Should liability insurers face extraordinary costs penalties?[1]

Introduction

Over the last fifteen years, some Canadian courts have begun to award solicitor-client costs simply because liability insureds have successfully enforced a defence from their insurer.[2] Such costs have been imposed even if the insurer's litigation conduct was otherwise entirely proper.

This article offers an analysis of this trend, which I call the "duty to defend" exception. Such trend is criticized as confusing 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.

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" in the litigation.[3]

M. (E.) v. Reed and the "Duty to Defend" exception

The "duty to defend" exception may be traced to the Ontario Court of Appeal decision in *M. (E.) v. Reed.*[4] The insureds in successfully enforced a defence from their insurer. They then 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:

> 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.[5]

Reed appeared to emphasize the insurer's contractual duty to indemnify legal expenses in the main action, and expanded this obligation to further encompass the insured's separate costs of enforcing coverage.[6]

Reed's compensatory logic has recently been applied beyond the liability insurance context. In *Tanious v. Empire Life Insurance Co*.,[7] the British Columbia Supreme Court invoked *Reed* in awarding solicitor-client costs to a disability claimant.

---

1 This article is condensed from James Steele, "The "Duty to Defend" Exception: Solicitor-Client Costs and Liability Coverage Proceedings", *Issues in Focus* in Craig Brown & Thomas Donnelly, *Insurance Law in Canada,* loose-leaf (Toronto: Thomson Reuters, 2016) [forthcoming in 2018].

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

3 *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].

4 *Reed,* [2003] OJ No 1791, 171 OAC 145 (ON CA). 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.

5 *Reed*, *ibid* [emphasis added].

6 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).

Despite its lack of thorough reasoning, *Reed's* basic conclusion has now found favour in other provinces, spreading ultimately to New Brunswick,[8] Newfoundland and Labrador,[9] Manitoba[10] and British Columbia.[11]

An insurer has no express duty to pay costs

Put simply, this article argues that a liability policy contains no terms justifying any special costs entitlement. Without any contractual rationale, such insureds must be seen as no more deserving of full indemnity costs than any other contractual claimant.

To illustrate this, let us textually consider whether the express terms of a liability policy justify full indemnity. After all, if an insurance policy does explicitly impose full indemnity as an obligation of the insurer, solicitor-client costs could be justified as expectation damages under the contract.[12]

A representative example of the terms of a standard liability policy is shown below:

> 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.[13]

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.

---

7 2017 BCSC 85, 274 ACWS (3d) 732.
8 *Dionne Farms Ltd v Fermes Gervais Ltée*, 2002 NBCA 98, [2002] ANB No 402.
9 *Ultramar Ltd. v. Rancur Petroleum Services Ltd.,* 2006 NLCA 55, 151 A.C.W.S. (3d) 1142.
10 *Gilewich v 3812511 Manitoba Ltd*., 2012 MBQB 252, [2013] 2 WWR 835.
11 *Williams v Canales*, 2016 BCSC 1811, 271 ACWS (3d) 717.
12 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.
13 *Ultramar, supra* note 9.

> These payments will not reduce the limits of insurance.[14]

The effect of these terms is plain. They clearly compel a liability insurer to defend against covered claims. If the insurer fails to do so, the law will force the insurer to reimburse all reasonable costs that the insured itself sustained in so defending.[15]

However, the policy nowhere speaks to the *separate* legal costs of enforcing said coverage in the first place. Such 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.”[16] 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.”[17]

I argue that such reasoning is vague, and fails as a simple matter of contractual interpretation. How can a contract have a “unique nature” if close scrutiny discloses no actual policy text supporting it? As with any contract, vague notions of a “unique”[18] or “special” nature should never supplant the actual words used to articulate the parties’ bargain.

Conclusion

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

Canadian courts should reject the “duty to defend” exception. Not only will this ensure consistency in the law by removal of an anomaly, but it will return solicitor-client costs to their exceptional status as a tool of censure and not of compensation.[19]

…

---

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

15 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.

16 *Ultramar, supra* note 9 at para 73.

17 Emphasis added.

18 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.

19 *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 3 at pp 2-91 to 2-92.