To Defend or Not To Defend: That is the Question!

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What is the scope of an insurer's obligation to defend its insured in the context of civil or professional liability proceedings, if the insurance policy only covers part of the acts or omissions alleged in the proceedings?

The Québec Court of Appeal answered this question in a judgment rendered on April 29, 2008 in the matter of *Groupe DMR Inc. v. Kansa General International Insurance Company Ltd.*[1]

The Facts

Group DMR Inc. ("DMR"), a company specializing in computer technology, was hired in 1985 by Groupe Promutuel ("PROMUTUEL") to implement various computer systems. DMR was insured under a professional liability insurance policy issued by KANSA. The project could not be completed in the timeframe or at the cost originally contemplated due to DMR's lack of familiarity with the insurance sector and PROMUTUEL's lack of familiarity with the computing sector. In September 1987, PROMUTUEL terminated the contract. DMR then claimed $1,553,367 from PROMUTUEL for breach of contract and unpaid fees. In February 1988, PROMUTUEL claimed damages of more than $4,000,000 from DMR.

KANSA assumed the defence of DMR, but reserved the right to withdraw if the investigation revealed the absence of coverage. In the spring of 1993, after PROMUTUEL amended its declaration, KANSA ceased to defend DMR on the ground that the facts alleged were not covered. DMR then instituted an action in warranty against KANSA, alleging that its withdrawal constituted an unjustified, unlawful and abusive decision. As for KANSA, it initiated winding-up proceedings under the *Winding-up and Restructuring Act* (the "Act"). In April 1999, PROMUTUEL and DMR arrived at a settlement, after KANSA had refused to participate in the discussions. On March 15, 2000, DMR filed a motion under section 135 of the Act, estimating its claim against KANSA at $4,271,033, namely, the reimbursement of the amount paid to PROMUTUEL ($1,500,000), the fees incurred to defend itself and damages for unjustified refusal.

The Judgment at First Instance

On August 5, 2004, the Superior Court dismissed DMR's motion and allowed KANSA's contestation. The judge stated that DMR had not committed a professional fault and that KANSA had therefore not been required to assume its defence.

Subsidiarily, the judge added that DMR was not entitled to reimbursement of the $1,500,000 paid to PROMUTUEL, because this payment had been made without KANSA's approval, such that the transaction could not be set up against KANSA by reason of the provisions of article 2504 of the Civil Code of Québec and of the policy.

The Judgment of the Court of Appeal

A) The Insurer's Obligation to Defend

The Court first pointed out that there is a distinction between the obligation to defend and the obligation to indemnify. With respect to the obligation to defend, the Court stated: [TRANSLATION] *"In fact, it arises from the mere possibility, which results prima facie from the allegations in the principal action and in the exhibits alleged in support thereof, that the insurance policy covers the alleged acts or omissions, while the obligation to indemnify is triggered only if the alleged acts or omissions are proven during the trial on the merits."* Four situations may then arise:

1° The claim seems to be totally covered by the policy. In such a case, the insurer must defend its insured, without the possibility of a recourse against the insured if the facts alleged are subsequently not proven.

2° It is clear that the alleged facts do not fall under the insurance coverage. In such a case, the insurer cannot be forced to defend its insured. If, subsequently, the facts introduced into evidence raise the possibility of coverage, the insured may once again ask the insurer to assume its defence, unless it prefers to proceed by way of an action in warranty or a recursory action against the insurer for the costs incurred in its own defence.

3° It is impossible to determine whether or not the claim is covered by the policy. In such a case, the insurer will have to defend its insured, because, at this stage, the mere possibility that the claim is covered is sufficient. However, the subsequent discovery of facts resulting in the exclusion of coverage could terminate the obligation to defend.

4° Part of the claim is covered, while another part clearly is not covered. In such a case, the insurer has the obligation to defend only with respect to the claim that is covered, and the insured must see to its own interests as regards the rest. If the insurer accepts, without prejudice, to defend the entire matter, the costs of the defence will be shared between the insurer and the insured, because the lawyer will be acting under two separate mandates. However, the insured will also have the right to designate its own lawyer for the portion that is not covered, and this lawyer will act as counsel. Nonetheless, it will be necessary to avoid creating an additional burden on the opposing party.

B) The Effect Against an Insurer of a Transaction Entered Into Without Its Consent

The Court of Appeal declared that if an insurer refuses to participate in discussions after having been invited to do so, it cannot subsequently complain about a settlement entered into by the parties, insofar as the settlement is reasonable.

In practical terms, in the case at bar, the Court of Appeal ruled that the portion of the claim that was covered represented 28% of the entire settlement, such that it determined that the insurer was required to assume 28% of the costs of the defence.

[1] C.A. Montréal, 500-09-014829-048, 2008 QCCA 807, AZ-50488250.