

THE “DUTY TO DEFEND” EXCEPTION: SOLICITOR-CLIENT COSTS AND LIABILITY COVERAGE PROCEEDINGS

AREA OF LAW: Costs and Insurance Law

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LEGAL ISSUE: Should liability insureds be automatically entitled to solicitor-client costs after successfully enforcing coverage? Or, should full indemnity costs remain within their traditional function of punishing reprehensible litigation conduct by a party?

KEY WORDS: Liability Insurance, Solicitor-Client Costs, Full Indemnity, Duty to Defend, Coverage Proceedings.

Conclusion:

Awards of solicitor-client costs are generally viewed as rare and exceptional. Seen as punishment for litigation misconduct, full indemnity costs have been described variously as a “penalty,”¹ “chastisement,”² “punitive,”³ or as a “rebuke.”⁴ As such, they have been traditionally “reserved for reprehensible, scandalous or outrageous conduct in rare and exceptional cases.”⁵

¹ *Estate of Jarvis Hayward Estabrooks et al v Barry et al. and Macey*, 2016 NBCA 55 at para 44, 452 NBR (2d) 296.

² *Labrador Inuit Assn. v. Newfoundland (Minister of Environment & Labour)*, 157 Nfld & PEIR 164 at para 23, 486 APR 164 (Nfld TD).

³ *Lindsay v Royal Bank of Canada*, 8 ACWS (2d) 35 at para 6, 1981 CarswellOnt 2748 (ON SC).

⁴ *Humby v Newfoundland and Labrador*, 2013 NLCA 7 at para 48, 331 Nfld & PEIR 201.

⁵ *Thirteen Rivers Ltd. v. 3285548 Nova Scotia Ltd.*, 2016 NSSC 232 at para 24, 271 ACWS (3d) 274.

However, recent liability coverage decisions have erected an exception to this consensus. Beginning with the Ontario Court of Appeal decision in *M. (E.) v. Reed*,⁶ Canadian courts have increasingly held that where an insurer has breached its duty to defend, the insured should automatically receive the entire costs attributable to enforcing said duty.

This article argues against this “duty to defend” exception. While these awards are purportedly justified on a “contractual basis,”⁷ examination of policy language shows no express or implied term actually warranting preferential costs treatment. As such, coverage proceedings are neither more nor less deserving of solicitor-client costs than those of other contractual claimants.

ARTICLE OUTLINE

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- II. *M. (E.) v. Reed* and the “Duty to Defend” exception
- III. An insurer has no express duty to pay solicitor-client costs
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- V. Conclusion

ANALYSIS:

I. Introduction

In Canada, unsuccessful litigants can expect to pay a portion of the winner’s costs.⁸ In measuring such costs, courts use one of two scales. The default is

⁶ [2003] OJ No 1791, 171 OAC 145 (ON CA).

⁷ *Ibid* at para 22.

⁸ ES Knutsen, “The Cost of Costs: The Unfortunate Deterrence of Everyday Civil Litigation in Canada” (2010) 36 Queen’s LJ 113.

partial indemnity,⁹ as embodied in the “party and party” scale. A second possibility is total indemnification. This solicitor-client scale is rare and exceptional,¹⁰ traditionally reserved for reprehensible, scandalous or outrageous conduct by one of the parties.¹¹

Over the last fifteen years however, certain liability coverage proceedings have begun to routinely award solicitor-client costs to liability insureds who have successfully enforced a defence from their insurer.¹² Such costs have been imposed regardless of the defendant’s conduct.

This article offers the first published analysis of this “duty to defend” exception. Such trend is criticized as unsound, as it confuses a policy’s obligation duty to pay an insured’s costs in the main action, with an insured’s separate responsibility to finance its own enforcement of the policy.

A liability policy imposes neither an explicit nor implied duty to pay full indemnity costs. As such, insureds are no more deserving of such awards than any other claimant enforcing a contractual right. I argue that the law should return coverage claimants to a norm of partial indemnity, and restore solicitor-client costs to their role in marking the court’s disapproval of a party’s conduct.¹³

⁹ Christopher Hodges, Stefan Vogenauer & Magdalena Tulibacka, *The Costs and Funding of Civil Litigation: A Comparative Perspective*, (Oxford: Hart Publishing, 2010) at p 254. See also *Reese v Alberta (Ministry of Forestry, Lands and Wildlife)*, [1992] AJ No 745, [1993] 1 WWR 450 (AB QB) at para 7.

¹⁰ *Evaskow v BBF*, 71 WWR 565 at para 24, 9 DLR (3d) 715 (MB CA).

¹¹ *Young v Young*, [1993] 4 SCR 3 (SCC) at para 260, 108 DLR (4th) 193.

¹² *Chubb Insurance Co. of Canada v SA Armstrong Ltd.*, 2012 ONSC 3416 at para 6, 219 ACWS (3d) 265.

¹³ *Hunt v. TD Securities Inc.*, [2003] O.J. No. 3245 at para 123, 124 ACWS (3d) 1033, citing Mark M. Orkin, *The Law of Costs* 2nd ed. (Aurora: Canada Law Book, 1993) vol 1 at pp 2-91 to 2-92 [Orkin].

II. *M. (E.) v. Reed* and the “Duty to Defend” exception

The “duty to defend” exception may effectively be traced to the Ontario Court of Appeal decision in *M. (E.) v. Reed*.¹⁴ Having successfully enforced a defence from their insurer, the insureds in *Reed* pressed further for solicitor-client costs. Despite an apparent lack of any litigation misconduct by the insurer, the Ontario Court of Appeal granted the request. The court justified its award on the “unique nature” of liability insurance claims:

22 Entitlement to solicitor-and-client costs in the third party proceeding flows directly from the unique nature of the insurance contract which entails a duty to defend at no expense to the insured. The obligation to save harmless the insured from the costs of defending the action is sufficiently broad to encompass the third party proceedings. It is the contractual basis for the claim to solicitor-and-client costs that justifies the award and therefore constitutes an exception to the usual rule that solicitor-and-client costs will not be awarded except in usual circumstances.¹⁵

Thus was born the “duty to defend” exception. In terms of its legal basis, *Reed* offered a rationale seemingly based in contract. Emphasizing the insurer’s contractual duty to indemnify legal expenses in the main action, *Reed* appeared to expand this obligation to further encompass the insured’s separate costs of enforcing coverage.¹⁶

While liability policies are in fact silent on the costs of enforcing coverage, subsequent cases have glossed over this in reliance on the supposedly “unique

¹⁴ *Reed*, *supra* note 6. An earlier 2000 decision of the Ontario Court of Appeal had also awarded solicitor-client costs for the insureds’ costs of enforcing coverage (see *Godonoaga (Litigation Guardian of) v. Khatambakhsh (Guardian of)*, (2000), 50 OR (3d) 417, 191 DLR (4th) 221 (ON CA)). However, *Godonoaga* offered no reasons, and it was not until *Reed* that the trend truly began in other provinces.

¹⁵ *Reed*, *ibid* [emphasis added].

¹⁶ The court in *Reed* further cited English and American authority suggesting that an insured should be fully compensated for any action required to establish a duty to defend. See, R. Merkin, *Colinvaux’s Law of Insurance*, 7th ed (London: Sweet & Maxwell, 1997) at 405, and *Chicago Title Ins Co v FDIC*, 172 F 3d 601 (8th Cir 1999) and *Preferred Mut Ins Co v Gamache*, 686 NE 2d 989 (Mass Sup Ct 1997).

nature” of liability policies. The following comments in *Ultramar Ltd. v. Rancur Petroleum Services Ltd.* are illustrative:

74 ...The insurer's obligation with respect to costs in this context is broadly stated in the *M. (E.) v. Reed* decision (paragraphs 22 to 24 quoted above). A review of the insurance contract in that case ...reveals no provision in the contract that directly relates, or could be construed as indirectly relating, to costs incurred by the insured enforcing the duty to defend. In other words, the court's imposition of the requirement to pay solicitor and client costs for the third party proceedings does not arise from a specific provision in the insurance contract. Rather, it arises from the unique nature of that contract. As stated by the Ontario Court of Appeal in *Reed*, an order for solicitor and client costs in this context “constitutes an exception to the usual rule that solicitor-and-client costs will not be awarded except in unusual circumstances” [citations omitted].¹⁷

Reed's compensatory logic has recently been applied beyond the liability insurance context. In *Tanious v. Empire Life Insurance Co.*,¹⁸ the British Columbia Supreme Court invoked *Reed* in awarding solicitor-client costs to a disability claimant. The insured in *Tanious* did not allege any improper litigation behaviour by her insurer. Rather, she characterized full indemnity costs as necessary to secure her the “full benefit of the contract,”¹⁹ lest the cost of retaining legal counsel otherwise deprive her of the value of the insurance contract.²⁰

The court in *Tanious* agreed, and cited *Reed* as authority for the compensatory use of solicitor-client costs, as to ensure that the successful parties would recover the “full benefit of their insurance contract where this was in the interests of justice.”²¹ The court in *Tanious* went on to find that without full indemnity, legal expenses would eat into Ms. Tanious's award, depriving her of the benefit of her disability benefits, “leaving her with less than the necessary

¹⁷ *Ultramar Ltd v Rancur Petroleum Services Ltd.*, 2006 NLCA 55, 42 CCLI (4th) 18 [*Ultramar*] [emphasis added].

¹⁸ 2017 BCSC 85, 274 ACWS (3d) 732.

¹⁹ *Ibid* at para 19.

²⁰ *Ibid*.

²¹ *Ibid* at para 146.

amount of income by which to obtain the basic necessities of food, clothing, and shelter.”²²

Despite its slender reasons, *Reed’s* conclusion has now found favour in other provinces, spreading ultimately to New Brunswick,²³ Newfoundland and Labrador,²⁴ Manitoba²⁵ and British Columbia.²⁶ Such decisions stand on the verge of entrenching a new freestanding basis for solicitor-client costs, focused on the underlying rights of a plaintiff, rather than any traditional focus of the litigation misconduct of a defendant.

III. An insurer has no express duty to pay costs

This article criticizes the “duty to defend” exception. Put simply, a liability policy contains neither express or implied terms justifying any special costs entitlement. Shorn of any contractual rationale, such insureds must be seen as no more deserving of full indemnity costs than any other contractual claimant.

Let us begin by considering whether the express terms of a liability policy justify full indemnity. After all, if an insurance policy did *explicitly* impose full indemnity as an obligation of the insurer, solicitor-client costs could be justified as expectation damages under the contract.²⁷

A representative example of the terms of a standard liability policy may be found in *Ultramar Ltd. v. Rancur Petroleum Services Ltd.*,²⁸ a decision

²² *Ibid* at para 155(d).

²³ *Dionne Farms Ltd v Fermes Gervais Ltée*, 2002 NBCA 98, [2002] ANB No 402.

²⁴ *Ultramar*, *supra* note 17.

²⁵ *Gilewich v 3812511 Manitoba Ltd.*, 2012 MBQB 252, [2013] 2 WWR 835.

²⁶ *Williams v Canales*, 2016 BCSC 1811, 271 ACWS (3d) 717.

²⁷ I say “might,” as the parties’ consent cannot fetter nor usurp a court’s ultimate discretion over costs. Prior courts have made clear that provisions in an insurance contract do “not bind a judge in the exercise of his or her discretion as to the appropriate costs order.” See *Alie v Bertrand & Frère Construction Co.*, [2002] OJ No 4697 at para 267, 222 DLR (4th) 687 (ON CA). See also *Darling v Kay* (1993), 15 OR (3d) 299, [1993] OJ No 1904 (ON GD).

As an aside, any award of solicitor-client costs made in response to a contractual provision would be better classed as “damages,” as opposed to discretionary “costs.” In other words, such an award would arise from the parties’ bargain, not their incidental litigation conduct.

²⁸ *Ultramar*, *supra* note 17.

adopting the “duty to defend” exception. The liability policy in *Ultramar* provided that the insurer would defend any action which sought damages for “bodily injury” or “property damage:”

1. Insuring Agreement

a. We will pay those sums that the Insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies. ... This insurance applies only to 'bodily injury' and 'property damage' which occurs during the policy period. The 'bodily injury' or 'property damage' must be caused by an 'occurrence'. The 'occurrence' must take place in the 'coverage territory'. We will have the right and duty to defend an 'action' seeking those damages.²⁹

The insurer also agreed to pay all the defence costs in the main action:

Supplementary Payments - Coverages A, B and D

We will pay, with respect to any claim or "action" we defend:

- 1) All expenses we incur.
- 2) The cost of bonds to release attachments, but only for bond amounts within the applicable limit of insurance. We do not have to furnish these bonds.
- 3) All reasonable expenses incurred by the Insured at our request to assist us in the investigation or defence of the claim or "action", including actual loss of earnings up to \$250 a day because of time off from work.
- 4) All costs taxed against the Insured in the "action" and any interest accruing after entry of judgment upon that part of the judgment which is within the application limit of insurance.

These payments will not reduce the limits of insurance.³⁰

The above terms are representative of those in any standard liability policy. Their effect is plain, and clearly compel a liability insurer to defend against

²⁹ *Ibid* at para 13 [emphasis added].

³⁰ *Ibid* at para 72 [emphasis in original removed, and emphasis added].

covered claims. If the insurer fails to do so, the law will force it to reimburse all reasonable costs that the insured itself sustained in so defending.³¹

However, the policy nowhere speaks to the separate legal costs of enforcing said coverage. Such silence was acknowledged in *Ultramar*, where the court noted that the policy made “no mention of costs where the duty to defend is disputed by the insurer.”³² In proceeding to award solicitor-client costs nevertheless, *Ultramar* concluded that the imposition of solicitor-client costs for such third party enforcement proceedings “does not arise from a specific provision in the insurance contract. Rather, it arises from the unique nature of that contract.”³³

I argue that such vague reasoning fails as a simple matter of contractual interpretation. How can there be a “unique nature” if close scrutiny discloses no actual policy text supporting it?

The construction of a liability policy is after all governed by ordinary principles of ordinary contractual interpretation.³⁴ As with any contract, vague notions of a “unique”³⁵ or “special” nature should never supplant the actual words used to articulate the parties’ bargain.

The terms of a liability policy clearly show that any expenses of enforcing coverage constitute amounts distinct from the main action. Under our system

³¹ See for example *Carneiro v Durham (Regional Municipality)*, 2015 ONCA 90 at para 13, 262 ACWS (3d) 731 (ON CA). See also *Zhou v Markham (Town)*, 2014 ONSC 435 at para 25, [2014] OJ No 351.

³² *Ultramar*, *supra* note 17 at para 73.

³³ Emphasis added.

³⁴ Gordon Hilliker, *Liability Insurance Law in Canada*, 6th ed (Markham, Ont.: LexisNexis, 2016) at 34.

³⁵ It is acknowledged that insurers – in a way unique from other contractual defendants – are subject to the singular duty to act fairly and in good faith. However, a breach of such a duty gives rise to a separate cause of action for damages (see *Ferme Gérald Laplante & Fils Ltée v Grenville Patron Mutual Fire Insurance Co.* (2002), 217 DLR (4th) 34 at para 78, 61 OR (3d) 481 (ON CA)). As such, this feature of insurance policies already has a remedy at law, and cannot act as the “unique” characteristic which *Reed* referred to in imposing full indemnity.

of self-financed litigation, such costs must therefore lie on the shoulders of any insured, absent any deliberate contractual re-allocation.

IV. An insurer has no implied duty to pay costs

Having found no explicit contractual wording, is there another basis for the same result? After all, the law has long recognized that a contract is not always confined to the terms expressly stipulated between the parties.³⁶ While the process of interpretation gives legal effect to the plain words used, the process of implication can fill gaps in those words.³⁷

In other words, might there in fact a nature “unique” to liability policies, such that a duty to pay solicitor-client costs was properly implied into a liability policy, or perhaps into all insurance policies? To answer, we turn to the law’s three distinct categories of implication.

(a) Implied Terms based on Custom or Usage:

The first category are those terms implied as a matter of custom or usage. Where parties deal in a particular market, a well-known custom of that industry may be incorporated into their contract.³⁸

However, this first category fails in our context. There simply is no pre-existing custom by which insurers are expected to pay the full indemnity costs of coverage proceedings.

³⁶ GHL Fridman, *The Law of Contract in Canada*, 6th ed (Toronto: Carswell, 2011) at 463.

³⁷ Geoff R. Hall: *Canadian Contractual Interpretation Law*, 3d ed, (Markham: LexisNexis, 2016) at 175.

³⁸ *Fairview Donut Inc v The TDL Group Corp*, 2012 ONSC 1252 at para 451, [2012] OJ No 834 (ON SC).

(b) Terms implied to give Business Efficacy to a Contract:

The second category are those terms implied to give business efficacy to a contract.³⁹ Two traditional tests exist in Canadian law.⁴⁰

- i. The “officious bystander” test, whereby the parties, if questioned, would have said that they obviously assumed a certain term to have been intended;
- ii. The business efficacy test, whereby a term is necessary to make the contract effective.

Described as “essentially synonymous,” these overlapping formulas are intended to determine the presumed intentions of the parties.⁴¹

However, this second category also fails in our context. Insurance contracts are meticulously drafted. If a duty imposing full indemnity had been intended, it certainly would have been inserted. Nearly all insurance contracts also possess an entire agreement clause, providing yet another sign that no implied term was intended by the parties.

Our proposed term is also unnecessary from a business efficacy standpoint. An insurer’s duty to indemnify is narrowly framed under the policy’s actual terms. It is satisfied as soon as defence costs are paid for the main action.⁴² When the insurer has conveyed this sum, the express purpose of the contract is given effect to. As to the separate costs of enforcement, those are a predictable reality of our system of modern litigation, and not an unexpected omission requiring a term to be inserted in the interests of “business efficacy.”

³⁹ *Machtinger v HOJ Industries Ltd.*, [1992] 1 SCR 986 at para 49, [1992] SCJ No. 41 [*Machtinger*].

⁴⁰ *Canadian Pacific Hotels Ltd v Bank of Montreal*, [1987] 1 SCR 711 at para 52, [1987] SCJ No 29 [*Canadian Pacific*].

⁴¹ John D. McCamus, *The Law of Contracts*, 2d ed (Toronto: Irwin Law, 2012) at 780.

⁴² Hilliker, *supra* note 34 at 151.

(c) Terms implied at law

The third category are those terms implied at law. Unlike the first two categories which depend on presumed intention, courts may also imply a term “as a matter of policy...even where it is clear the parties did not intend it.”⁴³ Such category invokes “a purely legal inquiry which tends to be driven by policy questions.”⁴⁴

The test for such implication is “necessity,”⁴⁵ and a broad understanding of such a concept might at first appear to offer arguments for implication. For instance, a policy’s indemnity is carefully measured, and every penny is often needed to fulfil its benefits, which include provision of peace of mind.⁴⁶ If so, perhaps solicitor-client costs might be considered “necessary” to realize this purpose.

Moreover, solicitor-client costs might be a useful means of redressing the power imbalance between the parties. Indeed, it is arguable that some insureds require nothing less than the promise of full indemnity in order to realistically litigate against powerful insurers in the first place. As a practical matter, insurance companies may be best placed to absorb any duty of full indemnity, given their ability to spread the cost across their pool of insureds.

Even assuming that all of the above factors fell within a generous conception of “necessity,” however, I suggest that they are ultimately outweighed by other considerations of policy.

The first argument against implication is the far-reaching consequences it could unleash for other claims. If the law is to accept “necessity” in the case of an insured, other claimants would soon begin to demand solicitor-client costs as well. After all, one can surely envisage other civil claimants who share features similar to insureds: contracting for peace of mind; facing a shortfall in

⁴³ *London Drugs Ltd v Kuehne & Nagel International Ltd.*, [1992] 3 SCR 299 at para 283, [1992] SCJ No. 84.

⁴⁴ Hall, *supra* note 37 at 177.

⁴⁵ *Machtiger*, *supra* note 39 at para 49.

⁴⁶ *Langton v Personal Insurance Company*, 2009 ABQB 467 at para 58, 479 AR 189.

functional recovery should they not receive solicitor-client costs; litigating against a powerful corporate defendant who is both better financed, and also able to absorb the burden of full indemnification.

Thus viewed, insurance policies possess nothing “uniquely” justifying them for special costs treatment. If the law were to accept that insureds could realize the “full benefit of the contract”⁴⁷ only by receiving full indemnity, what would stop such logic from applying to countless other claimants, whose intended damages would also be eroded without full indemnity?

The second argument against implication is the degree of judicial law-making it would involve. Our proposed term would effect a major re-allocation of the burdens of civil litigation, all without legislative guidance. Previously duties implied by law have been justified as “modest, incremental step[s]”⁴⁸ or as outgrowths of already recognized obligations in the law.⁴⁹ However, there is here no precedent for singling out insurers for the exceptional burdens of full indemnity costs. As our Supreme Court has previously said, “major revisions of the law are best left to the legislature.”⁵⁰ Such seems especially true for major changes to civil costs allocation, involving as they do questions of policy-making, and other implications for which the legislative process is best suited.

The third argument against implication is its ineffectiveness against the underlying problem. The social ill underlying the “duty to defend” exception is the excessive cost of modern litigation. To merely shift such burdens from the winning party onto the loser, leaves unreformed this basic problem, and helps only those fortunate enough to secure final judgment. It does nothing for the many insureds who find our system so expensive that they cannot reach that point, either from a lack of funds to initiate a claim, or, a fear of further costs should they ultimately lose. The law should work towards an ideal system of

⁴⁷ *Taniou*, supra note 18 at para 123.

⁴⁸ *Bhasin v Hryne*, 2014 SCC 71 at para 73, [2014] 3 SCR 494.

⁴⁹ *Wallace v United Grain Growers Ltd.*, [1997] 3 SCR 701 at para 145, [1997] SCJ No 94.

⁵⁰ *Watkins v Olafson*, [1989] 2 SCR 750 at para 19, [1989] SCJ No 94.

proportionate, predictable and reasonable litigation costs for all, and not simply the erection of exceptions for a few classes of litigants.

The final argument against implication is the subjective nature of such a term, and the emphasis it places on the personal circumstances of each passing insured. To simply impose a blanket duty to indemnify would wrongly assume that “necessity” exists as much for the billion-dollar corporate insureds – with their litigation budget and massive resources – as much as it does for impoverished disability claimants. At the same time, however, the law could not simply imply the duty selectively. The Supreme Court has declared that implied terms are not to operate differently simply because of a party’s personal qualities. Such would, “even if it were sound legally...lead to great uncertainty.”⁵¹ Indeed, one could imagine the imposition of our implied term resting ultimately with the taste of each individual judge, struggling to decide whether any given insured was “needy” enough.

V. Conclusion

The “duty to defend” exception is a topic of national significance to insurers across Canada, exposing as it does even good faith defendants to solicitor-client costs. Despite its clear departure from the traditionally punitive rationale of full indemnity costs, *Reed* has attracted surprisingly little academic analysis thus far.

This article has sought to scrutinize the basis on which the exception rests, and argue that it should ultimately be abandoned. Insurance policies are made against the context of our system of self-financed litigation and partial compensation. To overcome this default norm, express contractual allocation should be required. A standard liability policy offers neither express,⁵² nor implied, terms as would exempt liability insureds from normal rules of costs.

⁵¹ *Canadian Pacific*, supra note 40 at para 50.

⁵² See Hilliker, supra note 34, where the author notes that:

In a standard CGL wording the insurer has “the right and duty to defend” an action, and the insurer also agrees to certain supplementary payments, including all expenses it

Nor could special treatment be justified on by the simplistic logic that insureds could only realize the full benefit of their policy by receiving total reimbursement of costs. Such reasoning would offer no principled answer as to why other contractual claimants could not also expect preservation from erosion of their own, often-unique, damages.

The solution is to reject the “duty to defend” exception. Not only will this ensure consistency in the law by removal of this anomaly, but it will return solicitor-client costs to their exceptional status as a tool of censure and not of compensation.⁵³

incurs, reasonable expenses of the insured incurred at the insurer’s expense, and costs and interest in the underlying action. At no time does the insurer agree to fully indemnify an insured for an action to enforce a duty to defend [emphasis added].

⁵³ *Groh v. Steele*, 2017 ONSC 4925 at para 11, 282 ACWS (3d) 265. For authority that solicitor-client costs are not to be used simply to render a plaintiff intact, see Orkin, *supra* note 13 at pp 2-91 to 2-92.