

**Demystifying the Duty to Defend:
When are Insurers Responsible for Defending Insureds?**

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Demystifying the Duty to Defend: When are Insurers Responsible for Defending Insureds?¹

A. INTRODUCTION

Most liability policies of insurance contractually transfer to the insurer both the right and the duty to conduct the defence of the insured if a claim materializes.² Often the primary value of a liability policy from the insured's perspective is found in the defence provided by the insurer for such claims. The scope of the insurer's duty to defend under liability policies has therefore received considerable judicial attention in Canada in recent years.

This paper reviews the scope of the insurer's duty to defend from two perspectives: that of counsel who acts primarily for insurance companies and that of counsel who acts primarily for policyholders. The intent of this paper is to analyze the tension that exists between these two positions on a number of key questions, including:

- (a) When does an insurer's duty to defend arise?
- (b) How can an insurer preserve its right to recover from a policyholder where the insurer's duty to defend is not clearly made out?
- (c) How can a policyholder preserve its rights under a policy where an insurer conditionally offers to provide a defence?
- (d) What are the potential conflicts of interest for counsel representing an insurer and an insured?
- (e) What are the risks to an insurer in denying a defence?
- (f) What are the issues surrounding allocation of defence costs where not all of the claims are covered by the policy?

¹ The authors wish to acknowledge with gratitude the invaluable assistance of David McKenzie of McCarthy Tétrault LLP in the preparation of this paper.

² There are exceptions, however, such as in some Directors and Officers ("D&O") liability policies wherein the insured directors and officers retain the right and duty to conduct their own defence. Under such policies, the insurer has the obligation to reimburse defence costs, reasonably incurred, as an element of "Loss" covered by the policy.

B. WHEN DOES AN INSURER'S DUTY TO DEFEND ARISE?

Whether an insurer has a duty to defend or respond to a claim against the policyholder will depend on the following factors:

- (a) the facts surrounding each case;
- (b) the language of the policy, including the insuring agreement; and
- (c) the exclusions and conditions of the policy.

Generally, an analysis of whether an insurer has a duty to defend an insured where there is no question of a breach of condition by the insured proceeds in three stages:³

- (a) Do one or more claims fall within the insuring agreement?
- (b) Are the claims excluded by an exclusion clause?
- (c) Is there a possibility that one or more of the claims may succeed at trial?

The determination of a duty to defend should take place prospectively and at an early stage in the litigation; otherwise, the insured may be prejudiced through both a lack of funds to conduct a defence and a lack of certainty concerning the availability of any indemnity.⁴

From the insured's perspective, it is important to keep in mind that the insurer's duty to defend is generally much broader than its duty to indemnify:⁵

At the same time, it is not necessary to prove that the obligation to indemnify will in fact arise in order to trigger the duty to defend. The mere possibility that a claim within the policy may succeed suffices. In this sense, as noted earlier, the duty to defend is broader than the duty to indemnify. O'Sullivan J.A. wrote in *Prudential Life Insurance Co. v. Manitoba Public Insurance Corp.* (1976), 67 D.L.R. (3d) 521 (Man. C.A.), at p. 524:

³ *Ellett Industries Ltd. v. Laurentian P & C Insurance Co.* (1996), 17 B.C.L.R. (3d) 201 (C.A.). Where a breach of condition is alleged by the insurer, that issue should be determined in a coverage action before the duty to defend the underlying action is considered: *Agassiz Enterprises (1980) Ltd. v. General Accident Assurance Co. of Canada*, 49 D.L.R. (4th) 415; *Continental Insurance Company v. MTC Electronic Technologies Co. Ltd.*, [1995] I.L.R. 1-3238.

⁴ *Halifax Insurance Co. v. Innopex Ltd.* (2004), 72 O.R. (3d) 522 (Ont.C.A.) ("*Innopex*").

⁵ *Nichols v. American Home Assurance Co.*, [1990] 1 S.C.R. 801 at 810 ("*Nichols*").

Furthermore, the duty to indemnify against the costs of an action and to defend does not depend on the judgment obtained in the action. The existence of the duty to defend depends on the nature of the claim made, not on the judgment that results from the claim. The duty to defend is normally much broader than the duty to indemnify against a judgment. [Emphasis added.]

Nevertheless, although the duty to defend is broader than and separate from the duty to indemnify, it is not so broad as to arise with respect to allegations that are clearly beyond the scope of the policy by reason of an exclusion clause or otherwise.⁶

There are specific instances in which courts have held that no duty to defend arises even where there is a duty to indemnify;⁷ however, language to that effect in the policy must be clear and unambiguous.⁸

1. ASSESSING THE CLAIMS

i. The Pleadings Rule

The determination of whether an insurer's duty to defend has been triggered rests with an examination of the claims contained within the pleadings in the underlying action. The "pleadings rule", as it is known, has been described as follows:⁹

If the claim alleges a state of facts which, if proven would fall within the coverage of the policy, the insurer is obligated to defend the suit regardless of the truth or falsity of such allegations.

⁶ *Harvey v. Leger*, 2005 CanLII 23126 at para. 26.

⁷ See, for example, *British Columbia v. Surrey District School Board No. 36*, 2005 BCCA 106 ("Surrey").

⁸ *Appin Realty Corporation, Limited v. Economical Mutual Insurance Company*, 2008 ONCA 95 at para. 6 ("*Appin*"); application for leave to appeal to the S.C.C. was filed on 2008-04-11, docket number: 32555. The *Appin* decision is noteworthy for its examination into the duty to defend within a concurrent causation context. The statement of claim alleged that the insured was liable for bodily injury arising from exposure to mould and/or bacteria. The policy in question contained a mould exclusion clause which excluded coverage for bodily injury arising directly or indirectly from the actual, *alleged* or threatened inhalation of, ingestion of, contact with, exposure to, existence of, presence of, spread of, reproduction, discharge or other growth of any "fungi" or "spores" however caused. The policy stated that the mould exclusion applied regardless of the cause of the loss or damage, other causes of the injury, damage, expense or costs or whether other causes acted concurrently or in any sequence to produce the injury, damage, expenses or costs. The Court of Appeal rejected the insurer's argument that the presence of the word "alleged" in the exclusion absolved the insurer of a duty to defend, even though bacteria, a non-excluded peril, was also alleged. The Court held that as the insurer would have a duty to indemnify if it was found that the bodily injury was caused solely by bacteria, it could not escape its duty to defend without clearer language to that effect.

⁹ *Monenco Ltd. v. Commonwealth Insurance Co.*, [2001] 2 S.C.R. 699 at para. 28.

A number of principles guide a court's examination of the claims in the underlying action, including:

- (a) a court must accept the allegations as pleaded as true.¹⁰ The court does not engage in any fact finding and is required to be entirely disinterested in the truth or falsity of the allegations contained in the statement of claim.¹¹ It does not matter that the actual facts may be different than the alleged facts, and a court should not allow an inquiry into the facts at the duty to defend stage to turn the proceedings into a duty to indemnify inquiry;¹²
- (b) a court is not bound by the plaintiff's choice of wording or labels. Rather, it is the nature of the claim that is determinative. An insurer's obligation to defend will be triggered where, on a reasonable reading of the pleadings, a claim within coverage can be inferred.¹³ A three part test may be applied in this respect:¹⁴
 - (i) first, a court should determine which of the plaintiff's legal allegations are properly pleaded. A court must look beyond the choice of labels, and examine the substance of the allegations contained in the pleadings;
 - (ii) at the second stage, having determined what claims are properly pleaded, the court should determine if any claims are entirely derivative in nature; and
 - (iii) finally, at the third stage the court must decide whether any of the properly pleaded non-derivative claims could potentially trigger the insurer's duty to defend;

¹⁰ Ibid., at para. 28; *Sansalone v. Wawanesa Mutual Insurance Co.*, [2000] 1 S.C.R. 551.

¹¹ *Cooper v. Farmers' Mutual Insurance Co.* (2002), 59 O.R. (3d) 417 (Ont. C.A.) ("*Cooper*"). Despite this, there may be some situations in which it is appropriate for a court to determine that the policyholder is or is not entitled to indemnification. See *Axa Insurance (Canada) v. Anti-Wall Concrete Forming Inc.*, [2007] O.J. No. 3989 at paras. 37-39 (Ont. S.C.J.).

¹² *Innopex*, *supra* note 4.

¹³ *Nichols*, *supra* note 5.

¹⁴ *Non-Marine Underwriters, Lloyd's of London v. Scalera*, [2000] 1 S.C.R. 551 ("*Scalera*").

- (c) the court should employ a reasonable reading of the pleadings and the widest latitude should be given to the allegations in the pleadings in determining whether they raise a claim within the policy;¹⁵ and
- (d) where the claim is ambiguous, in that it is capable of a meaning that places it within coverage and equally a meaning that may place it outside of coverage, the ambiguity in the assessment of the pleading must be decided in favour of the insured.¹⁶

ii. What Constitutes the Pleadings

The law across Canada is not entirely uniform in terms of what constitutes the pleadings for the purpose of the pleadings rule. A majority of cases appear to hold that only the statement of claim constitutes examinable pleadings for the purpose of the pleadings rule, on the basis that the insurer's legal obligation to defend can only be found in the claim against the insured.¹⁷

However, the British Columbia Court of Appeal has stated in *obiter dicta* that statements of defence may be considered in certain circumstances:¹⁸

[33] Mr. Skorah, counsel for the Unraus, agrees that the Unraus are bound by *Scalera* and that they cannot go outside of the pleadings in order to demonstrate that there are realistic grounds to find that negligence might emerge as a finding. However, he urges this Court to consider the statements of defence as well as the statement of claim and the third party notice. This is based upon the reasoning in *Shragie v. Tanemura* (1987), reflex, [1988] 22 B.C.L.R. (2d) 64, [1987] B.C.J. No. 2582 (S.C.) (Q.L.). This was an application by a defendant for an order that a third party insurer defend him in the main action. Mr. Justice Ruttan said as follows at 68:

In most cases it is necessary only to examine the statement of claim, but the better opinion is that the insured must show that the claim alleges a state of facts which, if proven, would fall with[in] the coverage of the policy. To ascertain the nature of the claim, we are to look to the pleadings, which would include both statements of claim and defence and third party pleadings.

¹⁵ *Monenco*, supra note 9, at para.31; *Scalera*, supra note 14.

¹⁶ *R.W. Hope v. Dominion of Canada General Insurance Co.* (2001), 57 O.R. (3d) 425 (Ont. C.A.).

¹⁷ *Joachim v. Abel* (2001), 27 C.C.L.I. (3d) 50; *Fermes Dionne Ltée./Dionne Farms Ltd. v. Fermes Gervais Ltée.* (2003), 43 C.C.L.I. (3d) 1 (N.B.C.A.); *Hamel Construction Co. v. Lombard Canada Inc.*, 2005 CarswellINS 166 (C.A.).

¹⁸ *Unrau v. Canadian Northern Shield Insurance Co.*, 2004 BCCA 585 at paras. 33-34.

[34] I have looked at the defences. The Unraus say that they did nothing to prevent people from assisting the plaintiff; they had no knowledge of a plan to confront the plaintiff and did not participate in the formulation of any such plan; they did not encourage or incite others to commit assault and that they owed no duty of care to the plaintiff. As I see it, the position of the appellants is, in effect, a blanket denial of the claims. In some cases it might be helpful in defining the nature of the claims to analyze the defences. However, in the case at bar I do not find the defences to be of assistance in determining the issues before this Court.

A subsequent decision of the Alberta Court of Appeal in *Wi-Lan Inc. v. St. Paul's Guarantee Insurance Co.* disagreed, and held that it is “wholly inappropriate” to consider statements of defence.¹⁹ This was also the position taken recently by the Nova Scotia Court of Appeal in *Hamel v. Lombard*.²⁰

iii Manipulative Pleadings

As the claims in the pleadings form the basis of determining the duty to defend, it is readily apparent that some statements of claim are drafted in such a way as to trigger coverage. This is particularly evident where a statement of claim which does not trigger coverage is amended to contain pleadings which trigger coverage. The issue that arises is whether the court is bound by these “manipulative pleadings”.

A number of cases have examined the issue of manipulative pleadings in this context. In *Cooper v. Farmers' Mutual Insurance Co.*,²¹ the Ontario Court of Appeal held that it was not entitled to look behind the amended pleadings to consider the original statement of claim, as a court must take the factual allegations as pleaded.

As noted in *Non-Marine Underwriters, Lloyd's of London v. Scalera*,²² one of the underlying purposes of determining whether a pleading is determinative is to avoid manipulated pleadings:

¶85 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

¹⁹ *Wi-Lan Inc. v. St. Paul's Guarantee Insurance Co.*, 2005 ABCA 352, app'n for leave to appeal dismissed 2006 CanLII 8863 (S.C.C.). This decision was followed in *Dave's K. & K. Sandblasting (1988) Ltd. v. Aviva Insurance Company of Canada*, 2007 BCSC 791.

²⁰ *Hamel v. Lombard*, 2005 NSCA 69.

²¹ *Cooper*, *supra* note 11.

²² *Scalera*, *supra* note 14 at paras. 85 to 86.

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 of 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. Parenthetically, I note that the foregoing should not preclude a duty to defend simply because the plaintiff has pleaded in the alternative. As Pryor, “The Stories We Tell: Intentional Harm and the Quest for Insurance Funding”, *supra*, points out at p. 1752, “[p]laintiffs must have the freedom to plead in the alternative, to develop alternative theories, and even to submit alternative theories to the jury”. 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.

¶86 The reasons for this conclusion are twofold. First, as discussed above, one must always remember that insurance is presumed to cover only negligence, not intentional injuries. Second, this approach will discourage manipulative pleadings by making it fruitless for plaintiffs to try to convert intentional torts into negligence, or vice versa. While courts should not concern themselves with whether or not pleadings are designed to generate insurance coverage, following the guidelines set out above will provide insurers with sufficient protections against manipulative pleadings.

[emphasis added]

An interesting decision with respect to manipulative pleadings is that of *A.R.G. Construction Corp. v. Allstate Insurance Co. of Canada*,²³ which reviewed the relationship between derivative and manipulated pleadings:

It cannot be said that the claims in the main action by Co-operators are derivative. The allegations, if proven, support liability both in tort and contract.

However, it was argued by Citadel that the pleadings were derivative in the sense that they were manipulated by A.R.G. and Co-operators in order to attract coverage and in that sense were derivative. I am not of the view that the term derivative is intended to mean manipulated pleadings, but if I am wrong in that respect, I will consider the argument of Citadel.

To be sure, the pleadings were manipulated. As is indicated in the factual review above, there is no dispute about the fact that A.R.G. invited Co-operators to amend its pleadings to include the actual wording from the insurance contract, in

²³ *A.R.G. Construction Corp. v. Allstate Insurance Co. of Canada*, (2004), 73 O.R. (3d) 211 (Ont. S.C.J.).

an effort to attract coverage. A.R.G. went so far as to prepare the motion materials and the specific amendments to the pleadings of the plaintiff, and secured the issuance of the order.

At first blush this appears improper and manipulative and is conduct which ought to be discouraged. On the other hand, on discovery, Co-operators would have been entitled to the wording of the contract and it could have amended its pleading accordingly.

In any event, while the exercise may well be considered manipulative, A.R.G. did not provide false information to Co-operators. That is to say A.R.G. did not furnish a false statement of facts to manipulate a pleading which would then attract coverage. Rather it simply arranged an amendment to the pleading in the exact wording of the insurance contract. In these circumstances, although it may be said to be manipulative, the consequences are immaterial because the court is still required to examine the pleading to determine the true nature of the claim.

Accordingly, it is my view that the amended pleadings are not derivative, and while they were manipulated by A.R.G., the manipulation was of no consequence.

In *The Co-Operators General Insurance Company v. Morrison* (“*Morrison*”),²⁴ the Court similarly stated.:

What matters, as the applications judge concluded, is what is being alleged by the plaintiffs in their last amended Statement of Claim. As Iacobucci J. wrote in *Scalera*, at paras. 85-86, the principled approach which he advocates to determine whether a claim in negligence is derivative of a claim of intentional tort should discourage manipulative pleadings by making it fruitless for plaintiffs to try to convert intentional torts into negligence claims in order to access coverage. Iacobucci J. makes it clear that, in dealing with the issue of whether a negligence claim is derivative, the guidelines set out in *Scalera* will “provide the insurers with sufficient protections against manipulative pleadings” and that “courts should not concern themselves with whether or not pleadings are designed to generate insurance coverage”.

Arguably, the approach taken in *A.R.G. Construction* and *Morrison* is correct. Manipulated pleadings which are derivative in nature should not be countenanced by a court, while an insured should not be deprived of a defence against *bona fide* non-derivative claims which may occur for the first time in an amended statement of claim.

²⁴ *The Co-Operators General Insurance Company v. Morrison*, 2004 NBCA 62 (“*Morrison*”).

2. DETERMINING IF THE CLAIMS FALL WITHIN THE POLICY

While a court determines the true nature of the claims in the pleadings, it must also determine whether the claims fall within the covering provisions of the policy and further whether they are subject to any exclusion under the policy. This necessarily involves an interpretation of the policy or policies at issue. Insurance policies are agreements made between insurers and insureds and so must be read in accordance with the general principles of contractual interpretation.²⁵ Additionally, given the unique nature of insurance agreements, Canadian courts have developed the following specific principles to guide the interpretation of insurance policy provisions:

- (a) the *contra proferentum* rule;
- (b) the principle that coverage provisions should be construed broadly and exclusion clauses narrowly;²⁶ and
- (c) the desirability, at least where the policy is ambiguous, of giving effect to the reasonable expectations of the parties.²⁷

These principles of interpretation have been further elaborated on in recent case law:

- (a) the plain and ordinary meaning of an insurance policy should be respected;²⁸

²⁵ *Kingsway General Insurance Co. v. Loughheed Enterprises Ltd.*, 2004 BCCA 421 at para. 10 (“*Kingsway*”). It is noted in *Kingsway* that, in accordance with general rules of contractual interpretation, although evidence of subjective intention is generally inadmissible, the court may have regard to the factual background and the commercial purpose of the contract: see also *Hi-Tech Group Inc. v. Sears Canada Inc.*, (2001) 52 O.R. (3d) 97 (C.A.) at para. 23.

²⁶ *Amos v. ICBC*, [1995] 3 S.C.R. 405; *Reid Crowther & Partners Ltd. v. Simcoe & Erie General Insurance* (1993), 99 D.L.R. (4th) 741 (S.C.C.) (“*Reid Crowther*”). It has been held in *Axa Insurance v. Dominion of Canada General Insurance*, [2004] O.J. No. 4492, however, that the distinction between coverage provisions and exclusion clauses cannot be stretched to obtain different interpretations for the same words.

²⁷ *Reid Crowther*, *ibid.* While the law has been generally understood to require ambiguity before examining the reasonable expectations of the parties, the Ontario Court of Appeal in *Zurich v. 686234 Ont. Ltd.* (2002), 62 O.R. (3d) 447 (C.A.), appeared to go further and state that the reasonable expectations of the parties could be examined where the ambiguity lies in the historical context surrounding the drafting of the text: “to apply an exclusion intended to bar coverage for claims arising from environmental pollution to carbon monoxide poisoning is to deny the history of the exclusion, the purpose of the CGL policy, and the reasonable expectations of the policyholders acquiring the insurance.”

²⁸ *Trafalgar Insurance Company of Canada et al. v. Imperial Oil Ltd.* (2001), 57 O.R. (3d) 425 (C.A.); *Wagner v. Commercial Union Assurance of Canada* (1994), 95 B.C.L.R. (2d) 273 (S.C.).

- (b) an insurance policy should be interpreted in its entirety and construed liberally so as to give effect to the purpose for which it was written;²⁹
- (c) courts should not construe an insurance policy in such a way so as to nullify the purpose for which the insurance was sold;³⁰
- (d) if two opposing interpretations are possible, the one most favourable to the insured should be adopted;³¹
- (e) the language in an exclusion clause should be construed in a manner most favourable to the insured;³²
- (f) an interpretation that will result in either a windfall to the insurer or an unanticipated recovery to the insured is to be avoided;³³
- (g) even though courts advocate respect for the plain and ordinary meaning of the policy, a literal meaning of policy terms should not be given where to do so would bring about an unrealistic result or a result which would not be in accordance with commercial reality;³⁴ and
- (h) in accordance with the interpretation principles, the existence of a “no action” clause in the policy will not prevent the Court from inquiring into the duty to defend pending final outcome of the underlying action.³⁵

The onus is on the insured to establish that, on a possibility basis, the allegations made by the plaintiff, if proved, bring the claim within the ‘four corners’ of the relevant insurance policy. Once that threshold is met, the onus shifts to the insurer to show that the claim made falls outside the coverage provided by the policy because of an applicable exclusion clause.³⁶ If there is an

²⁹ *Wagner, supra; Opron Maritimes Construction v. Canadian Indemnity* (1986), 19 C.C.L.I. 168 (N.B.C.A.).

³⁰ *F.W. Hearn/Actes - A Joint Venture Ltd. v. Commonwealth Insurance Co.*, 2000 BCSC 764 (“*Hearn/Actes*”).

³¹ *Ibid.*

³² *Ibid.*

³³ *Brissette Estate v. Westbury Life* (1992), 3 S.C.R. 87.

³⁴ *Scalera, supra* note 14.

³⁵ *Great West Steel v. Simcoe & Erie* (1980), 106 D.R.L. (3d) 347 (Ont. C.A.).

³⁶ *Unger v. Unger* (2003), 68 O.R. (3d) 257 (Ont. C.A.).

exception to an exclusion, the insured bears the burden of establishing that the exception applies.³⁷

3. EXTRINSIC EVIDENCE

Generally, a court will avoid consideration of extrinsic evidence in a duty to defend inquiry. Nevertheless, there remains some question as to the extent to which a court may look beyond the pleadings and the policy and consider additional evidence when deciding the issue of whether a defence is owed to an insured under the terms of the policy in question. Different approaches appear to have been taken by courts in British Columbia and in Ontario. In British Columbia, the Court of Appeal held in *Douglas Symes & Brissenden v. LSBC Captive Insurance Co.*³⁸ that where the pleadings are muddled, extrinsic evidence may be admissible to determine the gravamen of the claims. There is also recent British Columbia authority which holds that the “underlying facts exception” allows a court to look beyond the pleadings and consider additional uncontraverted evidence when deciding the issue of whether a defence is owed to an insured under the terms of the policy in question.³⁹ In Ontario, on the other hand, the Court of Appeal recently held in its *Innopex* decision that, subject to minor exceptions (such as the use of expert evidence to assist the Court in the interpretation of insurance coverage and technical language in the underlying claim), only the pleadings and the policy should be admissible to determine the duty to defend.⁴⁰

Both *Douglas Symes* and *Innopex* were decided following the Supreme Court of Canada’s decision in *Nichols v. American Home Assurance Co.*⁴¹ (“*Nichols*”). In that case, the Court held that the duty to defend was to be determined not by reference to actual acts, but by the allegations in the pleadings, as the policy provided coverage for allegations made even if such allegations were “groundless, false or fraudulent.” The Court concluded that “the duty to defend

³⁷ *Monenco*, *supra* note 9.

³⁸ *Douglas Symes & Brissenden v. LSBC Captive*, 2000 BCCA 518 (“*Douglas Symes*”).

³⁹ *GCAN Insurance Company v. Concord Pacific Group Inc.*, 2007 BCSC 241 at para. 82 (“*GCAN*”); see also *Axa Pacific Insurance Co. v. Elwood*, 2000 BCSC 1248 where the Court refers to the underlying facts exception at para. 47. The underlying facts exception was rejected by the Ontario Court of Appeal in *Cummings v. Budget Car Rentals* (1996), 35 C.C.L.I. (2d) 219 at 238-239 and by the New Brunswick Court of Queen’s Bench in *Léger v. Canadian Lawyers Insurance Association* (1993), 132 N.B.R. (2d) 79.

⁴⁰ *Innopex*, *supra* note 4. See also *Cooper*, *supra* note 3 at paras.8-14 for a similar holding. Nevertheless, there may be some exceptions to this rule in extraordinary cases: see *McLean (Litigation Guardian of) v. Jorgenson*, [2005] O.J. No. 5207 at paras. 14-16 (C.A.).

⁴¹ *Nichols*, *supra*, note 5.

should, unless the contract of insurance indicates otherwise, be confined to the defence of claims which may be argued fall under the policy” [emphasis added]. The *Nichols* decision leaves open the possibility that the wording of the policy may determine the extent to which extrinsic evidence may be admissible.

Nevertheless, courts are generally unwilling to depart from the general rule regarding extrinsic evidence even where the policy wording would seem to compel a court to do so. An example of this unwillingness can be seen in the recent British Columbia Court of Appeal decision in *MWH International, Inc. v. Lumbermens Mutual Casualty Company*.⁴² In that case, the policy stated that the insurer would defend against “any claim against the insured seeking damages to which this insurance applies, even if any of the allegations are groundless, false or fraudulent.” The policy defined a “claim” as a demand received by the insured for money or services, but included an endorsement that expanded the definition of claim to include a “circumstance”. “Circumstance” was defined as “an event reported during the policy period from which the insured reasonably expects that a claim could be made.”

The insured brought an action for coverage before pleadings had been filed in the underlying action. The issue was whether the insurer was obligated to reimburse the insured for legal fees expended to protect the insured’s interest after the occurrence of an event out of which a claim could arise. At summary trial, the judge had regard to a considerable amount of extrinsic evidence in determining that the duty to defend under the policy had been triggered by the occurrence of a “circumstance”.

A majority of the Court of Appeal reversed this decision, and held that the insurer had no obligation to defend the insured. In so holding, the majority decision examined the wording of the policy, which required the insurer to “defend any claim against the insured seeking damages to which this insurance applies”. The majority held that despite the expansive definition of “claim” under the policy, until such time that a third party sought damages against the insured, the insurer had no duty to defend. Furthermore, the majority held that the event in question was not a “claim...to which this insurance applies”, as there must at least be a claim whose nature is such that if the claim were proven it would possibly fall within the coverage; a “circumstance”

⁴² *MWH International, Inc. v. Lumbermens Mutual Casualty Company*, 2007 BCCA 164, app’n for leave to appeal dismissed 2007 CanLII 45666 (S.C.C.).

was not sufficient. Absent a claim with these properties, no duty to defend was held to arise, and no extrinsic evidence was necessary.

The Supreme Court of Canada revisited the issue of the use of extrinsic evidence in determining the duty to defend in *Monenco Ltd. v. Commonwealth Insurance Co.*⁴³ (“*Monenco*”). At issue was the extent to which extrinsic evidence that related to a CGL policy, including the negotiations preceding the policy, the insured’s broader insurance program, and communications between the insured and other insurers, were admissible. The Court did not definitively decide the issue, but held:

Without wishing to decide the extent to which extrinsic evidence can be considered, extrinsic evidence that has been explicitly referred to within the pleadings, the review of which does not require factual findings that would impact the underlying litigation, may be considered to determine the substance and true nature of the allegations, and thus, to appreciate the nature and scope of an insurer’s duty to defend.

Justice Iacobucci further reasoned:

[W]e cannot advocate an approach that will cause the duty to defend application to become “a trial within a trial”. In that connection, a court considering such an application may not look to “premature” evidence, that is, evidence which, if considered, would require findings to be made before trial that would affect the underlying litigation.

In endorsing Southin J.A.’s rulings on this extrinsic evidence, I must emphasize that it was not considered for the purpose of examining the contentious points in issue in the underlying litigation between Suncor and the appellants. Reference to these documents did not require factual findings to be made that would impact this litigation which, in this particular case, had been settled by the time the duty to defend application was brought before the courts. A review of the extrinsic evidence simply illuminates the substance of the pleadings and as such, is consistent with the reasoning in *Scalera, supra*.

Despite the somewhat dissimilar approach taken by British Columbia and Ontario courts in this area, it is nonetheless clear that extrinsic evidence which goes to the truth of the allegations pleaded in the underlying action will not be acceptable in any Canadian court.⁴⁴ Extrinsic

⁴³ *Monenco supra* note 9.

⁴⁴ See, for example, *Marjak Services Ltd. v. Insurance Corp. of British Columbia* (2004), 244 D.L.R. (4th) 700, where the Court states “to admit [the evidence at issue] on a duty to defend application would create a trial within a

evidence referred to in the pleadings which does not go to the truth of the underlying allegations will be admissible.

C. PRESERVING RIGHTS AND PROTECTING INTERESTS

Where it is not clear that all or any of claims against an insured give rise to a duty to defend under the insurance policy, an insurer may choose to do one of the following:

- (a) defend and indemnify the insured;
- (b) defend the insured while protecting the insurer's right to later deny indemnity and recover costs from the insured under a reservation of rights letter or non-waiver agreement; and
- (c) deny coverage and refuse to defend the insured.

1. Insurer who defends without reservation

An insurer who defends without issuing a reservation of rights letter or a non-waiver agreement faces the possibility that it will not be able to recoup its defence expenses if it is subsequently determined that the claims were not in fact covered under the policy. An insurer through such actions may waive its right to later deny a defence.⁴⁵

one party to a contract, with full knowledge that his obligation under the contract has not become operative by reason of the failure of the other party to comply with the condition of the contract, intentionally relinquishes his right to treat the contract or obligation as at an end but rather treats the contract or obligation as subsisting. It involves knowledge and consent and the acts or conduct of the person alleged to so have elected, and thereby waived that right, must be viewed objectively and must be unequivocal.

An insurer who defends may also be estopped from later denying coverage where the following conditions are met.⁴⁶

trial requiring the trial judge to make findings of fact. This is clearly not permitted by the case law.” See also *GCAN*, *supra* note 39, at para. 82.

⁴⁵ *Mitchell & Jewell Ltd. v. Canadian Pacific Express Company* (1974), 44 D.L.R. (3d) 603 at 614 (Alta. C.A.).

⁴⁶ *Rosenblood Estate v. Law Society of Upper Canada* (1989), 37 C.C.L.I. 142 (Ont. H.C.); affirmed (1992) 16 C.C.L.I. (2d) 226 (Ont. C.A.).

- (a) the insurer has knowledge of the facts that indicate a lack of coverage;
- (b) the insured relies upon the conduct of the insurer to its detriment, although there may be circumstances where detriment can be assumed; and
- (c) the insurer realizes the significance of the facts which give rise to the off-coverage position.

An insurer can easily prevent the application of waiver or estoppel through the signing of a non-waiver agreement or the issuance of a reservation of rights letter, and should do so as soon as coverage issues arise.

2. Insurer who defends while protecting rights under a reservation of rights letter or non-waiver agreement

After a claim is reported, if an insurer is of the view that some portion of the claim is not covered under the policy, it may reserve its rights to later deny coverage for either part or all of the claims, by either a non-waiver agreement or a reservation of rights letter. Non-waiver agreements and reservation of rights letter are only useful where an insurer wishes to preserve its rights to argue the coverage position later: if an insurer is confident that there is no coverage, there is no need for such a document, since the insurer will deny coverage and will not take any steps on behalf of the insured that would indicate an intention to be bound by the terms of the contract.

A non-waiver agreement may be signed between the insured and insurer whereby the insurer may investigate, defend and settle the action against the insured when, even in the face of a policy breach, the insurer does not have to make an election whether to affirm or deny coverage. By signing the non-waiver agreement, the insured agrees not to raise any conduct by the insurer subsequent to the discovery of the breach against the insurer in an action for indemnification under the policy.

Non-waiver agreements, however, may go much further than merely reserving the insurer's right to deny coverage at a later date. They can significantly affect the policyholder's rights under the policy, and give the insurer rights it does not have under the policy or at common law. For

example, a non-waiver agreement may provide for a specific division of defence costs between the policyholder and the insurer where there are covered and non-covered claims in the same action.⁴⁷ Where some claims are covered and others are not, the non-waiver agreement or reservation of rights letter may also purport to impact a policyholder's right to be represented, at the insurer's expense, by separate counsel.

Further, a non-waiver agreement letter may give the insurer the right to settle the lawsuit or incur other costs to defend and investigate the claim without the policyholder's consent and the right to claim these amounts back from the policyholder. If an insurer subsequently determines there is no coverage, the policyholder may be left in the position of indemnifying the insurer for the settlement or other costs despite having had no input.

An insured can refuse to sign a non-waiver agreement, and should not agree to sign one without seeking legal advice. If the insured refuses, an insurer will customarily send a reservation of rights letter to the insured, which is a unilateral declaration by the insurer advising the insured not to interpret the insurer's conduct, subsequent to the discovery of the policy breach, as an affirmation of the contract. A copy of a typical reservation of rights letter is attached to this paper at **Tab "A"**.

A reservation of rights letter is generally more limited in its application than a non-waiver agreement, as it does not have contractual force, and therefore will not usually affect the substantive rights of the parties under the policy; nor can a reservation of rights letter generally be enforced against an insured.

Nevertheless, there are a number of U.S. decisions which bring the correctness of the above assertion into question. These cases involve policies that do not contain express provisions regarding reimbursement, yet the insurer in each case has nonetheless successfully reclaimed defence costs where the insurer reserved its right to seek reimbursement of such costs.⁴⁸ The insurers' success in these cases has been founded on the following arguments:

⁴⁷ Please see below for a discussion of allocation of costs.

⁴⁸ See, for example, *RLI Ins. Co. v. Grand Pointe, LLC*, 1:05-cv-00157 (E.D. Tenn. June 12, 2007) ("*RLF*"). In that case the insurer issued a letter that reserved its right to seek reimbursement for all expenses incurred in the defence of the underlying litigation. The insureds sent a letter to the insurer several months later rejecting this reservation

- (a) the insured has been unjustly enriched; and
- (b) the failure to object to a defence as set out in a reservation of rights letter results in an implicit agreement by the insured to the terms imposed.⁴⁹

Other American decisions have held that the implied contract in fact argument cannot succeed as it would amount to an impermissible unilateral modification of the insurance policy made without consideration.⁵⁰ With respect to the doctrine of unjust enrichment, an insured may argue that it is the insurance policy which must be examined first to determine the insurer's obligations. It may be argued that an insurer under a liability policy has both the right and the duty to defend, and usually does not provide a defence solely for the insured's benefit. In a situation where an insurer's duty to defend is not clear, an insurer may provide a defence under a reservation of rights letter to protect its own interests and avoid risks related to an ineffective defence in the underlying action.⁵¹ An insurer who does so is arguably not unjustly enriched.⁵²

An insured should therefore respond to a reservation of rights letter after getting legal advice to ensure its rights are protected. Additionally, there may be significant advantages in having the insurer set out its coverage reservations in specific detail, as the insurer may later be estopped from denying coverage on any other basis or it may lose its right to appoint defence counsel as discussed below.

In order to ensure its rights are adequately protected, in cases where there is more than one insured, the insurer should ensure that each insured is a signatory to the non-waiver agreement or receives the reservation of rights letter. From the insurer's perspective, a non-waiver agreement or a reservation of rights letter should be undertaken as soon as is practicable after a coverage problem arises, as delay will only serve to act against the interests of the insurer. A reservation of rights letter should be clear as to exactly what rights the insurer intends to reserve, since lack of

but then continued to take the benefit of the defence. The Court noted the conflicting lines of American authority with respect to the reimbursement of defence costs where the policy does not contain express reimbursement provisions, and held that reimbursement should be allowed upon a subsequent determination that the insurer had no duty to defend provided the insurer reserved its right to reimbursement in a timely, specific and adequate manner.

⁴⁹ See *RLI*, *ibid.*, for a decision where argument (a) was successful and *United National Ins. Co. v. SST Fitness Corp.*, 309 F.3d 914 (6th Cir. 2002) for a decision where argument (b) bore success.

⁵⁰ *General Agents Ins. Co. of Am. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092 (Ill. 2005) ("*General Agents*").

⁵¹ See *Perdue Farms, Inc. v. Travelers Casualty and Surety Co. of Am.*, 448 F.3d 252 at 259 (4th Cir. 2006).

⁵² *General Agents*, *supra*, note 50 at 1103.

clarity, based on the interpretation rules set out above, will likely be decided in favour of the insured.

In the unique case of motor vehicle liability, the insurer can use the mechanism found under the Insurance Act to have itself added as a statutory third party. As a statutory third party, the insurer can contest liability, damages, deliver pleadings, have production and discovery and examine and cross-examine witnesses at trial, as if it were a defendant in the action.

(c) Conflicts of Interest and the Insurer's Duty and Right to Defend

From the policyholder's perspective, as discussed above, there is no obligation to sign a non-waiver agreement or agree to a defence on the conditions set out in a reservation of rights letter. An insured should not agree (expressly or impliedly) to give the insurer rights which it does not have under the policy, but should invite the insurer to set out the specific issues it has with respect to coverage. The insurer can adequately protect itself by simply stating that by virtue of investigating the claim, it is not admitting coverage or waiving its rights to deny coverage in the future.

By reserving its rights, however, the insurer faces the risk of losing control of the defence to the insured. Even where the insurer's duty to defend is triggered under a policy which provides the insurer the right to appoint and instruct counsel, the insurer's right to defend is not absolute. An insured may have the right to independent counsel appointed by the insured and paid for by the insurer where a reservation of rights arises because of coverage questions which depend upon an aspect of the insured's own conduct that is at issue in the underlying litigation. Where a claim involving multiple causes of action is made against an insured and some of the causes of action are excluded under the policy, an insured may argue that counsel appointed by an insurer will shift the focus of liability to those causes of action excluded under the policy. In such a situation, the insured may wish to appoint and control counsel at the insurer's expense.

The issue of conflict of interest arising within the context of a statement of claim giving rise to both covered and uncovered claims was dealt with most recently by the Ontario Court of Appeal in *Appin Realty Corporation, Limited v. Economical Mutual Insurance Company* ("Appin").⁵³

⁵³ *Appin*, *supra* note 8.

The insured was concerned that any counsel retained by the insurer to defend the action might tend to “steer” the conduct of the case to an outcome that would not require indemnity. The insurer had a similar concern about using insured’s counsel and proposed a set of safeguards to keep its trial counsel separate from its coverage claims representative or, alternatively, that the parties would agree on an independent counsel to defend the plaintiff’s claim on behalf of the insured.

The Court rejected both proposed solutions and ordered that counsel appointed by the insured, who was found to be a competent and experienced insurance counsel, be retained by the insurer to defend the action at the insurer’s expense. In coming to this decision, the Court noted that the motion judge had found that the insurer’s right to control the defence of the action was not absolute and that in view of the insurer’s initial refusal to defend the plaintiff’s action and the ongoing coverage dispute, a reasonable person would perceive a conflict of interest if the insurer controlled the defence.

The *Appin* decision draws upon the principles established in *Brockton (Municipality) v. Frank Cowan Co.*⁵⁴ (“*Brockton*”), a seminal case in this area. In *Brockton*, the Court held that the governing principle when deciding whether the insurer loses the right to appoint counsel should be a “reasonable apprehension of a conflict of interest” on the part of counsel appointed by the insurer to defend the action.

As noted in the *Brockton*, the insurer’s right to control a defence may be lost in situations where coverage questions arise which relate to issues in the litigation.⁵⁵

The issue is the degree of divergence of interest that must exist before the insurer can be required to surrender control of the defence and pay for counsel retained by the insured. The balance is between the insured’s right to a full and fair defence of the civil action against it and the insurer’s right to control that defence because of its potential ultimate obligation to indemnify. In my view, that balance is appropriately struck by requiring that there be, in the circumstances of the particular case, a reasonable apprehension of conflict of interest on the part of counsel appointed by the insurer before the insured is entitled to independent counsel at the insurer’s expense. The question is whether counsel’s mandate from the insurer can reasonably be said to conflict with his mandate to defend the

⁵⁴ *Brockton v. Frank Cowan Co.* (2002), 57 O.R. (3d) 447.

⁵⁵ *Ibid.* at 457.

insured in the civil action. Until that point is reached, the insured's right to a defence and the insurer's right to control that defence can satisfactorily co-exist.

The majority of courts in other Canadian jurisdictions that have dealt with this issue since *Brockton* have adopted its approach: see *Roman Catholic Episcopal Corp. of St. George's v. Insurance Corp. of Newfoundland*;⁵⁶ *The Co-operators General Insurance Company v. Morrison*;⁵⁷ *Parlee v. Pembridge Insurance Co.*;⁵⁸ and *Tench v. Erskine*.⁵⁹ The approach conforms with the principle that once a lawyer is appointed for an insured, he or she must act on behalf of the defendant insured with utmost loyalty and such counsel may not take a position that is incongruous with the best interests of the insured.⁶⁰

Nevertheless, even where coverage disputes exist, it may be possible in some circumstances for the insurer to conduct itself in a manner that would allow it to retain control of the defence of the insured where the insurer acts by:⁶¹

- (a) retaining coverage counsel to report initially on the coverage problem;
- (b) subsequently appointing defence counsel blind to the coverage issue to defend the action; and
- (c) "splitting the file" in-house so that coverage counsel and defence counsel report to separate claims representatives.

Defence counsel should also be aware of this issue, and should take steps to minimize the circumstances in which a conflict between counsel's duty to an insurer and its insured arises. For example, counsel involved in coverage issues ought not to get involved in the liability dispute. Similarly, counsel appointed to defend an insured ought not to become involved in drafting and issuing non-waiver agreements or reservation of rights letters.

However, once the court satisfies itself that the initial counsel appointed by the insurer cannot proceed with the defence of the claim against the insured due to conflict, the insurer cannot

⁵⁶ *Roman Catholic Episcopal Corp. of St. George's v. Insurance Corp. of Newfoundland* 2003 NLCA 65.

⁵⁷ *Morrison*, *supra* note 24.

⁵⁸ *Parlee v. Pembridge Insurance Co.*, 2005 NBCA 49 ("Parlee").

⁵⁹ *Tench v. Erskine*, 2006 NSSC 115.

⁶⁰ *Parlee*, *supra* note 58.

⁶¹ See *Morrison*, *supra* note 24 at para. 50 and *King v. Chaulk Street*, 2006 NLTD 133.

simply appoint a second counsel to replace him or her. At this point, counsel for the insured will likely be given the authority to defend the claim against the insured.⁶²

An insurer itself may face a different type of conflict where there are multiple named insureds under the policy. This situation can arise where a principle insured enters into a business agreement with a third party whereby a term of the business arrangement is that the third party will be added as an insured to the insured's policy. If the business arrangement leads to a claim against the insured or the third party, where the third party blames the insured and vice versa, the insurer may be faced with the seemingly impossible task of defending both parties from covered and uncovered claims where each party seeks to avoid liability at the expense of the other.

Such a situation was the focus of the Ontario Superior Court of Justice's recent decision in *Riocan Real Estate Investment Trust (O&Y Properties Inc.) v. Lombard General Insurance Co.*⁶³ In this case, two actions were brought against RioCan with respect to two shopping malls that it operated for injuries resulting from falls that occurred in the mall parking lots. RioCan had hired a contractor to clear ice and snow in the parking lots. As part of the snow removal agreement, the contractor was required to name RioCan as an additional insured in the contractor's insurance policy with Lombard. As an additional insured, RioCan was covered solely for the contractor's negligence and not for RioCan's own negligence under the Lombard policy .

The Statements of Claim in the actions alleged that RioCan had implemented an insufficient program of inspection and maintenance and that Riocan failed to maintain the parking lots free of ice. The first allegation dealt solely with RioCan's duties as an occupier, while the second dealt with actions that were attributable to the contractor. Only some of the claims against RioCan were therefore covered under the Lombard policy.

The insurer argued that it should not be forced to provide a defence for Riocan, as it would be placed in an impossible position if it were obliged to defend the conflicting allegations. The

⁶² *Svischov v. Carol*, (2004) 68 O.R. (3) 19 (Ont. S.C.J.).

⁶³ *Riocan Real Estate Investment Trust (O&Y Properties Inc.) v. Lombard General Insurance Co.*, [2008] O.J. No. 1449 (Ont. S.C.J.).

Court examined the case law, including the following *obiter* passage in the Supreme Court of Canada decision in *Nichols* which deals with the defence of covered and uncovered claims:⁶⁴

The insurer's interest in defending a claim is related to the possibility that it may ultimately be called upon to indemnify the insured under the policy. It is in the insurer's interest that if liability is found, it be on a basis other than one falling under the policy. Requiring the insurer to defend claims which cannot fall within the policy puts the insurer in the position of having to defend claims which in its interest should succeed. The respondent suggested that this potential conflict could be avoided if the insured was able to retain his own lawyer, with the cost to be borne by the insurer. However, this would not end the difficulty. An insurer would be understandably reluctant to sign a "blank cheque", and cover whatever costs are borne by whatever lawyer is retained, no matter how expensive. Yet the insurer could not challenge any of these expenses without raising precisely the same conflict. For this reason, the practice is for insurer to defend only those claims which potentially fall under the policy, while calling upon the insured to obtain independent counsel with respect to those which clearly fall outside its terms."

Nevertheless, the Court had regard to the recent *Appin* decision in finding that the broader duty to defend prevailed notwithstanding the practical problems arising when an insurer raised a conflict issue of this type. Thus, in the words of the Court:

[t]he fact that a plaintiff pleads multiple and potentially conflicting claims does not automatically negate the insurer's duty to defend... [I]n most situations where there is a duty on an Insurer to defend some, or only one, of the claims made against an Insured and that claim embodies the true nature of the claim, a duty to defend the entire claim arises. This is so even where the pleadings include claims that may be outside the policy coverage.⁶⁵

This ruling indicates that an insurer will have the duty of defending the whole claim, even where parts of it are outside the policy coverage and where defending one of the claims could be in conflict with defending the other claim.

⁶⁴ *Nichols*, *supra* note 5 at para. 20.

⁶⁵ *Ibid.* at paras. 37 to 38.

3. Insurer who denies a defence

An insurer who denies coverage and refuses to defend the insured faces real and serious consequences. The insurer will lose the right to appoint counsel and the right to determine whether the action should be defended at all. If an insured is subsequently found liable, and it is ultimately determined that the insurer should not have denied coverage, the insurer faces the prospect of indemnifying the insured entirely in respect of the main action as well as for the insured's costs of prosecuting an action against the insurer. Furthermore, if the insurer does not participate in the defence of the action, it loses any control it otherwise would have had with respect to settlement of the action, and may face increased exposure to damages and costs as a result. Even though most liability policies stipulate that judgment against the insured must be obtained before the insured can recover against the insurer, Canadian courts have held that a denial of coverage obviates this requirement:

where a reasonable settlement has been entered into, it is not open to the insurer to resist indemnity on the basis of there not having been a judgment obtained. The insurer by its wrongful denial of coverage has excused the insured from having to run the risk of conducting a trial and facing the possibility of even increased damages.⁶⁶

Where an insured subsequently commences an action against an insurer seeking indemnification with respect to a judgment, the doctrine of issue estoppel will apply to preclude the insurer from disputing the insured's liability to the plaintiff in the underlying action, including with respect to the quantum of damages. Additionally, if it is ultimately determined that the insurer was not justified in denying coverage, the insured may be entitled to damages for breach of contract and possibly punitive damages.

To avoid these consequences, an insurer will usually seek an early declaration with respect to its duty to defend and in the cases of mixed claims (i.e., covered and uncovered allegations) an insurer will also seek an order with respect to the allocation of defence costs.

⁶⁶ *York Region Condominium Corp. no. 772 v. Richmond Hill (Town)*, 2003 CanLII 46003 at para. 22 (Ont. S.C.J.), citing *Reliance Petroleum Ltd. v. Stevenson*, [1953] O.R. 807 (Ont. H.C.J.); reversed in part [1954] O.R. 846 (Ont. C.A.); affirmed (1956), 5 D.L.R. (2d) 673 (S.C.C.); see also *Cansulex v. Reed Stenhouse Ltd.* (1986), 70 B.C.L.R. 273 (B.C.S.C.).

An insured should also seek legal advice when dealing with an outright denial of coverage. An insured should not take ‘no’ for an answer, but should seek clarification as to why coverage is being denied, as an insurer may subsequently be deemed to have impliedly waived its right to rely on any reasons to deny coverage which were not previously raised with the policyholder.

D. DEFENCE COSTS

Once it has been determined that an insurer will defend a claim against an insured, there still remains the issue of who will be responsible for defence costs. The question of how defence costs will be apportioned depends on several factors such as the nature of the claim being defended and whether the claim represents both covered and uncovered claims.

The issue of apportioning of defence costs arises when one counsel defends an action that presents both covered and uncovered claims against an insured. In such a case, the general rule is that the insurer must pay all of the defence costs except for those which are solely and undeniably referable to the uncovered claims. The burden of proving which costs are payable by the insured rests with the insurer.⁶⁷ If the facts underlying the covered and uncovered claims are inextricably intertwined, no allocation is possible and the defence costs are covered by the insurer. Similarly, where defence costs are incurred both for the benefit of covered and uncovered claims, the defence costs are also covered by the insurer. It is therefore generally not in the interests of an insured to agree to any apportionment of defence costs prior to the determination of litigation, as many of these costs will be borne by the insurer.

In terms of allocating defence costs, several issues arise, each of which will have an impact on the final determination of the quantum of defence costs and apportionment of the costs among the parties:

- (a) whether allocation should occur prospectively or retrospectively;
- (b) what methodology should be used; and
- (c) whether it makes a difference that the insurer has defaulted in its duty to defend;

⁶⁷ Gordon Hilliker, *Liability Insurance in Canada*, 4th ed. (2006) at 108.

Courts have generally refused to allocate defence costs before trial or settlement, and have further held that insurers should cover all defence costs until such time as they can be allocated.⁶⁸ However, in *Sommerfield v. Lombard Insurance Group*⁶⁹, an application was made seeking a declaration that there was a duty to defend. The Court concluded that in the circumstances of that case it was not premature to make an allocation order, as the majority of claims concerned allegations of intentional acts, which were not covered, whereas the covered negligence claim was limited to a discrete and non-intertwined issue. On this basis, the Court ordered that the insurer was required to pay only 20% of the defence costs of the insured.

An example of a retrospective allocation of defence costs was provided in *Hanis v. University of Western Ontario*⁷⁰ (“*Hanis*”). The insurer had denied having a duty to defend the insured in a third party action. The insurer and insured agreed to stay the proceedings pending the outcome of the main action. At the conclusion of the main action, the insured brought a motion in the third party action to obtain an order that there was a duty to defend certain of the causes of action. The Court ultimately found that there is a heavy burden on an insurer who breaches its duty to defend and held that 95% of the legal defence costs were to be paid by the insurer. The Court set out the following principles:

- (a) the burden on the insurer requires the insurer to propose a “consistent and rational” basis for a just allocation of defence costs, rather than an “after the fact, attempt to fashion some sort of equitable formula based on some undefined perception of fairness”;
- (b) the insurer, as the wrongdoer, is not relieved from its obligation to compensate the insured for its losses simply because it is impossible to measure damages with mathematical accuracy. The burden is on the insurer to clearly demonstrate what work and disbursements performed and incurred by the solicitors, or the insured itself, clearly do not relate to covered claims. Thus, the insurer will have no liability to reimburse the insured for defence costs which can be indentified by ‘reliable’ evidence as relating ‘solely’ to uncovered claims. Where there is no

⁶⁸ See, for example, *Daher v. Economical Mutual Insurance Company* (1996), 31 O.R. (3d) 4721 (C.A.).

⁶⁹ *Sommerfield v. Lombard Insurance Group*, (2005), 20 C.C.L.I. (4th) 301 (Ont. S.C.J.).

⁷⁰ *Hanis v. University of Western Ontario*, [2003] O.J. No. 4167 (Ont. S.C.J.).

practical means of readily distinguishing costs of defence between the covered and uncovered claims, the insurer should absorb them;

- (c) the insured, as the innocent party, must furnish such assistance to the court by proof of relevant facts as it may, under the circumstances, reasonably be expected to afford. The test is what is reasonable having regard to all the relevant circumstances. The focus must be on the temporal aspects such as what was reasonable in the insured's state of mind when the expenses were incurred. The insured also has a duty to mitigate costs and expenses.

There is still some debate over whether allocation can be done prospectively or retrospectively. An argument against prospective allocation is that it is premature as it is based on a fundamentally flawed assumption that the pleadings can reliably predict what future legal costs will be incurred on covered and uncovered claims. Further, the prospective approach ignores the issue of how courts deal with defence costs which relate to both covered and uncovered claims (i.e. mixed claims) and the consequences of amended pleadings on the allocation calculation.

Legal fees and disbursements may be expended for overlapping allegations, accordingly the prospective allocation implicitly adopts the “inclusion” test.

However, from an insurer's perspective, the costs of defending an entire action subject to allocation at the end of the action seems unfair, as a real concern facing the insurer is that it will never be able to successfully obtain reimbursement from the insured for defence costs related to uncovered claims. Thus it is in an insurer's interest to seek a prospective interim allocation of defence costs because this will require the insured to fund part of the defence costs from the outset, subject to reapportionment at the conclusion of the action. This may result in an insured being more likely to focus on an early resolution of the action.

Given the difficulty in obtaining a prospective allocation, insurers may wish to re-evaluate their defence obligation as set out in liability policies and consider redrafting their defence clauses. An example of such a clause is found in the LawPro policy that provides errors and omissions insurance to lawyers in Ontario (the “LawPro Policy”). The LawPro Policy contains the following qualification on the duty to defend:

The INSURER may decline to so defend...where it determines on reasonable grounds that the CLAIM does not arise out of an error, omission or negligent act in the performance of or failure to perform PROFESSIONAL SERVICES...does not comply with...the POLICY, or is excluded...

Under the provisions of LawPro Policy, disagreements or disputes regarding the duty to defend are to be submitted to an arbitrator or decided by action in the Ontario Superior Court of Justice. The policy specifically provides that the insurer or the insured may introduce evidence relating to the issues of coverage to be considered by the adjudicator.

Another option for an insurer is to insert an allocation clause into the policy that is similar to that found in the Ontario Court of Appeal decision in *Boliden Limited v. Liberty Mutual Insurance Company*⁷¹(“*Boliden*”). The D&O policy at issue in *Boliden* contained the following allocation clause:

11. Allocation: In the event that a claim involves a loss that is covered by this policy and a loss or payment not covered by this policy...

11.1 with respect to defence costs, to create certainty in determining a fair and equitable allocation of defence costs, 80% of all defence costs which must otherwise be allocated as described above shall be allocated to covered loss and shall be advanced by Liberty International Canada on a current basis...

It is clear that an anticipatory approach by insurers to the question of defence cost allocation will serve to inject some certainty into a situation which is often not determined until the final outcome of a judgment in a claim. A properly drafted cost allocation clause should therefore be a standard term of any insurance policy.

⁷¹ *Boliden Limited v. Liberty Mutual Insurance Company*, 2008 ONCA 288.