

Fighting Back: What to Do When An Insurer Allocates Defence Costs

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SEPTEMBER 2009

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OVERVIEW

Your company has been sued, but the insurer only offers to pay part of the cost of defending the claim. The insurer wants to “allocate” defence costs between the “covered” and “uncovered” claims. What do you do?

This article reviews recent developments on allocation of defence costs under Commercial General Liability policies, and suggests ways to challenge the insurer’s position.

ALLOCATION OF DEFENCE COSTS

If there is a “mere possibility” that a claim against an insured is covered by the insurance policy, the insurer has a duty to defend.

What happens, however, when only part of the claim triggers coverage? Many insurers try to allocate defence costs between the covered and uncovered allegations. There are two basic ways a claim might not be covered in this type of scenario under a CGL policy:

- Some allegations in a claim might not be covered because the claim does not fall within the insuring agreement, or are excluded; or
- The injury or damage did not occur during the time when the insurer was on risk.

In such instances, insurers will often assign an arbitrary percentage to the covered allegations. For example, the insurer may offer to pay for only 33% of the defence costs, if only one out of three causes of action in the claim are covered, or if the insurer covered only 3 out of 9 years at issue.

This article will focus on the first situation (some allegations in a claim are not covered). The issue of multiple policy periods will be dealt with in a future article.

THE LAW

¹ This article was originally published the September 2009 edition of *The Pulse*, a publication of the Ontario Risk and Insurance Management Society.

The Ontario law on allocation of defence costs has been evolving in recent years. In 1996, the Ontario Court of Appeal rejected attempts to allocate defence costs in a case called *Daher v. Economical Mutual Insurance Co.* (1996), 31 O.R. (3d) 472 (C.A.). In *Daher*, a child was injured when he used a can of Drano for a school experiment. He had obtained the Drano from his parents, who also happened to be shopkeepers insured under their store's liability policy. They had taken the Drano from the store and gave it to their child. The child sued the school, and the school third-partied the parents.

At issue was whether there was a duty to defend and, if so, whether the insurer was entitled to allocate defence costs. The court held there was a duty to defend, but that it was not practical to allocate. While the Court of Appeal did not prohibit allocation of defence costs in theory, the court held that it was not possible in this case to allocate. In particular, the allegations were so intertwined that it would be impossible to separate them.

Notwithstanding *Daher*, Ontario trial courts later started to allocate defence costs with some regularity, where part of the claim was covered and part was not (see, for example, *Sommerfield v. Lombard Insurance Group* (2005), 74 O.R. (3d) 571 (S.C.J) and *Scott v. Optimum Frontier Insurance Co.* (2005), 38 C.C.L.I. (4th) 129 (Ont. S.C.J.)).

Based on pro-insurer decisions like these, insurers started to be more bold with allocation proposals. Rather than covering the entire defence, many insurers now try to allocate and to require the policyholder to pay part of the defence costs.

The Ontario Court of Appeal released a very significant decision called *Hanis v. Teevan* (2008), 92 O.R. (3d) 594 which should curtail this type of behaviour. In that case a professor sued the University of Western Ontario. Some of the allegations were covered, and others were not. The court first held that it is necessary to examine the policy wording. Following a lengthy review of the allocation law in Ontario, the court held that, absent wording to the contrary:

- An insurer does have to pay for defence costs related to purely covered allegations;
- An insurer does not have to pay for defence costs related to purely uncovered allegations in the claim; and
- An insurer does have to pay for defence costs which benefit both covered and uncovered allegations.

With respect to the third category, the Court commented:

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.

The trial judge had held that 95% of the defence costs went to either purely covered allegations, or benefited both covered and uncovered allegations. The insurer therefore had to pay 95% of the defence costs.

Fighting Back - Practical Implications of the *Hanis* decision

A number of important points arise out of the *Hanis* decision:

- *Timing of the allocation:* Ontario courts have stated in other cases that duty to defend proceedings against insurers should occur, if possible, at the pleadings stage of the underlying litigation. At that point, however, there will be little evidence about whether the defence costs will have to be incurred for covered, uncovered, or mixed claims. Further, requiring the policyholder's lawyer to testify about defence strategy prior to trial and appeal would be contrary to the insured's interests. (The plaintiff in the underlying litigation would have access to the information, which is filed in the public court records.) While the court did not rule on this issue in *Hanis*, the practical reality is that allocation ought to take place only *after* trial or settlement in the underlying litigation.
- *Rough and ready allocations:* In *Hanis*, the Court of Appeal rejected interim "rough and ready" allocations, where the judge arbitrarily picks a percentage out of the air. This means that, if allocation has to take place at the end of the proceeding, then the insurer will *likely* have to pay 100% of the defence costs up front and then seek to allocate after trial or settlement. It is unlikely that a trial court will impose an arbitrary rough and ready interim allocation which requires the policyholder to fund part of the defence costs prior to settlement or trial.
- *Percentage of covered costs:* In most cases, the vast majority of defence expenses will go to either solely covered expenses, or to the mixed situations (where the defence expenses benefit both covered and uncovered claims). Consider the example of the drafting of an offer to settle, or a telephone call to opposing counsel to discuss examinations for discovery. Routine tasks such as that benefit both covered and uncovered allegations, and would be the responsibility of the insurer. In most cases a very high proportion of defence costs would likely be covered, even if there were an allocation at the end of the underlying litigation.

- *Allocation at the end of the proceeding:* As discussed above, the insurer does have the right to allocate at the end of the proceeding. However, the insurer would likely have to reserve its rights to do so, or to have a written agreement with the insured to this effect. Failure to have such a reservation or agreement could result in the insurer losing its right to allocate. In any event, insurers typically do not press for allocation following settlement or judgment, as they usually wish to close their files by that stage.

There are accordingly strong arguments that, under Ontario law, an insurer will often have to pay 100% of the defence costs up front, and then reserve its right to allocate following settlement or trial of the underlying litigation. While the case law is not fully developed on these issues, policyholders have strong grounds for opposing an insurer's attempts to allocate defence costs prior to settlement or judgment.

Tom Donnelly is a lawyer at Thomas Gold Pettingill LLP and frequently acts for policyholders in claims against insurers. His policyholder clients have recovered over \$400 million in judgments and settlements from their insurers.