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PREVENTATIVE PAPERWORK: NON-WAIVER AGREEMENTS, RESERVATION OF RIGHTS LETTERS AND THE DEFENCE OF CLAIMS IN QUESTIONABLE COVERAGE SITUATIONS

by

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INTRODUCTION

It is impossible to catalogue every ground upon which an insurer might be able to successfully void a policy or to otherwise deny liability or coverage under the policy. General categorization might be made as follows:

- breaches of the terms and conditions of the policy;
- misrepresentations or failure to disclose material information;
- claims or losses being of the type either excluded from or not falling within the scope of coverage afforded by the policy; and
- the accrual of a limitation period.

When confronted with grounds for denying coverage, the insurer must elect between denial and affirmation. If affirmation occurs, either expressly or impliedly, then in most cases the insurer will either be deemed to have "*waived*" its entitlement to deny coverage or, alternatively may otherwise be *estopped* from asserting a denial. The execution of a Non-Waiver Agreement or the issuance of a Reservation of Rights letter by the insurer is designed to avoid some of the pitfalls of waiver and estoppel. Even assuming any such agreement is enforceable (and in many cases it may not be) the conflict of interest respecting the coverage issue can create ethical traps for unwary counsel retained to defend the liability claim.

This paper addresses the preventative paperwork necessary for the insurer to avoid waiver and estoppel, together with the impact of the coverage dispute on both the liability insurer's duty to defend and the role of counsel in that regard.

THE DOCTRINES OF WAIVER AND ESTOPPEL

Whole books have been written on the law of estoppel. Similarly, the doctrine of waiver has received much attention from academic observers. No detailed analysis of the law in this regard is necessary for the purposes of this paper. While there is a difference between waiver and estoppel, they are brother and sister in the same family. The broad equitable principle unifying both doctrines is that the insurer must have affirmed the contract (and hence coverage) by its words or conduct in circumstances making it unfair or unjust for the insurer to later deny coverage.

The doctrine of waiver has been well defined in *Mitchell & Jewell Ltd. v. Canadian Pacific Express Co.* (1974) 44 D.L.R. (3d) 603 at p. 612, [1974] 3 W.W.R. 259 (Alta. C.A.), as follows:

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> ... waiver... arises where 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 a 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.

One of the better definitions of estoppel, on the other hand, can be found in the British Columbia Court of Appeal decision of *Ashe Trucking Ltd. v. Dominion Insurance Corp.* (1966) 56 D.L.R. (2d) 730, [1966] 55 W.W.R. 321, which specified the following requirements:

1. a representation or conduct amounting to a representation made by the defendant;

2. which was intended to induce the plaintiff to act upon it; combined with

3. actual reliance by the plaintiff upon the representation to his detriment.

The representation may be express, i.e. oral or written, or it may be implied by conduct. Indeed, in certain circumstances even silence or inaction may amount to a representation of the sort forming the basis for estoppel.

THE RELEVANT *INSURANCE ACT* PROVISIONS

Not surprisingly, there are some provisions in the Insurance legislation across the country that specifically address the question of waiver. Obviously, if the insurance contract is made in another province, eg. an auto policy in Alberta, then the legislation in that other province (i.e. Alberta in that example) would most likely apply to any contractual dispute between the insurer and the insured. When dealing with an out-of-province policy, insured and/or coverage dispute, it would be prudent for the insurer's counsel to seek clarification respecting any unique, out-of-province statutory provisions that might apply.

In British Columbia reference should be made to section 11 of the *Insurance Act*, R.S.B.C. 1996, c. 226 which reads as follows:

> Waiver of Term or Condition
>
> 11(1) A term or condition of a contract is not deemed to be waived by the insurer in whole or in part unless the waiver is stated in writing and signed by a person authorized for that purpose by the insurer.
>
> (2) Neither the insurer nor the insured are deemed to have waived any term or condition of a contract by any act relating to the appraisal of the amount of loss or to the delivery and completion of proofs or to the investigation or adjustment of any claim under the contract.

Although at first blush the provision seems far-reaching, it may only be of limited consequence. Firstly, it refers only to *"terms or conditions of the contract"*, i.e. it may not apply to common law or other remedies outside the specific contractual terms and which might otherwise be available to the insurer. Secondly, it makes no reference whatsoever to estoppel, the application of which to prevent denials of coverage is very broad: *MacKenzie v. Jevco*

Insurance Management Inc. (1986) 9 B.C.L.R. (2d) 127, [1987] I.L.R. ♦1-2157, 28 C.C.L.I. 358 (B.C.S.C.), affd. 24 B.C.L.R. (2d) 360, [1988] I.L.R. ♦1-2346, 32 C.C.L.I. 78 (C.A.). As well, it is entirely possible for the insurer to in effect "waive" the waiver-restricting provision itself. Lastly, of course, the requirement of "writing" can be very liberally construed and would no doubt include correspondence from insurers, adjusters, solicitors and the like.

CONDUCT AMOUNTING TO WAIVER OR ESTOPPEL

The type of conduct which may give rise to waiver or estoppel is limited only by the imagination of insureds seeking to bring themselves within coverage. It includes almost any action by or on behalf of the insurer that is arguably consistent with coverage being in place. A partial list of such conduct in both first or third party contexts and after the discovery of the grounds for denial includes:

- continued investigation of the claim;
- express acknowledgements that coverage is in order;
- cancelling the policy instead of voiding the same and returning premiums;
- conducting settlement negotiations;
- invoking policy provisions, i.e. appraisals, exercising the right to repair etc.;
- acceptance of late premiums or renewal of the policy;
- making payments to or in respect of the insured, the third party, the claims etc.; and
- defending the action against the insured, and so on.

The Courts sometimes go to extraordinary lengths to find coverage and, in cases of estoppel, will not hesitate to presume representations, reliance and prejudice of the sort necessary to establish estoppel. One striking example is *Rosenblood Estate v. Law Society of Upper Canada* (1989) 37 C.C.L.I. 142 (Ont. H.C.), affd. 16 C.C.L.I. (2d) 226 (Ont.C.A.), where the insurers denied liability on the grounds that the lawyer's conduct was dishonest, that he had failed to give notice of the potential claim within the reasonable time required by the policy and that the estate had settled the claim without its consent. The Court made a finding of fact that the lawyer's actions were indeed dishonest and that he had also breached the policy requirements respecting notice. However, the Court held that the insurer was estopped from denying coverage because, notwithstanding their knowledge of the exclusions' applicability, the insurer continued to defend the action against the insured and conducted both examination for discovery and settlement negotiations all before notifying the insured of the coverage problems. R.E. Holland, J. commented (at pp.156-7 C.C.L.I.):

> If the estate had been advised of an off-coverage position earlier the defence could well have been conducted differently. Settlement negotiations could have been conducted earlier and interest claims accordingly reduced....It is not possible to point to actual prejudice but in the circumstances

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> of this case where the insurer persisted in the defence through production and discovery into settlement negotiations, prejudice must be presumed.

He then went on to advise insurers and adjusters alike (p.157 C.C.L.I.):

> When a claim is presented to an insurer, the facts giving rise to the claim should be investigated. If there is no coverage then the insured should be told at once and the insurer should have nothing further to do with the claim if it wishes to maintain its off-coverage position. If coverage is questionable the insurer should advise the insured at once and in the absence of a non-waiver agreement or of an adequate reservation of rights letter, it [investigates, adjusts and] defends the claim at its risk. [The words in parenthesis are the author's]

See also: *Snair v. Halifax* (1995) 31 C.C.L.I. (2d) 279 (N.S.S.C.). But exactly how quickly is "at once"? The answer seems to be "as soon as there is any basis for questioning coverage". *Wawanesa Mutual Insurance Co. v. Buchanan* (1976) 14 O.R. (2d) 644, 74 D.L.R. (3d) 330 (Ont. Co. Ct.) provides a useful illustration. In that case, the insurer denied coverage for breach of the statutory condition respecting drunk driving. After settling the underlying tort claim, the insurer sought reimbursement from its insured relying on the standard form Non-Waiver Agreement signed by the latter.

The insured's agent had reported the claim to the insurer and had advised that the insured had been charged with impaired driving and refusing to blow. The adjuster interviewed the insured and advised that the involvement of alcohol could have a bearing on the outcome of his claim. The conversation with the insured was reduced to writing and the insured was also given a blank Non-Waiver Agreement. The adjuster explained that the agreement permitted the insurer to investigate, defend and settle the claim without prejudice to the issue of the policy violation. The adjuster said the insured appeared to understand the purpose of the Non-Waiver Agreement including the fact that the agreement might require reimbursement to the insurer of any settlement ultimately made. However, the Court ruled that the Non-Waiver Agreement was not enforceable and that the insurer was estopped from taking an off-coverage position. It commented (at p.342 D.L.R.):

> ...when the [insurer] through its [adjuster] became aware of a probable breach of a statutory condition of the policy, then at that moment there is a conflict position between the insured and the [insurer]. [In such circumstances] the insurer cannot go further in the defence of the action without a non-waiver.... having knowledge that liquor was involved and that there may be a statutory violation, the insurer must make it known to the insured that there is the possible conflict position between them [and the non-waiver agreement must be signed *before* interviewing the insured].
>
> ... [this] procedure... arises because there is in fact a special relationship between the insured and the insurer or its agents, which requires an exceptional degree of trustworthiness and honesty. The insurer [cannot], under the guise of representing the insured's interest, attend upon him and obtain from him information which is solely for benefit of the company without first advising him of the conflict.

The dilemma facing the adjuster in *Buchanan*, *supra*, also faces the solicitor encountering a deadline for filing an appearance in the tort action against the insured. In *Rowe v. Mills* (1986) 72 N.B.R. (2d) 344, [1986] I.L.R. ¸ 1-2116, 21 C.C.L.I. 112 (Q.B.), leave to appeal to N.B.C.A. refused, the snowmobile accident occurred on February 27th. No notice of the accident was given to the insurer until the lawsuit was commenced one month later. The insurers

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appointed an adjuster who investigated the accident and a lawyer who filed a notice of intention to defend. Approximately one month later the adjuster met with the defendant and was shortly thereafter advised that he might be in breach of the policy for late reporting. The insured then signed a Non-Waiver Agreement and a week or so later the insurer took the position that the insured was indeed in breach. The lawyer therefore made application to be removed as solicitor for the record and for the insurer to be added as a third party in the tort action pursuant to the New Brunswick *Insurance Act*. The Court refused the application and required the insurer to continue with the defence of the insured. The Court commented (at pp.8194-5 I.L.R.):

> As a general principle, an insurer may waive [breach of the policy] if it adopts a course of conduct which is consistent with the policy being in full force and effect.
>
> . . . . .
>
> The contract is one that calls for the utmost good faith on both sides. The date of the accident was clearly alleged in the plaintiff's statement of claim. Whether or not it addressed its mind to the matter the insurer must, or should have known, that the accident had not been reported to it....
>
> If counsel had merely entered the appearance and written advising the insured that it was investigating the possible breach and was reserving their rights in the meantime, I would have no difficulty in holding the insurer acted properly. Undoubtedly an insurer in such circumstances would be allowed some time to check the question of possible breach....
>
> [However] I do not believe the insurer is entitled to investigate the facts surrounding the accident and to conduct an investigation as to whether there exists proper grounds for repudiation of the contract at the same time....
>
> If the insurer is allowed to conduct both investigations simultaneously, the insurer is open to the charge that it is wearing two hats and will determine whether or not it has a better defence to the action as defendant or to claim repudiation and defend a possible claim by its insurer for breach of contract.

NON-WAIVER AGREEMENTS AND RESERVATION OF RIGHTS LETTERS

The execution of a Non-Waiver Agreement or the issuance of a Reservation of Rights letter is obviously designed to avoid some of the pitfalls of waiver and estoppel more particularly described above. There is, of course, a significant difference between the two; the Reservation of Rights letter amounts to a *unilateral* declaration by the insurer and, depending upon the circumstances of the case, may not necessarily be effective to preserve rights of coverage denial or recovery against the insured: see for example, *Allstate Ins. v. Foster* (1971) 24 D.L.R. (3d) 9, [1972] 1 O.R. 653, [1972] I.L.R.; ♦1-470 (Co. Ct.), [1972] I.L.R. 1-470 (Ont. Co. Ct.). On the other hand, the Non-Waiver Agreement theoretically represents an acknowledgement *by the insured* that the insurer's rights of denial in the future have been preserved.

Both communications have a common purpose, namely, to communicate the coverage problem to the insured and to eliminate arguments of waiver or estoppel as means of avoiding a denial of coverage at a later date.

Needless to say, the Reservation of Rights letter will have to be tailored to the peculiar facts of each case. It must be made perfectly clear that the insurer is not admitting any

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obligations under the policy and is reserving all rights to deny coverage under the same should that be necessary or appropriate in the future: *Hersh v. Wawanesa Mutual Insurance* (1994) 89 B.C.L.R. (2d) 225, [1994] I.L.R. ♦1-3071, 22 C.C.L.I. 242 (S.C.) (B.C.S.C.). A sample of an effective Reservation of Rights letter issued by an adjuster is attached as Appendix A to this paper.

As with almost any type of a contract, there is no particular form required for a Non-Waiver Agreement although, of course, standard form *"Non-Waiver Agreement"* (IBC Claim Form No. 6, two versions), *"Consent to Settlement"* (IBC Claim Form No. 6A) and *"Agreement by Insured to Reimburse Insurer and Authorizing the Insurer to Settle"* (IBC Claim Form No. 6B) have been issued to the industry. Copies of these documents are attached as Appendices to this paper.

A Non-Waiver Agreement can be entirely verbal (although this is most unwise) or constituted by an exchange of correspondence. Furthermore, as with any contract, the exact terms of the Non-Waiver Agreement can be negotiated between the parties. From the insurer's perspective, however, the best form of Non-Waiver Agreement would meet the following minimum standards:

- it would be written in clear language and properly signed by the insured (this facilitates proof of the agreement and its terms in the event a dispute arises);

- it would properly identify and refer to the policy, the insurer, the insured and the incidents/circumstances giving rise to the claim;

- it should contain an acknowledgment by the insured of the potential coverage problem necessitating the execution of a Non-Waiver Agreement along with an acknowledgment that the insurer may later deny coverage and/or seek to recover back any monies paid pursuant to the policy, any settlement or judgment, etc.;

- it should contain a request or at least a consent by the insured that the insurer and their representatives (adjusters, lawyers, etc.) at the latter's sole discretion, investigate, negotiate, settle and/or defend all claims or actions arising from the loss without any waiver or estoppel respecting the coverage issue being thereby created;

- in motor vehicle accident cases involving out-of-province insurers, the agreement should contain an acknowledgment that any settlement of third party claims shall be deemed to be and will be treated in all respects as though it were a judgment against the insured of the sort contemplated by the particular province's legislation, e.g. section 320(1) of Alberta's *Insurance Act*;

- it would also contain an agreement by the insured that in any proceedings between the insurer and the insured to recover the monies referred to above, the insured will neither plead nor contend any waiver or estoppel on the part of the insurer; and

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- it would impose an obligation upon the insured to repay all amounts paid by the insurer respecting claims, settlements or judgments in the event the insurer establishes that the policy affords no coverage in the circumstances (by virtue of policy breaches, exclusions or other circumstances disentitling the insured to claim indemnity under the same).

It can be said that the standard form Non-Waiver Agreement issued by the Insurance Bureau of Canada (IBC Claim Form No. 6) is inadequate in several respects. Firstly and most importantly, it is geared primarily towards policy breaches (of auto policies). It does *not* properly address the reservation of rights in situations where misrepresentation would otherwise entitle the insurer to void the policy and, indeed, the taking of such agreement might arguably constitute affirmation of coverage in such situations (since the agreement purports to reserve rights "*under the designated policy of insurance*", i.e. it arguably recognizes that a policy is in place). Further, the agreement in no way identifies the nature of the coverage problem thereby undermining its effectiveness as a defence to an estoppel argument. Lastly, it imposes no express obligation on the insured to repay claims expenses, settlements, judgments or other payments made by the insurer should the denial of coverage ultimately be sustained.

It will also be noticed that the IBC Form of Non-Waiver Agreement does not expressly state the consideration being exchanged between the parties as the basis of the contract. Arguably, if there is no valid consideration exchanged, then the agreement might be unenforceable. Of course, even if it was unenforceable as a contract, it would nevertheless remain compelling evidence undermining any assertions of representations or reliance of the sort required to found an estoppel. However, if counsel is drafting a unique Non-Waiver Agreement as opposed to relying on the standard IBC Form, it might be prudent to specifically insert provisions identifying the consideration being exchanged between the parties.

The writer has attempted to draft a general *Non-Waiver and Reservation of Rights Agreement* which addresses some of the above perceived deficiencies. A copy is attached as an Appendix to this paper. Although the form is considerably more complicated than the standard IBC Form, it has been used in many different cases to date, thus far without difficulty. Needless to say, the terms of the attached agreement can be revised or deleted in order to address the requirements of any specific factual situation.

OTHER ENFORCEABILITY CONSIDERATIONS

As with any contract, there are certain conditions which must be met for the Non-Waiver Agreement to be enforceable including the requirements that the insured not be under any legal disability, that there be no misrepresentations respecting the purpose or effect of the agreement and that it be executed without undue duress. Consequently, the agreement must be fully and properly explained to the insured and, indeed, it might be wise to invite the insured to obtain independent legal advice. For an example of a Non-Waiver Agreement which was unenforceable because of misrepresentation as to its effect, see *Halifax Ins. Co. v. Williams* (1966) 58 D.L.R. (2d) 86 (B.C. Co. Ct.) where the document was presented simply as a "formality to investigate the claim".

Obviously, the Non-Waiver Agreement can only be effective as against the signing parties. Accordingly, if there is more than one potential insured to whom coverage will be denied (i.e. multiple insureds, unnamed insureds, employees, etc.), then all should be made party to the agreement in the appropriate circumstances.

The adjuster securing the Non-Waiver Agreement should ensure the document is properly completed and should make careful notes of the circumstances. In *Zurich Insurance v. Crawford* [1993] O.J. No. 966 (Gen. Div.), the Court was reluctant to enforce a Non-Waiver Agreement which was not properly dated and where the insureds' signatures had not been formally witnessed. No evidence was put before the Court respecting the explanation of the agreement given to the insured. The Court commented that the document "has the appearance of being signed by persons who did not understand its implications" and suggested it was "in no position to judge [whether] the Non-Waiver Agreement may or may not be defective".

As well, it should be recognized that, regardless of the wording found in the documents, the Non-Waiver Agreement or Reservation of Rights letter might only maintain the status quo at the time of its execution. Subsequent breaches or the later discovery of additional grounds for denying coverage might not be "caught" by the earlier agreement/letter. Indeed, subsequent contact by either party might amount to a repudiation of the agreement or might itself constitute a "waiver" of the Non-Waiver Agreement/Reservation of Rights letter; an example of this is *Federal Insurance Company v. Mathews* [1956] 18 W.W.R. 193 (B.C.S.C.) where the Court ruled that the taking of a Non-Waiver Agreement merely permitted the insurer to *postpone* its decision respecting coverage. There it was determined that the Non-Waiver Agreement ceased to operate once the insurer commenced proceedings against the insured for a non-coverage declaration. Another example is *P.C.S. Investments Ltd. v. Dominion of Canada General Insurance Co.* (1994) 153 A.R. 187, 18 Alta. L.R. (3d) 270, 25 C.C.L.I. (2d) 119 (Q.B.), revd. on appeal 34 C.C.L.I. (2d) 113 (Alta. C.A.). At trial the Court held that the execution of a Non-Waiver Agreement during the investigation stage did *not* entitle the insurer to "sit on its right to defend"; there, the subsequent refusal to defend (on the basis the claims were outside coverage) constituted a waiver of the Non-Waiver Agreement and an effective repudiation (breach) of the insurance contract itself. However, on appeal the Court held that the insurer had a right under the policy to name its own counsel to participate in the defence and that this right had not been lost by the insurer's refusal to defend. That was not a "repudiation" that would justify a Court in refusing to enforce the other terms of the contract.

PROCEDURAL OPTIONS IF THE INSURED REFUSES TO COOPERATE

Sometimes, of course, the insured will refuse to sign the proposed Non-Waiver Agreement, usually on the advice of legal counsel. From a practical perspective, this is often wise counsel; if the insurer proceeds to handle the claim in the absence of the Non-Waiver Agreement, then it may well have affirmed coverage. If, on the other hand, the insurer indicates it will proceed with an outright denial, the insured can always change his mind and offer to sign the Non-Waiver Agreement at that time (counsel for the insured might term this the "why not give it a try" approach).

If the insured does refuse to sign the proposed Non-Waiver Agreement, then the insurer is put to its election to affirm or deny coverage, at least insofar as coverage denials for

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breach of policy conditions and misrepresentations are concerned. In situations where by virtue of wording, exclusions or otherwise, the policy might not actually afford coverage for the type or part of the claim being presented, an appropriate Reservation of Rights letter should be issued. In cases of outright denial, however, there are several alternative procedural options available to the insurer.

If the insurer denies coverage, the insured may well institute third party proceedings against the insurer in the tort litigation. In such circumstances, the insurer can file a defence to the plaintiff's claim pursuant to Rule 22(8) of the B.C. Rules of Court. Such a defence does *not* give rise to any estoppel respecting the denial of coverage between the insurer and the insured: *Mackenzie v. Jevco, supra* (C.A.).

Of course, the insured might not always "cooperate" by naming the insurer as a third party. In such circumstances, where the insurer is concerned that the underlying tort action might not be adequately defended, it can apply pursuant to Rule 15(5)(a)(ii) and (iii) to be added as a defendant in the tort proceedings in addition to its own insured. This approach was specifically endorsed by Mr. Justice Lambert of the B.C.C.A. in *Starr Schein Enterprises v. Gestas Corporation* (1987) 38 D.L.R. (4th) 593, 13 B.C.L.R. (2d) 85, [1987] 4 W.W.R. 664, and was the approach adopted by the insurer in the case of *Bryant v. Korres Moving & Transfer Ltd.*, unreported, file No. C890717 (September 13, 1989, B.C.S.C.). In *Bryant* goods owned by a customer were stored in a warehouse owned by the insured moving company. They were destroyed by fire and an action was brought alleging bailment, and in the alternative, a covenant to insure the goods. The policy provided coverage for negligence only and the insurer provided a defence solely for that claim. The insurer therefore appointed separate counsel and applied to add itself as a defendant in order to be free to defend the claim in its entirety or, if necessary, to insure a finding that was outside coverage.

In auto cases involving out-of-province insurers, it should be remembered that a denial by reason of a breach or misrepresentation would entitle the auto insurer to be made a third party in any underlying tort litigation against the insured pursuant to section 161 of the British Columbia's *Insurance Act*. Resort should be had to this process in appropriate cases.

QUESTIONABLE COVERAGE SITUATIONS AND THE DUTY TO DEFEND

The obligation to defend lawsuits against the insured is imported by a provision in liability policies commonly worded as follows:

> As respects insurance afforded by this policy, the insurer shall:
>
> (1) defend in the name and on behalf of the insured and at the cost of the insurer any civil action which may at any time be brought against the insured on account of such bodily injury or property damages ....

There have been quite a number of recent cases commenting on the insurer's duty to defend. Most of the pertinent case law respecting that duty is very usefully summarized in *Privest Properties Ltd. v. Foundation Co. of Canada Ltd.* (1991) 57 B.C.L.R. (2d) 88, at pp. 94-6, 6 C.C.L.I. (2d) 23 (S.C.), where Mr. Justice Drost had this to say:

Foundation initially argued that an insurer is obliged to defend its insured if there is simply a *mere possibility* that one or more of the claims advanced against its insured would fall within the terms of the insurance policy.

That proposition was vigorously opposed by each of the third party insurers.

An analysis of the law regarding the duty of an insurer to undertake the defence of a claim against its insured begins with the decision of Wallace J. (as he then was) in *Bacon v. McBride* (1984) 51 B.C.L.R. 228, 5 C.C.L.I. 146, [1984] I.L.R. 1-1776, 6 D.L.R. (4th) 96 (S.C.). There the procedure for determining whether or not such a duty exists was described in the following words [p.232]:

> The pleadings govern the duty to defend - not the insurer's view of the validity or nature of the claim or of the possible outcome of the litigation. If the claim alleges a state of facts which, if proven, *would fall* within the coverage of the policy, the insurer is obliged to defend the suit regardless of the truth or falsity of such allegations. If the allegations do not come within the policy coverage the insurer has no such obligation.... (my emphasis)

That test has been adopted in many subsequent decisions of this court including that of *Shragie v. Tanemura* (1987) 22 B.C.L.R. (2d) 64, [1988] I.L.R. 1-2278 in which Ruttan J. observed that [p.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 within 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.

In *Opron Maritimes Construction Ltd. v. Canadian Indemnity Co.* (1986) 21 C.L.R. 113, 19 C.C.L.I. 168, [1986] I.L.R. 1-2108, (N.B.C.A.), leave to appeal to the S.C.C. refused (1987), 21 C.C.L.I. xxxv, the New Brunswick Court of Appeal referred with approval to the test laid down in *Bacon v. McBride* and stated that [p.173]:

> While the insurers' obligation to defend is separate from its duty to indemnify, there is no duty on it to defend an action against its insured if there is clearly no liability to indemnify under the policy. The pleadings must be examined to see if they disclose facts or contain allegations which [*would bring*] the incident within the terms of the indemnity provisions of the policy. If, of course, the claim against the insured is not related to a subject matter covered by the policy, there is no obligation on the insurer to defend. Any doubt as to whether the pleadings [would] bring the incident within the coverage of the policy ought to be resolved in favour of the insured. (my emphasis)

In *Nichols v. American Home Assurance Co.* [1990] 1 S.C.R. 801, 45 C.C.L.I. 153, [1990] I.L.R. 1-2583, 68 D.L.R. (4th) 321, 39 O.A.C. 63, 107 N.R. 321, the Supreme Court of Canada approved the test laid down in *Bacon v. McBride* and *Opron*.

In writing for the court, Madam Justice McLachlin observed that [pp.325 and 327]:

> ... the duty to defend arises where the claim *alleges* acts or omissions falling within the policy coverage, while the duty to indemnify arises only where such allegations are *proven* at trial...
>
> ... general principles relating to the construction of insurance contracts support the conclusion that the duty to defend arises only where the pleadings raise

> claims which would be payable under the agreement to indemnify in the insurance contract. Courts have frequently stated that "[t]he pleadings govern the duty to defend": *Bacon v. McBride* (citation given). Where it is clear from the pleadings that the suit falls outside of the coverage of the policy by reason of an exclusion clause the duty to defend has been held not to arise: *Opron Maritimes Construction Ltd. v. Canadian Indemnity Co.* (citation given).
>
> 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. (my emphasis)

After considering several American authorities as well as other Canadian decisions, McLachlin J. concluded that [p.329]:

> ... considerations related to insurance law and practice, as well as the authorities, overwhelmingly support the view that the duty to defend should, unless the contract of insurance indicates otherwise, be confined to the defence of claims *which may be argued to fall under the policy*. That said, the widest latitude should be given to the allegations in the pleadings in determining whether they raise a claim within the policy. (my emphasis)

Relying upon the words I have just emphasized, Foundation argued that the Supreme Court had modified the test, and that, giving the pleadings the widest latitude, if there is *a mere possibility* of the claims against Foundation falling within the contracts of insurance, there is a duty to defend.

Not so, said the insurers. They maintained that the test laid down in *Bacon v. McBride* and *Opron* had not been altered.

In its reply, Foundation agreed with the position taken by the insurers and so do I. The Supreme Court has expressly approved the test as laid down in *Bacon v. McBride* and *Opron*. I think it is clear that what Madam Justice McLachlin had in mind when she used the phrases "which may be argued" and "there is a possibility" was the proof of the claim, not its character.

In *Ontario v. Kansa General Insurance Co.* (1994) 111 D.L.R. (4th) 757 at p.764, 17 O.R. (3d) 38, [1994] I.L.R. ♦ 1-3031 (C.A.), leave to appeal to S.C.C. refused [1994] S.C.C.A. No. 123, the unanimous Court of Appeal commented:

> There is no dispute... regarding the principles which are relevant to the insurer's duty to defend. These were stated by McLaughlin J. in *Nichols v. American Home Assurance Co.* The duty to defend arises when the allegations in the pleadings raise claims which might be payable under the agreement to indemnify in the insurance contract: the mere possibility that a claim may succeed is sufficient. If there is any ambiguity in the contract, it must be resolved in favour of the insured. The duty to defend is broader than the duty to indemnify since it is not necessary for the insured to establish that the obligation to indemnify will, in fact, arise in order to trigger the duty to defend.

In some cases, it may be difficult to determine whether, having regard to the pleadings alone, the duty to defend is triggered. In such circumstances can the Court examine the underlying facts of the claim to determine if the duty is indeed triggered? The Supreme Court of Canada has yet to comment on this point. There is a huge body of case law in the United States with widely divergent results. In Canada, the Ontario Court of Appeal has expressly rejected the notion: *Jon Picken Ltd. v. Guardian Insurance Co. of Canada* (1993) 66 O.A.C. 39, 17 C.C.L.I. (2d) 167 (C.A.). Such evidence was also disallowed in the *Privest*

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Properties case, *supra*. However, at least one British Columbia decision has declared that the parties are not in fact at the mercy of the pleadings and that an examination of the underlying facts may indeed be appropriate: *Cansulex Ltd. v. Reed Stenhouse Ltd.* (1986) 70 B.C.L.R. 273, 18 C.C.L.I. 24.

Some of the principles then emerging from the case law respecting the duty to defend can be summarized as follows:

- the duty to defend is triggered if the pleadings in the lawsuit allege a state of facts which, if proven, would fall within coverage;

- if the claim falls outside coverage by reason of an exclusion (or otherwise), there is no obligation on the part of the insurer to defend;

- in determining whether they raise a claim within coverage, the widest latitude should be given to the allegations found in the pleadings and any doubt in this regard should be resolved in favour of the insured; and

- at least in British Columbia, it is not yet clear whether in appropriate cases (where in the circumstances the issue cannot or ought not be resolved on the pleadings alone) the Court may examine the underlying facts of the claim to determine if the duty to defend is triggered.

What about those situations where it simply cannot be determined from the pleadings whether, for example, an exclusion *might* ultimately have application? Must the insurer defend or can it await the outcome at trial? In the *Privest Properties* case, *supra*, Justice Drost refused to grant an order requiring the insurers to pay past and future defence costs. Rather, in light of the difficulties in answering the coverage questions posed, he simply adjourned to the trial of the underlying action the coverage dispute between the insured and the insurer. No doubt most insureds will suggest that this is a most unsatisfactory result and would presumably support the philosophy espoused in *St. Paul Fire & Marine Insurance Co. v. Durabla Canada Ltd.* (1994) 19 O.R. (3d) 631 at p. 642 (Gen. Div.), affd. 36 C.C.L.I. (2d) 25, 290 O.R. (3d) 737, [1996] I.L.R. I-3355 (C.A.):

> Just because there is a chance there will be no need to indemnify should not mean there is no duty whatsoever to defend.... An insured should have assistance in defending an action so a Court of law, rather than an insurance company, can determine the duty to indemnify. In many cases an insured may not be financially able to defend. If this is the result, then it will be viewed that there is no duty to indemnify. This should not be a decision of the insurer merely because of a refusal of the duty to defend. It is a legal question that should be decided by a Court of law after a thorough review of the facts and law.

CONFLICTS OF INTEREST AND MECHANICS OF DEFENCE

There are many articles in legal literature dealing with the ethical quagmire confronting insurance defence counsel and which arises from the conflicting interests of the insured and the insurer. Recent examples include,

- B. Wunnicke, "The Eternal Triangle: Standards of Ethical Representation by the Insurance Defence Lawyer", February 1989, *For the Defence*;

- D.S. Ferguson, "Conflict Between Insured and Insurer: An Analysis of Recent Canadian Cases" (1990), 12 Adv. Q. 129;

- M.B. Snowden, "When Coverage is in Dispute: The Conduct of Insurers and Counsel in Canada" (1992), 4 C.I.L.R. 1;

- K.O. Bowdre, "Conflicts of Interest Between Insurer and Insured: Ethical Traps for the Unsuspecting Defence Counsel" (1993), 17 Am. J. Trial Advoc. 101;

- R.J. Berrow, "Conflicts of Interest in Defending Insured Claims", *Insurance Issues*, October 1993 CLES of B.C.

The relationship created by the insurance contract is inherently one of conflict. When conflicting interests arise in relation to liability coverage, unique ethical problems arise with respect to the defence obligations imposed by the policy. Who appoints counsel? Who pays? Who is the client? To whom does defence counsel report? What restrictions reply with respect to divulging information to the insurer and insured which might impact on the coverage issues?

The most common contexts in which the above questions arise include:

- defence of liability claims which are only partially within coverage;

- defence of a liability claim where the insurer has taken a Non-Waiver Agreement or has purported to reserve its rights to deny coverage;

- defence of claims for damages that exceed the policy limits; and

- defence of multiple insureds with different interests.

With respect to partially covered claims, the Supreme Court of Canada in *Nichols*, *supra* suggested "the insurer defend only those claims which potentially fall under the policy while the insured should obtain independent counsel with respect to those which clearly fall outside its terms."

Some recent cases, however, have condemned such an approach as "impractical and unworkable": *Continental Insurance v. Dia Met Minerals Ltd.* (1994) 5 B.C.L.R. (3d) 222, revd. on other grounds, 20 B.C.L.R. (3d) 331 (C.A.); *Wear v. Robertson* (1996) 38 C.C.L.I. (2d) 140 (B.C.S.C.). Instead, the case law dealing with such situations directs the *insured* to select and appoint counsel to defend *all* claims in the underlying litigation: *Karpel v. Rumack* (1994) 19 O.R. (3d) 555 (Gen. Div.).

Theoretically, the insurer only pays those costs related to the claims within coverage and the insured is obligated to absorb the costs respecting the defence of claims outside coverage. In practice, of course, such an apportionment of defence costs is very difficult. Furthermore, recent case law in British Columbia has accepted the proposition that so long as the

defence costs were to *any* extent referable to defending the insured claims, then those costs were to be paid in full by the insurer: *St. Andrews Service v. McCubbin* (1988) 31 C.C.L.I. 161 (B.C.S.C.); *Daher v. Economical Mutual Insurance* (1996) 31 O.R. (3d) 472; *Sansalone v. Wawanesa Mutual Insurance Co.* (1997) 29 B.C.L.R. (3d) 297. If allocation of the defence costs is not possible then the insurer will be required to pay all the defence costs: *Southern Okanagan Lands Irrigation District v. Commercial Union Assurance*, unreported, Kelowna Reg. file No. 1721 (July 24, 1989, B.C.S.C.), summarized 16 A.C.W.S. (3d) 443.

In fact, one Canadian case has gone even further. In *Modern Livestock Ltd. v. Kansa General Insurance* (1993) 11 Alta.L.R. (3d) 355, 143 A.R. 46, 18 C.C.L.I. (2d) 266 at pp. 279-80 (Alta. Q.B.), affd. 24 Alta.L.R. (3d) 21, 24 C.L.L.I. (2d) 254 (C.A.), the Court ruled that:

> ... once the third party advances one or more causes of action against the insured which are potentially within the coverage and other causes of action which are clearly outside coverage, the insurer, if it refuses to defend should not be heard to deny responsibility for *any* of the costs of defending
>
> . . . . .
>
> ... in such a situation [i.e. claims of partial coverage], where the insurer refused to defend, it must bear the *entire* costs of the defence.

Since the law essentially requires the insurer to pay the lions share if not all of the defence costs in any event, most insurers in partial coverage situations are prepared to undertake defence of the claim, albeit on a Reservation of Rights basis. In this way, they hope to maintain control over the selection and instruction of defence counsel. Unfortunately (although apparently little known by non-insurance lawyers), the taking of a Non-Waiver Agreement or the issuance of a Reservation of Rights declaration may *itself* entitle the insured to appoint and instruct defence counsel at the insurer's cost.

In the United States, the vast majority of States take the approach that a Reservation of Rights defence creates such a conflict of interest between the insurer and the insured that the insurer no longer has the right to select defence counsel and control aspects of the defence: *Bowdre, Op. Cit.* pp. 118-21 and cases at notes 75-88. On the other hand, a minority of the States reject the absolute right of the insured to independent counsel and hold that the existence of a Reservation of Rights merely creates a potential for a conflict but does not generate the need for independently selected counsel at the insurer's expense. For example, Minnesota recognizes the potential for conflict in such a situation but has ruled that the right of independent counsel does not arise until an *actual* conflict arises: *Mutual Service Casualty Ins. v. Luetmer* (1991) 474 N.W. (2d) 365 (Minn. C.A.); *Bowdre, Op. Cit.* pp. 122-23 & notes 91-100. In yet other jurisdictions, a Reservation of Rights defence does not result in independent counsel but only in an enhanced good faith obligation of the insurer to the insured: *Idem*, pp. 124-28 & notes 101-21.

In Canada, the case-law respecting the rights to appoint and instruct counsel in Reservation of Rights situations is sparse. The leading case is *Ontario v. Kansa General Insurance, supra* (Gen. Div.), revd on other grounds, in which Justice Zelinski referred extensively to the *Ferguson* article and the 1989 decision of the California Court of Appeal in *Foremost Insurance Co. v. Wilks* 253 Cal. Rptr. 596 as follows:

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In an article by D.S. Ferguson, "Conflict Between Insured and Insurer: An Analysis of Recent Canadian Cases" (1990), 12 Advocate's Q. 129 (Ferguson on Conflict), the learned author notes [at p. 131]:

> Where the insurer is obliged to defend a claim it is generally accepted that unless the policy provided otherwise, the insurer is entitled to select and instruct defence counsel and is obligated to pay the costs of providing the defence.

Issues of conflict of interest involve special considerations for lawyers engaged in insurance defence work. Counsel has a duty to both his insured client and his insurer client.

. . . . .

At p. 138 of his article (Ferguson on Conflict, supra), the learned author suggests:

> [I]f an insurer delivers a reservation of rights letter or proposed a non-waiver agreement this will give the insured the right to retain separate counsel at the insurer's expense.

This is a right which must be acted upon when it arises. It is lost if the terms are accepted. It is not restored unless, or until, a new situation arises which justifies a similar election.

. . . . .

In Ferguson on Conflict, at p. 142, the learned author states:

> It is commonplace for there to be "conflicts" or adverse interests between the insurer and the insured in the course of defending a third party's claim on such issues as tactics, whether or not to settle and for how much, and how much to spend on investigation and defence preparation. These are not unacceptable conflicts; as stated in *Fredrickson*, they are inherent in the relationship.

At p. 139, the learned author excerpts the following passage from *Foremost Insurance Co. v. Wilks*, 253 Cal. Rptr. 596 (Cal. C.A., 1989) [at pp. 601-02]:

> The insurer's duty to defend the insured obligates it to furnish independent counsel to represent the insured if a conflict of interest has arisen between the insurer and the insured... A conflict of interest between jointly-represented clients exists "whenever their common lawyer's representation of one is rendered less effective by reason of his representation of the other".... "Such a conflict is likely to arise in the insurance context in two situations: [1] where coverage under the policy is disputed... and [2] where the claim against the insured is likely to result in a recovery in excess of the policy limits unless the insurer accepts a settlement offer within the policy limits".... Moreover, if there is a coverage dispute and the insurer elects to defend the insured under a reservation of rights, the conflict created thereby may require the insurer to furnish independent counsel.... However, not every reservation of rights creates a conflict of interest; rather the existence of a conflict depends upon the grounds on which the insurer is denying coverage.... If the reservation of rights arises because of coverage questions which depend upon the insured's own conduct, a conflict exists.

. . . . .

> On the other hand, where the reservations 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.

The Court specifically adopted the test set out in the *Foremost Insurance* case. It noted that, although the insured did indeed have the right to retain separate counsel at the insurer's expense when the Reservation of Rights arrangement was proposed, it lost that right when the Reservation of Rights Agreement was accepted.

So long as the Non-Waiver/Reservation of Rights arrangement is accepted by the insured under circumstances which are properly characterized as producing informed consent, the insurer will retain the ability to appoint and instruct counsel. As well, as will be seen, such informed consent may eliminate many of the ethical dilemmas that might otherwise confront defence counsel in such situations.

THE ROLE OF DEFENCE COUNSEL

In the United States, most of the case law proclaims that defence counsel, independently appointed or not, stands in a solicitor-client relationship *only* with the insured. In *Continental Casualty Co. v. Pullman* 929 F. (2d) 103 (2d Cir., 1991), a Federal Appeals Court held that under Connecticut law, "it is clear beyond cavil that in the insurance context the attorney owes his allegiance, not to the insurance company that retained him but to the insured defendant". Indeed, in January 1993 the Colorado Bar Association Ethics Committee issued a ruling that discarded the concept of insurance defence counsel's dual representation and which stated, "this Committee has concluded that in the context of this tripartite relationship, the better rule is that the lawyer's client is the insured and not the carrier". Similar proclamations have been made by the Bar Associations in Los Angeles, Iowa and other jurisdictions. Of course, these jurisdictions also recognize that the independently appointed defence counsel does owe some obligations to the insurer, namely "to disclose to the insurer all information concerning the action, except privileged materials relevant to coverage disputes, and to inform and consult with the insurer, in a timely manner, on all matters relating to the action": Wunnicke, *Op. Cit.*

In British Columbia, at least, the Courts have not yet abandoned the notion that the tripartite relationship between insurer, insured and defence counsel comprises a joint retainer: *Chersinoff v. Allstate Insurance Company* (1968) 69 D.L.R. (2d) 653, [1969] 65 W.W.R. 449 (B.C.S.C.), varied 3 D.L.R. (3d) 560, [1969] 67 W.W.R. 750 (B.C.C.A.). In this case, Aikins J., in Chambers, recognized the implications of such a retainer on the disclosure of confidential information:

> ... the starting point now must be that the solicitors were acting as solicitors for both insurer and insured in respect to the claims for damages brought against the latter. Although the insured did not select the solicitors himself but was represented by them and became their client because of the contractual right of the insurer to conduct the defence and select the solicitors, the insured agreed as a condition of being indemnified that the insurer would have the right to select solicitors so I think the insured may properly be taken to be a party to the employment of the solicitor selected... the position of the solicitors in my view is that they must be regarded as having been jointly retained to represent both parties on the issues of whether or not the insured was liable to pay damages in respect to the motor accident and the amount of the damages. This being so, it is my view that the rule in respect to privilege in the case of joint retainer is applicable. The rule is stated in *Phipson on Evidence* ...:

> "*Joint retainer*. When two parties employ the *same solicitor*, the rule is that communications passing between either of them and the solicitor, in his *joint capacity*, must be disclosed in favour of the other - eg. a proposition made by one, to be communicated to the other; or instructions given to the solicitor in the presence of the other; though it is otherwise as to communications made to the solicitor in his exclusive capacity."

> It is unnecessary to express any comment on the advisability of the same solicitors acting in the joint interest of insurer and insured on the issues of liability and damages and at the same time acting for and advising the insurer on the issue of liability to indemnify on which insurer and insured are parties are adverse in interest, beyond saying that taking such a course will often raise substantial difficulties.

Some cases in the United States have held that an insurer cannot deny coverage on the strength of information disclosed by the insured to defence counsel. The stated rationale is that the insurer is estopped from relying upon such information because disclosure by defence counsel is unethical. A similar result occurred before the Quebec Court of Appeal in *Citadel General Assurance Co. v. Wolofsky* (1984) 2 R.D.J. 440, leave to appeal to S.C.C. refused, 58 N.R. 315n. There, after signing a Non-Waiver Agreement the insured supplied defence counsel with information substantiating a breach of the policy for late reporting. The insured had provided a statement to the lawyer on the matter and at the lawyer's request. In subsequent proceedings against the insurer to enforce coverage, the Court ruled that the statement was confidential, that it ought not have been given to the insurer and that the insurer could not rely on the information to refuse coverage in the circumstances.

In *Carter v. Kerr* (1989) 39 B.C.L.R. (2d) 345, [1990] I.L.R. ♦ 1-2533, 43 C.C.L.I. 233 (S.C.), revd. on appeal on different grounds, 69 D.L.R. (4th) 542, 45 B.C.L.R. (2d) 160, [1990] I.L.R. ♦ 1-2604 (C.A.), the Court extensively reviewed the case law respecting the conflict of interest issue and commented (from pp. 354-56 B.C.L.R.):

> The potential conflict of interest arises primarily in two ways. The first arises in the conflict between the insurer's duty to defend the insured, and their desire, when intending to deny indemnity, to protect their own interests not only on the issues of quantum and liability but coverage as well. The second and related potential conflict occurs in the context of the solicitor-client relationship when a lawyer acting on behalf of the insurer in the defence of an insured (under an obligation to cooperate with counsel) may become privy to confidential information relevant to the coverage issue.
>
> . . . . .
>
> The lawyer hired by the insurer faces a conflict between his duty to defend the insured and his duty to protect the insurer's interests
>
> . . . . .
>
> These divergent interests can be directly and irreparably effected during the preparation of the defence, particularly in relation to issues of liability, coverage and damages as well as during settlement discussions.
>
> . . . . .

> The provision [in the policy respecting the insured's obligation to cooperate in the investigation, settlement and defence of the claim] is
>
> > "... a material part of the policy, a breach of which by the insured constitutes a defence to liability on the policy, in the absence in a waiver by or estoppel of the insurer."
>
> . . . . .
>
> The insured is thus placed in the unenviable position of having to cooperate with the insurer even to the prejudice of his own interests or face the possibility of losing his right to indemnity if the insurer fails to prove some other breach. It would seem to be a no-win situation for the insured and a clear conflict of interest for the insurer and his duty to defend as well as for the lawyer to whom confidential information may be revealed, information that could shape the eventual conduct of the case and impact on the subsequent coverage dispute.
>
> . . . . .
>
> ...where conflicts of interest arise, conduct of the case should be left to either counsel chosen by the insured or by both counsel for insured and insurer working in concert.

The same issue arose in *P.C.S. Investments v. Dominion of Canada*, *supra* (Alta. Q.B.), revd. on other grounds (C.A.), a case where some of the claims fell inside and some of the claims fell outside coverage. The Court concluded that the insurer had "legitimate concerns" both in being unable to influence counsel chosen by the insured (both in terms of expense and competence) and in the insurer being excluded from information that the insured is obligated to disclose on grounds of good faith. Nevertheless, it held such concerns,

> ... do not override the need to afford the applicants a full defence to the allegation of [potentially within coverage] not marred by the potential for conflict.
>
> There is an appearance of conflict. The [insured] would prefer an adverse finding based on [the allegations falling within coverage]. The respondent insurer would prefer an adverse finding against the [insured] based on [the claims outside coverage] as there would then be no obligation to indemnify.
>
> If the respondent insurer has the right to conduct the defence, its counsel would be in an untenable conflict situation. As between the [claims outside coverage and the claims within coverage] counsel would be inclined to pursue the defence of the latter at the expense of the former. The issue of indemnity may well be determined by the actions of the defence counsel in the third party action. This aspect of the defence is difficult to prevent. While there are valid concerns by the insurers they are, I believe, superseded by the need to protect the rights of the insured.
>
> . . . . .
>
> [Accordingly] [t]he defence of the allegations [which may fall within coverage] will be conducted by counsel chosen by the [insureds] and the costs of this defence will be borne by the [insurer].

In *Carter v. Kerr*, *supra*, the Trial Court relied on the conflict in interest to grant an order declaring that:

- the insured could retain solicitors of his own choice to represent him at the expense of the insurer;

- the said solicitors would have sole conduct of the defence of the insured;
- the solicitors stood in a solicitor-client relationship only with the insured and did *not* stand in such a solicitor-client relationship with the insurer; and
- any information learned or evidence obtained in the course of defending the insured was subject to such laws of privilege as may apply, with the client entitled to assert such privilege being the insured.

It is implicit in the above order that the insured's solicitors were not required to report to the insurer with respect to any matters bearing on the coverage issues. An express term to this effect was included in a similar order granted in *Laurencine v. Jardine* (1988) 64 O.R. (2d) 336, [1988] I.L.R. ♦ 1-2292, (Ont.H.C.). The same order was also being sought (although ultimately was not granted) in the *Privest* case, *supra*.

Reference must also be made to the Professional Conduct Handbook published by the Law Society of British Columbia which contains the following ruling (effective January 1995) respecting conflicts in situations where the lawyer acts for more than one party:

> A lawyer may jointly represent two or more clients if, at the commencement of the retainer, the lawyer:
>
> (a) explains to each client the principle of undivided loyalty,
>
> (b) advises each client that no information received from one of them as a part of the joint representation can be treated as confidential as between them,
>
> (c) receives from all clients the fully informed consent to one of the following courses of action to be followed in the event the lawyer receives from one client, in the lawyer's separate representation of that client, information relevant to the joint representation:
>
> (i) the information must not be disclosed to the other jointly represented clients, and the lawyer must withdraw from the joint representation;
>
> (ii) the information must be disclosed to all other jointly represented clients, and the lawyer may continue to act for the clients jointly, and
>
> (d) secures the informed consent of each client (with independent legal advice, if necessary) as to the course of action that will be followed if a conflict arises between them.

If, as the British Columbia Court of Appeal has declared, the tripartite relationship is one of joint retainer, then the procedures specified above should be followed in every single case where defence counsel is retained by the insurer regardless of whether there exists any coverage dispute. Such a procedure is probably universally ignored in the absence of coverage disputes. However, where the insurer is appointing counsel to defend the insured in cases where coverage disputes might arise, the procedures set out in the Handbook *must* be followed.

In the insurance context, the procedures clearly contemplate that the following sensible, practical approach could be adopted in most cases where coverage disputes might arise:

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- the insurer can retain the right to appoint defence counsel of its choice;
- however, defence counsel's retainer should be limited to the defence of the action against the insured;
- defence counsel must not advise either the insured or the insurer on the coverage issues;
- defence counsel should confirm in writing to both the insurer and the insured that his retainer is limited to matters of defence, that he will not advise either side with respect to the coverage issues and that all information received from either side will not be treated as confidential from and will be available to the other; and
- both the insured and insurer should retain their own counsel, at their own expense, to provide advice as required with respect to the coverage issues.

It will be noted that the draft form of Non-Waiver Agreement attached to this paper specifically addresses the above matters. Whether the execution of such a document would amount to the requisite informed consent would of course depend on the circumstances surrounding the signing of the agreement.

Of course, if the insured (or his solicitor) objects to such a procedure and insists either on appointing its own counsel or ensuring that all information is treated as confidential, then a Court application will probably be necessary for determine exactly how the defence should be conducted in such circumstances.

THE ROLE OF COVERAGE COUNSEL

Ordinarily the issues of coverage will not be fully determined in the third party action. This raises the question of whether the findings of fact in the third party action will be binding upon the insured and insurer for the purposes of determining the insurance coverage dispute. Obviously, the resolution of this issue will have a substantial impact on the role of coverage counsel.

As we have seen, there are various procedural mechanisms available to the insurer which might help resolve the coverage issues in the underlying tort proceedings. Certainly, if the insurer is made a party to the underlying tort litigation, then the doctrines of res judicata and issue estoppel may well apply to prevent further litigation respecting the facts underlying the coverage issue.

In most cases, however, the insurer is not directly involved as a party in the underlying tort litigation. Although there is a considerable amount of American case law on the question, there is little consistency in approach. In British Columbia, the Court of Appeal has ruled that the insurer is *not* bound by a finding of fact in the third party action where the issue affecting coverage was not specifically addressed: *Hamilton v. Laurentian Pacific Insurance Co.* (1989) 58 D.L.R.(4th) 760, [1989] 5 W.W.R. 467, 37 C.C.L.I. (2d) 190, 37 B.C.L.R. (2d) 30, 30 C.C.L.I 190.

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In *Collier v. I.C.B.C.* (1995) 100 B.C.L.R. (2d) 201, 54 B.C.A.C. 81, 30 C.C.L.I. (2d) 69 (C.A.), leave to S.C.C. refused, the Court ruled that, although the insurer is not bound by the phraseology used in the reasons for judgment in the underlying tort action, it can be bound by certain "findings of primary fact". It indicated that the Court trying the coverage issue could "characterize" those findings "in the legal setting" of the coverage dispute but that the insurer could also lead evidence to demonstrate the application of exclusions or otherwise "raise issues that were not essential to the result in the underlying [tort] action".

Generally speaking, the insurer will make available to coverage counsel all of the information on the insurer's file pertinent to the issues of coverage including all information passed on to the insurer by defence counsel. Coverage counsel may well be in a position to give a summary opinion on some of the coverage issues. In some cases, coverage may be clearly excluded, i.e. a claim for punitive damages that is obviously caught in an exclusion respecting punitive/exemplary damages. In other cases, however, the coverage may depend on the findings of fact (i.e. was the property damage accidental or intentional). Such issues might be directly addressed by the Court in the third party action. If not, the insurer may wish to re-litigate the entire question.

The role of coverage counsel is to analyze all of this information, including all testimony and exhibits at the trial, and advise the insurer with respect to the coverage issues. In some instances, a determination will be made based on the material available that coverage is indeed in order and payment of the appropriate amounts with the solicitor for the insured will then be negotiated. Similarly, a determination may be made that the policy does not in fact extend coverage in the circumstances and counsel for the insured will be advised to this effect. At that point, if the insured wishes to take the matter further, it will be at liberty to launch an action against the insurer to seek indemnity.

Even if the insured does not dispute the denial of coverage, it will still be open to the plaintiff judgment creditor to launch their own recovery proceedings directly against the insurer pursuant to section 24 of the *Insurance Act*. That section permits the judgment creditor to sue the insurer directly where the insured has failed to satisfy the judgment. In such an action, the insurer is entitled to resist liability by establishing that the denial of coverage was well founded.

CONCLUSION

The defence of claims in questionable coverage situations can give rise to an ethical nightmare. In such cases it is incumbent on the insurer and their counsel to adopt a sophisticated approach to the handling of the coverage difficulties. The insurer will necessarily have to retain two separate counsel, one to advise on the coverage issues and to deal with the insured in that regard, the other to act as defence counsel once a decision to assume the defence has been taken. Some negotiation with the solicitor representing the insured may well be required in this regard but the execution of a properly drafted Non-Waiver Agreement in a timely fashion can avoid many of the potential pitfalls.

Nigel P. Kent

Preventative Paperwork:
Non-Waiver Agreements, Reservation of Rights Letters and the Defence of Claims in Questionable Coverage Situations
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SUMMARY OF CANADIAN CASES RE
NON-WAIVER/RESERVATION OF RIGHTS AGREEMENTS

1. *Allstate Insurance Co. of Canada v. Foster* [1972] I.L.R. 1-470 (Ont. Co. Ct.)

In this case the auto insurer defended the underlying tort action after issuing a reservation-of-rights letter. The letter had been issued because of a possible violation of a statutory condition of the policy. The insurer settled the underlying tort action and then brought action against the insured to recover the amount paid. The insured applied to strike out the insurer's statement of claim on the ground that it disclosed no reasonable cause of action.

By its reservation-of-rights letter the insurer had advised that its investigation, defence of the litigation and negotiation of a settlement did not constitute a waiver of its rights or an admission of any obligation under the auto policy. It identified that the reservation of rights was being made because of a possible violation of the statutory condition and it also informed the insured that the reservation also did not constitute any waiver or surrender of rights under the policy by the insured.

The Court ruled that the reservation-of-rights letter was *not* sufficient to maintain a cause of action by the insurer against the insured. It acknowledged that, in addition to the statutory cause of action contemplated by the Insurance Act, the claim could also be founded on a properly worded agreement between the parties. However, the reservation-of-rights letter forwarded by the insurer was "a strictly unilateral arrangement" to which the insured at no time agreed. Further, the insured's silence after receiving the reservation-of-rights correspondence did not amount to an estoppel imposing liability upon the insured in the circumstances.

2. *Canadian Mercantile Insurance Company v. Clark* [1946] 1 W.W.R. 673 (Man. K.B.)

This is a case where the auto insurer sought reimbursement of settlement amounts from its insured pursuant to a certain letter agreement made between the parties before the settlement was effected. The Court distinguished *North-West Casualty Co. v. Fritz* (see item 15) on the grounds that the agreement in that case did not specifically impose a reimbursement obligation. In this instance, however, the letter agreement made it perfectly clear that a reimbursement obligation was imposed and since there was "nothing [in the insurance legislation] prohibiting the insured and the insurer making such lawful agreements as they see fit to meet threatened claims against both of them", the Court was prepared to enforce the agreement and granted judgment against the insured.

3. *Commercial Union Assurance v. Locane* [1980] O.J. No. 260 (Ont.C.A.)

The insured appealed the trial decision which allowed an auto insurer to recover a payment made to an injured third party. The insured had breached the auto policy condition forbidding carrying of passengers for hire. The insurer therefore took a non-waiver agreement which permitted it to settle the third party injury claim and to recover the amount involved from the insured without a judgment first having been obtained in the underlying tort proceedings. The terms of the non-waiver agreement included the following:

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> "It is hereto understood and agreed by and between the parties hereto that... Commercial Union Ins. Co. may... make a settlement or settlements... or pay any judgments against us or either of us without prejudice to the rights of any of the parties hereto under a policy of... automobile insurance... and the parties hereto agree... in consideration of the foregoing, that they...will not in the said action or actions, or in any action or actions that may be brought between or among any of the parties hereto plead or contend that... Commercial Union Ins. Co. by conducting the said investigations or the said negotiations or defences or by making the said settlement or settlements or by payment of said judgment or judgments, created any estoppel or waived any of its legal rights to recover from us... the amount or amounts of settlement or settlements made or any judgment or judgments paid by it."

At trial, the Court ruled that the non-waiver agreement in question "was intended to be a mutual reservation of the rights of the parties and that this was clearly understood by the defendant at the time of the execution by him of such agreement". With respect to the form of the agreement, the Court commented "there is no specific form of non-waiver agreement [required], so long as the agreement clearly sets out that it is intended to be a mutual reservation of the rights of the parties".

However, on appeal, the Court overturned the trial decision and held that in this instance, the terms of the non-waiver agreement were not sufficient to displace the necessity of a judgment against the defendant by the third party.

4. *Federal Insurance Company v. Mathews* (1956) 18 W.W.R. 193 (B.C.S.C.)

The insurer obtained a non-waiver agreement from the insured because of a perceived breach of the statutory condition respecting drunk driving. The agreement contained the usual, exhaustive language respecting permission to investigate, defend and settle claims without the same prejudicing or constituting a waiver or estoppel respecting the insurer's rights to deny liability under the policy. The insurer then appointed counsel to defend the underlying tort action which was commenced in Washington State. In due course, even though the insurer continued to defend the Washington tort litigation, the insurer commenced action in B.C. for a declaration that coverage had been forfeited by virtue of the breach of statutory condition.

The Court ruled that the effect of the non-waiver agreement was to postpone the time when the insurer would have to make its election to affirm or deny coverage. As such, the defence of the underlying tort proceedings did not amount to a waiver of any rights of denial. However, the commencement of the declaratory action amounted to an election by the insurer to repudiate coverage and from that point forward the non-waiver agreement was no longer operative. The continued defence of the underlying tort litigation after that point in time therefore occurred without the protection of the non-waiver agreement and amounted to a waiver of the alleged breach and an affirmation of coverage. The insurer could not deny coverage in such circumstances and the action for declaratory relief was dismissed.

5. *Halifax Insurance Co. v. Williams* (1966) 58 D.L.R. (2d) 86 (B.C. Co. Ct.)

In this case the insurer alleged a breach of the auto policy and relied upon a non-waiver agreement in its efforts to recover from the insured the amounts paid pursuant to a settlement with the injured third party. The adjuster had requested the insured to sign the printed form upon which no particulars had been inserted in the spaces provided for that purpose (i.e. the date of the

accident, the policy number, etc.). The adjuster represented that the form was "a formality to investigate the claim" when she knew full well there was a potential breach. The Court ruled that the non-waiver agreement was obtained by misrepresentation and in circumstances where the insured was completely ignorant of the coverage difficulties. The Court ruled that the non-waiver agreement was void and unenforceable as against he insured and the insurer's action to recover the settlement monies was accordingly dismissed.

6. *Harrison v. The Ocean Accident & Guarantee Corporation Limited* [1948] O.R. 499 (Ont. C.A.)

In this case the plaintiff obtained judgment against the defendant for damages arising from an auto accident. She ultimately made a claim directly against the defendant's auto insurer pursuant to the provisions of the *Insurance Act*. The claim had been defended by the auto insurer following the execution of a non-waiver agreement. The plaintiff tried to argue that the taking of the non-waiver agreement and the defence of the action effectively estopped the insurer from denying coverage but the Court of Appeal ruled that the non-waiver agreement had "no bearing" on the plaintiff's rights of action. Robertson C.J.O. commented with respect to the non-waiver agreement,

> "The purpose of the agreement is quite obvious. There is an action against the Administratrix to be defended. The action may or it may not involve liability of the insured, against which the policy promises indemnity, and it may be that, whether it does nor does not, there are circumstances already known, or that may be discovered, that entitled the insurer to be relieved of liability to the insured on the policy. With matters in this condition the insurer and the insured consider it the wiser course, instead of immediately fighting each other, to defend the claimant's lawsuit and find out first whether or not there was really anything for them to fight with each other about."

7. *Heads v. Brownlee and McAlpine* [1943] 3 W.W.R. 257 (B.C.C.A.)

This case involved an application to have an appearance entered on behalf of a defendant vacated. The defendant was insured under an auto policy. The insurer had written a letter to the insured purporting to "repudiate all liability under the policy". When the lawsuit was started, the insurer indicated it would assume defence of the action on condition that the same did not constitute a waiver of the repudiation of liability. The insured refused to accept the condition. The Trial Court ruled that, by entering an appearance in such circumstances, the insurer had waived the repudiation of coverage, *i.e.*, that the insurer was bound to extend coverage. The Court of Appeal reversed the ruling; it ruled that an election to waive a breach required "a clear intention" which warranted an investigation of the underlying evidence. The evidence ultimately relied upon for the conclusion that there was no waiver in the circumstances was a letter from the insurer's solicitor declaring that,

> "[The insurer] still stands by its repudiation, and has no intention whatsoever of withdrawing from that position. However [it] is of the opinion that it is entitled under its policy, whether repudiated or not, to defend this action."

O'Halloran, J.A. commented on the insured's "inequitable and dangerous predicament" of permitting the insurer to defend without first accepting validity of the claim. Without such prior acceptance of the validity of the claim,

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> "An insured defendant [would find himself] compelled to accept, as his sole defender and spokesman, one (the insurance company) whose interest is in direct conflict with his, in that its financial advantage is equally served if the action is dismissed as if he is proven guilty of that degree of negligence which the law may regard as a crime."

8. *Hersh v. Wawanesa Mutual Insurance* (1994) 89 B.C.L.R. (2d) 225 (B.C.S.C.)

The insurer defended the underlying tort action pursuant on a "reservation of rights" basis. It had been concerned that most and perhaps all of the claims made against the insureds in the tort action fell outside coverage. The reservation of rights correspondence indicated that the insurer would undertake defence of the claim

> "On a reservation of rights basis with the [insurer] reserving the right to set up any and all defences of non-coverage under the policy. This reservation of rights also entails that the [insurer] does not waive any of its rights or admit any obligations under the policy."

Following judgment the insurer denied indemnity for the judgment amounts. The insured conceded that the policy was not obliged to provide indemnity for the judgment. However it contented that because the insurer had undertaken the defence of the tort litigation, it was thereby obliged to pay the award of taxable costs made in that action. The insurer denied such liability relying in part on the reservation of rights agreement. The Court upheld this position. It commented:

> "Wawanesa was faced with three options when it considered whether to undertake the defence of the Lee action:
>
> (i) it could deny coverage and refuse to undertake the defence, thereby risking an action for breach of contract, the damages for which would include the amount of indemnity under the policy and the costs of defending the action;
>
> (ii) it could undertake the defence, thereby losing any right to subsequently deny coverage by reason of waiver, estoppel or otherwise; or
>
> (iii) it could proceed on the basis of a non-waiver agreement or reservation of rights agreement."

The Court noted that the reservation of rights was "in no way limited to the duty to indemnify. [Rather] the words clearly refer to *any* obligations *under the policy*. ..... The reservation of rights letter makes it clear that the recovery of costs under the policy is not admitted and is not causally connected to the undertaking of the defence."

9. *Kowalyk v. Canadian Home Assurance* [1954] I.L.R. 1-147 (Man. Q.B.)

This was an action by a judgment creditor directly against the auto insurer for recovery of his judgment. Liability had been denied for breach of statutory condition respecting drunk driving. The Manitoba legislation provided that the judgment creditor's position was the same as the insured's. The plaintiff argued the insurer's defence of the tort action estopped it from denying coverage. The Court held that correspondence between counsel "discloses a non-waiver agreement in the clearest possible terms", namely, that in undertaking the defence "it is no waiver of the right of the [insurer] to deny [the insured] any right of indemnity for the accident in question". The Court ruled that the insurer's participation in the defence "was protected by this

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non-waiver agreement entered into in writing between counsel for the insured and counsel for the insurer".

10. *Laurencine v. Jardine* (1988), 64 O.R. (2d) 336 (Ont. S.C.)

A passenger sued the owner of a motorcycle involved in an accident. The insurer of the motorcycle initially refused to defend the action having denied liability on the ground that the same did not arise from the ownership, use or operation of the bike. The insurer sought to have the insured execute a non-waiver agreement and when the insured refused, the insurer declined to defend the lawsuit. Thereupon the insured obtained an order requiring the insurer to defend the action on his behalf. Thereafter he sought an order permitting him to be separately represented by counsel of his choice and at the insurer's expense. It also sought an order directing that the solicitors would *not* be required to report to the insurer respecting any matters bearing on the issue of coverage.

The Court granted the motion. In doing so it relied upon the American case law (*Cumis* and *Nandorf*) dealing with the conflict of interest arising from a reservation of rights respecting coverage. In such cases, it ruled that, in the absence of an informed consent by the insured to continued representation by the insurer-appointed counsel after full disclosure of the implications of joint representation, the interests of the insurer and the insured "diverge to such an extent as to create an actual, ethical conflict of interest" compelling a "limited exception to the general rule than an insurer controls the defence of its insured" and transforming the insurer's duty to defend "into that of reimbursing the insured for the expense of retaining his own [defence] counsel".

11. *The London Assurance v. Jonassen* [1969] I.L.R. 1-230 (Ont. C.A.)

The insurer sued the insured for reimbursement of the amount paid in settlement of a third party's claim. Breach of the statutory condition respecting drunk driving was the basis upon which a standard form non-waiver agreement had been obtained. Unlike the *North-West Casualty* case, this non-waiver agreement specifically authorized the insurer to settle and pay claims without the requirement of a judgment. Further, the insured agreed that it "would not plead or contend that such settlement was paid without the requirement of a judgment". The Court ruled that these provisions did indeed oblige the insured to repay the insurer; the agreement amounted to a waiver of the usual proof necessary for such recovery (judgment against the insured). It did note, however, that such agreement might be subject to "an implied term that the settlement would be reasonable". It also noted that the settlement would not abate the insurer's liability to the judgment creditor for the full limits of the policy nor, on the other hand, would it operate to increase the liability of the insured to reimburse the insurer beyond such limits.

12. *Minassian v. Toonen* [1987] O.J. No. 1826 (Ont. S.C.)

This was an application by an auto insurer to be added as a third party by order pursuant to the provisions of the *Insurance Act*. Coverage under the auto policy was denied on the grounds of misrepresentation respecting ownership of the automobile. The insurer voided the policy ab initio and refunded the premiums in full. At the application, the insured argued that the insurer should be refused the ability to deny coverage because the insurer did not obtain a non-waiver

agreement from the insureds at the time it took statements containing information on which the insurer might deny coverage. The Court ruled that the waiver issues ought not be determined in this type of motion but should rather be determined by way of an action between the insurer and the insured in due course. It did, however, make some comments on the purpose of a non-waiver agreement:

> "When an insurer receives information which it might use to deny coverage to its insured, it is faced with a dilemma. As indicated above, if it proceeds to defend the action on behalf of its insured it may be deemed to have affirmed the contract of insurance and thereby lose its right to deny coverage to its insured. On the other hand, it has an interest in defending the action brought by the third party against its insured because if it is successful, it will not be required to indemnify the insured. One way of solving that dilemma is for the insurer to enter into a non-waiver agreement with its insured. The most salient feature of such an agreement in this context is that the insurer may defend the action brought by the third party, thus protecting its own interest, while at the same time preserving its right to deny coverage to its insured. The insurer, therefore, is permitted to fulfil its obligation to defend the insured while at the same time preserving its right to deny him indemnity should the defence of the action brought against its insured be unsuccessful."

13. *M.P.I.C. v. Haddon* [1978] I.L.R. 1-992 (Man. S.C.)

This was another case where the plaintiff auto insurer sought to recover from the insured monies paid pursuant to a settlement of the personal injury claim arising from the motor vehicle accident. The alleged breach was drunk driving. A non-waiver agreement had been secured on the day following the accident. The insured resisted the claim on the grounds that no judgment had been obtained and that the non-waiver agreement was not specifically drafted to require reimbursement in the absence of a judgment. The Court referred to the *Fritz* (item 15) and *Jonassen* (item 11) cases. Even though there were no provisions in the non-waiver agreement similar to *Jonassen*, the insured's solicitor had been consulted with respect to the settlement and had agreed to the quantum of damages payable albeit on a "totally without prejudice" basis. The Court ruled the circumstances gave rise to an agreement between the parties that the claim could be paid without the requirement of a judgment and it therefore required the insured to reimburse the insurer for the amounts involved.

14. *New Zealand Insurance Company v. Campbell* [1959] I.L.R. 1-323 (B.C.S.C.)

In this case the insurer obtained a non-waiver for breach of the statutory condition respecting drunk driving. It settled the third party claim and sought reimbursement from the insured. The insured contended that the settlement of the underlying tort claim amounted to a waiver of any policy breach and an election to affirm coverage. The Court ruled, however,

> "There can be no doubt that the non-waiver agreement gave the insurer full discretion to settle all claims and any such settlement should be treated as though it were a judgment recovered against the defendant which the insurer had been compelled to pay by reason of the Insurance Act. ..... All settlements were arrived at with the full concurrence of the solicitor for the insured without prejudice to the rights of the insurer or the insured as between themselves."

The insurer therefore obtained judgment against the insured in the circumstances.

15. *North-West Casualty Co. v. Fritz* [1941] O.R. 287 (Ont. C.A.)

Because of a perceived breach of the auto policy condition respecting drunk driving a non-waiver agreement was signed by the insured and insurer. The agreement provided that the insurer could investigate, negotiate, settle, defend any action or pay any judgment "without prejudice to the rights of any of the parties [under the policy]". It further provided that in any subsequent proceedings between them, the insured would not "plead or contend that the [insurer] by [undertaking any of the above actions] created any estoppel or waived any of its legal rights to refuse payment or indemnity under the said policy of insurance or any of its legal rights to recover [from the insured] the amount of settlement made or judgment paid".

The insurer settled the third party tort claim and sought reimbursement from the insured relying upon the non-waiver agreement. The Court ruled that the agreement simply prevented either party from alleging estoppel or waiver in any subsequent proceedings; "it preserved whatever legal rights the [insurer] had at that time but it did not include a right to enforce reimbursement against the [insured]". This case is a clear example of an inadequately drafted non-waiver agreement; the agreement could have (and should have) imposed an obligation to reimburse the insurer provided the alleged breach was ultimately sustained at trial.

16. *P.C.S. Investments v. Dominion of Canada General Insurance* (1996) 34 C.C.L.I. (2d) 113 (Alta.C.A.)

The underlying action was for negligent and fraudulent defamation. In the course of investigating the claim the insurer obtained an non-waiver agreement from the insured. In due course, the insurer advised that "the facts as presented do not engage coverage under your .... policy" and refused to undertake defence of the litigation. The insured brought action seeking a declaration that the insurer was compelled to defend the litigation.

One of the insurer's defences was the non-waiver agreement. It argued it had not repudiated the insurance contract (by refusing to defend) but had rather reserved its rights under the non-waiver agreement. At trial, the Court commented that,

> "The non-waiver agreement is designed to ensure that the insurer who elects to defend is not thereby obligated to indemnify by that election. Nevertheless, it is not intended to allow the insurer to sit on its right to defend ..... even upon the insurer's interpretation of the non-waiver agreement, the refusal to defend would likely constitute a waiver of the terms of the agreement, because it is effectively a repudiation of the insurance contact."

The trial judge ordered that the allegations not within the terms of the insurance be defended by counsel chosen by the insured and at the insured's expense, and that allegations within the terms of the insurance be defended at the insurer's expense by counsel chosen by the insured. Both the insurer and the insured appealed.

The appeal and cross-appeal were allowed in part. The Court held that the insurer had a right under the policy to name its own counsel to participate in the defence. That right had not been lost by the insurer's refusal to defend. That was not a "repudiation" that would justify a court in refusing to enforce the other terms of the contract.

17. *The Queen v. Kansa General Insurance Co.* (1991) 3 O.R. (3d) 543 (Gen. Div.), revd on appeal on other grounds, 22 C.C.L.I. (2d) 262 (C.A.)

The insurer undertook to defend the claim but as costs mounted, it asked the Crown, the insured, to assume the defence.

The insured sought an Order declaring that

- the insured had the right to control the defence including the right to select solicitors;
- the insurer must pay the solicitor client costs of the solicitors in question;
- the solicitors would not be required to report to the insurer respecting matters bearing on the issue of coverage; and
- other solicitors representing the insurer might be permitted to participate in the defence of the claim but subject to the control by the insurer's solicitors.

In this case the solicitors for the insurer had negotiated a reservation of rights arrangement whereby they would act as defence counsel. The insured had agreed to the arrangement. One of the bases on which objection was taken to the insurer's solicitor continuing to act was conflict of interest arising by virtue of the reservation of rights. Justice Zelinski commented:

> "In an article by D.S. Ferguson, "Conflict Between Insured and Insurer: An Analysis of Recent Canadian Cases" (1990), 12 Advocate's Q. 129 (Ferguson on Conflict), the learned author notes [at p. 131]:
>
> > Where the insurer is obliged to defend a claim it is generally accepted that unless the policy provides otherwise, the insurer is entitled to select and instruct defence counsel and is obligated to pay the costs of providing the defence.
>
> Issues of conflict of interest involve special considerations for lawyers engaged in insurance defence work. Counsel has a duty to both his insured client and his insurer client.
>
> Normally, unless counsel engaged by an insurer is also personally retained by the insured (as, for example, to represent the insured in a claim for personal injuries), the skills and abilities of the counsel who is retained more directly affects an insurer. The insurer will be liable for the payment of any amount recovered against its insured. There are circumstances where it is the insured who relies most heavily upon counsel's skill and the conduct of a defence. A practitioner in a profession may lose a hard-earned reputation if a judgment is obtained. A settlement made in such an instance, because payment is preferable to a complex defence, is contrary to the interests of the insured. Similar unfavourable consequences are possible where important policy positions of an insured are at stake. Such an insured must be confident that the defence is handled in an appropriate manner. Such concerns are not, however, of the type which gives rise to a conflict of interest which affects the rights of appointed counsel to continue to act.
>
> .....At p. 138 of his article (Ferguson on Conflict, supra), the learned author suggests:
>
> > [I]f an insurer delivers a reservation of rights letter or proposes a non-waiver agreement this will give the insured the right to retain separate counsel at the insurer's expense.

This is a right which must be acted upon when it arises. It is lost if the terms are accepted. It is not restored unless, or until, a new situation arises which justifies a similar election. The rights of HMQ herein differ from those of the insured in *Laurencine, supra*. In that case the insurer had repudiated the contract of insurance by its initial *refusal* to defend. I have already concluded that, here, Kansa did not repudiate its contract with HMQ.

When HMQ elected to accept the terms set out in Blaney's letter, and to use the services of that firm in accordance with its letter, it lost its right to retain separate counsel at Kansa's expense, at that stage. .....

In Ferguson on Conflict, at p. 142, the learned author states:

> It is commonplace for there to be "conflicts" or adverse interests between the insurer and the insured in the course of defending a third party's claim on such issues as tactics, whether or not to settle and for how much, and how much to spend on investigation and defence preparation. These are not unacceptable conflicts; as stated in *Fredrikson*, they are inherent in the relationship.

At p. 139, the learned author excerpts the following passage from *Foremost Insurance Co. v. Wilks*, 253 Cal. Rptr. 596 (Cal. C.A., 1989) [at pp. 601-02]:

> The insurer's duty to defend the insured obligates it to furnish independent counsel to represent the insured if a conflict of interest has arisen between the insurer and the insured ... A conflict of interest between jointly-represented clients exists "whenever there common lawyer's representation of one is rendered less effective by reason of his representation of the other" ... "Such a conflict is likely to arise in the insurance context in two situations: [1] where coverage under the policy is disputed ... and [2] where the claim against the insured is likely to result in a recovery in excess of the policy limits unless the insurer accepts a settlement offer within the policy limits" ... Moreover, if there is a coverage dispute and the insurer elects to defend the insured under a reservation of rights, the conflict created thereby may require the insurer to furnish independent counsel ... However, not every reservation of rights creates a conflict of interest; rather the existence of a conflict depends upon the grounds on which the insurer is denying coverage ... If the reservation of rights arises because of coverage questions which depend upon the insured's own conduct, a conflict exists. .....
>
> On the other hand, where the reservations 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.

Adopting this test to the facts of this case indicates to me that there is no conflict of interest here. It must be remembered that it is only appropriate for the court to find a conflict of interest which affects the rights of counsel to continue to act when the conflict arises in connection with counsel's obligation to his/her clients. It is the solicitor who must be in a conflict of interest. This arises either by his/her actions or by virtue of the special nature of the dispute between the parties that he/she represents. Conflicts between the parties only become the problems of the counsel when the problems between the clients put into question the ability of counsel to be able to properly and objectively represent the clients, in fact and in appearance. .....

It is the nature of insurance contracts that, absent conflict or other proper objection, the insured is consenting to the retainer of counsel appointed by the insurer, and that information from the insured, unrelated to coverage, or otherwise inappropriate, will be communicated to the insurer. In this instance it is only proper for HMQ to insist upon new counsel, of its choosing, under its control, and at the expense of Kansa, if I conclude that a reasonable person, reasonably informed,

> would not be satisfied that Blaney has not used, and will not use, confidential information improperly.
>
> I am satisfied that such a finding is not warranted here."

18. *Rowe v. Mills* [1986] I.L.R. 1-2116 (N.B.Q.B.)

In this case the snowmobile accident occurred on February 27th. The defendant did not notify his insurer until he was served with notice of the action one month later. The insurers then retained an adjuster who investigated the accident and a lawyer who filed a notice of intention to defend. Approximately one month later the insured signed a non-waiver agreement which was requested because of a potential policy breach respecting late reporting. Several days later the insurer took the position that a breach had in fact occurred and its lawyer made application to be removed as solicitor of the record for the insured and for the insurer to be added as a statutory third party.

The Court noted that, "as a general principle an insurer may waive insufficiency of notice of an accident if it adopts a course of conduct which is consistent with the policy being in full force and effect". It emphasized that action must be *immediately* taken if a denial is to be permitted:

> "The contract is one that calls for the utmost good faith on both sides. The date of the accident was clearly alleged in the plaintiff's statement of claim. Whether or not it addressed its mind to the matter the insurer must, or should have known, that the accident had not been reported to it. There can be a great deal of pressure on counsel appointed by an insurance company as to what he or she should do as the time approaches when an appearance must be entered.
>
> If counsel had merely entered the appearance or written advising the insured that it was investigating the possible breach and was reserving their rights in the meantime, I would have no difficulty in holding the insurer acted properly. Undoubtedly an insurer in such circumstances would be allowed some time to check the question of possible breach. ..... [However] I do not believe the insurer is entitled to investigate the facts surrounding the accident and to conduct an investigation as to whether there exists proper grounds for repudiation of the contract at the same time. ..... If the insurer is allowed to conduct both investigation simultaneously the insurer is open to the charge that it is wearing two hats and will determine whether or not it has a better defence to the action as defendant or to claim repudiation and defend a possible claim by its insured for breach of contract."

19. *R. Sherwin Enterprises v. Municipal Contracting Services* [1994] O.J. No. 2233 (Ont. Gen.Div.)

The insurer's law firm obtained a non-waiver agreement from the insured as a result of a coverage dispute on a liability policy. When that insured was ultimately sued, a different law firm was appointed by the insurer as defence counsel for the insured. However, the original law firm was retained by another one of the defendants. In due course the insured brought application to have the law firm removed as solicitors for the co-defendants on grounds of conflict of interest. The Court agreed that advising the co-defendants' insurer with respect to coverage did indeed give rise to a conflict of interest inasmuch as confidential information would most probably have been developed by the law firm in that regard. Justice Jarvis commented,

> "A non-waiver agreement is utilized to permit an insurer to investigate a claim without thereby creating a waiver or estoppel regarding any position it might have with the insured as to coverage.

> The non-waiver agreement does not affect the obligations or responsibility of [defence] counsel. ..... [Although] the solicitor in such circumstances is retained by the insurer [he] nonetheless acts for the insured [and] the relationship with the insured attracts solicitor-client privilege."

It is noteworthy that the non-waiver agreement in this particular case did not address the obligations of defence counsel or the confidentiality attached to information obtained by counsel.

20. *Wawanesa Mutual Insurance Co. v. Buchanan* (1979) 74 D.L.R. (3d) 330 (Ont. Co. Ct.)

In this case, the insurer denied coverage for breach of the statutory condition respecting drunk driving. After settling the underlying tort claim, the insurer sought reimbursement from its insured relying on the standard form non-waiver agreement signed by the latter.

The insured's agent had reported the claim to the insurer and had advised that the insured had been charged with impaired driving and refusing to blow. The adjuster interviewed the insured and advised that the involvement of alcohol could have a bearing on the outcome of his claim. The conversation with the insured was reduced to writing and the insured was also given a blank non-waiver agreement. The adjuster explained that the agreement permitted the insurer to investigate, defend and settle the claim without prejudice to the issue of the policy violation. The adjuster said the insured appeared to understand the purpose of the non-waiver agreement including the fact that the agreement might require reimbursement to the insurer of any settlement ultimately made. However, the Court ruled that the non-waiver agreement was not enforceable and that the insurer was estopped from taking an off-coverage position. It commented:

> "When the [insurer] through its [adjuster] became aware of a probable breach of a statutory condition of the policy, then at that moment there is a conflict position between the insured and the [insurer]. [In such circumstances] the insurer cannot go further in the defence of the action without a non-waiver ..... having knowledge that liquor was involved and that there may be a statutory violation, the insurer must make it known to the insured that there is the possible conflict position between them and the non-waiver agreement must be signed *before* interviewing the insured .....
>
> [This] procedure arises because there is in fact a special relationship between the insured and the insurer or its agents, which requires an exceptional degree of trustworthiness and honesty. The insurer [cannot], under the guise of representing the insured's interest, attend upon him and obtain from him information which is solely for benefit of the company without first advising him of the conflict."

21. *Woodside v. Gibraltar General Insurance* (1988) 66 O.R. (2d) 630 (Ont. H.C.J.), revd on appeal on other grounds, 1 O.R. (3d) 474 (C.A.)

In this case the coverage dispute arose with respect to whether the insured's homeowners policy extended to a house not mentioned in the policy but which was occupied by the insured. A prospective purchaser of the house had been injured on the property. The insurer obtained a non-waiver agreement from the insured with respect to the coverage dispute. In due course, however, it declined to defend the liability claim even though it had obtained the non-waiver agreement and even though it knew the insured was impecunious. In due course the insured settled the liability claim with the insured claimants and assigned their cause of action against their insurer. In the subsequent proceedings against the insurer for recovery of the settlement monies and the

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defence costs, the insurer argued that their obligation to pay was not triggered until "judgment after trial" and that in any event, the insureds had failed to mitigate their damages by not defending the matter at trial. The Court ruled that the insurer was estopped from making such arguments. The insurer could have defended the matter itself pursuant to the non-waiver agreement "without exposure to liability" which would have been "a reasonable alternative" in the circumstances. By deliberately choosing not to defend the matter, however, the insurer "left the [insureds] hanging out to dry".

22. *Zurich Insurance v. Crawford* [1993] O.J. No. 966 (Ont. C.J.G.D.)

The insurer sought an ex parte default judgment against the insured for the amounts paid to third parties in settlement of the underlying tort action. A non-waiver agreement was placed in front of the Court by way of a solicitor's affidavit. No evidence was put in front of the Court of the explanation given to the insureds respecting the implications of the non-waiver agreement and advising them to seek independent counsel. The agreement was not properly dated, was not under seal and the signatures of the insureds had not been witnessed. The Court dismissed the motion for default judgment on the grounds that the evidence was insufficient to establish whether the non-waiver agreement was effective in the circumstances.

23. *Co-opérative Avicole De St. Isidore Ltd. v. Co-operators General Insurance Company*, unreported, file No. 4644-96 (March 18, 1997, Ont.Gen.Div.)

The plaintiff Co-opérative Avicole De St. Isidore ("St. Isidore"), claims indemnification against their insurer, the defendant Co-operators General Insurance Company ("Co-operators"), pursuant to an insurance contract, for their loss as a result of a judgment rendered against them. Co-operators took from their insured a non-waiver agreement and left St. Isidore on its own to defend, negotiate or settle its claim, even after the statement of claim was amended to allege items within the coverage of the insurance policy. One issue to be decided was whether St. Isidore was contractually barred from bringing an action against Co-operators on the basis that proper notice of the claim was not given and St. Isidore failed to commence a claim within one year.

The Court held that St. Isidore was not contractually barred from bringing an action against Co-operators. The Court said that where an insurer refuses to defend an action brought against the insured when it is obligated to do so under the policy, the insurer has breached its own policy. Such a breach in effect repudiates the insurance contract and the insurer is estopped from relying on the policy clauses or conditions to avoid liability. Thus, in the case at bar, Co-operators was not entitled to insist on St. Isidore's strict compliance with the notice provisions contained in the insurance policy.

24. *Ward Estate v. Olds Aviation Ltd.* [1996] A.J. No.791 (Alta.Q.B.), revd 40 C.C.L.I. (2d) 119 (Alta.C.A.)

The insurer applied in the name of the insured to set aside a judgment and a noting in default of the insured. The insurer denied the insured's claim alleging that the policy of insurance had been breached by the insured. The insurer requested that the insured execute a non-waiver agreement but the insured refused. The insurer took no part in any of the proceedings.

The Court said that the insurer in this case made an irrevocable election to deny coverage to the insured. Belzil J. said:

> It is well established that an insurer which elects to deny coverage will profoundly alter its relationship with its insured and its ability to participate in the litigation. As noted in Gordon Hilliker's text *Liability Insurance Law in Canada* at p. 82:
>
> > "Serious consequences flow from an insurer's refusal to defend its insured in circumstances where the policy stipulates that a defence is required. In addition to being in breach of contract, the insurer will have lost certain rights under the policy.
> >
> > (a) Loss of Policy Rights
> >
> > By taking the position that the policy does not respond to the claim, the insurer forgoes both its right to defend the action and its exclusive right to settle the action on behalf of the insured. With the exception of automobile liability policies, a liability insurer has no right to add itself as a third party for the purpose of contesting the plaintiff's claim against the insured."

It is clear that at all times the insurer made a conscious decision to not participate in the proceedings having made an irrevocable election to deny coverage. Absent a non-waiver agreement or other actual or express authorization, the insurer has no status to represent the insured in any application.

25. *Snair v. Halifax Insurance* (1995), 31 C.C.L.I. (2d) 279 (N.S.S.C.)

The plaintiff was found 100% at fault for the injuries incurred by a third party as a result of a boating accident. Quantum of damages remained to be determined. The plaintiff commenced an action against his insurer asking for a declaration that valid coverage was in existence at the time of the accident and indemnification for his liability up to his policy limits. Shortly before trial on the issue of liability, the plaintiff was advised that the insurer would not indemnify him. No reservation-of-rights letter had been sent to the plaintiff nor had a non-waiver agreement been signed. As an alternative argument, the plaintiff claimed that the insurer waived any right at law, by virtue of the policy, to deny that the plaintiff was entitled to indemnification.

On this alternative argument, the Court held that the insurer was in fact estopped from denying coverage because its acts and omissions represented to the plaintiff that he was covered. There was no new information which came to light after 1988 which could have been used as a basis for denying coverage under the policy. The insurer had this information and chose not to act on it until almost five years after the claim was reported. The acts and omission of the insurer represented to the plaintiff that he was covered. The plaintiff relied on the insurer's acts and omissions to his detriment, especially in preparing his defence. Therefore, the prejudice to the plaintiff was manifest.

26. *Thomas v. Hickey* (1995), 29 C.C.L.I. 104 (Ont.Gen.Div.)

Noting the late reporting of a claim, the insurer obtained a non-waiver agreement from the insured permitting the insurer to investigate and defend the action without prejudice to its rights under the insurance policy. The insurer conducted its own investigation of the accident, and one

year later, took the position that it was denying coverage and would no longer maintain a defence for the insured. Default judgment was entered against the insured in an Indiana court and the plaintiff obtained a summary judgment in Ontario against the insured.

The Court held that the third party action should be allowed. The fact that the insurer entered into a non-waiver agreement with the insured upon learning of the serious delay in reporting the claim suggested that the insurer was treating the insured's breach of the policy as a matter of imperfect compliance rather than non-compliance. The insurer's only consideration was whether the delay in reporting had prejudiced its position.

27. *Black v. State Farm Fire and Casualty* [1995] N.B.J. No. 202, revd on other grounds, 170 N.B.R. (2d) 151, 435 A.P.R. 151 (N.B.C.A.)

This was an action brought by the insured's against the insurer for the payment of insurance proceeds. The primary issue at trial was whether or not evidence showed that one of the insured or a stranger intentionally started the fire. A secondary issue was whether the insurer was estopped from denying coverage by its failure to obtain a non-waiver agreement or to otherwise reserve its rights.

At trial the Court was satisfied that the insurer had met the heavy burden of proof of arson by one of the insured. In addition, the Court held that the omission of the insurer to obtain a non-waiver agreement or otherwise formerly preserve its rights did not legally prevent or estop the insurer from denying liability at the conclusion of its investigation into the cause of the fire.

In support of this finding, the trial judge said:

> [That] [t]he insurance company did not have [either of the insured parties] execute a non-waiver agreement. But by the morning of the fire both of them knew that the police and insurance company were investigating the fire. Both [of the insured parties] cooperated with the insurance company as they were legally required to do.

NON-WAIVER AND RESERVATION-OF-RIGHTS AGREEMENT

WHEREAS:

A. Name of Insurance Company (hereinafter referred to as the "Insurer") has issued a certain policy of insurance bearing policy number Policy Number (hereinafter referred to as the "Policy");

B. On or about Date at or near Location there occurred a certain Descrption of Occurrence - mva/fire/etc (which event is hereinafter referred to as the "Occurrence");

C. There have been or will be made claims for payments, benefits or indemnity under the Policy (hereinafter the "Claims") with respect to the injuries, losses, expenses, damages, claims, actions or other proceedings arising as a result of the Occurrence (which matters are hereinafter collectively referred to as the "Losses");

D. The Insurer may have grounds to void the Policy or to deny liability or coverage thereunder for the Claims or Losses by reason of:

D.1 breaches of the terms and conditions of the Policy;

D.2 certain misrepresentations or failure to disclose material information;

D.3 some or all of the Claims or Losses being of a type either excluded from or not falling within the scope of coverage afforded by the Policy; and/or

D.4 such other grounds as may presently exist or as may be hereafter discovered; and

E. The Insurer, its employees, adjusters, lawyers and other agents have experience in investigating, evaluating, defending and settling claims and losses of the sort referred to above and the undersigned wishes to take advantage of such experience while at the same time permitting the Insurer to reserve all rights it may have respecting the coverage matters referred to above;

NOW THEREFORE THIS DEED WITNESSES that in consideration of the Insurer postponing its decision to void the Policy or deny liability or coverage thereunder and also in consideration of the matters set forth in paragraph 1 hereof, the Undersigned agrees with the Insurer as follows:

MANAGEMENT OF CLAIMS AND LOSSES

1. The insurer will or will continue to:

1.1 investigate the Claims and Losses;

1.2 in the name of the Undersigned (or as otherwise required), commence, prosecute, defend, try and/or settle all Actions or other legal proceedings arising from the Claims or Losses; and/or

1.3 negotiate, settle and/or pay the Claims and Losses or any settlements and judgments arising therefrom,

all as the Insurer in its sole discretion deems necessary or appropriate. Insofar as the Insurer may appoint counsel to represent the Undersigned in any Actions or other legal proceedings arising from the Claims or Losses, the Undersigned expressly agrees and consents that:

1.4 the retainer of such counsel shall be limited to the representation of the undersigned in the said Action or other legal proceeding;

1.5 the said counsel shall not advise either the Insurer or the Undersigned with respect to any coverage issues arising from the matters set forth in subparagraph D above;

1.6 all information received by the said counsel from either the Insurer or the Undersigned will not be treated as confidential from and will be available to both the Insurer and the Undersigned; and

1.7 both the Undersigned and the Insurer shall be at liberty to retain their own separate counsel, at their own expense, to provide advice or representation as required with respect to the said coverage issues.

2. The Insurer may at any time withdraw from any further involvement in any of the matters referred to in paragraph 1 hereof and in such event this Agreement shall nevertheless continue to be in full force and effect.

3. The Undersigned will provide all reasonable cooperation and assistance to the Insurer and its representatives in carrying out the various matters contemplated in paragraph 1 hereof.

RETURN OF PREMIUM

4. Insofar as the Insurer may have grounds to void the Policy or any claim or coverage thereunder, it shall not be necessary for the Insurer to presently return to the Undersigned (or to any other persons entitled to the same) any premiums paid in connection with the Policy. Rather, the amount of premium, if any, to be returned to the Undersigned or

others may be set off against all amounts presently or hereafter owed by the Undersigned to the insurer, (pursuant to paragraph 5 hereof or otherwise), with any balance to be paid after such set-off has been made.

REIMBURSEMENT BY UNDERSIGNED

5. In the event that the Insurer establishes that it was or is entitled to void the Policy or to deny liability or coverage thereunder for the Claims or Losses or any of them by reason of the matters set forth in paragraph D hereof, then upon demand therefor the Undersigned will repay to the Insurer all appropriate amounts paid by the Insurer respecting the said Claims, Losses or any of the matters in respect thereof set forth in paragraph 1 hereof.

NON-WAIVER

6. Neither the making of this Agreement nor anything done before or after the same by or on behalf of the Insurer,

6.1 shall prevent or estop the Insurer from hereafter voiding the Policy, denying liability or coverage under the same for the Claims or Losses and/or seeking reimbursement from the Undersigned; or

6.2 shall constitute either

6.2.1 an affirmation of the Policy or coverages thereunder, or

6.2.2 a waiver of any right by the Insurer to void the Policy, to deny liability or coverage thereunder and/or to seek reimbursement from the Undersigned,

and in the event of any Action or other proceedings between the Insurer and the Undersigned, the Undersigned will,

6.2.3 neither plead nor claim such estoppel, affirmation or waiver;

6.2.4 admit that no such estoppel, affirmation or waiver has occurred, and

6.2.5 will not dispute the quantum or reasonableness of any payments or settlements made or entered into by the Insurer or any other steps taken by the Insurer pursuant to this Agreement.

EXECUTION OF AGREEMENT

7. The Undersigned also acknowledges that he/she/it,

7.1 in making this Agreement, has not been influenced to any extent whatsoever by any representations, statements or conduct of any description on the part of the Insurer or anyone on its behalf;

7.2 has carefully read this Agreement and does fully understand the terms and conditions of the same; and

7.3 before executing this Agreement, either has obtained or has been given the opportunity to obtain independent legal counsel regarding this Agreement and all matters referred to herein or related thereto.

ENTIRE AGREEMENT

8. This Agreement constitutes the entire agreement between the Undersigned and the Insurer respecting the matters set forth herein and there are no oral statements, representations, warranties, undertakings or collateral agreements between the Undersigned and the Insurer modifying or affecting the terms hereof.

ENUREMENT

9. This Agreement will enure to the benefit of and be binding upon the Undersigned and the Undersigned's heirs, executors, administrators, employees, agents, successors and assigns. In the event the Undersigned is a "Named Insured" under the Policy, then the Undersigned is executing this Agreement on the Undersigned's own behalf and also as agent and on behalf of all persons insured under the Policy, whether named or unnamed, and this Agreement will enure to the benefit of and be binding upon the said persons.

DATED this _____, 2006

SIGNED, SEALED and DELIVERED in the presence of:	
_____	_____
(name of Witness)	(Print name under signature. If a corporation and authorized officer signing on behalf of same.)