CAUGHT IN THE MIDDLE: WHEN LIABILITY INSURANCE DEFENCE COUNSEL ENCOUNTER COVERAGE PROBLEMS

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This paper explores the ethical and legal difficulties encountered by insurance defence counsel when confronted with a coverage problem on a liability insurance policy. Ordinarily, where a claim is made against an individual insured by a liability insurance policy, defence counsel is hired by the insurance company to protect the common interest of the insurance company and the insured: namely, to reduce or avoid any liability finding against the insured. Frequently, however, while serving this role, defence counsel may become aware of potential problems with the policy: problems which may entitle the insurer to deny coverage to the insured. In this situation, should defence counsel favour the interest of the insurer in denying coverage or the interest of the insured in avoiding liability under the protection of the insurance policy? While this problem is encountered daily by lawyers across the country, to date the Canadian courts have provided little guidance for defence counsel caught between its obligations to the insurer and the insured. This paper attempts to offer solutions to this problem by identifying the common situations where this issue arises and by identifying and critically analysing the relevant Canadian case law to date.

Cet article touche les difficultés éthiques et juridiques que rencontre un avocat de défense en assurance lorsqu'il est confronté à un problème de couverture dans une police d'assurance-responsabilité. Lors d'une demande contre un individu couvert par une police d'assurance-responsabilité, ordinairement la compagnie d'assurance engage un avocat pour défendre les intérêts communs de l'individu et de l'assureur : soit de réduire ou d'éviter la responsabilité de l'assuré. Cependant, en remplissant cette fonction, souvent l'avocat découvre des problèmes éventuels concernant la police – des problèmes de nature à permettre à l'assureur de nier couverture. Dans une telle situation, l'avocat devrait-il accorder préférence aux intérêts de l'assureur, en niant couverture, ou à ceux de l'assuré, en essayant d'éviter toute responsabilité? Bien que chaque jour des avocats soient confrontés à ce problème à travers tout le pays, jusqu'à maintenant les tribunaux canadiens ont fourni peu d'indications à l'avocat pris entre ses obligations vis-à-vis l'assureur et celles vis-à-vis l'assuré. Cet article cherche à apporter des solutions à ce problème, en identifiant les situations où il surgit habituellement, en relevant la jurisprudence canadienne pertinente et en faisant la critique.

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I. *Introduction*

The relationship between an insurance company and its insured is by nature an uneasy one, unavoidably characterized by mutual reliance and suspicion between the parties. The insured, for example, relies upon the insurer to provide the promised protection. The insurer, in turn, relies upon the insured to provide all of the information required for the insurance company to properly assess the insurance risk and to respond to any claim. While relying upon one another, however, the parties to an insurance contract are also aware that their underlying fundamental interests conflict: the insured's interests lie in maximizing the insurer's obligation to pay a given claim while the insurance company's interests lie in minimizing that obligation. In order to protect its individual interests, each party is necessarily cautious and, to some extent, suspicious of the other.

The potential for conflict in the relationship between an insurance company and its insured is particularly apparent in the case of liability insurance policies, in which the insurance company typically agrees to pay for the defence costs and any judgments arising from lawsuits brought against the insured. From the insured's point of view, the tension between the insurer and the insured can be

exacerbated in a liability policy situation because these policies generally allow the insurance company to appoint and instruct defence counsel to act on behalf of the insured, leaving the insured with limited, if any, input as to how the liability claim is resolved.[1] From the insurance company's perspective, the high costs which can be involved in defending a claim make the insurer wary of assuming the defence of an insured unless the policy and the claim clearly require it to do so. This concern is magnified by the insurer's knowledge that, by assuming the defence of its insured, it may later be estopped from denying coverage under the policy.[2]

When an insurance company assumes the defence of its insured pursuant to a liability policy, the uneasiness inherent in the insurer/insured relationship lands squarely upon the shoulders of the lawyer retained to conduct the defence.[3] If no coverage issues[4] arise, no major difficulties for defence counsel typically arise because the potentially divergent interests of the insurer and the insured are superceded by a primary, common goal: to avoid or limit a liability finding against the insured.[5] Once a real or potential problem with insurance

[1] Even though a liability insurance contract ordinarily requires the insurance company to pay for any judgment or settlement against the insured, the insured still may have a serious stake in the outcome of the lawsuit against him. For example, the insured has an interest in protecting its reputation and therefore may want to avoid settling the claim as a matter of principle. Alternatively, in order to protect its reputation, the insured may want a matter to be settled without protracted litigation. Further, depending upon the nature of the claim and the coverage of the insurance policy, the insured may be obliged to pay a portion of any judgment or settlement. Throughout, the insured may be personally responsible for paying any judgment obtained against him if his insurer becomes insolvent or successfully denies coverage.

[2] Generally, the law provides that, if a liability insurer acts in a manner which leads the insured to reasonably believe that the insurer has accepted its obligation to defend or indemnify the insured against a given claim, and if the insured relies on this belief to its detriment, the insurer will be estopped from later denying coverage for the claim in question. For further discussion on this point, see G. Hilliker, *Liability Insurance in Canada*, 2nd ed., (Markham: Butterworths, 1996) at 94-95 and C. Brown & J. Menezes, *Insurance Law in Canada*, 2nd ed., (Scarborough: Carswell, 1991), Ch.14.

[3] Hereafter, the terms "insurance defence counsel" or "defence counsel" will be used to refer to the lawyer(s) hired by an insurance company to defend an insured pursuant to a liability insurance policy.

[4] A "coverage issue" arises when the available facts indicate that the insurance policy in question may not apply or may not have to respond to the claim in question. Coverage issues which are of particular relevance to this paper are summarized in Part II of this paper.

[5] The insured ordinarily shares this goal with the insurer because the insured wants to protect its reputation and to avoid paying a deductible on any judgment obtained. This is not to say, however, that the relationship between an insured and its liability insurer is always without complication in the absence of a coverage issue. As already noted, the relationship between an insured and its insurer is by nature fraught with a certain degree of tension and mistrust. Accordingly, even when coverage issues don't arise, defence counsel must be conscious of the different concerns which the insured and the insurance company may have with respect to any given liability claim. (See n.1). For example, defence counsel is often left with the job of explaining to an insured the insurance company's decision to settle an action for financial reasons when the insured wants to

coverage is raised, however, the divergent interests of the insurance company and the insured are brought to the fore and defence counsel is confronted with a fundamental yet complex issue: whose interest should defence counsel hold paramount? On one hand, defence counsel is retained and instructed by the insurance company and therefore is expected to act in the insurance company's interests. On the other hand, however, defence counsel is hired to protect the insured and therefore is expected to act in the insured's best interests. Hence, the critical issue arises: where the interests of the insurer and the insured are inconsistent, what obligations does defence counsel owe to each party and how can defence counsel fulfill these obligations while meeting the expectations of both parties?

Although practising lawyers across the country encounter variations of this conflict of interest[6] issue daily, to date Canadian law does not provide a definitive answer to this problem. Accordingly, defence counsel are forced to resolve the problem on a case by case basis, influenced by a variety of factors including counsel's professional ethical standards, counsel's business interests in maintaining either the insurance company or the insured as a client, and counsel's desire to achieve the best possible result in the liability action. In this article, I hope to offer some guidance as to how defence counsel, the courts and the insurance industry in general should respond when liability insurance coverage is called into question, taking into account both the practical and legal perspectives on this question. Before suggesting new approaches for dealing with this problem, I will review some common situations in which insurance defence counsel encounter the conflict of interest problem, summarize the relevant Canadian law to date, and critically analyse the approach currently being taken to this problem by the courts and by academic commentators.

II. *Common Situations in Which the Conflict of Interest Problem Arises*

There are a variety of situations in which defence counsel may have to balance the divergent interests of an insurer and its insured because of a real or potential insurance coverage problem. Some of the most common examples of such coverage concerns include the following:[7]

6 This article will use the term «conflict of interest» to generally refer to defence counsel's dilemma of whose interest to prioritize when a coverage problem arises. As will be noted later in this article, however, one of the issues to consider in resolving this problem is whether a given coverage problem actually results in the insured and the insurer having "conflicting interests" in the liability action.

7 The examples set out are not an exhaustive list. For a further discussion and description of common situations giving rise to a potential conflict of interest for defence counsel, see N.P. Kent, "Preventative Paperwork: Non-Waiver Agreements, Reservation of Rights Letters and the Defence of Claims in Questionable Coverage Situations" (1995) 17 Adv. Q. 399.

Partial Coverage of the Claim / Alternative Claims

A coverage problem arises at the outset of a liability action because some parts of the claim made against the insured clearly fall within the coverage provided by the insurance policy while other parts of the claim do not. This situation can arise where the claim includes alternative grounds of liability, such as where the Statement of Claim alleges that the damage was caused by the negligent actions of the insured or, alternatively, by the intentional actions of the insured and where the applicable liability policy provides coverage for the alleged negligence but not for the alleged intentional act. This situation may also arise where the Statement of Claim pleads alternative heads of damage, such as damage to the insured's product and damage resulting from the insured's product. A typical liability policy will provide coverage only for the latter damage claim.

Faced with a partial coverage situation, a liability insurer typically has three possible responses. First, the insurer may advise the insured to hire its own lawyer to defend the uninsured portion of the claim (while the insurer pays for a separate lawyer to defend the insured portion of the claim). The practical problem with this approach is that the parties must coordinate with respect to the roles to be performed by each lawyer: there can, for example, be only one counsel of record for the insured. Second, the insurer may enter into an agreement with the insured whereby the insurance defence counsel defends the entire action with the legal fees apportioned by agreement between the insurer and the insured. Finally, if the uncovered allegations form only a minor part of the claim and are unlikely to be successful, the insurer may agree to pay for the defence of all claims. Regardless of which of the three options is pursued, any liability finding against the insured ordinarily will be paid either by the insurer or the insured depending upon which allegations support the liability finding.

In each of the above scenarios, insurance defence counsel may find itself having to choose between the interests of the insured and those of the insurance company when developing strategies for defending the liability action. In each case, defence counsel's first strategy in the liability action presumably will be to try to absolve the insured of any liability. No conflict arises with regard to this strategy because it reflects the common interest of the insured and the insurer. As a secondary strategy, however, defence counsel may argue that any liability on the part of the insured arises from the insured's uninsured actions. This strategy is clearly in the interest of the insurance company but is directly contrary to the interest of the insured.

Possible Exclusion of Coverage

A coverage problem arises at the outset or during the course of the liability action because an exclusion clause or the insuring agreement limits the insurer's obligations to defend the action. For example, the Plaintiff may allege that his loss was caused by the insured's negligence in throwing a rock out of

his car window. The automobile liability policy relied upon by the insured obligates the insurance company to defend only those claims arising from the "use and operation" of the insured vehicle. Some time during the course of the action, a factual dispute arises as to whether the insured threw the rock out of the window of the insured vehicle or out of another vehicle.

In this type of situation, the insurer may want to assume control of the liability defence just in case the claim is ultimately determined to fall within the policy coverage: that is, in case a court finds that the insured did in fact throw the rock out of the insured vehicle. Again, defence counsel retained by the insurer is in a potential conflict when determining what defence strategy to employ. Obviously, the first argument of defence counsel will be that the insured did not injure the Plaintiff as alleged. This argument is in the best interests of both the insurer and the insured. The question, however, is whether, as a secondary argument, defence counsel should take the position that the alleged actions of the insured did not involve the insured vehicle. This secondary argument benefits the insurance company on the coverage question but may not assist the insured's liability position.

Possible Forfeiture of Coverage

A coverage problem arises at the outset or during the course of the liability action because the insured may have breached a term or condition of the policy. At the time the claim against the insured is made and a defence is required, it is not possible to determine whether the policy breach actually occurred or can be relied upon to deny or limit coverage. For example, the insured may have failed to report the accident in question within the time period required under the terms of the policy or may have failed to report a change of circumstances material to the policy prior to the accident in question occurring.

In this situation, the insurance company's legal obligation to defend the liability action is uncertain.[8] Nevertheless, the insurer may want to participate in the liability defence in order to limit any judgment against the insured because the insurer will be required to pay the judgment if coverage is later found to be in place. In this circumstance, what should insurance defence counsel do if, during the course of defending the liability claim, defence counsel obtains information which might enable the insurer to successfully deny coverage? Should defence counsel pass such information

[8] At present, Canadian case law appears divided as to whether the insured's breach of a liability insurance policy term or condition absolves the insurer of its duty to defend the insured against a claim which would otherwise fall within the policy's protection. For a further discussion of this issue, see C. Mauro, "Confusion Reigns in Canadian Courts Over Duty to Defend" (20 November 1998) *The Lawyers Weekly* 9.

to the insurer even though doing so runs contrary to the interest of the insured? Should defence counsel advise the insured at the outset that any information obtained during the course of the liability action may be passed on to the insurer for the purposes of assessing coverage? The insured may be inclined to withhold relevant information from defence counsel (even if the information would be helpful in exonerating him from liability or limiting his liability) if that information will be passed to the insurer to support a coverage denial.

Complicating Factors

The conflict of interest questions raised by the above scenarios are frequently complicated by additional factors. First, what should defence counsel do if it comes across information to suggest that the insurance company has made an error in denying coverage for all or part of the claim? In this circumstance, should defence counsel provide the insured with advice about the existence or extent of insurance coverage? Clearly such information would be helpful to the insured in deferring the costs of defending himself in the liability action yet providing this information to the insured would be contrary to the insurance company's interest in limiting its exposure for the claim.

Second, what is the proper role of defence counsel if the insurer decides to assume the liability defence pursuant to a non-waiver agreement or reservation of rights letter? Both of these documents are designed to inform the insured of a possible coverage problem and to allow the insurer to defend the insured against the liability claim without waiving or being estopped from exercising its right to deny coverage at a later date. Both documents also ordinarily attempt to provide the insurer with the ability to recover from the insured any costs expended in the defending the liability claim if coverage is subsequently determined not to have been in place.[9] The use of non-waiver agreements and

[9] The difference between a non-waiver agreement and a reservation of rights letter is concisely explained as follows by Kent, *supra* note 7 at 405:

> . . . the reservation of rights letter amounts to a *unilateral* declaration by the insurer and, depending upon the circumstances of the case, may not necessarily be effective to preserve rights of coverage denial or recovery against the insured . . .On the other hand, the non-waiver agreement theoretically represents an acknowledgement *by the insured* that the insurer's rights of denial in the future have been preserved.

In the case of automobile liability insurance only, the insurance company also may have the option of denying coverage to its insured while participating in the liability defence as a "Third Party by Order." This procedure is generally available where automobile insurance legislation obliges the insurer to pay at least some portion of a judgment on a liability finding against its insured in spite of a policy breach by the insured. See for example, *Insurance Act of Alberta*, R.S.A. 1980, c. I-5, s. 320. (Note: A new *Insurance Act of Alberta*, S.A. 1999, c. I-5.1 has been passed but remains unproclaimed at the time of writing. The equivalent provision in the new statute is s. 625)

reservation of rights letters understandably exacerbates the insured's inherent distrust of his insurer:[10]

> [These documents] are aimed at allowing the insurer to participate in the defence of the action and to exercise some control over liability and damages while at the same time keeping open the question of coverage. This can be a very unsatisfactory state of affairs for the insured who is asked to entrust his defence to an insurer which has said, in essence, that it may refuse to pay any damages awarded against him. It would not be surprising if the insured, in such circumstances had less than full confidence in the adequacy of the legal representation afforded him by the solicitors approved and instructed by the insurer.

The insurer's desire to have a non-waiver agreement or a reservation of rights letter in place also raises a number of questions for insurance defence counsel. For example:

- if a coverage issue is identified, can defence counsel provide advice to the insurer about the need for a non-waiver agreement or a reservation of rights letter?
- if a coverage issue is identified, can defence counsel prepare or send the reservation of rights letter or explain the letter to the insured?
- if a coverage issue is identified, can defence counsel prepare the non-waiver agreement, advise the insured about the implications of signing the agreement, or attend to the insured's execution of the agreement?
- In defending the liability claim pursuant to a non-waiver agreement or a reservation of rights letter, can defence counsel pursue strategies designed to assist the insurer in later claiming recovery from the insured? (For example, an insurer's action against its insured may be simplified if a liability settlement is reduced to a formal judgment even though a judgment is not otherwise necessary to resolve the liability action. In this situation, should defence counsel arrange for a Judgment to be entered instead of a conventional settlement?).
- If the insurer assumes the defence of the liability claim pursuant to a non-waiver agreement or a reservation of rights letter, can defence counsel act for the insurer in pursuing recovery from the insured after the liability action is resolved?

III. *Canadian Law to Date*

A. *The Major Question Raised Before the Courts: "Cumis Counsel"*

At present, the Canadian law addressing the proper role of defence counsel where coverage is in dispute is relatively sparse. Almost all of the relevant cases

[10] J.S. Cavanagh, "Conflicts of Interest and the Insurer's Right to Control the Defence of its Insured" (1988) 9 Ad. Q. 385 at 386.

deal with applications brought by an insured seeking to have the insurance company pay for "Cumis Counsel"[11], who is a lawyer selected and instructed by the insured but paid by the insurer. Thus, the Canadian case law to date provides little guidance on a fundamental aspect of the conflict problem: that is, what should defence counsel do when faced with a coverage problem in the absence of an insured's application to assume the defence. Further, while the cases generally espouse the same fundamental principles for determining when a conflict of interest exist which would entitle an insured to Cumis Counsel, the Canadian courts have been largely inconsistent and unpredictable in applying these principles such that the decisions offer limited guidance for defence counsel and insurance companies faced with a coverage problem on a liability policy.

B. *General Principles Regarding Coverage Problems & Cumis Counsel*

The leading and most cited Canadian case on point is *Laurencine* v. *Jardine*, a 1988 decision of the Ontario High Court of Justice.[12] In this case, the claimant Laurencine was injured while riding Jardine's motorcycle. At the time of the accident the motorcycle was insured under a liability policy issued by Halifax Insurance Company. Additionally, Jardine was an unnamed insured under a homeowner's liability policy issued by Wellington Insurance Company. A coverage dispute arose between Jardine and Halifax stemming from uncertainty as to whether Jardine had consented to Laurencine's use of the vehicle and as to whether Laurencine's injuries were attributable to the "use and operation" of the motorcycle within the meaning of the policy. The insurer sought to defend the action under a non-waiver agreement but Jardine rejected this proposal. Both Halifax and Wellington refused to defend the lawsuit and Jardine brought a motion before the court to determine which of the two insurance companies was obliged to provide a defence. The Court ordered Halifax to defend the action. Jardine then brought a subsequent motion to permit him to appoint and instruct his own solicitors at Halifax's expense and to prohibit his counsel from reporting to Halifax on any matter bearing on coverage. In support of this application, Jardine argued that, since Halifax had not agreed to indemnify Jardine against the claim, Halifax was in a conflict in instructing defence counsel because "what is good for Halifax is not necessarily good for Jardine."[13]

Justice O'Driscoll granted Jardine's application. First, Justice O'Driscoll concluded that, if Halifax was allowed to continue controlling the defence, Jardine would be obliged to disclose details of the accident to the defence

[11] "Cumis Counsel" is a term adopted from *San Diego Federal Credit Union* v. *Cumis*, 208 Cal. Rptr.494 (Calif, C.A., 1984)(hereinafter Cumis), wherein the California Court of Appeal ruled that the insured should be entitled to select and instruct counsel of its choice at the insurer's expense. For further discussion of this case, see Part III.B. of this paper.

[12] [1988] O.J. No. 302 (QL) (Ont. H.Ct.) (hereinafter *Laurencine*). The fact that this lower level court decision is touted as the landmark Canadian case on point is indicative of the lack of jurisprudence in this country on the conflict of interest issue.

[13] *Ibid.* at 2.

counsel appointed by Halifax and that some of these details may be material to the coverage dispute:[14]

> It might well be that something said by Jardine in those conversations and interview with that counsel will be the corner-stone of Halifax's defence in its resistance of the declaration for indemnity sought by Jardine; that is, confidential information might well be given or elicited from Jardine by counsel for Halifax.

According to Justice O'Driscoll, the possibility that defence counsel retained by Halifax could use its position to advance Halifax's coverage denial satisfied the "appearance of impropriety" or "possibility of real mischief or prejudice" test necessary to establish a conflict of interest.[15] Second, Justice O'Driscoll relied upon two American case authorities[16] to conclude that, where a conflict of interest arises between a liability insurer and its insured because of a coverage dispute, the insurer's ordinary duty to provide a full defence may be transformed into a duty to reimburse the insured for the expense of retaining his own counsel.

In some ways, *Laurencine* is indeed a ground-breaking decision, establishing in Canadian insurance law the principle that, where a coverage dispute leads to the "appearance of impropriety" by an insurance company, an insured is entitled to choose and instruct its own liability defence counsel at the insurer's expense.[17] *Laurencine* clearly indicates that:[18]

(1) insurers do not have an absolute or inalienable right to control the defence of an insured;

(2) when a conflict of interest arises between the insured and the insurer, it may not be sufficient for the insurer to simply appoint new counsel to take over the defence since the coverage issues arose;[19]

(3) the appropriate test for determining when a conflict of interest arises is the "appearance of impropriety" test.

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[14] *Ibid.* at 3.

15 Justice O'Driscoll adopted the Ontario District Court's finding in *Szebelledy* v. *Constitution Insurance Co. of Canada* (1985) 11 C.C.L.I. 140 that the "appearance of impropriety" or "possibility of real mischief or prejudice test" (as contrasted to the "probability of real mischief test"), is the most appropriate test to apply in order to preserve the legal profession's integrity and in order to protect the administration of justice. The "appearance of impropriety" or "possibility of real mischief or prejudice" test will hereafter be referred to as the "Appearance of Impropriety Test."

16 *Cumis*, *supra* note 11, and *Nandorf, Inc.* v. *CNA Ins. Cos.*, 79 N.E. 2d 988 (Ill. App. 1 Dist., 1985).

[17] Hereinafter *Laurencine Principle*.

[18] Cavanagh, *supra* note 10 at 394.

[19] *Ibid.* Cavanagh explains that having the insurer simply choose new counsel is not likely to be sufficient to alleviate the insured's concerns:

> An insured who has doubts as to whether or not his interests are being properly represented by a single firm acting both for and against him is unlikely to be reassured by the substitution of another firm which is still under the control of the insurer and *Laurencine* attempts to address this concern on the part of the insured.

Beyond these three general points, however, the implications and applicability of *Laurencine* is unclear.

In particular, *Laurentine* leaves considerable uncertainty as to whether a coverage dispute always results in the insured being entitled to assume control of his own defence at the insurer's expense. Does every coverage dispute result in a conflict of interest which entitles the insured to assume control of the defence, or are there "acceptable" coverage disputes and resulting conflicts of interest which do not lead to a forfeiture of the insurer's right to choose and instruct defence counsel? This question is unresolved by *Laurencine* because the decision does not precisely identify the circumstances of the case which led to the appearance of impropriety.[20] Does the conflict of interest arise by virtue of the coverage dispute alone, by the insurer's attempt to defend under a Reservation of Rights letter, by some other circumstance, or by a combination of one or more of these factors? Unfortunately, these issues remain unresolved by the Courts and by legal scholars. Commentators have ranged in their opinions from limiting *Laurencine* exclusively to its facts,[21] to limiting the finding to particular coverage problems,[22] to simply recognizing that the implications of the case are unclear.[23] Some Courts have endorsed the Laurencine Principle in theory but have refused to apply it to the facts of specific cases. Therefore, the case law to date only increases the confusion about when an insured is entitled to control its defence at the insurer's expense.

In *R.* v. *Kansa*,[24] an insured brought an application for the same relief as that sought by the applicant in Laurencine. In *Kansa*, the insurance

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[20] The one point which is specifically noted by Justice O'Driscoll is that defence counsel may obtain coverage related information from the insured as a result of counsel's involvement in the liability action. This fact alone cannot be the basis for granting Cumis Counsel, however, because it is always the case that defence counsel may unearth coverage information, even when a coverage dispute does not exist in the initial instance or even where defence counsel is receiving instructions from the insured.

[21] For example, see Hilliker, *supra* note 2 at 102-03. In support of his view that *Laurencine* is "not of general application", Hilliker suggests that the "special circumstances" in *Laurencine* were that the counsel appointed by the insurer to defend the liability action was the same counsel who appeared to oppose the insured's application and that defence counsel could not satisfy the Court that confidential information regarding coverage would not be disclosed to the insurer.

[22] See, for example, Cavanagh, *supra* note 10 at 394. Cavanagh suggests that, in order for the Appearance of Impropriety test to be satisfied such that Cumis Counsel is required, "the insurer must be in a position to influence, to the detriment of the insured, the outcome of the issue between insurer and insured by their representation of the insured in the liability action." Accordingly, if the coverage question does not involve a consideration of any facts in common with the liability action, no "appearance of impropriety" will exist.

[23] See, for example, B. Snowden, "When Coverage is in Dispute: The Conduct of Insurers and Counsel in Canada" (1992) 4 C.I.L.R. 1.

[24] [1991] O.J. No. 757 (QL) (hereinafter *Kansa*).

company was concerned that certain allegations in the liability claim might not be covered by the policy and consequently had been defending its insured pursuant to a Reservation of Rights letter which had been accepted by the insured. When defence costs started to escalate, the insurer encouraged the insured to take over the defence at the insured's expense. The insured refused and obtained a court order requiring the insurer to continue defending. The insured then applied for a further order entitling the insured to select and instruct its own defence counsel at the insurer's expense and prohibiting its lawyers from disclosing any coverage information to the insurer. In support of its application, the insured argued that a conflict of interest existed between itself and the insurer which warranted application of the Laurencine Principle.[25] As evidence of the alleged conflict of interest, the insured pointed out that the insurer's Reservation of Rights letter had been delivered to the insured by the same lawyer whom the insurer had elected to handle the liability defence: a fact which arguably demonstrated that, at least prior to assuming the liability defence, insurance defence counsel had advised the insurer on the coverage question.

In spite of these facts and the precedent established by *Laurencine*, Justice Zelinski of the Ontario Court (General Division) refused to apply the Laurencine Principle in *Kansa*. First, Justice Zelinski distinguished *Laurencine* on the basis that the insurer in *Laurencine* had repudiated the insurance contract in the initial instance by refusing to defend the claim. According to Justice Zelinski, the insurer in *Kansa* had been defending the action from the start and had therefore not repudiated the contract simply by asking the insured to take over the defence. Further, the Judge noted that the insured in *Laurencine* had rejected the proposed Reservation of Rights letter whereas the insured in *Kansa* had accepted the Reservation of Rights letter and had been accepting the insurer's services pursuant to same. Justice Zelinski concluded that, because the insured accepted the terms set out in the Reservation of Rights letter and used defence counsel's services in accordance with that letter, the insured could not invoke the Laurencine Principle.

Second, Justice Zelinski found that no conflict of interest existed which would justify an application of the Laurencine Principle. Relying upon the Supreme Court of Canada's decision in *MacDonald Estate* v. *Martin*,[26] Justice Zelinski found that the appropriate test to apply for determining whether defence counsel is in a conflict of interest is whether a reasonably informed person would be satisfied that improper use of confidential information would

[25] The insured also argued that the insurer had, by its conduct, repudiated its right to control the defence. For the most part, the repudiation argument is separate from the conflict of interest issue so is not addressed in this paper. The repudiation argument is only considered here with respect to the ways in which the repudiation issue impacted upon the court's consideration of the conflict of interest question.

[26] [1990] 3 S.C.R. 1235 (hereinafter *MacDonald Estate*).

occur.[27] According to Zelinski, this test was not met on the facts before him because:[28]

> "a reasonable person must . . . take into account the nature of the insurance contract, the right and duty of [defence counsel] to keep [the insurer] informed of matters affecting it which do not relate to coverage, and the continued representation of [the insured] during discoveries and proceedings up to this time, at the insistence of [the insured]."

Moreover, upon being retained by the insurer, defence counsel had an obligation to convey all relevant information concerning the conduct of the action to the insurer and this passage of information alone was not sufficient evidence to conclude that defence counsel was continuing to provide coverage advice to the

[27] This test is hereafter referred to as the "Reasonable Person Test". A brief explanation of the Supreme Court's decision in *MacDonald Estate* is helpful in understanding the substance of this test.

MacDonald Estate dealt with an application by one party to an action to have the other party's counsel removed due to a conflict of interest. The case did not involve insurance considerations, but arose from the fact that a lawyer formerly employed by the law firm representing the Applicant and involved in the Applicant's case had taken a job with the law firm representing the Respondent. The Supreme Court of Canada concluded that, when considering whether a lawyer has a disqualifying conflict of interest, the "probability of mischief" test is not sufficiently stringent to satisfy the public requirement for the appearance of justice. Instead, the Supreme Court held that the appropriate test "must be such that the public represented by the reasonably informed person would be satisfied that no use of confidential information would occur."

According to the Supreme Court, the application of this test requires two questions to be answered: (1) whether the lawyer received confidential information attributable to a solicitor and client relationship relevant to the matter at hand, and (2) whether a risk exists that the information will be used to the prejudice of the client. The majority of the Court held that, "once it is shown by the client that there existed a previous relationship which is sufficiently related to the retainer from which it is sought to remove the solicitor", a rebuttable presumption arises that confidential information was imparted. As to the second question, the Court held that a lawyer who has received confidential information must be disqualified on the irrebutable assumption that such information will be misused against the client. The majority opinion of the Court differed from that of the dissent only with respect to whether confidential information should be assumed to also have been communicated to other members of the lawyer's firm such that the entire firm should be disqualified: the majority of the Court held that the assumption is rebuttable and the minority held that the assumption is irrebuttable.

In substance, the "reasonable person" test is virtually indistinguishable from the Appearance of Impropriety or "possibility of mischief" test employed in *Laurencine* (especially when considered in the context of insurance defence counsel and when the question of a law firm's role, as opposed to the role of an individual lawyer, is not at issue). In fact, the Supreme Court's reasons indicate that the only reason the Court does not adopt the "possibility of real mischief" wording is that this test is employed in the United States where it is associated with an irrebuttable presumption that the lawyer received confidential information as soon as a substantial relationship between the lawyer and client is established. The majority of the Supreme Court apparently wanted to make absolutely clear that evidence could be raised to satisfy a court that no confidential information was received by a lawyer, even though this burden would be difficult to meet.

[28] *Supra* note 24 at 12.

insurer. Finally, Justice Zelinski specifically distinguished the case at bar from *Laurencine* on the basis that, in *Laurencine*, "counsel for the insured, while defending, could conduct the defence in such a way as to direct liability away from the insurer, to the detriment of the insured. That is not the situation before me at this time."[29]

In many ways, the decision in *Kansa* appears to contradict *Laurencine* and Justice Zelinski's attempts to distinguish *Laurencine* are unclear and unconvincing. Apart from the fact that the insured in the *Kansa* case had initially agreed to be defended by the insurer pursuant to a Reservation of Rights letter, the circumstances of the cases appear to be virtually identical. In particular, contrary to Justice Zelinski's conclusion, defence counsel in both instances appears to have had the same opportunity to enhance the insurer's coverage denial by its involvement in the litigation claim. Further, any differentiation which may be drawn between the cases on the question of whether the insurer repudiated the contract should be immaterial to the question of whether a conflict of interest exists which entitles the insured to control its own defence. Accordingly, the best explanation of Justice Zelinski's finding in the *Kansa* case may be found not in his attempts to substantively distinguish *Laurencine*, but rather in his fundamental view of insurer's rights as disclosed in his concluding comments:[30]

> Finally, as noted in Ferguson on Conflicts, at p.140, the problem that occurs when there is a change of counsel (and control over an action) is that «some cases appear to replace unfairness for the insured with unfairness for the insurer.» In this case, in my view, a fair-minded, knowledgeable person would not lose confidence in the judicial system by the continued representation of the insurer, and of the insured, by [the insurer's defence counsel]. The costs and confusion inherent in a change of counsel and control at this time is not warranted under any reasonable assessment of the respective rights of the parties.

This comment betrays the Court's bias against shifting the balance of power in favour of the insured in the absence of compelling reasons to do so.

Justice Zelinski's interest in sustaining the insurer's right to appoint and direct insurance counsel is also apparent in his application of the Reasonable Person test. In substance, this test is nearly identical to the Appearance of Impropriety test: both tests indicate that, subject to compelling evidence to the contrary, a conflict of interest meriting the disqualification of counsel is presumed where a lawyer is in a position to receive confidential information from a client on one matter and where the lawyer is in a position to misuse the information in a related matter.[31] In applying the Reasonable Person test in *Kansa*, however, Justice Zelinski refuses to presume a conflict of interest based on the circumstances and instead indicates that evidence of a real or probable

[29] This view appears to support Cavanagh's view of the Laurencine Principle as outlined in note 22.

[30] *Supra* note 24 at 13.

[31] See note 27 for a more detailed explanation of the Reasonable Person test and its relationship to the Appearance of Impropriety Test.

misuse of information by insurance defence counsel is required before the insured can invoke the Laurencine Principle to obtain Cumis Counsel.[32] In taking this approach, Justice Zelinski seems to ignore the presumption of impropriety which is inherent in the Supreme Court's explanation of the Reasonable Person test. Noting that the insured expressly consents to the appointment of counsel by the insurer by the terms of the liability insurance policy, Justice Zelinski concludes that the insured accedes to the tri-partite relationship necessarily created by the policy. By focussing on the nature of the solicitor-client relationship between the insured and defence counsel as created by the insurance contract, Justice Zelinski imposes a positive evidentiary obligation on the insured to prove that a misuse of confidential information is likely.[33] This approach either implicitly distinguishes or ignores the MacDonald Estate test.

Justice Zelinski's reluctance to apply the Laurencine Principle is mirrored by the Quebec Court of Appeal in *Zurich du Canada, Compagnie d' indemnite c. Renaud & Jacob*.[34] In this case, a lawsuit was commenced against several accountants, claiming damages on a variety of grounds including fraud, breach of fiduciary duty and conflict of interest. Several of these allegations were not covered under the accountants' liability insurance policy. The insurer agreed to defend the action under a Reservation of Rights letter and advised the insureds to retain their own counsel. A dispute arose as to which counsel would control the defence and the accountants brought an application for an order requiring the insurance company to pay for a lawyer chosen and instructed by the insured. In support of the application, the accountants argued that uncertainty existed about whether the insurer would honour its duty to defend, that a conflict of interest existed for the insurance defence counsel, and that the insurer would not provide them with a proper defence. The Superior Court granted the Order, however, this ruling was overturned by the Court of Appeal. The Court of Appeal took the position that the insurer's right to select counsel and lead the defence of its insured is not to be easily dispensed with. While acknowledging

[32] *Supra* note 24 at 10-11.

[33] Even if one accepts Justice Zelinski's imposition of a positive evidentiary obligation on the part of the insured to establish a likelihood of impropriety, Justice Zelinski's comments do not clearly indicate what such evidence might be. Given Justice Zelinski's disposition in *Kansa*, the fact that defence counsel previously provided a coverage opinion to the insurer would apparently not be sufficient evidence of possible impropriety. Further, Justice Zelinski does not comment on whether the difference in the results between *Laurencine* and *Kansa* might be attributable to the fact that defence counsel in *Laurencine* defended the insured's application for Cumis Counsel whereas the insurer in *Kansa* appointed different counsel for this purpose. For a further discussion of these points, see Snowden, *supra* note 23 at 10-12.

[34] [1996] A.Q. No. 2670 (hereinafter *Jacob*). The review of this case is based on the facts and findings as translated by A Legrand, 'The Duty to Defend: The Québec Court of Appeal Takes a Stand' (1996) 6 C.I.L.R. 307. As Legrand notes at 310, although Québec functions under a Civil Law Code, "the various issues surrounding the duty to defend in liability insurance, and the conflicts of interest which may or may not arise in that context, are no different in Quebec civil law' than in other

that certain circumstances might result in a conflict of interest which merits the application of the Laurencine Principle, the mere reservation of rights by an insurer does not alone qualify as such a circumstance:[35]

> One cannot assume, as the trial judge appears to have done, that the legal relationship formed pursuant to a contract of liability insurance and entailing the duty to defend gives the insured the right to take over the defence as soon as the insurer expresses the intention of reserving its rights with respect to the duty to indemnify should the facts established at trial indicate an absence of coverage.

The Court recognized that, where circumstances raise doubts about an insurer's ability to provide a fair defence, an insured may be granted control of its own defence. In order to for an insured to gain control of its defence, however, more evidence of impropriety is required than just a mere concern that the insurer will favour its own interests over those of the insured. In the case at bar, the Court noted that the Reservation of Rights letter had been sent to the insured by the insurance adjuster and not by the insurance defence counsel. There was no evidence to suggest that insurance defence counsel was receiving instructions from the insurer which were incompatible with his duty to the insured.

As in *Kansa*, the ruling in *Jacob* suggests that a liability insurer's right to control the defence of its insured should not be tampered with in the absence of clear evidence of a conflict of interest on the part of the insurer. While endorsing the Reasonable Person test for a conflict of interest, both *Kansa* and *Jacob* appear to apply a more stringent evidentiary test in determining whether a conflict of interest exists which warrants the appointment of Cumis Counsel. While purporting to apply the test of whether a reasonable person would be satisfied that improper use of confidential information would occur, both cases in fact appear to have been decided on the basis of whether the evidence before the court indicated that improper use of confidential information had occurred. Accordingly, uncertainty remains as to how the Laurencine Principle should be applied.

As already noted, the three cases discussed above and nearly all of the Canadian case law discussing the duty of insurance defence counsel in a coverage dispute situation arises from applications by insureds for Cumis Counsel. Recently, however, in *Hopkins* v. *Wellington*,[36] Justice Burnyeat of the British Columbia Supreme Court issued a judgment discussing the proper role of defence counsel in the absence of such an application. In *Hopkins*, two actions had been commenced with respect to claims arising from a motor vehicle accident. In the first action, Hopkins sued Wellington and, in the second action, Wellington sued Hopkins. In their respective roles as Plaintiffs, Hopkins and Wellington had each retained his own counsel. As Defendants, Hopkins and Wellington were each represented by insurance defence counsel. A number of questions were put to the Court regarding the scope of privilege and

[35] Legrand, *ibid.* at 309 (translating the Court of Appeal's comments).

[36] [1999] B.C.J. No. 1164 (QL) (hereinafter *Hopkins*).

confidentiality owed by the counsel involved to each Plaintiff and Defendant. One of the questions was what duties of confidentiality and disclosure the defence counsel of each party owed to the insurers and the insureds. In resolving this issue, Justice Burnyeat held that defence counsel's only true client is the insured and that defence counsel therefore owes the same duties to the two defendants as if counsel had been personally retained by the two defendants.[37] Accordingly, Justice Burnyeat concluded that:[38]

(a) insurance defence counsel could not provide a coverage opinion to the insurers as part of their retainer to defend the liability actions. Separate counsel should be retained by the insurer to deal with any coverage questions.
(b) if insurance defence counsel did provide any information to the insurers pertaining to coverage, defence counsel must pass that information to the insureds.
(c) if, as a result of a separate retainer with the insurer, defence counsel obtained information which has the potential of leading to a coverage denial, defence counsel owed conflicting obligations of confidentiality to the insurers and disclosure to the insureds and must therefore withdraw.
(d) if, in the course of defending the liability claim, defence counsel obtained any information which might prejudice coverage, defence counsel must not pass this information to the insurers.

Although Justice Burnyeat was not specifically asked to address the need for Cumis Counsel, his comments regarding defence counsel's proper role clearly indicate his view that the mere existence of a coverage problem does not necessitate the appointment of Cumis Counsel. On the contrary, his conclusions indicate that defence counsel can continue to act in the liability action provided that counsel doesn't get involved in coverage matters. On this point, the finding is consistent with the decisions in *Kansa* and *Jacob*.[39]

C. *Cases Regarding the Common Situations in Which the Conflict of Interest Issues Arise*

Partial Coverage of the Claim / Possible Exclusion of Coverage:

The Supreme Court of Canada has established that an insurer's duty to defend is broader than its duty to indemnify and that an insurer's obligation to defend is therefore determined solely by the terms of the policy and the allegations made in the claim against the insured.[40] Following this principle, Canadian case law is generally consistent in finding that, where a claim against an insured includes any allegations which may be covered by the policy, the

[37] *Ibid.* at para. 7.

[38] *Ibid.* at paras. 12-14.

[39] Justice Burnyeat's comments are arguably subject to criticism for identifying the insured as defence counsel's sole client. For a further discussion, see Part IV.C. below and the accompanying footnotes.

[40] *Nichols* v. *American Home Assurance Co.* [1990] 1 S.C.R. 801 (hereinafter *Nicholls*).

liability insurer must pay the legal costs associated with defending the insured against the covered allegations.[41] But who controls the defence?

Surprisingly, there is very little Canadian case law which considers whether an insurer loses its right to control the defence of a claim where only some of the allegations are covered by the insurance policy or where coverage is arguably excluded by the terms of the policy. As noted above, *Laurencine*, *Kansa* and *Jacob* fail to provide a definitive response to this problem. In each of these three cases, however, the Court's analysis is complicated by the fact that the insurer attempted to assume the defence of the entire action pursuant to a Reservation of Rights letter.

In the few cases where an insurer has outright refused to defend the entire claim on the grounds that coverage is excluded or that only partial coverage exists, the Courts have been much more willing to conclude that a conflict of interest exists which prohibits the insurer from controlling the defence and to apply the Laurencine Principle. For example, in *P.C.S. Investments Ltd.* v. *Dominion of Canada General Insurance Co.*,[42] the Alberta Court of Queen's Bench considered whether an insurer was obligated to pay for counsel retained by the insured to defend the insured against a claim which included an allegation of negligent defamation (which fell within the policy cover) and an allegation of fraudulent defamation (which fell outside of the policy cover). The Court considered various authorities, including *Laurencine*, and concluded that in the case at bar a conflict of interest existed which satisfied the Reasonable Person test because of the insurer's interest in having any liability finding against the insured fall within the uninsured allegations:[43]

> If the Respondent insurer has the right to conduct the defence, its counsel would be in an untenable conflict situation. As between the fraudulent defamation claim and the negligent defamation claim counsel would be inclined to pursue the defence of the latter at the expense of the former. The issue of indemnity may well be determined by the actions of the defence counsel in the third party action. This aspect of the defence is difficult to prevent. While there are valid concerns by the insurers they are, I believe, superceded by the need to protect the rights of the insured.

Accordingly, the Court ordered the entire claim to be defended by counsel chosen and instructed by the insured, with the defence costs associated with the insured claims being paid for by the insurer. On Appeal, the Order was upheld

[41] See for example: *St. Andrews Service Company Ltd.* v. *McCubbin* [1988] I.L.R. 1-2305 (B.C.S.C.); *Gosse* v. *Huemiller* (1988) 34 C.C.L.I 265 (Ont. S.C.); *Schwartz* v. *Kuszko Estate* [1988] O.J. No. 611 (QL) (Ont. D.C.); *Kerr* v. *Lawyers Professional Indemnity Co.* [1995] O.J. No. 2823 (QL)(Ont.C.A.); and *Continental Insurance Co.* v. *Dia Met Minerals Ltd.* [1996] B.C.J. No. 1293 (QL)(B.C.C.A.); *Sansalone* v. *Wawanesa Mutual Insurance Co.* [1997] B.C.J. No. 466 (QL)(B.C.S.C.); and *Daher* v. *Economical Mutual Insurance Company* [1997] I.L.R. I-3414 (Ont.C.A.). Note, however, that the cases frequently differ in their determination of when (and if) the amount of defence costs arising from the defence of covered allegations can be separately assessed from the costs attributable to the defence of uncovered allegations.

[42] [1994] A.J. No. 204 (QL) (hereafter referred to as "*PCS Investments*"); affirmed in part [1996] A.J. No. 33 (ABCA) (QL).

[43] *Ibid* at para. 62.

but the Court of Appeal also held that, in the circumstances, the insurer had a right under the insurance contract to apply to the Court to have its own counsel participate in the defence to protect the interest of the insurance company.[44]

The finding in *P.C.S. Investments* follows an earlier ruling by the Ontario High Court of Justice in *Gosse* v. *Huemiller*.[45] In *Gosse*, the claimant sued the insured for damages allegedly rising from the negligent operation of an automobile and for intentional assault. The insured's automobile insurer took the position that only the negligence claim fell within the coverage of the automobile insurance policy. On the insured's application, the Court found that the insured was entitled to choose and instruct his own counsel to defend him, with the costs associated with the negligence claim to be paid by the insurer.[46]

Thus, both *PCS Investments* and *Gosse* suggest that, where alternative allegations or policy exclusions create uncertainty about an insurer's obligations to indemnify the insured, the Reasonable Person test is satisfied, thereby entitling the insured to Cumis Counsel. These cases do not require evidentiary proof that the insurer will act contrary to the insured's interests but are satisfied of a conflict based solely on the conflicting allegations contained in the pleadings. Other cases confirm this result and also indicate that, although partially covered allegations might lend themselves to having two counsel to represent the insured,[47] the matter is usually more appropriately resolved by having the insured elect and instruct its own counsel, with the insurer paying for only those defence costs associated with the covered allegation.[48] Where the

[44] *Supra* note 42 at para. 13.

[45] *Supra* note 41 (hereinafter *Gosse*).

[46] *Gosse* was complicated by the fact that the insurer had elected not to defend any part of the claim on behalf of the insured and instead was defending the claim via a statutory provision which allowed the insurer to act as a Third Party by Order. Hilliker, *supra* note 2 at 102, suggests that this circumstance makes the *Gosse* decision unique and inapplicable to liability claims outside of the automobile insurance context. He notes that the reasons in *Gosse* indicate that 'the issue of coverage between the insurer and the insured was to be decided in the same proceedings as the issue of liability between the plaintiff and the insured' which is not the case in a typical liability insurance coverage situation. The finding in *P.C.S. Investments* arguably brings Hilliker's comments about *Gosse* into question since the Court in *P.C.S. Investments* arrived at the same result in a non-automobile insurance case. Further, as with *Laurencine*, Hilliker points out that the insurer's chosen defence counsel appeared on behalf of the insurance company in responding to the insured's motion for separate counsel: resulting in what Hilliker calls a 'clear appearance of impropriety'. With respect, this 'appearance of impropriety' is not clear on the facts of *Gosse* since the insurer had denied coverage (a requirement in order to be named a Third Party by Order) and its defence counsel therefore arguably did not owe any duty to the insured.

[47] That is, one counsel appointed by the insurer to deal with allegations falling within coverage and one counsel appointed by the insured to deal with allegations falling outside of coverage.

[48] See for example *Wear* v. *Robertson* (1996) B.C.J. No. 1627 (B.C.S.C.)(QL) and *Karpel* v. *Rumack* [1994] O.J. No. 1617 (Ont. Ct. Gen. Div.)(QL). For a slightly different fact scenario and finding, see *Donovan Estate* v. *Patricia Fly-In Camps* [1989] O.J. No. 1394 (QL) (Ont. S.C.) in which, as suggested in *PCS Investments*, the insurer was allowed to file a separate defence in the liability claim while still paying for the insured's Cumis Counsel defence

defence costs cannot be properly divided between covered and uncovered allegations, the costs are paid entirely by the insurer.[49]

Possible Forfeiture of Coverage:

As already noted, there is currently uncertainty in Canadian law as to whether an insurer must defend an insured against allegations which are covered by a liability policy but where the insured may have forfeited coverage by breaching a term or condition of the policy.[50] The Court in *Desmond* v. *Guardian Insurance Co. of Canada*[51] held that, where a duty to defend in such an instance is found, the conflict of interest necessary to justify Cumis Counsel is established. In *Desmond*, the court was presented with a claim against the insured which would ordinarily have been covered by the insured's automobile liability insurer. The auto insurer denied coverage on the basis that the policy was void for lack of insurable interest. The court concluded that the insurer had an obligation to defend the insured until the coverage issue could be legally determined and, relying upon the "clear authority" established by *Laurencine*, the court further held that the coverage dispute entitled the insured to Cumis Counsel:[52]

> While the [coverage] action is tried subsequent to the [liability] action I believe it will be impossible not to bring out all of the facts on whether or not the defendant is an owner or has an insurable interest and whether or not the insurer is estopped from denying the policy is in force int eh trial of the issue between the plaintiff and the defendant. The trial will not be a simple question of proving Desmond was not the owner of the automobile, which is what triggers his liability to the same extent as the driver. Desmond alleges an alternate position that the policy is in full force and effect. Here Desmond's and Guardian's interests clash and counsel for Desmond will have to expend considerable effort in preparation for trial of this issue.

Finally, the court in Desmond noted that the insurer was obligated to pay for Cumis Counsel because without such funding the "cost of litigation could itself prevent Desmond from obtaining justice."[53]

Reservation of Rights / Non-Waiver Agreement:

As noted in *Laurencine*, *Kansa* and *Jacob*, an insurer's reliance or attempted reliance upon a reservation of rights letter or non-waiver agreement appears to complicate rather than to simplify a court's analysis of when a conflict of interest arises between the insured and a liability insurer. Considering the frequency with which liability insurers assume the defence of claims on the

[49] *Daher* v. *Economical Mutual Insurance Company*, *supra* note 41.

[50] See note 8.

[51] (1995) 167 N.B.R. (2d) 93 (QB) (hereinafter *Desmond*).

[52] *Ibid.*at paras. 8-9.

[53] *Ibid.* at para. 11.

strength of such documents, the lack of definitive case law as to how these agreements impact on the insurer's right to defend a claim is again surprising. Given the limited court consideration of this specific issue, the state of the applicable law is probably adequately summarized as follows:[54]

> Since the law essentially requires the insurer to pay the lion's share if not all of the defence costs in any event, most insurers in partial coverage situations are prepared to undertake defence of the claim, albeit on a reservation of rights basis. In this way, they hope to maintain control over the selection and instruction of defence counsel. Unfortunately, (although apparently little known by non-insurance lawyers), the taking of a non-waiver agreement or the issuance of a reservation of rights declaration may itself entitle the insured to appoint and instruct defence counsel at the insurer's cost . . .
>
> [In the case of Kansa] . . . although the insured did indeed have the right to retain separate counsel at the insurer's expense when the reservation of rights arrangement was proposed, it lost those rights when the reservation of rights agreement was accepted.

So long as the non-waiver/reservation of rights arrangement is characterized as producing informed consent, the insurer will retain the ability to appoint and instruct counsel. As well, as will be seen, such informed consent may eliminate many of the ethical dilemmas that might otherwise confront defence counsel in such situations.

IV. *Critical Analysis of the Law to Date*

In summary, the Canadian cases indicate that a coverage dispute on a liability policy may result in the insurer having to forfeit its right to control the defence of its insured while retaining its obligation to pay for the insured's defence. Further, the cases indicate that a coverage dispute may lead to this result if the insurer's conduct of the defence gives rise to an appearance of impropriety or, in other words, would lead a reasonable person to conclude that the insurer's continued control of the defence would be improper. Nevertheless, while clearly providing for the possibility that an insurer may lose its right to control its insured's defence in a conflict of interest situation, the cases to date insufficiently address three critical issues which are discussed below.

A. *What Circumstances (if any) Necessarily Require the Appointment of Cumis Counsel?*

Although the cases generally support the Appearance of Impropriety and Reasonable Person tests to determine whether a conflict exists which requires the appointment of separate counsel, the cases appear to apply these tests with varying degrees of stringency. Consequently, the cases do

[54] Kent, *supra* note 7 at 416-18.

not provide a clear indication of exactly what factors satisfy this test. While some cases require strict evidence of impropriety, other cases suggest that this test may be satisfied by the mere existence of a coverage problem, the issuance of a reservation of rights letter by the insurer, or the proposal of a non-waiver agreement by the insurer. Accordingly, from a practical perspective, the case law does not help insurance defence counsel in determining how to respond to a potential coverage problem without forfeiting the insurer's ability to control the liability defence. For example: Does a conflict of interest arise if defence counsel advises the insurer of facts obtained from the insured which could lead to a denial of coverage? Does a conflict of interest arise if defence counsel presents the insured with a Reservation of Rights letter on behalf of the insurer? Does a conflict of interest arise if defence counsel provides the insurer with an opinion on coverage?

Although the Laurencine Principle was brought into Canada on the basis of the *Cumis* decision from California,[55] the American case law is also of limited assistance in trying to identify the precise factors which would satisfy the Reasonable Person/Appearance of Impropriety tests.[56] In California, an attempt has made to evade the effects of Cumis through legislative changes.[57] Further, the notion of Cumis Counsel has sparked numerous articles by American legal authorities trying to determine when a disqualifying conflict of interest arises for insurance defence counsel[58] and what the legal and ethical obligations of defence counsel should be.

[55] *Supra* note 11.

[56] The findings of the American courts are so diverse that a comprehensive discussion of the decisions is well beyond the scope of the present paper.

[57] See Section 2860 of the California Civil Code.

[58] Some of the articles considering this issue and the surrounding problem of how to best resolve such a conflict of interest problem include: T.W. Bouch, "His Master's Voice: Just How Many Are There Anyway?" (May, 1997) 3 Prof. Lawyer 18; K.O. Bowdre, "Conflicts of Interest Between Insurer and Insured" (1993) 17 American Journal of Trial Advocacy 101; Brady & McKee, "Ethics in Insurance Defense Context: Is Cumis Counsel Unnecessary?" (1991) 58 Def. Counsel J. 230; Callahan, "War on Two Fronts" (July 1995) 58 Texas Bar Journal 676-678; J.S. Cavanagh, "Conflicts of Interest and the Insurer's Right to Control the Defence of its Insured" (1988) 9 Ad. Q. 385; C. Chapman & J. Mallon, "Conflicts of Interest Faced by Solicitors Instructed by Insurers to Conduct Litigation on Behalf of Insureds" (November, 1996) 26 Vict. University Wellington Law Review 679-716 (Vo. 4, No. 26); Dugdale, "Serving 2 Masters" (April 1997) 8 Insurance Law Journal 161-166; L.A. Foggan & E.A. Eastwood, "Assessing Conflict of Interest in the Tri-Partite Relationship" (Autumn, 1997) Vol 10; 1 Environmental Claims Journal 47; B.L. Gelman, "The Insurance Company or the Insured: Where Does Defense Counsel's Loyalty Really Lie?" (1992) 70 U.Detroit Mercy Law Review 215; Gilbreath, "Guidelines for Texas Insurance Defence Counsel" (1996) 27 Texas Tech Law Review 139-180; S.K. Hall, "Confusion over Conflict of Interest: Is There a Bright Line for Insurance Defense Counsel?" (1992) 41 Drake Law Review 731; P.R. Jarvis & B.F. Tellam, "The Insurance Defense Lawyer's Duty of Confidentiality" (1996) The Professional Lawyer 93; Knepper, "Conflicts of Interest in Defending Insurance Cases" (1970) 19 Defense L.J. 515; R.E. Mallen, "Guidelines or Landmines? Preserving the Tri-Partite Relationship" (August 1998) 40 For the Defense 3; J.K. Owens, "Wrestling with the Tar Baby: Ethical Obligations of Mississippi Insurance Defence Lawyers" (Spring 1997) 17 Miss. C.L. Rev. 359; R.L. Neumeier, "Serving 2 Masters: Problems Facing Insurance Defense Counsel and Some Proposed Solutions" (June, 1992) 77 Mass. La. Rev. 66; D.R. Richmond "Lost in the Eternal Triangle of Insurance Defence Ethics" (winter, 1996) 9 Geo. J. Legal Ethics 475; R.L. Shearer & D.A. Ross "Current Status of the Cumis Doctrine in Colorado" (July 1997) 26 Colorado Lawyer 97-100; C. Silver, "Does Insurance Defence Counsel Represent the Company or the Insured" (1993) 72 Texas Law Review 1583; C. Silver; & M.S.Quinn, "Wrong Turns on the 3 Way Street" (November/December 1995) 5 Coverage 11; Silver & Syverud, "The Professional Responsibilities of Insurance Defense Lawyers" (1995) 45 Duke L.J. 255; J.R. Singleton, "When Must the Insurer Relinquish Control of the Defense of its Insured" (March 1992) 1 U.F. 34-40; B. Wunnicke, "The Eternal Triangle: Standards of Ethical Representation by the Insurance Defense Lawyer" (February, 1989) For the Defense 7.

B. *Is Cumis Counsel Necessarily the Most Appropriate Remedy for a Conflict of Interest?*

To date, Canadian court decisions have focussed on whether a conflict of interest exists which entitles an insured to Cumis Counsel, the remedy generally being applied for by the insured. In resolving this question the courts have not yet offered a detailed policy consideration of whether Cumis Counsel is necessarily the most appropriate remedy when a conflict of interest exists. In particular, the courts have not considered whether a conflict of interest problem may be more appropriately resolved by some other method which does not require the insurer to forfeit control of the liability defence.[59]

The idea that an insured should be entitled to select and instruct its own counsel at the insurer's expense has been widely, and justifiably, criticized.[60] From a practical perspective, the insured's selection and instruction of counsel deprives the insured of the insurer's expertise in the selection of experienced counsel and in determining defence strategies. Thus, the insurer has a reduced ability to control the quantum of tort damages despite potentially being responsible for those damages. Further, the insurer loses the ability to limit defence costs despite continuing to be responsible for these costs. Without being involved in the litigation matter, the insurer may also lose its ability to access the necessary information which would lead to a denial of coverage. Overall, then, the Cumis Counsel solution may do little more than replace a perceived unfairness to the insured with actual unfairness to the insurer.[61]

[59] For example, one alternative solution might be to allow the insured to instruct counsel but to still allow the insurer to select counsel. One commentator even suggests that separate insurance policies should cover the defence costs and the liability exposure. See A.I. Widiss, "Abrogating the Right and Duty of Liability Insurers to Defend Their Insureds: The Case for Separating the Obligation to Indemnify from the Defense of Insureds" (1990) 51 Ohio St. L.J. 917.

[60] For example, see Brady & McKee, *supra* note 58 at 233.

[61] See for example: Singleton, *supra* note 58 at 36 and D.S. Ferguson, "Conflict Between Insured and Insurer: An Analysis of Recent Canadian Cases", (1990)12 Ad. Q. 129 at 140; and Kansa, *supra* note 24 at 13.

C. *In the Absence of an Insured's Application for Cumis Counsel, What are Defence Counsel's Obligations When a Coverage Question Arises?*

Because the existing case law generally arises from applications by insureds for Cumis Counsel, the majority of court decisions focus on whether the circumstances merit that relief. Thus, with the exception of *Hopkins*, the case law only tangentially discusses the ethical and legal obligations of defence counsel when a real or potential coverage question arises in the absence of such an application. What course of action should defence counsel take in such a situation?

There is currently a large body of academic writing which attempts to assess defence counsel's obligations by determining who defence counsel's true client is: the insured or the insurer.[62] The theory behind this approach is that every lawyer only owes a professional duty of confidentiality and loyalty to his client. Thus, if defence counsel's client is the insurance company, defence counsel can, and must, disclose all information pertaining to coverage to the insurer. On the other hand, if the insured is the client, defence counsel is ethically prevented from providing the insurance company with any information obtained from the insured (without the insured's consent) and cannot act in any way contrary to the insured's interest.[63]

Overall, the arguments in favour of treating either the insured or the insurer as defence counsel's sole client have not resulted in a practical resolution of defence counsel's responsibilities. The failure of this approach to resolving the conflict of interest problem is not surprising because the arguments favouring either the insured or the insurer as client are unrealistic and beg the whole conflict question. The fact that the insurance company pays and *instructs* defence counsel makes it obvious that the insurer must be defence counsel's client (as opposed to a mere third party payor). Similarly, the fact that the insured's liability exposure is the substance of the defence makes it obvious that the insured must also be defence counsel's client. Finally, the insured and the insurance company must both be clients of defence counsel in order for the

[62] For example, see Bowdre, *supra* note 58 at 128; Brady & McGee, *supra* note 58; Chapman & Mallen, *supra* note 58; Ferguson, *supra* note 61 at 140; Kent, *supra* note 7 at 419; N.J.Moore, "The Ethical Duties of Lawyers–Are Specific Solutions Required?"(1998) Conn. Ins. Law Journal 259; T.V. Murray & D.M. Bringus, "Insurance Defense Counsel–Conflicts of Interest" (Spring, 1991) 41 Fed. Of Insurance & Corporate Counsel Quarterly 283; R.E. O'Malley (1991) 66 Tulane; Silver, supra note 58 at 1606; Silver & Syverud, *supra* note 58 at 309, Widiss, *supra* note 59 at 928; D.A.Winiarski, "Walking the Fine Line: A Defense Counsel's Perspective" (1993) 28 Tort and Ins. L.J. 596. Note that, once again, many of these commentaries are American.

[63] Note that this is the approach taken by Justice Burnyeat in *Hopkins*, supra note 36. Justice Burnyeat characterizes this approach as the one followed by Canadian courts to date, a characterization which is misleading and, in my view, incorrect. For further criticism of Justice Burnyeat's comments on this point, see G. Hilliker, "Life in the Bermuda Triangle", unpublished, as presented to the Canadian Bar Association annual general meeting in Edmonton, Alberta, August, 1999.

conflict of interest question to arise in the first place. If defence counsel owed a clear and singular duty to either of these parties alone a conflict of interest question would never arise. Logically, then, it must be conceded that both the insured and the insurer are clients of defence counsel such that defence counsel owes professional, legal and ethical duties to both.[64]

Accepting that both the insurer and the insured are clients of defence counsel, another approach which has been taken in an attempt to guide defence counsel's conduct is to rely upon the requirements for dual representation set out in the Professional Code of Conduct.[65] In Canada, the relevant provisions of the typical Code provide that:[66]

- a lawyer may not represent two parties who are in a conflict or potential conflict situation unless the parties consent to this representation and it is in the best interests of the parties that the lawyer act for both.
- every lawyer has an obligation to keep a client's information confidential (unless the client gives consent to disclosure) and must not act or continue to act for another client if the lawyer would have a duty to disclose such information to that client.
- where a lawyer acts for more than one party in the same matter, the lawyer must disclose to all such parties any material confidential information relating to the matter in question.

Applying these standards, defence counsel apparently can properly represent both an insured and its insurer in a liability action as long as both parties consent to dual representation notwithstanding a real or potential conflict over insurance coverage. The insured arguably agrees to this dual representation by entering into the insurance contract which expressly obligates the insured to cooperate with a defence to be provided for by counsel selected and instructed by the insurer.[67] If, however, defence counsel obtains confidential information from an insured which relates to the coverage matter, and if the insured does not give

[64] See Hilliker, *ibid.*, in support of this view. As Hilliker notes, identifying the insured or the insurer as the sole client of insurance defence counsel also leads to questionable practical results. For example, in Hopkins, the conclusion that defence counsel's sole client is the insured leads Justice Burnyeat to hold that defence counsel cannot advise the insurer of any information pertaining to a possible coverage denial. The difficulty with this conclusion is that facts pertaining to coverage may also pertain to liability. Counsel's failure to advise the insurer of all facts pertaining to liability is a disservice to the insurer and to the insured because of their common interest in limiting the insured's liability exposure.

[65] Each province and territory in Canada has its own professional or ethical code of conduct to govern the legal profession. Generally, however, each code has similar provisions. For simplicity, this paper will hereafter refer to all of these codes of conduct generically as the "Code." For further discussion on the implications of the Code to the conflict of interest question, see Silver & Quinn, *supra* note 58 and Silver & Syverud, *supra* note 58.

[66] Summarized from the Alberta Code of Professional Conduct of Alberta, Chapters 6 & 7.

[67] Several authorities support the notion that the terms of the insurance policy affect the terms of the retainer agreement between the insured and defence counsel. See for example: Dugdale, *supra* note 58 at 165 and Silver & Syverud, *supra* note 58 at 347-48

permission for this information to be disclosed to the insurer, defence counsel must withdraw from representing either party and must not disclose the confidential information.

While the conduct required by the Code may be appropriate for most dual representation situations, the Code's approach does not provide a workable solution to defence counsel's dilemma when a coverage dispute arises. The Code's procedures simply do not recognize the nature of the tri-partite relationship[68] created by a liability insurance policy. First, the Code does not indicate *when* defence counsel must secure the consent of the insured in order for counsel to properly represent both parties. While the insured may agree to dual representation as an implied term of the insurance contract, there is no coverage dispute contemplated by the insured at the time of the formulation of that contract. Since a specific conflict over coverage only arises after a claim is made under the policy, the Code may require defence counsel to obtain the consent of the insured to dual representation at that point. Presumably, this consent may be obtained by agreement, although standard form non-waiver agreements presently do not specifically address this point. If the insured refuses this consent, then the insured must obtain separate counsel, possibly at the expense of the insurer. Thus, under the requirements of the Code, the existence of a coverage question and the insured's refusal to sign a non-waiver or accept a reservation of rights may be sufficient to entitle the insured to Cumis Counsel.

Second, even where the insured consents to dual representation, the Code suggests that defence counsel cannot disclose to the insurer any information obtained from the insured about coverage without the insured's express consent. This requirement places a burden on defence counsel to be continuously conscious of any potential coverage issues which may arise as a result of information provided by the insured in order to avoid inadvertently communicating information to the insurer which relates to a coverage issue. This sort of "cautious counselling" may be detrimental to the liability defence if some pertinent information is not communicated to the insurer for fear that the information may raise a coverage issue. Further, in many cases, the information which is pertinent to coverage may also be pertinent to a liability question.[69] Moreover, the failure to disclose information to the insurer would itself constitute a breach of defence counsel's obligations to the insurer unless advance consent to avoid such disclosure was obtained by the insurer.

Finally, the Code requires defence counsel to withdraw from the case entirely if confidential information is received from an insured with respect to

[68] The 'tri-partite relationship' is the relationship of interdependency which a liability insurance policy naturally creates between the insurer, the insured and insurance defence counsel.

[69] This would be the case particularly in circumstances where alternative pleadings or potential exclusions are the subject of the coverage issue. For example, the fact that an insured intentionally committed a given act may be relevant to coverage while also being very important for an assessment of liability.

coverage and if the insured does not consent to this information being released to the insurer. This solution relieves defence counsel of its ethical struggle but does not advance the interests of either the insured or the insurance company. Neither the insured nor the insurance company is assisted in the liability defence because every defence counsel hired by the insurance company will encounter the same ethical problem and be forced to withdraw, leaving the insured with no effective legal representation.[70] Further, defence counsel's withdrawal may inadvertently act against the insured's best interests because the withdrawal may itself alert the insurer to the fact that a coverage question exists.[71]

V. *Rethinking the Role of Defence Counsel When a Coverage Problem Arises*

The Goals

A. *The Primary Goal of the Insurer, the Insured, and Defence Counsel*

Given all of the above considerations, resolving defence counsel's potential conflict of interest problem in a coverage dispute situation clearly requires a recognition of the fundamental, common goal of the parties embroiled in the problem and a return to basic insurance law principles. The goal of the insurer, the insured and the defence counsel involved in a liability action is to avoid or reduce a liability finding against the insured. In other words, the common objective is to give the insured the same quality of defence he would be entitled to if he had the expertise to select the most appropriate counsel, and the money to pay for same, without insurance coverage. The existence of the insurance policy and the relationship of each of these parties to that policy represents a belief by each of the parties that, considering only the liability action, the above noted goal is best achieved by the insurer retaining and instructing defence counsel and by the insured providing all information necessary for the defence of the liability action.

The notion that both the insured and the insurer must do their best to achieve this goal is reflected in the basic insurance principle of '*uberimmae fides*' or 'utmost good faith'. While the full legal implications of this doctrine are still being developed, fundamentally this doctrine recognizes that, upon entering into an insurance contract, insureds and insurers are entitled to rely upon one

[70] For further discussion of this point, see Bowdre, *supra* note 58 at 107-108; Hall, *supra* note 58 at 735; Jarvis & Tellam, *supra* note 58 at 101; Widiss, *supra* note 58 at 926; L.E.Williams & D. Jernberg, "Conflicts of Interest in Insurance Defense Litigation: Common Sense in Changing Times" (1981) 31 Federation of Insurance Counsel Quarterly 111 at 116-17.

[71] For further discussion of this point, see Bowdre, *ibid.* at 107-108; Gilbreath, *supra* note 58 at 167; Hall, *ibid.*at 735; Jarvis & Tellam, *ibid.* at 101; and Widiss, *supra* note 59 at 926.

another to completely and honestly fulfill their obligations under the policy and, where possible, to protect each other from relying upon erroneous information. Hence, in the context of a liability insurance policy, this doctrine requires the insured to disclose all relevant or requested information about the liability claim to the insurer. The doctrine should also apply to require the insurer to ensure that the insured's liability position is fully protected to the extent provided for by the policy without concern for possible coverage problems.[72] It is reasonable to interpret the good faith duty of a liability insurer as obligating the insurer to provide the insured with the same protection of its interests that would be given if the insured was paying for and instructing its own counsel.[73]

B. *Achieving the Goal by Changing the Law*[74]

How then, can the law be developed to promote the common goals of the insurer, insured and defence counsel and to enforce the reciprocal duty of uberimmae fides when a coverage issue is raised in a liability action? If, as suggested above, the existence of a liability insurance policy indicates that the insurer and the insured implicitly agree that the best liability defence for the insured is one provided by and controlled by the insurer, this arrangement should be maintained except in exceptional circumstances. To some degree, such circumstances must be determined on a case by case basis through the application of the Reasonable Person test (as is currently the practice), however, the results of this test should be more predictable than suggested by the current case law. Specifically, the Courts must be careful to apply the Reasonable Person test consistently, always placing the evidentiary burden on the insurer to disprove the presumption of impropriety once defence counsel's relationship to the insured in the liability action and to the insurer on a coverage question has been established. Accordingly, while the substance of the current legal tests is acceptable, the application of these tests must be revised.

The courts should also be more explicit in identifying particular factors which satisfy or fail the Reasonable Person test. If the insured's interests are to be protected by the insurer with the same diligence as the insured would use itself, then an appropriate threshold for the Reasonable Person test might well be that any involvement by defence counsel on coverage matters necessarily constitutes a disqualifying conflict of interest. On such a standard, the

[72] Of course, if the insurer denies coverage completely, then the duty to provide a defence does not arise. The situation contemplated here is where coverage is in issue but the insurer is still defending.

[73] This application and interpretation of the duty of *uberimmae fides* is supported by several commentators. See for example: Brady & McKee, *supra* n. 58 at 240; Dugdale, *supra* note 58 at 163-65; Knepper, *supra* note 58; Murray & Bringus, *supra* note 62 at 288; Silver, *supra* note 58 at 1599; and Singleton, *supra* note 58 at 1599.

[74] Since the current law on point consists primarily of common law, the comments in this section similarly deal with possible changes in the law arising from court decisions. The changes suggested, however, could also be made through statutory revisions.

Reasonable Person test would not be satisfied by the mere existence of a coverage problem, but would be satisfied by defence counsel's involvement in any coverage issues. In other words, defence counsel would act only on the liability question; an appearance of impropriety would arise as soon as counsel called the insurer's attention to a coverage problem, issued a reservation of rights letter or non-waiver agreement to the insured,[75] provided the insurer with a coverage opinion,[76] or in any way tried to manipulate the liability action to achieve a result on the coverage question. Undoubtedly, this is a very strict application of the Reasonable Person test, however, this approach best reflects the common goal of the insured and the insurer and provides proper recognition of the mutual duty of utmost good faith. Moreover, this strict approach offers clear instruction to the insurer and defence counsel as to defence counsel's proper role in the litigation action.

In the ordinary course, the law should permit defence counsel to provide the insurer with all information relevant to the liability issues, regardless of whether such information also impacts on coverage, as long as defence counsel does not identify or comment on any coverage concerns for the insurer which might arise from the information provided.[77] Authorization for defence counsel's right and obligation to communicate all liability-related information to the insurer is easily implied by the terms of the typical liability policy which require the insured to fully cooperate with the defence and which indicate that the insurer will be appointing and instructing defence counsel. These policy terms prima facie dispel any suggestion by the insured that it didn't realize that insurance defence counsel would be disclosing information provided by the insured to the insurer. Further, interpreting the policy to allow defence counsel to communicate fully with the insurer prevents the insured from escaping its good faith obligation of disclosure under the guise of a conflict of interest. This interpretation also allows defence counsel to fulfill its ethical obligations under the relevant Code of Professional Conduct since the Codes generally allow and require counsel to share information among co-clients as long as both clients agree to the arrangement.[78]

If an insured withdraws its consent to disclosure to the insurer, a court should view same as a breach of the policy obligation, thereby arguably disentitling the insured to further protection under the policy. Although some people might be concerned about this policy interpretation being a disincentive to the insured to be fully candid with defence counsel, it must be recognized that, outside of the liability action, the insured has an obligation to provide its insurer with all information pertaining to coverage. The insured should not be entitled to benefit from coverage which would not exist if the insurer knew the true state of affairs: this principle is a basic component of the doctrine of utmost good faith.

[75] Assuming rejection of same.

[76] Even prior to the litigation action starting.

[77] The job of determining whether any of the liability information has coverage implications would fall on the insurer or on separate counsel retained by the insurer to consider coverage implications.

[78] See Part IV.C *supra*.

C. *Achieving the Goal Without Changing the Law: Suggestions for Insurance Companies and Insurance Defence Counsel*

Unless the current law changes, in virtually any liability case where a coverage question arises, an insured may apply for and be granted Cumis Counsel, depending on how strictly the court of the day applies the Reasonable Person or Appearance of Impropriety tests. At present, then, whenever a coverage question arises on a liability policy, the insurer and its defence counsel are at risk of losing control of the liability defence. For the insurer, this loss of control usually means having to pay two sets of litigation defence costs (the cost of the Cumis Counsel and the cost of the insurer's counsel retained to monitor the insured's conduct of the liability action or to advance additional defences which reflect the insurer's specific interests) plus the legal costs associated with defending the application. Further, if the application for Cumis Counsel is granted and if the insurer's coverage defence is not ultimately successful, the insurer will be responsible for payment of a liability judgment over which it had little or no control. For defence counsel, a successful application for Cumis Counsel means the loss of litigation business and the loss of an opportunity to serve a potentially long-term insurance company client. Clearly, then, both the insurer and defence counsel have an interest in successfully opposing an insured's application for Cumis Counsel.

In order to curtail the risk of insureds being granted Cumis Counsel, insurers and defence counsel must limit the likelihood of a court finding the conflict of interest necessary to support such relief. Given the unpredictability of the current law, insurers and defence counsel can best protect their interest in controlling the liability defence by being proactive in eliminating, as much as possible, defence counsel's involvement in coverage matters. First, insurers and defence counsel should ensure that defence counsel does not provide any advice to insurers about coverage and does not become involved in issuing reservation of rights letters or non-waiver agreements. In fact, defence counsel need not even be apprised of any coverage dispute. Second, insurers and defence counsel should ensure that every insured is aware of, and consents to, defence counsel's intention to disclose all relevant liability information to the insurer, irrespective of whether the information is also relevant to a possible coverage issue. For example, upon receiving a liability defence file, insurance defence counsel could send a clearly worded retainer letter to both the insured and the insurer explaining that counsel will be acting only with respect to the liability defence and that all information provided by the insured or the insurer will be freely disclosed to the other. Alternatively, the complete disclosure rule could be clearly set out in the insurance policy itself.[79] Defence counsel and the insurer may even go so far as to ensure that the insured receives a copy of all reporting letters in order to assure the insured that defence counsel is not providing coverage advice to the insured. Finally, insurers should also maintain

[79] See Dugdale, *supra* note 58 at 165.

"Chinese walls" in their own offices to ensure that personnel instructing defence counsel on liability strategies are not sharing information with personnel dealing with coverage issues. All of these steps may discourage an insured from raising a conflict of interest argument and will assist insurers and defence counsel in disproving any allegation of conflict of interest regardless of how strictly a court applies the Reasonable Person or Appearance of Impropriety tests. Taking these steps will also assist insurers and defence counsel in proving that their defence of the insured is in keeping with the insurer's duty of utmost good faith.[80] The failure to proceed as indicated may result an applications for Cumis Counsel, an action by the insured against the insurer for bad faith, an action by the insured or the insurer against defence counsel for negligence or breach of duty, or disciplinary proceedings against defence counsel for breach of professional responsibility. Accordingly, the insurer and defence counsel disregard these obligations at their peril.

VI. *Conclusion*

At present, Canadian law does not provide insurers or defence counsel with any clear answers about their obligations when a coverage issues arises in a liability claim against an insured. As a result, as one commentator aptly notes, whenever such a coverage issue arises, "there ensues an elaborate minuet" in which insurers, defence counsel and insureds attempt to protect their own interests without violating their increasingly hazy obligations to one another: "This dance is nerve-wracking for defence counsel and often severely prejudicial to the insured."[81] In order to protect the interests of the insurers, defence counsel and the insureds, this dance must stop: the rules regarding defence counsel's obligations need to be clarified. The questions discussed herein about the duties of defence counsel in these situations arise everyday and consequently beg for resolution. Insurance companies and defence counsel ignore or sidestep these conflict of interest issues at their peril: risking the loss of control of the liability defence and incurring extra costs if their insureds are successful in court applications for Cumis Counsel. Courts, insurers and defence counsel must each do their part to ensure that coverage questions are severed entirely from defence counsel's mandate and that insureds fully understand the dual representation disclosure obligations of defence counsel.

[80] It has also been suggested that voluntary steps taken by the insurer and defence counsel to prevent the coverage issue from impacting on the liability defence may increase public faith in the reliability of insurers and ultimately reduce the applications by insureds for Cumis Counsel. See for example Brady & McKee, *supra* note 58 at 763.

[81] O'Mally, *supra* note 62 at 516.