Articles

The insurer's duty of good faith and fair dealing

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I. INTRODUCTION

A typical automobile insurance policy requires the insurer to both indemnify its insured for liability to pay damages arising out of the use or operation of a motor vehicle and to defend third party actions against its insured. The policy will give the insurer exclusive control of the conduct of the defence, including the power to appoint and instruct counsel and to compromise or settle the action.

Conflicts between the interests of the insurer and its insured arise in cases where the claim has the potential to exceed the policy limits. The insurer wants to minimize the amount paid under the policy, while the insured wants to avoid any personal exposure to pay a judgment in excess of the policy limits. The insurer's exclusive power to settle can entice the insurer to gamble with the assets of its insured. Can the insurer gamble with impunity or does the law impose an *affirmative* duty on the insurer to settle for the policy limits where an excess judgment is likely?

Mr. Justice Finch answered this question in *Shea v. Manitoba Public Insurance Corp.*[1] where he concluded that the insurer's exclusive power to settle imposes a duty of "good faith and fair dealing" in relation to its insured and requires the insurer to use reasonable efforts to settle within policy limits. He stated:[2]

> 298...Those reasonable efforts include affirmative attempts to settle, and where a finding of liability is highly probable, and where the judgment to be awarded will probably exceed the policy limits, include the affirmative duty to offer to pay the third party liability policy limits in exchange for a release of its insureds.

This paper will review the Canadian cases prior to Shea that first considered the issue of the insurer's obligation to its insured to settle for the policy limits. The paper will then canvass the following issues raised by Mr. Justice Finch in *Shea*:

1. The decision in *Fredrikson v. Insurance Corp of British Columbia*
2. The nature of the relationship between the insurer and the insured.
3. The insurer's affirmative duty to initiate settlement discussions.
4. The insurer's vicarious liability for negligence of defence counsel.
5. Assignment of the action by the insured.
6. Impecuniosity of the insured.
7. Does equity require indemnity from the insurer?
8. Punitive damages.

II. THE LEGISLATIVE SCHEME

The insurer's duty to its insured arises from the provisions of the automobile insurance policy or government regulations that give the insurer the exclusive right to defend and settle actions brought against the insured. In British Columbia, the Insurance Corporation of British Columbia ("ICBC") is the primary motor vehicle insurer for residents of the province and derives it powers from the *Insurance (Motor Vehicle) Act.*[3] The source of its duties is contained in the regulations passed under that legislation, which express the statutory scheme of insurance. The exclusive right to defend and settle actions brought against an insured is set out in sections 74 and 74.1 of the Regulations, which provide:

> **Duties of corporation**
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> 74 On receipt of notice of a claim for damages brought against an insured for which indemnity is provided under this Part and subject to an act or omission by the insured entitling the corporation to raise any question as to whether or not the insured is entitled to indemnity, the corporation, at its expense, shall
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> (a) assist the insured by investigating and negotiating a settlement, where in the corporation's opinion its assistance is necessary, and
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> (b) defend in the name of the insured any action for damages brought against the insured.
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> **Rights of corporation**
>
> 74.1 Upon assuming the defence of an action for damages brought against an insured, the **corporation shall have exclusive conduct and control of the defence of the action** and, without limiting the generality of the foregoing, **the corporation shall be entitled to**
>
> (a) appoint and instruct counsel to defend the action,
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> (b) admit liability, in whole or in part, on behalf of the insured,
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> (c) participate in any non-judicial process which has as its goal the resolution of a claim, and
>
> (d) **compromise or settle the action.**

III. THE INSURER'S DUTY OF GOOD FAITH AND FAIR DEALING

Where there is a potential judgment in excess of the policy limits, the discretionary power of the insurer to settle or try the action places the insured in a vulnerable position. Professor Brown in his text, *Insurance Law in Canada*, suggested that in these circumstances the insurer has a duty of good faith and is required to consider the interests of its insured in deciding on the appropriate course of action:[4]

> This 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. This means that when the person bringing the lawsuit makes a settlement offer within the policy limits, the insurer may not reject it without taking into account it's customer's interests. Remember, if in the normal course, a case is allowed to go to judgment, and the court awards the person bringing the action damages in excess of the policy limits, the customer has to pay the extra amount personally. It is therefore in the customer's interest that a settlement offer within the policy limits be accepted. **But the insurer may consider it to be in its own interest to let the matter go to court, calculating that the case is winnable by the defence. An insurer must resolve this dilemma with care. If it guessed wrong and loses the case and the damages exceed the policy limits, it may have to pay the full amount despite the limits.** The test to be used is whether the insurer gave at least equal consideration to the customer's interest as it did its own interest. In practice insurers seek to meet this standard by obtaining

independent legal advice on whether a case is winnable or what damages are likely to be awarded. [emphasis added]

If the insurer unreasonably refuses to settle for the policy limits it is gambling with the assets of its insured. If the insurer guesses wrong, the insured faces bankruptcy, whereas the insurer is only exposed to the additional costs of defending the action. Would the insurer be as likely to gamble and reject a policy limits offer if it knew that it might be required to pay an excess judgment?

IV. CANADIAN CASE LAW

In the United States it is well established that an insurer can be liable to its insured for unreasonably failing to settle for the policy limits. The cause of action has been referred to as "bad faith refusal to settle." In Canada there are only a handful of cases that have considered the nature and scope of the insurer's duty to settle for the policy limits.

A. *Pelky v. Hudson Bay Insurance Co.*[5]

The issue of the insurer's unreasonable refusal to settle was first considered in *Pelky v. Hudson Bay Insurance Co.* The action arose out of a prior action in which two plaintiffs were seriously injured when the driver lost control of the vehicle in which they were riding as passengers. The plaintiffs offered to settle the case before trial for the policy limits of $50,000. The solicitor representing the driver and owner ("insureds") failed to communicate the offer to settle to the insurer or to advise the insureds of the possible consequences of failing to settle. The case went to trial and judgment was obtained for $149,060. The insureds had no assets and were unable to pay the excess judgment. They sued both their insurer and the solicitor alleging breach of contract and negligence for failing to settle the action within the policy limits.

The court made the following observations with regard to the duty of the insurer in cases where the judgment exceeds the policy limits:[6]

> 86 In argument, counsel addressed submissions to me on the legal duty of an insurer to accept a settlement offer within the limits of its policy in the circumstances of the case at bar. Mr. Crane's submission was that Royal was in breach of a duty it owed to Pelky and Fortes, either in contract or in tort, to consider reasonably and to accept an offer of settlement within its policy limits and not to expose Pelky and Fortes to the very real and foreseeable risk of judgments for amounts substantially in excess of such limits.
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> 87 It is common ground that there is no precedent in Canada or in England dealing with the situation, and that the Court may in such circumstances properly look to American authorities for guidance: *Cory & Sons v. Burr* (1882), 9 Q.B.D. 463; *Kiefer v. Phoenix Insuran. Co.* (1901), 31 S.C.R. 144 *Kiefer v. Phoenix Insurance Co.* (sub nom. *Keefer v. Phoenix Insurance Co. of Hartford*) (1901), 31 S.C.R. 144.
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> 88 I was, accordingly, referred to a number of American cases dealing with the liability of an insurer in such circumstances, illustrative of which is *Crisci v. Security Ins. Co. of New Haven, Connecticut*, 58 Cal. R. 13 (1967), a decision of the Supreme Court of California, in Bankruptcy. The following appears at p. 16 of that report:
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> > The liability of an insurer in excess of its policy limits for failure to accept a settlement offer within those limits was considered by this court in *Comunale v. Traders & General Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198, 68 A.L.R. 2d 883. It was there reasoned that in every contract, including policies of insurance, there is an implied covenant of good faith and fair dealing that neither party will do anything which will injure the right of the other to receive the benefits of the agreement; that it is common knowledge that one of the usual methods by which an insured receives protection under a liability insurance policy is by settlement of claims without litigation; that the implied obligation of good faith and fair dealing requires the insurer to settle in an appropriate case although the express terms of the policy do not impose the duty; that in determining whether to settle the insurer must give the interests of the insured at least as much consideration as it gives to its own interests; and that when "there is great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a consideration in good faith of the insured's interest requires the insurer to settle the claim." (50 Cal. 2d at p. 659, 328 P.2d at p. 201).
> >
> > [1] In determining whether an insurer has given consideration to the interests of the insured. the test is whether a prudent insurer without policy limits would have accepted the settlement offer.
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> 89 Mr. Fitzpatrick confirmed the absence of any but American authority on the subject, and agreed that the appropriate test was that stated in the last paragraph quoted above.
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> 90 In the view which I take of this matter, it is not necessary for me to rely upon the American jurisprudence in order to impose liability in the circumstances of this action, but I record, lest it be thought that I had overlooked it, Mr. Brown's able submission that there is not only one line of American authority on this subject, but rather three different lines of authority, namely, the "negligence approach", the "good faith/bad faith approach", and a third approach which is a combination of both negligence and good faith/bad faith.

The court held that the solicitor assumed the mantle of counsel with respect to the insureds, and owed them a duty to settle the actions at a minimum exposure to them. The solicitor was negligent in failing to communicate the offer and in proceeding to trial without instructions. The solicitor was acting as agent for the insurer, and accordingly the insurer was vicariously liable to indemnify the defendants for any sums, including costs that they were obliged to pay pursuant to the judgment.

B. *Dillon v. Guardian Insurance Company Limited*[7]

Two years later another decision of the Ontario High Court became the first Canadian case to apply the American cause of action for "bad faith refusal to settle". In *Dillon v. Guardian Insurance Company Limited*, the insurer refused an offer to settle a motor vehicle liability action within the policy limits of $50,000. Prior to trial, the plaintiff offered to settle for $45,000. The insurer refused the offer and would not agree to pay more than $40,000. At trial, the plaintiff was awarded $77,959.95. The insured sued his insurer and the lawyer acting for him. The insurer then brought a third party action against the lawyer. The Court held that the insurer did not use reasonable care for the protection of its insured and was for that reason guilty of bad faith. Both actions against the lawyer were dismissed. Mr. Justice Fitzpatrick

considered the nature of the standard to be applied in deciding whether the insurer failed in its duty to its insured:[8]

> 4 I am not aware of any Canadian jurisprudence with respect to the standard to be applied to the conduct of the insurer. At one time there appeared to be three standards in the United States: 1. absolute liability; 2. liability for failing to act reasonably; 3. liability for bad faith. There is presently a widely held view in that country that the second two standards for determining liability have merged. If an insurer does not use reasonable care in settling a claim against its insured, that want of care is a want of good faith. The standard of absolute liability is that if an insurer can settle a claim against an insured within its limits and does not do so, it is liable to reimburse its insured for whatever claim goes against him.
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> 5 Some reasons for that position are given in Crisci v. Security Ins. Co. of New Haven, Connecticut, which is reported at (1967), 426 P.2d 173. They are as follows:
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> > Amicus Curiae argues that, whenever an insurer receives an offer to settle within the policy limits and rejects it, the insurer should be liable in every case for the amount of any final judgment whether or not within the policy limits.
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> > The proposed rule is a simple one to apply and avoids the burdens of a determination whether a settlement offer within the policy limits was reasonable. The proposed rule would also eliminate the danger that an insurer, faced with a settlement offer at or near the policy limits, will reject it and gamble with the insured's money to further its own interests.
> >
> > Finally, and most importantly, there is more than a small amount of elementary justice in a rule that would require that, in this situation where the insurer's and insured's interests necessarily conflict, the insurer, which may reap the benefits of its determination not to settle, should also suffer the detriments of its decision.
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> 6 I find them persuasive, but I do not have to decide what the standard is here, because in this case the Guardian is liable by any standard. Mr. Longum testified that just before the trial he believed the probable general damages of Bertrand to be $35,000, and the specials had been agreed upon at $7,959.95
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> 7 There is some conflict in the evidence with respect to the figure for which the Guardian could have settled. I am satisfied that all who have testified as to this were doing so to the best of their recollections, and I find that the Guardian could have settled for 45,000 or $46,000, which was the evidence given by both Mr. Evans, who had been counsel for the Jacques, and by Mr. Perras, who had been acting for Mr. Dillon with respect to the amount by which the claim of the Jacques exceeded Mr. Dillon's insurance; in other words, the Guardian could have settled for 2,000 or $3,000 more than Mr. Longum believed the probable damages to be.
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> 8 Mr. Longum testified that he believed there was some chance of Dillon succeeding on liability. He had been advised, however, by Mr. Inch, that there was no real chance of Mr. Dillon discharging the onus, and as Bertrand Jacques was only five years old, there was no chance of a finding of contributory negligence. The overwhelming probability, therefore, was that Mr. Dillon would be found to be 100 per cent at fault.
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> 9 I would have assessed Bertrand Jacques' general damages at well above $35,000, and Mr. Justice O'Driscoll, who tried the case, assessed them at $70,000. The Court of Appeal did not see fit to change that. I find that Guardian, in refusing to pay more than $40,000 to settle the action, did not use reasonable care for the protection of its insured, Mr. Dillon, and is for that reason guilty of bad faith.

The Ontario High Court in *Dillon* held that the defendant insurer was liable for the excess judgment under any of the standards for determining "bad faith", and as such it was unnecessary to decide which standard to apply.

Both *Pelky* and *Dhillon* are examples of cases where the court was looking for a remedy to alleviate the hardship to the insured by the insurer's unreasonable refusal to settle for the policy limits. There was no detailed analysis of the American authorities dealing with nature of the insurer's duty to its insured as the Judge in each case was more than satisfied that the conduct of the insurer was so egregious that it was liable regardless of what standard was employed.

C. *Fredrikson v. Insurance Corp. of British Columbia*[9]

In *Fredrikson v. Insurance Corp. of British Columbia*, ICBC insured Fredrikson to a limit of $500,000 plus interest and costs for any liability to pay damages arising out of the use and operation of a motor vehicle. Linda Nielsen sued Fredrikson for personal injury damages resulting from a collision between Fredrikson's vehicle and a freight train. Nielsen was originally a passenger in Fredrikson's vehicle and was driving the vehicle at the request of Fredrikson when the collision occurred. The trial proceeded before a jury on the issue of liability and the jury found Fredrikson 80 percent liable for the accident, likely on the basis of evidence that he knew that Nielsen had consumed some alcohol before allowing her to drive the vehicle. Fredrikson appealed liability. Prior to the separate trial on quantum of damages, Nielsen offered to settle the claim within the policy limits. ICBC refused to settle and the damages awarded were $1,100,000 or $600,000 in excess of the policy limits. The jury verdict on liability was upheld on appeal. Fredrikson then assigned to Nielsen his action against ICBC for negligence, breach of fiduciary duty, and bad faith refusal to settle.

Chief Justice Esson explored the nature of the duties owed by the insurer to its insured but did not find it necessary to decide the precise nature or scope of the duty. He held that regardless of the standard to be applied in determining whether an insurer can be held liable for an excess judgment, ICBC had discharged it's duty to Fredrikson by acting in a fair an open manner and by approaching the question of settlement as if it's own resources were at risk. He noted that prior to the trial even the insured Fredrickson did not want ICBC to settle with Nielsen.

While Esson C.J. declined to decide the specific standard to be applied in determining liability of the insurer for a judgment in excess of the policy limits, he did observe that an insurer was still required to consider the interests of the insured:[10]

> 113 That is not to say that liability insurers are under no obligation to consider the interests of their insured in deciding whether to settle. Where there is a potential for a judgment over the limits, the interests of the insured are significant. The insurer has assumed by contract the power of deciding whether to settle. Although, for the reasons which I have already stated, I would not find the insurer to be under a fiduciary duty in the strict sense applied in cases such as *Guerin*, it is clear that certain of the fundamental elements which give rise to fiduciary duty

are present in the relationship of insurer and insured. In the words of Dickson J. in the passage from *Guerin* quoted at p. 50 [pp. 331-32] one party "has an obligation to act for the benefit of" the other, and that obligation "carries with it a discretionary power". In the language of Lambert J.A. in *Burns v. Kelly Peters*, supra, at p. 25, the relationship is one in which the insured is "in a vulnerable position with respect to" the insurer. Those circumstances are a basis for holding that, 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 insured, and in a manner entailing, in some sense, an obligation of good faith. That obligation does not arise from a general doctrine that every contract includes a term of good faith and fair dealing, but rather from the particular circumstances of the class of transactions.

114 Insurance contracts are said to be contracts *uberrimae fides*. Although that language is often used in the most general way, the obligation of utmost good faith has historically been imposed only upon the insured at the point of formation of the contract. Because the material facts are entirely within the knowledge of the applicant for insurance, and because the insurer is therefore vulnerable to any concealment, the law imposes a duty of full disclosure. Because of the power reposed in the insurer by its control over the question whether to settle, and the potential vulnerability of the insured, there is a basis for imposing a somewhat analogous duty upon the insurer.

115 But what is the nature of that duty? This is not the appropriate case in which to seek to answer that question because, whatever the scope of the duty, it was met in this case by ICBC. It acted in a fair and open manner, it approached the question of settlement as if only its own resources were at risk, and it followed the course which its insured wished it to take. ICBC, which does not suggest that it was under no duty to Fredrikson, submits that the essence of the duty upon it was one of honesty. I think that may well be right. But even were I to apply the most "liberal" version of the various American doctrines, I would be unable to find a basis for holding ICBC liable.

D. *Shea* v. *Manitoba Public Insurance Corp.*[11]

The infant plaintiff, Jamie Shea, was seriously injured while riding as a passenger in a motor vehicle driven by his father and owned by his uncle. The accident occurred in British Columbia. The vehicle was licensed in Manitoba and insured by the defendant Manitoba Public Insurance Corporation (MPIC). The defendant father was an insured under a certificate issued by ICBC.

It became apparent to the MPIC that the plaintiff's damages would exceed the $300,000 limits on the defendant uncle's insurance policy. The plaintiff offered to settle for the third party policy limits, provided that it was without prejudice to the plaintiff's claims for no fault benefits and court order interest. However, MPIC insisted on a consent judgment for the policy limits of $300,000. The plaintiff would only agree to a consent judgment for an amount that was greater than the policy limits so that any deduction for no fault benefits would be made from the consent judgment and not from the lower policy limits of $300,000.

The action proceeded to trial and the plaintiff recovered judgment for $831,327 plus court order interest. The judgment was affirmed on appeal. MPIC paid the policy limits of $300,000 plus the court order interest. After credit was given for no fault benefits payable by ICBC, there still remained a substantial sum that remained owing on the judgment for which the insureds were liable. The insureds were impecunious and the plaintiff agreed to take an assignment of the insureds' claim against MPIC. The plaintiff commenced an action against the insurer claiming indemnity for the amount of the judgment in excess of the policy limits.

Finch J. extensively reviewed the literature dealing with the nature and scope of the insurer's duty to its insured to settle for the policy limit. Finch J. held that there was a duty of "good faith and fair dealing" required of an insurer in dealing with third party claims against its insured. In cases where there is a risk of an excess judgment, the insurer must give at least as much consideration to the interests of the insured as it does to its own interests and it must disclose all material information touching upon the insured's position in the litigation and settlement negotiations. **While Finch J. recognized the legitimate interest of the insurer to try to effect a saving on the policy limits if there existed a reasonable prospect of settling the claim for less (as in *Fredrikson*), the insurer has no legitimate interest in trying to settle a claim for less than the policy limits when it is clear (as in *Shea*) that the claim will exceed the available coverage.**

Finch J. held that the exclusive power to settle required that the insurer use reasonable efforts to settle within policy limits, particularly where there was no doubt that the judgment would exceed the policy limits. In such a case, there is an affirmative duty to offer to pay the policy limits in exchange for a release of its insureds. He held that MPIC failed to give adequate consideration to the interests of its insureds and was required to indemnify the insureds for the full amount of the excess judgment plus interest.

V. ISSUES ARISING IN *SHEA*

The following issues addressed by Mr. Justice Finch create the legal framework to succeed in an action against an insurer that has unreasonably exposed its insured to personal liability to pay an excess judgment.

A. The decision in *Fredrikson* v. *Insurance Corp. of British Columbia*

The only conflict of interest that arose in *Fredrikson* was the conflict inherent in a contract of third party liability insurance. Finch J. noted that there were additional conflicts between the interests of MPIC and its insureds in *Shea* that were not present in *Fredrikson*:[12]

> 166 Before leaving the *Fredrikson* case, I would make certain observations. There the Chief Justice was concerned only with the inherent conflict of interest between insured and insurer which is a necessary incident of a third party liability claim where there may or may not be a chance of settling for less than the policy limits. In such a case, as the Chief Justice points out at p. 332, the insurer has a legitimate interest in trying to effect a saving on the policy limit, if on the facts of the claim there is a reasonable prospect of settling for less than the limits.
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> 167 That is, of course, to be distinguished from the present case where the insurer and defence counsel recognized before trial that the judgment in the third party liability claim would "no doubt" exceed the policy limit. When there is no reasonable prospect of settling a tort claim for less than the limits of coverage, an insurer can have no legitimate interest in trying to do so.
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> 168 I would note also that in *Fredrikson* the only conflict of interest arose because of the conflict inherent in a contract of third party liability insurance. In this case there are other factors. In addition to its role as a liability insurer, MPIC also faced claims for court order interest and as an accident benefit insurer. In that sense it had only one

interest, namely, its own interest, in defeating or minimizing a potential liability to pay accident benefits, and defeating the claim for payment of court order interest in addition to the policy limits. Those are interests which it could properly assert, or defend, on its own behalf.

169 But in doing so, it took a position which was directly opposite to the interests of its insureds. To the extent that they faced potential liability for a claim in excess of the liability coverage, they had a direct and legitimate interest in minimizing the extent of that excess exposure by any lawful means. So it would have been very much in the insureds' interests to attempt to maximize the amount of accident benefits payable by MPIC and to see that those benefits were payable in addition to the third party liability coverage, since all accident benefits paid or payable were potentially deductible from the amount of any judgment against them.

If an excess judgment is likely, then the insurer is in direct conflict with its insured with regard to payment of the policy limits. In many cases there will be the additional conflict over the payment of accident benefits. As these benefits are potentially deductible from the tort judgment, the insured will want to maximize the payment of past and future benefits to avoid personal liability for an excess judgment. Conversely, the insurer will want to minimize such payments. Finch J. held that where it is probable that the judgment will exceed the policy limits, the insurer had a duty to minimize the exposure of the insured to pay damages, which included the obligation to pay accident benefits in addition to the policy limits. The insurer exacerbates the conflict when it retains the same lawyer to defend the claim for accident benefits that it appointed to defend the third party claim against the insured.

B. The nature of the relationship between the insurer and the insured

In reviewing the nature of the relationship between insurer and its insured, Finch J. decided against characterizing the insurer's duties as distinctly contractual, delictual or fiduciary in nature. Instead he examined the framework of the relationship between the insurer and the insured described in the legislation and applied common law principles to identify the nature and scope of the particular duties owed by the insurer. He summarized the relationship between the insurer and the insured as follows:[13]

203...an insurer may owe duties to its insureds which are fiduciary in nature, but that it is not a true fiduciary since the commercial nature of the relationship between insured and insurer does not require the latter to act solely for the benefit of its insureds, and does not demand a duty of undivided loyalty. The insurer is held however, to a duty of good faith, and fair dealing, and to give equal consideration to the insureds' interests with its own.

Finch J. considered the insurer's duty of good faith and cited the following passages from Keeton's, *On Insurance Law*:[14]

205 ...With respect to the decision whether to settle or try the case, the insurance company must in good faith view the situation as it would if there were no policy limit applicable to the claim.

The following proposition, likewise appropriate as a jury instruction, expresses the combination of the requirements of ordinary care and equal consideration:

With respect to the decision whether to settle or try the case, the insurer, acting through its representatives, must use such care as would have been used by an ordinarily prudent insurer with no policy limit applicable to the claim. The insurer is negligent in failing to settle if, but only if, such ordinarily prudent insurer would consider that choosing to try the case (rather than to settle on the terms by which the claim could be settled) would be taking an unreasonable risk - that is, trial would involve chances of unfavorable results out of reasonable proportion to the chances of favorable results

In assessing whether the MPIC's conduct was appropriate in the circumstances of the case, Finch J. noted the following passage from Appleman's *Insurance Law and Practice*:[15]

207 ...As the champion of the insured, it must consider as paramount his interests, rather than its own, and may not gamble with his funds. Its relationship is somewhat of a fiduciary one, and the liability is greater than indicated by some of the earlier holdings. Thus, if an insurer refuses to settle a claim because it believes the insured is not liable, it is nevertheless answerable for such refusal if its belief was arbitrary or capricious. This obligation has been placed upon the insurer because of its right of complete control over the negotiations...

Factors that will be weighed in determining the good faith of an insurer include promptness and thoroughness of investigation, informing the insured of the possibility of an excess verdict, whether the insurer in good faith believed that either the insured was not liable or that the proposed settlement was higher than the amount of a jury award, and whether an objective assessment of the evidence justified the position adopted by the insurer. Absence of an offer is only one factor in considering whether an insurer was guilty of bad faith in failing to settle a claim against the insured.

Finch J. noted that the exclusive power to negotiate settlement of claims against the insured results in a "special relationship of trust and confidence" that gives rise to a duty of "good faith and fair dealing" that requires the insurer to give at least equal consideration to the interests of the insured. Finch J. summarized his view of the law with regard to the insurer's duty to its insured as follows:[16]

210 1. The relationship between the insurer and insured is a commercial one, in which the parties have their own rights and obligations;

211 2. Within the commercial relationship, special duties may arise over and above the universal duty of honesty, which do not reach the fiduciary standard of selflessness and loyalty;

212 3. The exclusive discretionary power to settle liability claims given by statute to the insurer in this case, places the insured at the mercy of the insurer;

213 4. The insured's position of vulnerability imposes on the insurer the duties:

a) of good faith and fair dealing;

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.

214 5. The fact that the insured is at the mercy of the insurer for the purposes of settlement negotiations gives rise to a justified expectation in the insured that the insurer will not act contrary to the interests of the insured, or will, at least, fully advise the insured of its intention to do so;

215 6. While the commercial nature of the relationship permits an insurer to assert or defend interests which are

opposed to, or are inconsistent with, the interests of its insured, the duty to deal fairly and in good faith requires *the insurer to advise the insured that conflicting interests* exist, and of the nature and extent of the conflict;

216 7. The insurer's statutory obligation to defend its insured imposes on *the insurer, where conflicting interests* arise, a duty to instruct counsel to treat the interests of the insured equally with its own; and where one counsel cannot adequately represent both conflicting interests, an obligation to *instruct separate counsel to act solely for the insureds,* at the insurer's own cost;[1]

217 8. The insurer's duty to defend includes the obligation to defend on the issue of damages, and to attempt to minimize by all lawful means the amount of any judgment awarded against the insured. In this case that would include arguing that court order interest and no fault benefits are payable in addition to *the policy limits*, where such an argument is available in law; and

218 9. Defence preparations and settlement negotiations must take place in a timely way, and, where last minute negotiations are required, advance planning must be made to ensure that the insured's interests are given equal protection with those of the insurer.

Shea does not impose a duty to settle in every case where there is a potential for an excess judgment. The failure to settle within policy limits only gives rise to liability where the insurer fails to meet the particular duties set out in *Shea*. MPIC was found liable for breaching its duty of good faith as it could have settled the tort claim on terms that were favorable to *its insureds without prejudicing its own position* as to the payment of no fault benefits. MPIC did not advise the insureds about the position they were taking with regard to the deductibility of no fault benefits and did not provide the insureds with independent legal counsel to represent their interests. Finally, MPIC failed to make a timely investigation and assessment of the quantum of damages, which contributed to the difficulties in the settlement of the claim.

C. The insurer's affirmative duty to initiate settlement discussions

There are some jurisdictions where an insurer cannot be liable for a breach of its duty to settle unless the claimant makes a settlement offer within the policy limits. In other jurisdictions the courts have held that *the insurer has a positive duty to initiate settlement opportunities in* circumstances where liability is not a significant issue and the amount of damages would likely exceed the insurance coverage. Finch J. accepted the latter approach and stated:[19]

> 297 If *the insurer's duty to settle could be met by requiring* it only to respond to offers made within policy limits by the plaintiff, the insurer could avoid its duty to settle in any case where the plaintiff failed to make such an offer. The insured has lost the power to initiate settlement on his own behalf, which, but for the statutory insurance scheme (or a similar provision in a private insurance contract) it would have *retained. Since MPIC's power to settle under* the regulation is an exclusive one, the insured would be placed not only at the mercy of the insurer, but also at the mercy of the plaintiff, or its counsel.
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> 298 **In my view, the exclusive power to settle conferred on MPIC by the regulations requires it to use reasonable efforts on the insureds' behalf to settle within policy limits. Those reasonable efforts include affirmative attempts to settle, and where a finding of liability is highly probable, and where the judgment to be awarded will probably exceed the policy limits, include the affirmative duty to offer to pay the third party liability policy limits in exchange for a release of its insureds.** [*emphasis added*]

This statement encapsulates the essence of the insurer's affirmative duty to settle in cases where there is an unreasonable risk to the insured *of a judgment in excess of the policy limits.*

D. The insurer's vicarious liability for negligence of defence counsel

One of the issues addressed in *Shea* was whether the insurer is vicariously liable for any negligence or other breach of duty committed by the defence counsel. The insurer is required by section 74 of the Regulations to the *Insurance (Motor Vehicle) Act* to defend the action against the insured. The insurer chooses the lawyer who will defend the action and decides whether to settle the case, what witnesses to *call, and whether to appeal.*

The insurer in *Shea* tried to escape liability by blaming the lawyer it appointed to represent the insured. Finch J. was of the view that any fault in the steps taken in *defending the action* by the defence lawyer will not attract vicarious liability:[19]

> 138 It is, I think, probably correct to say that with respect to its obligation "to defend" an action, an insurer can in *general discharge the obligation by employing competent* counsel with a level of experience appropriate to the case. If counsel is in breach of some duty owed in the exercise of his professional skills when defending a case, any liability *is his and not that of the insurer.*
>
> 139 In British Columbia the defence of a lawsuit on behalf of another can only be conducted by a lawyer.

However, *Finch J. concluded that when the lawyer is involved in* settlement negotiations, the lawyer is an agent of the insurer. As such, the insurer is vicariously liable for any negligence or breach of duty attributed to the lawyer in conducting the negotiations:[20]

> *140 The position of defence counsel with respect to* settlement of liability claims is quite different. To begin with, settlement negotiations need not be conducted by lawyers. The insurer may discharge its statutory responsibility to assist the insured by negotiating settlement of claims equally well by its own employees, or by independent adjusters, whether the person authorized to *negotiate settlement is a lawyer or not. Although settlement* negotiations are frequently conducted by lawyers, there is nothing about them which requires that they be conducted by lawyers, unlike the defence of a lawsuit, which must be.
>
> 141 No matter who conducts the settlement negotiations on an insurer's behalf, whether an employee, independent adjuster, or lawyer, all authority to settle up to the limits of the liability coverage must come from the insurer. It is no part of the lawyer's professional skill to authorize the payment of his client's money. The lawyer may recommend *payment, he may seek instructions to offer settlement, or* to respond to offers made by the plaintiff, and he may communicate offers or responses which he has been authorized to make by his client. However, up to the limits of liability coverage the decisions to pay or not to pay, and if to pay how much to pay, are the insurer's.

Finch J. was of the view that MPIC had the exclusive obligation to negotiate settlement and could not escape vicarious liability by delegating that duty to a lawyer:[21]

> 152 In my view, MPIC cannot avail itself of the defence that its lawyers were independent contractors in conducting *the settlement negotiations. MPIC owed duties to its*

insureds imposed by statute. It may delegate the work of discharging those duties, but it cannot delegate the duty itself. MPIC can be in no better position by hiring a lawyer to conduct the settlement negotiations than it would have enjoyed if the settlement negotiations were conducted by one of its own employees. In either case, it is MPIC which owes whatever duties accompany the power to negotiate settlement, and who is responsible for any breach of that duty. That is because both the employee and the lawyer can act only with the authority of, and at the direction and control of, the insurer.

153 Nor do the insurer and insured have roles as "co-principals" in the settlement process of claims within the policy limit. The insured is precluded by the regulations from interfering with or exercising any influence over the settlement process. Ordinarily, the insured is not, within the limits of coverage, required to pay anything, and his authority or assent is not required. It is entirely up to the insurer to give instructions for settlement up to the limits of coverage. Only if some contribution from the insured beyond those limits were sought, would he become a principal in the settlement negotiations.

E. Assignment of the action by the insured

If an insurer has gambled and lost, the insured is required to pay the excess judgment and the claimant will commence execution proceedings. The insured has two options at this stage:

1. Retain counsel and commence an action against the insurer and any other parties who may share responsibility for the unreasonable exposure of the insured to pay a judgment in excess of the policy limits;
2. Convince the third party claimant (judgment creditor) to accept an assignment of the insured's action against the insurer in exchange for the judgment creditor giving up any right to execution.

In *Shea*, counsel for MPIC attacked the assignment of the action by the insureds and argued that the assignment released the insureds from liability and extinguished the claim for indemnification against MPIC. Finch J. rejected this view and held that a release of a judgment debtor in consideration for an assignment of the action does not preclude a subsequent action against the insurer on the excess judgment. He stated:[22]

> 324 To construe the document as MPIC contends would require it to be read as a release which pre-dated, and operated independently of, the paragraphs effecting the assignment. That is not the agreement which the document records. On its face, the insureds' rights to indemnity against MPIC existed up to and including the time at which they were assigned to Jamie and, only in consideration of that assignment, did Jamie agree to release the insureds personally.
>
> 325 The authorities cited by counsel for the plaintiff, referred to above, are consistent with this reasoning, and support the conclusion that an assignee of the right to sue a third party can maintain his action even though he has given up his right to claim against the assignor.
>
> 326 In my view, the true effect of the Agreement of June 27, 1985 was to vest in Jamie the insureds' legal rights against MPIC. From the time of the assignment forward, the insureds had no claim left to advance against MPIC. In exchange for acquiring their right to sue, Jamie gave up his right to execute on the judgment against them. Their release does not destroy the assignment of their rights against MPIC. Those rights vest now solely in Jamie.

This issue was also addressed by the Court of Appeal in *Fredrikson v. Insurance Corporation of British Columbia*:[23] McLachlin J.A. considered whether an assignment violates the Regulations to the *Insurance (Motor Vehicle) Act*, which prohibits the insured from interfering with ICBC's right to negotiate, settle and defend the action. She found that the assignment did not prejudice ICBC by requiring them to pay more money because of the assignment, and stated:[24]

> 14 The only difference it might make to ICBC is that instead of paying the money to Mr. Fredrickson, its insured, upon proof that he had satisfied Miss Nielsen's judgment, it would pay it to Miss Nielsen directly.

McLachlin J.A. noted that the timing of the assignment is significant in determining whether the assignment interfered with ICBC's rights under the Regulations:[25]

> 15 The next question is whether, assuming the assignment constituted a settlement, it amounts to an interference with ICBC in any negotiations, settlements or legal proceedings. ICBC does not allege specific interference but argues that to permit such assignments creates a disincentive to injured claimants to settle for less than the policy limits and removes the interest of the insured in having his defence succeed in whole or in part.
>
> 16 I do not accept the contention of ICBC that the assignment interfered with its ability to negotiate, settle and defend this action. The action had been concluded before the assignment took place, save for an unsuccessful application for leave to appeal to the Supreme Court of Canada. Moreover, it cannot be contended on the facts of this case that the assignment or the prospect of an assignment provided any disincentive to Miss Nielsen settling the action. The Public Trustee on her behalf made seven offers to settle the case. ICBC rejected them all and made no offers of its own, except for one offer made after the appeal was dismissed.

McLachlin J.A. further considered whether an assignment was valid in law or equity. The traditional rule is that causes of action in tort and contract are not assignable. She referred to a number of exceptions to the rule against assigning an action in tort and stated the following:[26]

> 40 In my view, if the fact that Miss Nielsen's and Mr. Fredrickson's interests were once opposed has any relevance, it must be on the ground that to permit a defendant to assign a cause of action against his insurer to a plaintiff whose interests are opposed to his, is to promote improper collusion between the plaintiff and the defendant to the detriment of the insurer. If this assignment had taken place while the interests of the parties were opposed, it might be attacked as invalid on the ground that it violates the duty of the assured to cooperate with his insurer. I need not decide whether such an attack would succeed, since those are not the circumstances in the case at bar. Here the assignee had a judgment and was entitled to pursue Mr. Fredrickson in execution proceedings and all realistic prospect of compromise had vanished. The insured's duty to cooperate with his insurer had effectively been discharged. His interest at that point lay not with his insurer, but rather with the assignee; it was in their common interest to secure satisfaction of the judgment which had been rendered by the court and confirmed on appeal.

She noted similar exceptions to the rule against assigning a cause of action in contract and stated:[27]

57 Adopting that approach, it is my conclusion for the reasons stated earlier, that the assignment of the cause of action for breach of contract here at issue does not savour of maintenance. Nor, as already noted, can it make any difference to ICBC to whom it pays damages awarded in any judgment which may be entered against it.

In light of the decision in *Fredrikson* it is unlikely that an insurer will be successful in attacking the assignment of an action against the insurer for the unreasonable refusal to settle unless it can be shown that the *assignment was made prematurely and affected ICBC's ability to* negotiate, settle, or defend the original action against the insured.[38]

E. Impecuniosity of the insured

If the insured is impecunious or of modest means, and there is no likelihood of the plaintiff successfully executing on the judgment, has *the insured suffered any loss? In Shea the infant plaintiff had obtained* an excess judgment against his father and uncle who were without any financial resources. Finch J. held that the financial means of the insured is an irrelevant consideration in determining the insurer's liability for an excess judgment:[39]

> 335 Counsel for the plaintiffs referred me again to Magarick at p. 128 where this statement is made:
>
> > Several cases have specifically held that the insured's solvency has no bearing on an insurer's responsibility for an excess verdict, and that damage to an insolvent insured is *sustained by the mere entry of judgment against* him and not necessarily by any ability to collect on such a judgment.
>
> And he refers me to Appleman, Insurance Law and Practice (1979), vol. 7C, at pp. 490-92, as follows:
>
> > **Payment of excess judgment by insured**
> >
> > The rule is that the insured is not required to prove that he has paid the excess of the judgment rendered against him in order to recover. Whether the insured estate is insufficient to pay the entire judgment or whether the insured is hopelessly insolvent and the judgment is uncollectible is immaterial: the fact that there is such a judgment outstanding against the insured is considered to be sufficient harm to justify recovery from the insurer.
>
> 336 On this issue, I prefer the argument put forward on Jamie's behalf. *The insureds' legal rights arising under* a policy of insurance should not depend upon whether he is rich or poor. And the scope of the insurers' obligations should not depend upon such ad hoc inquiries.

G. Does equity require indemnity from the insurer?

MPIC argued that as the insureds' claim for indemnity to pay the excess judgment arose in equity, no relief should be granted for a liability that is too remote. In the alternative they argued that any indemnity should be limited to the value of the insured's assets prior to the assignment. Finch J. did not accede to either argument. He held that the insurer was liable to indemnify the insureds for the full amount of the excess judgment for the following reasons:[40]

> 334 ...the risk of a judgment in excess of the policy limits was within MPIC's contemplation almost from the commencement of the lawsuit... When the judgment was entered it constituted a present debt of both insureds which *continued in place until the debt was assigned and the* insureds released. It would not be just and reasonable to deny the claim to indemnity, where it arose only because the insurer ignored the interests of the insured, and gave *preference to its own interests.*

Finch J. also refused the argument that the insurer's indemnity should be limited to the insureds' maximum possible exposure at the material time - namely, the value of their assets subject to legal process between judgment and assignment. Finch J. held that the insurer was liable to indemnify the insureds for the full amount of the excess judgment and stated:[41]

> 352 As I view the matter, the rationale behind the concept of an indemnity limited to the value of the insured's assets is simply a modification of the arguments which would deny an impecunious insured of any claim to indemnity for an excess judgment, but which would award an insured with ample means a full indemnity against such a liability. As I have said above in addressing those submissions, the parties' rights and obligations under a contract of insurance ought not to depend upon the financial means of the particular insured. To measure the loss in that way is to create an obvious double standard, and is also uncertain and inconvenient. Parties to a contract of insurance should know where they stand when the contract is made, including knowledge of what the results would be if an insurer breaches the duties it owes to its insured.

H. Punitive damages

As noted above, a contract of insurance is a contract requiring the utmost good faith. As a result of this requirement, the insurer is required to give equal consideration to the interests of its insured. A liability insurer can be liable to its insured for punitive damages where it fails to adhere to the duties of good faith. In *Shea*, Finch J. acknowledged that punitive damages are awarded in the United States for "bad faith refusal to settle", but found that there was no evidence of any pattern of *unconscionable behaviour by Canadian insurers that would justify* punitive damages.[42]

> 350 Counsel for MPIC acknowledges that most United States courts award indemnity for the full amount of an excess judgment. He says however that this is an example of the United States courts' tendency to over-compensate insureds for the purposes of deterring insurers against bad faith practices (see, for example, the statements in *Frankenmuth*, supra, at p. 696). That is why, says counsel, the United States courts also award punitive damages in such a case. He says a limited indemnity based on the value of the insured's assets would be a sufficient deterrent.
>
> 351 Counsel for the plaintiffs points out that they do not seek punitive or other damages, but only a full indemnity for the excess judgment. He points to the law adopted by the majority of United States courts, and says that equitable considerations, including what he calls the insurer's "callous" disregard for the insureds' interests should be weighed in the balance....
>
> 353 I prefer the majority United States view of this matter, and hold that the insureds were, and that hence Jamie is, entitled to indemnity for the full amount by which the insureds' liability exceeded the insurance moneys already paid. The insurer's obligation to make a full indemnity is not founded upon any policy of deterrence aimed at insurers who seek to avoid their obligations. As Esson C.J.S.C. pointed out in *Fredrikson*, supra, at p. 336, in refusing to import into Canada holus-bolus, the United States law on bad faith insurance claims, there has been *amongst Canadian insurers "no pattern of unconscionable*

behaviour." Rather, this result derives from the desirability of treating all insureds, rich and poor, equally, and the certainty and convenience of a rule for full indemnity.

The Supreme Court of Canada recently affirmed in *Whiten v. Pilot Insurance Co.*,[33] that punitive damages can be awarded against an insurer for failing to deal with the insured in good faith. Justice Binnie, writing for the majority, upheld a jury award of $1,000,000 in punitive damages in a first party liability insurance bad faith action. Binnie J. summarized the standard to be applied for awarding punitive damages by setting out a list of considerations to be read in the trial judge's charge to the jury with respect to punitive damages:[34]

> 94 To this end, not only should the pleadings of punitive damages be more rigorous in the future than in the past (see para. 87 above), but it would be helpful if the trial judge's charge to the jury included words to convey an understanding of the following points, even at the risk of some repetition for emphasis. (1) Punitive damages are very much the exception rather than the rule, (2) imposed only if there has been high-handed, malicious, arbitrary or highly reprehensible misconduct that departs to a marked degree from ordinary standards of decent behaviour. (3) Where they are awarded, punitive damages should be assessed in an amount reasonably proportionate to such factors as the harm caused, the degree of the misconduct, the relative vulnerability of the plaintiff and any advantage or profit gained by the defendant, (4) having regard to any other fines or penalties suffered by the defendant for the misconduct in question. (5) Punitive damages are generally given only where the misconduct would otherwise be unpunished or where other penalties are or are likely to be inadequate to achieve the objectives of retribution, deterrence and denunciation. (6) Their purpose is not to compensate the plaintiff, but (7) to give a defendant his or her just desert (retribution), to deter the defendant and others from similar misconduct in the future (deterrence), and to mark the community's collective condemnation (denunciation) of what has happened. (8) Punitive damages are awarded only where compensatory damages, which to some extent are punitive, are insufficient to accomplish these objectives, and (9) they are given in an amount that is no greater than necessary to rationally accomplish their purpose. (10) While normally the state would be the recipient of any fine or penalty for misconduct, the plaintiff will keep punitive damages as a "windfall" in addition to compensatory damages. (11) Judges and juries in our system have usually found that moderate awards of punitive damages, which inevitably carry a stigma in the broader community, are generally sufficient.

While *Whiten* is a first party liability bad faith action, there is no reason why the same considerations would not apply to the award of punitive damages in an action against an insurer for the unreasonable refusal to settle a third party claim for the policy limits. The likelihood of such an award being made and the quantum of damages will be a function of the extent to which the liability insurer is guilty of what the Supreme Court of Canada refers to as: "high handed, malicious, arbitrary, or highly reprehensible misconduct".

VI. CONCLUSION

The exclusive power to settle residing with the insurer imposes certain duties on the insurer which include the duty of good faith and fair dealing and the duty to give at least as much consideration to the interests of its insured as it does to its own interests. These duties require that the insurer take ***affirmative*** steps to settle a third party claim for the policy limits in cases where a finding of liability is highly probable and where the judgment to be awarded will probably exceed the policy limits. The insurer is not entitled to gamble with the assets of its insured. If it chooses to gamble and loses, the insurer can be liable to pay the full amount of the judgment despite the policy limits. The insurer may also face an award of aggravated and/or punitive damages if its misconduct reaches the level described by the Supreme Court of Canada in *Whiten*.

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1 1991 CarswellBC 60, 55 BCLR (2d) 15 (SC).
2 *Ibid.*, para. 298.
3 RSBC 1996, c. 231.
4 Craig Brown et al., *Insurance Law in Canada*, looseleaf ed. (Toronto: Carswell, 1999) ch. 10-4 at p. 10-20.
5 1981 CarswellOnt 706, 35 OR (2d) 97 (HC)
6 *Ibid.*, para. 86.
7 1983 CarswellOnt 693, I.L.R. 1-1706 (HC).
8 *Ibid.*, para. 4.
9 1990 CarswellBC 68, 44 BCLR (2d) 303 (SC).
10 *Ibid.*, para. 113.
11 *Supra*, n. 1.
12 *Ibid.*, para. 166.
13 *Ibid.*, para. 203.
14 *Ibid.*, para. 205.
15 *Ibid.*, para. 207.
16 *Ibid.*, para. 210.
17 The Manitoba Court of Appeal reached a different conclusion in *Piche v. Manitiba Public Insurance Corp.* 1994 CarswellMan 90 (CA). In that case the Court of Appeal was not of the view that the fact that the claim "may" exceed the policy limits was enough to create an actual conflict that would require MPIC to pay for the cost of independent counsel. However, the Court of Appeal indicated that they might reach a different conclusion in the situation where an actual conflict existed.
18 *Supra*, n. 1 at para. 297.
19 *Ibid.*, para. 138.
20 *Ibid.*, para. 141.
21 *Ibid.*, para 152
22 *Ibid.*, para. 324.
23 *Fredrikson v. Insurance Corp. of British Columbia*, 1986 CarswellBC 131, [1986] 28 DLR (4th) 414 (CA), affirmed [1988] 49 DLR (4th) 160 (SCC).
24 *Ibid.*, para. 14.
25 *Ibid.*, para. 15.
26 *Ibid.*, para. 40.
27 *Ibid.*, para. 57.
28 Query whether *Fredrikson* permits an assignment of an action against parties other than the insurer who may also be in breach of a duty owed to the insured. In these cases it may be prudent for the claimant to forgo the assignment and allow the insured to pursue the claim against the insurer and any other responsible parties.
29 *Supra*, note 1 at para 335.
30 *Ibid.*, para. 334.
31 *Ibid.*, para. 352.
32 *Ibid.*, para. 350.
33 2002 CarswellOnt 537, 2002 SCC 18 (SCC).
34 *Ibid.*, para. 94.