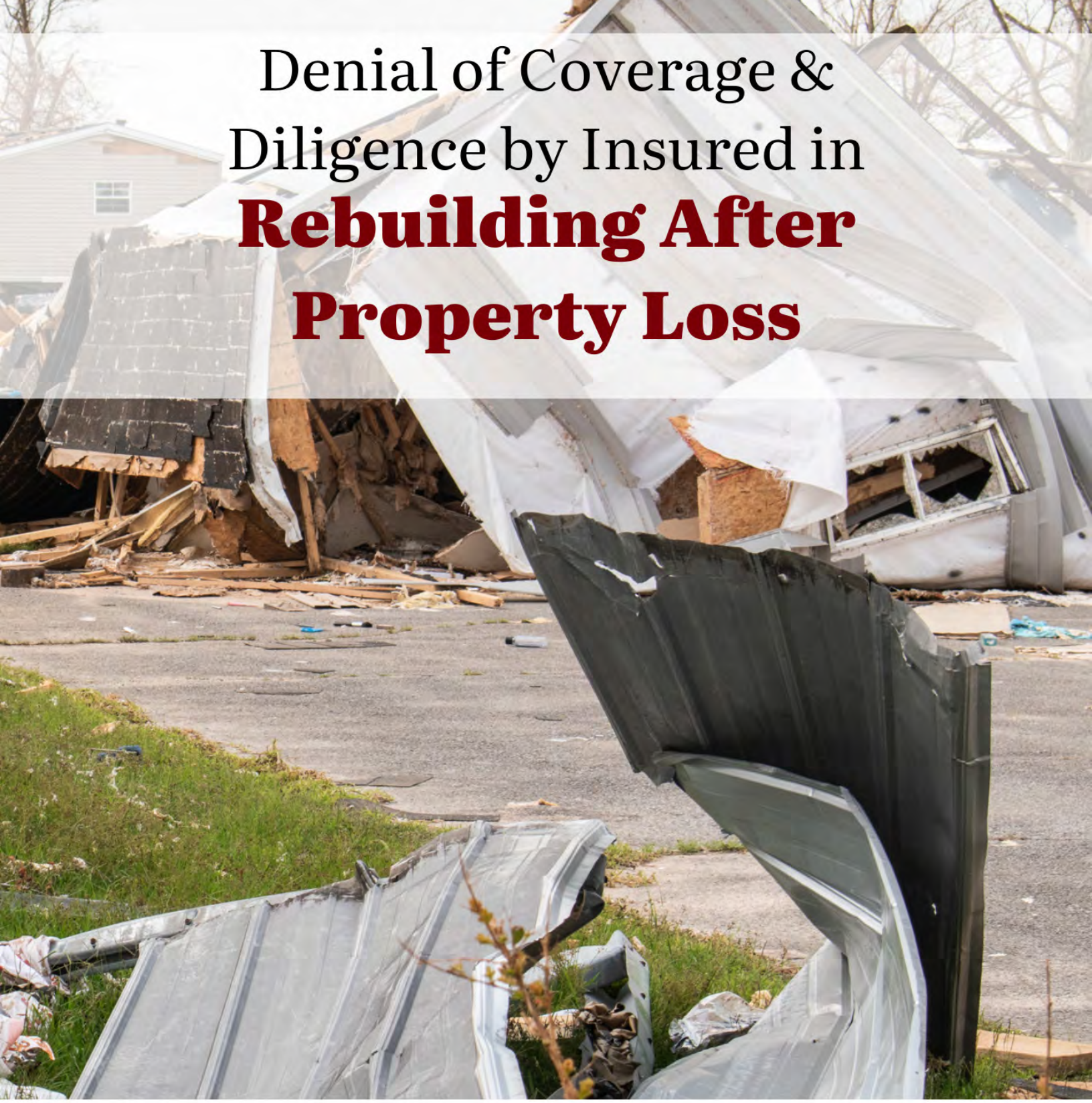
Denial of Coverage & Diligence by Insured in **Rebuilding After Property Loss**



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An insured property owner who suffers damage or loss of the property – for example, due to fire or flooding – will normally turn to their insurer for coverage and indemnification to assist in rebuilding. If the insurer denies coverage, however, the lack of insurance funds may delay the insured's efforts at rebuilding, and in the case of a commercial property, may also result in loss of revenues.

While property insurance policies often provide that an insured must act with diligence in rebuilding as a condition of receiving indemnity, courts have held that an insurer may not be entitled to invoke delay against the insured to reduce or avoid indemnity, either for replacement costs or lost revenues, where the insured lacked funds to carry out the rebuild due to a denial of coverage that is later found to be without justification. Punitive damages are unlikely to be awarded in the absence of bad faith by the insurer; however, courts have sometimes allowed pre-judgment interest on the basis that the insurer had the use of the money while denying coverage, and therefore suffers no prejudice from such an order.

Leading Authorities

In *Insurance Law in Canada* (Toronto: Carswell, looseleaf, at §11:5), the authors discuss the requirement for an insured to exercise due diligence in rebuilding in order to claim replacement costs:

> Although replacement cost endorsements provide customers with better protection, they are not necessarily free of problems. […] problems have arisen out of insurers' typical requirement that payment for replacement depend on actual replacement (or repair) having been made **and that it has been done with due diligence. Provisions such as these may create a catch-22 for a customer if s/he is unable to finance the repairs without insurance money.** In practice, insurers often pay actual cash value before the work is done and then make further payments to meet additional bills. But it seems that the insurer can meet its obligation by merely undertaking to pay on completion of the work because with that undertaking the customer can obtain credit to finance the work. **But if the insurer refuses to pay for other reasons, such as an allegation of arson, that turn out to be invalid, the insurer cannot defeat the claim for replacement cost on the ground that the customer failed to exercise due diligence**. […]. [Emphasis added]

Cases have affirmed that where the insurer's unjustified denial of coverage has meant that the insured lacked funds to carry out rebuilding, the insurer may not be able to resist or reduce payment on the basis of delay. A leading decision setting out this principle is *Olynyk v Advocate General Insurance of Canada*, [1984] MJ No 80, 32 ManR (2d) 171 (QB), affirmed [1985] MJ No 91, 33 ManR (2d) 234 (CA). The insured's property was destroyed by fire in suspicious circumstances, although ultimately it could not be established that the insured was involved in the arson. The insurer had argued that she was entitled only to the value of the property at the time it was destroyed, which was $28,000. The court held that the insured was entitled to the replacement costs up to the limits of the policy, which was $75,000, and dismissed the insurer's objection based on lack of diligence in rebuilding:

> 17 […] **an insurance company which wrongfully repudiates the contract and refuses to make any payment at all cannot defeat the claim of the insured to be indemnified against the costs of actual replacement simply because the insured has not exercised due diligence in getting on with the rebuilding. The breach by the insured is overshadowed by the much more basic breach by the insurer.** In this case the repudiation by the insurance company, however understandable, turned out to be unjustifiable, and **it is very much a smudged finger which the company points at the insured for delaying the decision to rebuild.** It is not inequitable that an insured person who has paid the premium set by the company for replacement indemnity should be able, when the risk materializes, to have a fair opportunity of deciding what to do in the light of the funds which will be available. Complete repudiation by the insurance company cripples the anticipated freedom of action of the insured.
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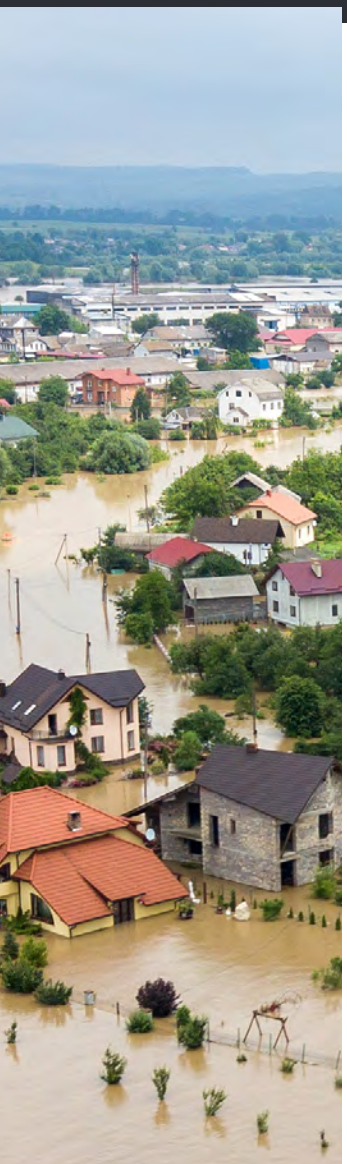
> 19 In the present case, having deliberately sought and obtained replacement coverage, the **insured has been compelled, because of the refusal to pay on the part of the defendant insurer, to undertake several years of litigation to establish that she has any right whatever under the policy. The company has shown no more diligence about performing its obligation to indemnify than she has in taking steps to replace.** I am not prepared, therefore, to infer from her lack of diligence that she has abandoned the expectation, on the basis of which she contracted, of replacing the building. I have therefore concluded that her delay has not dissipated or negated her entitlement to rebuild. [Emphasis added]

In addition, the court found the plaintiff was entitled to indemnity



for lost rental income, up to the maximum period contemplated by the policy:

> 23 […] **Rental recovery, according to the policy, is limited to "such length of time as would be required with the exercise of due diligence and dispatch to rebuild, repair or replace ..."** and that period commences with the date of destruction and is absolutely limited to 12 consecutive calendar months from that date. **In the ordinary course, a period of four or five months would be adequate. However, having repudiated liability under the policy, the insurer cannot demand that the rental loss be restricted to an arbitrary and fictional four-month period.** Accordingly I have concluded that the plaintiff is entitled to the rental loss for the maximum period of 12 months contemplated by the policy, namely $4,200. [Emphasis added]

However, the court did not consider that pre-judgment interest should be awarded, given the highly suspicious circumstances of the fires, which warranted judicial evaluation of the matter:

> 26 The plaintiff sought prejudgment interest on the sums awarded. I do not consider that the case calls for the award of such interest. Although the insurer has failed to meet the high demands imposed by the jurisprudence, the circumstances gave rise to such grave suspicion that the case required subjection to critical examination in a public forum. […]

The *Olynyk* decision was followed in another interesting decision, *Smith Building and Development Ltd v Wynward Insurance Group,* 2021 SKQB 54, [2021] SJ No 92, affirmed 2023 SKCA 57, [2023] SJ No 178. The insurer's denial of coverage after a fire destroyed the insured's commercial building was based on a material change in risk argued to result from the fact that the insured had rented the premises to a motorcycle club which the insurer alleged was affiliated with Hell's Angels. That allegation was not proven at trial, and the court similarly rejected the insurer's argument that the insured was not entitled to replacement costs due to a delay in rebuilding:

> 48 All of this aside, **it ill lies in the mouth of the insurer to rely on a failure to rebuild when the failure to provide coverage has effectively kept the necessary construction funds out of the hands of the plaintiff.** Were this as the insurer has submitted, an insurer would potentially avoid paying replacement coverage simply by always denying a claim advanced. Their denial then becomes a self-fulfilling prophecy on the inability to rebuild. **This is not the way insurance coverage is intended to be applied. Based on the evidence presented here, I decline to apply it in this case.** [Emphasis added]

The court in *Smith Building* also held that the insured was entitled to indemnity for one year of lost rental income, the maximum under the policy. The insurer had argued against that compensation on the basis that the insured had not offered to rent any of its other commercial premises to the displaced motorcycle club, which indicated it recognized the undesirability of that tenant and would not have re-rented to them in any event. The court again pointed to the insurer's own conduct as an obstacle to accepting that argument, and the likelihood that the insured would have found other tenants:

> 53 In addition, very quickly after the fire the plaintiff learned, in no uncertain terms, this insurer was declining any risk associated with this motorcycle club. Indeed, the defendant cancelled all of its outstanding insurance contracts with the plaintiff. As a result of that, **it appears disingenuous for the defendant to now suggest the plaintiff was recognizing the error of its ways. It had been told this rental was not acceptable.**
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> 54 Furthermore, **the evidence does not permit me to conclude, on a balance of probabilities, the plaintiff would have been unable to rent its other premises to a third party.** As this is so, the plaintiff

> would have lost out on the one year's rental by renting to the motorcycle club. This would result in its very real loss of rental revenue being ignored. [Emphasis added]

Finally, the court held that although the insurer's conduct in poorly investigating and denying the claim was open to some criticism, it was not so egregious as to offend the court's sense of decency and warrant an award of punitive damages. Solicitor-client costs were similarly denied; however, the court did allow pre-judgment interest, though provided no explicit reasons for that award:

> 125 […] **the test for punitive damages is much more rigorous than merely an insurer failing to properly do its investigation, or even improperly concluding to deny coverage for a loss.** It is conduct which is malicious, oppressive and high handed. It is conduct such as to offend the court's sense of decency. It is behaviour deserving of punishment. It is, and should be, available only in exceptional cases.
> 126 I have determined this is not one of those clearest of cases, offending the court's sense of decency. […] That the insurer was wrong in its determination to deny the claim has been determined by this judgment. That it could have done more, and a more effective, investigation, is also an undercurrent that runs through these reasons. And, that it perhaps ought to have seen the shortcomings in the extent of its investigations can be taken from how this judgment has dealt with the evidence. Indeed, it could have done much more. **Its lack of diligence is not considered to be malicious or high handed. The word "negligent" likely more appropriately fits here.**
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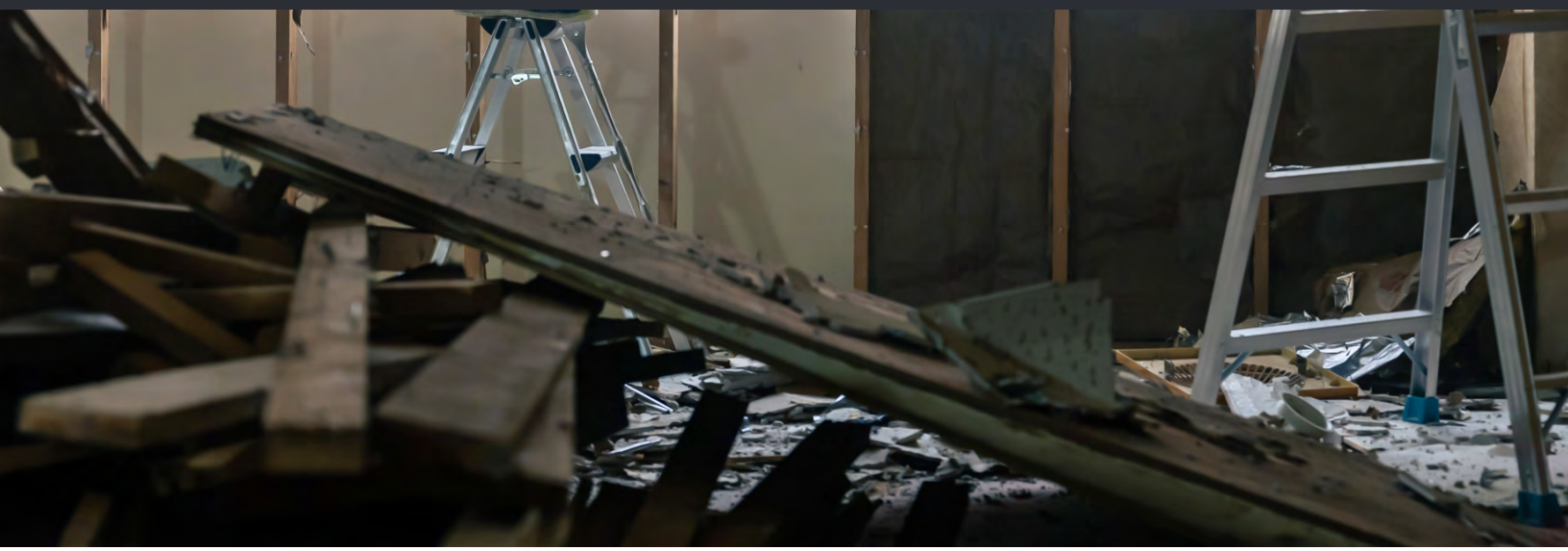
> 127 **There is nothing in those shortcomings which suggests either misconduct or a need to punish the defendant. The clear tenor of the evidence, to the court, is the insurer was honestly concerned about the nature of this motorcycle gang and that honestly, but mistakenly, held belief resulted in the denial of coverage. There is nothing to suggest it was being malicious or oppressive.** [Emphasis added]

On appeal, the trial judge's conclusion concerning entitlement to replacement costs despite the delay in rebuilding was expressly affirmed: 2023 SKCA 57 at paras 113-114, [2023] SJ No 178.

A similar approach was adopted in the Alberta case of *319107 Alberta Ltd v New Hampshire Insurance Co, [*1993] AJ No 315, 9 Alta LR (3d) 151 (QB). The insured's hotel was destroyed by fire. Under the insurance policy, the insured was required to effect replacement with "due diligence and dispatch" in order to be entitled to indemnity for replacement costs. Following the fire, the plaintiffs learned that they would not be permitted to rebuild due to a land-use bylaw. They therefore sought to purchase a new property, but the insurer took the position that the purchase would not fall within "replacement costs". Attempts to bring the ques-



tion to trial to obtain a resolution of that dispute, which ultimately favoured the insured, took several years. The court rejected the insurer's argument that the delay should bar the insured's claim to the full replacement cost:

> Three principles which emerge from the cases cited above are applicable to the issue of due diligence in this case. One is **that the insured should have had a "fair opportunity of deciding what to do in the light of the funds which will be available"** (*Olynyk*). The second is an extension of the statement in *Olynyk* that **refusal to pay any sum "cripples" the anticipated freedom of action of an insured:** outright refusal on the part of the insurer to agree to pay the full sum when confronted with a specific proposal to purchase a replacement hotel similarly impaired the ability of this insured to effect replacement. A third principle is that **the insured, faced with a disputed interpretation of coverage, would be foolhardy to go ahead with a purchase** (Foley).
> […]
> It is true that there is no express term in the contract requiring the insurer to consult with the insured concerning what constitutes replacement under the contract. **However, the business reality is that it would be imprudent, and sometimes impossible for an insured to replace an item or building worth large sums of money when there is uncertainty as to whether he will be reimbursed by the insurer.** The insured has contracted and paid the required premium for an endorsement which will permit him to fully replace his loss, up to the policy limit. **It is therefore reasonable to imply terms which facilitate or enable the insured to make use of the replacement cost endorsement for which he has given valuable consideration and upon which he has relied.** An insurer is required to engage in some kind of meaningful dialogue with an insured seeking information as to what will be covered under the policy.
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> **Thus an insurer may not rely on lack of due diligence of an insured in replacing a loss if the insurer has failed to cooperate with the insured in a substantive way** to determine whether a proposed replacement might or would qualify under the contract. This would include consulting with an insured concerning whether a generic type of replacement, such as an existing hotel, or a specific proposed replacement, such as the Barrhead Neighborhood Inn, would qualify under the contract. **If an insurer wrongly informs the insured that a replacement does not qualify, failure of an insured to follow through with that replacement cannot be construed as lack of due diligence.** [At p 8 (QL), emphasis added]

On the question of pre-judgment interest, the court distinguished *Olynyk*, noting that the decision with respect to interest in that case turned on the fact that the insured's conduct was highly suspicious and the insurer was justified in litigating the issue. Although the policy in *319107* did not entitle the insured to payment until replacement actually occurred, which on the facts had been significantly delayed, the court noted that the insurer had, during the period of delay, had the use of the money, and thus would suffer no prejudice from being required to pay pre-judgment interest. The court relied on s. 2 of the *Judgment Interest Act* to award interest from the date at which the insurer's conduct gave rise to a cause of action.

Olynyk was also followed in *3764525 Manitoba Ltd v CGU*

Insurance Co of Canada, 2004 MBQB 95, 183 ManR (2d) 13, affirmed 2006 MBCA 35, 205 ManR (2d) 19. The court in that case determined that the principal of the insured company was involved in the arson that caused the explosion destroying the property, and therefore dismissed the insured's claim to indemnity. However, the court also set out what its reasoning as to damages would have been, had it found the insurer liable on the policy. The insured would have been permitted to choose from replacement costs at present day value, or cash value at the time of fire, with pre-judgment interest being allowed only in latter case:

> 140 I, too, am prepared to accept this approach and, in fact, would enlarge somewhat on the reasons of Scollin J. and comment that **there is in fact no breach at all by the insured of its policy obligation to exercise due diligence in getting on with rebuilding, in the face of a wrongful repudiation by the insurer.** That obligation only comes into force when there exists, in the words of Scollin J. "a fair opportunity of deciding what to do in the light of the funds which will be available". That opportunity no longer exists in the event of repudiation. **It is not a question then of a breach by the insured being overshadowed by a much more basic breach on the part of the insurer; rather, the unjustified repudiation is the only breach.** [Emphasis added]

In *O'Byrne v Farmers' Mutual Insurance Co*, 2012 ONSC 468, [2012] OJ No 2056, affirmed 2014 ONCA 543, 121 OR (3d) 387, the principle established in *Olynyk* was applied to a claim for coverage for costs of repairing damages caused by oil leaking from a furnace. The insurer denied coverage on the basis of a pollution exclusion. At trial, the exclusion was found not to apply, and the insurer's argument that the insureds had not carried out repair work with due diligence was rejected:

> 44 The position of Farmers' is that the plaintiffs' failure to perform the work bars recovery by the O'Byrnes. Mr. Forget's position was that even if the O'Byrnes were impecunious, and so unable to effect the repairs, that is irrelevant. The contractual bar to recovery is absolute.
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> 47 I […] conclude that, to paraphrase Insurance Law in Canada and Olynyk, **the refusal of Farmers' to pay means that Farmers' cannot rely upon the failure to effect repairs to defeat the O'Byrne's claim to damages based on replacement cost.** [Emphasis added]

The decision in *JILM Enterprises & Investments Ltd v INTACT Insurance*, 2017 ONSC 357, [2017] OJ No 436 applies the principles from *Olynyk*, but also goes further on the particular facts of that case to award the insured damages beyond the policy limits, based on a finding that the insurer failed to act in good faith and was in breach of contract for denying coverage and persisting in investigating the fire as a suspicious fire long after police had concluded to the contrary. The insured sought indemnity from the insurer for the cost to rebuild, lost profits and punitive damages after its hotel and restaurant building were partially destroyed by fire. The court found that it was reasonable for the insurer to delay payment of indemnity for one year while it conducted its investigation, but there was no justification for the addition two years it waited before paying out the actual cash value of the property, and doing so was a breach of contract:

> 68 **Within five or six months of the fire, INTACT did not have much to go on to support arson. Nevertheless, INTACT, through Mr. Bourett, continued down that path.** Based on my review of the adjuster's reports, I conclude that **Mr. Bourett was not "balanced and reasonable" but, in fact, adversarial.** Even as late as his discovery in September 2010, Mr. Bourett was adamant that the investigation was ongoing. This was notwithstanding

> the opinion of the second adjuster on the file, Mr. McKay, that the causation investigation had been concluded by the spring or early summer of 2010.
> 70 I acknowledge that, **where grounds exist, an insurer is entitled to conduct an appropriate investigation.** How long the investigation will take will depend on the circumstances. […] I accept that in these particular circumstances it was within reason (but close to the limit) to delay the decision to pay for one year. **The ACV payment therefore should have been available to J.I.L.M. by May 2010. I find that the failure to pay until almost two years later is a breach of the contract.** [Emphasis added]

Based on this finding, the insurer was required to indemnity the insured for replacement costs up to the policy maximum, less the amount it had already paid out as the actual cash value (ACV) of the property. However, taking note of the increase in construction costs that had occurred over the period of time that the insured was forced to delay construction because the insurer would not accept the new location as a "replacement", the court increased the replacement cost limit under the policy by 3% for each year of delay. At the same time, the court noted that once the ACV was paid out, the insured had the funds to commence reconstruction, and the failure to do so at that time was a failure to mitigate (at paras 75-76).

With respect to lost profits, the court noted that the policy provided for indemnity for a period of 12 months after the fire, but held that damages outside the policy were warranted, and awarded compensation for lost profits for the entire period of delay attributable to the insurer's unwarranted denial of coverage (at paras 82-85). The court also found that punitive damages, assessed at 10% of the ACV that should have been paid, were warranted based on the insurer's breach of its obligation of good faith. In particular, the court was influenced by the insurer's conduct in persisting in attempts to prove arson in the absence of any credible reason to do so (at paras 87-94).

Conclusion

As these cases illustrate, the insured's obligation to proceed with diligence in rebuilding its property will generally not be found to prevent indemnification where the insured's delay in carrying out construction resulted from an unjustified denial of coverage. In assessing the overall compensation owed, including pre-judgment interest and punitive damages, courts will be particularly influenced by the reasonableness of the denial of coverage. Conversely, however, courts also remain alive to any continued delay by the insured once financial or other obstacles have been removed, and are likely to take such conduct into account in considering whether there has been a failure to mitigate.