COURT FILE NO.: 06-CV-316950 PD1
DATE: 20090625

SUPERIOR COURT OF JUSTICE – ONTARIO

RE: PCL Constructors Canada/Applicant
Lumbermens Casualty Company Kemper Canada/Respondent

BEFORE: J. A. Thorburn J.

COUNSEL: *Jamieson Halfnight* for the Moving Party, PCL Constructors Canada

Les D. Manley for the Respondent, Lumbermens Casualty Company Kemper Canada

DATE HEARD: April 6, 2009

E N D O R S E M E N T

PART I: INTRODUCTION

[1] An action for property damage was brought by l'Hôpital Regional de Sudbury (Hôpital) against PCL Constructors Canada (PCL). In the Statement of Claim, l'Hôpital claims damages resulting from water leaks in the PVC roof membrane and resultant damage to the roof system. L'Hôpital claims the damage was caused by the negligence of PCL or its subcontractors, for whom PCL is liable.

[2] The Applicant, PCL asserts that this claim is covered by Lumbermens Mutual Casualty Company Kemper Canada's (Lumbermen's) Commercial General Liability (CGL) insurance policy No. 3AA 044 163-00 (the "Policy"). As such, its insurer, Lumbermens, has a duty to defend the action brought by l'Hôpital against PCL. PCL further claims that, because of Lumbermens refusal to defend the action on PCL's behalf and the resulting potential conflict of interest, Lumbermens must pay PCL's independent counsel's legal fees.

[3] The decision regarding coverage involves the interpretation of CGL policy No. 3AA 044 163-00, its exclusions and the exception to one of those exclusions.

[4] For the reasons that follow, I find there is a duty to defend the Claim brought against PCL as there may be coverage for resulting damage during the policy period. The insurer may have ongoing involvement in the defence of the Claim pursuant to the terms of the Policy provided it meets certain conditions set out below.

PART II: BACKGROUND FACTS

The Construction Contract between PCL and the Hospital

[5] Lumbermans and l'Hôpital were parties to a CGL insurance policy relating to the expansion and renovation of l'Hôpital. As primary insurer, Lumbermans insured PCL pursuant to the Policy.

[6] The policy period was September 1, 1999 to September 1, 2002. The policy period for the Exception to Exclusion 6 was extended to September 1, 2004.

[7] PCL was the construction manager and built the first phase of the renovation project. PCL provided some services directly and others through subcontractors. PCL was required to provide roofing systems according to certain specifications set out in the Agreement between PCL and l'Hôpital. PCL's subcontractor Douro Roofing and Sheet Metal Ltd. was responsible for installation of the roof system.

[8] Work on the renovation project was substantially complete on September 12, 2002. The roof system "began to reflect water leakage in 2003" and the issue was reported to PCL and Douro Roofing[1].

[9] In 2007, l'Hôpital engaged a roofing consultant to conduct an investigation. L'Hôpital was advised by its roofing consultant that the leaking roof was caused or contributed to by the actions and omissions of PCL or its subcontractor, Douro Roofing.

L'Hôpital's Claims against PCL

[10] L'Hôpital issued a Statement of Claim against PCL on March 12, 2008. L'Hôpital claims property damage arising out of alleged construction mistakes, defects and deficiencies, particularly regarding the roof. L'Hôpital alleges that the damage and leaking roof was caused or contributed to by the installation and subsequent removal of a temporary cooling tower and other construction activities, including the construction of a new exhaust stack. L'Hôpital further alleges that the roof system has been irreparably damaged by excessive water on the inside of the PVC membrane. L'Hôpital claims that one of PCL's subcontractors negligently damaged the roofing membrane and that PCL failed to:

a) review and supervise its subcontractors and their work;
b) observe damage caused by its sub-contractors;
c) instruct its subcontractors to adequately repair the damage;
d) provide staff to properly perform the construction management of the project, and
e) notify l'Hôpital of damage or construction deficiencies.

[1] Statement of Claim at para. 10.

[11] L'Hôpital claims that the cost of effecting repairs is anticipated to be $150,000.

Damages Claimed

[12] The damage to l'Hôpital claimed in the Statement of Claim includes damages to the PVC roof membrane itself and resulting damage to the "roof system" arising from damage to the roof membrane, apparently as the result of water passing through the damaged membrane. Although the roof system began to reflect water leakage in 2003, damage to the PVC roof membrane could have occurred during the term of the policy period.

[13] Resulting damage arising from damage to the PVC membrane may have occurred at any time from the time the membrane was damaged and thus both before and after the work was completed and before and after the policy period ended.

Request for Coverage

[14] PCL tendered notice and defence of the Action to Lumbermens on April 23, 2008, shortly after it became aware of the claim. PCL requested that Lumbermens defend the action on its behalf.

[15] On September 10, 2008, Lumbermens denied its duty to defend and any duty to indemnify PCL in respect of the claims made by l'Hôpital.

PART III: THE ISSUES

[16] The issues to be determined are:

a) Does Lumbermans have a duty to defend the claim by l'Hôpital against PCL on the basis that the Policy covers losses claimed by l'Hôpital in its Statement of Claim? If so,

b) Should this court allow PCL to choose and instruct its own independent defence counsel and be reimbursed by Lumbermens?

PART IV: THE INSURANCE POLICY TERMS

The Insuring Agreement

[17] The "Bodily Injury and Property Damage" section of the policy covers liability for property damage caused by an occurrence. The relevant provision of the insuring agreement reads as follows:

> We will pay those sums that the insured becomes legally obligated to pay as compensatory damages because of … "property damage" to which this insurance applies…This insurance applies only to … "property damage" which occurs during the policy period. The "bodily injury" or "property damage" must be caused by an "occurrence".

[18] Property damage is defined in Section V, paragraph 10 of the policy as "physical injury to tangible property, including all resulting loss of use of that property or loss of use of tangible property that is not physically injured."

[19] Occurrence is defined in Section V, paragraph 7 of the policy as "an accident including continuous or repeated exposure to substantially the same general harmful conditions."

[20] The policy provides insurance for property damage caused by an occurrence in the coverage territory if the property damage occurs during the policy period. The policy period was from May 1, 1999 to September 1, 2002.

Exclusion h.5

[21] Exclusion h.5 , as amended by endorsement, provides that,

> This insurance does not apply to,
>
> 3. Property damage to:
>
> 5. Real property on which you or any contractor or subcontractor working directly or indirectly on your behalf is performing operations, if the "property damage" arises out of those operations:

Exclusion h.6

[22] Exclusion h.6 of the Policy, as amended by endorsement, provides in part that,

> This insurance does not apply to,
>
> 3. Property damage to:
>
> 6. Real property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

Exception to Exclusion h.6

[23] The amending Endorsement provides that "Paragraph 6) of this exclusion [h] does not apply to "property damage" included in the "products-completed operations hazard."

[24] The "Products Completed Operations Hazard" is defined to be:

> 9.a. The Products Completed Operations Hazard includes all …"property damage" occurring away from premises you own or rent or arising out of "your product" or "your work" except:
>
> 1) Products that are still in your physical possession; or
>
> 2) Work that has not yet been completed or abandoned.
>
> "Your work" will be deemed completed at the earliest of the following times:
>
> 1) When all of the work called for in your contract has been completed…
>
> 4) Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as completed."

[25] The "Products and Completed Operations Hazard" (Exception to Exclusion 6), as amended by endorsement, was extended to September 1, 2004 by virtue of the following:

> It is hereby understood and agreed that coverage proved (*sic*) under the "products and completed operation hazard" is extended for a period of 24 months after the expiration dated as noted in the declaration pages attached to and forming part of this policy.

PART V: THE POSITIONS TAKEN BY THE PARTIES

[26] Both parties agree that:

a) the policy provides coverage for property damage caused by an occurrence within the policy period;

b) the Statement of Claim suggests that the resulting damage was within the roofing system and resulted, in part, from the work done in accordance with the contract between PCL and l'Hôpital;

c) the plaintiff became aware of property damage in 2003. Therefore some of the property damage occurred during the policy period, that is, prior to September 1, 2002, or the renewal period for the Exception to Exclusion 6, that is, prior to September 1, 2004; and

d) there is a duty to defend if there is a "mere possibility" that the claims pleaded in the Statement of Claim fall within coverage.[2]

[27] The parties disagree on the application of Exclusions 5 and 6.

PCL's Position

PCL is Covered by the CGL Policy

[28] PCL claims that the exclusions do not apply in this case and PCL is therefore covered under the CGL insurance policy.

[29] PCL says that Exclusion 5 does not apply. Exclusion 5 only excludes coverage for damage to property while PCL or its subcontractor is performing operations (i.e. during the course of the insured's performance of its operations) if the damage arises out of those operations. In this case, the damage is alleged to have occurred after the project was completed.

[30] PCL argues that if Exclusion 6 applies, the facts in this case fit within the exception to Exclusion 6. Exception to Exclusion 6 covers property damage even if it is due to faulty workmanship of the insured or someone acting on its behalf unless the work has not yet been completed or abandoned or the products are still in the insured's possession.

[31] Work on the project was substantially complete in September 2002 and damage was first apparent to the plaintiff in 2003. Exception to Exclusion 6 makes it clear that the policy covers resultant damage from a completed project within the policy period for Exception to Exclusion 6, that is, is prior to September 1, 2004.

PCL Should be Entitled to Retain its Own Counsel to Defend the Action and Receive Indemnification of those Costs from Lumbermens

[32] PCL states that Lumbermens' "prejudicial conduct"[3] justifies PCL's request to appoint its own counsel to conduct the defence of this Claim.

[33] PCL states that given the position of the insurer, there is a risk that defence counsel appointed by Lumbermens will have an incentive to demonstrate that the allegations against PCL fall within the policy exclusions as this would be consistent with their stated "no indemnity" position.

[34] The email from the insurer provides that:

> … it is our view that Exclusions 5) and 6) (Work Performed Exclusion) of the Policy clearly exclude coverage on the facts of this case so that there is no duty to neither indemnify nor defend (*sic*) PCL."

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[2] *Non-Marine Underwriters, Lloyds of London v. Scalera*, [2000] 1 S.C.R. 552 at paras. 74-78 [*Scalera*].
[3] PCL Factum at para. 25.

[35] PCL claims the concept of potential conflict of interest should be liberally applied.[4] In this case, there is a reasonable apprehension of conflict of interest between the insured and the insurer and PCL should be entitled to select its own counsel and receive indemnification for those costs from Lumbermens.

Lumbermens' Position

PCL is Not Covered by the CGL Policy

[36] Lumbermans argues that Exclusions 5 and/or 6 exclude coverage for the losses alleged by l'Hôpital against PCL. As such, there is no duty to defend or to indemnify PCL for legal costs.

[37] The Claim is based on the allegation that the roof system installed by PCL and its subcontractors was damaged in the course of work negligently performed on the roof by PCL or one of its subcontractors. The insurance coverage was never intended to be a guarantee of workmanship. Because the damages were caused by PCL's failure to do its work properly, it should be denied coverage.

[38] In this case, the roof system installed by PCL's subcontractor was damaged in the course of work negligently performed on the roof by PCL or its subcontractor while operations were being performed on the roof. Thus, even if the claim were made after operations were complete, the exclusion still applies because the damage occurred while the operations were being performed.[5]

[39] The purpose underlying the "own work" exclusions in 5 and 6 is to cover unforeseen occurrences that might result in damage to property other than the property being worked on. Lumbermens claims that the policy was never meant to insure the cost of repairing the insured's own defective work. Lumbermens suggests that the interpretation of the policy offered by PCL is contrary to the purpose of the policy as on PCL's interpretation, the insurer would become a surety for the policyholder's performance. This, Lumbermens says, is not what the parties intended. Lumbermens points to clauses similar to this wherein the courts have determined that "defects in the very work the contractor is employed to do is not covered by the insurance policy."[6]

[40] Finally, damage to the roof occurred while operations were ongoing. Thus, the Exception to Exclusion 6 does not apply and there is no obligation to defend this claim.

PCL Should Not be Entitled to Retain its Own Counsel to Defend the Action and Receive Indemnification of those Costs From Lumbermens

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[4] *Uniroyal Chemical Ltd. v. Kansa General Insurance Co.*, [1992] O.J. No. 4003 per Blair J. at para 7 (Gen. Div.); aff'd (1996), 33 C.C.L.I. (2d) 165 (Ont. C.A.).
[5] Lumbermens' Factum at para. 25.
[6] *B.C. Master Blasters Inc. v. Aviva Insurance Co. of Canada* (2006), 62 B.C.L.R. (4th) 324 at para. 32 (S.C.).

[41] Lumbermens takes issue with PCL's request to retain its own counsel and receive indemnification for those costs from Lumbermens. There are usually two different counsel engaged by the insurer: coverage counsel and tort counsel. Moreover, Lumbermens says the insurer denied coverage only because it received legal advice telling the insurer no coverage was warranted under these circumstances. As such, there is no evidence that they prejudged the situation.

[42] Lumbermens claims that although the counsel they choose will act on behalf of the insured, counsel will also report to the insurer.

[43] These facts, says Lumbermens, distinguish the facts in this case from those in the cases cited by PCL. Lumbermens claims that on the facts of this case, there is no reason to take away the insurer's right to appoint counsel (as provided for in the policy) while requiring the insurer to pay for legal costs incurred to defend the action.

PART VI: LEGAL ANALYSIS AND CONCLUSIONS RE COVERAGE

Insurance Interpretation Principles Applicable In This Case

[44] The duty to defend is triggered by the mere possibility that the claims are covered by the policy.[7] The duty to defend therefore arises if the Statement of Claim can be interpreted to plead facts that might fall within the policy coverage.[8]

[45] Coverage provisions in insurance policies are to be interpreted broadly in favour of the insured while exclusions are interpreted strictly and narrowly against the insurer.[9]

[46] The onus is on the insured to establish that the allegations made by the plaintiff, if proved, bring the claim within the scope of the policy. The onus then shifts to the insurer to show that the claim falls outside the policy coverage because of an exclusion to the policy.[10] If there is an exception to the exclusion, the insured must establish that the exception applies.[11]

[47] In *Alie*[12] the Ontario Court of Appeal held that,

> CGL policies are generally intended to cover an insured's tortious liability to third parties, but not including the cost of repairing or replacing the insured's own defective work or product. This intent is manifest by the language usually found in CGL policies and the interpretation generally given by the courts to such policies.

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[7] *Nichols v. American Home Assurance Co.*, [1990] 1 S.C.R. 801 at para. 17.
[8] *Scalera*, *supra* note 2 at para. 74.
[9] See *Amos v. Insurance Corp. of British Columbia*, [1995] 3 S.C.R. 405 at para. 16.
[10] *Trafalgar Insurance Co. v. Imperial Oil Ltd.*, [2001] O.J. No. 4936 at para. 18 (C.A.), Osborne A.C.J.O..
[11] *Ibid.*
[12] *Alie v. Bertrand & Frere Construction Co.* (2003), 222 D.L.R. (4th) 687 at para. 27 (Ont. C.A.).

[48] The Court in *Alie* went on to cite the justification for this conclusion in *Privest*:[13]

> If the insurance proceeds could be used to pay for the repairing or replacing of defective work and products, a contractor or subcontractor could receive initial payment for its work and then receive further payment from the insurer to repair or replace it. Equally repugnant on policy grounds is the notion that the presence of insurance obviates the obligation to perform the job initially in a good and workmanlike manner.

[49] However, in the later decision of *Bridgewood*,[14] the Ontario Court of Appeal determined that while the general principle is that a CGL policy is not intended to be a means for a contractor to cover the expenses incurred to repair its own defective workmanship, "the judge was obliged to decide the issue not upon general insurance principles nor upon the general nature of the policies, but upon the exact terms of the insurance policies themselves." The Court further held that the general principle that a CGL policy precludes coverage of an insured's own defective work, "constitutes an interpretative aid that can be helpful, though not decisive, when interpreting particular provisions of a CGL policy in an effort to determine the scope and extent of the risks that the insurer has agreed to cover."

[50] Thus, although the general principle serves as an interpretive aid, determination of the coverage must be made by examining the wording in the Policy.

[51] The parties agree that the policy provides coverage for property damage caused by an occurrence. It is clear that at least a substantial portion of the claim falls within the insuring agreement. The issue is the effect of Exclusions 5 and 6.

Analysis of the Provisions and Conclusion

[52] The insuring agreement provides the insurer will pay those sums that the insured becomes legally obligated to pay as compensatory damages because of "property damage" which occurs during the policy period.

[53] Consequently there is coverage under the insuring agreement for all of the damages because of property damage which occurred before the termination of the Policy term. This clearly includes at least a substantial portion of the Claim including damage to the roof membrane itself that occurred during work on the property and any other damage which occurred to the roof system until the termination of the Policy term.

[54] The issue is whether the Exclusions exclude coverage.

[55] Exclusion h.5 provides that,

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[13] *Privest Properties Ltd. v. Foundation Co. of Canada Ltd.* (1992), 57 B.C.L.R. (2d) 88 at 131 (S.C.).
[14] *Bridgewood Building Corp. v. Lombard General Insurance Co.* (2006), 79 O.R. (3d) 494 (C.A.), leave to appeal to S.C.C. refused, [2006] S.C.C.A. No. 204.

> This insurance does not apply to,
>
> 3. Property damage to:
>
> Real property on which you or any contractor or subcontractor working directly or indirectly on your behalf is performing operations, if the "property damage" arises out of those operations:

[56] In *Harvey Oil Ltd.*[15] Barry J. interpreted the words "is performing operations" found in the exclusion clause of a CGL insurance policy to mean that the exclusion is confined to property damage that arises while the policyholder is performing operations.

[57] The exclusion excludes property damage to the building on which the insured is working which indicates that it excludes the damage caused during the work but not that which occurs after the "operations" are complete. As such Exclusion 5 may exclude the cost of repairing the damage to the membrane caused during the work but not the resulting property damage which occurred after the "operations" are complete.

Exclusion h.6 to the Insuring Agreement

[58] Exclusion 6 of the Policy provides that,

> This insurance does not apply to,
>
> 3. Property damage to:
>
> 6. Real property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

[59] "Your work" is defined in the policy as "work or operations performed by you or on your behalf; and materials, parts or equipment furnished in connection with such work or operations. [It] includes warranties or representations made at any time with respect to the fitness, quality, durability, or performance of any of the items included in a. or b. above."

[60] Exclusion h.6 excludes the cost of repairing the building which must be repaired because of the insured's defective work on that building. It appears that Exclusion h.6 is consistent with the intent reflected in the reasons of the Court of Appeal in *Alie* which are referred to in paragraphs 48 and 49 above.

[61] By deleting Exclusion h (which includes Exclusions 5 and 6) and replacing it with the Amending Endorsement which appears at page 30 of the Record, the effect is to broaden Exclusions 5 and 6. The earlier exclusion was limited to that "*particular part of* any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it." It

[15] 7 C.C.L.I. (4th) at paras. 51-53, Barry J. (Nfld. T.D.), aff'd 2004 N.J. No. 47 (C.A.) (Q.L.)

appears that the exclusion excludes property damage to the building because the insured's work was incorrectly performed on the building.

[62] The exclusion seems to exclude all of the claims, subject to the exception.

Exception to Exclusion 6

[63] The Endorsement provides that Exclusion h.6 does not apply to property damage included in the "products-completed operations hazard."

[64] The "products-completed operations hazard" reads as follows:

> 9.a. The Products-Completed Operations Hazard includes all …property damage occurring away from premises you own or rent or arising out of "your product" or "your work" except:
>
> 1) Products that are still in your physical possession; or
>
> 2) Work that has not yet been completed or abandoned.
>
> "Your work" will be deemed completed at the earliest of the following times:
>
> 1) When all of the work called for in your contract has been completed.
>
> 2) When all of the work to be done at the site has been completed if your contract calls for work at more than one site.
>
> 3) When that part of work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.
>
> 4) Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as completed."

[65] The policy period for Exception to Exclusion 6 was extended to September 1, 2004.[16]

[66] The effect of Exclusion h.6 is to deny coverage for property damage to real property that must be restored, repaired or replaced because "your work" was incorrectly performed on it.

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[16] Coverage for "Products and Completed Operations Hazard" was "extended for a period of 24 months after the expiration dated as noted in the declaration pages attached to and forming part of this policy." The Coverage Part Declarations provide that the policy period is from May 1, 1999 to September 1, 2002.

However, Exception to Exclusion 6 includes all property damage arising out of "your work" except work that has not yet been completed.

[67] The effect of the Exception to Exclusion 6 is to restrict Exclusion h.6 by restricting the "property damage" excluded to property damage which arises out of the insured's own work before all of the insured's work provided for in the contract, has been completed.

[68] Here the claim is for property damage to the building that must be repaired because "your work" was incorrectly performed on it. The work was complete by the time the damage came to the attention of l'Hôpital in 2003. The property damage to the roof membrane arose before the work was complete but property damage to the sub-roof may have arisen after the contract was complete. If the property damage arose out of work that had not yet been completed, coverage may be excluded but if it arose after the work was complete, then it may not be excluded.

[69] The effect of Exclusion h.6 after taking into account Exception to Exclusion 6, is that it excludes property damage to the building that must be restored, repaired or replaced because the insured's work was incorrectly performed on it, but only if such property damage occurred before the work was completed or abandoned. If the property damage occurs after the work is completed or abandoned, the exclusion does not apply and coverage turns on the other terms of the Policy.

Summary of Conclusions re Coverage

[70] The effect of the Insuring Agreement and Exclusions h. 5 and h. 6, including the Exception to Exclusion h.6, is that there may be coverage for the claims alleged subject to the following:

- There is no coverage for damages that occurred outside the policy period due to the term of the insuring agreement.

- Pursuant to Exclusion h.5, "there is no coverage for damage caused to the building on which the insured, or its sub-contractor …., was performing operations where the damage occurred at the time of such operations and arose out of them." This may exclude damages for the repair of the roof membrane itself but not damages resulting from damage to the membrane.

- Pursuant to Exclusion h.6, there is no coverage for property damage to that particular part of the building that must be restored, repaired or replaced because "your work" was incorrectly performed on it but only if such property damage occurred before the work is completed or abandoned. On the basis of the plaintiff's claims, this would exclude the claim for property damage which occurred before the insured's work was completed but not the property damage which occurred after the insured completed his work.

[71] While this means that portions of the claim against the insured may not be covered, damages to the building other than to the membrane which occurred during the policy period may be covered. Lumbermens therefore has a duty to defend the action against PCL.

PART VIII: WHETHER PCL SHOULD BE ENTITLED TO SELECT COUNSEL OF CHOICE AND RECEIVE INDEMNIFICATION FROM THE INSURER

[72] The Policy provides that the insurer has the right and duty to defend a claim and "may investigate and settle any claim or "action" at our discretion." Thus upon a finding that some or all of the claims against the insured may be covered, the insurer has the obligation and the right to control the defence. The insurer must pay the cost of the defence and the covered portion of any resulting judgment on behalf of the insured.

[73] In some circumstances an insured may be concerned that in controlling the defence an insurer may prejudice the insured. Where there is a conflict of interest between the insurer and insured, the insured may not wish to allow the insurer to exercise its rights under the contract fearing that in exercising such powers the insurer may prefer its own interest to that of the insured.

[74] In the face of such concerns, the courts have on occasion determined that the insured should be entitled to select its counsel at the insurer's expense and that such counsel will be instructed exclusively by the insured. While this responds to the insured's concern, it creates a similar concern on the part of the insurer. The insurer may be prejudiced by the conduct of the defence in these circumstances and the insurer's contractual right to control the defence and to settle would be denied.

[75] The Courts must seek to strike a balance in these 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. There must be a reasonable apprehension that if counsel were to act for both the insurer and the insured in defending the action, counsel would be in conflict of interest.[17]

[76] In *Brockton (Municipality) v. Frank Cowan Co.*[18] Goudge J.A. for the Court described the dilemma as follows:

> 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

[17] *Brockton (Municipality) v. Frank Cowan Co.* (2002), 57 O.R. (3d) 447, Goudge J.A. (C.A.) [*Brockton*]; *Zurich of Canada v. Renaud & Jacob*, [1996] R.J.Q. 2160 at 2168, Lebel J.A. (Que. C.A.) [*Zurich*]; *Appin Realty Corp. v. Economical Mutual Insurance Co.* (2008), 89 O.R. (3d) 654 at paras. 8-14 (C.A.).

[18] *Brockton, ibid.* at para. 42.

> 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. …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.
>
> In speaking of the insured and the insurer, D.S. Ferguson (now Ferguson J.) put it this way in "*Conflict Between Insured and Insurer: An Analysis of Recent Canadian Cases*", (1990) 12 Advocates' Quarterly 129 at 142-43.
>
> > It is important to recognize what the two parties have not agreed to. They have not agreed, unless the policy says so, that the insurer will provide free counsel to the insured to protect his separate interest whether to defend himself against uninsured claims, or to consider his position with respect to claims in excess of limits, or to protect his interest in any dispute with the insurer. Conversely, they have not agreed that the insurer will be able to instruct defence counsel to act to the prejudice of the insured's rights [footnotes omitted].

[77] In the earlier decision of *Uniroyal Chemical Ltd.,*[19] relied on by the Applicant, Blair J.(as he then was) held that the concept of conflict should be liberally construed and "should not be subjected to the sort of fine dissection in which courts and counsel sometimes like to revel." In that case, the insurer was ordered to defend the insured while the insured was granted the right to control the defence.[20]

[78] However, Blair J. recognized that:

> Just as the insured may feel uncomfortable with the protection of its interests being left to the insured, if it is not allowed to intervene in the action, I don't think it is fair to the insurer that it should be put in this position simply because the insured exercises its right not to sign a non-waiver agreement. To allude to one of Mr. McNeil's submissions again, "those who are being asked to pay should be entitled to participate."

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[19] *Uniroyal Chemical Ltd. v. Kansa General Insurance Co*., [1992] O.J. No. 4003 (Gen. Div.)., aff'd on appeal though the issue of the insurer's obligation to pay for the insured's choice of legal counsel was not in issue.

[20] On the basis of the authorities provided to him at the time, Blair J. held that the actions of the insurer were "sufficient to create the kind of 'appearance of impropriety' referred to in the authorities cited." The Court of Appeal in *Brockton*, *supra* note 19 at para. 38 has since held that the "'appearance of impropriety' carries a vagueness which would make it difficult to apply with consistency and therefore unwise to adopt."

[79] Accordingly, he granted the insurer the right to intervene as an added party defendant for the purposes of protecting its position with respect to the coverage issues.

[80] In order to remove the insurer's contractual right to "defend and control the defence of the litigation," there should exist both a conflict of interest and a reasonable apprehension that the insurer may abuse its right to defend and settle to the prejudice of the insured.

[81] In this case, the insurance policy provides that the insurer has a "duty and right to defend and control the defence of the litigation." The insurer may "investigate or settle any action at our discretion." [21]

[82] Counsel should therefore have the confidence of the insurer who is obliged 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 obligation to defend the action on behalf of the insured. This is of particular concern in a case such as this, where the insurer has denied coverage.

[83] The mere fact that an insurer has questioned coverage should not in itself require the court to order that the insured can exclusively choose and instruct counsel at the insurer's expense given the contractual provisions and the duty of counsel appointed by the insurer to fairly ensure the defence of the insured and fully protect its interests. The potential tension between insurer and insured is inherent in both the structure of liability insurance policies and in the separate and different obligations of the insurer to defend and indemnify.[22] In cases where an insurer has reserved its rights on coverage, the courts have found that this does not cause the insurer to lose its right to control the defence and appoint counsel.[23]

[84] Thus, for the reasons set out above, the insurer has a duty to defend these claims and may be obligated to indemnify the insured against a portion of the claim. It also appears that some portions of the claim may be covered and others not and both the insurer and insured have an interest in defending the action. Both will seek to prove that the insured is not liable for the damage or that the damages claimed are excessive. As such there is no conflict of interest in this regard.

[85] It is reasonable to conclude that defence counsel retained by the insurer will be instructed to contest the insured's liability on the basis that it did nothing wrong and that in any event, the damages claimed are excessive.

[86] In order for there to be a conflict of interest based on instructions to counsel, one would have to speculate that the party instructing counsel, whether it be the insurer or insured, decides to instruct counsel to present the defence on the basis that any liability is on the basis of an insured or uninsured risk in order to advance the instructing party's interest on coverage.

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[21] Sections 1. A. 1. and 2 of the Insurance policy.
[22] *Brockton*, *supra* note 19 at para. 40.
[23] *Zurich*, *supra* note 19 at 2168, cited with approval in *Brockton*, *ibid.*

[87] On the facts of this case there does not appear to be a sufficient air of reality to such speculation to require the insurer's right to defend and settle to be removed. This is not the sort of situation where a party acting improperly could mischaracterize the insured's conduct so as to take a claim into or out of coverage. Rather, if there is a coverage issue, at the end of the day the core of the coverage issue is likely to be with respect to the interpretation of the policy.

[88] There is no evidence that this is the case or that there is any reason to doubt that appropriate defence counsel, who will have a professional ethical obligation to defend the insured properly, will not conduct the defence in the best interests of the insured.

[89] Having said that, given part of the claim may be covered by the policy and part not, the party not having control of the defence may have a legitimate concern about the conduct of the defence. In this case, steps can be taken to lessen the concerns and provide meaningful protection to the party not having control of the defence.

[90] 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.

[91] Moreover, defence counsel should not have a close connection to either the insurer or the claim, and the insurer's personnel handling carriage of the defence of the claim should be different from personnel handling the coverage issue.

[92] While there is no ideal solution in cases such as this, the insured did set out an alternative request for relief for the first time in his factum. I agree with this order requested by the insured that Lumbermens "pay for the defence of PCL in the Action by paying the professional fees and disbursements that will be billed by defence counsel mutually agreeable to PCL and Lumbermens."[24]

[93] Unless the parties agree otherwise, legal counsel selected:

a) must be different from counsel who argued coverage;

b) must be counsel who has not acted for either party in the past five years, such that there is no appearance of conflict of interest;

c) must have no discussions about the case with coverage counsel; and

d) will provide identical concurrent reporting to both the insurer and the insured.

[94] Moreover, the claim is to be assigned to claims staff within the insurer who have had nothing to do with this claim up until this point, and who will have no communication with any

[24] Factum filed on behalf of PCL Constructors Canada at para. 31(ii).

person who has had dealings with this claim. New claims staff is to have access to the claims file only once it has been purged of any consideration of coverage.

[95] This order will be without prejudice to the parties' right to seek a further order from this Court should they be unable to find mutually agreeable defence counsel, or should there be evidence that indicates that these provisions do not in fact adequately protect the rights of the insured or the insurer.

[96] On the basis of the evidence before me, I believe that the above conditions will provide sufficient protection for the insured without unduly undermining the legitimate interests of the insurer.

[97] For the above reasons, the Applicant's request for a declaration and order that Lumbermens must provide a defence of PCL in the action brought by application l'Hôpital is granted. The Applicant's request for an order requiring Lumbermens to provide a defence to PCL in the Action by paying the professional fees and disbursements that will be billed by PCL's defence counsel in the defence of the Action is denied.[25]

PART IX: COSTS

[98] If the parties cannot agree on costs, they may file brief written submissions no more than three pages long and a Bill of Costs within two weeks.

THORBURN J.

RELEASED: June 25, 2009

[25] The relief addresses is the relief sought in the Notice of Application not the relief sought in the factum as no submissions were made about any changes to the relief sought in oral submissions.