

NAVIGATING THE TRIPARTITE RELATIONSHIP IN LIABILITY INSURANCE CLAIMS: MINIMIZING THE NEED FOR INSURED-APPOINTED INDEPENDENT COUNSEL

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The tripartite relationship is very unique . . . it is a relationship riddled with potential abuses and conflicts.¹

There can be no judicial tolerance whatsoever for the simultaneous representation of litigants who are adverse in interest . . . simultaneous representation of adverse parties in ongoing litigation, if tolerated by the courts, would cause grievous damage to the public's perception of the administration of justice.²

Introduction

The goal of this paper is to explore the tripartite relationship between the insured, insurer and defence counsel in third party claims under liability insurance policies. While the tripartite relationship can be beneficial for the insured and insurer, it can also be a source of anxiety, suspicion and mistrust among the parties giving rise to claims of conflict of interest. This paper explores some potential sources of conflicting interests, the effectiveness of the remedies for conflicts of interest in protecting the interests of all stakeholders — insured, insurers and other policyholders — and some ways to avoid or minimize conflicts of interest, thus eliminating the need for the insured to appoint independent counsel at the insurer's expense.

In Part I, the paper explores the nature of the tripartite relationship, followed in Part II by a discussion of the insurer's duty to defend in the context of Strategic Alliance Agreements. Part III explores what constitutes a conflict of interest and the remedy for

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1. Patrick M. Anthony, "Insurance Defense Litigation: The Ethics and Legality of Insurance Policies that Impose Cost Guidelines on Attorneys Hired by the Insurer to Defend Insurance Claims" (2001), 79 *Univ. of Det. Mercy L. Rev.* 97 at 121.
2. *Saint John Shipbuilding Ltd. v. Bow Valley Husky (Bermuda) Ltd.*, 2002 NBCA 41, 16 C.L.R. (3d) 1, 18 C.P.C. (5th) 216 (N.B. C.A.) at paras. 38-39.

such a determination. Part IV asks whether courts should adopt a different approach when dealing with coverage disputes as opposed to allegations of breach of condition. Part V discusses whether the appointment of independent counsel by the insured at the insurer's expense is an effective remedy. In Part VI, the paper concludes with a discussion of some ways to avoid or at least minimize conflicts of interest in the tripartite relationship.

I. The Tripartite Relationship between the Insured, Insurer and Defence Counsel

The insurer-insured relationship is one of mutual dependence and vulnerability, which requires openness and trustworthiness to protect the interests of the contracting parties and other policyholders. An insurance contract is, therefore, a contract of *uberrimae fides*, requiring utmost good faith by insureds and insurers. Utmost good faith requires that the insured disclose all matters relevant to the risk to be insured, and in the event of a loss, to completely and candidly disclose the events surrounding the loss. Utmost good faith places corresponding duties on the insurer to treat the insured fairly, not to exploit the insured's vulnerability and to protect the insured's interests if a suit alleging liability is filed against the insured. The insurer's duty to defend³ and indemnify the insured under liability insurance policies entitles the insurer to retain and instruct counsel in liability actions against the insured, resulting in a tripartite relationship between the insurer, insured and defence counsel.⁴ When there is a unity of interests between the insurer and the insured,

3. The insurer's duty to defend under liability policies is triggered where the pleadings disclose a cause of action that, if true, will give rise to the insurer's obligation to indemnify the insured. The duty to defend is broader than the duty to indemnify; it is irrelevant whether the obligation to indemnify will in fact arise. See *Nichols v. American Home Assurance Co.*, [1990] 1 S.C.R. 801, 68 D.L.R. (4th) 321, 45 C.C.L.I. 153 (S.C.C.); *Non-Marine Underwriters, Lloyd's London v. Scalera*, 2000 SCC 24, [2000] 1 S.C.R. 551, 185 D.L.R. (4th) 1 (S.C.C.); *Cummings v. Budget Car Rentals Toronto Ltd.* (1996), 136 D.L.R. (4th) 330, 35 C.C.L.I. (2d) 219, [1996] I.L.R. I-3349, at paras. 13-17 (Ont. C.A.), leave to appeal refused (1997), 101 O.A.C. 80 (note) (S.C.C.).
4. The insurer has discretion to admit liability on behalf of the insured, participate in settlement negotiations and otherwise settle the claim against the insured. See *Insurance (Vehicle) Act, Insurance (Vehicle) Regulation*, B.C. Reg. 447/83, s. 74.1, which gives ICBC exclusive right to conduct and control third party liability claims. Although appointing counsel does not necessarily mean the insurer should control the defence it is unlikely an insurer will voluntarily surrender that right. See Gordon Hilliker, *Liability Insurance in Canada*, 5th ed. (Toronto: Butterworths, 2011) at 152-3.

this tripartite relationship has many advantages, but when the parties' interests diverge, there are legitimate concerns about how the relationship functions.

The interests of the insured and the insurer often align; both parties seek to avoid or at least minimize the insured's liability in a third party claim. Insurers can protect their own financial interests using experienced counsel, usually for reasonable fees. Insureds can also avoid or limit financial risks by choosing to have large deductibles or by settling when claims exceed policy limits or when a finding of liability might damage their reputation.

Where the parties' interests diverge, however, the tripartite relationship has potential for actual or perceived conflicts of interest. Some of the most common conflicts of interest occur when one or more of the following arise:

- Coverage issues such as when the insurer raises an issue that might result in denial of coverage and proceeds to defend pursuant to a reservation of rights letter or non-waiver agreement.
- An alleged breach of condition such as misrepresentation or failure to give timely notice of a claim.
- Large claims that exceed policy limits and expose the insured to some personal liability.
- Large deductibles and claims that fall within the insured's deductible.
- Mixed claims where some of the claims against the insured are not covered by the policy and the insurer is under no obligation to defend and indemnify in respect of those claims.
- Mutually exclusive bases of liability where the statement of claim alleges loss arising from negligent or intentional conduct and the policy excludes coverage for intentional conduct.⁵
- Settlement versus judgment disputes where the insurer may want to settle to limit defence costs and give it control and predictability over the amount of indemnity that may be required or it may wish to proceed to trial if there is a chance that the claim may be unsuccessful in part or in whole. The insured, on the other hand, may want to settle and avoid

5. The concern is that insurer-appointed defence counsel might be interested in seeing that the insured is found liable on the basis of intentional conduct rather than negligence to avoid the insurer's liability. See *American Family Mutual Ins. Co. v. W.H. McNaughton Builders, Inc.*, 843 N.E.2d 492 (Ill. App. Ct. 2d Dist., 2006) at p. 498. See also *National Casualty Co. v. Forge Indus. Staffing Inc.*, 567 F.3d 871 (7th Cir., 2009) at p. 874.

negative publicity or want the case to be tried because a judgment in their favour will protect their reputation.

- Strategy disputes where the insurer may want the insured to make a counterclaim in the underlying action in the hope that the plaintiff may abandon their claim or be open to a less favourable settlement but the insured refuses to bring a counterclaim.

The insurer-insured relationship is commercial and each party is entitled to protect their interests.⁶ For the insured, this may take the form of withholding information relevant to the risk or a liability claim that may be detrimental to their interest and result in coverage denial contrary to the duty of good faith and cooperation. Similarly, while insurers are not in a fiduciary relationship with their insureds, they owe a duty of good faith and are expected to consider the insured's interests in exercising their discretion.⁷

It is important to emphasize that defence counsel's primary responsibility is to represent the insured and act in their best interest in any liability action. This will also benefit the insurer as the party ultimately liable to indemnify the insured for damages from the liability claim. In *Parlee v. Pembridge Insurance Co.*,⁸ Deschênes J.A. stated:

It is now beyond dispute that a lawyer appointed and paid for by an insurer to defend its insured in compliance with the insurer's contractual duty to defend owes a duty to fully represent and protect the interest of the insured. By doing so, the lawyer, of course, is also acting in the insurer's interest in the sense that the plaintiff's claim (a claim that the insurer may eventually have to pay) is being challenged. But, first and foremost, once appointed, the lawyer must represent and act on behalf of the defendant insured with the utmost loyalty and only in the latter's best interest. No one seriously contends that the lawyer is or should be allowed to take a position contrary to the interests of the insured defendant which he has been appointed to represent.

However, because the insurer has the right to retain and instruct counsel, it is common that defence counsel will be in a joint representation situation if they are acting on behalf of both the insurer and the insured. In this situation counsel must try equally to protect the interests of the insurer and insured; counsel owes ethical obligations to both clients and must advise them about the implications of the

6. *Shea v. Manitoba Public Insurance Corp.* (1991), 1 C.C.L.I. (2d) 61, 55 B.C.L.R. (2d) 15, [1991] B.C.J. No. 60 (B.C. S.C.) at para. 177.

7. *Fredrikson v. Insurance Corp. of British Columbia* (1990), 69 D.L.R. (4th) 399, 42 C.C.L.I. 250, [1990] 4 W.W.R. 637 (B.C. S.C.) at para. 113.

8. *Parlee v. Pembridge Insurance Co.*, 2005 NBCA 49, 253 D.L.R. (4th) 182, 22 C.C.L.I. (4th) 223 (N.B. C.A.) at para.17.

joint representation.⁹ Counsel's responsibility is to resolve the liability action in the insured's favour. However, there is a concern that counsel could give greater priority to the insurer's interests, particularly when a viable defence appears unattainable or when the plaintiff's claim includes alternative grounds of liability that are not covered by the insurance policy.¹⁰ In the event of a conflict of interest, counsel in a joint retainer situation must withdraw unless they obtain the written consent of both clients to continue.

The Duty to Defend and Strategic Alliance Agreements

Agreements and practices that impose an obligation on counsel to protect the insurer's interests, potentially to the detriment of the

9. Once it is accepted that defence counsel in liability insurance claims acts for two clients who may have distinct interests, the lawyer's obligation of undivided loyalty pursuant to the rules of professional conduct is triggered. See B.C. Law Society Ethics Committee, "Third Party Liability Claims", *Benchers' Bulletin* No. 4, October 2008, online: www.lawsociety.bc.ca/page.cfm?cid=491&t=Third-party-liability-claims; BC Law Society Ethics Committee, "Joint retainers in the defence of third-party liability claims: What should be a lawyer's obligations?" *Benchers' Bulletin*, July-August 2006, online: www.lawsociety.bc.ca/page.cfm?cid=868&t=Joint-retainers-in-the-defence-of-third-party-liability-claims; *Chersinoff v. Allstate Insurance Co.* (1968), 69 D.L.R. (2d) 653, [1969] I.L.R. 1-217, 65 W.W.R. 449 (B.C. S.C.) at paras. 20-21, 27, reversed in part (1969), 3 D.L.R. (3d) 560, [1969] I.L.R. 1-285, 67 W.W.R. 750 (B.C. C.A.); D.S. Ferguson, "Conflict between Insured and Insurer: An Analysis of Recent Canadian Cases" (1999-91), 12 *Adv. Q.* 129 at 143; Barbara Billingsley, "Caught in the Middle: When Liability Insurance Defence Counsel Encounter Coverage Problems" (2000), 79 *Can. Bar. Rev.* 221 at 244-45. It remains open in Canadian jurisdictions other than British Columbia whether, in addition to the insured, the insurer is also defence counsel's client. Given that both insured and insurer may have interests at stake in such actions and the latter has contractual and statutory rights to control the action, they should both be considered defence counsel's clients to ensure their interests are sufficiently protected. This position is consistent with the expectation of counsel to be mindful of conflicting interests between the insured and insurer and the need to withdraw in the event of a conflict. See *Halsbury's Laws of Canada – Legal Profession*, Chap. IV, section 7. As well, while third party liability claims are against the insured, the insurer's duty to defend and indemnify make them the *de facto* defendant. See *Azeri v. Esmati-Seifabad Estate*, 2009 BCCA 133, 68 C.P.C. (6th) 229, 452 W.A.C. 262 (B.C. C.A.). There is a similar division of opinion in United States jurisdictions whether the insurer is also defence counsel's client. See Anthony, *supra* note 1 at 105-110.
10. See *National Casualty*, *supra* note 5 at 874; *American Family Mutual Ins Co.*, *supra* note 5 at 498; *Travelers Indem. Co. of Illinois v. Royal Oak Enterprises, Inc.*, 344 F.Supp.2d 1358 (M.D. Fla. Ocala Div., 2004) at pp. 1372-73; Billingsley, *ibid.* at 225; Douglas R. Richmond, "Independent Counsel in Insurance" (2011), 48 *San Diego L. Rev.* 857 at 862; Anthony, *ibid.* at 98-99.

insured's interests, can create ethical dilemmas. An example is the Strategic Alliance Agreement (SAA) between the Insurance Corporation of British Columbia (ICBC) and its defence counsel in motor vehicle claims. ICBC requires defence counsel to sign an SAA by which defence counsel and their firm pledge loyalty to the insurer.¹¹ SAAs stipulate that counsel is required to withdraw their representation of the insured if there is a reasonable possibility that the insured could have an action against the insurer for bad faith regarding the third party claim. In addition, counsel cannot disclose the reason for their withdrawal or advise the insured regarding available remedies or the merits of a possible claim. Furthermore, SAAs prevent other lawyers in the same firm as counsel from acting in ways contrary to ICBC's strategic business or financial interests or the interests of ICBC customers. This includes a prohibition against counselling, assisting, commencing or participating in claims or actions against ICBC that include allegations of bad faith or seek aggravated or punitive damages. As well, lawyers in that firm cannot advise or assist others to defend against claims made by ICBC.

Insurance companies have a wide range of rights in conducting legal actions because it is in the public interest to keep insurance costs at a reasonable level. However, this consideration does not necessarily justify limiting the insured's ability to retain their preferred legal counsel when there is a conflict with the insurer. SAA restrictions, for example, may prevent an insured that is a long-time client of the firm or of an individual lawyer in the defence counsel's firm from retaining their preferred counsel to represent them. Although restrictions on counsel's ability to represent an insured under an SAA do not preclude counsel from acting for clients against the insurer on claims outside the scope of the agreement, there is a risk of conflict where defence counsel acts for the insured in these circumstances. This could leave the insured to deal with a potential discontinuation of representation without an explanation regarding the reasons for withdrawal.

The SAA could therefore frustrate a lawyer's ethical obligation of undivided loyalty and may constrain their independent professional judgment.¹² The rules of professional conduct allow the potential for

11. The same effect will occur even absent the SAA given that counsel and their firm will often be looking to ICBC for defence work, whereas the customer would often be a one-time player and a short-term relationship. In any event, ICBC retains counsel, therefore counsel is more likely to protect the insurer's interests in a joint retainer situation.
12. Restrictions imposed on defence counsel under SAAs are akin to cost containment guidelines that can also affect the lawyer's ability to exercise independent judgment in ways favourable to the insured whose interests they

counsel to continue representing all clients despite a conflict if all clients consent. The SAA eliminates this potential because it requires counsel to withdraw from representing the insured and to continue acting for the insurer unless the insurer terminates the agreement. In addition, SAAs may prevent counsel from meaningfully balancing their professional responsibilities and providing undivided loyalty for all clients in a joint retainer because the insurer has the sole discretion to impose penalties and restrictions.

Even without an SAA, regulatory provisions relating to automobile insurance may frustrate a lawyer's ethical obligation of undivided loyalty. Under the British Columbia *Insurance (Vehicle) Regulations*, ICBC has discretion in responding to liability insurance claims, and counsel has no obligation to withdraw where the insured objects to the insurer's instructions about the conduct of the liability claim, admission of liability or terms of a proposed settlement.¹³ As well, lawyers' codes of conduct permit counsel to continue representing the insurer in the event of a conflict in joint retainers, subject to the insured's consent. Counsel must advise the insured to seek independent advice while they continue to act for their "real" client, the insurer.¹⁴

Requiring the insured to consent may be insufficient to balance the power inequality between the insurer and the insured. There are

are supposed to protect in liability claims. See *In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures*, 2 P.3d 806 (Mont., 2000), holding that those guidelines violate lawyers' ethical obligations of undivided loyalty to the insured and the exercise of their independent judgment (note that the decision was premised on the insured being defence counsel's sole client); Hilliker, *supra* note 4 at 167-9; Richmond, *supra* note 10 at 876; Anthony, *supra* note 1.

13. *Insurance (Vehicle) Regulation*, B.C. Reg. 447/83, ss. 74.1 and 75. In commenting on defence counsel's obligations in third party liability claims under s. 74.1, the B.C. Ethics Committee noted that ICBC's right to retain and instruct counsel is not affected by the insured's objections to being represented by an ICBC-appointed lawyer. The remedy for the insured is to either retain their own lawyer or self-represent. Ethics Committee, "Further Questions Concerning Counsel's Obligations to the Insured and Insurer in Third Party Liability Issues" (April 2, 2009), 4(c).
14. Federation of Law Societies of Canada (FLSC); The Law Society of British Columbia, *Code of Professional Conduct for British Columbia*, Rule 3.4-9 (the *BC Code*); Law Society of Upper Canada, *Rules of Professional Conduct*, approved at October 2013 Convocation, comes into effect October 1, 2014, Rule 3.4-9; The Law Society of Alberta, *Code of Professional Conduct*, 2012, Rule 2.04(1)-(3); Law Society of Newfoundland and Labrador, *Code of Professional Conduct*, Rule 3.4-9; B.C. Law Society Ethics Committee, "Chapter 6, Rule 4: Further Questions Concerning Counsel's Obligations to the Insured and Insurer in Third Party Liability Issues" (April 2, 2009).

concerns about the reality of the insured's consent because it may be provided without the insured appreciating the implications of that consent or because they may feel compelled to provide it. Liability insurance is no longer an arm's length relationship between sophisticated, commercial entities. Rather, it is now a relationship often marked by inequality because most insureds are average consumers requiring protection.¹⁵ It is noteworthy that ethical opinions from bar associations in the United States emphasize the importance of defence counsel's loyalty to the insured and mandate that counsel act exclusively for the insured in the event of a conflict between the insurer and insured.¹⁶ Presumably, a defence counsel who continues to represent the insurer will not be counsel in the coverage dispute. It could be a delicate matter for counsel to inform the insured of the insurer's decision regarding coverage and to advise them to seek independent advice because they must be careful not to provide information on the basis or merits of a potential claim. Defence counsel and their entire firm risk severing a business relationship with a major client if counsel acts in breach of an SAA.

That an unexplained withdrawal by counsel of their representation of an insured is acceptable conduct raises questions about the scope of counsel's ethical obligation of undivided loyalty to their clients in joint representations.¹⁷ Sudden withdrawal of counsel could leave the insured confused and disillusioned about the insurance and legal systems that seemingly permit insurers to act with impunity in ways that are detrimental to the insured's interest. It can also contribute to undermining the public confidence in the insurance system, the legal profession and the administration of justice.¹⁸

One possible way of alleviating the negative effects for the insured would be to permit counsel to advise the insured to seek independent legal advice and to provide information about the situation in question without providing an opinion. The insurer would also be obligated to pay the cost of retaining independent counsel instructed by the insured. Such a disclosure is consistent with the reality that information obtained regarding the common matter in a joint retainer is not confidential between the clients and hence should not violate solicitor-client privilege under the joint representation

15. See Diana C. White, "Liability Insurers and Third-Party Claimants: The Limits of Duty" (1981), 48 U. Chicago L. Rev. 125.

16. See Anthony, *supra* note 1 at 118-121.

17. See Hilliker, *supra* note 4 at 168.

18. See concern expressed by the British Columbia Trial Lawyers Association to the Ethics Committee, B.C. Law Society Ethics Committee, "Whether a Lawyer entering into Agreement with ICBC may be placed in a Conflict" (April 6, 2006).

relationship.¹⁹ As well, information about the possible claim of bad faith or conflict of interest could be considered within the scope of defence counsel's professional and ethical obligation, specifically the requirement that counsel withdrawing from a case must ensure an orderly transfer to the successor counsel, including noting the reason for the withdrawal.²⁰ This safeguard does not provide the insured with the information that gave rise to the conflict but it ensures that the insured's independent counsel will have access to relevant information. However, protecting the insured's interest even in this limited manner could be seen as a violation of counsel's obligation to act in the insurer's best interests, especially where counsel is bound by an SAA; obtaining the insurer's consent may be required before counsel proceeds with advice or disclosure to the insured.

II. Determining Conflict of Interest

The insurer's duty of good faith does not preclude the insurer from proceeding with a course of action or controlling the liability claim notwithstanding the insured's objections.²¹ As well, existence of coverage issues and/or different interests *per se* does not necessarily indicate conflicts of interest between the insured and insurer, and may not entitle the insured to independent counsel at the insurer's expense. In *R. v. Kansa General Insurance Company*,²² the court stated:

There are circumstances where it is the insured who relies most heavily upon counsel's skill and the conduct of a defence. A practitioner in a profession may lose a hard-earned reputation if a judgment is obtained. A settlement made in such an instance, because payment is preferable to a complex defence, is contrary to the interests of the insured. Similar unfavourable consequences are possible where important policy positions of an insured are at stake. Such an insured must be confident that the defence is handled in an appropriate manner. Such concerns

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19. See FLSC, *Model Rules of Professional Conduct*, Rule 3.4-5(b); the *B.C. Code*, *supra* note 14, Rule 3.4-5(b); Law Society of Upper Canada, *Rules of Professional Conduct*, Rule 2.04(6).
 20. See *B.C. Code*, Rule 3.7-8, 9(a)(ii). Although the rules on withdrawal of representation are generic and not specifically aimed at the insurer-insured relationship, there is no reason to depart from these rules since the insured is equally a client of defence counsel.
 21. See *Mara (Guardian ad litem of) v. Blake* (1996), 134 D.L.R. (4th) 716, [1996] 10 W.W.R. 277, 23 B.C.L.R. (3d) 225 (B.C. C.A.).
 22. (1991), 8 C.C.L.I. (2d) 261, (*sub nom. Ontario v. Kansa General Insurance Co.*) [1991] I.L.R. 1-2727, 3 O.R. (3d) 543 (Ont. Gen. Div.), reversed on unrelated grounds (1994), 111 D.L.R. (4th) 757, 21 C.C.L.I. (2d) 262, 13 C.E.L.R. (N.S.) 59 (Ont. C.A.), leave to appeal refused (1994), 115 D.L.R. (4th) viii (note) (S.C.C.).

are not, however, of the type which gives rise to a conflict of interest which affects the rights of appointed counsel to continue to act.²³

As has been previously noted, the insurer-insured relationship entails an inherent element of conflict, mutual trust and dependence. The insured is often in a vulnerable position whereas the insurer has power to exercise its discretion in ways that can be detrimental to the insured's interests. This fiduciary-like relationship obliges the insurer to deal in good faith with the insured and requires protection of the insured's interests. However, this obligation of good faith does not constitute a fiduciary duty because the insurer also has legitimate interests that cannot be ignored in the relationship.²⁴ Differences in the parties' interests such as those referred to above are inevitable. Such differences are legitimate and may require the insured to seek independent legal advice, but they are not necessarily indicative of a conflict of interest impairing the insurer's right to select and instruct counsel or triggering the insured's right to independent counsel.²⁵ As the B.C. Court of Appeal noted in *Mara*,

... Indeed, the courts have on many occasions recognized the unique nature of the insured-insurer relationship, in which the insurer, although bound to deal with

23. *Kansa*, *ibid.* at at 554. See also *National Casualty*, *supra* note 5 at 874.
24. *Fredrikson*, *supra* note 7, at para. 91 ff; *Saskatchewan Crop Insurance Corp. v. Greba* (1997), 42 C.C.L.I. (2d) 277, 154 Sask. R. 289, 1997 CarswellSask 116 (Sask. Q.B.) at para. 141, additional reasons (1997), 154 Sask. R. 289 at 320, 1997 CarswellSask 322; *Plaza Fiberglas Manufacturing Ltd. v. Cardinal Insurance Co.* (1994), 18 O.R. (3d) 663, 115 D.L.R. (4th) 37, 56 C.P.R. (3d) 46 (Ont. C.A.) at para. 15; *Industrial Alliance Insurance and Financial Services Inc. v. Brine*, 2014 NSSC 219, 2014 CarswellNS 463 (N.S.S.C.) at para. 190.
25. See *Fredrikson*, *ibid.*; *Carter v. Kerr* (1989), 43 C.C.L.I. 233, [1990] I.L.R. 1-2533, 39 B.C.L.R. (2d) 345 (B.C.S.C.), reversed (1990), 69 D.L.R. (4th) 542, 43 C.C.L.I. 249, [1990] I.L.R. 1-2604 (B.C.C.A.); *Regency Plymouth Chrysler Inc. v. Insurance Corp. of British Columbia* (1999), 11 C.C.L.I. (3d) 94, [1999] I.L.R. I-3694, 69 B.C.L.R. (3d) 342 (B.C. S.C.); *McLean v. Insurance Corp. of British Columbia*, 2007 BCSC 91, 46 C.C.L.I. (4th) 78, 67 B.C.L.R. (4th) 316 (B.C. S.C.); *Boxeur v. Smith* (1992), 90 D.L.R. (4th) 314, 66 B.C.L.R. (2d) 356, 6 C.C.L.I. (2d) 267 (B.C. C.A.); *Agassiz Enterprises (1980) Ltd. v. General Accident Assurance Co. of Canada* (1988), 49 D.L.R. (4th) 415, 32 C.C.L.I. 203, [1988] I.L.R. 1-2336 (Man. C.A.) (breach of condition); *137328 Canada Inc. v. Economical Mutual Insurance Co.*, 2011 ONSC 1085, 97 C.C.L.I. (4th) 284, 105 O.R. (3d) 141 (Ont. S.C.J.), additional reasons 2011 ONSC 2563, 97 C.C.L.I. (4th) 295, [2011] I.L.R. I-5147 (Ont. S.C.J.); *Theriault v. ING Insurance Co. of Canada*, 2006 NBQB 407, 43 C.C.L.I. (4th) 283, 307 N.B.R. (2d) 99 (N.B. Q.B.); *Appin Realty Corp. v. Economical Mutual Insurance Co.*, 2008 ONCA 95, 57 C.C.L.I. (4th) 187, 89 O.R. (3d) 654 (Ont. C.A.), leave to appeal refused (2008), 255 O.A.C. 397 (note), 389 N.R. 399 (note) (S.C.C.).

the insured in good faith, is ultimately entitled as a matter of contract to decide upon what course is to be taken in the conduct of an action, notwithstanding that the insured may vigorously object.²⁶

An insurer's decision to defend the liability claim under a reservation of right letter or non-waiver agreement often indicates a potential coverage issue. However, this does not necessarily constitute a conflict of interest giving the insured the right to appoint independent counsel at the insurer's expense. A conflict arises only where the insurer takes a position contrary to the insured or raises questions about the insured's conduct that is also an issue in the liability action.²⁷ As Goudge J.A. stated in *Brockton*:

If the reservation of rights arises because of coverage questions which depend upon an aspect of the insured's own conduct that is in issue in the underlying litigation, a conflict exists. On the other hand, where the reservation of rights is based on coverage disputes which have nothing to do with the issues being litigated in the underlying action, there is no conflict of interest requiring independent counsel paid for by the insurer.²⁸

Earlier cases suggest that an appearance of impropriety is a conflict of interest that compels the insurer to relinquish its right to select and instruct counsel.²⁹ However, the appearance of impropriety test is vague and unhelpful in determining whether an insurer has surrendered its right to control the liability action to entitle the insured to retain and instruct counsel at the insurer's expense. Recent jurisprudence indicates that the appropriate test is the objective reasonable person test. This is a principled approach that focuses on the substance rather than the source of the conflict. A conflict of interest exists where defence counsel represents both the insured and insurer in a liability action if there is a reasonable apprehension of a conflict of interest. Specifically, the objective test

26. *Mara*, *supra* note 21 at para. 10.

27. See also *Morrison v. Co-operators General Insurance Co.*, 2004 NBCA 62, 12 C.C.L.I. (4th) 171, [2004] I.L.R. I-4337 (N.B. C.A.) at para. 49; *Roman Catholic Episcopal Corp. of St. George's v. Insurance Corp. of Newfoundland*, 2003 NLCA 65, 6 C.C.L.I. (4th) 83, 232 Nfld. & P.E.I.R. 65 (N.L. C.A.) at paras. 36-37; *Parsons (Guardian ad litem of) v. Wall*, 2006 NLTD 12, 34 C.C.L.I. (4th) 135, 253 Nfld. & P.E.I.R. 320 (N.L. T.D.).

28. *Brockton (Municipality) v. Frank Cowan Co.* (2002), 34 C.C.L.I. (3d) 1, [2002] I.L.R. I-4097, 57 O.R. (3d) 447 (Ont. C.A.) at para. 42. See also *King v. Chaulk*, 2006 NLTD 133, 43 C.C.L.I. (4th) 288, 261 Nfld. & P.E.I.R. 209 (N.L. T.D.) at paras. 43-46.

29. See *Laurencine v. Jardine* (1988), 30 C.C.L.I. 187, [1988] I.L.R. 1-2292, 64 O.R. (2d) 336 (Ont. H.C.), *Carter*, *supra* note 25; *Szebelledy v. Constitution Insurance Co. of Canada* (1985), 11 C.C.L.I. 140, 3 C.P.C. (2d) 170, 1985 CarswellOnt 420 (Ont. Dist. Ct.); *Ferguson*, *supra* note 9 at 135.

is whether a reasonable person would perceive defence counsel's ability to equally protect the insured and insurer as compromised in the circumstances. A finding that a conflict of interest exists entitles the insured to retain independent counsel at the insurer's expense. Similarly, where the situation presents a potential for conflict of interest between the insured and insurer, the insured as the vulnerable party gets the benefit of the doubt and will be entitled to appoint and instruct independent counsel at the insurer's expense.³⁰ As Goudge J.A. reasoned in *Brockton*: "If the insurer puts counsel in a position of having conflicting mandates, it must surrender control of the defence to an insured who wishes to retain its own counsel paid for by the insurer."³¹

The insured's entitlement to appoint and instruct independent counsel in the event of a potential conflict of interest is necessary to maintain public confidence in the insurance system and the administration of justice. However, this has serious repercussions for the insurer, who must surrender control of the conduct of the defence but remains liable for the insured's defence cost and indemnification. Under what circumstances does a conflict of interest justify such an extraordinary remedy? Courts are generally deferential to insurers' right to select and instruct counsel.³² The mere possibility of divergent interests between the insured and insurer or the insured's subjective perception or anxiety about possible denial of coverage is not enough. As the court noted in *Mara*, it will not interfere with the insurer's right to control the liability action unless counsel have conflicting mandates from the insurer and their continued involvement raises a reasonable apprehension of conflict of interests in the mind of a reasonable person.³³

A conflict of interest arises where there is a reasonable apprehension that defence counsel's efforts will favour the insurer's coverage concerns. As Goudge J.A. noted in *Brockton*, the relevant question

30. *Morrison v. Co-operators General Insurance Co.*, 2003 NBQB 150, 47 C.C.L.I. (3d) 299, [2003] N.B.R. (2d) (Supp.) No. 24 at para. 74 (N.B. Q.B.), affirmed 2004 NBCA 62, 12 C.C.L.I. (4th) 171, [2004] I.L.R. I-4337 (N.B. C.A.).

31. *Brockton*, *supra* note 28 at para. 41.

32. See *Travelers Indemnity Co. of Illinois v. Royal Oak Enterprises, Inc.*, 344 F.Supp.2d 1358 (M.D. Fla. Ocala Div., 2004) at p. 1374. Billingsley suggests that courts might be too deferential to the insurer's contractual rights to control the liability action to the detriment of the insured's interests. Billingsley, *supra* note 9 at 231-36.

33. See also *Appin Reality Corp Ltd.*, *supra* note 25 at para. 11; *Morrison C.A.*, *supra* note 27, at para. 47; *Lively v. Thompson-Hatt*, 2006 NSSC 195, 39 C.C.L.I. (4th) 119, 245 N.S.R. (2d) 163 (N.S. S.C.), at para. 21.

is: “Do the circumstances of the particular case create a reasonable apprehension of conflict of interest if that counsel were to act for both the insurer and the insured in defending the action?”³⁴ For example, a conflict would be found to exist where the insurer-appointed counsel also advises the insurer or is somehow involved in the coverage issue³⁵ or when counsel otherwise protects the insurer’s interests to the insured’s detriment by structuring the defence so as to favour the insurer’s position on the coverage issue.³⁶ As well, a conflict of interest may arise where an insured is reasonably concerned that given the coverage dispute, an insurer is likely to steer defence of the liability claim against the insured in such a manner as to favour the insurer by excluding coverage.³⁷ In such cases, the insured cannot, and should not be expected to, rely on defence counsel to act in their best interest in the liability claim. An adequate representation of the insured’s interest and the maintenance of public confidence in the administration of justice requires the insurer to relinquish control of the action and allow the insured to appoint and instruct independent counsel at the insurer’s expense. In *Sydie v. Murad*,³⁸ the court held that it was reasonable for the insured to perceive a conflict of interest as the insured believed that defence counsel’s loyalty was to the insurer because of the active role the insurer had taken in the ongoing coverage issue. There was the potential that the insured’s belief could ultimately undermine the client-counsel relationship that is expected to exist between the insured and defence counsel. Thus, the insured was entitled to retain independent counsel at the insurer’s expense. In such cases, a reasonable person in the insured’s position would not reasonably perceive that defence counsel was protecting their interests and would not want that counsel to represent them. Therefore, an insured in such a situation should be entitled to independent counsel at the insurer’s expense.³⁹

34. *Brockton*, *supra* note 28 at para. 41.

35. See *Morrison C.A.*, *supra* note 27, para. 49; *Pope & Talbot Ltd., Re*, 2011 BCSC 548, 78 C.B.R. (5th) 304, [2011] I.L.R. I-5141 (B.C. S.C.), leave to appeal allowed 2011 BCCA 326, 337 D.L.R. (4th) 664, 81 C.B.R. (5th) 1 (B.C. C.A. [In Chambers]).

36. See *Lively*, *supra* note 33, at paras. 17-19; Hilliker, *supra* note 4 at 160; Billingsley, *supra* note 9 at 248-9.

37. *Coakley v. Allstate Insurance Co. of Canada* (2009), 73 C.C.L.I. (4th) 113, [2009] I.L.R. I-4841, [2009] O.J. No. 1832 (Ont. S.C.J.).

38. 2011 ONSC 5781, [2011] I.L.R. I-5224, [2011] O.J. No. 5381 (Ont. S.C.J.) at para. 41, additional reasons 2012 ONSC 416.

39. See *Parlee*, *supra* note 8 at para. 20; Hilliker, *supra* note 4 at 166-7; *Morrison C.A.*, *supra* note 27 at para. 44.

Conflicts of interest can also arise when a statutory third party adopts a position contrary to that of the insured. An automobile insurer, for example, has a statutory right to add itself as a third party in the underlying action when it disputes liability. The purpose of this statutory right is to give the insurer the opportunity to advance its interests and to contest the insured defendant's liability or quantum of damages in the underlying action and not to be used as a vehicle to raise the coverage dispute between the insurer and insured. An insurer who exercises its statutory right to be joined as a third party in the underlying action against the insured is expected to take a position consistent with the insured defendant's interest in the liability claim.⁴⁰ As the court noted in *Parlee*:

It is now beyond dispute that a lawyer appointed and paid for by an insurer to defend its insured in compliance with the insurers contractual duty to defend owes a duty to fully represent and protect the interest of the insured . . . once appointed the lawyer must represent and act on behalf of the defendant insured with the utmost loyalty and only in the latter's best interest. The lawyer appointed to represent the insurer added as a third party under the Act is not expected to protect the interests of the insurer to the detriment of the defendant insured. The third party is not entitled to file a statement of defence or take a position at trial that is incompatible with the interests of the defendant insured.⁴¹

An insured may be entitled to independent counsel where the statutory third party insurer adopts a position contrary to that of the insured or tries to use its third party status in the liability claim to contest coverage issues between itself and the insured, resulting in a conflict of interest.⁴² In *Parlee*, the insured was held entitled to appoint and instruct their own counsel because the insurer and insured had conflicting views regarding the events that gave rise to the liability claim.

Whether a conflict of interest exists in any given situation ultimately depends on the degree of divergence between the insured and insurer's interests. Courts must assess the balance of the parties' competing interests: the insured has a right to a complete and fair

40. *Insurance (Vehicle) Act*, R.S.B.C. 1996, c. 231, s. 77(3), (4); *Insurance Act*, R.S.A. 2000, c. I-3, s. 579(14), (15); *Saskatchewan Insurance Act*, R.S.S. 1978, c. S-26, s. 210(14), (15); *Insurance Act*, R.S.O. 1990, c. I.8, s. 257(14), (15); *Insurance Act*, R.S.N.B. 1973, c. I-12, s. 250(14), (15); *Insurance Act*, R.S.N.S. 1989, c. 231, s. 133(14), (15). For a review of the history of the insurer's statutory third party rights, see *Parlee*, *ibid.* paras. 12-19; Hilliker, *supra* note 4 at 154-5.

41. *Parlee*, *ibid.* at paras. 17-19.

42. See *Parsons*, *supra* note 27 at paras. 36-38 and 40; *Gosse v. Huemiller* (1988), 34 C.C.L.I. 265, [1988] I.L.R. 1-2372, [1988] O.J. No. 1595 (Ont. H.C.); Hilliker, *supra* note 4 at 154-5.

defence in the liability action, while the insurer is obliged to pay defence costs and indemnify the insured for any judgment or settlement against them, and has the corresponding right to control the defence. There is a presumption that the interests of the insured and insurer are aligned, entitling the insurer to control the liability action. This presumption may be rebutted by evidence of a reasonable apprehension of a conflict of interest, entitling the insured to appoint and instruct their own defence counsel. In *Brockton*, Goudge J.A. noted:

In my view, that balance is appropriately struck by requiring that there be, in the circumstances of the particular case, a reasonable apprehension of conflict of interest on the part of counsel appointed by the insurer before the insured is entitled to independent counsel at the insurer's expense. The question is whether counsel's instructions from the insurer can reasonably be said to conflict with his mandate to defend the insured in the civil action. Until that point is reached, the insured's right to a defence and the insurer's right to control that defence can satisfactorily co-exist.⁴³

There is no conflict of interest entitling the insured to appoint independent counsel where the point of divergence between the insured and insurer has no bearing on the liability action,⁴⁴ the insurer has not instructed defence counsel to raise issues that might lead to denial of the insurer's duty to defend and indemnify, or where the insurer appoints or undertakes to appoint separate counsel to deal with the liability and coverage issues.⁴⁵ In *Roman Catholic Episcopal Corporation of St. George's*,⁴⁶ the court found that there was no conflict of interest between the insurer and insured because defence counsel was not acting under a conflicting mandate. Rather,

43. *Brockton*, *supra* note 28, para. 43.

44. See *Parlee v. Pembroke Insurance Co.*, 2004 NBQB 38, 10 C.C.L.I. (4th) 70, 272 N.B.R. (2d) 327 at para. 18 (N.B. Q.B.), affirmed 2005 NBCA 49, 253 D.L.R. (4th) 182, 22 C.C.L.I. (4th) 223 (N.B. C.A.); *Zurich du Canada, cie d'indemnité c. Renaud & Jacob*, [1996] R.J.Q. 2160, [1996] A.Q. No. 2670 (C.A. Que.); *Foremost Insurance Co. v. Wilks*, 206 Cal. App. 3d 251, 253 Cal. Rptr. 596 (U.S. Cal. Ct. App., 1988); *National Casualty Co.*, *supra* note 5 at 878-9; *American Family Mutual Ins Co.*, *supra* note 5 at 498; Richmond, *supra* note 10 at 859-60, 870.

45. See *Brockton*, *supra* note 28; *2091533 Ontario Ltd. v. Vertigo Investments Ltd.*, 2013 ONSC 2731, 23 C.C.L.I. (5th) 121, 115 O.R. (3d) 457 (Ont. S.C.J.); Hilliker, *supra* note 4 at 156; but see *Appin Reality Corp Ltd.*, *supra* note 25, where the court perceived the insurer's suggestion to have different counsel represent the liability action and coverage issues as impractical because "a reasonable person would still perceive a conflict despite the proposed safeguards" and held that the insured could retain independent counsel at the insurer's expense.

46. *Supra* note 27 at para. 38.

counsel's purpose was to clear the insured of liability in the underlying action.

There is a high threshold for the establishment of a conflict of interest and the onus is on the insured to establish that a conflict exists. This appears to disadvantage the vulnerable party in an unequal relationship and raises concerns about access to justice. An insured may have to appoint their own counsel to watch the conduct of the liability claim and advise her or him about potential conflicts of interest. Furthermore, an insured may not have the desire or the means to pursue a claim of a conflict of interest in addition to a potential coverage dispute and the likelihood of financial risk with substantial deductible or claims exceeding policy limits. Notwithstanding these concerns, the presumption of a unity of interests that grounds the current position is necessary for an effective insurance system and resolution of liability claims.

III. Coverage Issues v Breach of Condition

The pleadings rule states that the insurer's duty to defend is triggered where the pleadings disclose a cause of action within the terms of the coverage provided by the insurance contract. As discussed above, it is clear that the insured is entitled to appoint independent counsel funded by the insurer when there is a conflict of interest between the parties as a result of coverage issues or conflicting policy interpretations about whether the duty to defend has been triggered. It is unclear, however, whether the insured should enjoy similar rights where the insurer alleges breach of a condition. Some courts have taken the view that where an insurer denies liability under a motor vehicle policy alleging breach of a condition and exercises its statutory right to be joined as a third party in the liability action, the insurer's duty to defend is suspended pending determination of the allegation of breach of condition.⁴⁷ This position is premised on an exception to the pleadings rule articulated in *Nichols* that there is no duty to defend claims that are excluded

47. See *Veillieux (Litigation Guardian of) v. Chambers* (1995), [1996] I.L.R. 1-3262, 25 O.R. (3d) 538, [1995] O.J. No. 2755 (Ont. Gen. Div.), additional reasons 1995 CarswellOnt 3673; *Laughlin (Litigation Guardian of) v. Sharon High Voltage Inc.* (1993), 16 C.C.L.I. (2d) 184, (*sub nom.* Laughlin v. Sharon High Voltage Inc.) [1993] I.L.R. 1-2934, 12 O.R. (3d) 101 (Ont. Gen. Div.); *Featherstone v. Zurich Insurance Co.* (1991), 8 C.C.L.I. (2d) 245, [1992] I.L.R. 1-2801, 6 O.R. (3d) 639 (Ont. Gen. Div.); *Colitti v. Popp* (1998), 3 C.C.L.I. (3d) 161, 20 C.P.C. (4th) 363, [1998] O.J. No. 1898 (Ont. Gen. Div.); *Litton Systems Canada Ltd. v. Olympia Engineering Ltd.* (1990), [1991] I.L.R. 1-2701, 1 O.R. (3d) 780 (Ont. Gen. Div.); *Carter*, *supra* note 25.

from coverage under the liability policy.⁴⁸ Other courts have held that an alleged breach of condition by the insured does not affect the insurer's duty to defend and may entitle the insured to appoint independent counsel at the insurer's expense.⁴⁹ Each position presents difficulties. In *Longo*, the court noted the potential detriment to the insurer where they are obliged to defend the insured despite the allegation of breach of condition and to the insured where the insurer is not obliged to defend.⁵⁰

In recent decisions, courts have refused to adopt rigid positions in situations of alleged breach of condition because either position is considered unduly restrictive and potentially unfair to the insured or insurer. Instead, courts have adopted a flexible approach to determining when an insured should be entitled to independent counsel in situations where an insurer alleges breach of condition. This is a case-specific determination based on the relevant facts, policy considerations, and the relative strength of the insurer's and insured's positions and it allows courts to do justice in the particular circumstances.⁵¹ In *Morrison*, the court noted that the same considerations should apply when determining an insured's entitlement to independent counsel regardless of the source of the conflict of interest; it should make no difference whether the conflict or potential for a conflict of interest arises because the insurer chooses to defend under a non-waiver agreement or reservation of rights, alleged breach of condition or denial of coverage.⁵² In *Longo*, involving an alleged breach of condition, the court held that there was no need for the insured to have independent counsel where the

48. Notwithstanding that the duty to defend is broader than the duty to indemnify, a duty to defend does not arise where the conduct that gives rise to the liability claim is excluded from coverage under the policy: *Nichols*, *supra* note 3, para. 13; *Cummings v. Budget Car Rentals Toronto Ltd.* (1996), 136 D.L.R. (4th) 330, 35 C.C.L.I. (2d) 219, 29 O.R. (3d) 1 (Ont. C.A.) at para. 17, leave to appeal refused (1997), 101 O.A.C. 80 (note) (S.C.C.).

49. See *Dominion of Canada General Insurance Co. v. MacCulloch* (1991), 78 D.L.R. (4th) 593, 2 C.C.L.I. (2d) 267, 102 N.S.R. (2d) 136 (N.S. C.A.); *Griffen v. Hope Estate*, [1998] I.L.R. I-3606, 39 M.V.R. (3d) 276, 41 O.R. (3d) 216 (Ont. Gen. Div.). (For a suggestion that *Griffen* may not have properly reflected the existing case law, see *Longo v. Maciorowski* (2000), 193 D.L.R. (4th) 371, 23 C.C.L.I. (3d) 1, 50 O.R. (3d) 595 (Ont. C.A.) at para. 31, leave to appeal refused (2001), [2001] I.L.R. I-3917 (note), 150 O.A.C. 200 (note) (S.C.C.).)

50. *Longo*, *ibid.* at paras. 33-34.

51. See *Longo*, *ibid.* at paras. 35-37; *Drane v. Optimum Frontier Insurance Co.* (2004), 2004 NBCA 52, 241 D.L.R. (4th) 748, 11 C.C.L.I. (4th) 163 (N.B. C.A.) at paras. 23-24; *Parsons*, *supra* note 27.

52. *Morrison* C.A., *supra* note 27 at para. 4.

insurer alleges breach of condition that, if true, will excuse the insurer of its duty to defend and indemnify. The court reasoned that the insured had not provided materials alleging estoppel or relief from forfeiture. As well, although the insurer had invoked its statutory third party right in the underlying action, its position on liability and quantum of damages was consistent with the insured's interests.⁵³ The court came to the opposite conclusion in *Parsons*, noting that the coverage issues are inextricably connected with the liability dispute and that it was inappropriate to suspend the underlying action pending resolution of the coverage dispute.⁵⁴ Furthermore, the insurer had aggressively contested the insured's positions on both liability and coverage. There was therefore no doubt that a reasonable person would perceive counsel appointed by the insurer as having a conflict of interest. Hence, it was held that the insured was entitled to independent counsel funded by the insurer.⁵⁵

Focusing on the substance rather than the source of the conflict of interest is the preferred approach to determining whether appointment of independent counsel is warranted because it is a principled approach. It is appropriate that the focus of the determination is on how the reasonable person would perceive defence counsel's ability to equally represent the interests of the insured and insurer. This might seem unfair for an insurer who is obliged to keep paying an insured's defence costs notwithstanding allegations of breach of condition, which if substantiated, would relieve the insurer of the duty to defend and indemnify the insured. The insurer would have to take steps to recover from the insured any costs incurred in the liability claim should there be a finding of breach against the insured, and there is a risk that the insurer would not be able to recover those costs where the insured is indigent. However, the insurer faces similar risks in relation to coverage disputes that are resolved in their favour after the liability claim. Hence, there is no justification for a different approach in relation to alleged breaches of condition.

IV. Does Appointment of Independent Counsel Guarantee the Insured Effective Representation?

Appointment of an independent counsel at the insurer's expense may not necessarily protect the insured's interests. Retaining new counsel can delay resolution of the liability claim and cause unnecessary frustration and anxiety, especially where a finding of

53. *Longo*, *supra* note 49 at para. 37.

54. *Parsons*, *supra* note 27 at para. 29.

55. *Parsons*, *ibid.* at paras. 36-38.

liability may be detrimental to the insured's reputation. Counsel withdrawing from a case following a conflict of interest must take all reasonable steps to assist in the transfer of the file, including the provision of all documents that the client is entitled to by law to ensure that the insured is not prejudiced.⁵⁶ This practice guarantees that an insured's counsel obtains relevant information about the liability claim. However, it does not adequately ensure that the insured gets effective representation because the insurer's counsel is not obligated to provide the insured or counsel with information about the situation that gave rise to the conflict. Counsel may have to sift through the transferred files to ascertain the conflict issue in order to determine an effective defence strategy in the circumstances. The insured may not be of much assistance to counsel in this regard. Given that the insurer has the exclusive right to control the liability claim and the insured is only a nominal party, the latter may have been indifferent to the conduct of the litigation, particularly where the liability claim is within the policy limit and the insured had no reason to suspect a dispute. Notification of the withdrawal of representation by counsel for an alleged conflict without disclosing information about the situation that gave rise to the conflict may significantly disadvantage the insured and could leave them confused where counsel under the joint retainer continues to represent the insurer.

Appointment of independent counsel at the insurer's expense does not preclude the insurer from proceeding with coverage or breach of condition issues in a separate action. The insured could end up being liable for the settlement or judgment against them in the liability claim as well as defence costs if a court determines that the insurer had no duty to defend or indemnify the insured in the circumstances. Thus, while appearing to favour the insured's position, appointment of independent counsel may not necessarily further their interests.

As well, it is often not in the insurer's interest to lose the right to appoint and instruct counsel. Liability insurers are professional litigants who often have access to a pool of lawyers and firms who efficiently defend liability claims at negotiated fees and who have expertise in relevant substantive areas. This resource would be unavailable to an insured who appoints independent counsel. The average insured may be a one-time or unsophisticated litigant, and without the benefit of an insurers' accumulated wisdom, could appoint counsel who may not be able to effectively and efficiently defend the liability claim.⁵⁷ Furthermore, the insured could be

56. FLSC, *Model Code of Conduct*, Rule 3.7-8, 3.7-9(b); *B.C. Code*, *supra* note 14, Rule 3.7-8, 3.7-9(b).

constrained in their choice of counsel because lawyers who have entered into SAAs with the insurer may not be able to represent the insured. The insurer could be exposed to a greater financial risk both in the possibility of adverse findings against the insured and quantum of damages.

The exercise of an insurer's statutory third party rights under automobile insurance policies or when they obtain such status in relation to other liability policies entitles an insurer to appoint counsel to participate in the liability claim when the insured retains and instructs independent counsel. However, this does not alleviate the insurer's exposure to financial risk because the insurer cannot take a position contrary to the insured's interests in the liability claim. The insured's counsel makes ultimate decisions about the defence and can disregard the advice of the insurer's counsel as long as they do not breach their fiduciary duty to their client and are not negligent in the circumstances. It is possible that the insurer's interests may not be given due consideration in defence strategies since the insured is the lawyer's sole client and there is no duty of loyalty owed to the insurer. The insurer could end up paying increased defence costs, remain liable to indemnify the insured, and be disentitled from exercising control of the defence. Thus, paying the piper may not entitle the insurer to call the tune when an insured appoints independent counsel at the insurer's expense.

The potential for increased expenses when an insured appoints independent counsel is a source of anxiety for insurers. As McLachlin J. (as she then was) notes in *Nichols*:

An insurer would be understandably reluctant to sign a "blank cheque", and cover whatever costs are borne by whatever lawyer is retained, no matter how expensive. Yet the insurer could not challenge any of these expenses without raising precisely the same conflict.⁵⁸

A lawyer's professional obligation to charge fair and reasonable fees regardless of the payor is not sufficient to alleviate concerns about high defence costs.⁵⁹ What constitutes fair and reasonable fees is a case-specific determination depending on a number of factors such as the lawyer's experience, the level of complexity of the action, and any relevant agreement between the lawyer and client. Unlike insurance companies, the insured may not have an incentive to control defence costs.

57. See Richmond, *supra* note 10 at 883-84.

58. *Nichols*, *supra* note 3 at para. 20. See also Richmond, *ibid.* at 881-82.

59. See FLSC, *Model Code of Professional Conduct*, Rule 3.6-1; *B.C. Code*, *supra* note 14, Rule, 3.6-1; Alberta *Code of Conduct*, *supra* note 14, Rule 2.06(1).

The possibility of losing the right to control the liability action coupled with uncertain financial liability can lead an insurer to abandon the coverage dispute or pay for the claim in order to maintain control over the defence of the underlying action.⁶⁰ This creates the possibility of an insured not being accountable for a breach of duty, benefitting from a generous interpretation of policy terms, or gaining the benefit of the defence of and indemnification for uncovered claims.⁶¹ This is detrimental to the insurance system, and unfair to other policyholders who have to pay higher premiums and the general public as consumers of insurance products who have to pay higher prices for goods and services.

In summation, both the insured and insurer may be prejudiced when an insured appoints independent counsel at the insurer's expense. Care must be taken in these cases to avoid giving the insurer or insured an unfair advantage in advancing their interests at the detriment of the other party. A finding of conflict of interest does not preclude the alignment of interests between the insured and insurer in the underlying action. There is no reason why counsel for the insured and insurer should not cooperate regarding the underlying action based on their common interests, provided there is no disclosure of confidential information or advice on the coverage dispute.

V. Avoiding Conflicts of Interest in the Tripartite Relationship

Appropriate Disclosures in Joint Representations

It may be impossible to completely eliminate perceived or actual conflicts of interest in liability actions against an insured. However, the potential for conflict and the need for an insured to appoint independent counsel can be minimized. One way of avoiding conflicts of interest is for counsel who has signed an SAA or is in some continuing relationship with an insurer to disclose that fact to the insured and advise them to seek independent advice regarding the joint retainer.⁶² While this is consistent with lawyers' rules of professional conduct in joint retainers, it may not be sufficient to protect the insured, given the power imbalance in the insurer-insured relationship. The rules of professional conduct regarding joint retainers are not specifically designed for liability insurance claims where joint representation is the norm. It is unlikely the insurer will

60. Ferguson, *supra* note 9 at 138-9; Richmond, *supra* note 10 at 860, 877-78.

61. See John R Singleton, "Representation of Insureds and Insurers: Who is your Client?" in *Liability Insurance Coverage Disputes* (Vancouver: Insight Educational Services, 1990), Tab V, at 18-20.

62. See the *B.C. Code*, *supra* note 14, Rule 3.4-8.

be liable for the cost of obtaining independent advice prior to the insured accepting joint representation. The cost of independent legal advice may be prohibitive for many insureds, particularly where there is a possibility of non-coverage either in whole or in part,⁶³ or where the insured is subject to a significant deductible. Further, an insured may not have reason to suspect a potential conflict of interest in a joint representation or bad faith on the part of the insurer and therefore be unable to justify the expense of independent legal advice. In any event, the insured may not have a realistic choice in the circumstances and may feel compelled to accept the joint retainer pursuant to the insurer's duty to defend and right to control the liability claim.

As has already been noted, joint representation is a corollary of the tripartite relationship between the insured, insurer and defence counsel. This is premised on the unity of interests between the insured and insurer in the liability action. Counsel must advise the parties that communication received from one client in relation to the liability claim cannot be considered confidential *vis-à-vis* the other client.⁶⁴ Sharing confidential information is intended to assist counsel in the effective representation of the parties' interests. Effective defence strategies including decisions about settlement require full disclosure by the insured of the circumstances giving rise to the claim and their cooperation consistent with the insured's duty to co-operate.⁶⁵ Yet, the insured should feel secure that communication with defence counsel will not be used to her or his detriment. The insurer should also feel secure that any disclosure that it makes will not be used by the insured to allege bad faith in the conduct of the underlying action.⁶⁶ Counsel cannot disclose confidential information relating exclusively to coverage issues or breach of the

63. For example, where the insurer is seeking a non-waiver agreement or has submitted a reservation of rights letter to the insured. As well, doubts about coverage may exist where the plaintiff's claim alleges alternate grounds of liability or where the claim includes covered and uncovered bases of liability.

64. See FLSC, *Model Rules of Professional Conduct*, Rule 3.4-5; *BC Code*, *supra* note 14, Rule 3.4-5; Law Society of Upper Canada, *Rules of Professional Conduct*, *supra* note 14, Rule 2.04(6).

65. The insured's duty to cooperate is not affected by the existence of a coverage dispute. Although the insured is often the vulnerable party in the insurer-insured relationship, they can be in a position of power where they hold key information that the insurer does not know or can only discover at considerable time and expense. This is the rationale for the insured's disclosure duty at the time of application, regarding changes material to the risk, and in making claims under the policy.

66. See Gordon Hilliker, *Insurance Bad Faith*, 2nd ed. (LexisNexis: 2009), chapter 3.

obligation of good faith. However, counsel is obligated to disclose information necessary for the defence of the underlying action that may also point to possible conflicts of interest, without specifically advising the parties about the possible conflict of interest.⁶⁷ This may cause anxiety for the parties, particularly where there is the potential for a conflict of interest, that the information could be used to deny coverage or maintain a claim for breach of the obligation of good faith. This creates a risk of a party withholding relevant information that may undermine the defence of the liability claim.

Separate Counsel for Liability Claims and Coverage Disputes

The expectation of counsel's undivided loyalty in joint retainers, including SAAs, is laudable but may not always be attainable or reflect the reality of joint representations.⁶⁸ Oftentimes, actual or perceived conflicts of interest arise from counsel's access to confidential information during the liability action that can be relevant in a coverage dispute and can result in coverage denial.⁶⁹ This situation tends to arise when counsel is somehow involved in both the liability action and coverage disputes or when counsel represents multiple parties with divergent interests. Concerns about conflicts of interest and the need for independent counsel may be minimized with a strict demarcation between lawyers defending liability claims and those acting on coverage disputes. There should also be a similar

67. *Chersinoff v. Allstate Insurance Co.* (1969), 3 D.L.R. (3d) 560, [1969] I.L.R. 1-285, 67 W.W.R. 750 (B.C. C.A.); *Browne v. Cigna Insurance Co. of Canada*, 2000 BCSC 1176, 20 C.C.L.I. (3d) 257, 2000 CarswellBC 1604 (B.C. Master); *Abick v. Continental Insurance Co. of Canada Inc.* (2002), 157 O.A.C. 334, 2002 CarswellOnt 767, [2002] O.J. No. 877 (Ont. Div. Ct.); Hilliker, *supra* note 4 at 166.

68. In fact, it has been observed that counsel do not always comply with their professional and ethical obligations in joint representations. See B.C. Law Society Ethics Committee, Practice and Ethics, *Bencher's Bulletin*, July-August 2006, 10; Hilliker, *ibid.* at 163; Ferguson, *supra* note 9 at 144.

69. See *Szebelledy v. Constitution Insurance Co. of Canada* (1985), 11 C.C.L.I. 140, 3 C.P.C. (2d) 170, 1985 CarswellOnt 420 (Ont. Dist. Ct.) at paras. 38-42; *Yilmaz v. Royal Insurance Canada*, 1993 CarswellOnt 4311, [1993] O.J. No. 2209 (Ont. Gen. Div.) at paras. 22-23; *Kansa, supra* note 22; *Hopkins (Committee of) v. Wellington* (1999), 68 B.C.L.R. (3d) 152, 1999 CarswellBC 1113, [1999] B.C.J. No. 1164 (B.C. S.C.) at paras. 12-14. See also *Morrison C.A., supra* note 27 at para. 50, where although the statutory third party insurer did not adopt a contrary position to that of the defendant insured in the liability action, the court nevertheless held the insured was entitled to independent counsel at the insurer's expense because the involvement of the insurer's counsel in the underlying action may be detrimental to the insured's interest in the liability claim.

separation in the reporting structures for the different files within the insurance company.⁷⁰

In *Morrison*, Deschênes J.A. advised insurers on how to avoid losing control over the underlying action when there is a coverage dispute between the insurer and insured:

. . . it may be possible for the insurer to conduct itself in a manner that would allow it to retain control of the defence of the insured. For example, when the coverage or breach of condition issue relates to the conduct of the insured in the underlying action, the insurer “ought to act by retaining coverage counsel to report initially on the coverage problem” and “. . . [a]t that point, the insurer ought to proceed to appoint defence counsel to defend the action blind to the coverage issue and ‘split the file’ in-house so that coverage counsel and defence counsel report to separate claims representatives.” [reference omitted] In such circumstances, it might still be possible for an insurer to convince the court that it should be allowed to keep control of the defence without compromising the insured’s right to a full, fair and complete defence.⁷¹

Such an arrangement avoids the potential that defence counsel may inadvertently disclose to the insurer information that could be relevant for the dispute between the parties and prevents the phenomenon of “cautious counselling”.⁷² This arrangement allows defence counsel to feel secure that they may divulge confidential information in relation to the underlying action to the other client without the risk of such information being used by either party in a coverage claim or allegation of breach of duty of good faith. Such an arrangement encourages full and honest disclosures under the joint representation consistent with the parties’ reciprocal duty of utmost good faith. As well, it ensures a full and complete defence of the liability action. The distinct mandate arrangement would be a source of assurance for the insured that they will not be prejudiced by the disclosure of confidential information pertinent to the liability claim that could also have a bearing on the coverage dispute because that disclosure would not be available for use in the latter dispute. It would also minimize the likelihood of ethical dilemmas for defence

70. See *Pope & Talbot Ltd.*, *supra* note 35 at paras. 17-19. Part of the problem in *Chersinoff*, *supra* note 9, was that defence counsel in the underlying action also represented the insurer in the coverage dispute.

71. *Morrison C.A.*, *supra* note 27 at para. 50. Even where the insurer has appointed separate counsel to deal with the coverage dispute, a conflict of interest can still arise entitling the insured to independent counsel where the coverage dispute is litigated before the liability claim and the coverage issue such that it cannot be ignored in the underlying action; see *British Columbia Medical Assn. v. Aviva Insurance Co. of Canada*, 2011 BCSC 1399, [2012] I.L.R. I-5212, [2011] B.C.J. No. 1948 (B.C. S.C.) at paras. 77-83.

72. Billingsley, *supra* note 9 at 246.

counsel as both clients will have common goals in the liability action, and it would correspondingly decrease the potential of negligence claims against counsel.⁷³ More importantly, it would allow an effective defence of the liability claim while reducing the incidence of conflicts of interest resulting in the need for the insured to have independent counsel at the insurer's expense and potential claims of bad faith against the insurer. This benefits insureds, insurers and other policyholders.

73. *Ibid.* at 250-51.