Duties of an Insurer and practical impacts of duty to defend and indemnify

The "duty to defend" and "duty to indemnify" describe different obligations that an insurer may owe to an insured who has been formally alleged to have committed wrongdoing. The wording of an insurance policy dictates whether the insurer has agreed to assume a duty to defend and/or a duty to indemnify. Though these duties are often confused, it is important to consider their difference in scope and the stage of litigation during which they are often triggered.

For example, the duty to defend can be considered forward-looking in that is often triggered early in litigation as a preliminary matter. As the Supreme Court of Canada has summarized, the duty to defend is triggered "[i]f the claim alleges a state of facts which, if proven, would fall within the coverage of the policy".[1] Neither the truth of the allegations nor the possible outcome of the litigation is relevant to this assessment.

In contrast, the duty to indemnify is backward-looking in that is often triggered at the end of litigation. The duty to indemnify is only engaged when the claimant's allegations are proven at trial. Accordingly, the duty to indemnify is narrower than the duty to defend and is less often triggered.

I. When is the duty to defend triggered?

The determination of whether an insurer has a duty to defend is a contextual inquiry that will depend on: (i) the provisions of the insured's policy and (ii) the facts as pleaded by the claimant.

Step #1: Does the policy stipulate a duty to defend?

The first step in determining whether a duty to defend arises is to look to the provisions of the insured's policy. Duty to defend must be specifically stated in the insured's policy.[2] It cannot simply be inferred from the duty to indemnify. Moreover, courts will interpret the language of the policy that triggers the duty to defend in the context of the entire insurance agreement.[3] However, it is important to note that any ambiguity in the policy will be resolved in the insured's favour.[4]

Step #2: Are the acts and omissions alleged in the pleadings covered under the policy?

a. The "pleadings rule"

The second step in determining whether a duty is owed is to assess whether the pleadings allege an act or omission which falls within the coverage of the insured's policy.[5] The "pleadings rule", as it is called, was recently articulated by the Supreme Court of Canada in *Monenco Ltd. v. Commonwealth Insurance Co.* [6] The Court stated:

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[1] *Monenco Ltd. v. Commonwealth Insurance Co.*, 2001 SCC 49 (CanLII), [2001] 2 SCR 699 at para 28.

[2] *Alie v. Bertrand & Frere Construction Co* (2002), 62 OR (3d) 345 (Ont. C.A.) para 174 [*Alie*].

[3] *Alie* at para 184.

[4] *W.(T.) v. (W.(K.R.J.)* (1996), 29 O.R. (3d) 277 (Ont. Gen. Div.) at para 30.

[5] *Non-Marine Underwriters, Lloyd's of London v. Scalera*, 2000 SCC 24, [2000] 1 SCR 551 (SCC) at para 50 [*Scalera*].

[6] *Monenco Ltd. v. Commonwealth Insurance Co* [2001] 2 SCR 699 (SCC).

> "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."[7]

Accordingly, it is not necessary for the pleadings to definitively establish that the acts or omissions alleged will succeed.[8] The "mere possibility" that a claim within the policy may succeed is sufficient to trigger the duty to defend.[9]

b. "True nature" of the claim

While the courts will look to the pleadings in order to assess whether the claim falls within the insured's policy, they are cognizant that claimants may draft the pleadings in order to intentionally include the alleged acts or omissions in the scope of the insurer's policy, In order to curb manipulation of claims in this manner, courts will determine whether claims actually fall within the insured's coverage by assessing the "true nature" or the substance of the claim.[10] Accordingly, the courts will not be bound by the plaintiff's potentially arbitrary characterization of the claim in determining whether the insurer has a duty to defend.[11]

Step #3: Is the claim derivative?

The third step in determining whether the duty to defend is triggered is to assess whether any claims pleaded are entirely derivative in nature.[12] For example, the duty to defend will not be triggered if a claim is characterized in terms of both negligence and an intentional tort. If both the negligence and intentional tort arise from the *same* set of factual circumstances, the negligence claim is derivative and it will be subsumed into the intentional tort.[13] However, a claim for negligence will not be entirely derivative if the factual circumstances are sufficiently distinct such that the two claims are unrelated. In this case, the insurer would be obligated to defend against both claims.

II. Can the duty to indemnify arise when there is no duty to defend?

The duty to defend is often linked to the duty to indemnify. However, a duty to indemnify may arise, in limited circumstances, where there is no duty to defend. For example, in *British Columbia v Surrey District School Board No 36*[14], the British Columbia Court of Appeal held that the insurer, the British Columbia Ministry of Education had a duty to indemnify the Surrey District School Board (the "Board") for legal fees and cost. It ordered the Board to pay intervenors in a separate litigation under which the Board was deemed to have passed unconstitutional resolutions. The Ministry of Education argued that it did not have a duty to indemnify because while the pleadings alleged a violation of constitutional rights, and as such, there was no allegation of economic loss. However, the Court concluded that the language of the policy was intended to indemnify school boards for the costs of other parties in litigation which they were ordered to pay as a result of their duties on behalf of the school district. Justice Newbury acknowledged that it was unusual for the duty to defend coverage not to be co-extensive with the duty to indemnify. He noted that if the duty to

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[7] *Ibid* at para 28.

[8] *Nichols v. American Home Assurance Co.*, [1990] 1 SCR 801.

[9] *Ibid*.

[10] *Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada*, 2010 SCC 33, 2010 CarswellBC 2501.

[11] *Ibid* at para 20.

[12] *Scalera* at para 52.

[13] *Ibid* at 85.

[14] 2005 BCCA 106.

defend could be broader than the duty to indemnify, "[…] I see no reason in principle why the converse may not be true where the plain meaning of the policy so indicates."[15]

III. Preferred Procedure for Duty to Defend Applications

Recently the Court affirmed that issues concerning the duty to defend are preliminary and determined exclusively upon the relevant insurance policy, the pleading, and documents explicitly referred to in the pleading.[16] Accordingly, the Superior Court strongly reiterated the Court of Appeal's previous remark that issues concerning the duty to defend are not amenable to summary judgment, a process which requires the responding party to put its "best foot forward" and permits both parties file affidavit evidence and to cross-examine on that evidence.

The appropriate procedure for disputing issues related to the duty to defend is an application under Rule 14.05(3)(d) or a motion under Rule 21.01(a) (with leave of the court to adduce the relevant insurance policy as evidence).

The choice between these procedures is a matter of practicality. In most cases, where the insurer has not been made a party to the dispute involving the insured, the appropriate procedure would be for the insured to commence an application under Rule 14.05(3)(d). Otherwise, the insured would be required prepare and issue a separate Statement of Claim against the insurer prior to preparing a Rule 21 motion.

IV. Pleadings Pitfalls

Identify all causes of actions and their elements: It is critical to plead each cause of action with all its elements clearly. This is particularly important as some causes of actions may or may not be covered by the insurance policies. In addition, unless causes of actions are clearly pleaded it creates issues of identifying and assessing coverage which require clarity of allegations.

Identify right parties: It is important to identify the right parties and correctly plead corporate names and structures. This can be particularly relevant if some of the related corporate entities may be covered through the related party provisions or as an additional insured.

Be aware of common exclusions in policies: When drafting pleadings is it important to keep in mind some of the most common exclusionary provisions in all insurance policies. For example: fraud exclusions, bad faith or conduct exclusions and contractual exclusions.

Note contractual and statutory limitation periods: Most recently, the Court of Appeal disallowed the plaintiff to amend a pleading after 2 years where the plaintiff failed to plead the factual matrix necessary for negligent misrepresentations.[17] It is critical to keep in mind that you plead as much information as possible in your initial pleading so that even if you do need to amend it, you can find ways to tie it back to the original pleading. In addition to the statute, also be aware of any special time limitations in insurance policies.

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[15] *Ibid* at para 28.

[16] *Roumann Consulting, Inc. v. Aviva Insurance Company of Canada et al.*, 2020 ONSC 3387.

[17] *Polla v. Croatian (Toronto) Credit Union Limited*, 2020 ONCA 818.

Impact of pleading punitive damages: Most insurance policies do not cover punitive or aggravated damages. Therefore, keep in mind when seeking these damages that they are not going to be covered by insurers.

V. Effects of denial of coverage and/or reservation of rights

Insurers must think carefully about a potential decision to deny coverage. In most cases, they will obtain a coverage opinion to inform this decision-making. This is especially critical given the consequences if their decision to deny coverage is successfully challenged.

If an insurer denies coverage, not surprisingly, it will lose the right to appoint counsel and the right to determine whether the action should be defended at all. This is a significant risk for an insurer. If the insurer denies coverage, the insured can proceed with its claim and is entitled to settle the claim in any reasonable way and for any reasonable amount. If the insurer is found to have wrongfully refused to defend an action despite an obligation to do so under a policy, the insurer may be able to recover settlement costs (and other costs) from the insurer. In other words, the insurer will bear financial responsibility for an outcome it had no part in directing. Whether or not the matter settles, of course, if the insurer is found to have improperly denied coverage, they may have to indemnify the insured entirely in respect of the underlying action. Additionally, if the insured is successful on an application that the insurer has a duty to defend, the insurer will also likely bear the costs of that application, in the normal course.

Rather than an outright denial of coverage, many insurers take the route of delivering a reservation of rights letter or asking the insured to sign a non-waiver agreement. A reservation of rights letter is essentially a declaration by an insurer that it will investigate and defend the insured's claim, while at the same time reserve its right to later deny coverage and refuse to indemnify the insured against any settlement or judgment since all or part of the claim is not covered. Reservation of rights letters will not usually affect the substantive rights of the parties under the policy at issue or be enforced against an insured, as they are unilateral directives.

A non-waiver agreement, however, is a contract between the insured and the insurer, which represents an acknowledgement by the insured that the insurer's future rights of denial are preserved. Non-waiver agreements are mechanisms by which the insurer seeks to avoid an allegation in subsequent proceedings that its conduct in defending the original claim has estopped it from denying coverage. If the parties sign a non-waiver agreement, the insurer may investigate, defend, and settle the action against the insured without making an election whether to affirm or deny coverage. For its part, the insured usually agrees not to raise any conduct by the insurer in an action for indemnification under the policy.

As an illustrative example, a copy of the Insurance Bureau of Canada's Non-Waiver Agreement is attached as Schedule A.

Some of the issues that arise are as follows:

Control of the Defence: If coverage is denied, the insured must proceed with its own defence. In the case of a reservation of rights, the insurer has the right to control the defence strategy. The insurer's right to control strategy may be challenged by an insured if the insurer is not protecting the insured's best interest or acting in good faith. Insureds generally cannot challenge defence strategy or tactics in cases where the

insurer retains the right to control the defence.[18] In *Laurencine v. Jardine*,[19] the court granted an order permitting the insured to appoint counsel who would also not report on the claim to the insurance company, based on such a conflict raised by the insured. It appears that, increasingly, courts are finding that where there is a conflict of interest between the insurer and the insured, the insured has a right to retain and instruct their own counsel at the insurer's expense.[20]

One may also raise questions about control of the defence if there is more than one insured, including an excess insurer. In such a case, courts have flagged that there may be a duty of care between primary and excess insurers such that, although the primary insurer may control the defence, it has certain obligations to the excess insurer, including keeping it informed of the litigation and likely involving it in settlement discussions if the possible settlement amount would exceed the primary insurance level. Thus, in *Hollinger International Inc. v. American Home Assurance Co.*,[21] Hollinger's primary insurers settled one of several cases against the insured for $50 million dollars, which was the limits of the primary policies. The excess insurers argued that the settlement should not be approved on the grounds that they were not involved in the settlement process, that a summary judgment motion should have been brought, and that there was no explanation as to the reasonableness of the settlement amount. In reviewing the evidence before it, the Court held that it was reasonable that the excess insurers were not directly consulted in settlement discussions as the settlement did not expose them to an obligation to indemnify. Further, the Court found that the primary insurers were reasonable in concluding that there was a risk that a summary judgment motion would not succeed, and that $50 million was not an unreasonable settlement amount in the circumstances

Conflict of Interest: A situation may arise where the insured and insurer's interests are in conflict. The most obvious example is a case where there are covered and uncovered claims; the insured may perceive a conflict if the insurer defends. In other words, the insured may argue that the insurer defend by pushing focus to the uninsured claims. As is set out in *Brockton (Municipality) v. Frank Cowan Co.*, 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.[22] As is further set out in *Brockton*, which is a case about the Walkerton *e coli* outbreak:

> If the reservation of rights arises because of coverage questions which depend upon an aspect of the insured's own conduct that is in issue in the underlying litigation, a conflict exists. On the other hand, where the reservation of rights is based on coverage disputes which have nothing to do with the issues being litigated in the underlying action, there is no conflict of interest requiring independent counsel paid for by the insurer.[23]

In the recent case of *Markham v. AIG Insurance Company of Canada*,[24] the Court of Appeal found that both insurers had conflicts of interest, but noted that its role was to balance the insured's right to a full and fair defence with the insurers' right to control the defence such that one insurer did not abuse its right to defend

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[18] *Brockton (Municipality) v. Frank Cowan Co.*, 2002 CarswellOnt 25 [*Brockton*] at para. 49

[19] *Laurencine v. Jardine*, 1988 CarswellOnt 698 (Ont. H.C.).

[20] *Appin Realty Corp. v. Economical Mutual Assurance Co.*, 2008 ONCA 95.

[21] *Hollinger International Inc. v. American Home Assurance Co.*, [2006] O.J. No. 140, 144 A.C.W.S. (3d) 1098 (Ont. Sup Ct.)., esp. at para. 63-68.

[22] *Brockton*, at para. 45.

[23] *Ibid.* at para. 42.

[24] *Markham v. AIG Insurance Company of Canada*, 2020 ONCA 239 [*Markham*].

and settle the claim to the detriment of the other insurer or the insured.[25] The court observed that in these situations, it is important to have in place mechanisms to minimize conflicts of interest and to provide meaningful protections to the party not having control of the defence.[26] In this case, the court found that appropriate counsel honouring their ethical obligations would mitigate any possible issues, and that AIG's proposed internal protocols would allow it to manage the defence while also permitting the other insurer and the insured to participate.[27] Notably, the other insurer and the insured did not propose an alternative strategy, other than that AIG should fund the defence and have no role in instructing counsel.

Costs of Defence: Defence costs are usually only determined and apportioned after a trial or settlement. It may be possible to apportion defence costs where only certain claims fall within the terms of the policy.[28] If the covered and uncovered claims are inextricably intertwined, a court may order an insurer to assume all defence costs. An insurer can avoid this eventuality if it can identify a principled basis for apportionment.[29] Keep in mind that an excess insurer with a duty to defend may be required to contribute to the costs of the primary insurer in defending the claim, usually on an equal basis.[30]

This article has been prepared and submitted by Deepshikha Dutt (Dentons Canada LLP) and Andrea J. Sanche (Ricketts Harris LLP), please contact them for further information.

[25] *Ibid.* at para. 102-103.

[26] Citing *PCL Constructors Canada Inc. v. Lumbermens Mutual Casualty Company Kemper Canada* (2009), 76 C.C.L.I. (4th) 259 (Ont. S.C.), at para. 89.

[27] *Markham*, at para. 105-116.

[28] *Tedford v. TD Insurance Meloche Monnex,* 2012 ONCA 429 (CanLII).

[29] *Harris v. University of Western Ontario* (2003), 67 O.R. (3d) 539 (Ont. S.C.J.); affirmed (2008), 2008 CarswellOnt 5867 (Ont. C.A.); leave to appeal refused (2009), 2009 CarswellOnt 1638 (S.C.C.)

[30] *Alie v. Bertrand & Frère Construction Co.* (2002), 62 O.R. (3d) 345 (Ont. C.A.); leave to appeal refused (2003), 326 N.R. 399 (note) (S.C.C.); *Boreal Insurance Inc. v. Lafarge Canada Inc.*, 2004 CarswellOnt 1511 (Sup. Ct.).

IMPORTANT NOTICE: Your insurance company does not have enough information to make a decision whether or not the loss or occurrence you have reported to it is covered under the insurance policy. The purpose of having you sign this form is to allow the insurance company to continue investigating the loss or occurrence, to make investigations about your coverage under the policy, and to settle and pay any claims against you without giving up its rights to deny that the occurrence or loss is covered under the policy once its investigations are completed. You are not giving up your rights under the policy by signing this form. If the insurance company determines that there is no coverage for the occurrence or loss, it can require you to repay the amount of any settlement or judgment it has paid on your behalf, plus its costs of handling and defending any claim against you.

NON WAIVER AGREEMENT

IN THE MATTER OF .....
(Describe Nature of Claim or Loss)

which is reported to have occurred on or about the.....

day of ..... 20 ..... at or near .....
(Place of Occurrence)

involving the undersigned..... .....

and claim made by .....

AND IN THE MATTER OF a Policy of Insurance No. .....

issued by ...., hereinafter called the Insurer, under which policy the Insured alleges the insured has coverage, which the insurer does not admit, and whereas the Insurer requires further information to determine if the Insured is entitled to coverage under the policy, whether for defence or indemnity.

The undersigned hereby covenants and agrees with the Insurer, as follows:-

1. The Insurer may make such investigations of the loss or occurrence and claims arising there from as it deems necessary. In the event that issues relating to coverage arise as a result of such investigation, the Insurer will not be estopped from relying on such facts to make a decision on the coverage available to the insured under the terms and conditions of the Policy.

2. The Insurer may appear and defend all actions arising from the occurrence in the name of the undersigned.

3. The Insurer may carry on negotiations toward possible settlement in respect of claims or actions arising from the loss or occurrence without Judgement against the undersigned or without the further consent of the undersigned.

4. The Insurer may negotiate, settle and pay any claims arising from the occurrence or loss without a Judgement having been obtained against the undersigned. The undersigned realizes that this means that he has made himself liable to the Insurer to the extent of the payment made by the Insurer under the policy should the undersigned be found in breach of the policy.

5. Any action taken by the Insurer shall be without prejudice to the respective rights of the Insurer and the undersigned under the designated policy of insurance.

6. In the event of any proceedings between the Insurer and the undersigned to recover the amount of any settlement paid by the Insurer, the undersigned will not plead nor contend (a) that the Insurer has waived any of its rights under the policy by investigation of the occurrence or loss, by defending any action or by negotiating any settlement in respect of the occurrence or loss nor (b) that the settlement was made without a judgement having been obtained against the undersigned.

SIGNED AT: .... this .....

day of ....
(Year)

In the presence of:

..... **.....SEAL**
Witness (Include name of Organization and Title of Person signing if the named insured is not an individual)

..... **.....SEAL**
Witness