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Premises Damaged by Fire? Don't Be Left Holding the Bag

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By Macdonald Allen

An Appellate Review of Insurance and Indemnity Clauses in a Commercial Lease In an article from January 2015, we cautioned landlords and tenants to pay particular attention to the interplay of insurance and indemnity clauses in a commercial lease as a result of the Superior Court of Justice's surprising decision in *Deslaurier Custom Cabinets Inc. v. 1728106 Ontario Inc.* This decision held the landlord responsible for damage to the tenant's property caused by fire, a peril against which the tenant specifically contracted to insure.On April 4, 2016 the case was overturned on appeal. Justice Cronk, writing for the Court of Appeal, held that the motions judge's failure to apply applicable jurisprudence constituted an error of law, and the effect of the tenant's covenant to insure was to presumptively fix the tenant, rather than the landlord, with responsibility for the tenant's losses. Insurance and indemnity clauses determine the allocation of risk between the parties in the event of damage and destruction. The tenant commenced an action against the landlord for damages to its property and its business interruption losses for approximately $4.1 million (the amount over and above the tenant's insurance coverage). The landlord brought a summary judgment motion and the tenant brought a cross-motion to determine who assumed the risk of damage resulting from the fire.Despite the tenant contractually undertaking to obtain insurance against "all risks of loss or damage to the tenant's property" and "against the risk of damage to the tenant's property within the Premises caused by fire", the motions judge arrived at an unexpected result: the landlord was responsible. The motions judge failed to give effect to the parties' agreed allocation of risk. Instead the motion judge held that the tenant's covenant to insure was limited by other express provisions in the lease.The Court of Appeal overturned the motion judge's decision. "The motions judge was obliged to presumptively interpret the tenant's insurance covenant in a manner that gave effect to the parties' agreed allocation of risk. Only then would the issue arise as to whether this presumption was rebutted by other provisions of the Lease."The motions judge's failure to deal directly with the parties' agreed allocation of risk flowed from her interpretation of the meaning of the word "Premises". After considering how the term was used in other sections of the lease, the motions judge held that the reference to "Premises" in the landlord's indemnity covenant must refer to something more than the rentable area; otherwise, in the motion judge's view the landlord would be indemnifying the tenant for something in which it did not have an interest. In our previous article, we questioned whether the motion judge considered the tenant's leasehold interest as an interest the tenant had which was capable of indemnification by the landlord. Similarly, the Court of Appeal noted that contrary to the motion judge's implied finding that the tenant has no interest under the lease in the space rented to it, "the Tenant has a leasehold interest in the Premises', namely, the contractual right to the exclusive use and occupation of the rented space during the term of the Lease and any renewals thereof."The Court of Appeal relied on the reasoning in the case of *Lincoln Canada Services LP v. First Gulf Design Build Inc.[1]* to read the landlord's indemnity covenant and the tenant's insurance covenant together, such that the parties intended the landlord to be exempt from liability for the specific matters that were to be insured against by the tenant. The reasoning in Lincoln is as follows:

i. the tenant was obliged to obtain the specific insurance required by its insurance covenant;
ii. the tenant had to look to its own insurer for any damage that was the subject of the tenant's insurance obligation, whether or not caused by negligence, and the tenant and its insurer were restricted from claiming against the landlord for recovery of such damage;
iii. if the landlord's negligence caused any damage against which the tenant was not required to insure, the landlord was obliged to indemnify the tenant for such damage; and

iv. apart from negligence, the landlord had no liability to the tenant for any damage listed in the landlord's indemnity covenant, whether or not the tenant had to insure for such damage.

The Court of Appeal applied the above reasoning to hold the tenant to its contractual bargain: it assumed responsibility for the risk of loss or damage to its own property caused by fire. The landlord only indemnified the tenant for risks against which the tenant was not required to insure (i.e. for risks other than loss or damage caused by fire). This interpretation also protects the landlord from negligence claims where the tenant specifically agreed to insure against an underlying risk, such as fire. Finally, this interpretation confines the scope of the term "Premises" to the agreed definition of that term under the Lease."In our view, the Court of Appeal rightly concluded that the Tenant was required to insure against the very risk that materialized:loss or damage to its property by fire. The Landlord and Tenant were ultimately held to their bargain. The Tenant was underinsured for its loss, and it was unjust to shift the remainder of its loss to the Landlord. This case, and its treatment by the courts is a warning to landlords and tenants to ensure they understand the interplay and relationship of the insurance and indemnity clauses contained in their leases in order to avoid an unexpected result.*[1] 2007 CanLii 45712 (Ont. SCJ), aff'd 2008 ONCA 528.*

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