

Determining the Duty to Defend: An Expeditious, Non-Extrinsic Exercise

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by Michael Teitelbaum

The Ontario Court of Appeal in *Halifax Insurance Co. of Canada v. Innopex Ltd.*, [2004] O.J. No. 4178, has reaffirmed that the defence obligation should be determined as early as possible and without the use of extrinsic evidence. In so doing, the Court spoke in disapproving terms of insurers attempting to introduce evidence to counteract the allegations made in the originating pleading, noting that this diverted the Court from deciding the real issue of whether an insurer had a duty to defend.

In its October 15th, 2004 decision, the Court reversed a decision of Justice Greer, who had found that Halifax was not obliged to defend its insured, Innopex, with respect to a complaint by Gucci America, Inc. in the United States District Court, Southern District of New York.

Gucci's claims related to Innopex's distribution and sale in the United States, without authorization or approval from Gucci, of watches bearing copies of the Gucci trademark. Gucci's claims were based on trademark

infringement and unfair competition and sought injunctive relief, an accounting of profits, damages and costs.

Halifax's policy with Innopex included coverage for "personal injury and advertising liability". The Insuring Agreement stated that Halifax would pay "those sums that the insured becomes legally obligated to pay as compensatory damages because of... 'advertising liability' to which this insurance applies". The policy also stipulated that the insurance for "advertising liability" applies "only if caused by an offence...arising out of the conduct of the Named Insured's business; and...arising out of advertising done by or for the Named Insured in the normal course of the Named Insured's business".

"Advertising liability" was defined as meaning "injury arising out of an offence committed during the Policy Period occurring in the course of the Named Insured's advertising activities, if such injury arises out of ... infringement of copyright, title or slogan". An exclusion in the policy provided that the insurance

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Noteworthy

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did not apply to “advertising liability” arising out of “infringement of trademark, service mark or trade name, other than titles or slogans, by use thereof on or in connection with goods, products, or services sold, offered for sale or advertised”.

After the complaint was tendered to Halifax for a defence, the insurer referred it to noted insurance coverage counsel for an opinion on whether it was under a duty to defend. It appears that opinion was produced in the course of lengthy cross-examinations on Affidavits filed by both parties.

Justice Borins quoted extensively from coverage counsel’s opinion, which essentially concluded that because the duty to defend is determined by the allegations pleaded in the underlying lawsuit, read together with the coverage provided by the insurance policy, Halifax likely had an obligation to defend the action. Counsel’s opinion noted that a number of the allegations in the complaint either alleged the commission of an offence in the course of advertising, or, for duty to defend purposes, certain of the allegations were likely sufficient to be considered to have been committed in the course of advertising. Moreover, although there is an exclusion for trademark infringement, there is an exception for infringement of title, and counsel concluded that

based on a review of American case law, infringement of title clearly encompasses claims for trademark infringement and, therefore, the inclusion of the exception likely meant Halifax could not rely on the trademark exclusion.

The Court noted that having recognized that a duty to defend would be found if the Courts followed “a conventional *Nichols*¹ application, [coverage counsel] recommended that Halifax initiate a ‘proactive’ procedure that involves putting the true facts before the Court”, with a view to establishing that Innopex was not engaged in advertising or marketing activity in the sale of the watches.

Halifax followed this recommendation and issued a Statement of Claim requesting a declaration that it had no duty to defend. In response, Innopex delivered a Statement of Defence and Counterclaim for a declaration that Halifax was under a duty to defend, alleging breach of contract and a failure to act in good faith, and claiming punitive damages. Motions for judgment by both Halifax and Innopex then ensued which led to the filing of numerous Affidavits upon which cross-examinations were held, resulting in a record before the motions judge of about 3,000 pages and a three-day hearing.

At first instance, Justice Greer found as a fact that Innopex

was not engaged in advertising within the meaning of the policy when it sold the watches to an American purchaser and, therefore, Halifax had no contractual duty to indemnify Innopex if the Gucci lawsuit were to succeed. Although, given this finding, she did not have to go on to do so, she also interpreted the word “title” in the exception to the trademark exclusion in favour of Halifax, again holding that the Gucci complaint was excluded from coverage.

The motions judge also held that there was no factual basis to support Innopex’s counterclaim for punitive damages and, accordingly, dismissed it.

The Court of Appeal, in reversing the motions judge, noted that although Innopex challenged the admissibility of the extrinsic evidence generated by the summary judgment motions, Greer J. applied that evidence in making findings of fact relative to the underlying Gucci claim. The Court observed that this was contrary to the procedure generally followed on a *Nichols* application to determine a duty to defend issue. An inquiry into whether the insured had in fact engaged in the conduct complained of in the underlying action should not be part of the inquiry on a duty to defend application.

In the end result, the Court essentially agreed with coverage counsel’s opinion on the

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¹ *Nichols v. American Home Assurance Co.*, [1990] 1 S.C. R. 801.

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duty to defend, while also quoting extensively from the Supreme Court of Canada's decision in *Monenco Ltd. v. Commonwealth Insurance Co.*, [2001] 2 S.C.R. 699, which was decided after counsel's opinion was rendered. The Court noted that the reasons in *Monenco* are helpful in "reviewing the legal principles and the test governing an insurer's duty to defend and for the admonition against admitting extrinsic evidence on a motion or application to determine this issue".

Applying the Supreme Court of Canada decisions in *Nichols*, *Scalera*² and *Monenco*, the Court found that "on their substance and true nature, the essence of the claims in Gucci's complaint is trademark infringement on the part of Innopex arising from the unauthorized use of Gucci's trademark on the watches that Innopex sold in the United States...[A]lthough Halifax contends that a claim for trademark infringement is not within the coverage...the exception to [the trademark exclusion] retains infringement of "titles or slogans" as an advertising offence".

Although the Court's findings with respect to the specific coverage issues are of importance, its comments dealing with the general principles relating to determining the duty to defend and on what basis this should be accomplished are even more significant. The Court also restored Innopex's counter claim for punitive damages.

The Court made the following observations and declarations on these issues, (and where we have comments and elaborations, they are included):

1) "Motions or applications to determine whether an insurance company has a duty to defend a policyholder who is a defendant in an underlying lawsuit are intended to be decided expeditiously. Invariably, such proceedings are decided by reading the claim or claims asserted in the statement of claim in the underlying action with the coverage provided by the insurance policy. If one or more of the claims in the underlying action fall within the coverage, the insurer has a duty to defend the action on behalf of the insured." (Paragraph 1 of the Court's Reasons). The results of earlier decisions by the Court had established the latter principle, but it has now made an unequivocal statement to this effect.

2) While to some degree the Supreme Court of Canada in *Monenco* had left open the extent to which extrinsic evidence can be considered, the Court of Appeal, following its approach in earlier decisions, is emphatic as to its understanding of the meaning of *Monenco* in terms of the scope of extrinsic evidence that can be considered. On a duty to defend application the Court "may consider documents referred to in the underlying statement of claim where to do so may assist in determining the substance and true nature of that claim".

The Court also notes that the Ontario summary procedure avoids a duty to defend application from becoming a "trial within a trial" into the truth of the allegations in the underlying statement of claim, which *Monenco* stated should not occur, but which did occur in the case at hand. Accordingly, "extrinsic evidence going to the truth of the allegations pleaded...is not receivable". The Court must also "avoid findings that would compromise or affect the underlying litigation".

Somewhat surprisingly, however, given the traditional approach in how coverage issues are usually addressed, the Court continued with the following statement:

"This is not to say that evidence is never permissible on a duty to defend application. Indeed, as in this case, it is not uncommon that expert evidence is helpful to the court in the interpretation of the insurance coverage and, on occasion, in interpreting technical language in the underlying claim".

It appears the Court is making a distinction between extrinsic evidence that goes to the truth of the allegations as opposed to the interpretation of the insurance coverage or other technical matters, and does not consider the latter to be unacceptable "extrinsic evidence". It also appears the Court wishes to leave open the possibility of expert evidence in such limited

² *Non-Marine Underwriters, Lloyd's of London v. Scalera*, [2000] 1 S.C.R. 551.

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instances notwithstanding the fact that the most common approach is for the Court to determine the defence obligation based on the submissions of the parties without the use of opinion evidence. There is some logic to this in specific instances. It appears the Court is looking for opinions on particular matters that will help it to decide coverage, as opposed to opinions on the coverage issues themselves. It remains to be seen how the Court will apply this in future cases, and whether, as appears to be the intention, it will limit this to the type of opinions received in *Innopex*, i.e., opinions by American attorneys about the federal, state and common law causes of action raised in the complaint, and U.S. trademark laws.

Also, *quaere* whether in cases where the extrinsic evidence does not affect the underlying claim, (for example,

who qualifies as an insured), some limited possibility exists that a court can be persuaded that such evidence can still be received.

3) At paragraph 38, the Court noted that what the insurer did in this case, by the procedure it followed, was to “turn a duty to defend application into a duty to indemnify application by introducing extrinsic evidence pertaining to what it termed ‘the true facts’. It is well-recognized that the insurer’s duty to defend is broader than its duty to indemnify. The time to determine the insurer’s duty to indemnify, if at all, is at the conclusion of the underlying litigation”.

With its critical commentary on the approach taken by the insurer, together with the admonition relating to the use of extrinsic evidence, (and subject to what appear to be rare instances when expert evidence

might be permissible), the Court of Appeal is sending a strong message about what is to be considered when determining whether a defence obligation exists.

The Court of Appeal has made it quite clear that it will not look favourably upon any attempt to widen the scope of a determining the duty to defend by the use of extrinsic evidence. It has also reiterated other principles it has previously applied in determining the duty to defend. Courts in other provinces have flirted to some degree with the use of extrinsic evidence in particular instances. Based on the Court of Appeal’s strong statements in this decision it appears that, at least in Ontario, the possibility of using extrinsic evidence other than within the limited confines as expressed by the Court in this case, has been permanently laid to rest.

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