DATE: 20040115
DOCKET: C39205 & C39204

COURT OF APPEAL FOR ONTARIO

MCMURTRY C.J.O., DOHERTY and BLAIR JJ.A.

B E T W E E N :	)	
	)	
ROYAL BANK OF CANADA	)	**David Zarek for the appellant State Farm**
	)	
Plaintiff (Respondent)	)	
- and -	)	
	)	
STATE FARM FIRE AND CASUALTY COMPANY	)	**Richard Horodyski for the respondent Royal Bank of Canada**
	)	
Defendant (Appellant)	)	
	)	
B E T W E E N :	)	
	)	
MICHAEL IAN BEARDALL ALEXANDER	)	**Troy H. Lehman for the respondent Michael Alexander**
	)	
Plaintiff (Respondent)	)	
	)	
- and -	)	
	)	
STATE FARM FIRE AND CASUALTY COMPANY	)	
	)	
Defendant (Appellant)	)	
	)	**Heard: December 2, 2003**

On appeal from the judgment of Herman J. Wilton-Siegel of the Superior Court of Justice dated November 1, 2002, reported at (2002) 43 C.C.L.I. 274.

DOHERTY J. A.:

I

[1] A fire of undetermined origin destroyed a home near London, Ontario in April 2000. The respondents, Royal Bank of Canada ("Royal Bank") and Michael Alexander ("Alexander") held mortgages on the property and claimed under the provisions of a fire insurance policy issued by the appellant, State Farm Fire and Casualty Company ("State Farm").

[2] State Farm acknowledged that the Royal Bank and Alexander were insured under the policy but took the position that coverage was voided as of January 2000. State Farm contended that the house had been vacated in November 1999 and remained vacant, to the knowledge of the mortgagees, when the fire occurred. State Farm further took the position that the vacancy constituted a material change in risk which was not disclosed to State Farm and entitled State Farm to void the policy. The Royal Bank and Alexander sued State Farm in separate actions.

[3] All parties moved for summary judgment. The outcome of the motions turned on the proper interpretation of three provisions in the policy:

- the mortgage clause which applies to mortgagees who are insured under the policy;
- the vacancy exclusion which excludes liability for damage caused after the property has been vacated for more than thirty days; and
- Statutory Condition Number 4 ("Statutory Condition"), which refers to material changes to the insured risk and entitles the insurer to void or cancel the policy.

[4] Wilton-Siegel J. held that the mortgage clause and the Statutory Condition were part of the contract between State Farm and the mortgagees. He held, however, that in the circumstances the insurer could not rely on the Statutory Condition to void coverage under the policy. Wilton-Siegel J. further held that the vacancy exclusion in the policy was inconsistent with the terms of the mortgage clause and could not be applied against the mortgagee. He gave judgment for the respondents. State Farm appealed.

[5] I would allow the appeal and dismiss both actions. I agree with the motion judge that State Farm could not rely on the vacancy exclusion to refuse payment on the policy. I would, however, hold that the Statutory Condition did apply and in the circumstances, entitled State Farm to void the contract.

II

[6] A brief summary of the agreed statement of facts relied on at the motion will suffice for the purposes of appeal. The house, which burned down in April 2000, was purchased by the Deeks in March 1997 and placed in the name of Julaine Deeks. She and her husband lived in the house. In December 1997, the Royal Bank registered a first mortgage against the property. In March 1998, Alexander registered a second mortgage against the property.

[7] The home was insured against fire by the Deeks under a policy issued by State Farm. Royal Bank and Alexander, as mortgagees were named insured under that policy.

[8] The Deeks defaulted on both mortgages in June 1999. Alexander commenced power of sale proceedings in August 1999. In September 1999, both mortgages remained in default and Julaine Deeks moved out of the house. Todd Deeks continued to live in the house. The Royal Bank commenced foreclosure proceedings on October 14, 1999. It retained a company to inspect the property on a weekly basis. Mr. Deeks was living in the house as of November 12, 1999, but had vacated the property permanently by November 19, 1999.

[9] On about November 20, 1999, the Royal Bank gave instructions to change the locks on all the doors and directed that steps be taken to preserve the property while it was vacant. The plumbing was drained, utilities were rerouted, and the hot water tank was emptied and turned off.

[10] On November 26, 1999, Alexander brought the Royal Bank's first mortgage into good standing thereby taking control of the power of sale proceedings. He continued to make payments on the first mortgage until the fire. From November 26th until the date of the fire Alexander was in control of the property and the Royal Bank had no involvement with it. Alexander retained real estate agents to list and sell the property. The property remained vacant.

[11] At no time after November 20, 1999 and before the fire on April 16, 2000 did the Royal Bank, Alexander or anyone else tell State Farm that the Deeks had moved out of the property. State Farm was not told that the house was vacant, that the mortgagees had taken control of the property by retaining the only set of keys to the property or that power of sale proceedings had been commenced.

[12] Alexander's lawyer advised State Farm of the fire on April 18, 2000. In the summer of 2000 Royal Bank and Alexander made claims under the policy. In March 2001 State Farm advised the Royal Bank and Alexander that no payment would be made as in State Farm's view the policy had been voided effective January 7, 2000.

State Farm took the position that material changes in the insured risk had occurred and that it had not received notice of those changes. State Farm's letter said in part:

> The insured risk became vacant on or about November 20, 1999. The Royal Bank assumed control of the property. Neither of these facts, nor the subsequent change of interest to Michael Alexander, were made known to State Farm.…

[13] It was agreed by the parties that "this factual situation would have caused any other similar insurer to either cancel its policy or increase the premium charged".

III

[14] The relevant parts of the policy are set out below:

> **Vacancy Exclusion**
>
> We do not insure:
>
> 1. Loss or damage occurring after your dwelling has been vacated for more than thirty consecutive days….
>
> **Statutory Condition Number 4**
>
> *Any change material to the risk and within the control and knowledge of the insured voids the contract as to the part affected thereby, unless the change is properly notified in writing to the insurer or its local agent*, and the insurer when so notified may return the unearned portion, if any, of the premium paid and cancel the contract, or may notify the insured in writing that, if he desires the contract to continue in force, he must, within 15 days of the receipt of notice, pay to the insurer an additional premium and in default of such premium, the contract is no longer in force.
>
> **Mortgage Clause**
>
> *This insurance and every documented renewal thereof – AS TO THE INTEREST OF THE MORTGAGEE ONLY THEREIN – is and shall be in force notwithstanding any act,*

> *neglect, omission or misrepresentation attributable to the mortgagor, owner or occupant of the property insured, including transfer of interest, any vacancy or non-occupancy, or the occupation of the property for purposes more hazardous than specified in the description of the risk; PROVIDED ALWAYS that the Mortgagee shall notify forthwith the Insurer (if known) of any vacancy or non-occupancy extending beyond thirty (30) consecutive days, or of any transfer of interest or increased hazard THAT SHALL COME TO HIS KNOWLEDGE; and that every increase of hazard (not permitted by the Policy) shall be paid for by the Mortgagee – on reasonable demand – from the date such hazard existed, according to the established scale of rates for the acceptance of such increased hazard, during the continuance of this insurance*. …
>
> … The term of this mortgage clause coincides with the term of the Policy, PROVIDED ALWAYS that the Insurer reserves the right to cancel the Policy as provided by Statutory provision but agrees that the Insurer will neither terminate nor alter the Policy to the prejudice of the Mortgagee without the notice stipulated in such Statutory provision.
>
> *Should title or ownership to said property become vested in the Mortgagee and/or assigns as owner or purchaser under foreclosure or otherwise, this insurance shall continue until expiry or cancellation for the benefit of the said Mortgagee and/or assigns.*
>
> *SUBJECT TO THE TERMS OF THIS MORTGAGE CLAUSE (and these shall supersede any policy provisions in conflict therewith BUT ONLY TO THE INTEREST OF THE MORTGAGEE), loss under this Policy is made payable to the Mortgagee* [emphasis added].

[15] The Statutory Condition is part of every fire insurance policy by virtue of s. 148(1) of the *Insurance Act*, R.S.O. 1990, c. I.8. The vacancy exclusion and the mortgage clause are written into the policy by the insurer. They are standard provisions that have been in residential fire insurance polices for many years.

[16] The mortgage clause creates a contract between the mortgagee and the insurer. That contract is said to be "engrafted" on to the contract between the mortgagor and the insurer, but is distinct from that contract: *National Bank of Greece (Canada) v. Katsikonouris*, [1990] 2 S.C.R. 1029 at 1036-1037; *London Loan and Savings Co. of Canada v. Union Insurance Co. of Canton Ltd.* (1925), 4 D.L.R. 676 at 679 (Ont. H.C.) aff'd [1925] 4 D.L.R. 680 (Ont. C.A.). By its terms the mortgage clause insulates the mortgagee from conduct of the mortgagor which would vitiate coverage under the policy: *National Bank of Greece (Canada)*, *supra*, at p. 1047. The mortgage clause does not however constitute the entire contract between the mortgagees and the insurer. The terms and conditions of the rest of the policy apply for or against the mortgagee except to the extent that those provisions are not inconsistent with the terms of the mortgage clause: *Royal Bank of Canada v. Red River Valley Mutual Insurance Co.* (1986), 42 Man. R. (2d) 124 at 130-31 (C.A.). The primacy of the terms of the mortgage clause over the other terms and conditions of the policy is made explicit by the closing words of the mortgage clause which provide that its terms "supersede any policy provisions in conflict": See *Economical Mutual Insurance Co. v. State Farm Insurance Co.*, [1999] O.J. No. 3885 at para. 8, 9 (Gen. Div.).

[17] In fleshing out the terms of the contract between the mortgagees and the insurer I begin with the language of the mortgage clause. As Laforest J. observed in *National Bank of Greece (Canada)*, *supra*, at p. 1043, the clause should be read as it would be "understood by an average person applying for insurance". To assist in interpreting the relevant part of the mortgage clause I break it into three parts. The first part reads:

> This insurance and every documented renewal thereof – as to the interest of the mortgagee only therein – is and shall be enforced notwithstanding any act, neglect, omission or misrepresentation attributable to the Mortgagor, owner or occupant of the property insured, including transfer of interest, any vacancy or non-occupancy, or the occupation of the property for purposes more hazardous than specified in the description of the risk. [emphasis added]

[18] The opening part of the mortgage clause declares that the contract between the mortgagee and the insurer remains in effect regardless of conduct by the mortgagor which would entitle the insurer to void the contract as between the mortgagor and the insurer. In short, the insurer cannot rely on the conduct of the mortgagor to void the policy against the mortgagee.

[19] The second part of the mortgage clause reads:

> Provided always that the mortgagee shall notify forthwith the insurer (if known) of any vacancy or non-occupancy

> extending beyond thirty (30) consecutive days, or of any transfer of interest or increased hazard that shall come to his knowledge; … [emphasis added]

[20] This part of the mortgage clause places an obligation on the mortgagee to notify the insurer forthwith of the facts specified in the clause if they come to the knowledge of the mortgagee.

[21] The third part of the mortgage clause provides:

> … every increase of hazard (not permitted by the Policy) shall be paid for by the Mortgagee – on reasonable demand – from the date such hazard existed, according to the established scale of rates for the acceptance of such increased hazard, during the continuance of this insurance. [emphasis added]

This provision requires the mortgagee to pay, on reasonable demand, increases in the premiums resulting from increases in the hazard.

[22] As I read the mortgage clause, it does not void coverage against the mortgagee where the mortgagor has vacated the property and the mortgagee has become aware that the property is vacant. Instead, the mortgage clause places an obligation on the mortgagee to notify the insurer of the vacancy and pay any increased premiums that flow as a result of the vacancy.

[23] My analysis of the interaction between the vacancy exclusion and the mortgage clause tracks that of the motion judge. He held (at p. 290) that the automatic exclusion from coverage provided in the vacancy exclusion term in the policy was inconsistent with the terms of the mortgage clause and therefore, could not be applied against the mortgagee. Mr. Zarek, in his well-crafted submissions for State Farm, placed heavy reliance on the contrary decision of the Quebec Court of Appeal in *American Home Assurance Co. v. Axa Assurances Inc.*, [2002] J.Q. No. 343 (C.A.)[1]. *American Home Assurance Co.* was released a few months before this motion was heard and was not brought to the attention of the motion judge.

[24] In *American Home Assurance Co.* the court held on facts which are similar to the facts of this case that the exclusion clause could be enforced against a mortgagee when the mortgagee had taken possession of the insured property, knew that the mortgagor had vacated the property, and did not notify the insurer. The essence of the court's reasoning is set out below:

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[1] The reasons in *American Home Assurance Co.* are in French. I have relied in the translation provided by counsel.

> [20] From the time that the mortgagee took possession of the building to manage it and was informed that it was vacant, it was the mortgagee, and no longer the mortgagor that bore the risk for it. In other words, it was the mortgagee that was responsible for it or had control of whether the building was vacant. If the vacancy continues for more than 30 days, the exclusionary clause in the contract takes effect.
>
> [21] The first sentence of the mortgage clause provides that the insurance contract continues in force even if the insured contributes to an increase in the risk. The second sentence adds a qualifier by requiring that the mortgagee inform the insurer of the situation upon becoming aware of it.
>
> [22] It follow that, if the mortgagee does not inform the insurer of the increase in risk that it bears, the protection of the mortgage clause is no longer in force.
>
> [23] This appears to me to be the only interpretation that allows us to reconcile the terms of the insurance contract, which excludes the risk related to the vacancy of the building, with the mortgage clause, which preserves the insurance if the insured contributes to an increase in the risk.
>
> [24] The second part of the mortgage clause is really an obligation for the insurer to refrain from using actions attributable to the insured against the mortgagee if the mortgagee does not know of them. In this case, the insurer is required to indemnify the risk that it excluded or that could result in the cancellation of the contract, but the insurer can obtain an increase in the premiums. (article 2488 C.c.B.C.)

[25] I do not agree with the reasoning in *American Home Assurance Co.* The assertion in para. 20 of *American Home Assurance Co.* that the mortgagee assumed the risk is a conclusary statement that must be tested against the terms of the mortgage clause. I also cannot agree, as set out in para. 22 of the judgment, that it flows from the mortgagee's failure to notify the insurer as required, that the insurer must loose the protection of the mortgage clause. The effect of failing to give the required notice must depend on the language of the mortgage clause. Nothing in the mortgage clause suggests that the failure to give the required notice triggers the exclusionary clauses against the mortgagee. The mortgage clause speaks only of an entitlement to increased premiums. The court, in *American Home Assurance Co.* at para. 23 also speaks of "reconciling" the insurance

contract and the mortgage clause. This approach suggests that the two must be read together and harmonized. As I read the mortgage clause it is trump where there is an inconsistency between its terms and the rest of the policy.

[26] The court, in *American Home Assurance Co.*, *supra*, at para. 25 also relied on the judgment of the Manitoba Court of Appeal in *Royal Bank of Canada v. Red River Valley Mutual Insurance Co.*, *supra*. That case, however, did not hold that the vacancy exclusion in the policy applied against the mortgagee. Rather, the court held that the mortgagee was subject to the terms of Statutory Condition Number 4 if there was a material change in the insured risk that was within the control and knowledge of the mortgagee.

[27] In summary, I prefer the motion judge's analysis of the mortgage clause and the vacancy exclusion to that of the court in *American Home Assurance Co.* His reasoning is consistent with a formidable line of authority: *London Loan and Saving Co. of Canada v. Union Insurance Co. of Canton Ltd., supra*; *Royal Insurance Co. of Canada v. Gordon* (1981), 125 D.L.R. (3d) 372 (N. S. C.A.) affg (1980) 40 N.S.R. (2d) 259 (N.S.S.C.); *Citicorp Realty Ltd. v. Zurich Insurance Co.* (1983), 1 C.C.L.I. 222 (Ont. Cty. Ct.); *Montreal Trust Co. v. Dominion of Canada General Insurance Co.* (1987), 46 R.P.R. 102 (Ont. H.C.).

[28] Having concluded that the motion judge correctly held that the vacancy exclusion did not apply to the mortgagee I turn to Statutory Condition Number 4. That Condition requires an insured, which includes a mortgagee, to notify the insurer of any change "within the control and knowledge of the insured" that is material to the risk. A change is material if it increases the risk insured. Failure to give the required notice voids the contract. If notice is given, the insurer has an option as to whether to continue coverage: *Yorkshire Trust Co. v. Laurentian Pacific Insurance Co.* (1987), 28 C.C.L.I. 368 at 374-76 (B.C. S.C.); *Royal Bank of Canada v. Red River Valley Mutual Insurance Co.*, *supra*, at 307. It is important to appreciate that while the mortgage clause protects the mortgagee against the misdeeds of the mortgagor, Statutory Condition Number 4 makes the mortgagee, as an insured, responsible for increases in the risk flowing from the mortgagee's own conduct. If the material change in the risk is "within the control and knowledge" of the mortgagee, Statutory Condition Number 4 makes the mortgagee responsible to notify the insurer of that change failing which, the contract between the mortgagee and the insurer is void.

[29] The motion judge concluded that there was no inconsistency between the terms of the mortgage clause and Statutory Condition Number 4. Both were properly considered part of the contract between the insurer and the mortgagees:

> … [T]he mortgage clause and the statutory condition coexist, with the mortgage clause setting out the general remedy of available to the insurer in the event the mortgagee receives

> knowledge of, and fails to give notice of, any of the enumerated changes to the risk and the statutory condition provided an additional remedy of a right to void the policy where the particular change to the risk was within the control as well as the knowledge of the mortgagee. [p. 289]

[30] The motion judge's conclusion is consistent with *Royal Bank of Canada v. Red River Valley Mutual Insurance Co.*, *supra*, and *Royal Bank of Canada v. Safeco Insurance Co.* (1988), 85 A.R. 357 at 362-63 (Alta. Q.B.). Counsel for the respondent, Alexander also conceded that there was no inherent inconsistency between the mortgage clause and Statutory Condition Number 4. Counsel for Royal Bank argued that there was an inconsistency between the two.

[31] I think the motion judge is correct. The mortgage clause is concerned with conduct of the mortgagor and the mortgagee's obligations if and when that conduct comes to the attention of the mortgagee. Statutory Condition Number 4 is concerned with the conduct of insured, including insured who are mortgagees. It addresses the consequences of the mortgagee's actions which materially increase the insured risk.

[32] The motion judge's determination that Statutory Condition Number 4 was part of the contract between the mortgagee and the insurer led to the final question – did it apply in these circumstances to void the policy? To answer that question, the motion judge had to identify the material change in risk, and decide whether that change was "within the control and knowledge" of the mortgagees. The motion judge found that the material change in risk occurred when Mr. Deeks vacated the residence on or about November 20. He further held, at p. 288, that this change could be said to be within the "control" of the mortgagee only if "the mortgagee is in a position to reverse the change in the risk which occurred on the vacancy of the property". He concluded that the mortgagees did not have the requisite control:

> … It cannot be said that the mortgagees caused the vacancy, much less could restore the property to the original level of risk, as only occupation by a mortgagor having an interest in the property would satisfy this test and the default of the mortgagees under the mortgage made this unattainable. On this view, it is only after completion of foreclosure proceedings, when title is acquired by the mortgagee, that notice must be given to avoid the risk of avoidance of the policy. [p. 288] [emphasis added]

[33] When the owners vacated the property, the insured risk increased. I agree that the mortgagees cannot be said to have had any control over the mortgagor's vacating of the property. I cannot agree however, that the concept of "control" in Statutory Condition

Number 4 as applied to mortgagees is limited to situations in which the mortgagee is able to "restore the property to the original level of risk".

[34] Statutory Condition Number 4 is directed at any material increase in the risk. I take risk to mean the risk which the insured agreed to insure when it entered into the contract. The Statutory Condition makes any insured responsible for any material increase in the risk that is "within the control and knowledge" of that insured. If the conduct of the mortgagee materially increases the risk from that which the insurer agreed to insure, I think the Statutory Condition applies to void the policy unless notice is given to the insurer. The operation of Statutory Condition Number 4 against the mortgagee does not depend either on the conduct of the mortgagor, or the mortgagee's ability to undo a risk created by the conduct of the mortgagor. The motion judge misdirected the inquiry when he looked to whether the mortgagees could "restore the property to the original level of risk". He should have asked himself whether the actions of the mortgagees materially increased the risk from that which State Farm had agreed to insure when it entered into the policy.

[35] The Royal Bank on November 20, and Alexander after he brought the second mortgage into good standing, effectively took possession and control of the property. They controlled the property and took steps to keep it vacant and preserve the property until it could be sold. In doing so they acted as prudent mortgagees and no doubt reduced the risk that existed when the property was left vacant and unattended by the owners. For the purposes of Statutory Condition Number 4 however, the correct comparison is not between the level of risk after the mortgagor left the property, but rather must be with the level of risk State Farm agreed to insure. State Farm insured a residence occupied by its owner. As of November 20, 1999, the house was vacant and in the exclusive possession and control of the mortgagees. Both the continued vacancy after November 20 and the effective possession and control of the property by the mortgagees after that date were "within the control and knowledge" of the mortgagees and materially increased the risk when compared to the risk State Farm had agreed to insure. Statutory Condition Number 4 required that the mortgagees give notice to State Farm of these material changes. They chose not to give notice, thereby, voiding their contract with State Farm. The mortgagees were not entitled to collect under the policy.

IV

[36] I would allow the appeal, set aside the orders below and in their place grant judgment to State Farm dismissing both actions. The appellant is entitled to its costs of the motion below on a partial indemnity basis to be assessed if they cannot be agreed upon. The appellant should have costs against the Royal Bank in the amount of $3500 in this court and costs against Alexander in the same amount.

"D.H. Doherty J.A."
" I agree R.R. McMurtry C.J.O."

"I agree R.A. Blair J.A."

RELEASED: January 15, 2004