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Article abstract

Il existe relativement peu de jurisprudence sur l'obligation de l'assureur de prendre fait et cause de l'assuré, conformément à l'ancien article 2604 C.c., lequel faisant maintenant l'objet de l'article 2503 C.c.Q. M^{e} Carolena Gordon passe en revue trois décisions récentes, la première et la troisième venant des tribunaux québécois, alors que la deuxième émane de la Cour d'appel de l'Ontario. Cette brève revue jurisprudentielle a le mérite de faire ressortir les grands paramètres de cette obligation et certaines controverses l'entourant. À titre d'exemples : les deux concepts différents que sont l'obligation de défendre et l'obligation d'indemniser, l'existence de l'obligation subordonnée à la garantie principale du contrat d'assurance et le partage de l'obligation de défendre entre l'assureur primaire et l'assureur d'excédent.

Three recent cases on the duty to defend

by

Carolena Gordon*

Il existe relativement peu de jurisprudence sur l'obligation de l'assureur de prendre fait et cause de l'assuré, conformément à l'ancien article 2604 C.c., lequel faisant maintenant l'objet de l'article 2503 C.c.Q. Me Carolena Gordon passe en revue trois décisions récentes, la première et la troisième venant des tribunaux québécois, alors que la deuxième émane de la Cour d'appel de l'Ontario. Cette brève revue jurisprudentielle a le mérite de faire ressortir les grands paramètres de cette obligation et certaines controverses l'entourant. À titre d'exemples : les deux concepts différents que sont l'obligation de défendre et l'obligation d'indemniser, l'existence de l'obligation subordonnée à la garantie principale du contrat d'assurance et le partage de l'obligation de défendre entre l'assureur primaire et l'assureur d'excédent.

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A number of cases have recently been decided in the area of the liability insurer's duty to defend and several of them will have an important impact on this obligation in Quebec law. Both insurers and their attorneys as well as insureds and their attorneys are closely following recent developments in this area which may significantly alter both the scope and content of the insurer's statutory obligation to defend.

A wealth of case law has developed across Canada in the last 10 years with respect to particular aspects of the scope and content of the duty to defend. We do not intend to examine this case law but rather we propose to review three recent cases, two

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from Quebec and one from Ontario, which will most certainly be raised in negotiations between insurers and their insureds with respect to the insurer's obligation to defend. Because these cases arose out of policies issued prior to January 1, 1994, the Civil Code of Lower Canada applied.

Article 2604. of the Civil Code of Lower Canada sets out the insurer's statutory obligation to defend as follows:

> **Art. 2604** Subject to other legislative provisions, the insurer is bound to take up the interest of any person entitled to the benefit of the insurance and assume his defence in any action brought against him.
>
> No transaction made without the consent of the insurer may be set up against it.

Further, the Civil Code of Lower Canada provides at Article 2605 that the costs and expenses of the suits taken against the insured, including defence costs and interest on the amount awarded to the third party, are to be borne by the insurer over and above the limits of the insurance. The legislator, in adopting the new Civil Code, adopted both the above-mentioned articles, without any amendment, into Article 2503 of the Civil Code of Quebec.

I. *Boreal Insurance Inc.* v. *Réno Dépôt Inc. et als.*

The first case of interest is that of *Boreal Insurance Inc.* v. *Réno Dépôt Inc. et als.*[1]. In this case Réno Dépôt and Isolation Val-Royal [hereinafter Val-Royal] were sued by a number of home owners who purchased urea formaldehyde insulation (UFFI) from them for their residences. The Plaintiffs' claims included the costs of removing the insulation, damages for bodily injury and the inconveniences suffered by the homeowners. At least one of the Plaintiffs alleged that the damages occurred "subsequent" to the installation of the insulation.

[1](December 21, 1995), Montreal 500-09-000070-920, (C.A.).

The defendants had insurance, but the installation of the product and the subsequent manifestation of damages occurred over a period of many years. Since the defendants had changed carriers during that period, this obviously created some difficulty in determining how an "occurrence" would be defined under the three CGL policies at issue.

Two of the insurers (General Accident Insurance Company and The Continental Insurance Company) initially agreed to defend the various claims but subsequently formulated a number of reservations under which both insurers would tender a defence. Val-Royal was not of the view that these reservations were compatible with offering it a complete and unbiased defence. Consequently, the counsel appointed by the insurers to defend the claims withdrew from the various litigious files and Val-Royal's attorneys took control of the defence. The third insurer (Boreal Insurance Company) denied that its policy was ever triggered. Val-Royal instituted third party proceedings against all three insurers.

The trial Court judge dismissed the Plaintiffs' actions against Val-Royal and dismissed the third party proceedings against General Accident and Continental but maintained the action against Boréal with respect to its duty to defend. The Court was of the view that the offer to defend formulated by Continental and General Accident, subject to certain reservations, was reasonable and that Val-Royal's refusal to allow those insurers to tender a defence, subject to the reservations, was unreasonable.

Appeals were launched by Boreal and by Val-Royal. These appeals dealt solely with the obligation to defend. All of the policies contained the ordinary clauses which trigger the duty to defend the insured for any action instituted against it alleging bodily harm or property damage falling within the insuring clauses of the policy.

The Court of Appeal adopted the reasoning of the Supreme Court of Canada decision in *Nichols* v. *American Home*

Assurance Company[2] (hereinafter "*Nichols*") thus adopting this decision as law in Quebec. In *Nichols*, the Supreme Court ruled that the duty to defend is broader than the duty to indemnify. Consequently, where the third party's claim against the insured contains allegations which fall, at least in part, within the scope of coverage afforded under the policy, the duty to defend is triggered. The ultimate duty to indemnify, on the other hand, is restricted by the findings of fact set out in the Court's judgment against the insured.

252 With respect to General Accident and Continental's offer to defend, Val-Royal argued that given the reservations of rights, if the lawyers appointed by the insurers also represented Val-Royal, they would have clients with divergent interests.

The Court of appeal, in dealing with the perceived conflict of interest issue which stemmed from the extensive reservations invoked by two of the insurers, and referring to a number of exclusions as well as the definition of an "occurrence", overturned the Superior Court's finding that these reservations were reasonable under the circumstances. The Court of Appeal found that these reservations of rights were broad enough to prevent the insured from having the benefit of a full and complete defence in the various lawsuits. The Court of Appeal commented that the insured was within its rights to refuse the offer put forth by the two insurers and was entitled to engage its own counsel to defend the claims. The Court was clearly sympathetic to the obvious conflict of interest and stated that the insured had the right to an impartial defence from its insurers. The reservations as formulated by the two insurers were incompatible with providing such an impartial defence.

With respect to the third insurer, it argued that its policy had never been triggered and that it was aware of facts, which were not alleged in the various Statements of Claim, which led it to conclude that no coverage was available under the policy. The Court of Appeal dismissed the argument that the third insurer's

[2][1990] 1 R.C.S. 801.

policy had never been triggered. At least one of the actions alleged that the damages occurred "subsequent" to the installation of the insulation which implied that the damages, whether to property or by way of bodily injury, occurred on a certain date and continued to occur. Thus, no insurer on the risk from the moment in time which the Plaintiffs in that action installed the UFFI in their homes could escape its obligation to tender a defence. Consequently, the Court of Appeal concluded that the trial judge was correct in his decision to the effect that all three insurers owed a duty to defend to Val-Royal.

With respect to the facts known by the insurer but not alleged in the Statements of Claim, the Court of Appeal held that the duty to defend is based **solely upon the allegations contained in the Statements of Claim.** Therefore, the third insurer could not escape its obligation to provide a defence to the insured by invoking facts known it but not alleged in the pleadings. The Court did, however, mention that if during examinations on discovery or during the trial, facts were discovered which brought the claim outside the scope of coverage, then any of the insurers could withdraw the defence. This echoes the general rule that where an insurer, in the process of defending a claim, discovers that the claim falls squarely outside of the scope of the coverage offered under the policy, it may withdraw the defence. However, we remind the reader that the insurer must withdraw immediately upon learning that the claim falls outside of the scope of coverage or it may find itself estopped from withdrawing the defence.

The Court of Appeal decided that all three insurers owed the insured a duty to defend. However, the Court did not comment as to how the duty to defend should be divided between the various insurers. Presumably, the various insurers will enter into negotiations with respect to sharing the costs of the defence to these claims and dealing with issues such as allegations which are not covered by the policy. It remains to be seen whether or not these negotiations will ultimately lead to litigation amongst the insurers.

Three important points must be stressed with regard to the impact that this case has upon the duty to defend with respect to liability policies:

i) First, if an insurer issues lengthy reservations of rights, it can expect that its insured will invoke the above-mentioned decision in support of its position that the reservations create an inherent conflict of interest on the part of any lawyers appointed by the insurer. Therefore, in such a scenario, the insured may invoke this decision to justify the
254 engagement of its own counsel to defend the claim, asking the insurer to pay for the defense costs incurred by the insured without any opportunity to control the defence. In losing control of the defence, the insurer might lose the opportunity to have its counsel negotiate a timely settlement at a reasonable price, thus exposing itself to not only the defense costs but to an adverse judgment, with interest and costs. Arguments over the entitlement to appoint counsel might lead to further litigation. In light of the foregoing, the insurer may want to tread carefully in issuing its reservations of rights letters to ensure that the insurer's and the insured's respective positions are not unnecessarily polarized.

ii) Second, the Court of Appeal has specifically precluded the insurer from invoking facts known to it, but not alleged in the proceedings, as a basis for a denial of coverage. Therefore, the insurer is faced with a dilemma as to whether it should defend the claim, subject to its reservations of rights, until the facts that it is aware of eventually surface or to deny coverage and find itself sued in third party proceedings. If it chooses to defend, it may find itself in another difficult situation, since it may not instruct defence counsel to specifically and purposefully find a way to unearth the facts known to the insurer which could form the basis of the denial. This would clearly create a conflict of interest and would necessarily deprive the insured of the impartial defence which it is due under the policy.

An additional caution should be added to the foregoing. If the insurer uncovers a basis upon which the policy may be entirely voided, such as a material misrepresentation, it must be cautious about how it presents its case in the third party proceedings. In a recent case, the Ontario Supreme Court held that a liability insurer could not allege facts in a preliminary motion which would prejudice the insured's defence in the principal action.[3] In this case, the insurer was attempting, in a preliminary motion, to prove material non-disclosure. Relying on American case law the Court held that the insurers could not attempt to prove facts not alleged between the principal plaintiff and the insured to demonstrate their allegation of material non-disclosure by the insured which would result in the voiding of the policy. The Court was of the view that the case should proceed to trial and the judge on the merits will then determine whether in fact there was material non-disclosure. If the facts the insurer wishes to allege are entirely irrelevant to the principal action, the insurer may proceed without fear.

iii) Third, the rule as set out in *Nichols* and discussed above has been adopted by the Quebec Court of Appeal, resolving any ambiguity that may have existed with respect to whether or not this case was applicable in Quebec.

II. *Re Kerr* v. *Lawyers Professional Indemnity Company*

The second case of interest is a decision rendered recently by the Court of Appeal of Ontario in the matter of *Re Kerr* v. *Lawyers Professional Indemnity Company*[4]. In this case, a lawyer insured by the Lawyers Professional Indemnity Company (hereinafter LPIC) for claims arising out of his duties as a lawyer filed a motion to have LPIC defend him with respect to an alleged breach of duty in his work as the corporate secretary of a company. The Motions Court judge held that the claims fell

[3]See *Slough Estates Canada Ltd.* v. *Federal Pioneer Ltd* [1995] 25 O.R. (3d) 429 (O.S.C.).

[4][1995] 25 O.R. (3d) 804 (O.S.C.).

outside the coverage afforded by the policy and therefore there was no duty to defend.

Following this decision, the Plaintiff amended its Statement of Claim and alleged that the claims were asserted not only against the lawyer as the corporate secretary of the company but also in his capacity as its solicitor. No new facts were alleged, however, in the amended claim.

In light of the foregoing, LPIC acknowledged that it had a duty to defend but attempted to negotiate an allocation to split
 defence costs since the insured was clearly being sued in both capacities. The insured refused this offer and took the position that LPIC should pay for all of his defence costs.

The Court referred to the *Nichols*' decision and concurred that the obligation to defend is broader than that to indemnify. The Court was of the view that the allegations of breach of duty made against the insured came within the scope of coverage provided under the policy. Therefore, the duty to defend was triggered. Further, the Court held that the presence of allegations against the insured with respect to his role as corporate secretary to the company "does not alter the fact that the amended pleadings leave it open to the Court to connect all alleged breaches of duty to the appellant's retainer as N.B.S.'s solicitor providing professional services. Thus, I think LPIC is required to defend the claim made against the appellant".[5]

As well, the Court held that the duty to indemnify may be assessed retrospectively once the Court has rendered its decision on whether or not the liability which may be imposed on the insured is related to his duties as corporate secretary or attorney. However, the Court ruled that the duty to defend may **not** be assessed retrospectively. It must be determined when the claim is made and in accordance with the allegations made against the insured.

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[5]Supra at 812.

This decision may have an important impact on negotiations between an insurer and its insured under liability policies where the insured is sued not only in a covered capacity but also in some other capacity which is clearly not covered by the terms and conditions of the policy.

Usually in such cases the insurer negotiates with the insured and his attorney to determine an allocation for defence costs which reflects the covered portion of the claim. This case may prove to be an impediment in negotiating such defence costs allocations between insurers and insureds. However, one important distinguishing feature in this case is that **all** of the allegations made against the insured were made with respect to his role as the company's attorney and the corporate secretary with no distinction between the two. Therefore, it is possible to distinguish this case from situations in which the allegations against the insured for breaches of duty are different, depending upon which particular duties he was carrying out at the time of the alleged breach. In cases where there is such a distinction a defence costs allocation may still be negotiated but perhaps with more difficulty.

III. *Leclerc* v. *Société de Transport de la Rive-Sud de Montréal*

The final decision of interest is the decision of *Leclerc* v. *Société de Transport de la Rive-Sud de Montréal*[6]. In this case, the Superior Court of Quebec dealt with the issue of the obligation to defend between primary and excess insurers. There is little known case law in this area in Quebec and thus this decision is of interest to insurers as well as their attorneys.

In this case Mr. Leclerc sought the permission of the Court, by way of Motion, to institute a class action suit against La Société de transport de la Rive-Sud de Montréal (hereinafter "STRSM"). STRSM requested that its liability insurers take up its defence with respect to this Motion and when the insurers

[6] (1995-09-06), Longueuil 505-06-000001-953, J.E. 95-1922 (C.S.).

failed to do so, it took third party proceedings against its primary, excess and umbrella carriers, requesting that they defend in conformity with their respective statutory obligations. The excess and umbrella carriers presented a Motion to Dismiss the third party proceedings, arguing that the obligation to pay defence costs should be borne solely by the primary insurer. Both the excess and umbrella carriers' policies included clauses which stipulated that defence costs were to be borne by the primary carrier with certain exceptions which were not relevant in this case. Further, both the excess and umbrella carriers
258 referred to a clause in the umbrella carrier's policy which prevented the insured from taking an action before the primary carrier's limits were exhausted, in support of their proposition that the defence should be tendered by the primary carrier only.

Mr. Justice Mercure began his analysis by reiterating that articles 2604 and 2605 of the Civil Code of Lower Canada are of public order. Further, the clause preventing the insured from taking an action until the primary carrier's limits were exhausted did not convince the Court that this necessarily meant that the primary carrier was solely responsible to defend.

Both insurers invoked the decision of *Allstate du Canada Compagnie d'assurance* v. *Assurance Royale du Canada*[7]. In this case, Mr. Justice Martin of the Superior Court held that the provisions with respect to liability insurance in the Civil Code of Lower Canada are of little assistance in determining the duty to defend as between a primary and excess carriers. In this case, the excess carrier specifically excluded the obligation to investigate and defend the claim in its policy wording. The Court held that the excess carrier set out the limits of its obligation to pay defence costs and that if the primary carrier was unhappy with this position it should have objected, since it did not it was obliged to live with the consequences. Therefore, in the context of a Motion for Declaratory Judgment between the primary and excess carrier with respect to defence costs, the Court held that

[7][1994] RJQ 2045.

the primary carrier was obliged to pay the entire amount of the defence costs.

With respect for the above-mentioned decision, Mr. Justice Mercure stated that he was not convinced that this necessarily meant that any third party proceedings against an excess and umbrella carrier should be dismissed. He also noted that the *Allstate* case is presently under appeal and the issue of how defence costs should be dealt with as between primary and excess insurers is far from being resolved. He then stated that it would be prudent to allow the parties to proceed to trial and permit the trial judge to hear the third party proceedings on their merits. This would allow the judge to make a determination, after having heard each party's evidence, as to whether or not there is an obligation to defend on the part of the excess and umbrella carriers.

This decision introduces uncertainty that had not previously existed, since it has always been presumed that the duty to defend rested upon the shoulders of the primary carrier who had the opportunity to set the premium accordingly. However, this presumption has never been tested in Quebec. The excess and umbrella carriers set their respective premiums on the basis that defence costs are not covered. Thus, imposing such an obligation will have a significant impact on the cost of purchasing such coverage which could make it unattainable for certain insureds. In our view, rather than reflecting the state of the law on this matter, this case might merely be about a simple procedural matter. In fact, this decision may simply reflect the reluctance of our Courts to dismiss such an action at the preliminary stage without allowing the insured to be fully heard on the merits of his case before the trial judge. Consequently, a wait and see approach should be adopted for the time being.

This decision, as well as the *Allstate* decision, should be closely monitored by excess and umbrella insurers who may well face a controversy on a matter which the insurance industry considered for practical purposes to be settled for some years.