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Subrogation and the Covenant to Insure in Commercial Leases

Fires on commercial and industrial premises are an unfortunate fact of life for landlords, tenants, and insurers. In the wake of a fire loss, investigations may reveal that the fire was in fact caused by the negligence of a tenant or a tenant's employee.

A negligent tenant is an attractive target for a subrogated claim by the landlord's insurer. Commercial leases usually contain terms requiring the tenant to keep the demised premises in repair and requiring the tenant to indemnify the landlord for any liability caused by the tenant's wrongful acts or neglect. The tenant usually carries liability insurance, and is often specifically required to do so by the terms of the lease. On a subrogated claim, the insurer steps into the shoes of the landlord, and is accordingly entitled to the benefit of these lease provisions.

However, the landlord's covenant to insure, a commonplace lease provision, may derail an insurer's attempt to collect from a negligent tenant. In summary, the issue is whether the landlord, by agreeing to insure a building, has assumed the risk of loss or damage by fire. This analysis is to be conducted on a case-by-case basis, and is based on the wording of the specific lease in question.

I. The Covenant to Insure and the Trilogy

The impact of a landlord's covenant to insure on the ability to bring a subrogated claim was considered in a trilogy of cases from the Supreme Court of Canada decided in the late 1970s: *Pyrotech Products Ltd. v. Ross Southward Tire Ltd.,* [1976] 2 S.C.R. 35 (S.C.C.) ["*Pyrotech*"], *Cummer-Yonge Investments Ltd. v. Agnew Surpass Shoe Stores Ltd.,* [1976] 2 S.C.R. 221 (S.C.C.) ["*Cummer-Yonge*"] and *Smith v. T. Eaton Co.,* [1978] 2 S.C.R. 749 (S.C.C.). ["*Smith*"].

The first case to come before the Supreme Court was *Cummer-Yonge*. In that case, the landlord covenanted to insure a building "against all risk of loss or damage caused by or resulting from fire, lightning or tempest or any additional peril defined in a standard fire insurance additional perils supplemental contract." The tenant covenanted to insure all glass and plate glass in the leased premises, and to maintain public liability insurance, naming the landlord as an additional insured. The tenant was required to pay to the landlord any increase in the landlord's insurance premiums resulting from improvements or structural changes made by the tenant.

In that case, the majority of the Supreme Court held that the landlord's covenant to insure

the building, coupled with its obligation to repair the side walls, roof, floors and foundation of the building "force the conclusion that the [tenant] is to have the benefit of fire insurance to be effected by the [landlord] in respect of loss or damage arising from the [tenant's] negligence". The landlord's insurer was thereby prevented from bringing a subrogated claim.

In *Pyrotech*, the lease contained a provision which stated that, "the [tenant] shall pay all realty taxes including local improvements and school taxes, electric power and water rates and insurance rates immediately when due". The landlord presented the tenant with an insurance bill for fire insurance which was paid by the tenant. The tenant was unaware of the nature of the fire insurance policy taken out by the landlord. The landlord's building was destroyed by the negligence of the tenant's employees. The lease in *Pyrotech* contained clauses which, absent the payment of insurance rates, "would have saddled the tenant with liability for losses from such fires."

In that case, the tenant argued that under the provision of the lease respecting the payment of insurance rates by the tenant, the risk of loss by fire passed to the landlord, and that the matter became solely one between the landlord and its insurer. The landlord argued that there was no provision excepting the tenant from liability for negligence. The majority of the Supreme Court held that "the tenant may well be liable to answer for negligence in other respects but, in my opinion, it is entitled to rest in respect of loss by fire on the discharge of its obligation to pay for fire insurance." In conclusion, the Supreme Court held that the landlord's insurer was unable to subrogate against the tenant.

In the case of *Smith*, the lease contained a provision which required the landlord to maintain fire insurance on the building. However, the landlord attempted to distinguish *Cummer-Yonge* and *Pyrotech* on the basis that the tenant's covenant to repair expressly fixed the tenant with liability for fires arising by reason of negligence. The tenant's covenant to repair also did not include any reference to the landlord's covenant to insure. In this case, as in *Cummer-Yonge* and *Pyrotech*, the majority of the Supreme Court held that the tenant was entitled to the benefit of the landlord's covenant to insure, and as a result there was no ability to subrogate against the tenant.

In essence, the trilogy cases stand for the proposition that one must look to the terms of a commercial lease to determine whether the risk of loss by fire has been assumed by the landlord. It is a question of intention which must be adequately expressed by the parties.

II. The Law in Manitoba – Sooter Studios

This issue came before the Manitoba Court of Appeal in the case of *Sooter Studios Ltd. v. 74963 Manitoba Ltd.* 2006 MBCA 12 ["*Sooter Studios*"]. In that case, the Court considered a "net lease", which did not contain an express covenant for the landlord to insure the building, but did include the costs of insurance as an "operating cost", for which the tenant was responsible. The lease in that case also contained indemnification and save harmless clauses in favour of the landlord. In the circumstances of that case, the Court of Appeal held that the landlord was not precluded from bringing a subrogated claim against the tenant. It was held that to do so would render meaningless the express indemnification and save harmless clauses in the lease.

On its face, this case appears to be inconsistent with the decisions of the Supreme Court in the trilogy. However, it is submitted that *Sooter Studios* is indicative of the importance of the wording of each particular lease at issue. One should be careful not to paint all commercial leases with the same brush. There are a number of cases across Canada considering the issue outlined in the trilogy arriving at diametrically opposite conclusions. The outcome of any given case is far from certain.

III. Conclusion

The issue of whether a landlord or a landlord's insurer is barred from bringing a subrogated claim against a negligent tenant for a fire loss is highly case-specific. It is a question of intention that must be adequately expressed by the parties. The landlord's covenant to insure the building is a very important consideration in that analysis.

Landlords, insurers, and tenants would be well-served by considering whether the risk of fire loss has been transferred to the landlord under the terms of a commercial lease.

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