an unrealistic result or a result which would not be contemplated in the commercial atmosphere in which the insurance was contracted. Where words may bear two constructions, the more reasonable one, that which

produces a fair result, must certainly be taken as the interpretation which would promote the intention of the parties. Similarly, an interpretation which defeats the intentions of the parties and their objective in entering into the commercial transaction in the first place should be discarded in favour of an interpretation of the policy which promotes a sensible commercial result. It is trite to observe that an interpretation of an ambiguous contractual provision which would render the endeavour on the part of the insured to obtain insurance protection nugatory, should be avoided. Said another way, the courts should be loath to support a construction which would either enable the insurer to pocket the premium without risk or the insured to achieve a recovery which could neither be sensibly sought nor anticipated at the time of contract.[xvii]

Note that there is no explicit mention of "reasonable expectations". While this passage may have indeed laid the foundation for acceptance of the doctrine, in fact, the doctrine of reasonable expectations was first introduced in Canada by the Ontario Court of Appeal in *Wigle v. Allstate Insurance Co. of Canada.**[xviii]***

At issue in *Wigle* was whether an unidentified automobile which struck the plaintiff fell within the designation of an "uninsured vehicle" as that term is used in the Underinsured Motorist Endorsement (S.E.F. No. 42) to a standard policy of automobile insurance. Writing for the majority, Cory J.A. (as he then was), found that the endorsement was a standard form contract. He noted that the American Courts had adopted a policy with regard to the interpretation of standard forms of insurance contracts known as the "reasonable expectations" doctrine. The doctrine required that courts honour the reasonable expectations of an insured in situations where the policy is ambiguous despite the presence of policy provisions which would appear to negate coverage.

Following a review of the history and application of the doctrine in the United States, Cory J.A. stated:

The basic rules of construction adopted by the American courts are as follows:

1. The court should look at the words of the contract to determine if there is an ambiguity;

2. the court should ascertain the intention of the parties concerning specific provisions by reference to the language of the entire contract;

3. the court should construe ambiguities found in the insurance contract in favour of the insured, and

4. the court should limit the construction in favour of the insured by "reasonableness" and apply it only if it is impossible to give the contract a fair interpretation by using other rules.

The doctrine has been extended to give effect to the reasonable expectations of policyholders to cases which did not involve ambiguous provisions in the policy. For our purposes it is necessary only to consider situations where there is ambiguity in the contract. I am of the opinion that the first three rules of construction, above, are appropriate to the interpretation of standard form

motor vehicle insurance contracts in Ontario. Their application is equitable for it is the insurer that has the only real opportunity to settle upon the wording of the coverage, whether it will offer such coverage and to explain it to their clients who can only accept or reject the coverage.[xix]

The Court concluded that the endorsement was ambiguous, as the average person reading it would find nothing that would indicate that unidentified motor vehicles, as defined in the policy, were specifically excluded from coverage. Consequently, it was an appropriate case to give effect to the insured's reasonable expectation.

The Traditional Interpretation

Less than a decade after *Wigle*, the Supreme Court of Canada had the opportunity to consider the doctrine in *Brisette Estate v. Westbury Life Insurance Co.**[xx]*** In *Brisette,* the Court grappled with the question of whether, where a joint policy of insurance is issued to a couple, the husband's murder of the wife absolves the insurance company from paying out under the policy. It was accepted that public policy precluded recovery by the husband, but the wife's estate made a claim for the proceeds.

Sopinka J., writing for the majority, held that there was nothing ambiguous about the wording of the contract and made no mention of the reasonable expectations doctrine. The Court concluded that the insurance contract could not be construed to require payment to the wife's estate. However, Cory J., in dissent, discussed the doctrine at some length. He noted that in the United States there were essentially three versions of the doctrine:

1. Application of the doctrine wherever there is an ambiguity in the policy of insurance, so that ambiguities are resolved in favour of the insured in order to satisfy his or her reasonable expectation;

2. Application of the doctrine to provide that the insured is entitled to all the coverage that might reasonably be expected to be provided under the policy. Only an equivocally plain and clear manifestation of the company's intent to exclude coverage will defeat that expectation; and

3. The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honoured even though painstaking study of the policy provisions would have negated those expectations.[xxi]

With respect to the third version, Cory J. noted that commentators justified the broad approach for three reasons: (1) policy forms are long and complex and cannot be understood without detailed study; (2) rarely do policyholders read their policies carefully enough to acquire such understanding; and (3) most insurance transactions are final before a policyholder has a chance to see the detailed policy terms.[xxii] He stated that he set out the American authorities "not with any intention of slavishly following any of them" but rather to show how far certain jurisdictions have gone to give effect to the reasonable expectations of the insured. Justice Cory then went on to briefly discuss the Canadian approach, reiterating the basic rules set out in *Wigle*, which accept that the doctrine applies only in cases of an ambiguity.

In applying the relevant legal principles, he found that it was apparent that an ambiguity existed with the policy as it did not address the situation of one spouse murdering another. In his view, whether it was called "the reasonable intention or the reasonable expectation of the parties, the result is the same", that is, that the sum insured should be paid to the wife. He concluded that while public policy reasons precluded the husband from benefiting from his crime, he must hold those funds as trustee for the administrator of the estate of the wife.

Only one year later, MacLachlin J. (as she then was), writing for the majority of the Supreme Court of Canada pronounced the doctrine a "principle of construction" in *Reid Crowther & Partners Ltd. v. Simcoe & Erie General Insurance Co.*:***[xxiii]***

I turn to the third relevant principle of construction, the reasonable expectations of the parties. Without pronouncing on the reach of this doctrine, it is settled that where the policy is ambiguous, the courts should consider the reasonable expectations of the parties.[xxiv]

Accordingly, in the course of less than a decade the doctrine of reasonable expectations went from being first introduced by the Ontario Court of Appeal to being labelled a "principle of construction" by the Supreme Court of Canada. Today, the doctrine is applied in cases across the country.[xxv]

Where No Ambiguity is Present

While it is clear that the doctrine of reasonable expectations has been adopted by Canadian courts, there is some debate as to whether a Court may consider the reasonable expectations of the parties absent an ambiguity in the policy. To date, while appellate courts have only endorsed a limited application of the doctrine they have also refused to pronounce on its precise reach.

Most notably, the Ontario Court of Appeal in *Chilton v. Co-Operators Insurance Co.****[xxvi]***set out various factors that could merit the application of the doctrine even when the policy wording was unambiguous. The Court reviewed the various justifications that had been used in the United States to extend the principle to unambiguous wording:[xxvii]

(i) insurance policies are typically long, complicated documents which insurers know policy holders will not even read, let alone study carefully;

(ii) insurers' marketing approaches ordinarily do not even allow a purchaser to examine a copy of the policy until after the contract has been concluded;

(iii) in some cases protecting reasonable expectations is appropriate because allowing an insurer to enforce limitations or restrictions in the policy would be unconscionable or unfair;

(iv) expectations caused by the marketing practices of the insurer should be protected; and

(v) expectations resulting from the insurer's characterization of the insurance coverage warrant protection in some circumstances.

The Court stated that no Canadian appellate Court had yet embraced the broader application of the doctrine, and that they need not decide the reach of the principle either, as the wording in the policy at issues was clear. Nevertheless, the Court provided a road map for its possible use:

In considering whether to apply the reasonable expectations principle to cases in which there is no ambiguity in the policy, first the court should consider whether a reasonable insured could have expected coverage. An arguable case for coverage may exist, for example, if the policy is difficult to read or understand and if the insurer, either by its marketing practices or by giving its policy a misleading name, created or contributed to a reasonable expectation of coverage. Coverage may also be warranted where the insurer's interpretation of the relevant policy provision would virtually negate the coverage the insured expected by paying a premium. In these circumstances the court may be justified in looking beyond the words of the contract and holding the insurer responsible for the insured's reasonable expectation of coverage.[xxviii]

The Court of Appeal continued this discussion in *Segnitz v. Royal & Sun Alliance Insurance Co. of Canada,* ***[xxix]*** where it held that its earlier decision on the application of deductibles upon payment of motor vehicle property damage claims under automobile insurance policies was wrongly decided. The Court determined that the statutory condition at issue formed part of the Ontario automobile insurance policy and, therefore, should be considered in light of the principles for interpreting insurance policies, including reasonable expectations. Laskin J.A., for the Court, stated:

I do not consider the interpretation of statutory condition 6(7) or the application of a deductible in total loss cases to be ambiguous. Nonetheless, and without deciding whether the reasonable expectations principle should have a wider reach in Canada, I think that I can safely say it is always desirable when a court's interpretation accords with the parties reasonable expectations. That is undoubtedly the case here. Deductibles are a well-understood and well-accepted feature of automobile insurance policies. A reasonable insured would fully expect the insurer to apply a deductible in total loss cases, including in those cases where the insurer acquires the salvage. A reasonable insured would not expect to receive more than he or she bargained for.[xxx]

While the Court did not go so far as explicitly to broaden the doctrine in this case, the decision does seem to suggest that in certain situations, as with deductibles, it is desirable to consider the reasonable expectations of the parties even absent an ambiguity.

Finally, in *Fresh Taste Produce Ltd. v. Sovereign General Insurance Co.* ***[xxxi]*** the insured submitted a claim to its insurer following the province-wide power black-out that occurred in the summer of 2003. The insurer brought a motion for summary judgment and the insurer sought an adjournment to file extrinsic evidence regarding its reasonable expectations respecting the policy. The Motion Judge refused, and the insured appealed.

In dismissing the appeal, the Court noted that its decision in *Chilton* recognized the doctrine of reasonable expectations, and stated that it applies "primarily" when a Court is required to construe an ambiguity. The Court noted the discussion in *Chilton* about the potential broader

application of the reasonable expectations doctrine but concluded that it had no basis for finding that this case warranted a broader application of the doctrine of reasonable expectations.

Naturally, these comments have led to speculation that the Court is simply waiting for the right case to come along before it will expand the doctrine. At least one commentator suggested that these aforementioned Court of Appeal decisions indicate a willingness to do so:

Given the Court of Appeal's recent observations about and characterizations of the reasonable expectations doctrine and in what circumstances and on what basis it might be applied, it appears the Court of Appeal is anticipating, or one might even go so far as to say encouraging, the receipt of an appropriate case in which it may directly deal with whether or not the doctrine of reasonable expectations should be extended to the interpretation of unambiguous policy language.[xxxii]

More recently, the Court of Appeal again left the door open for expansion in *CUMIS General Insurance Co. v. 1319273 Ontario Ltd.* ***[xxxiii]*** The Court stated:

Moreover, Canadian courts have typically used the reasonable expectations principle to resolve ambiguities in a policy…And even if the reasonable expectations principle had a broader scope it would not apply in this case because the G.L. Plus rider is not misleading.[xxxiv]

There is also at least one Ontario lower court case where a court has applied the doctrine of reasonable expectations absent an ambiguity. At issue in *Smith v. Crown Life Insurance Co.* ***[xxxv]*** was whether the insured was entitled to increased benefits payable under her disability income policy.

The facts are sympathetic, albeit convoluted. The insured was rendered partially disabled after a surgery left her partially deaf and with facial nerve paralysis. Consequently, she reduced her hours of work and applied to obtain a Future Increase Option (FIO). The FIO rider provided a once-a-year option to increase coverage without having to provide evidence of insurability and was, therefore, available to an insured who was disabled as of the date of application. Her application was denied without reason and she commenced an action against her insurer. She subsequently became aware that the reason she was denied was because she was already eligible for the maximum level of income benefits based on her income. She was then led to believe that if she cancelled her group coverage she would be able to re-apply and obtain an increase in benefits under her individual disability policy. She did so, but was again denied FIO coverage, this time because of the drop in her income since becoming partially disabled. Accordingly, she brought an application for a declaration that Crown Life had wrongly denied her application, for although Crown Life's decision complied with the strict wording of the policy, it produced an arbitrary result.

The Court found that "although the provisions of the policy [were] not ambiguous, the circumstances of this case [were] such that the principle of reasonable expectations ought to apply and that Smith [was] entitled to an increase in benefits of $300 per month in accordance with the FIO rider".[xxxvi]

In reaching its decision, the Court considered Laskin J.A.'s dicta in *Chilton* and appeared persuaded that this was an instance where a "reasonable insured could have expected coverage". The Court held:

In considering whether to apply the reasonable expectations principle to cases in which there is no ambiguity in the policy, the court should consider whether the reasonable insured could have expected coverage. On the facts of this case, Smith could reasonably have expected increased coverage pursuant to the FIO rider. The nature of the policy and the actions of Crown Life contributed to this reasonable expectation. The court also takes into account that the provisions for determining eligibility under the rider, as outlined above, may produce an arbitrary result. Coverage may be negated for no reason other than the fact that the date of the disabling event is too far removed from the option date. In the present case, Smith could reasonably have expected to receive increased coverage when she cancelled the group policy and reapplied for the FIO option in accordance with the minutes of settlement. In these circumstances, the court is justified in looking beyond the words of the policy and applying the principle of reasonable expectations.[xxxvii]

Curiously, the *Smith* case does not appear to have garnered much in the way of discussion or notable judicial treatment. It was cited only once by Bromstein J. of the Ontario Small Claims Court in *Ashby v. Personal**[xxxviii]*** for the proposition that the reasonable expectations principle could apply where there is no ambiguity in the policy. As such, this interesting decision does not appear to carry much weight at this time.

The sum of these cases clearly suggests there is some appetite for expansion of the doctrine. That said, the Supreme Court of Canada has cautioned against doing so haphazardly. In *Jesuit Fathers of Upper Canada v. Guardian Insurance Co. of Canada**[xxxix]*** the Court held:

[T]he courts should try to give effect to the reasonable expectations of the parties, without reading in windfalls in favour of any of them. In essence, "the courts should be loath to support a construction which would either enable the insurer to pocket the premium without risk or the insured to achieve a recovery which could neither be sensibly sought not anticipated at the time of the contract".[xl]

In this same decision, the Supreme Court reminded courts to "remain mindful of the rules and principles governing insurance law" and "pay close attention to the structure and actual wording of the policy, read as a whole",[xli] suggesting perhaps a return to more conservative methods of interpretation.

In summary, as set out above, the law with respect to the doctrine of reasonable expectations is in a somewhat uncertain state both within Ontario and across Canada. At present, the law in Canada remains that the reasonable expectations of the parties will only be applied where an ambiguity is found. Some Courts have clearly emphasized that it is only to be applied where an ambiguity in the wording of the particular policy arises, while still others have expressed a desire

to expand it beyond requiring an ambiguity in the policy, although there may be a need for ambiguity at a broader level.

c) Application (and Confusion) of the Doctrine

As the doctrine of reasonable expectations is a relatively new one, the methods or rules of application are still developing. At present, however, the case law does provide some general guidelines.

Firstly, the case law suggests that the doctrine requires consideration of the expectations of both the insured and the insurer. This was stated explicitly by Binnie J. in *Vytlingam (Litigation Guardian of) v. Farmer*: “[i]nsurance policies must be