Defence Counsel and Coverage Issues:
Assisting Insurers in Avoiding Bad Faith Claims

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The changing legal landscape respecting the duties of insurers and the consequences of breaching those duties has an impact on the role of defence counsel. In this paper we review the duties of insurers, the ethical obligations of counsel in the tripartite relationship and the impact defence counsel can have on insurers' liability, focusing on matters where the insurer and insured have conflicting interests.

In short, defence counsel ought to take reasonable care to avoid involvement in coverage matters because their actions can adversely affect the insurer client.

1. DUTY AND STANDARD OF CARE OF AN INSURER

Under a liability policy, an insurer is obliged to investigate and defend an action, and in doing so the insurer must exercise reasonable care and skill. This duty arises in tort because of the relationship of proximity with the insured, and in contract as an implied term under the policy.

In *Shea v. Manitoba Public Insurance Corp.*, B.C. Supreme Court emphasized that:

> "the Insurer's duty to defend carries, among other things, a duty to advise the insured of the nature and extent of any conflicting interests and to instruct counsel to treat the interests of the Insured equally with those of the Insurer".
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> (emphasis added)

The insurer's right to defend carries with it an obligation to safeguard the interests of the insured. The *Shea* decision confirms that the insurer must treat the insured's interests equally with its own. Difficulties in meeting this duty will only arise when the insured and insurer do not share identical interests. The circumstances when conflicting interest might arise fall into four general categories:

the claim might not fall within the scope of coverage under the policy; the claim might be affected by a policy exclusion; the conduct of the insured might breach the policy conditions; or deductibles and/or limits can be affected by the defence. For each of these circumstances there will be a number of occasions in the course of defending a claim when the actions of defence counsel can sway a result to the benefit or detriment of the insured. It is the duty of the insurer, then, to not just avoid influencing the outcome of the action to result in a finding of non-coverage, but to ensure that defence counsel does not sway, or can be seen to sway, the result in favour of the insurer.

The BC Courts have signaled in *BCMA v. Aviva* how far they are willing to go to protect the rights of an insured where there is a conflict. In the 2011 decision the BC Medical Association sued its insurer for denying coverage in a defamation action. The pleadings alleged a "campaign of vilification" with the direct intent to injure and with full knowledge of the falsity of the statements. The insurer took the reasonable position that the allegations of intentional falsehood meant there was no coverage under the policy.

The Court found there was a duty to defend. On the issue of the conduct of the defence, Aviva sought control. The Court confirmed the existing state of the law; that the insurer does not have an absolute right to control the defence. Where a reasonable apprehension of conflict arises, the right to appoint and instruct counsel may rest with the insured. Although the mere fact that a reservation of rights is issued does not give rise to a conflict of interest, as between Aviva and BCMA coverage questions were going to depend on the intention, knowledge and purpose of the insured defendants. The conflict was deemed "too substantial to ignore". BCMA was awarded conduct of the defence, with defence counsel of their choosing, and defence counsel were not required to report to Aviva on issues of liability.

The only way to absolutely ensure that defence counsel cannot be found to have adversely impacted the insured's interests in a case is to keep defence counsel ignorant of the coverage issues, and to have independent counsel protecting the insured's interests and dealing directly with the insurer, outside defence counsel's knowledge, on any issues of conflict. In reality this is difficult to achieve. The file material sent to defence counsel frequently includes coverage correspondence, especially reservation letters or references to them.

Also, insurance defence counsel are familiar with coverage issues. No matter how isolated defence counsel is from conflicts, he or she will be readily aware that certain facts, pleadings or actions by the insured have coverage consequences. The courts are aware of this, as is the plaintiff's bar. Therefore, it has become increasingly likely that insureds will argue, and courts will infer, that defence counsel were aware of coverage issues when certain decisions were made during the defence of a claim. As a result, insurers need to be vigilant, both in keeping defence counsel objective and in being seen to be doing so.

2. ROLE AND DUTY OF DEFENCE COUNSEL

Defence counsel has two clients: the insurer and the insured, and owes duty to both. This duty is made clear by counsel's ethical obligations, which have been confirmed at law. In *Chersinoff v. Allstate Insurance Co.*,[1] in the context of considering the issue of document disclosure as between an insurer and insured, the court held that defence counsel appointed on behalf of the insured must be seen as having been jointly retained, even though the insured did not have any say in the selection of counsel. The insured becomes counsel's client by virtue of the insurer's contractual right to conduct the defence and the insured's agreement to indemnification under the contract.

Counsel's duty to its two clients is equal, despite the obvious differences in the two relationships. In the case of insurer, defence counsel and the insurer will typically have the benefit of a well-established relationship extending over a number of matters, where trust and familiarity already exist. The insured, on the other hand, will have had no say in the selection of counsel, and will typically have had no prior relationship with counsel. Generally speaking, all instructions come from the insurer, and counsel's contact with the insured is very limited in comparison. Accordingly, care must be taken by counsel to identify and avoid conflicts of interest between the two clients, and to ensure that both clients are fully protected.

The obligations imposed on defence counsel in a situation where there are conflicting interests between two clients have been well canvassed, and the Law Society of BC has made it clear that the

[1] 69 D.L.R. (2d) 653, appeal allowed in part ((1969) 3 D.L.R. (3d) 560), however no disagreement was expressed by the Court of Appeal with respect to the principle of joint retainer and the requirement to disclose communications with both clients.

Code of Professional Conduct—and not the insurance contract—governs counsel's obligations to the insured. Counsel's duties prescribed by the Code of Professional Conduct include the following:

> 3.4-5 Before a lawyer is retained by more than one client in a matter or transaction, the lawyer must advise each of the clients that:
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> a. the lawyer has been asked to act for both or all of them;
> b. no information received in connection with the matter from one client can be treated as confidential so far as any of the others are concerned; and
> c. if a conflict develops that cannot be resolved, the lawyer cannot continue to act for both or all of them and may have to withdraw completely.

Conflicts can easily arise where counsel learns of information that would adversely affect coverage. One of the most important considerations in the duty of defence counsel is the confidentiality of solicitor-client communications. Where only one client is involved, the duty is clear: counsel cannot reveal the content of solicitor-client communications absent the client's consent. In contrast, where counsel has two clients—in the case of insurer and insured—information received from one that concerns their joint representation must be disclosed to the other. Accordingly, all efforts must be made to avoid such circumstances from arising.

Conflict inevitably arises when issues relating to coverage or obligations under the insurance contract arise, and must be considered outside of defence counsel's joint retainer. By virtue of the established and ongoing relationship between counsel and the insurer, practice had developed over time among some counsel and insurer clients where counsel would advise the insurer on matters of coverage while acting in their joint role as defence counsel on liability. This practice created an obvious appearance of impropriety to the insured, and is no longer considered acceptable and is likely to warrant counsel's withdrawal. Counsel's retainer should be restricted to the defence of issues of liability and damages.

Other situations that may give rise to conflicts include where there is a defence under a reservation of rights, where the claim may exceed policy limits, and where there are conflicting interests among more than one insured. While a discussion of these is beyond the scope of this paper, they are nevertheless situations to keep in mind as creating a potential conflict for defence counsel.

3. VICARIOUS LIABILITY

The insurer's obligation to exercise its duty of good faith is non-delegable. Therefore, when an insurer retains and instructs defence counsel to represent an insured, the insurer has an ongoing responsibility to treat the insured's interests equally with its own. One area of the law which may impact insurers going forward is that of vicarious liability.

Historically, vicarious liability depended more on the category of relationship (i.e., agency) than on the nature of the relationship. In the 1999 SCC decision *Bazley v. Curry*, in an employment context, the Court expanded vicarious liability by establishing guiding principles. The principles included openly confronting

> …the question of whether liability should lie against the employer, rather than obscuring the decision beneath semantic discussions of 'scope of employment' and 'mode of conduct'.

Also,

> The fundamental question is whether the wrongful act is sufficiently related to conduct authorized by the employer to justify the imposition of vicarious liability. Vicarious liability is generally appropriate where there is a significant connection between the creation or enhancement of a risk and the wrong that accrues therefrom, even if unrelated to the employer's desires.

Bazley has been applied in insurance cases (*Thiessen v. Mutual Life Assurance Company of Canada*) against insurance agents, and against other professionals in cases such as *Hub Excavating v. Orca Estates Ltd.*

As for defence counsel, the law had been that insurers were not responsible for defence counsel's negligent defending. In the 1991 decision of *Shea v. Manitoba Public Insurance Corp*., the BC Supreme Court distinguished between the lawyer's defence duties and his or her role in settlement negotiations. The insurer would not be liable for the lawyer's breach of professional duty because that liability in the exercise of professional skill was the sole responsibility of the lawyer. Liability

for the lawyer's actions in settlement negotiations was different, however, because settlements can be negotiated by anyone, not just lawyers, and settlement authority comes from the insurer.

The *Bazley v. Curry* decision came after *Shea*. Decisions such as *Thiessen* and *Hub Excavating* reveal an expansion of vicarious liability into the realm of independent professionals. Also, in terms of the guiding principles of *Bazley*, including the idea of a significant connection to authorized conduct, it has also been noted, correctly, that the relationship between insurer and defence counsel has changed.

We refer to the following passage from Gordon Hilliker's book, Insurance Bad Faith, (3rd ed.):

> Both lawyers and adjusters take their instructions from the insurer, not the insured. Although, in the past, lawyers especially were provided with a considerable degree of independence in the manner in which they carried out their duties, that is less so today. Many insurers now provide the lawyers they retain with detailed litigation guidelines, stipulating what the lawyers may and may not do in the defence of the action. Many actions which, in the past, lawyers would undertake as a matter of course now require prior approval from the insurer. This degree of control and involvement by the insurer may well render the insurer vicariously liable for certain actions of defence counsel, which, in the past, would not have attracted such liability. In addition, where a conflict of interests exists and defence counsel favours the insurer's interests over those of the insured, the insurer may be vicariously liable for defence of counsel's breach of fiduciary duty.

There are a couple of Canadian decisions, both predating *Bazley v. Curry*, which consider the issue of vicarious liability of the insurer for the actions of defence counsel. In *Frederickson v. Insurance Corporation of British Columbia*, BC Courts accepted the proposition that defence counsel "…may bind the insurer by his derelictions". In *Pelky v. Hudson Insurance Co*, the insurer conceded it was vicariously liable for the negligence of the lawyer it had appointed to conduct the defence. The Court held the insurer liable for an excess judgment.

Where defence counsel has acted negligently in defending a claim, we assume that the insurer then has its own negligence claim against defence counsel. However, where defence counsel is acting on instructions from the insurer, or perhaps not acting because of restrictions expressly or

impliedly imposed by the insurer, it is unlikely there would be liability owed by defence counsel to the insurer.

4. AGGRAVATED AND PUNITIVE DAMAGES

Another developing area of insurance law which might be impacted by the actions of defence counsel is the increase in aggravated and punitive damages. To briefly distinguish the two types of damages, aggravated damages are not meant to punish or deter. If there has been a breach of an independent cause of action, such as the duty of good faith, which can arise concurrently with a finding of contractual breach, then if the plaintiff proves mental distress from the breach he or she can recover accordingly. Punitive damages are, on the other hand, obviously meant to punish. They arise from conduct that is "harsh, vindictive, reprehensible and malicious" (*Vorvis v. ICBC*).

There may also be damages for breach of the insurer's implied duty of good faith under the insurance policy. Regardless of the category of damage, however, there is now a sufficient body of caselaw for one to reach some conclusions as to the impact on insurers of a breach by defence counsel in handling a claim.

In the 2012 *McDonald v. ICBC* decision, the Court held that ICBC's failure to inform the insured that she was not being defended in an action, and in settling the claim and then pursuing her for recovery of the indemnity, amounted to "harsh, high-handed and oppressive" conduct, and a "significant departure from the Court's sense of decency and fair play". The Court also took into account the vulnerable position of the insured and the ability to ICBC to afford a punitive award, and awarded $75,000. This was an instance where there was no defence counsel appointed, but it is indicative of the BC judiciary's willingness to punish insurers.

There is a passage in *McDonald* which describes a typical bad faith claim:

> Stated in overview, a typical insurer bad faith claim encompasses a constellation of acts undertaken by an insurer that offend or run counter to the broad duty of good faith and fair dealing inherent in the insurance contract. The misconduct is

> often aimed at or has the effect of obtaining an advantage or gain for the insurer, at the expense of the interests of the insured. Evidence of conduct that amounts to fraud or corrupt motive might be present, but it need not be.
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> (emphasis added)

This passage underscores the position of the courts on the subject of an insurer's obligation to treat the insured's interests equal to its own.

In light of the increased likelihood of insurers being vicariously liable for the actions of defence counsel, and the tendencies of certain insurers to impose greater control on the conduct of defence, the seeds have been sown for aggravated and punitive damages to be awarded where an insurer is found to have failed to treat the insured's interests equally with its own. Those instances will arise where an insurer actively or impliedly seeks the involvement of defence counsel in coverage matters.

5. MEETING THE DUTY OF GOOD FAITH AND FAIR DEALING

In order to assist the insurer in meeting its broad duty of good faith and fair dealing, and to comply with his or her own ethical obligations, defence counsel does not provide advice on coverage. Where information collected in defence of a claim is relevant to that defence it is reported to the insurer. Defence counsel does not comment on coverage implications, but he or she also does not withhold information from insurers just because it might have coverage implications.

Referring to the four general categories of conflicting interests mentioned earlier herein, in situations where the conduct of the insured in the course of defending an action might breach a policy condition, defence counsel ought to report the breach to the insurer if it also adversely affects the defence of the claim. For example, a failure to cooperate needs to be brought to the insurer's attention. This does not offend the insurer's good faith duties.

For the three other categories of conflicting interests there are no readily apparent scenarios by which defence counsel can make any comment on the impact of evidence and pleadings on coverage. The New Brunswick Court of Appeal, in considering a duty to defend under a motor

vehicle policy, adopted a comment from a Quebec Court of Appeal decision addressing the actions of defence counsel.

> However, Justice LeBel pointed out that the involvement of the same lawyer with respect to coverage issues and in the defence of the insured could justify a decision to allow an insured to retain separate and independent counsel as it might be the only practical way of fulfilling the insurer's duty to defend.

Occasionally individual examiners request coverage advice from defence counsel. The only appropriate response is a reminder that coverage advice cannot be given. When coverage material is received from the insurer upon retention of defence it should be returned or deleted/destroyed with confirmation of same to the insurer. For one-off instances like these, the actions of defence counsel can protect the insurer in the event that a coverage conflict arises on the file.