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THE EXPANSION OF "DERIVATIVE" CLAIMS SINCE SCALERA

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February 2005

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A. INTRODUCTION

Five years ago, in *Non-Marine Underwriters, Lloyd's of London v. Scalera*[1] in the context of a sexual abuse case, the Supreme Court of Canada made clear that a claim covered under a liability policy will be excluded if it "derives" from an excluded claim. Since *Scalera*, Canadian Courts have been expanding the range of cases that fall under this rule. This paper will review the basic underpinnings of *Scalera* and discuss cases since *Scalera* in which claims otherwise covered have been found "derivative". It will also discuss cases where courts have refused to apply the derivative label. Finally, it will address practical considerations for underwriters and claims personnel flowing from the development of the law in this area.

B. *SCALERA*

This case involved a series of sexual assault allegations by an adolescent female against five B.C. Transit bus drivers, including Vincent Scalera, who was insured by Lloyd's under a homeowner's insurance policy. The female plaintiff alleged that Scalera:

a) committed various sexual acts;

b) misrepresented the sexual acts as being healthy and normal;

c) breached the duty of care he owed her as a passenger on his bus; and

d) breached the fiduciary duty he owed.

The policy excluded coverage for bodily injury caused by "any intentional or criminal act or failure to act".

Lloyd's sought a declaration that it not be required to defend the plaintiff's claim on the basis that the claims against the insured were excluded as intentional acts.

The Supreme Court of Canada, in deciding the matter, had recourse to the general purpose of insurance and highlighted that:

> "*Insurance is a mechanism for transferring fortuitous contingent risks. Losses that are neither fortuitous nor contingent cannot economically be transferred because the premium would have to be greater than the value of the subject matter in order to provide for marketing and adjusting costs and a profit for the insurer. It follows, therefore, that even where the literal working of a policy might appear to cover certain losses, it does not, in fact, do so if (1) the loss is from the inherent nature of the subject matter being insured, or (2) it results from the intentional actions of the insured.*"

[1] [2000] 1 S.C.R. 551

On this foundation, as well as other well entrenched insurance contract interpretation principles, the Court went on to examine the insurer's duty to defend. In doing so the Court determined that the insurer's duty to defend was confined to the defence of claims for which there may be a duty to indemnify and that pleadings govern the duty to defend. In other words, the existence of the duty to defend depends on the nature of the claims made, not on the judgment that results from the claims. The Court, in elaborating this point went on to say:

> *"This does not, however, mean that the parties to an insurance contract are to be bound by the plaintiff's choice of labels, and thus defenceless against inaccurate or manipulative pleadings.* Nichols *only held that, having determined the nature of the claim, an insured need not further prove that the claim would succeed. This is just common sense, since otherwise an insured would have to prove he is actually liable in order to get an insurer to defend a liability claim.*
>
> *In my view, the correct approach in the circumstances of this case is to ask if the allegations, properly construed, sound in intentional tort. If they do, the plaintiff's use of the word "negligence" will not be controlling."*

The Court continued with its analysis:

> *"Having construed the pleadings, there may be properly pleaded allegations of both intentional and non-intentional tort. When faced with this situation, a court construing an insurer's duty to defend must decide whether the harm allegedly inflicted by the negligent conduct is derivative of that caused by the intentional conduct. In this context, a claim for negligence will not be derivative if the underlying elements of the negligence and if the intentional tort are sufficiently disparate to render the two claims unrelated. If both the negligence and intentional tort claims arise from the same actions and cause the same harm, the negligence claim is derivative, and it will be subsumed into the intentional tort for the purposes of the exclusion clause analysis. If, on the other hand, neither claim is derivative, the claim of negligence will survive and the duty to defend will apply….A claim should only be treated as "derivative", for the purposes of this analysis, if it is an ostensibly separate claim which nonetheless is clearly inseparable from a claim of intentional tort."*

In determining the issue of coverage the Court concluded that since the misrepresentations and breaches of duty were designed to seduce the plaintiff and convince her to engage in sexual activity with the plaintiff they were entirely secondary to the sexual battery. As such, the Court concluded, as a matter of insurance law, that the negligence and fiduciary duty claims are excluded from coverage as being derivative of the intentional sexual assault claims.

C. DERIVATIVE CLAIMS ACROSS CANADA

This portion of the paper will review subsequent court decisions that have addressed and, in many instances, expanded the range of claims that are derivative of excluded claims and therefore not covered by a liability policy.

1. Assault and Battery

It is understandable that assault and battery, also known as trespass to person, cases would be at the fore of claims tested as being derivative. Below we discuss three cases that indicate a varied willingness to cast claims of negligence as derivative of assault.

a) *Joachin*

In *Joachin v. Abel*,[2] the plaintiffs brought three actions against the insured all claiming damages arising from a single incident. One plaintiff alleged that the insured operated his motor vehicle in a malicious, reckless and dangerous manner by deliberately "ramming" into the plaintiff, a pedestrian, intending to cause him harm. An alternative pleading of negligent operation of his motor vehicle was also made against the insured. It is notable that the first plaintiff alleged that the insured had been charged, but not yet convicted, with attempted murder. In the second action, none of the deliberate, malicious or intentional language was used in pleading and the action was framed as being one that "resulted solely from the negligence of the [insured]". The pleadings in the third action mirrored those of the second action.

The automobile insurer refused to defend on the basis that all claims against the insured were derivative of the illegal use of the automobile and excluded by the "illegal use" provisions of the "Ontario Automobile Policy (OAP 1) Owners' Policy" as well as the "criminal or unlawful act exclusion" in the Ontario *Insurance Act*.

In spite of the particulars of negligence alleged, including improper lookout, improper vehicle maintenance and improper control, the Court concluded that:

> "*the* substance *of the allegations of wrongdoing relate to deliberate wrongdoing or conduct that, in the circumstances, leaves no room for allegations of negligence or non-deliberate conduct. The alleged negligence is based on the same conduct and harm as the intentional wrongdoing. I can find no non-derivative claims or allegations that could trigger the insurer's duty to defend."* (Emphasis added)

The Court in *Joachin* did not specifically state its rationale for precluding the insurer from its duty to defend in the two actions that did not allege deliberate wrongdoing. We must presume that it did so in order to avoid an obvious absurdity.

[2] (2001) 27 C.C.L.I. (3d) 50 (Ont. S.C.)

b) *Morrison*

In 2004 the New Brunswick Court of Appeal in *Morrison v. Co-Operators General Insurance Co.*[3] had occasion to determine a case that potentially contained the manipulative pleadings described in *Scalera*. *Morrison* involved a series of amended Statements of Claim. The initial claim alleged that the defendant insured, "*in an effort to prevent the Plaintiffs from leaving his property, violently struck the* [plaintiffs'] *vehicle with* [his] *vehicle with such a force that the* [plaintiffs'] *vehicle was flipped on its side causing injuries to the Plaintiffs*". The Claim went on to allege that the insured, subsequent to the collision, exited his vehicle and assaulted the plaintiffs with an aluminum baseball bat.

Following the original Statement of Claim the plaintiffs exercised their right to amend without leave and removed all allegations of deliberate conduct in respect of the collision from the Claim alleging that the collision was simply a result of the insured's negligence. The insurer refused to defend on the basis that all of the insured's acts violated criminal or other law and were thus excluded from coverage pursuant to the public policy rule in the New Brunswick *Insurance Act.*

In determining the matter the Court upheld the motion Court's decision and obliged the insurer to defend on the basis that:

a) the last filed Statement of Claim was the relevant one for the analysis;

b) the insurer's contention that the pleadings were manipulative was simply conjecture (the amendment, for example, could be explained on the basis that the original claim was simply misdrafted) ;

c) no extrinsic evidence as to manipulation, even if admissible, was tendered by the insurer; and

d) the allegations in the last Claim support the view that the negligence claim was not derivative of the assault claim because it is not based on the came act or conduct.

The Court also took the further step of stating that an allegation of deliberately causing the collision, combined with an alternative pleading of negligently causing the collision, may still attract a duty to defend:

> "*Having said all this, I am not convinced that, in a case such as this, a plaintiff could not claim that* [the defendant] *intentionally caused the collision in an attempt to stop the Dedam vehicle from leaving his property, or, in the*

[3] (2004) 12 C.C.L.I. (4th) 171 (N.B.C.A.)

alternative, that he caused the injuries by driving his vehicle in a negligent manner. It is arguable, in my view, that the two torts involve different acts or conduct based upon [the defendant's] state of mind, one being an intentional tort and the other a non-intentional tort." (Emphasis added)

It should also be noted that the Court in *Morrison* quoted extensively from the Ontario Court of Appeal decision in *Cooper v. Farmers' Mutual Insurance Co.*[4] on the issue of admissibility of extrinsic evidence in showing manipulative pleadings. In *Cooper* the Court refused to allow the introduction of pleadings in an action founded on the same events discontinued by the plaintiff. The admissibility of such pleadings, for which clearly there was no duty to defend, would have shown that the current action contained manipulative pleadings. The Court in *Morrison* however did not go so far as to discuss the appropriateness of admitting extrinsic evidence to resolve allegations of manipulation.

c) *Unrau*

The case of *Unrau v. Canadian Northern Shield*,[5] the British Columbia Court of Appeal considered whether an insurer, in the context of a homeowners' liability policy, had a duty to defend a lawsuit entailing allegations that the insureds prevented the plaintiff's friends from assisting him and rescuing him from a beating being administered by others. The policy excluded coverage for "*bodily injury or property damage caused by the intentional or criminal acts or the failure to act, by or at the direction of any person insured by this policy*".

The allegations in the Second Amended Statement of Claim stated that the plaintiff was injured as a result of the intentional assault by the Defendants Jewell and Lord and also the following wrongs by the Unraus:

a) negligent participation in formulating a plan to confront the plaintiff;

b) negligently inciting a mob to assault the plaintiff and failing to take any steps to prevent the assault;

c) careless participation in a group activity with a reasonable forseeability of harm to the plaintiff; and

d) negligently failing to contact the police.

The Unraus were also defendants to a third party notice which alleged that they were aware of Jewell's propensity to violence and, amongst other things, failed to warn the plaintiff of these tendencies.

[4] (2002) 59 O.R. (3d) 417 (C.A.)
[5] (2004) 15 C.C.L.I. (4th) 189 (B.C.C.A.)

At issue was whether any of the negligence allegations, properly construed, sound in intentional tort. Counsel for the insureds submitted that the failure to take any steps to prevent the assault or to intervene were true pleas in negligence. Counsel for the insurer posed the question "*If you take away the intentional tort, is there any basis for negligence?*" and stated that if this question is answered in the affirmative a duty to defend arises. The Court answered this question in the negative. It went on to say:

> *"What are outlined in the alleged facts and claims are the intentional acts of the Unraus to participate in a mob activity and a deliberate decision not to act. In the latter category are assertions that the appellants should have called the police or other persons. The plaintiff pleaded that there was a duty of care owed by the appellants "to take reasonable steps to prevent assault." In response the respondent cites what was said by Mr. Justice Sopinka (in his dissent) in* Hall v. Hebert*, [1993] 2 S.C.R. 159:*
>
> > *The good Samaritan deserves the world's accolades because he had no legal duty to act and would not have been civilly liable if he, too, had crossed over to the other side as did the Levite and the priest.*
>
> *One way that the plaintiff might establish that the Unraus owed a duty of care to him is by proving that they participated in placing him in a position of danger. That is, that they, in the words of the pleadings, ""incited the mob and encouraged the assault." However, if this is established it does not sound in negligence, but rather in an intentional or criminal act. If it was found that there was a negligent component to the failure to act, the negligence claim, per* Scalera*, would be "derivative" and it will be subsumed into the intentional tort."*

The decision in *Unrau* highlights that seemingly viable pleadings of negligence may be subsumed in an intentional tort excluded from coverage.

2. Parental Supervision

Two cases, one in the context of an assault and one in the context of the use of a motor vehicle, have determined that allegations of negligent parental supervision are not derivative of an excluded claim. The findings of the Court in both these cases was based on the fact that the alleged offending acts of the parents did not arise from the actions excluded under the policies though the same harm arose.

a) <u>*Godonoaga*</u>

In *Godonoaga (Litigation Guardian of) v. Khatambaksh (Guardian of)*[6] the Ontario Court of Appeal dealt with a case involving allegations that the defendant insured children assaulted the plaintiff child and that the defendant children's' mother sent at least one

[6] (2000) 20 C.C.L.I. (3d) 262 (Ont. C.A.)

of the children to commit the assault. In addition to the allegations of intentional harm the plaintiff alleged that the mother and father were negligent for:

a) failing to instil in their children reasonably acceptable values;

b) failing to properly supervise their children; and

c) allowing their emotionally and psychologically disturbed children into the community.

The Court found that the claims of negligence against the parents were not derivative of the excluded claims of intentional harm. The Court stated:

> *"The action by [the plaintiff's mother] against the Khatambaksh parents in negligence is derivative in the sense that she does not have a cause of action in circumstances where her son would not have one. However, it does not follow that the Khatambaksh parents would not have a defence to the action against them simply because their sons may not have one. In this case, the sons could readily be held liable for assault and the action in negligence against their parents dismissed. In this sense the liability of the parents is not derivative of the claims against their sons and can not constitute a reason for denying them coverage and a defence."*

b) *Fitzgerald*[7]

In this case the insured parents applied for an order compelling their homeowner insurer to defend them in an action for bodily injury allegedly caused by the negligent operation of an ATV by the Fitzgerald's twelve year old son. The insurer took the position that all claims in the lawsuit were derivative of an excluded claim, namely the "ownership, use or operation of any motorized vehicle." In addition to alleging that the plaintiff's injuries resulted from the child's negligent use of the motorized vehicle the plaintiff alleged that the insured parents, amongst other things, negligently supervising their child and negligently maintaining the brakes on the ATV. The latter allegation was deemed to be a "use or operation" of the motor vehicle.

The Court concluded that the parents were entitled to a defence stating:

> *"In my opinion, neither the claim of negligent operation nor the claim of negligent supervision is derivative under the other in the sense of* Scalera. *While both "cause the same harm" they do not arise from the same actions. The claim against the boy arises from his "lookout", "control" and "regard to the presence of other motorists". The charge of negligent supervision broadens the claim from the events that day on Quarry Road to the entire history of the boy and his family. Further, a finding of negligent operation on the part of the boy is not prerequisite to a finding of negligent supervision on the part of the parents. In the former, the*

[7] *Fitzgerald v. Co-operators Insurance Co.* (2003) 50 C.C.L.I. (3d) 307 (N.S.S.C.)

plaintiffs must establish that the boy is capable of being found negligent and, if he is, that he did not exercise the carefulness expected of a twelve year old having like intelligence and experience….Negligent supervision aims at the behaviour of children, even children so young etc. as to be incapable of negligence. Behaviour which is not negligent for the child may still be behaviour which a parent has a duty to control."

3. Malicious Prosecution

In 2002 the Ontario Supreme Court was asked to determine the issue of coverage under a standard tenant's insurance policy for a lawsuit alleging malicious prosecution.

In *Lee v. Townsend*,[8] the claim arose from an unsuccessful criminal prosecution for assault brought against Mr. Lee, based on a complaint made by Ms. Townsend. Upon trial, Mr. Lee was acquitted of the charge. The Statement of Claim alleged that the insured defendant made untrue allegations against the plaintiff that she "knew or ought to have known … would result in criminal or other charges being laid against the plaintiff by the police". The Claim went on to allege the plaintiff's damage and losses were caused by Townsend's negligence including her failure "to disclose to the police and the defendant [police officers] her history of prior emotional and psychiatric problems." The insurer declined to defend on the basis of the "intentional act" exclusion and the premise that malicious prosecution is an intentional tort. The insured attempted to trigger coverage through the recent broadening of the intent component required for malicious prosecution to reckless indifference – a mental state with a negligence basis.

The Court refused to follow the insured's argument which it described as ingenious. The Court held that even if any of the allegations of negligence could constitute the high level of negligence involved in reckless indifference, which was not pleaded, such conduct was still derivative of the intentional tort of malicious prosecution and subject of the exclusion clause. Neither bare negligence nor its highest form of recklessness could survive apart from the intentional tort to avoid the excepting language of the policy.

4. Conspiracy and Deceit

A civil conspiracy entails a confederacy of two or more entities having the common purpose of defrauding or causing economic harm to another. A claim in deceit entails a fraudulent or deceptive misrepresentation used by one or more to induce a course of conduct detrimental to the recipient of the misrepresentation. Both of these causes of action were recently canvassed by the Ontario Court of Appeal in the context of insurance coverage.

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[8] (2002) 43 C.C.L.I.(3d) 261 (Ont. S.C.)

In *Temple Insurance Co. v. Sirman Associates Ltd.*[9] the Court upheld the trial judge's decision to preclude a defence under an "Errors and Omissions Liability Policy" for the appellant environmental consultants. The decision was made in the context of an action brought by the Ontario Realty Corporation for the consulting and remediation work done by insureds on thirty-five properties. At the heart of the action were allegations of deceit, secret commissions, bid-rigging, fraud and conspiracy. Also alleged was breach of contract and negligence in respect of the various schemes of the insured. The policy excluded coverage for "claims arising out of deliberate, dishonest, criminal or fraudulent acts committed by the insured".

In deciding coverage for the allegations of negligence the trial judge stated:

> *"It would seem to me that every allegation of negligence to the foregoing 6 properties would be truly derivative of the intentional conduct excluded by the dishonesty exclusion. … The true nature of the claims are not negligence in a non-derivative form, notwithstanding some general language of negligence is found."*

The Court of Appeal stated:

> "*The plaintiff's claims of negligence, as pleaded in the main action, arise from precisely the same allegations giving rise to the claims of fraud, conspiracy and dishonesty. Indeed, the plaintiff's pleadings repeat the same factual allegations in support of both claims of fraud and alternative claims of negligence."*

5. Trespass to Land

Trespass to land provides a remedy for the direct, intentional or negligent physical interference with land in the possession of another. It is actionable without proof of damage. It is to be distinguished from trespass to person which is akin to assault and battery.

The case of *F.(R.D.) (Litigation Guardian of) v. Co-Operators General Insurance Co.*[10] concerned the duty of an insurer to defend an insured against a claim seeking damages in negligence and, alternatively, the intentional tort of trespass to land. The insured was a schoolboy who allegedly started a fire on school property that spread and resulted in extensive damage. The school boy was insured under his parents' homeowner's policy. The insurer denied its duty to defend on the basis of the "intentional act" exclusion in the policy.

The Statement of Claim alleged that the schoolboy "started a small and local fire on the grounds of [the school and] negligently allowed the fire to spread from its point of origin to the school buildings thereby causing substantial damage to the property." It

[9] (2003) 4 C.C.L.I. 162 (Ont. C.A.)
[10] (2004 MBCA 156)

was alleged in the alternative that the schoolboy "committed a trespass onto the school property and that the [schoolboy is] liable for the damages caused by their trespass."

The insurer took the position that the true nature of the allegations is that the schoolboy intentionally caused the damage by starting the fire and therefore no duty to defend arises. The intention relied upon is a deemed intention arising from the tort of trespass. If a tort is intended, it matters not that the scope of damage was more than intended or even foreseen. The intentional act of lighting the fire was essential both to the allegations of trespass and the allegations of negligence.

On behalf of the insured the fact that the fire was set deliberately was not argued, but, it was said that a distinction must be drawn between the intentional act of setting the fire and the intention to cause the damage to the school that is required to trigger the exclusion. The fire must have been started with the intent to damage the school. If the damages were unforeseen the allegations sound in negligence.

In commencing its analysis the Court distinguished this case from *Scalera* on the basis that the latter, a sexual abuse case, necessarily entailed intent to injure if consent was absent. The Court stated that the intent to injure could not be deemed in this case and proceeded with an analysis of numerous fire cases in which insureds were afforded coverage on the basis that an intent to start fires did not equate with an intent to damage property. After referring to the allegation that the fire started was "small and local" the Court concluded that:

> *"Even though the fire was intentionally started, the damages to the school may very well have been unforeseen physical consequences; that is, they were not substantially certain. The claim in negligence is properly pleaded. So to is trespass to property. They are alternate claims. The negligence claim is not derivative of the claim in trespass. The claims as pleaded raise, at a minimum, a possibility that a claim within the policy will succeed. Therefore, Co-Operators has a duty to defend".*

The judgment in *F.(R.D.)* is very thorough and well reasoned and stands for the proposition in *Scalera* that alternative pleadings of intentional torts and negligence can stand together in certain circumstances.

D. CONCLUSION

In the five years since *Scalera* the Canadian legal landscape has changed significantly through the affirmation that covered claims deriving from excluded claims will not beget coverage. Below we set out the guiding principles on which a Court will decide if a claim is derivative. Thereafter we highlight some practical considerations for insurance personnel that may be useful in dealing with the changing legal landscape surrounding derivative claims.

1. The Essence of a Derivative Claim

Close examination of the varying decisions makes clear that in some cases otherwise "covered pleas" will be excluded from coverage and yet in other cases those same pleas will attract coverage. In attempting to rationale the differing outcomes the Courts have developed a "bright line" test in applying the "derivative plea" doctrine. If the factual underpinnings of the cause of action practically dictate that the ensuing cause of action is within the ambit of an exclusion clause any suggestion that this cause of action falls within coverage is likely to fail. That is so even if the "label" afforded to the cause of action might suggest, by its very name, attract coverage. However, if the factual underpinnings to the cause of action are capable of giving rise to a cause of action that is otherwise within coverage and that cause of action could be pleaded separate and independent of a cause of action that is otherwise outside of coverage, the Courts will compel the liability insurer to afford a defence.

It is perhaps useful to illustrate the application of these principles using case examples. If, for example, a claimant alleges that an act of rape constitutes "negligence" the Courts will not compel a liability insurer to defend the action notwithstanding the Statement of Claim uses the label "negligence". That arises because Judges recognize that the act of rape, by its very nature, is "intentional" and thus outside of coverage. In contrast, if a motorist strikes a pedestrian on the side of the road and the pedestrian sues the driver contending that either the driving behaviour was done with an intent to harm, or, at the very least, arose through carelessness, then the driver is likely to be afforded a defence. That is because Judges equally recognize that poor driving behaviour can arise either from an accident, or, with an intent to harm. It is not inconceivable that the driver's conduct arises from mere carelessness as opposed to the intention to harm.

In practical terms this means that the "derivative doctrine" is likely to have its greatest application in cases where the "gist" of the lawsuit primarily entails conduct which, by its very nature, falls within an exclusion and the so-called "covered claims" do not sensibly arise out of the complained of conduct.

2. Practical Considerations for Insurers

1) *Joaquin* and *Cooper* demonstrate that pleadings in other actions may be relevant in determining if claims are derivative. Prior to finalizing a position, take steps to determine whether pleadings in other actions exist that may be relevant to the analysis. Conducting a court registry search for other actions, either active or discontinued, should be considered;

2) Closely examine preceding or related pleadings to determine whether the preceding admissions give rise to the spectre of manipulative pleadings;

3) The result in *Morrison* was a product of continuing amendment and refinement of pleadings by the plaintiff. The amendments may have been made for the purpose of attracting a "deep pocket" to the claim. In order to prevent this type of tactic liability insurers should commence proceedings to determine coverage early in the litigation;

4) The "intentional act" exclusion has been the focus of much of the litigation involving derivative claims but attention should also be paid to other exclusions such as "use or operation of a motor vehicle" in homeowner's policies and "dishonesty" and "damage to tangible property exclusions" in E&O policies;

5) In addition to policy wordings, consider the impact of legislation on coverage. Section 28 of the *Insurance Act*, R.S.B.C. 1996, c. 226 provides that a violation of criminal or other law with the intent to cause loss renders a claim for indemnity unenforceable;

6) In cases involving assault of any kind, pleadings should refer to the status of criminal proceedings, if any exist;

7) Understand the nature of the wrong alleged in the underlying action. Intentional torts such as malicious prosecution, trespass to person or land, false imprisonment, intentional infliction of mental suffering and breach of privacy may allow for a denial of coverage though framed as negligent acts. The same can be said of unlawful possession of property claims such as conversion and detinue.

8) Be extremely careful of "artful" pleadings such as those contained in *Unrau*. Seemingly negligent pleadings may not be viable "but for" an excluded act, thereby rendering them derivative.

Canadian insurers can expect plaintiffs, in attempting to trigger "deep pockets", to frame claims based on typically excluded acts as negligent acts without reference to the excluded acts. Accordingly, insurers must be both creative and vigilant in order to expose such tactics as manipulative.