
THE TRIPARTITE RELATIONSHIP BETWEEN INSUREDS, INSURERS AND COUNSEL: THE IMPORTANCE OF GOOD FAITH

By: Nick Peters

Overview

Our clients are under an obligation to consider principles of Good Faith in respect of their dealings with both their own insureds, and us as legal counsel. Insurers are held to a legal standard of conduct which is based upon the principles of *utmost good faith*. This means that, above all else, when dealing with insureds, and notwithstanding the terms of policy wordings, statutory conditions, or other contracts and rules, insurers are bound to conduct themselves with good faith as the governing principle.

Good faith is of particular importance in the context of the unique relationship between insureds, insurers and counsel. As our insurance clients are already aware, we, as defence counsel, stand in a unique position between the insurers, and the insureds. As noted within the *Alberta Insurance Act*, an insured is defined as “a person insured by a contract whether named or not”. This gives rise to a clear relationship between insurer and insured where, among other things, both the terms of specific insurance policies and those of the *Alberta Insurance Act* will most certainly govern. When insureds become parties to litigation, however, the third prong of the “tripartite relationship” comes into play. Once defence counsel is appointed, it is important to

note that counsel acts officially on behalf of the insured; however, in actual fact, counsel is often instructed by and the litigation process is generally controlled on the recommendation of the insurer.

This tripartite relationship can only be maintained on the basis of active implementation and adherence to the principles of utmost good faith. Most importantly, insurers must be aware of circumstances in which insureds will have a role in instructing counsel, authorizing settlement, or, in some circumstances, retaining separate personal counsel. Further, it is incumbent upon insurers to ensure that their insureds receive a full legal defence to any civil action, and that certain business protocols established from time to time by insurers do not interfere with or otherwise impair counsel from taking steps which serve to promote, enhance, or preserve the legal rights and remedies of insured parties to litigation.

The Principle of Good Faith Defined at Law

The principle of good faith as a legal concept was defined clearly in a recent case of the Ontario Court of Appeal, *702535 Ontario Inc. v. Non-Marine Underwriters, Lloyds of London* (2000) 184 D.L.R. (4th) 687 (“*Lloyds*”). In the *Lloyds* decision, the court made the following important statements:

The relationship between an insurer and insured is contractual in nature. The contract is one of utmost good faith. In addition to the express provisions in the policy and the statutorily mandated conditions, there is an implied obligation in every insurance contract that the insurer will deal with claims from its insured in good faith: *Whiten v. Pilot Insurance Co.* (1999) 42 O.R. (3d) 641 (Ont. C.A.). The duty of good faith requires an insurer to act both promptly and fairly when investigating, assessing and **attempting to resolve claims by its insureds.**

The first part of this duty speaks to the timeliness in which a claim is processed by the insurer.... The duty of good faith also requires an insurer to deal with its insureds claim fairly.... What constitutes bad faith will depend on the circumstances in each case. A court considering whether the duty has been breached will look at the

conduct of the insurer throughout the claims process.... A breach of the duty to act in good faith gives rise to a separate cause of action from an action for the failure of an insurer to compensate for loss covered by the policy.

The above noted passage, therefore, confirms that insurers are bound to act in good faith not only during the initial assessment and investigation of a claim made by their insureds, but also throughout the claims handling process through and up to the appointment of defence counsel for the purposes of resolving such claims. This means that insureds should be included in the process by which defence counsel acting on their behalf is instructed and in the manner in which either steps in litigation, or steps in a settlement process, are advanced. The *Lloyds* case cited above was adopted and affirmed by the Supreme Court of Canada in *Fiddler v. Sun Life Assurance Co. of Canada* [2006] 2 S.C.R. 3.

Good Faith In Practice: The Tripartite Relationship

These principles of good faith in the context of control over the litigation process and the tripartite relationship have been further summarized by various legal authorities, including the following excerpt from *Introduction to Canadian Insurance Law*, 2nd Ed., C. Brown Ed. (Markham, Ont.: Lexis Nexis Butterworths, 2006):

The right to control the litigation from the defence point of view carries with it certain obligations. In particular, the insurer must conduct itself in accordance with a duty of good faith and fair dealing in relation to its customer. In addition to the general obligation to treat its customer fairly, ... good faith imposes an additional requirement on a liability insurer. If the person bringing the lawsuit makes an offer of settlement within the policy limits, the insurer may not reject it without taking account of its customer's interest The test is, did the insurer give at least equal consideration to the customer's interest as it did its own interest?

This highlights the importance of consulting and, indeed, obtaining the consent of an insured when engaging in settlement negotiations, notwithstanding the fact that their deductible may be only a small portion of the overall amount. In short, it is clear law in Canada that insurers can be

held liable in circumstances where settlement offers within the policy limits are either refused without the input of the insured, or are not adequately communicated to the insured.

One of the landmark decisions in Canadian law upholding these principles was *Fredrikson v. Insurance Corp. of British Columbia*, wherein the court stated that:

It is clear that certain of the fundamental elements which give rise to fiduciary duty are present in the relationship of insurer and insured ... [although] the insurer is not subject to the strict duty of a fiduciary, it must nevertheless exercise its power having regard to the interests of its insureds, and in a manner entailing, in some sense, an obligation of good faith ... because of the power reposed in the insurer by its control over the question of whether to settle, and the potential vulnerability of the insured, there is a basis for imposing a somewhat analogous duty [to the duty of utmost good faith] upon the insurer.

These principles were further entrenched in the decision of *Shea v. Manitoba Public Insurance Corp.* (1991) 55 B.C.L.R. (2d) 15. In *Shea*, the insureds were seriously injured as passengers in a motor vehicle accident in which other family members were the driver and owner of the vehicle. Based on the claims and cross-claims advanced in the action, it became obvious that any potential judgments would exceed the policy limits. Despite the fact that offers of settlement were received within the policy limits, the insurer instructed counsel to continue defence of the tort action through to trial. Judgment was eventually awarded for more than \$800,000.00 in excess of the policy limits. As a result, the insureds sought the court's declaration that the insurer was obligated to indemnify them for this amount in excess of the policy limits, simply on the basis that the insurer had breached its duties of good faith, contract, and other fiduciary duties, in failing to appropriately settle the claim. The court in *Shea* recognized the principle that there is an inherent conflict between insurers and insureds in situations where claims or potential judgments could exceed the policy limits. It concluded in that particular case, that the insurer had directed defence counsel pursuant to its own internal business considerations and interests, and had ignored and in fact jeopardized its insured's legal rights and remedies in so doing. Therefore, the insurer was found to have failed to comply with principles of good faith in giving the insured an opportunity to consent to or direct defence counsel through such process:

The exclusive discretionary power to settle liability claims given by statute to the insurer ... places the insured at the mercy of the insurer ... [and] the insured's position of vulnerability imposes on the insurer the duties of (a) good faith and fair dealing; and (b) to give at least as much consideration to the insured's interests as it does to its own interests; and (c) to disclose with reasonable promptitude to the insured all material information touching upon the insured's position in the litigation and in the settlement negotiations.

This has obvious practical considerations for our insurance clients, and the relationship between defence counsel, the insurer and the insureds.

The interaction between insurers, insureds and defence counsel during the course of litigation must be informed by the above noted principles of good faith. Some examples of important legal concepts in this regard include the following:

- Insurers are bound to preserve insureds' rights of indemnity notwithstanding steps in the litigation;
- The insurers duty to defend is broader than the duty to indemnify;
- An insurer's right to select and instruct defence counsel is not absolute;
- Insureds may have choice in certain circumstances as to the instruction and retention of counsel;
- Reservation of rights/non-waiver agreements are essential when insurers believe coverage issues may exist; however, when such agreements are entered into as between insureds and insurers, insureds may have a right to retain separate counsel at the expense of the insurer.

With respect to the first point above, the Alberta Court of Queen's Bench in *Lombard Canada Ltd. v. Kostash* (2006) 400 A.R. 260, citing the Supreme Court of Canada in *Western Canada Accident and Guarantee Insurance Co. v. Parrott*, made the following observation:

An insurer which becomes aware of any defence under the policy, such as a breach by the insured or any other ground upon which the insurer could deny liability to indemnify the insured ... which thereafter takes unequivocal steps which affirm the insured's right of indemnity, such as by defending proceedings against the insured or adjusting and paying a third party claim, cannot later deny liability to the insured, in the absence of a judgment or an agreement or acknowledgement of the insured that the insurer may proceed without prejudicing its right to rely on the ground for denial of liability. The insurer is bound by its actions by a reason of election, not merely estoppel, and no prejudice to the insured need be shown.

This was also previously confirmed by the Supreme Court of Canada in *Nichols v. American Home Assurance Co.* [1990] 1 S.C.R. 801. This highlights the importance of non-waiver/reservation of rights agreements in situations where insurers wish to appoint defence counsel to defend an action, yet wish to simultaneously maintain the opportunity to deny coverage or limit indemnity, even on a partial basis, at a later date as a result of the conduct or potential breach of its own insured.

However, the important factor in all of the above is that the more an insurer takes formal steps to preserve its rights as against the insured and simultaneously defend its insured in the litigation, the more it must ensure it makes the insured aware of the opportunity for the insured to either instruct the defence, or appoint its own separate counsel at the expense of the insurer.

The Evolving Impact of Good Faith: Insured's Expanding Right to Control Litigation

A recent decision of the Ontario Court of Appeal in *Brockton (Municipality) v. Frank Cowan Co. Ltd.*, (2002) 57 O.R. (3d) 447, confirmed that the principles of good faith apply to the tripartite relationship in such a way as to increase the role of the insured in the litigation process in several areas and under certain circumstances:

- When coverage disputes are live issues;
- When potential claims or judgments against the insured could exceed the policy limits;
- When insureds seek legal defence on a “reputation basis” or otherwise seek a “full fledged defence” contrary to an insurer’s instructions to defence counsel, or an insurer’s desire to settle the matter;
- When solicitor/client privilege is in issue.

The court in *Brockton* confirmed that once the duty to defend is assumed, insurers generally enjoy a corresponding right to select and instruct counsel and to control the litigation process. However, this right is not unfettered.

Of course, the duty to defend generally arises out of the coverage provided under a policy, and should always be considered from the perspective of the exact nature of any claim made against an insured. Whether in commercial, motor vehicle, property, or personal liability contexts, the well known principles of insurers’ duty to defend arise out of the *Nichols* case cited above and include:

- (a) Insurers must only consider the allegations contained in a claim, or the pleadings related thereto, made against an insured;
- (b) Where it is clear from the pleadings that the claim falls outside of policy coverage, the duty to defend will not arise;
- (c) The substance and not the form of the pleading will govern the duty to defend.

This demonstrates the importance of engaging counsel at the earliest opportunity to evaluate the scope of a claim against an insured. When counsel is engaged, they can provide an opinion as to

the nature of a claim against an insured and give legal advice solely to the insurer prior to being appointed to act on behalf of the insured. This will also allow an insurer to determine whether or not a reservation of rights or non-waiver agreement is necessary, and will frame the relationship between all three parties on an ongoing basis from that point forward.

The principles outlined above were affirmed by the Quebec Court of Appeal in *Zurich du Canada, cie d'indemnité c. Renaud & Jacob* [1996] R.J.Q. 2160 (Que. C.A.). This case has subsequently been followed in other common law provinces and has generally been accepted as a firm principle in commuting insurance law. In that policy, an insured was sued for professional negligence. The insurer appointed defence counsel, however they also maintained a reservation of rights agreement due to potential coverage issues with certain aspects of the claim. Despite this reservation of rights and despite the inherent tension between insured and insurer in respect of coverage issues and the balance between indemnity and liability defence, the court found that the insurer generally retained the right to instruct counsel and control the steps of the litigation. However, there was no privilege over coverage opinions provided to the insurer by counsel. Ultimately, everything depends on the mandate given to defence counsel as instructed by an insurer at the outset of litigation.

Contrasted with the more recent decision in *Brockton*, it would appear that Canadian courts are placing an increasing burden on insurers to ensure that they give their insureds options to participate in the control of the litigation process, and in certain circumstances, to preserve their own legal rights by retaining separate counsel at the expense of the insured. *Brockton* involved water contamination in a municipality which caused widespread illness. The municipality was sued on a class action basis by its residents. The municipality's insurer appointed defence counsel; however, the municipality brought a court application for a declaration that it alone had the right to control the defence process and not its insurers. Although the court found that, in the absence of a clear conflict of interest or of a coverage dispute, the insurer's right to appoint and instruct counsel and control the litigation process was an implied term in the contract of insurance:

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 sole 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 property claim.

Notwithstanding the above, the court in *Brockton* made it clear that, now more than ever in Canadian law, insureds in any context (as was the case in those particular circumstances) may have legal rights to assert control over the litigation process, even when defence counsel has been appointed for them by the insurer:

However, the right of the insurer to control the defence is not absolute.... The usual right of the insurer to control the defence and appoint counsel should be overwritten if there is “an appearance of impropriety” which can be based on “conflicts, divergences of interest and other proper objections or factors.

The court confirmed that the principle of utmost good faith is implicit in these “other factors”. In other words, if an insurer, for any reason, is instructing defence counsel to act in a manner which is inconsistent with the principles of good faith (such as in a way that would prejudice an insured’s right to indemnity or judgment by settling a matter prematurely, or alternatively by taking a matter to trial which deserves settlement), then the insured themselves may have the right to “step into the shoes” of the insurer and either control the litigation themselves or appoint separate counsel. To this end, it is important for our insurance clients to remember that the guiding principles for managing the flow of litigation and instructing counsel cannot be restricted to indemnity or policy payment considerations alone, and must instead be governed by the overriding principles of utmost good faith.

Practical Considerations

Implementing the above-noted principles can be achieved through a variety of practical measures, many of which have been confirmed by recent case law, including the decision in *PCL*

Constructors Canada Inc. v. Lumbermens Casualty Co. [2009] 81 C.L.R. (3d) 186 (Ont. S.C.J.). In the *PCL* decision, the court noted that one of the pillars of exercising good faith and preserving an insurer's right to control the litigation process includes "identical and concurrent reporting" to both the insurer and the insured as a means of mitigating against potential prejudice. This has a substantial practical implication on the relationship between our insurance clients and legal counsel. As is the common practice of our insurance clients, initial assessment of claims upon assignment to defence counsel includes detailed reporting, litigation plans and budgets, and assessments of the potential liability of insureds. Often, following the review of a claim, supporting documentation, such as the medical records of either the insured or an opposing party, defence counsel will issue a detailed report to the "insurer client". The implication in the above noted case law is that such reports are equally the property of an insured as that of the insurer, unless reservation of rights or non-waiver agreements are in place. Even then, such reports will likely remain the joint property of the insured and the insurer, and may not be subject to attorney client privilege until such time as the insured is appointed separate defence counsel (possibly at the expense of the insurer). The court in *PCL* recognized that:

The courts must seek to strike a balance in the circumstances recognizing the legitimate interests of both the insured and the insurer. The potential tension in the relationship between insured and insurer is not sufficient to require the insurer to surrender control of the defence. Counsel should therefore have the confidence of the insurer who is obligated to pay the legal fees and may have to pay a substantial judgment on behalf of the insured. On the other hand, counsel must meet his or her legal and ethical obligations to defend the action on behalf of the insured. Both the insured and the insurer should be fully and promptly informed of all steps taken in defence of the litigation in order to be in a position to monitor the defence effectively and address any real bases for concern. This obligation is not unduly burdensome, nor does it compromise the right to defend. It allows the insurer in this case to benefit from its contractual rights to defend and settle while providing meaningful protection to the insured against the possibility in the event that it later appears that there is some legitimate basis for concern.

Based on the above, it is clear that courts are increasingly of the view that an insured is entitled to concurrent access to all information, analysis, and opinions provided by defence counsel to the

insurer. Further, there is an increasing trend in Canadian law that no privilege will exist between and insurer and counsel in respect of such reports should coverage denials be brought forward at a future date during the litigation. These principles were confirmed by the Ontario Court of Appeal in a recent landmark decision of *Appin Realty Corporation Limited v. Economical Mutual Insurance Company* (2008) ONCA. 95, where the Ontario Court of Appeal stated that “an insurer’s right to control the defence of the action is not absolute,” and that defence counsel and the insurer jointly must ensure that they do not take any steps to “steer the defence of the case to an outcome not covered by the policy”.

Conclusion

To remain in compliance with the principles of utmost good faith, and to participate in the tripartite relationship between insured, defence counsel, and an insurer’s own interest in the litigation, it is imperative that insurers remain mindful of the following:

- The duty to act in good faith encompasses equal consideration of an insured’s interest in the litigation as that of an insurer’s;
- This requires consultation, and even consent in some circumstances in respect of potential settlement opportunities;
- Open communication and concurrent reporting of liability analysis provided by defence counsel must be shared with, and remain the joint property of, the insured as well as the insurer;
- In circumstances where reservation of rights/non-waiver agreements are maintained to protect coverage positions, insurers must not only inform insureds of their right to separate defence counsel, but may actually be required to indemnify them for same;

- Notwithstanding all of the above, in the absence of overriding factors, the insurer generally remains in the “litigation driver’s seat” and has substantial statutory and contractual authority to appoint and instruct counsel.