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ALLOCATION OF DEFENCE COSTS UNDER CGL POLICIES: EMERGING ISSUES

The test to determine whether there will be an allocation of defence costs between an insured and insurer for the cost of covered and uncovered claims and/or insureds in Ontario prior to the ultimate disposition of the action is for the insurer to propose an equitable formula for the allocation of defence costs. This test was enunciated in **St. Paul Fire & Marine Insurance Co. v. Durabla Canada Ltd.** (1996) 137 D.L.R. (4th) 126 (Ont. C.A.), where several claims were advanced against the insured due to exposure of third parties to asbestos fibres manufactured by an insured who did not have insurance coverage throughout the entire period of the claims. The Court agreed that, in these circumstances, it would be fair that the insured make some contribution to the costs of the defence. However, the Court went on to state:

> We do not find ourselves in a position to articulate an equitable formula for such proration at this stage of the proceedings. The impediments to a formulation that would fairly reflect the competing interests of the insurer and the insured at this stage of the proceeding are the imprecision of the allegations asserted by the claimant in the underlying actions and the absence of any firm factual foundation for whatever proration formula might be selected.

The Court concluded that the insurer alone would bear the defence costs, but that the insurer could come back to the Court after the ultimate disposition of the underlying action to seek a reapportionment of defence costs.

In **Daher v. Economical Mutual Insurance Company** (1996) 31 O.R. (3d) 472 (Ont. C.A.), the insurer took the position that the defence costs should be apportioned between the insured and the insurer since the principal claim being

'DEFENCE COSTS' CONTINUED AT PAGE 3

ARE COVERAGE LEGAL OPINIONS PROTECTED BY PRIVILEGE IN BAD FAITH CLAIMS?

Insurers have long believed that legal opinions from their lawyers are privileged. Recent Ontario Superior Court decisions have given insurers good reason to question this in the context of bad faith claims.

Generally, direct communications between solicitor and client are forever privileged, even when the litigation giving rise to the communication is long over. Generally, the only exception to this is if the client, by his words or conduct, waives the privilege.

In the case of **Samoila v. Prudential of America General Insurance Co. (Canada)** (2000), 50 O.R. (3d) 65, Justice Brockenshire ordered the disclosure of legal opinions obtained by the insurer from its counsel. The insured had been injured in a motor vehicle accident. The insurer paid long-term sickness and accident benefits for five years, at which point, it terminated the payments and sued the insured for recovery of all benefits paid out on the basis of fraud on the part of the insured. The insured counter-claimed for the value of the benefits denied him and for damages based on bad faith.

After examinations for discovery, the insurer withdrew its allegations of fraud and re-instated the benefit payments. The action continued solely on the bad faith claim. The insured sought the production of any legal opinions obtained by the insurer that related to the decision to deny coverage.

At the insurer's examination for discovery, questions were asked about whether the insurer had obtained a legal opinion on the issue of fraud before deciding to deny coverage and whether a reasonable insurer would obtain such an opinion before deciding to deny coverage. The representative of the insurer stated that he did not know whether the insurer in

'LEGAL OPINIONS' CONTINUED AT PAGE 2

INSURANCE OBSERVER

'LEGAL OPINIONS' CONTINUED FROM PAGE 1

this case had obtained a legal opinion before making the decision to deny coverage, but stated that, in his view, an insurer, at a minimum, should obtain such an opinion before denying coverage.

The Court held that these admissions made on discovery amounted to a waiver of solicitor-client privilege because they had put the insurer's state of mind with respect to the decision to deny coverage in issue.

The apparent effect of the decision is that when an insurer denies coverage and admits it obtained or should have obtained a legal opinion before doing so, the insurer is putting its state of mind in issue and is therefore waiving solicitor-client privilege with respect to legal opinions relied on to deny coverage.

The question to ask is whether there really has been waiver in such a case. There is nothing in the decision to indicate that the insurer had affirmatively pleaded as a defence to the allegation of bad faith, the fact that it took the prudent step of obtaining a legal opinion upon which it relied in good faith. Such a defence would clearly have put the insurer's state of mind in issue and would have amounted to a waiver of the solicitor-client privilege.

Furthermore, from the transcript of the examination reproduced in the case, it is clear that the representative of the insurer did not know whether an opinion had actually been obtained. As such, there was no evidence that a legal opinion had ever influenced the insurer's state of mind. At most, there was only evidence that, in deciding to deny coverage, the insurer should have turned its mind to obtaining a legal opinion.

In the more recent case of **Davies v. American Home Assurance Co.** [2001] O.J. No. 677 (S.C.J.), Justice Kiteley went even further than her colleague Justice Brockenshire. Her Honour ordered the legal opinion obtained by American Home be disclosed merely on the basis of the plaintiff's allegations of bad faith in the Statement of Claim. Her Honour did consider whether the defendant had put its state of mind in issue as a basis for her decision and eventually avoided the question of whether there was waiver.

These decisions should be read in light of appellate decisions which have clearly supported solicitor and client privilege. The Supreme Court of Canada has recently commented that "solicitor-client privilege must be as close as possible to absolute to ensure public confidence and relevance" because it is a "principle of fundamental justice" which, if eroded, would have the potential of stifling communications between the lawyer and client. How the **Samoila**, **Davies**, and similar cases will be reconciled with these statements at the appellate level remains to be seen.

The whole area of privilege is a difficult one, particularly in the context of bad faith claims. Insurers and their counsel should therefore make certain in these cases to carefully assess both the pleadings and examination for discovery questions in advance and to respond effectively.

Failing to obtain coverage opinions is a dangerous alternative as the standard of care to be met by an insurer may well require an insurer to obtain such an opinion, at least where there is a question of law.

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INSURANCE OBSERVER

'DEFENCE COSTS' CONTINUED FROM PAGE 1

advanced against the insured was not covered by its policy. The court acknowledged that it may be possible to apportion defence costs where there are multiple causes of action, but this was not one of those cases. The Court found that there was "[n]o firm factual foundation for any proration formula." The suggestion was made that an assessment officer could deal with the allocation, but the Court could find no basis to guide the officer. Therefore, the court held that the insurer was obligated to pay all of the defence costs.

In **Continental Insurance Co. v. Dia Met Minerals Ltd.** (1996) 20 B.C.L.R. (3d) 331 (B.C.C.A.), the action settled before reaching the Court of Appeal. The issue on appeal was the allocation of defence costs. The Court ordered that the insured provide the insurer with all information which the insurer may require to determine what portion of the defence costs were covered. The issue would then be referred back to the court for trial or for a hearing before the registrar. In separate reasons, McEachern (C.J.B.C.), concurring with the majority, stated that if the action had not settled, "the insurer could be required to make interim payment if the costs of defending insured claims could be identified." However, Justice McEachem made it clear he was not deciding that issue.

The allocation of defence costs was once again before the British Columbia Court of Appeal in **Coronation Insurance Co. v. Clearly Canadian Beverage Corp**. (1999) 168 D.L.R. (4th) 366. In that case, the Court considered whether there should be an allocation of defence costs and settlement funds between the directors and officers and the corporation. Allocation was sought on the theory that the corporation would receive a windfall in having all of its defence costs and settlement funds paid simply because the directors and officers were sued along with the corporation.

The Court reviewed a number of cases and concluded that there was no basis in law for applying the principle of restitution between an insurer and an insured, although this principle was applicable between multiple insurers. Nonetheless, the Court ruled that apportionment on the basis of the larger settlement rule should take place. In this regard, the Court stated as follows: "That at least where the insurer does not have conduct of the defence, costs incurred to defend a covered claim are properly segregated from those incurred in respect of non-covered claims." The matter was referred to the trial judge to determine whether the settlement of the underlying action was increased by the joinder of the corporation as a defendant.

The Courts have left open the door for allocation of defence costs between covered and uncovered insureds. In **Godonoaga (Litigation Guardian of) v. Khatambakhsh** (2000) 50 O.R. (3d) 417 (Ont. C.A.), the Court held that some of the insureds were covered under the policy and entitled to a defence, while others were not. All the insureds had retained the same counsel. The Court ultimately declined to allocate defence costs between the covered and non-covered insureds. As a result, the insurer was required to pay all of the defence costs incurred by both covered and non-covered insureds. The Court declined to allocate defence costs as it would require an audit, which the Court stated would not result in any significant savings to the insurer. The Court did not explain what formula it used to determine that there would be no significant saving to the insurer.

Courts routinely apportion liability in multi-party tort cases as well as costs at trial and on appeal. In so doing, Courts have not required formulas. Several directors' and officers' policies contain criteria for allocation of defence costs, such as financial exposure and legal benefit. However, CGL policies are silent. Underwriters should consider this issue and decide whether they should insert such clauses into their policies.

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INSURANCE OBSERVER

******Dicta*, a regular opinion column featuring personal views on broader legal issues of interest, will not be published in the Summer issue of Insurance Observer. *Dicta* will return in the Fall issue.

DIVISIONAL COURT: NO SUBROGATION BY SAB INSURERS

On May 1, 2001, the Divisional Court released its decision in **Wawanesa v. The Queen**. The Court, in a split decision, ruled that automobile insurers cannot bring subrogated actions to recover the statutory accident benefit payments they make to their insureds following motor vehicle accidents.

In the lower court decision, Kozak J. ruled that automobile insurers were entitled to recover the statutory accident benefits they paid to motor vehicle accident victims from anyone who was not insured under a motor vehicle liability policy issued in Ontario. Subsection 267.8(17) of the **Insurance Act** specifically strips automobile insurers of these rights of subrogation. However, Kozak J. concluded that another provision, which was intended to allow OHIP to subrogate, could be interpreted to permit subrogation by statutory accident benefits insurers.

Until this decision was released, there had never been a reported Ontario decision allowing an automobile insurer to subrogate for repayment of accident benefits. Suddenly, insurers of municipalities, which are often sued for non-repair, automobile manufacturers, which are sued for faulty design, and taverns and restaurants, which are sued for host liability, were facing millions of dollars of claims which had never been contemplated when their policies were underwritten. If it stood, this decision would have allowed automobile insurers, which priced the cost of statutory accident benefits into their rates, to transfer the burden of such benefits to insurers which had never contemplated this risk. As the Divisional Court commented: "The ruling under appeal would result in a dramatic change in the insurance industry if it stands."

Following the release of Kozak J.'s decision, a number of automobile insurers commenced or threatened to commence similar subrogated actions. Many of those actions were put on hold pending the result of this appeal.

At the Divisional Court, Ferguson J., for the majority, concluded that the provisions in the **Insurance Act**, which prohibited such subrogation, were not ambiguous and could not be interpreted in the manner suggested by Kozak J. It is not known whether the plaintiff will seek leave to appeal this decision to the Court of Appeal.

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Editor's Note:
Mr. Stephen Moore successfully argued this appeal before the Divisional Court on behalf of Her Majesty the Queen. If you have any questions about this case or require a copy of it, please feel free to contact Stephen.

Insurance Observer is a publication of the Insurance Law Group of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

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