“What’s the Claim Actually Worth?”

Challenges in Assessing Commercial Property Damage Claims

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I. INTRODUCTION

An insurer that has afforded coverage for its insured's damaged property is often faced with the issue of the extent it can recover its financial outlay from the third party that caused the damage. Likewise, an insurer defending its insured tortfeasor is often faced with the issue of assessing recoverability of the damages claimed.

These questions in assessing damages arise because insurers are usually required to indemnify their insureds for replacement cost value, which entails replacing old, worn or depreciated damaged property with comparable new property, resulting in an insured receiving a "betterment". Since damage awards in tort are based on the principle of compensation or putting the injured party in the place it would have been had the wrong not occurred, the right to recovery is limited to the value of the old or depreciated property components, or "actual cost value", instead of the cost of new replacement components.

The measure of tort damages for property loss are driven by a multitude of factors including the purpose for which the property is used, its uniqueness and age, the owner's pre-loss plans for the property and whether the owner has rebuilt or could reasonably have rebuilt on the property. It will be shown that different considerations are given to commercial property than to residential property and that building code upgrade costs are generally recoverable but subject to the overriding condition of reasonableness of the award as a whole to both the plaintiff and defendant.

The second issue that arises is whether adjuster's fees are recoverable as damages. According to case law, adjuster's fees are likely to be recoverable as damages if they can be shown to flow as a natural and probable consequence of the defendant's wrong. A strong argument can be made for the inclusion into damages the adjuster's fees incurred to investigate the extent of the damage and cause of the wrong. The fact that a plaintiff has not personally paid for an investigatory cost in a subrogated action will not prevent its recovery as damages. However, adjuster fees associated with the first-party claim may be challenged on the basis that they are meant to deal with the issue of payment under the policy between an insurer and its insured.

Lastly, this paper will turn to the topic of set-off as a defense in litigation and in what circumstances it is permissible. The jurisdictional differences between British Columbia and Ontario in permitting the defense of set-off in subrogated actions are highlighted, as Ontario stands firmly against the ability of a defendant to utilize this defence.

The totality of case law makes apparent that the assessment of recoverability of damages and the extent of the award are variable and that every case will turn on its own particular facts.

II. THE BETTERMENT PRINCIPLE

The guiding principle in any tort case is *restitutio in integrum* – to place the innocent/aggrieved party in the same position as it would have been in if the damage had not occurred. Thus, the appropriate measure of compensation for negligent damage is the difference in value immediately before and immediately after the damaging act.

However, in practicality, this principle is oversimplified, as it is often nearly impossible to place a party in the exact same position for a variety of reasons and a court's task becomes to attempt to do so as closely as possible through the assessment damages. To prevent overcompensation or a windfall to the plaintiff, the concept of betterment limits a plaintiff's award on account of being placed in a better position than prior to the loss.

There can be difficulties in deciding between awarding damages for how much a property has diminished in value or how much it would cost to replace the property in order to put the injured party back in their original position. For example, the injured party may want his property in the same state before the tort occurred, but the amount necessary for this to occur is substantially greater than the amount that the property has depreciated in value.

Following the decision of Lord Denning in *Harbutt's "Plasticine" Ltd. v. Wayne Tank & Pump Co. Ltd.*, [1970] 1 Q.B. 447 [*Harbutt's "Plasticine"*], the notion of "new for old" without deduction, at least in the context of a building, seemingly found its way into the jurisprudence. At page 468, Lord Denning explained:

> The destruction of a building is different from a chattel. If a second-hand car is destroyed, the owner only gets its value; because he can go into the market and get another second-hand car to replace it. He cannot charge the other party with the cost of replacing it with a new car. But when this mill was destroyed, the plasticine company had no choice. They were bound to replace it as soon as they could, not only to keep their business going, but also to mitigate the loss of profit (for which they would be able to charge the defendants). They replaced it in the only possible way, without adding any extras. I think they should be allowed the cost of replacement. True it is that they got new for old; but I do not think the wrongdoer can diminish the claim on that account. If they had added extra accommodation or made extra improvements, they would have to give credit. But that is not the case.

In modern judicial approaches to betterment, at one end of the spectrum, no allowance for betterment is made; however, at the other, it can be held to be appropriate to deduct in full the increase in value of the restored or substituted asset with little or no recognition of the cost of the unplanned and unwelcome investment of capital forced upon the plaintiff.

(a) Purpose of the Property

In respect of damage to residential property, the British Columbia Court of Appeal in *Nan v. Black Pine Manufacturing Ltd.* (1991), 55 B.C.L.R. (2d) 241 (C.A.) [*Nan*], examined betterment after a residential home was destroyed by fire as a result of the defendant's negligent installation of a hearth heater. The house was completely rebuilt and the plaintiff was awarded the full replacement cost of the house. The Court explained that the cost of replacement is the starting point in assessing damages, particularly where a residential home is concerned. The Court held that the principles in *Harbutt's "Plasticine"* applied when "assessing damages for the negligent loss of or damages to a private dwelling house which is occupied by the owners as their permanent home." Consequently, the Court held that the cost of replacement was appropriate when considering that a deduction for betterment would result in a family financing the construction of a new home that it otherwise would not have.

Moreover, the Court suggested that commercial nature of a property may be a factor in considering whether a deduction for betterment should apply. The commercial versus residential distinction was affirmed by the British Columbia Court of Appeal in *Prince George (City) v. Rahn Bros. Logging Ltd.*,

2003 BCCA 31. There, the Court of Appeal clarified that *Nan* should be construed narrowly and only to residential buildings and therefore distinguished *Nan* from the case before it as the property in question was purely commercial in nature.

In *James Street Hardware and Furniture Co. Ltd. v. Spizziri et al.*, [1987] O.J. No. 1022 [*James Street*], the Ontario Court of Appeal applied the principles of *restitutio in integrum* and reasonableness but arrived at a different conclusion with respect to compensating the plaintiff for the loss of its commercial retail building. This case involved fire loss of the plaintiff's 25-year-old retail premises caused, in part, by the negligence of the welding company hired to form an archway for a door. As the *Building Code Act* prohibited the restoration of the building to its pre-fire condition, the plaintiff repaired and significantly improved the entire building. The plaintiff appealed an order wherein the trial judge reduced its damages on account of betterment. In support of its position, the plaintiff argued that the trial judge ought to have followed the approached applied by Lord Denning.

After reviewing *Harbutt's "Plasticine"*, the Court further acknowledged that a plaintiff's loss may, at times, be measured in a number of ways. At para. 61, the Court referred to Waddams, The Law of Damages (1983):

> It commonly occurs that a plaintiff, in making good damage to property, will not be able to restore himself to his pre-loss position without improving it. If the plaintiff's ten-year-old roof is damaged, he will not be able to purchase a replacement 10-year-old roof. The only reasonable course will be to replace with a new roof. If roofs have a life of twenty years, and the defendant is compelled to pay the full cost of the replacement, the plaintiff will be in a better position after satisfaction of the judgment than if the damage had not occurred in the first place. It would seem, therefore, that the damages should be reduced by the value of the improvement of the plaintiff's position. The contrary argument is that it is the defendant's wrong that has caused the need for replacement, and that the plaintiff should not be compelled against his will to invest his money in a replacement he might not have chosen to make. These arguments, however, do not appear to be conclusive. The fact that the defendant is a wrong doer is not sufficient reason for over-compensation. The argument that the plaintiff is forced to make an unwanted investment can be met by conceding the point and increasing the damages by any loss suffered by the plaintiff's making such an investment. The plaintiff's interest can be met by putting the onus of proof on the defendant to show that the plaintiff does not suffer any loss by this reason.
>
> These cases [cases concerned with the principle of mitigation of the plaintiff's loss] seem inconsistent with a rule that improvements to the plaintiff's position by effecting repairs are to be ignored. The increase in the plaintiff's wealth is one that could not have occurred in the absence of the wrong. It is suggested, therefore, that an anticipated benefit accruing to the plaintiff on repairing damaged property ought to be taken into account to reduce damages, with compensation, however, for the cost to the plaintiff of the unexpected expenditure required of him, and with the onus of proof upon the defendant in case of doubt on this question, or on the value of the benefit.

In making its determination, the Court of Appeal found that the plaintiff's reconstruction of its building was reasonable in the circumstances but it did not award the plaintiff the full cost of reinstatement. The Court explained, at paras. 62 and 65:

> Quite simply, if a plaintiff, who is entitled to be compensated on the basis of the cost of replacement, is obligated to submit to a deduction from that compensation for incidental and unavoidable enhancement, he or she will not be fully compensated for the loss suffered. The plaintiff will be obliged, if the difference is paid out of his or her own pocket, whether borrowed or already possessed, to submit to "some loss or burden" to quote from Dr. Lushington.

> Widgery L.J. in Harbutt's "Plasticine" called it "forcing the plaintiffs to invest their money in the modernising of their plant which might be highly inconvenient for them."
>
> In cases where there is a serious issue of betterment, the approach outlined in Waddams offers a useful guide to accommodating the interests of the defendant who wishes to avoid paying for a windfall and of a plaintiff who wishes to avoid being forced to spend money that he or she may or may not have. We add the reservation that, where the plaintiff alleges a loss with respect to being required to make an unexpected expenditure, the onus of proof with respect to it should lie on him or her.

These considerations, however, do not necessarily mean that in cases of this kind the plaintiff is entitled to damages which include the element of betterment. As Waddams suggests, the answer lies in compensating the plaintiff for the loss imposed upon him or her in being forced to spend money he or she would not otherwise have spent — at least as early as was required by the damages occasioned to him by the tort. In general terms, this loss would be the cost (if the plaintiff has to borrow) or value (if the plaintiff already has the money) of the money equivalent of the betterment over a particular period of time.

The Court concluded that there was not enough evidence regarding life expectancy of the building or the increase in value of the building after the fire to arrive at a firm conclusion on betterment versus depreciation. The Court did however "set-off" any betterment received by the plaintiff by not granting an award for the cost of Building Code upgrades to which, the Court stated, the plaintiff may well have been entitled.

Courts are more inclined to reduce damage awards for betterment in the context of damage to commercial buildings than they are in the context of damage to residential buildings. Courts will, however, recognize increased financing costs faced by plaintiffs from the need to make an early cash outlay to repair or replace their property and will typically afford a measure of damages in this regard in addition to the depreciated value of the building.

(b) Distinction between Material and Labour Costs

If there is to be any deduction for betterment, only those amounts relating to the cost of materials used in the non-emergency repairs are potentially subject to depreciation. Amounts incurred for emergency restoration, code upgrades, professional consulting and contractor's fees, and labour are not subject to depreciation.

In *City of Guelph Board of Light and Heat Commissioners v. United Dairy & Poultry Co-operative Ltd.*, [1966] 2 O.R. 467 (Ont. Co. Ct.), affd [1966] 2 O.R. 469*n* (Ont. C.A.), the Court was tasked with assessing damages to be awarded to the plaintiff for damage to its hydro poles caused by the defendant's negligence which necessitated the replacement of the poles. The Court noted that, although it is proper to allow only the residual value of the damaged poles by making an allowance for depreciation by reference to the average life of the poles and their age at the time of the damage, no allowance should be made for depreciation in respect of the labour costs. While it is true that the poles have a limited life and would have to be replaced sooner or later, no consideration should be given to the fact that the plaintiff is obtaining something better than it had before the accident at the defendant's expense because the labour cost to the plaintiff would be the same if, instead of replacing the old poles with new ones, it had chosen to install poles of the same age as those damaged in the accident.

(c) Intention to Rebuild

In aiming to restore the plaintiff to the position it would have been in but for the tort, the Courts, in an attempt to avoid creating a situation where the plaintiff is awarded a windfall, look to the plaintiff's intentions and the reasonableness of rebuilding the property. Courts are loath to line a plaintiff's pockets with the cost of replacing a building if the plaintiff has, in fact, no intention of effecting the replacement and instead, for example, plans to sell the vacant lot and spend the profits on some other endeavour.

In *Lamont Health Care Centre v. Delnor Construction Ltd.*, 2003 ABQB 998, the plaintiff was denied the full replacement cost of its fire damaged hospital wings. Instead, the Queen's Bench held that it was not reasonable for the defendant's to pay the cost of replacement in light of the hospital's intent to demolish the 48 and 28 year old buildings. The test laid out by the Alberta court uses the replacement cost as its starting point as suggested in *Nan*, but factors in not only the lifespan of the damaged property but the commercial plaintiff's cognizance of an impending replacement and its intent to do so.

In *Scaffidi-Argentina v. Tega Homes Developments Inc.,* 2016 ONCS 5448 [*Scaffidi-Argentina*], a recent Ontario Superior Court decision, the plaintiffs were a family corporation that owned a 100-year-old single family home converted into a five-unit rental property. The defendants constructed a neighbouring building that rendered their property uninhabitable by damaging the soil. The plaintiffs' building was condemned in 2011. At the time of trial, the plaintiffs had made no sincere efforts to rebuild. They obtained speculative drawings of a larger six-unit building from an architect without any mechanical, civil or HVAC elements, and their estimates of the cost of rebuilding varied from $1.4 million to $2.4 million throughout trial. Largely because the Court held that the plaintiffs had no intention of rebuilding their property, cost of replacement was not awarded. Rather, the appropriate measure of damages was the diminution in value of their property, plus the cost to restore the land to a condition where it could be built on.

Reference was made to *Safe Step Building Treatments v. 12382680 Ontario Inc.,* 2004 CanLII (Ont. SC), although this case is distinguishable because it was a claim in breach of contract and not tort. The defendants installed a defective floor in a gym. Although the defective floor was usable, and the plaintiff may not have used the money to replace the defective floor, the cost of replacement was awarded. In a tort claim, the court prefers more evidence that replacement cost awards will be used for that purpose. "Clearly, where the injured party has already carried out some or all of the work, courts will be more likely to award the full cost of the performance."

The Court in *Scaffidi-Argentina* acknowledged that usually the cost of restoring the plaintiff's property will exceed the diminution in the value of that property. The test to determine whether the plaintiff is entitled to restoration is the reasonableness of the plaintiff's desire to reinstate their property. A court must weigh the advantages to the plaintiff of restoration against the extra cost to the defendants. The court stresses that each case is unique, and the overriding concerns are practicality and justice between the parties.

(d) Unique Property

Full replacement costs have typically been awarded when the property has been unusual or unique. For example, in *Forsyth v. Sikorsky Aircraft Corp.*, 2002 BCCA 231, a helicopter owned by the plaintiff crashed after a failure of the spindle in the tail-rotor assembly produced by the manufacturer. The plaintiff sought to recover the replacement cost of the helicopter and the defendant argued that the market value of the helicopter on the date of the loss should determine the extent of damages. However, the plaintiffs had modified the damaged helicopter to enable it to perform heli-logging operation, which increased the cost. Subsequently, replacement costs were awarded for the helicopter.

An award of replacement costs can also be justified in circumstances where there is no market value for the property destroyed. In *Goodyear Canada Inc. v. Wall Beresford Holdings Ltd. (c.o.b. Industrial Machinery Movers)* [1992] O.J. No. 2130, the Court considered whether the plaintiffs should receive full replacement costs for the loss of their tire-making machine. The plaintiffs converted a machine from one already in their warehouse, although the added costs to make the enhanced machine were relatively minimal. The tire-making machine was unique and there was no available market into which the plaintiffs could have gone to replace the lost tire-making machine. They had no alternative but to either build one from scratch or, as they did in this case, convert one from a machine already in their warehouse. The court awarded full replacement costs but deducted the unreasonable enhancements of the machine.

(e) Onus of Proof

The Courts will first require the plaintiff to prove the damage flowed from the defendant's tortuous act. The onus then shifts to the defendant to prove betterment. Finally, the onus shifts back to the plaintiff to prove their loss by unexpected expenditure.

(f) Summary

In modern law concerning commercial property, the "new for old" principle from *Harbutt's "Plasticine"* has been modified by the more realistic betterment concept as set out in *James Street* — namely, that the plaintiff should have deducted from its award the amount by which its property had improved, but also be compensated to the extent that it had to put out money prematurely to obtain the betterment.

Betterment is a question of fact to be determined on the evidence and with regard to what is reasonable in the particular case. The starting point is the cost of repair. In some cases, that will also be the end point. In other cases, betterment will be proven and it will fall to the trier of fact to assess the extent of the betterment. The analysis of betterment must involve a determination of what is reasonable and what is fair to both parties with onus on the defendant to prove betterment.

III. RECOVERING ADJUSTER'S FEES AS DAMAGES

Adjusters are an integral part of insurance claims, in both investigating the insured's first party claim to ascertain damage and investigating any third party claims as to the cause. In subrogated claims, an adjuster's role pre-litigation is critical in assessing whether a third party bears responsibility for the loss the insured has suffered.

Pre-litigation investigation can be costly and time consuming, requiring the insurer to expend further outlay beyond restoring the insured, in order to ascertain the true nature of the insured's claim. As such, it seems that such expenses incurred by the insurer to address the insured's claim should be recoverable from the at-fault party.

Recovering pre-litigation adjuster's fees following a judgment and in a costs assessment is unlikely. As the BC Court of Appeal stated in *MacKenzie v. Rogalasky*, 2014 BCCA 446, at para. 80:

> To be recoverable a disbursement must arise directly from the exigencies of the proceeding and relate directly to the management and proof of allegations, facts and issues in litigation, not from other sources.

Further, in *Canada (Attorney General) v. British Columbia Ferry Corporation*, 1981 CanLII 492 (BC CA), a disbursement must be qualified to be limited to an outlay which is in character an outlay specifically referable to the particular litigation in which they are claimed as costs. Disbursements that would have been made whether proceedings occurred or not are not recoverable. As such, recovering pre-litigation adjuster fees with respect to a first and potential third party claim as costs would be difficult given that they arise whether litigation occurred or not.

The question that arises is whether pre-litigation adjuster's fees in a subrogated action would be recoverable as damages.

In *The Law of Damages: Looseleaf Edition*, S.M. Waddams, Thomson Reuters at 5.1050, the author made the following statement under the heading "Costs of Investigating the Wrong":

> Litigation costs are not generally considered to be part of the law of damages and are not discussed in this book. However, some cases have permitted recovery, not as costs but as damages, of the expense of investigating the defendant's wrong. Such recovery has been allowed in cases of breach of contract and of inducing breach of contract, and nuisance, and there seems to be no reason why recovery should not be supported wherever investigatory costs can be anticipated as a natural and probable consequence of the defendant's wrong.

From this, it seems logical that an insurer in a subrogated claim would have a basis for asserting a damages claim for the pre-litigation investigation work undertaken by its adjuster to investigate the insured's damages suffered, as well as the possible causes of those damages.

(a) Investigative Costs in Contractual Claims

As noted by Waddams, recovery for costs associated with investigating the defendant's wrong has been allowed in a number of actions in Canada. *Acme Investments Ltd. v. York Structural Steel Ltd.*, [1974] NBJ No. 145, 9 NBR (2d) 699 (NBSCAD) [*Acme*], was a New Brunswick case focused on breach of contract. The plaintiff alleged that the defendant breached the terms of a building contract relating to the design, fabrication and erection of the steel structure of a shopping mall. The trial judge found that the steel structure was under-designed and overstressed and failed to comply with the contract and applicable building code. He estimated the cost of repairing or reinforcing the structure to make it comply with the terms of the contract and building code, and made an award of damages for breach of contract. The fact that the steel structure was under-designed and overstressed only came to the plaintiff's attention after a heavy snow storm that had caused excessive deflection of the structure to the point it was impossible to open or close certain sliding doors until the snow was gone. The situation prompted the plaintiff to have a professional engineer

conduct a study of the steel structure, with the engineer expending considerable time investigating and preparing a report that was in excess of $30,000 billed to the plaintiff. The New Brunswick Supreme Court – Appeal Division declined to interfere with the trial judge's damages award in the amount of $30,000 holding, at para. 31:

> While the plaintiff is clearly entitled to the cost of correcting deficiencies in the defendant's work on the principle of reinstatement, I do not think the plaintiff is precluded from recovering any other expense reasonably incurred in ascertaining the extent of the defendant's breaches of contract and the cost of correcting them.

The court went on to say, at para. 32:

> In my opinion [a] reasonable person in the position of the defendant would be taken to know how there was a serious possibility that in the "ordinary course of things" an owner who had reason to believe a building contract was improperly performed by the builder would seek the assistance of a professional engineer to ascertain the deficiencies and the cost of correcting them.

As such, the Court of Appeal agreed that the cost of the engineering services was reasonable and they did not disturb the trial judge's decision, dismissing the appeal.

A more recent decision of the BC Supreme Court in *Century 21 Canada Ltd. Partnership v. Rogers Communications Inc.,* 2011 BCSC 1196 [*Century 21*]., cited and relied on *Acme* in its decision. In that decision, Century 21 and two real estate brokers sought an injunction and damages against Zoocasa and its parent company Rogers as Zoocasa was indexing Century 21's online real estate listings. Century 21 operated a website that featured its brokers' property listings, and Zoocasa operated a website that indexed listings from a number of real estate websites. Zoocasa copied property descriptions and photographs from the Century 21 website, which was a violation of Century 21's Terms of Use. Century 21's claim for damages for breach of contract consisted of both a general damage claim founded in damages for breach but also as part of the damages claimed expenses incurred in dealing with the consequences of the breach.

Punnett J. cited both S.M. Waddams, *Law of Damages*, as well as *Acme*, came to the conclusion that it was reasonably foreseeable that breach of the Terms of Use would cause the plaintiff to incur certain expenses arising from the breach. Century 21 is entitled to damages for loss as part of their claim for general damages for breach of contract. While Punnett J. awarded damages for the costs of investigating the wrong, Century 21 did not substantiate their claim in a significant way. The result was that, based on the lack of evidence of loss and expenses incurred relating to the actions of Zoocasa, an award in the sum of $1,000 in favour of Century 21 would be appropriate

From both *Acme* and *Century 21*, the case law supports the recovery of costs of investigating the wrong in a breach of contract claim so long as they flow naturally as a result of the Defendant's conduct. As such, actions undertaken by an adjuster in a subrogated claim to investigate the cause of the breach of contract and resulting damage are arguably supported as recoverable as damages.

(b) Investigative Costs in Negligence Claims

Moving onto negligence, *Laichkwiltech Enterprises Ltd. v. "Pacific Faith" (The)* 2009 BCCA 157 [*Laichkwiltech*], was a decision of the BC Court of Appeal that upheld an award of additional investigatory costs. In this case, a fishing vessel (the Pacific Faith) was being docked behind another

fishing vessel (the Western Prince) when it collided causing damage to the Western Prince and the attached dock, with the plaintiff suing in negligence. The appeal was over whether the trial judge erred in assessing the amount of damages for repair of the Western Prince and related costs. The plaintiff had incurred specific costs related to pre-litigation investigation involving marine survey costs with the trial judge holding, at para 41, that "[b]ut for this accident, the plaintiffs would not have incurred any expert report fees." The Court of Appeal cited Waddams and concluded, at paras 44to 46 that "[the] evidence supports the implied reasoning of the trial judge that these additional investigatory costs were reasonably incurred as a 'natural and probable consequence' of the tort." As such, the trial judge's award for pre-litigation investigation expenses as damages was upheld. The trial decision did not explicitly state whether cost of the survey was a general or special damage in this case.

The Federal Court decision of *Forsey v. Burin Peninsula Marine Service Centre*, 2014 FC 974 (CanLII), is a subrogated action that follows *Laichkwiltech* for an award of additional investigatory costs associated with respect to a pre-litigation survey undertaken by the plaintiff. The fishing vessel had been stored at the defendant's marine service centre where the vessel was lifted from the water and had fallen, damaging the hull of the plaintiff's vessel. The vessel was declared to be a constructive total loss and the plaintiff's insurers paid out in respect of that loss. After determining the defendant was liable for the plaintiff's loss, the Court turned to the issue of the costs of the survey, which was in dispute (all other items of damages were agreed upon between the parties). Citing the general rule from *Hadley* and following *Laichkwiltech*, Heneghan J. concluded, at para. 141, that:

> Here, the parties agreed that the Vessel was declared to be a constructive total loss and the Plaintiff recovered from his insurers. In the circumstances, I am satisfied that the cost of the survey is a "natural and probable consequence" of the loss for which I have found the Defendant to be liable, and the Plaintiff is entitled to recover this amount.

The plaintiff was thus granted general damages for the cost of the surveyors report. While this case is a marine case with reference to surveyors, it is interesting to note that the argument by the defendant that the costs of the survey were not recoverable because the plaintiff did not pay these costs personally, was rejected by the Court. In essence, it would seemingly appear that the principle that damages that flow directly from an injury are recoverable, and so long as they were a natural and probable consequence of the tort, overrode the fact that the actual plaintiff had not personally paid for the survey as a bar to allowing the insurer to recover this investigative cost.

Forsey may be seen as supporting the proposition that costs incurred by the insurer which the insured would himself have had to incur are recoverable as damages so long as they arise as a natural and probable consequence of the defendant's conduct, despite the insured not actually paying these costs. This principle would logically support the recovery as damages of a subrogation adjuster's fees in investigating a claim.

(c) Investigative Costs in Nuisance Claims

In *Nor-Video Services Ltd. v. Ontario Hydro* (1978), 84 DLR (3d) 221, the plaintiff, a cable television company, alleged that the defendant had located its electrical power installations so as to interfere with the reception and transmission of television broadcasting signals. The trial judge ruled that the tort of nuisance had been established by the plaintiff and then turned his mind to the proper measure of damages to be assessed against the defendant.

While the judge accepted that the plaintiff had been subjected to unreasonable interference and had a lessened capacity to receive and distribute TV signals, he underscored that the plaintiff had lost no subscribers and maintained the same level of income as if Hydro had not entered the picture. The judge accordingly declined to award damages for nuisance. He did, however, award damages in respect of the expense of investigating the defendant's wrong, stating at paras. 46 and 47:

> Nor-Video is entitled to recover as damages certain costs and expenses it has incurred and which in my view are referable to the nuisance committed by Hydro. At Hydro's invitation it retained a consultant expert in the field to meet with Hydro in an effort to cure the situation; he developed and submitted, also at Hydro's request, a number of proposals […]

The trial judgment was affirmed by the Ontario Court of Appeal in a unanimous decision.

(d) Summary

It appears as though recovering adjuster's fees as damages is not a topic that has been explored in great detail by the Courts. However, the case law supports that, as long as the investigation costs are a natural and probable consequence of the defendant's wrong, they will be recoverable as damages.

Referring back to *Forsey* and *Laichkwiltech*, this can be seen as including adjuster's fees that are necessarily incurred to investigate the extent of the damage and cause of the wrong. There is no precedent in Canadian law disallowing the costs of investigating the defendant's wrong with respect to adjusters fees, and it may be that insurers have simply foregone these costs considering them as unallocated expenses which are incurred in the natural course of their business. However, the rule is still that costs that arise as a natural and probable consequence of the defendant's wrong are recoverable as damages. The fact that a plaintiff has not personally paid for an investigatory cost in a subrogated action will not prevent its recovery as damages, with the cost still naturally arising as a natural and probable consequence of the wrong.

However, adjuster fees associated with the first-party claim may be challenged on the basis that they are meant to deal with the issue of payment under the policy between the insurer and insured. Once again, there is no Canadian precedent disallowing these fees and one could still argue for or against the proposition that quantifying the plaintiff's loss is a natural and probable consequence arising from the defendant's wrong. Adjuster investigation fees for third party claims on the other hand would be recoverable as damages, and can be be pursued as part of the insurer's subrogated claim.

IV. THE DEFENSE OF SET-OFF

In British Columbia, the law permits a defendant to raise claims owed by the plaintiff in the proceeding commenced by the plaintiff. Two different methods for doing this are available to the defendant: counterclaim and set-off. Counterclaim is a simple procedural concept. It contemplates that parties who have cross demands which can be heard separately may be heard in the same proceeding. Set-off is an exceedingly technical defence. It allows cross demands between parties to be heard in the same proceedings when the obligations of the parties should be resolved on a net basis.

(a) Counterclaim

Any claim by the defendant can be brought by counterclaim. Essentially, each party is bringing a separate proceeding. For convenience, however, they are heard at the same time. Judgment is handed down on the plaintiff's claim, and a separate judgment is handed down on the defendant's claim. An order for costs may be made for the plaintiff's proceeding, and another order for costs may be made for the defendant's counterclaim. If such a cross demand is without merit, the plaintiff can apply to have it struck. If the cross demand is inconvenient to hear at the same time as the plaintiff's claim, the court can order that it be tried separately.

(b) Set-Off

Before the rights of counterclaim were introduced in the late nineteenth century, procedural rules generally required the parties to bring their claims in separate proceedings. The only method by which a defendant could raise a cross demand against a plaintiff was as a set-off.

When successfully applied, the defence of set-off has the effect of cancelling out the debts owed by the respective parties and replacing them with a single net amount owed to whichever party has the larger claim. Set-off is based on the view that in some cases it is appropriate to look to the net effect of cross demands between parties, rather than to regard them as separate matters. The law is being realistic when it recognizes that the net position between the parties is the basis of their obligations to each other.

Complex rules determine what may be set-off. They are the product of legislation, as well as common law and equitable principles. The inter-play of these three sources of jurisdiction has led to a degree of confusion in the cases concerning exactly what may be set-off.

There are three different types of set-off: contractual, legal, and equitable.

i. Contractual Set-off

Contractual set-off operates primarily on principles of contract. As this type of set-off is a creature of contract law, the normal rules of set-off regarding mutuality, liquid debts, and connected debts do not apply. Within the bounds of legality and public policy, parties are free to contract whatever result they wish. Accordingly, agreements to set-off which would, aside from the agreement, not be granted relief due to the absence of the requirements of setoff, will be upheld. To create this type of set-off, the standard elements of a contract must be present and satisfied:[1]

1. Offer;
2. Acceptance;
3. Consideration;
4. Intention to create legal relations; and
5. Capacity to create legal relations.

In short, there must be a contract providing for this form of set-off for it to be present in a given scenario.

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[1] Kelly R. Palmer, *The Law of Set-Off in Canada* (Aurora: Canada Law Book Inc., 1993) at 263 [Palmer]

ii. Legal Set-off

In order to achieve set-off "at law", two conditions must be fulfilled:[2]

1. The obligations existing between the two parties must be debts, and those debts must be for liquidated sums of money which can be ascertained with certainty; and

2. Both debts must be mutual cross-obligations, i.e. cross-claims between the same parties in the same right.

Where both are established, the amount due will be deducted from the award for unjust enrichment. Where one or both of these requirements cannot be established, legal set-off is not available.

In the context of subrogation, one major hurdle faced by parties is the requirement of 'mutuality'. This is because it is not entirely clear whether mutuality between the parties is extinguished when an insurer brings a subrogated action to recover damages paid out to the insured. The Ontario Court of Appeal in *Lewenza v. Ruszczak,* [1959] OWN 317 [*Lewenza*], held that there was no right to set-off where one of the claims sought to be set-off was a subrogated claim asserted by an insurer because of lack of mutuality. Schroeder J.A. remarks:

> Set-off could only arise where the claim to be set-off against each other existed in the same right_and here that situation did not obtain, and the claim to be set-off failed because of want of mutuality between the two claims.

However, the Supreme Court of British Columbia *Best Buy Carpets Ltd. v. 281856*, [1987] B.C.J. No. 410 [*Best Buy*], recognized that mutuality was not extinguished in a subrogated action, and therefore, set-off was available as a defence.

These two competing approaches will be further discussed below.

iii. Equitable Set-off

Equitable set-off is available where there is a claim for a money sum, whether liquidated or unliquidated. There is no requirement of mutuality (*Holt v. Telford,* [1987] 2 SCR 193 [*Holt*]). Rather, for equitable set-off to apply, there is a requirement for the cross claims to be 'clearly-connected' (*Coopers & Lybrand Limited v. Lumberland Building Materials Ltd.*, 1983 CanLII 615 (BC SC)).

The test for equitable set-off was articulated by Macfarlane J. in *Coba Industries Ltd. v. Millie's Holdings (Canada) Ltd,* [1985] B.C.J. No. 1994 [*Coba*], and was subsequently summarized and affirmed by the Supreme Court of Canada in *Holt*, as follows:

1. The party relying on a set-off must show some equitable ground for being protected against his adversary's demands.

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[2] *Citibank Canada v. Confederation Life Insurance Co (Liquidator of)* (1996), 42 CBR (3d) 288, 1996 CanLII 8269 (ON SC) at para 37

2. The equitable ground must go to the very root of the plaintiff's claim before a set-off will be allowed.

3. A cross-claim must be so clearly connected with the demand of the plaintiff that it would be manifestly unjust to allow the plaintiff to enforce payment without taking into consideration the cross claim.

4. The plaintiff's claim and the cross-claim need not arise out of the same contract.

5. Unliquidated claims are on the same footing as liquidated claims.

In *Irving Oil Ltd. v. Blanchard*, 2002 PESCTD 52, the Court helpfully explained its essence at para. 9:

> Equitable set-off arises where there are certain equitable circumstances which give a right to a person who sets them up against an opposing party to an action. It is a doctrine based on fairness. Equitable set-off is available provided there is a relationship between the cross-obligations such that it would be unfair or inequitable to permit one to proceed without taking the opposing claim into account.

By its nature, equitable set-off is more difficult in application.

(c) Jurisdictional Differences in the Application of Set-Off

In the context of subrogation, the application of the defence of set-off in Canada is not uniform. In British Columbia, the leading precedent makes the defence of equitable set-off available to a defendant in a subrogated action. In Ontario, set-off is completely unavailable to a defendant in a subrogated action.

i. Set-off in British Columbia

Best Buy involves an insured who had been leasing a warehouse from the defendant for storage. A leak caused damage to the property stored in the warehouse and the insured made a claim which was paid out. Prior to this action, the defendant (as plaintiff) had made a claim against the plaintiff for arrears on the lease. The court was faced with a motion by the plaintiff to strike the part of the defendant's defence that raised set-off.

The analysis of the court in this case is framed by the decision of the court in *Finlay v. Mexican Investment Corporation*, (1897) 1 Q.B. 517, which states:

> Where an insurer exercises a right of subrogation and pursues a third party in the name of its insured, the third party as defendant in the action may raise any defence that was open to it as if the action had been brought by the insured.

The court essentially entered into an exercise of determining fairness: if a defendant would be able to raise a defence in normal circumstance, why does the presence of an insurance company alter that? As a result the analysis was done in large part by considering the applicability of the law of equity, which finds its roots in what is fair and just.

The court first determined whether the claim for arrears could be classified as a legal set-off. As the amount owed to the defendant in arrears did not arise out of the same facts that support the plaintiff's claim – namely that the leak was unrelated to the overdue rent – the court determined that the amount could not be considered a legal set-off.

Hogarth J. then went on to consider whether the amount qualified as an equitable set-off, and whether equitable set-off was available in a subrogated action. Before engaging in an analysis of the case law on this issue the court did two important things. First, it confirmed that *Coba* laid out the proper test for determining whether equitable set-off exists, and second, it did not determine whether equitable set-off was actually present on the facts of this case.

In order to determine whether set-off was permissible as a defence, the Court engaged in an analysis of the decision in *Lewenza*. The Court sought first to determine whether subrogation did in fact prevent mutuality. The decision in *Lewenza* and a later BC Court of Appeal decision, *McMahon v. Canada Permanent Trust Company*, [1980] 2 W.W.R. 438, stood for the proposition that set-off is only available where the debts are mutual and exist in the same right between the parties, and that this was not possible in a subrogated action.

The court differentiates the line of authority beginning with *Lewenza* by examining the case on which it was based: *Gough v. Toronto and York Radial R.W. Company* (1918), 42 D.L.R. 415. Upon careful review of this decision the court found that nowhere did the court in Gough state that an insurer was suing in a different right than an insured. In light of this, and the fact that the right of subrogation is an equitable right, the court found that any equitable defence should be available against it.

In British Columbia, if an amount qualifies as an equitable set-off it can be used as a defence to a subrogated claim.

ii. Set-off in Ontario

In *Colonial Furniture Company (Ottawa) Limited v. Saul Tanner Realty Limited,* [2001] O.J. No. 292 (QL) [*Colonial*], Saul Tanner Realty Limited ("Saul") owned a building in which Bond's Décor Limited ("Bond") was a tenant, and on which Multi Maintenance was conducting roof work. Bond spray painted furniture as part of its business, and in the course of performing this work caused over-spray from to build up and vent through a chimney in the building. In the course of the roof work, an employee of Multi Maintenance threw a lit cigarette down the chimney, causing a fire that damaged the building in question as well as several neighbouring buildings.

At trial, the court found the defendants negligent and apportioned one-third of the fault to each of Saul, Bond, and Multi Maintenance. The parties sought to set-off, against each other, the amounts owing among themselves. The appeal arose because Bond was fully indemnified by its insurer for its own losses, meaning that Bond's claim was fully subrogated, but had insufficient coverage to cover the liability to Saul and Multi Maintenance. The main issue at trial was whether set-off could be used to reduce a sum owed to the insurer by a defendant. The Court found that the nature of subrogation means that the claims sought to be set-off do not exist "in the same right."

The Court was directed to several decisions including *Lewenza*, *Holt*, which was a Supreme Court of Canada decision that affirmed *Coba*, as well as the decision in *Best Buy*. The court found that *Holt*

stands for the proposition that no mutuality is required for equitable set-off to apply in cases where there are assigned interests. Because assigned interests are not the same as subrogated interests, there was nothing in *Coba* or *Holt* that would cast doubt on the decision in *Lewenza*.

This finding allowed the court to critique the analysis of Hogarth, J. in *Best Buy* and determined that, while the reasoning was persuasive, *Lewenza* was still binding on the court and there was nothing in the subsequent decisions to suggest that it was decided incorrectly. The Court referenced *Ledingham v. Ontario (Hospital Services Commission)*, [1975] 1 S.C.R. 332 and *Lord Napier and Ettrick et al. v. Hunter et al.*, [1993] A.C. 713 (H.L.) for the proposition, as the court stated in *Lewenza*, that:

> […] as a result of subrogation the claims sought to be set off do not exist in the same right.

In light of this precedent, the court found that not only was legal set-off unavailable as a defence by the defendant, but that equitable set-off was also unavailable for the same lack of mutuality.

(d) Summary

In British Columbia, the defence of equitable set-off is available to a defendant in a subrogated action. As a party suing using a subrogated interest is suing in the same shoes as the insured, and subrogation is itself an equitable right, an equitable defence that could be made out would be successful just as if it were brought against the insured and not the insurer.

In Ontario, the courts have decided the opposite. An insurer suing a defendant through a right of subrogation is not suing in the same right as the party trying to utilize the defence of set-off. The judicial history of set-off and subrogation in Ontario stands firmly against the ability of a defendant to utilize this defence.