Insurance liability contracts generally provide the insured with two important benefits. First and foremost, the insurer will indemnify the insured for damages he may be legally obliged to pay as a result of a claim instituted against him. A second and equally important obligation of the insurer is to defend the insured against the claim itself.

The purpose of this paper is to outline the general principles governing the insurer’s duty to defend its insured when the latter is the subject of a claim. While the author of this paper practises in Quebec and therefore the focus of the paper will be on Quebec civil law, the insurance provisions of the Civil Code of Quebec ("C.C.Q.") are common law inspired and more importantly, liability insurance contracts are fairly standard throughout Canada. Thus, the law on the subject is similar in most provinces.

1 The author wishes to thank Lisa Chamandy and Jean-Philippe Duchesneau for their excellent research and contribution to this paper.
When appropriate, we have attempted to distinguish the key differences between the common law approach and Quebec civil law.

1. **The Source of the Duty to Defend**

   The source of the duty to defend varies among provinces. In general, in common law Canada, the duty to defend finds its roots in the contractual relationship between the insured and the insurer, i.e. the insurance policy. In Quebec, the duty finds its legal foundation in the limited public order provisions of the Civil Code of Quebec. This difference, although fundamental, is less consequential than one might think.

   (a) **Common Law Canada**

   In common law provinces, the duty to defend finds its origins in the contractual relationship between the insured and the insurer. Indeed, most liability policies expressly define the insurer’s duty to defend. According to most contractual wordings, the obligation to defend applies only to claims that may give rise to a damage covered by the policy. Hilliker provides the following example of defense clause:

   "As respects such Insurance as is afforded by the other terms of the Policy, the Insurer agrees to defend in the name of and on behalf of the Insured, claims, suits, or other proceedings which may at any time be instituted against the Insured for any occurrence covered by this Policy, although such claims, suits, proceedings or allegations and demands may be groundless, false or fraudulent."  

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4 Krempulec, supra, note 2, p. 3.
6 Ibid.
Thus the source of the obligation in common law Canada appears to be the contractual relationship between the insured and the insurer as provided for by the insurance policy.

We should point out that there is at least one case that has read a duty to defend into an insurance policy in the absence of a duty to defend provision. In *Asleson v. Continental Insurance Co.*[^7], Justice Mackenzie stated:

> “The policy is silent on the matter of an obligation to defend and the costs of the defence. In my view, an obligation to defend third party claims or alternatively to pay the costs of a reasonable defence claims is a necessary incident of liability coverage which should be implied in the absence of express words.”[^8]

However, in *W.-V.(T.) v. W.(K.R.J.)*[^9], the Ontario Court General Division discarded the *Asleson* approach. Justice Reilly stated:

> “…[T]he duty to defend must be specified in the contract of insurance, as it is in most policies. It cannot simply be presumed from the duty to indemnify. If that were so, what terms does the court then presume as well, what conditions does the court “write” for the parties, when they have failed to specify the terms themselves. A policy of insurance is a contract, and the general principles of contract law must apply. The duty to indemnify must be set out, together with any exclusions. In the event of any ambiguity of course, the *contra proferentum* doctrine will apply in favour of the insured. Counsel for M. [policyholder] submits that the duty to defend is simply presumed from the duty to indemnify. I disagree. There must be, I conclude, a duty to defend set out in the policy of insurance, just as in any other contract.”[^10]

Thus, it appears to be settled law in common law Canada, that the duty to defend is, ultimately, a creature of contract.

[^8]: *Asleson*, supra note 7 at 3188
[^9]: 29 O.R. (3rd) 277 [hereinafter *Wilkeson*]
[^10]: *Wilkeson*, supra note 9 at 288, cited in *Krempulec*, supra note 2 at 7
(b) Quebec

Unlike the situation in common law provinces, where the duty to defend stems ultimately from the consent of the parties, in Quebec, the duty to defend is a legal obligation codified in article 2503, *C.C.Q*. This article states:

“2503. The insurer is bound to take up the interest of any person entitled to the benefit of the insurance and assume his defence in any action brought against him.

Costs and expenses resulting from actions against the insured, including those of the defence and interest on the proceeds of the insurance are borne by the insurer over and above the proceeds of the insurance.”

This article is of limited public order meaning that the insurer may only derogate from its duty to defend to the extent that the derogation imparts increased benefits to the insured.\(^{11}\)

This being said, the text of the insurance policy remains relevant. Indeed, it has been suggested by Sanderson et. al. that “[i]t can be said that in Quebec the duty to defend, although mandated by Article 2503 of the *Civil Code*, is also contractual in nature.”\(^{12}\) Accordingly, although Quebec differs from the common law provinces in that the duty to defend is not exclusively contractually governed, the courts will rely heavily on the contract to determine the rights and obligations of the parties. In *AXA Assurance c. Les Habitations Claude Bouchard Inc et. al.*\(^{13}\), for instance, Justice Beauregard states the following:

\(^{11}\) “2414 C.C.Q. Any clause in a non-marine insurance contract which grants the client, the insured, the participant, the beneficiary or the policyholder fewer rights than are granted by the provisions of this chapter is null. Any stipulation that derogates from the rules on insurable interest or, in liability insurance, from those protecting the rights of injured third persons is also null.”

\(^{12}\) Sanderson, *supra*, note 3 at 211.

“[a]u Québec les obligations d’un assureur sont celles qui sont définies dans la police et par les dispositions spéciales et générales contenues aux chapitres du Code civil concernant les assurances et les obligations....”

Article 2503, in this context acts as a minimum standard that insurers must meet.

As such, the approach taken by the common law courts has been influential in Quebec.

2. **General principles of interpretation relating to the duty to defend**

   Although insurance contract interpretation could in itself form the basis of a paper, a brief discussion of the principles is useful in analyzing the duty to defend.

   Again, despite differences in the sources of the duty to defend in Quebec and in common law provinces, these differences have fewer consequences on method of interpretation used by the courts than one might have predicted.

   The Supreme Court reiterated the principles of interpretation in *Scalera*.15

   (a) **Contra proferentum**

   The first relevant principle of interpretation is *contra proferentum*,16 “[t]he doctrine that, in interpreting documents, ambiguities are to be construed unfavorably to the drafter.”17 Indeed, in *Brisette Estate v. Westbury Life Insurance Co.*18, Justice Sopinka applied this principle to insurance contracts, stating that “…[a]mbiguities will be construed against the insurer.”19 Justice McLachlin articulated a corollary principle in

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14 *Ibid.* at para.54
16 *Scalera, supra* note 159 at 591
19 *Ibid.* at 92. See also in *Scalera, supra* note 15 at 591
Reid Crowther & Partners Ltd. v. Simcoe & Erie Insurance Co.\textsuperscript{20}, that “…coverage provisions should be construed broadly and exclusion clauses narrowly…”\textsuperscript{21} Moreover, Justice Iacobucci provides insight into the impetus for this approach in Scalera, in which he cautions that “one must always be alert to the unequal bargaining power at work in insurance contracts, and interpret such policies accordingly.”\textsuperscript{22}

(b) The industry practice

Having discussed the principle of \textit{contra proferentem}, we turn now to a second interpretive tool appearing in the context of the duty to defend. As Justice Iacobucci articulates in Scalera, it is the importance of “keep[ing] in mind the underlying economic rational for insurance.”\textsuperscript{23} According to Justice Iacobucci, C. Brown and J. Menezes explain that:

“[i]nsurance is a mechanism for transferring fortuitous contingent risks… [E]ven where the literal wording of a policy might appear to cover certain losses, it does not, in fact, do so if (1) the loss is from the inherent nature of the subject matter being insured, or (2) it results from the intentional actions of the insured.”\textsuperscript{24}

To this, Justice Iacobucci adds, “[i]n other words, insurance usually makes economic sense only where the losses covered are unforeseen or accidental.”\textsuperscript{25}

(c) Reasonable expectation of the insured

The third principle of interpretation involves “giving effect to “reasonable expectations of the parties.”\textsuperscript{26} Courts have always shied away from a literal interpretation

\textsuperscript{20} [1993] 1 S.C.R. 252 [hereinafter Crowther]
\textsuperscript{21} Ibid. at 269
\textsuperscript{22} Scalera, supra note 15 at 591
\textsuperscript{23} Scalera, supra note 15 at 590
\textsuperscript{24} C. Brown and J. Menezes, \textit{Insurance Law in Canada} (2\textsuperscript{nd} ed. 1991), pp 125-126 [hereinafter Brown and Menezes], cited in Scalera, supra note 15 at 590
\textsuperscript{25} Scalera, supra note 15 at 590
\textsuperscript{26} Scalera, supra note 15 at 591, which cites Crowther, supra note 42 at 269, which itself refers to Brown and Menezes, supra note 50 at 123-131 and Brisette, supra note 37
of the contract which would frustrate the reasonable expectations of the insured or bring about a commercial absurdity. As Justice Estey stated in *Consolidated-Bathurst Export Ltd. v. Mutual Boiler and Machinery Insurance Co.*, [27]

“[C]ourts should be loath to support a construction which would either enable the insurer to pocket the premium without risk or the insured to achieve a recovery which could neither be sensibly sought not anticipated at the time of the contract.” [Our underlining]

We have indicated these key principles of interpretation as they have proven to be influential in the caselaw. With these principles in mind, it is possible to address the substantive issues that arise when the courts consider whether an insurer owes its insured a duty to defend.

3. **Substantive Principles**

   (a) **The duty to defend is broader than, yet related to, the duty to indemnify**

As mentioned, liability insurance contracts provide two distinct benefits to the insured, a duty to defend and a duty to indemnify.

The duty to defend has been described by the Quebec Court of Appeal as follows:

«L'obligation de défendre impose à l'assureur la prise en charge, en temps opportun, de la défense de la personne assurée. Il s'agit pour l'assureur de comparaître pour cette personne et d'assumer les frais et les coûts afférents à sa défense. Les avocats de l'assureur agissent alors pour le compte de la personne assurée et en son nom, dans son seul intérêt et en toute loyauté.» [29]

The same court defined the duty to indemnify as such:

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[27] [1980] 1 S.C.R. 888 [hereinafter *Mutual Boiler*]
«De son côté, l'obligation d'indemniser doit s'exécuter lorsque la personne assurée, poursuivie en responsabilité par un tiers, doit payer des dommages, soit à la suite d'un jugement ayant force de chose jugée, soit à la suite d'une transaction opposable à l'assureur.»  

It is now recognised that these two obligations, though related, are distinct in nature and must be evaluated at different times within the claim process.

The first is triggered by the claim itself and is usually appreciated before the evidence is filed. The second is evaluated after the judgement, that is, after all the evidence has been analysed. As such, it is generally acknowledged that the duty to defend is broader than the duty to indemnify:

“The respondent also relies in this connection on the contention that the duty to defend is broader than and independent of the duty to indemnify. This is so, in the sense that the duty to defend arises where the claim alleges acts or omissions falling within the policy

28 Ibid. at 901-902, cited in Scalera, supra note 9 at 592
30 Boreal, supra note 29, p. 61
31 Boreal, supra, p. 61:
«Ces deux obligations n'existent qu'en cas d'applicabilité du contrat d'assurance. L'appréciation de cette condition varie, cependant, selon qu'il s'agit de l'obligation de défendre ou de celle d'indemniser.
La première obligation est beaucoup plus large que la deuxième; elle en est distincte. Dans un arrêt majoritaire, rendu le 9 décembre 1959, le juge Bissonnette reconnaissait la différence entre les deux obligations:
Et ceci m'amène à considérer la deuxième stipulation de cette clause: l'obligation de défendre à toute action intentée contre l'assuré. Avant d'apprécier la conduite de la défenderesse en garantie, je désire souligner que les diverses obligations prises par elle sont conjonctives et cumulatives et non disjonctives ou alternatives, de plus, que l'engagement de contester toute demande n'est pas conditionnel ou facultatif, mais bien impératif.
[…] L'obligation de défendre et celle d'indemniser ne se concrétisent pas à la même époque et, à cause de cela, leurs conditions de naissance, bien que reliées toutes deux à l'applicabilité du contrat d'assurance, s'apprécient différemment.»
32 Nicholl, supra, note 2, p. 109: “[…] Les dispositions des articles 2500 et suivants C.c.Q. ou, antérieurement des articles 2602 et suivants C.c.B.C. portent donc sur deux obligations contractuelles, distinctes de l'assureur, qui doivent nécessairement s'évaluer à des époques différentes dans l'évolution d'une réclamation."
coverage, while the duty to indemnify arises only where such allegations are proven at trial.”

“At the same time, it is not necessary to prove that the obligation to indemnify will in fact arise in order to trigger the duty to defend. The mere possibility that a claim within the policy may succeed suffices. In this sense, as noted earlier, the duty to defend is broader than the duty to indemnify.”

(b) **There is no duty to defend when the allegations are clearly outside of the coverage provided by the policy**

This principle is a corollary of the first and it has never been really contested. Indeed, authors and caselaw have always recognized that an insurer who is presented with a clearly excluded claim does not have to defend it.

“Where it is clear from the pleadings that the suit falls outside of the coverage of the policy by reason of an exclusion clause, the duty to defend has been held not to arise: *Opron Maritimes Construction Ltd. v. Canadian Indemnity Co.* (1986), 19 C.C.L.I. 168 (N.B.C.A.), leave to appeal refused by this Court, [1987] 1 S.C.R. xi.”

(c) **The Pleadings Rule: Nichols v. American Home Insurance Company**

In *Nichols*, the Supreme Court of Canada confirmed that the pleadings rule was good law in Canada.

The issue in *Nichols* stemmed from a conflict between an insurer and its insured over whether the former had a duty to defend the latter in a civil suit for fraud. The

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34 *Ibid.* at 807-808.
35 C. Brown et al., *Insurance Law in Canada*, Vol. 2, Toronto, Carswell, 2001, ch. 18, p. 18-12, 18-13: “[...] even if the claim is substantiated, if the allegations against the insured are clearly outside the terms of coverage, there will be no duty to defend.”; Hilliker, *supra*, note 2, p. 68: “The insurer is not obliged to defend claims which fall wholly outside of the coverage provided by the policy.”; Boreal, *supra*, p. 61 : “il n’y a pas obligation de défendre s’il ressort clairement des procédures que la réclamation ne tombe pas sous la protection de la police en raison d’une clause d’exclusion.”
36 *Nichols*, supra note 33 at 810.
insurer claimed that it did not have a duty to defend because an exclusion clause in the insurance policy stated that the policy was not applicable “to any dishonest, fraudulent, criminal or malicious act or omission of an Insured.” Moreover, the defense clause in the insurance policy explicitly stated that the insurer’s obligation to defend was applicable to “any suit against the Insured… alleging such act or omission and seeking damages which are or may be payable under the terms of this Policy.”

In addressing this issue, the Ontario Court of Appeal found that the insurer did have a duty to defend. It arrived at its decision reasoning that, “if an insured did not actually perform the alleged fraudulent acts, then the exclusion does not apply.” In her comments on the Court of Appeal’s decision, Justice McLachlin states that “in the result, she [McKinlay, J.A.] appears to have held implicitly that it was not the allegations in the pleadings which determined if an obligation to defend arose, but rather the acts proved at trial.”

In allowing the appeal, the Supreme Court concluded that this did not represent an accurate view of the law. Justice McLachlin indicated that the insured’s argument, which was accepted by the Court of Appeal, was “overly complex and flawed… The insured had argued that “in the absence of a finding of actual fraud, the exclusion does not apply and the duty to defend remains.” To the insurer, however, “no duty to defend arose

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37 Nichols, supra note 33
38 Nichols, supra note 33 at 803.
39 Nichols, supra note 33 at 806.
40 Nichols, supra note 33 at 804.
42 Nichols, supra note 33 at 805.
43 Nichols, supra note 33 at 807.
44 Ibid.
because the only damages claimed, damages for fraud, are not payable under the policy.”

In finding for the insurer, Justice McLachlin held:

“In my view, there is no ambiguity relating to the obligation to defend. That obligation is clear. It arises only where a suit is brought against the insured alleging an act or omission under the policy "and seeking damages which are or may be payable under the terms of this Policy". The question which must be asked is whether, in the case at bar, the Bank of Montreal's suit claimed damages which might be payable under the policy. The answer to this question must be negative. The only damages sought against the insured were on account of fraudulent acts or omissions. It is common ground that such damages are not payable under the policy. It follows that the Bank's claim was not for damages payable under the policy and that the defence clause does not apply. […]”

As such, Nichols elaborated the principle that the focus is on the allegations of the statement of claim, that is, what is actually being alleged, i.e. fraud, and not what might have been alleged, i.e. negligence. Even if it is the case that the same fact could have given rise to proceedings which might have entailed a duty on the part of the insurer to defend, “[w]ithout an amendment to the pleadings, the Bank’s claim [i.e. that of the plaintiff] could not give rise to damages payable under the Policy.”

The Ontario Court of appeal recently summarized the Nichols approach in Trafalgar Insurance Company of Canada v. Rogers as follows:

“The onus is on the insured to establish that, on a possibility basis, the allegations made by the plaintiff, if proved, bring a claim within the four corners of the relevant policy. Once that threshold is met, the onus shifts to the insurer to show that the claim made falls outside the coverage provided by the policy because of an

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45 Nichols, supra note 33 at 806.
46 Nichols, supra note 33 at 807-808; 810.
47 Nichols, supra note 6 at 808
48 Ibid.
49 2001 57 (O.R.) 3d. 425 [hereinafter Trafalgar]
applicable exclusion clause. If there is an exception to the exclusion, the insured bears the burden of establishing that the exception applies.”\textsuperscript{50}

The pleadings rule is also applied in Quebec. In \textit{Associations des hôpitaux du Québec c. Fondation pour le cancer de la prostate, Centre hospitalier de l’Université Laval},\textsuperscript{51} Mr. Justice LeBel, then of the court of appeal, states:

“[l]’existence de l’obligation de défense s’apprécie par rapport aux allégations des procédures. Elle peut être exécutoire durant le procès sans que nécessairement, au terme de ce dernier, un jugement conclut que la garantie d’indemnisation était applicable.”\textsuperscript{52}

(d) \textit{Scalera, Sansalone and Monenco: The “true nature of the pleadings” test and the use of extrinsic evidence}

The Supreme Court was asked to reconsider the duty to defend in \textit{Scalera}.\textsuperscript{53} In that case, Scalera was being sued for “sexual assault”.\textsuperscript{54} The carefully worded allegations of the claim stated that the action was based on intentional acts, negligence and breach of fiduciary duty.\textsuperscript{55}

The exclusion clause in the homeowner’s insurance policy was for “any intentional…act.”\textsuperscript{56} Justice Iacobucci’s reasons for finding that there is no duty to defend provide insight into the appropriate approach to the issue of the duty to defend. Justice Iacobucci began by restating that there was no obligation to defend excluded claims.

\textsuperscript{50}Ibid. at para 18
\textsuperscript{52}Ibid. at para. 26; See also Boreal, supra note 29 at 62 and \textit{Zurich v. Renaud-Jacob} [1996] R.J.Q. 2160 (C.A.) [hereinafter \textit{Zurich}] at p. 2165
\textsuperscript{53}Scalera, supra note 15
\textsuperscript{54}Ibid. at 580
\textsuperscript{55}Ibid. at 583-6
\textsuperscript{56}Ibid. at 577 (McLachlin, J.)
“[a]bsent express language to the contrary, the duty to defend extends only to claims that could potentially trigger indemnity under the policy.”\(^{57}\)

Furthermore, although he reiterated that the duty to defend was broader than the duty to indemnify, he severely restricted the scope of the principle:

“Absent specific language to the contrary, the duty to defend is broader than the duty to indemnify only in so far as it extends to groundless, false, or fraudulent claims. Given the historical evolution of the duty to defend as a way for insurers to protect their interests when they will be forced to pay any resulting judgment [...], it makes little sense to presume an independent duty to defend absent express language: [...]. To hold otherwise would convert indemnity insurance into litigation insurance. In my opinion, such an interpretation would violate the reasonable expectations of the parties absent express language to that effect.”\(^{58}\)

He then proceeds to enunciate a three-part test to be used to determine whether such a duty arises. First, the court must look at the true nature of the pleadings, second, it must determine whether some claims are derivative of each other, and thirdly, the court must determine whether these non derivative claims would give rise to coverage under the policy.

i) Look at the true nature of the pleadings

The first prong of the test requires the court to look at the pleadings. Justice Iacobucci states that the court “should determine which of the plaintiff’s legal allegations are properly pleaded.”\(^{59}\) What is important for the court in this part of the analysis is to understand “the substance of the allegations contained in the pleadings,”\(^{60}\) and not merely

\(^{57}\) Scalera, supra note 15 at 581  
\(^{58}\) Scalera, supra note 15 par. 76  
\(^{59}\) Scalera, supra note 15 at 581  
\(^{60}\) Ibid.
“the choice of labels.” The plaintiff’s wording is not determinative, but the court must “decide, based on the pleadings, the true nature of the claim.” The obvious purpose of this first part of the test is to take the coverage away from the hands of Plaintiff’s counsel. “Otherwise, the parties to an insurance contract would always be at the mercy of the third-party pleader.”

ii) Compare the claims and see whether some are derivative of the others

The second prong of the test requires the court to compare the claims. Justice Iacobucci states that the court must determine “if any claims are entirely derivative in nature.” Justice Iacobucci makes it clear that “[i]f the alleged negligence is based on the same harm as the intentional tort, it will not allow the insured to avoid the exclusion clause for intentionally caused injuries.” Later in the judgment, Justice Iacobucci provides further insight into the second prong of this test. In particular, he addresses how to properly apply this stage of the test in case both an intentional tort (i.e. one that would not give rise to a duty to defend) and negligence (i.e. one that would) are properly pleaded:

“[A] claim for negligence will not be derivative if the underlying elements of the negligence and of the intentional tort are sufficiently disparate to render the two claims unrelated. If both the negligence and intentional tort claims arise from the same actions and cause the same harm, the negligence claim is derivative, and it will be subsumed into the intentional tort for the purposes of the exclusion clause analysis. If, on the other hand, neither claim is derivative, the claim of negligence will survive and the duty to defend will apply.”

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61 Ibid.
62 Ibid.
63 Ibid. par 79
64 Scalera, supra note 15 at 581
65 Scalera, supra note 15 at 581-582
66 Scalera, supra note 15 at 589
iii) determine whether one of the non-derivative claims may trigger the duty to defend

Having described the first two prongs of the test, we will now turn to the third prong. Justice Iacobucci states that finally, the “court must decide whether any of the properly pleaded, non-derivative claims could potentially trigger the insurer’s duty to defend.” Justice Iacobucci comes to the conclusion that “the respondent will only have to defend the appellant if the plaintiff’s statement of claim alleges a state of facts that, properly construed, would support an action that could potentially fall within coverage.” Justice Iacobucci thus reaffirms the pleadings rule set forth in *Nichols*. However, he also expands on the meaning of the pleadings rule, arguing that:

“[i]n my view, the correct approach in the circumstances of this case is to ask if the allegations, properly construed, sound in intentional tort. If they do, the plaintiff’s use of the word “negligence” will not be controlling... When determining the scope of the duty to defend, courts must take the factual allegations as pleaded, but then ask which of the plaintiff’s legal claims could potentially be supported by those factual allegations... It is important to emphasize that at this stage a court must not attempt to determine whether, assuming the verity of all of the plaintiff’s factual allegations, the pleadings could possibly support the plaintiff’s legal allegations.”

Larocque has summarized the process as follows:

« En somme, il doit déterminer quelle est la base juridique de l’action du demandeur à la lumière des faits allégués tenant ceux-ci pour prouvés et déterminer ensuite s’il s’agit d’un cas visé par la garantie d’assurance. C’est ainsi que la Cour suprême met à l’abri tant l’assureur que l’assuré contre la rédaction manipulatrice d’actes de procédure. »

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67 Scalera, supra, note 9 at 582
68 Scalera, supra note 9 par. 90
69 Scalera, supra note 9 at 595
70 Ibid. at 599
Applying the test to the facts in issue, the Court held that the “claims for negligence and breach of fiduciary duty fail to trigger the duty to defend not because they could not fall within coverage but because they are either not properly pleaded, or derivative of the claim for sexual battery. As a result, they are also covered by the exclusion for injuries intentionally caused.”72

It is interesting to note, however, that in Godonoaga (litigation guardian of) v. Khatambakhsh73, the Ontario Court of Appeal expressed some reservations about the application of the test enunciated in Scalera to other types of torts. Justice Fynlayson stated with respect to Justice Iacobucci’s comments respecting derivative claims at para. 51 that:

“It seems to me that these statements must be confined to the facts of Scalera. The facts pleaded in Scalera give rise to a cause of action against a single insured defendant based on sexual assault only. To place the case in context, it would be interesting if the plaintiff in Scalera had brought an action against B.C. Transit and raised certain issues in tort. Would B.C. Transit’s insurer be obliged to respond to a claim that B.C. Transit was negligent in failing to screen Scalera, or in failing to properly supervise and control him during the course of his employment? … I do not read Scalera as stating that different tort actions cannot arise out of the same occurrence. Rather I read it to mean only that a given plaintiff cannot convert an assault and battery into an action in negligence solely to insure that the defendant’s insurer will provide the necessary ‘deep pocket’ to make a judgment recoverable. The use of the term “derivative” in Scalera is problematic…”74

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71 Larocque, supra note 1 at 14
72 Scalera, supra note 9 at 582-3.
73 49 O.R. (3d) 22 (C.A.) [hereinafter Godonoaga]
74 Ibid. at 30-31
Irrespective of the concerns expressed about the formulation of the test in *Scalera* set forth above, the Supreme Court reaffirmed the test in *Sansalone v. Wawanese Mutual Insurance Co.*⁷⁵, and further expanded upon the principles set forth in *Scalera* in *Monenco Ltd. v. Commonwealth Insurance Co.*⁷⁶

iv) Monenco and the use of extrinsic evidence

In *Monenco*, the issue before the court was whether the insurer owed a duty to defend the insured on the basis of the “comprehensive general liability policy”⁷⁷, which afforded general coverage but which contained two exclusions: a professional liability exclusion and a turnkey exclusion. As Justice Iacobucci stated, “[p]ursuant to the terms of the policy… if a claim against the insured fell within either of these exceptions, the insurer’s duty to defend would not be triggered.”⁷⁸

In finding that there was no duty to defend on the basis that the allegations are within the purview of the turnkey exclusion, Justice Iacobucci affirmed that the longstanding pleadings rule applies.

“The starting premise for assessing whether an insurer's duty to defend has been triggered rests in the traditional "pleadings rule". Whether an insurer is bound to defend a particular claim has been conventionally addressed by relying on the allegations made in the pleadings filed against the insured, usually in the form of a statement of claim. If the pleadings allege facts which, if true, would require the insurer to indemnify the insured for the claim, then the insurer is obliged to provide a defence. This remains so even though the actual facts may differ from the allegations pleaded.”⁷⁹

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⁷⁶ *Monenco*, supra note 51
⁷⁷ *Ibid.* at para 1
⁷⁸ *Ibid.* at para 1
⁷⁹ *Monenco*, supra note 51 at para 28
The court further reiterated that “the bare assertions advanced in a statement of claim are not necessarily determinative” and that the court should “look behind the literal terms of the pleadings in order to assess which of the legal claims put forward by the pleader could be supported by the factual allegations”. Furthermore, Mr. Justice Iacobucci invites the courts to consider the “factual allegations […] in their entirety to determine whether they could possibly support the plaintiff’s legal claims.”

Where Monenco, innovates is that it allows the court to consider the evidence filed by the plaintiff in order to properly characterize the claim:

“Without wishing to decide the extent to which extrinsic evidence can be considered, I am of the view that extrinsic evidence that has been explicitly referred to within the pleadings may be considered to determine the substance and true nature of the allegations, and thus to appreciate the nature and scope of an insurer’s duty to defend.” [emphasis added]

Moreover, Mr. Justice Iacobucci proceeds to set forth limits to the extent to which extrinsic evidence may be considered. He reiterates the importance of keeping in mind that determining whether there is a duty to defend is a “preliminary matter.” He states:

“we cannot advocate an approach that will cause the duty to defend application to become a ‘trial within a trial’. In that connection, a court may not look to ‘premature’ evidence which, if considered, would require findings to be made before trial that would affect underlying litigation.”

Thus in Scalera and Monenco, the Supreme Court seems to have given the courts a good indication of how to determine whether a duty to defend exists in common law provinces. In these cases, the Supreme Court’s emphasis seems to have been on looking
at the terms of the insurance policy as compared to what is alleged in the pleadings or extrinsic evidence mentioned in the pleadings. Our discussion will now turn to Quebec.

The Quebec Court of Appeal dealt with the duty to defend for the first time since Monenco in *AXA Assurance c. Les Habitations Claude Bouchard inc et. al.* In that case, Mr. Justice Biron affirms that:

> “Les arrêts Nichols, Scalera et Monenco trouvent l’application en droit des assurances québécois et la question qui nous est soumise doit être tranché à la lumière des principes qui y sont exposés.”

However, in his concurring reasons, Mr. Justice Beauregard characterizes the judgment ordering a duty to defend as a sort of interlocutory injunction:

> “Le jugement qui ordonne à un assureur d’assumer la défense de son assuré est un jugement avant faire droit et est en quelque sorte une injonction interlocutoire qui est prononcé suivant l’apparence du droit de l’assuré et en tenant compte de la prépondérance des inconvénients. Il est évident qu’avant de décider s’il va assumer la défense de son assuré, l’assureur va prendre connaissance de la procédure introductive d’instance. Cette procédure peut comporter des allégations qui peuvent être farfelues et qui, si elles sont tenues pour avérées, permettent à l’assureur de refuser d’aider son assuré. Dans les circonstances, il serait injuste pour celui-ci qu’il ne puisse pas, sans entrer dans un débat avec la partie demanderesse, produire une ou des déclarations assermentées pour démontrer au juge que, malgré les allégations de l’action, il a un droit apparent à ce que l’assureur assume sa défense et que la prépondérance des inconvénients joue en sa faveur.”

Larocque rightly expressed concerns with respect to this statement. Firstly, he notes that *Monenco* limits the use of extrinsic evidence to the evidence that was referenced in the pleadings. Secondly, allowing the insurer to file extrinsic evidence at this preliminary stage may allow the coverage debate to become a “trial within a trial”:

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85 *Axa, supra* note 13
86 *Axa, supra* note 13 at para 34
87 *Axa, supra* note 13 at para 56
“Ainsi, la méthode avancée par le juge Beauregard suggérait que l’assuré pouvait faire une preuve pour démontrer l’inexactitude des allégations, semble, à notre humble avis, contraire aux enseignements de la Court suprême et a pour conséquence de faire « un procès dans le procès ».”

The question remains as whether extrinsic evidence filed by the insured will also be examined. Hopefully, Monenco will not be interpreted as going that far. Indeed, as mentioned by Hilliker:

“There is some confusion as to whether the duty to defend can be founded on the pleadings filed on behalf of the insured. As a general rule it is only the pleadings filed against the insured which should be taken into account. An insured cannot, in a statement of defence, create coverage where none is found in a statement of claim.”

In a more recent case, the Quebec Court of Appeal relies on Monenco and quotes from it the following principles: 1) the mere possibility that a claim comes within the scope of the policy is sufficient; 2) you must give the allegations a generous interpretation to determine whether they constitute a claim covered by the policy.

4. **Conflict of Interest between insurer and insured**

Having considered how the courts deal with the duty to indemnify and the duty to defend, we have seen that the mere possibility of a claim falling within coverage will be sufficient to generate a duty to defend. That being the case, there will be times when the

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88 Larocque, supra note 1 at 19; See also Roy, supra, note 2, at p. 120
89 Hilliker, supra, note 5, p. 69
90 Royal Sun Alliance v. RIO 2002 DCQI 297 (C.A.)
insurer will be asked to defend a case which will ultimately lead to a non covered judgment.91

In such a case, there may be a conflict between the interests of the insurer and its insured. At that time, questions may arise as to who appoints counsel, who directs the defense and who will pay for counsel fees.

(a) **In general, in exchange for his undertaking to defend the claim, the insurer has the right to appoint counsel and conduct the defense**

In *Foundation pour le cancer*, Justice LeBel acknowledged that in general, a litigant was free to use the counsel of his choice. This being said, he noted that this principle was not without exceptions. One of these exceptions occurs when in exchange for a premium, the insured contracts out the defense of his claims to a liability insurer. In those cases, the insurer has the right to appoint counsel:

“Certes, le libre choix de l’avocat demeure un principe fondamental de l’organisation judiciaire et de la législation professionnelle québécoise. Ce principe a reçu des atténuations traditionnellement considérées comme compatibles avec l’ordre public, lorsque l’assuré, en contrepartie de l’endossement des frais de sa défense par l’assureur, aliène sa liberté de choix et accepte le procureur désigné par celle-ci.”92

Moreover, in general cases, this right to appoint counsel includes the right to conduct the defense. The insurer will satisfy its duty to defend if it provides a defense that leads to the dismissal of the claim against the insured.

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91 *Boreal*, supra, p. 61: “L’assureur peut ainsi se retrouver dans des situations où il aura l’obligation de défendre, mais pas celle d’indemniser, soit parce que la preuve ne permettra pas de retenir la responsabilité de la personne assurée, soit parce que cette même preuve aura révélé beaucoup plus que ce que laissait entrevoir la simple lecture des allégations.”; Renaud-Jacob, supra, p. 2165 : « L’assuré admet, au départ, qu’il peut arriver que, suivant le déroulement de la cause, l’assureur ait assumé sa défense mais que l’issue du procès démontre une situation d’exclusion ou de non-application qui le justifiera alors de ne pas l’indemniser pour la condamnation au dommages. »
92 *Fondation pour le cancer*, supra, note 51 para. 28
« Toutefois, il appartient à l’assureur, en vertu du contrat d’assurance lui-même, d’identifier les moyens de défense et il satisfait à son obligation fondamentale de défendre son assuré s’il propose des moyens qui permettent le rejet complet de la poursuite. Dans ce contexte, son obligation de défense ne l’oblige pas à préparer le terrain pour une contre-réclamation éventuelle de l’assuré ou à inclure celle-ci dans ses propres procédures exécutées sans réserve et de façon utile, en utilisant des moyens qui permettraient le rejet de la poursuite contre l’assuré, l’obligation de défense est bien remplie. S’il refuse de collaborer à cette défense, l’assuré viole les engagements qu’il a contracté dans ce contrat synallagmatique que demeure une convention d’assurance. »  

Mr. Justice LeBel notes that the duty to defend entails a correlative duty on the part of the insured. He describes this duty as a duty to fully and loyally co-operate in the defense.

These principle had been recognized by the Court of Appeal in Zurich:

“Par ailleurs, lorsque la défense de l’assuré est une obligation pour l’assureur, son exécution lui confère des droits. Le Principal de ceux-ci est la conduite de la défense. Il choisit les avocats et les experts, définit l’orientation de la défense, de la procédure écrite comme de la plaidoirie éventuelle devant le tribunal, et même, éventuellement, décide de l’opportunité de régler ou non l’affaire. De plus, elle impose à l’assurée l’obligation de collaborer avec l’assureur et ses représentants.”

If the insured refuses to co-operate with the appointed counsel, the Quebec Court of Appeal has held that this may constitute a sufficient reason for the insurer to deny coverage.

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93 Fondation pour le cancer, supra, note 51 para. 28
94 Ibid at para 26, noted in Monenco at para 30
95 Ibid.
96 Zurich, supra note 52 at 2165
97 Fondation pour le cancer, supra, note 51 at para. 29
(b) Counsel appointed by the insurer remains the counsel of both the insurer and the insured and owes a legal and ethical obligation to both.

As Mr. Justice Lebel observes, the appointment of counsel by the insurer does not relieve counsel from his legal and ethical obligations towards his client: the insured. He states:

« Ce mode de désignation de dispense pas le procureur choisi par l’assureur de ses obligations déontologiques à l’égard de l’assuré, puisqu’il doit éviter notamment de se placer en situation de conflit d’intérêt.»

The rule is no different in common law. In Bullock v. Trafalgar Insurance Co., the court held:

“There is a duty arising from the insurance contract on the part of the insurer to act fairly and refrain from doing anything to impair the contractual rights of the insured. The insurer owes a duty of fairness… The insurer must give as much consideration to the welfare of the insured as it gives to its own interest. The insurer cannot do anything to injure the rights of the insured to receive benefits under the policy.”

The same idea can be found in Hopkins (Committee of) v. Wellington:

“The insurer controls the defence of the action because of the contractual provisions in the policy of insurance. However, this provision in the contract of insurance does not alter the fact that the client of Mr. Whitelaw is Mr. Wellington and the client of Mr. Lindsey is Mr. Hopkins. Defence counsel owes the same duties to the two defendants as if counsel had been personally retained by the two defendants.”

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98 Fondation pour le cancer, supra, note 51 at para. 28; cf also Boreal, supra note 29 at p. 68: “L’avocate ou l’avocat choisi et rémunéré par l’assureur doit être considéré comme le procureur ad litem de la personne assurée et lui offrir toutes les garanties d’un dévouement total” and Zurich, supra, note 52 at p. 2166: “L’avocat désigné et payé par [l’assureur] est tenu d’assurer loyalement la défense de l’assuré et de préserver intégralement ses intérêts”

99 See C.M. MacIntyre & V. Yankou, “The Duty Of Defence Counsel As Between Insurer And Insured” Canadian Journal of Insurance Law, Vol. 18 No. 5

100 [1996] O.J. No. 2566

(c) Where there is a serious conflict, the insured may appoint counsel at the insurer’s expense

According to Krempulec, where there is a conflict of interest between insured and insurer and the insurer is under a duty to defend, the insured is entitled to appoint counsel of their choice while being funded by the insurer.102

This view is based on the well known case of Laurencine v. Jardine.103 In Laurencine a motorcycle owner obtained an order requiring the insurer of the motorcycle to defend an action brought against him. The owner then sought an order permitting him to be separately represented at the insurer's expense. The court held that because of the possibility of a conflict of interest between the insurer and its insured, the insurance company should provide separate representation. In deciding, the court applied the test ultimately adopted by the Supreme Court of Canada in Succession Macdonald v. Martin104 mainly whether there was a “possibility of real mischief or prejudice” or whether there was “appearance of impropriety”. The court found two potential problems. Firstly, it was felt that counsel retained by the insurer could take actions that would be contrary to the interests of the insured with regard to coverage. Secondly, it was felt that there was a risk that confidential information shared between the insured and the insurer appointed counsel could be used by the insurer to deny coverage.

Although the Laurencine case has since been distinguished105, it has also been followed. For example in Incerto v. Landry106, Landry was sued by the Incerto family who claimed that Landry was responsible for Incerto’s death in an automobile accident.

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102 Krempulec, supra note 2 at 39
103 [1988], 64 O.R. (2d) 336 (Ont. H.C.) [hereinafter Laurencine]
104 [1990] 3 S.C.R. 1235
Lombard, Landry’s insurer denied that Landry was either the driver or an occupant of the vehicle which according to Lombard would allow it to deny the claim. The court held that these facts presented a potential conflict and that Landry was entitled to his choice of counsel at Lombard’s expense.

The same rule applies in Quebec. In *Boreal*, the Court of Appeal held that an insured who had a reasonable fear that his defense would not be complete could retain his own counsel and recuperate the expense from his insurer.\(^{107}\)

However, a mere possibility of a conflict is not sufficient. Indeed, in *Zurich*\(^{108}\), the Quebec Court of Appeal, specifically declined to follow the reasoning of the Ontario Court in *Laurencine*. It observed that the possibility of a conflict is always present when an insurer-appointed counsel represents an insured. This mere possibility should not be sufficient to deprive the insurer of the rights that are granted to it by the policy. Indeed, as the case law forces insurers to communicate coverage limitations to the insured as early as possible, a harder line would put the insurer between a rock and a hard place. Indeed, it would be forced, either to guarantee that it will indemnify (which it must now only decide based on the findings of the judgment) or abandon its right to defend and settle the claim (a right guaranteed to it by the insurance policy). As such the Court of Appeal held that you need more than a simple apprehension of bias, but rather that the facts of the specific case demonstrate an incompatibility between the dual mandates given

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\(^{107}\) *Boreal, supra*, note 29 at p. 68: “Un assureur est malvenu d’ébranler, au moment d’exercer son obligation de défendre, l’aspiration légitime de la personne assurée à une défense complète par toutes sortes de réserves sur son obligation d’indemniser puisque celle-ci ne dépendra que de la preuve. La personne assurée, parce qu’elle a droit à une loyauté totale, est alors justifiée de refuser la défense offerte et de désigner un avocat indépendant pour assumer sa défense.” See also comments by *Sanderson, supra*, note 2, pp. 252-254.
to counsel by the insurer and the insured.\[^{109}\] In the absence of a conflict, the possibility of part of the claim being outside coverage gives the insured the right to appoint counsel for those parts that are not covered. However, in those cases, the new counsel must be paid exclusively by the insured.\[^{110}\]

\[^{109}\] Zurich may now be the state of the law in common law Canada as well. Indeed, it was specifically approved and referred to in the recent Ontario Court of Appeal case of Municipality of Brockton v. Frank Cowan Company.\[^{111}\] In the spring of 2000 the community of Walkerton was plagued with a catastrophic bacterial infection of its water system. Fearing a suit, the city of Walkerton (who after amalgamation became Brockton) sought comfort from its insurers, Frank Cowan Company and others (“Cowan”). In early May 2000, Brockton officials met with Cowan officials and coverage counsel Borden Ladner Gervais LLP (“BLG”). The next day BLG wrote a reservation of rights letter. Brockton wasn’t satisfied with this response and appointed Miller Thompson LLP to represent it on May 26\(^{th}\). The same day a class action suit was instituted against the municipality. On June 13\(^{th}\) the Province of Ontario ordered a public inquiry into the tragedy. On June 23\(^{rd}\), BLG advised Brockton that Cowan had appointed Lawson McGrenere to act on behalf of Brockton in the civil action but that no coverage was afforded with regard to the public inquiry. Miller Thompson provided significant assistance to Brockton. It orchestrated responses to the Ministry of the Environment, the Coroner’s inquest and criminal investigation, prepared for the civil trial and the public

\[^{108}\] Supra, note 52
\[^{109}\] Zurich, supra, note 52 at p. 2169
\[^{111}\] January 11, 2002 (Ont. C.A.) :
inquiry. Brockton claimed that Cowan should reimburse those fees. The Court of Appeal clearly confirmed that the right to control the defense belonged to the insurer. Unless the circumstances surrounding the defense created an appearance of impropriety, an insured could not charge the insurer with additional defense fees simply because it disagreed with the strategy of the insurer appointed counsel:

“[31] The appellant does not contest that in the first instance this right to control the defence (including the appointment of counsel) is that of the insurer. The insurance contract makes this clear. It provides that it is the role of the insurer to investigate and defend claims covered by the policy and it is the role of the insured to assist in that regard. It is the insurer which conducts the defence. This includes the appointment of defence counsel. Indeed this right of the insurer to control the defence can be seen as being in return for its obligation to pay a proper claim. LeBel J.A. made this point in Zurich of Canada v. Renaud & Jacob, [1996] R.J.Q. 2160 (Que. C.A.) at 2168. […]

[41] LeBel J.A. concluded that the potential tension which inheres in the relationship between the insurer and the insured and which is manifested by the reservation of rights by the insurer is not per se sufficient to require the insurer to surrender control of the defence. It would too quickly cost the insurer the right it contracted for. Rather, the focus must be on the mandate given by the insurer to the counsel it appoints to conduct the defence. Do the circumstances of the particular case create a reasonable apprehension of conflict of interest if that counsel were to act for both the insurer and the insured in defending the action? If the insurer puts counsel in a position of having conflicting mandates it must surrender control of the defence to an insured who wishes to retain its own counsel paid for by the insurer. […]

[43] I agree with the approach taken in Zurich […] The issue is the degree of divergence of interest that must exist before the insurer can be required to surrender control of the defence and pay for counsel retained by the insured. The balance is between the insured’s right to a full and fair defence of the civil action against it and the insurer’s right to control that defence because of its potential ultimate obligation to indemnify. In my view, that balance is appropriately struck by requiring that there be, in the circumstances of the particular case, a reasonable apprehension of conflict of interest on the part of counsel appointed by the insurer
before the insured is entitled to independent counsel at the insurer’s expense. The question is whether counsel’s mandate from the insurer can reasonably be said to conflict with his mandate to defend the insured in the civil action. Until that point is reached, the insured’s right to a defence and the insurer’s right to control that defence can satisfactorily co-exist.

[49] The appellant’s complaint is really about the way counsel proposed to conduct that defence. However, the tactics used in the defence remain the province of the insurer where the insurer retains the right to control that defence. One can sympathize with the appellant, given the catastrophic circumstances which faced the community of Walkerton. However, absent an insurance contract providing specific terms (for example, allowing the insured to direct counsel appointed by the insurer in defence of claims arising from an environmental disaster) the insurer’s right to control the defence remains unless there is a reasonable apprehension of conflict of interest.”

5. **Conclusion**

This discussion has attempted to highlight the key principles that are relevant to the duty to defend in Canadian law. We conclude that although the duty to defend has different sources in both the common and civil law provinces, the analysis taken by the courts is very similar. The major difference between Quebec and the other provinces is the courts’ treatment of policies that do not expressly contain a defence clause. In the Quebec, the insured will still have the benefit of having the defence costs covered. However, in the common law provinces, this is not the case, as the duty is a creature of contract. Recent Supreme Court cases have confirmed and refined the application of the “pleading rule”. Indeed, the true nature of the pleadings still governs the coverage analysis. Arguably, the reason for this links back to the insurance policy, and to the consent arrived at between the parties.

We have also advanced that the insurer remains in control of the defense. He is thus free to appoint counsel, direct the defense and ultimately to settle the claim. Unless
the circumstances lead to the conclusion that the situation creates a conflict, the insurer will not be able to appoint separate counsel unless he does it at his own cost.