RECENT DEVELOPMENTS IN THE LAW OF ADDITIONAL INSUREDS AND THE DUTY TO DEFEND

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Overview

1. Introduction: Why should you care about defence and indemnity?
2. Defence Cost Allocation Pre-2020
3. *Markham v. AIG* 2020 ONCA 239: Ushering in a Brave New World
4. Advising Additional Insureds Post *Markham v. AIG*
5. Juggling Multiple Insurers and Joint Retainers: Practical Guidance for Insurers
6. To Litigate or not to Litigate a Defence Obligation?
7. Failure to Procure Insurance
8. Cross-liability vs Exclusions
9. Key Take-Aways

Introduction: Why Do You & Your insured Care About Defence and Indemnity?

- In an increasingly specialized world, public entities are increasingly contracting with third parties in a wide range of contexts including contracts for the provision of goods and services and rental agreements
- When a loss occurs, public entities may be put in the situation where they have to defend claims arising from third party activity over which they have limited control
- In the municipal context where many of the cases have been litigated, the claims often arise from the activities of third party contractors/consultants, renters of municipal facilities and builders/developers

Need for Reallocation of Defence Costs

- In cases of third party negligence, your insured may eventually be released or have the case dismissed against them without payment
- However, you or your insured are typically left with significant legal and adjusting costs, not to mention administrative costs
- In the absence of effective defence and indemnity provisions, your insureds may be left subsidizing claims against third parties by way of nuisance payments in the interest of minimizing defence costs

Typical Contractual Defence and Indemnity Provisions

- Require third parties to indemnify your insured in respect of actions arising from the operations of the third party
- Require third parties to obtain/maintain insurance providing coverage for claims arising from the third party activity
- Require third parties to furnish an insurance certificate certifying that your insured has been added as an additional insured under the third party's insurance policy

Issues your Insured needs to be concerned about (1): Covered versus Uncovered Allegations

- Typical insurance certificate language: Your insured is named as an additional insured under the policy but only with respect to “liability arising from the operations of the named insured”
- Complications where the Statement of Claim alleges independent negligence on the part of your insured (uncovered allegations) in addition to “liability arising from the operations of the named insured” (covered allegations)
  - e.g. in the municipal context, winter maintenance (done by a contractor) versus some other element of non-repair of the highway, like rutting, potholes or depressions (typically done in-house by the municipality)

Issues your Insured needs to be concerned about (2): Conflict of Interest

- Your insured's defence costs should be borne by the third party insurer as much as possible
- At the same time, for a defence to be worth anything, it must be focused on protecting the interests of your insured and not on the interests of the third party or the third party's insurer
- Where your insured and the third party are both named as defendants, the third party's insurer has a vested interest in directing the defence to shift liability onto your insured
- Additionally, notwithstanding the notion that there should be an ethical wall between the handling of your insured's defence and the third party's defence, in reality, it would not be difficult for the third party examiner to access your insured's confidential defence information

Duty to Defend Principles Before *Markham v. AIG* in a Nutshell

- Duty to defend determined at outset of litigation based on the pleadings including any Response to Demand for Particulars (*Zhou v. Markham* 2014 ONSC 435; *Sinclair v. Markham* 2014 ONSC 1550)
- Additional insured typically entitled to appoint and direct independent defence counsel (*Pabla v. Mississauga* 2015 ONSC 5156)
- Third party's insurer must cover additional insured's defence as long as any of the allegations are covered claims (*Carneiro v. Durham* 2015 ONCA 909)
- Third party insurers beginning to raise the doctrine of "equitable contribution", the principle that where there are two policies that cover the same risk, equity requires that both insurers contribute

Markham v. AIG – Background Facts (from decision of Casullo J)

- [5] The actions arise out of an incident on February 2, 2015 wherein the Plaintiff was struck by a hockey puck while watching his brother's pre-game hockey warm up. The ice rink is located in the Angus Glen Community Centre in the City ("Ice Rink"). The Plaintiff claims his injuries were caused by the negligence of both the City and Hockey Canada, for failing to keep the Ice Rink in a safe condition.
- [6] The City and Hockey Canada each crossclaim for contribution and indemnity.
- [7] There is also a third party claim in which the City seeks contribution and indemnity from the Markham Waxers Hockey Club, the Markham Waxers Minor Hockey Association, and the Markham Minor Hockey Association (collectively, the "Waxers").

The Rental Contract

- [8] In or about September 2014, the City entered into a rental contract with the Waxers, wherein the Waxers rented out the Ice Rink on February 2, 2015 (among other days) to both practice and play hockey ("Contract"). The Contract was in effect at the time of the Plaintiff's injury.

- [9] Pursuant to the Contract, the Waxers were responsible for:

  - (a) the conduct and discipline of its club, group, participants, spectators and invitees;

  - (b) assuming all liabilities and costs for damages caused directly or indirectly by the licensee or invitees while on or using the facility; and

  - (c) assuming the risk of damage and injury while on the premises for the licensee and invitees and hold the licensor harmless and indemnified therefrom.

- [10] The Waxers were required to obtain third party general liability insurance covering bodily injury arising from the use of the premises and insuring the City as an additional insured under that policy.

The Insurance Contract

- [11] AIG issued a liability policy covering the operations of its policy holders Hockey Canada and other entities including the Waxers ("AIG Policy").

- [12] AIG does not contest that the Waxers agreed to add the City as an additional insured to the AIG Policy. Pursuant to the provisions of the insurance certificate ("Certificate"), the City was covered for Commercial General Liability for $5,000,000, with respect to liability arising out of the operations of the Waxers.

- [13] The Certificate provides for indemnity for legal fees incurred in the defence of the insured, without limitation or reduction in respect of allegations made against the insured that fall outside the coverage provided for under the AIG Policy. In other words, 100% of the defence costs are to be paid regardless of whether there are allegations that fall outside the coverage provided for under the AIG Policy.

- [14] The AIG Policy also stipulates that if there is other insurance available to an insured, the AIG policy is primary (with certain exceptions not applicable here). It bears noting that the City's policy of insurance with Lloyd's stipulates that it is excess to any other policy of insurance.

Decision on Original Application (Casullo J.)

- AIG owes a duty to defend (as there are at least some covered allegations);
- Lloyds does not owe a duty to defend (reasons for this determination unclear);
- Due to the conflict of interest between the two insureds on account of their respective crossclaims, and as between AIG and the City in AIG desiring to have liability assessed against the City on the basis of uncovered allegations only, the City is entitled to appoint and instruct counsel of its own choosing, at AIG's expense.

AIG's Appeal to the ONCA

- *Markham (City) v. AIG Insurance Company of Canada*, 2020 ONCA 239
- Panel: Doherty, Brown and Thorburn JJ.A.
- Reasons for Decision authored by Thorburn J.A. released on March 31, 2020

Issues and Conclusions on Appeal

- [8] The issues on this appeal are:
  - a) Does Lloyd's owe the City a concurrent duty to defend?
  - b) Must Lloyd's pay an equitable share of the City's defence costs? and
  - c) Does AIG have the right to participate in the defence, including the right to retain and instruct counsel?
- [9] For the reasons that follow, I conclude that:
  - a) Both AIG and Lloyd's owe a duty to defend the City in the action;
  - b) AIG and Lloyd's must share the City's defence costs equally, subject to a right to seek a reallocation of the defence costs at the conclusion of the action; and
  - c) AIG has a right to participate in the defence, including the right to retain and instruct counsel.

Appeal Issue #1: Does Lloyd's have a concurrent duty to defend? - Yes

- [74] To the extent the AIG and Lloyd's policies cover *the same* claims, AIG has a duty to defend up to its policy limit, and Lloyd's may be an excess insurer.

- [75] However, at a minimum, Lloyd's owes a duty to defend the City against claims which may fall outside the scope of the AIG policy and which fall within the scope of its own policy.

- [76] The fact that AIG has a duty to defend the City does not, by itself, excuse another insurer from its duty to defend. Lloyd's also has a duty to defend.

- [77] Therefore, the application judge's determination that only AIG has the duty to defend the action is incorrect.

Appeal Issue #2: Must Lloyd's share equally with AIG in the ongoing costs of defending the claim? – Yes

- Each of AIG and Lloyd's has a duty to defend at least some of the claims in the action so each is responsible to contribute to the defence costs of the City…. As there is no contract between them with respect to the defence, their respective obligations should be governed by the principles of equity.

- On the facts of this case, the respective risk of the two insurers is real but the level of risk cannot yet be ascertained given the early stage of the proceedings and the claim does not allow for a precise allocation of defence costs.

- Since the Lloyd's policy is more comprehensive than AIG's, and there is a concurrent duty to defend, the fairest and most equitable allocation of defence costs would seem to be to require each of AIG and Lloyd's to pay an equal share of the defence costs pending final disposition of the action and the final determination of the allocation of defence costs.

Appeal Issue #3: Does AIG have a right to participate in the defence including the right to retain and instruct defence counsel? – Yes

- Thorburn J.A. acknowledges that AIG has an interest in directing the defence such that any finding of liability will fall outside of AIG's coverage
- However, she states that the City and Lloyd's are also in a conflict of interest – Lloyd's has an interest in directing the defence such that any finding of liability will fall within AIG's coverage; the City has the same interest due to the concern that its insurance premiums will rise
- Thorburn J.A. concludes that all interests must be balanced and that ultimately there is no reason to believe that appropriate counsel who has an ethical obligation to defend the insured properly, will not conduct the defence in the best interest of the insured

Ont CA re: Procedural Safeguards re Multiple Insurers and Joint Retainers

- [104] In situations such as this, it is important to have in place mechanisms to minimize conflicts of interest and provide meaningful protections to the party not having control of the defence…

- [105] AIG suggests implementing a "split file" verbal protocol to lessen the concerns and provide protection to the insured and Lloyd's. This would ensure that potentially conflicting interests insured by one policy are handled separately and that the separate claims be dealt with by separate counsel.

Procedural Safeguards re Multiple Insurers and Joint Retainers (2) – AIG's Proposal (para 106)

- a) The City's defence as an additional insured would be handled and screened internally so that Hockey Canada and Waxers' information is held separately and kept confidential from information in respect of the City claim;
- b) Physical files would be scanned and converted into digital format upon receipt;
- c) A file subject to the "split file" protocol would be digitally marked confidential and would not be accessed by any other handler, including the handler responsible for the defence of another adverse insured party. This is to protect confidential information and avoid any perceived or actual "party-based" conflict of interest between the insured interests;
- d) The handlers for the City defence would be different from those handling the Hockey Canada defence. Similarly, the handlers for coverage issues would be different from the handlers for liability issues;
- e) A claims handler in breach of the "split file" protocol would be subject to disciplinary action and could be dismissed if confidential information is disclosed;
- f) AIG agrees to work cooperatively with Lloyd's to agree upon, appoint/instruct, and pay for an independent defence counsel. That counsel will be different from AIG's coverage counsel; and
- g) AIG commits to sharing funding costs incurred in the City's defence.

Procedural Safeguards re Multiple Insurers and Joint Retainers (3)

- [113] The AIG proposal attempts to minimize the risk of harm by creating a system to protect confidential information and separate files, enable all three parties to participate in retaining, instructing and receiving instructions from counsel and provide recourse against those who do not adhere to the system.

- [114] However, if AIG is to retain its right to participate in the defence, a few additional terms are warranted. This court imposes these additional obligations in accordance with AIG's acknowledgment of the "balanced screen" approach set out in PCL Constructors Canada and its powers under the Courts of Justice Act, R.S.O. 1990, c. C. 43, s. 134(1)(a) as follows:

Procedural Safeguards re Multiple Insurers and Joint Retainers (4)

- a) The terms of this proposal must be provided in writing to those involved in managing the defence;
- b) Counsel appointed would be instructed to fully and promptly inform the City and Lloyd's of all steps taken in the defence of the litigation against the City such that each would be in a position to monitor the defence effectively and address any concerns;
- c) Defence counsel must have no discussion about the case with either coverage counsel; and
- d) Counsel must provide identical and concurrent reports to the insured and both insurers regarding the defence of the main action.
- [115] This will allow AIG to participate in the defence and resolution of the action as set out in the AIG policy, while at the same time, allowing Lloyd's and the City the opportunity to know of and address concerns in a timely manner: PCL Constructors Canada, at para. 90.

Thorburn J.A. Summary of Conclusions

- [117] Each of AIG and Lloyd's has a duty to defend the action.
- [118] Each must therefore contribute to the ongoing cost of the defence.
- [119] The apportionment of costs cannot yet be determined. AIG and Lloyd's are required to share the cost of the defence equally, subject to a right to seek a re-apportionment of the costs upon final resolution of the action.
- [120] AIG and Lloyd's may also jointly retain and instruct counsel provided the above steps are implemented to safeguard the interests of all parties. This order is without prejudice to the parties' right to move for directions from the Superior Court should they be unable to agree on the conduct of the defence.

SCC Leave to Appeal Application – Issues of National Importance on which there are conflicting appellate court decisions

1. How the standard additional insurance coverage clause “arising out of the operations of the named insured” is to be interpreted;

2. The interpretation of a common excess insurance clause in a commercial general liability policy;

3. The factors to be considered in applying the doctrine of equitable contribution;

4. The appropriate time to decide whether insurers have a duty to defend and in what proportion defence costs are to be shared amongst multiple insurers; and

5. When, in an additional insured context, an additional insurer loses the right to appoint and direct counsel for the additional insured by virtue of a conflict of interest between the additional insurer and the additional insured.

SCC's Judgment in Leave Application

Issued December 3, 2020

- The application for leave to appeal from the judgment of the Court of Appeal for Ontario, Number C67455, 2020 ONCA 239, dated March 31, 2020, is dismissed with costs.

Advising Additional Insureds Post *Markham v. AIG*

- Advise your insured to consider attempting to negotiate new contractual insurance and defence/indemnity provisions to specify:
  - Your insured/insured's primary liability insurer will not be required to contribute to defence costs
  - Your insured will be entitled to appoint and instruct independent defence counsel
- In the meantime, continue to tender your insured's defence -- It remains the case that the third party's insurer has a duty to defend as long as there are any covered allegations
- Arguably equitable contribution should not apply where there is a significant self-insured retention
- Negotiate defence arrangements based on the particular facts in each case
  - Where it's clear the focus of the case is on covered allegations, the third party's insurer may still agree to full defence (and indemnity)
  - Consider relative importance of defence funding and indepen
    each case

Sky Clean Energy v. Economical

2020 ONCA 558

- Marnoch, an electrical contractor, agreed to add Sky Clean, a solar energy project developer, as an additional insured under its liability policy
- Economical issued a policy adding Sky Clean as an additional insured in respect of the operations of Marnoch
- Marnoch installed electrical transformers selected by Sky Clean
- A loss occurred due to Sky Clean's selection of inappropriate transformers and not due to Marnoch's installation of them
- Marnoch's connection to the loss in installing the transformers was merely incidental -- Sky's liability therefore did not arise out of the operations of Marnoch

Advising Additional Insureds Post *Markham v. AIG*

- The OCA appeal in *Sky Clean* focused on the requisite connection between a contractor's operation and the owner's liability in an additional insured duty to defend context - the same issue raised in the Appeal that the panel therein failed to address.
- Chief Justice Strathy, writing for the unanimous panel, addressed the issue of whether the trial judge erred in interpreting the insurance policy and finding that Sky Clean's liability did not "arise out of the operations" of Marnoch
  - [99] The "arising out of the operations" issue can be addressed by answering the question: "why did the additional insured's liability arise?"
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  - [100] In sum, I agree with the articulation in *Vernon* of the requisite connection between the named insured's operations and the liability of the additional insured, in respect of which it seeks insurance coverage. It provides certainty and predictability for all parties by requiring more than an incidental or fortuitous connection between the liability of the additional insured and the named insured's operations. This limitation is consistent with both the reasonable expectations of the parties to the construction contract and that of their liability insurers.
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  - [101] To summarize, the phrase "arising out of the operations" requires more than a "but for" connection between the liability of the additional insured and the operations of the named insured. There must be "an unbroken chain of causation" and a connection that is more than "merely incidental or fortuitous": *Vernon*, at para. 52. Furthermore, the word "operations" includes "the creation of a situation, or circumstance, that is connected in some way to the alleged liability. It does not necessarily imply an active role by the named insured in creation of the liability event": *Vernon*, at para. 54.

Juggling Multiple Insurers and Joint Retainers: Practical Guidance for Insurance Defence Counsel

- *Markham v. AIG*: "No reason to believe that appropriate counsel who has an ethical obligation to defend the insured properly, will not conduct the defence in the best interest of the insured"
- Easier said than done to balance the interest of the third party insurer in minimizing defence costs and avoiding liability based on covered allegations versus the interests of the additional insured and primary liability insurer in avoiding liability based on uncovered allegations
  - e.g., how to advise regarding economic/nuisance settlement opportunities?

Juggling Multiple Insurers and Joint Retainers (2)

- Will counsel who have previously acted for the additional insured, the primary liability insurer or the third party insurer be eligible to act as defence counsel under the joint retainer?
- Additional insured may have to part ways with their panel counsel and thereby forego accumulated expertise regarding the additional insured's operations
- Municipalities named as additional insureds who are defended by counsel appointed by the third party insurer will typically appoint their own panel counsel/coverage counsel to maintain a watching brief. *Markham v. AIG* states that defence counsel are not to communicate with coverage counsel. Raises issue as to who will receive repor behalf of the additional insured.

Juggling Multiple Insurers and Joint Retainers (3)

- Insurance defence counsel will be required to navigate the procedural safeguards set out in *Markham v. AIG* (slides 17 – 20) including concurrent reporting.
- Must all verbal discussions be joint?
- How will decisions be made – what is the relative weight accorded to the preference of the additional insured and the two insurers, respectively?

Juggling Multiple Insurers and Joint Retainers (4)

- Based on limited experience to date, anticipate third party insurer examiners will attempt to avoid over-stepping, possibly to establish that joint retainers are workable
- There may be situations where the third party insurer alone will agree to contribute to a settlement while the additional insured and additional insured primary liability insurer maintain a denial of liability – defence counsel are mediating the interests to some extent
- What should defence counsel do if they become aware of a breach of the procedural safeguards on behalf of the third party insurer?

To Litigate or Not?

- Is there a strong argument for equitable contribution in your case? Is your insured self-insured or have a significant self-insured retention?
- Does the case relate primarily to covered or uncovered allegations? If the defence is anticipated to focus primarily on uncovered allegations where costs can be clearly separated from the defence of covered allegations, likely not worthwhile to pursue a defence.
- Is it evident that the third party caused the loss or does your insured have the most exposure? If the additional insured is liable at the end of the day, defence costs may be outweighed by potential claim for costs advanced on behalf of third party co-defendant.

To Litigate or Not? (cont.)

- How important is it for your insured to appoint and instruct independent defence counsel in the circumstances of your case and what is the evidence regarding potential conflict of interest? Does it rise above the level considered in *Markham v. AIG*? (clear evidence of bad faith?)
- How significant is the underlying claim and how much defence costs can your insured expect to recover, e.g., are there multiple expert reports that would be covered? Could the case go to trial?
- To what extent is the third party insurer being unreasonable? Can a compromise be reached? Can a contribution to indemnity be negotiated in lieu of a defence?
- Is your insured prepared to take the risk of litigating the defence entitlement at hand in terms of costs exposure or precedential effect?

Contractual Obligation to Defend where no Policy Procured

- Contract provision has a broad indemnity agreement and insurance provisions
- Contractor fails to obtain insurance. This information comes to light upon receipt of claim
- In order to hold contractor liable, client will need to bring a motion
- Leading case on issue: *Papapetrou v. 1054422 Ontario Limited*, 2012 ONCA 506

Contractual Obligation to Defend where no Policy Procured

- Collingwood's breach of this contractual obligation does not create a duty to defend; rather, it gives rise to a remedy in damages.
- The quantum of such damages is the amount The Cora Group will be required to pay for a defence of the claims Collingwood's insurer would have been obliged to defend on The Cora Group's behalf had Collingwood fulfilled its contractual obligations, save for any costs incurred exclusively to defend claims that do not arise from Collingwood's performance or non-performance of the service contract

Cross Liability vs Exclusions

- Where the policy **expressly excludes** coverage for a particular risk or peril, the insurer has no duty to defend the insured.
- The language of the policy will be construed in accordance with the usual rules of construction, rather than inferred expectations unapparent on a fair reading of the document. This is particularly so in the case of commercial insurance policies involving sophisticated parties. The insurer must explicitly state the basis on which coverage may be limited.
  - ***Family and Children's Services of Lanark, Leeds and Grenville v. Co-operators General Insurance Company*, 2021 ONCA 159**
- Ambiguous language: Where the language of the insurance policy is ambiguous, the courts rely on general rules of contract construction and should prefer interpretations of the policy that are consistent with the reasonable expectations of the parties

Cross Liability vs Exclusions

- Unambiguous language: The court will give effect to that language, reading the policy as a whole.

- The *contra proferentem* rule applies to resolve ambiguities. It does not apply where, as in this case, the insurance policy is clear and unambiguous on its face.

  - ***Non-Marine Underwriters, Lloyd's London v. Scalera*, 2000 SCC 24, [2000] 1 S.C.R. 551, at para. 71.**

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Key Take-Aways

- *Markham v. AIG* raises significant issues for insurance defence counsel in terms of file handling, potential conflicts and what work any particular counsel will be eligible to receive
- The duty to defend landscape has become less favourable for additional insureds -- nevertheless worthwhile to tender defence at first instance
- Consider whether the third party insurer will be entitled to "participate in the defence" of the additional insured and whether that participation will essentially undermine any value of the defence entitlement
- Consider striking a compromise that will serve the additional insured's highest priorities, which may vary from case to case
- Consider the circumstances of each case from all angles and your insured's risk tolerance in determining whether to litigate or not
- Where no policy procured to protect insured, will be determined on the basis of breach of contract


QUESTIONS?

THANK YOU!

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