



# The Defence Costs Allocation Dispute

Finding principled solutions and retaining the insured's future premiums

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The allocation of defence costs between covered and uncovered insurance claims is an area of insurance law that has recently created considerable confusion across Canada. Certain court decisions that have attempted to provide a framework for determining the allocation of defence costs have proven awkward to apply in practice, while other decisions are inconsistent in their application of certain principles.

The issue of allocation of defence costs is often a significant one that affects both insurers and insureds alike. The relationship between the insurer and the insured is often put to the test with the integrity of the insurer and the insured's future premiums at stake. It is certainly an issue worthy of close examination with a view of properly understanding the guiding principles in order that a fair and well-reasoned allocation can be achieved in any given set of circumstances.

The starting point for reviewing the issue of defence cost allocation is the Supreme Court of Canada decision in *Nichols v. American Home Assurance Co.*, [1990] 1 SCR 801. In this decision, the Court held that the duty to defend is triggered not by actual acts or omissions, but rather by the allegations, "even if any of the allegations of the suit are groundless, false or fraudulent."<sup>1</sup> However, the duty to defend is not so broad as to apply to allegations which are clearly beyond the scope of the policy. "The practice is for the insurer to defend only those claims which potentially fall under the policy, while calling upon the insured to obtain independent counsel with respect to those which clearly fall outside its terms."<sup>1</sup> This is called the pleadings rule.

The pleadings rule has been refined in two subsequent deci-

sions of the Supreme Court. Firstly, in *Non-Marine Underwriters Lloyd's of London v. Scalera*, [2000] 1 S.C.R. 551, the Supreme Court determined that there are cases where the pleadings in the underlying action may be framed in a manner to bring the allegations within the scope of coverage when the actual substance

of those allegations are such that they would not be ordinarily covered. Rather than leave the insurer and the insured at the mercy of those drafting the underlying action, the Supreme Court indicated that, in certain cases, the real substance of the underlying claim must be examined rather than the actual words used in the underlying action.

Secondly, the Supreme Court in *Monenco Ltd. v. Commonwealth Insurance Co.*, [2001] 2 SCR 699 established further principles specifically in respect of pleadings that are not clearly drafted. The Court stated that:

"Where pleadings are not framed with sufficient precision to determine whether the claims are covered by a policy, the insurer's obligation to defend will be triggered where, on a reasonable reading of the pleadings, a claim within coverage can be inferred. This principle is congruent with the broader tenets underlying the construction of insurance contracts, namely the *contra preferendum* rule, and the principle that coverage provisions should be construed broadly, while exclusion clauses should receive a narrow interpretation."<sup>2</sup>

While it seems clear that the insurer should not be made to defend claims which clearly fall outside the policy, there are practical difficulties in trying to determine how defence costs should be allocated. For example, engaging two or more counsel



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to defend the same action on behalf of the same party is often not economically efficient and can be cumbersome. Issues such as who conducts examinations and who is the lead counsel in terms of strategy can also arise. Mass tort litigation where the loss occurs over time and involves several insurers can also make matters difficult in attempting to determine an allocation of costs. The practical question becomes: how do the parties allocate the cost of one defence counsel among two or more interested parties for covered and non-covered claims? Moreover, the question of when this determination should be made is also of importance to the parties.

### Which Are Covered and Which Are Not

Certain courts have held that it is often easier to determine allocation of defence costs if the underlying action is resolved. The difficulty with this is that it often allows for the build-up of animosity between the parties, resulting in increased costs and inefficiency. There is also the continued uncertainty throughout the trial of the underlying action as to what costs are going to be covered and which costs are ultimately going to be paid by the insured.

The British Columbia Court of Appeal in *Continental Insurance Co. v. Dia Met Minerals Ltd.*, [1996] B.C.J. No. 1293 ordered an allocation of the defence costs on an interim basis, subject to reallocation at conclusion of the underlying action. The allocation of costs on an interim basis has not been embraced by most other jurisdictions, but an interim allocation would appear to be preferable to deferring the allocation question until the end of the underlying action. Interim allocation allows the insurer and the insured to then work together with the comfort of knowing that there can be a readjustment of the allocation later, if necessary.

Other courts have determined the allocation of defence costs before the main underlying action is resolved if a sensible and workable formula for that allocation can be established. Further, in making a determination, the conduct of the insurer and the insured will be scrutinized. For example, in *Modern Livestock Ltd. v. Kansa General Insurance Co.*, [1993] A.J. No. 575, the Court found that an insurer cannot act arbitrarily or "wrongfully" in denying a defence where some allegations are within coverage. If an insurer does so and arbitrarily denies a defence, an insurer will be required to pay all defence costs, even for the non-covered claims. The onus is on the insurer to bring forward clear evidence of a sensible allocation formula.

In *P.C.S. Investments Ltd. v. Dominion of Canada Insurance Co.*, [1996] A.J. No. 33, the Alberta Court of Appeal held that it was not necessary to resolve all points of coverage arising in the underlying action as the vast majority of claims fell within the policy coverage. The Court allocated costs based on the questions "how much would be expended if only the insured's risks were raised by the Plaintiff's claim?"<sup>3</sup> The Court found that the overwhelming bulk of any defence work was the burden of the insurer. The insured's own defence counsel was given carriage of the defence and was directed to divide his bill with the insurer paying the covered tasks and the insured paying the non-covered tasks.

Courts have also found that in some cases there is simply no reasonable or workable way to apportion defence costs in an action, such as when there is one cause of action with multiple theories of liability, some of which are covered and some of which are not. The challenge in such cases is to develop a reasonable

basis for an allocation formula. Where that is not done, or is not possible, the insurer will be forced to bear the defence costs for all of the claims, covered or not.

### Defence Costs Should Be Apportioned

In *Kelly Panteluk Construction Ltd. v. AXA Pacific Insurance Co.* [2005], S.J. 370, the Court was faced with the allocation question where the underlying action alleged causes of action falling within policy coverage and within an exemption to that coverage. The Court held that defence costs should be apportioned between the insurer and the insured. Three exceptions to this were noted:

- (a) no apportionment would be found where a claim alleges one cause of action with different theories of liability;
- (b) where an action raises claims within and outside coverage that overlap to the degree that apportionment is impractical or impossible, all costs will be paid by the insurer; and
- (c) where the insurer has failed to discharge its obligation to defend or share in the cost of defending a claim covered by its policy, the insurer will pay all costs.

How courts will deal with applications to determine the allocation of defence costs is still a developing area. Clearly, it is preferable to have an allocation formula in the policy than to have the insurer and the insured left at the peril of the pleadings in the underlying action.

Short of any such provision for allocation in the policy, be aware that the insurer's conduct, as in all areas of insurance law, will be closely scrutinized. An insurer cannot act arbitrarily in denying the duty to defend lest the insurer be faced with the prospect of paying all of the defence for both covered and uncovered claims. The insurer must bring forward clear evidence of a sensible allocation formula.

The bulk of the authority suggests that courts are inclined to defer a decision on allocation of defence costs until the conclusion of the underlying action. In the view of these authors, that may not be the best practice. There are certain costs and inefficiencies that can likely be avoided if the issue is dealt with as soon as possible and early mediation of the allocation issue ought to be considered in such cases. This can be to the benefit of the insurer and the insured. If handled properly, early resolution of this issue can salvage the relationship between the insurer and the insured, and possibly result in the future business of the insured being retained by the insured. For that, your underwriters will thank you. 🍁

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1. Judgments of The Supreme Court of Canada, *Nichols v. American Home Assurance Co.*, [1990] 1 S.C.R. 801, April 12, 1990; <http://scc.lexum.umontreal.ca/en/1990/1990rcs1-801/1990rcs1-801.html>

2. Judgments of The Supreme Court of Canada, *Monenco Ltd. v. Commonwealth Insurance Co.*, [2001] 2 S.C.R. 699, 2001 SCC 49; <http://scc.lexum.umontreal.ca/en/2001/2001scc49/2001scc49.html>

3. Singleton, Q.C., John R., and Brearley, Scott "The Defense of a Mixed Claim" Singleton Urquhart LLP