

## INSURANCE LAW BULLETIN

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### DEFENCE COSTS: COVERED AND UNCOVERED CLAIMS

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The general rule governing an insurer's duty to defend is that a defence must be provided to any claim which, if it succeeds, could fall within the coverage provided under the policy. When faced with litigation in which several different claims are advanced, it can become problematic to properly distinguish between claims that are afforded a duty to defend and claims that are not. This is especially difficult when covered and non-covered claims both arise from the same factual situation, and where efforts and resources expended to defend one claim will automatically advance the defence of another.

In the recent decision of *Hanis v. Teevan*, the Court of Appeal for Ontario held that in such situations, the fact that the costs expended to defend a covered claim result in an uncovered claim being defended as well does not provide a justification for forcing the insured to contribute to the defence costs. So long as a defence is owed, an insurer must provide a full defence, even if it results in a defence being provided to claims that would not otherwise be covered.

#### **BACKGROUND**

The dispute over the allocation of defence costs in *Hanis* was one of the final chapters in a dispute that dated back to 1987. Hanis was fired from his position at the University of Western Ontario for allegedly using the University's computer facilities to further his own private business interests. At the same time, Hanis was charged with fraudulent use of a computer. Almost all of the evidence the charge was based on was provided by the University.

After Hanis was acquitted of the charges he launched a lawsuit against the University. The scope of the claim against the University was massive, encompassing claims for wrongful dismissal, breach of contract, defamation, malicious prosecution, conspiracy and a number of business torts. Hanis also

requested numerous declarations and injunctions related to computer programming projects he had worked on at the University. After a 64 day trial, followed by a successful appeal, Hanis was found to have been wrongfully dismissed by the University and was awarded approximately \$150,000 in damages.

The University's insurer, Guardian, had denied a defence. After the main litigation was commenced, the University obtained a declaration by the court that it had been entitled to a defence under the Guardian policy. More specifically, Guardian was required to provide a defence to the allegation of malicious prosecution. It was held by a motion judge that Guardian was liable to reimburse the University for 95% of the more than \$2,000,000 in defence costs incurred by the University in defending the main action.

## **THE COURT OF APPEAL**

Guardian appealed the apportionment of defence costs on the basis that most of the claims advanced by Hanis were not covered claims. Guardian further argued that it was not fair for the University to effectively profit from situations where Guardian's defence of the covered claims (had a defence been provided) would have advanced the defence of uncovered claims. Guardian claimed that this was what would have happened on a large scale in Hanis' action, as a defence of the malicious prosecution claim would have effectively resulted in the defence of most of the remaining claims. When faced with "mixed claims", Guardian argued that the defence costs should be divided on a "fair and equitable" basis.

The Court of Appeal rejected the argument that "fairness" requires a division of the defence costs where a defence of covered claims results in a defence of uncovered claims. In doing so, the Court emphasised the contractual nature of insurance. Since the obligation to defend arises from the terms of the policy of insurance, there can be no issue of "fairness" in holding an insurer to those terms, regardless of what inadvertent benefits may accrue to the insured. The Court's position was summarized by Justice Doherty as follows:

I see no unfairness to the insurer in holding it responsible for all reasonable costs related to the defence of covered claims if that is what is provided for by the language of the policy. If the insurer has contracted to cover all defence costs relating to a claim, those costs do not increase because they also assist the insured in the defence of an uncovered claim. The insurer's exposure for liability for defence costs is not increased. Similarly, the insured receives nothing more than what it bargained for – payment of all defence costs related to a covered claim.

In an interesting post-script, the Court of Appeal also went on to deal with a further point of law that has sometimes been employed in disputes over an insurer's duty to defend. In some cases, where an insurer has been held to have inappropriately denied a defence to a claim that is partially covered, the insurer can be forced to pay the costs of the entire claim, i.e both covered and uncovered portions, by way of punishment for failing to defend the claim in the

first place. The Court of Appeal, following on its earlier emphasis on the contractual nature of insurance, held that there was no basis to force a party to a contract to perform an obligation it had never contracted for. As such, no insurer can be held liable for defence costs it would never have been responsible for, regardless of how reprehensible its conduct.

## COMMENTARY

Canadian insurance law has generally been informed by the principle of broadly interpreting the coverage provisions of insurance policies, and the Court of Appeal's decision in *Hanis* follows this principle. The Court made the point that should insurers wish to avoid defence costs windfalls to their insureds, the only valid remedy is to provide for limitations on defence costs in the actual terms of the policy.

While the Court of Appeal eschewed the idea of "fairness" having a role in determining an insurer's defence cost obligations under its policy, it is important to note that *Hanis* dealt with the relationship and obligations between an insurer and its insured. General concepts such as fairness and equity are still alive and well when it comes to the apportionment of defence costs as between insurers in situations where multiple policies must respond to the same loss. In its 2002 decision of *Alie v. Bertrand Frée Construction Co.*, the Court of Appeal specifically noted that dividing defence costs between insurers "is essentially a matter of fairness" and will often be "somewhat arbitrary."

The Court of Appeal's rejection of the idea of requiring insurers to pay the full costs of a claim in a situation where a defence is improperly denied as a form of penalty may not be as helpful as it initially appears. Once an insurer is held to have improperly denied a defence, the court will have to determine which claims are covered and which are not. This will, of course, present significant practical problems for the insurer. In the normal course of events, the insurer will not have been involved in the defence of the action that they are subsequently held to be responsible for, and will not have access to much of the evidence needed to support its position regarding coverage. Furthermore, a denial of a defence leaves an insured free to conduct the defence in any many they wish. This means that an insured could employ a defence that is more expensive, or which is specifically tailored to create the appearance that a properly provided defence to one claim would have resulted in the effective defence of other uncovered claims, thus exposing the insurer to more defence costs.