THE BEST DEFENSE MAY BE A GOOD OFFENSE: A POLICYHOLDER'S PERSPECTIVE

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When an insurer has a duty to defend or to pay a policyholder's defense costs, the majority of courts hold that the insurer also must fund the policyholder's pursuit of "affirmative claims," at least when those affirmative claims are either:

(a) inextricably intertwined with the claims against the policyholder for which the insurer has a defense obligation;[2] and/ or

(b) defensive in nature, in that the affirmative claims may eliminate or reduce the insured's liability to the claimant.[3]

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[1] Marion Adler and Lyndon Bittle both regularly represent commercial policyholders in coverage disputes. The views expressed in this paper are theirs alone and do not necessarily represent the views of their firms or clients.

[2] *See, e.g., Safeguard Scientifics, Inc. v. Liberty Mut. Ins. Co.*, 766 F. Supp. 324, 334 (E.D. Pa. 1991), *aff'd mem.*, 1992 U.S. App. LEXIS 38473 at *14-15, 1992 WL 12915247 (3d Cir. 1992) (unpublished order under F.R.A.P. 32.1).

The term "defense obligation" is used to encompass situations in which the insurer either (i) has a duty to defend, or (ii) has the duty to pay defense costs incurred by the policyholder, who controls its own defense.

[3] *See, e.g., Oscar W. Larson Co. v. United Capitol Ins. Co.*, 845 F. Supp. 458, 461 (W.D. Mich. 1993), *aff'd on other grounds*, 64 F.3d 1010 (6th Cir. 1995).

Very few courts adopt a bright line rule that an insurer who has a duty to defend or fund the defense never has a duty to pay for pursuing affirmative claims.[4] Rather, when the insurer prevails in such disputes, it is typically because the court concludes that:

(a) the affirmative claims are not defensive in nature; and/ or

(b) because the insurer has accepted the defense of the claims asserted against the policyholder, the insurer is entitled to control the defense, including whether to pursue the affirmative claims as a defense strategy.[5]

Broadly speaking, the question of whether the insurer has a duty to fund affirmative claims arises in two distinct circumstances. Most frequently, the "affirmative claims" are asserted as counterclaims, cross-claims, or third-party claims in the lawsuit in which the policyholder was named as a defendant.[6] Less often, the policyholder seeks to hold the insurer responsible for the litigation expense of an entirely separate lawsuit, often in situations where the policyholder sues preemptively so as to seize the initiative in a long-simmering dispute.[7] Conceptually, it is simpler for the policyholder to frame the affirmative claims as "defensive" if they are asserted as a counterclaim, cross-claim, or third-party claim in response to a suit against the policyholder. Even when the affirmative claims are pursued in a separate lawsuit, however, a policyholder may be able characterize them as "defensive"–e.g., if the affirmative lawsuit is filed to obtain a more favorable forum.[8]

Alternatively, a policyholder may be able to recoup the costs of affirmative claims from its insurer under "allocation" theories. Courts typically require an insurer to pay all fees for legal services that are reasonably related to the claims within the insurer's defense obligation, even where that work may also benefit claims outside the insurer's defense duties.[9] As discussed below, however, this general rule

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[4] *But see Mt. Vernon Fire Ins. Co. v. VisionAid, Inc.*, 477 Mass. 343, 347, 354 (2017).

[5] *See, e.g., Bennett v. St. Paul Fire & Marine Ins. Co.*, ME Civil No. 04-CV-212-GNZ, 2006 U.S. Dist. LEXIS 29017 at *14-15, 2006 WL 1313059 at *4 (D. Me. May 12, 2006) (relying upon both reasons to deny policyholders' effort to force insurer to fund affirmative claims).

[6] *See., e.g., Great West Cas. Co. v. Marathon Oil Co.*, 315 F. Supp. 2d 879 (N.D. Ill. 2003).

[7] *See, e.g., Great Am. E&S Ins. Co. v. Power Cell, LLC*, 356 F. Supp. 3d 730 (N.D. Ill. 2018).

[8] *IPB, Inc. v. Nat'l Union Fire Ins. Co.*, 299 F. Supp. 2d 1024, 1026 (D.S.D. 2003).

[9] *See generally Safeway Stores, Inc. v. Nat'l Union Fire Ins. Co.*, 64 F.3d 1282, 1289 (9th Cir. 1995) (although insurer had no duty to defend corporate defendant, insurer

is subject to exceptions and qualifications, especially where the policy language dictates specific allocation procedures.

A. Insurer's Duty to Pay for Counterclaims, Cross-Claims, Third-Party Claims

There are a large number of cases that address whether an insurer must pay for the legal costs of counterclaims, cross-claims, or third-party claims asserted by the defendant-insured in response to a suit for which the insurer owes a defense obligation. The following list is not exhaustive, but is illustrative of the reasoning typically offered in support of or against requiring the insurer to fund such claims.

1. Case law holding that costs of counterclaims, cross-claims, and third-party claims are within the scope of an insurer's defense obligation

The following cases are among those where courts have upheld a policyholder's right to the payment by the insurer of the fees associated with a counterclaim, cross-claim, or third-party claim that has been joined to a suit against the policyholder for which the insurer has a duty to defend.

In ***Safeguard Scientifics, Inc. v. Liberty Mut. Ins. Co.*, 766 F. Supp. 324 (E.D. Pa. 1991), *aff'd mem.*, 1992 U.S. App. LEXIS 38473, 1992 WL 12915247 (3rd Cir. 1992) (unpublished)**, the insured was the president of a corporation, which sued him for alleged acts of corporate malfeasance, including alleged defamation of the corporation. The defamation claims entitled the officer to a defense under the Personal Injury Coverage of a CGL policy. The insured counterclaimed, alleging misconduct by the corporation, including breach of contract, fraud, and breaches of the duty of good faith and fair dealing. The court held the allegations of the counterclaim were inextricably intertwined with allegations of the claims asserted against the officer and therefore the insurer was required to fund the cost of the counterclaim.

The insured in ***Oscar W. Larson Co. v. United Capitol Ins. Co.*, 845 F. Supp. 458, 461 (W.D. Mich. 1993), *aff'd on other grds.*, 64 F.3d 1010 (6th Cir. 1995)**, was named as a third-party defendant in a multi-party suit involving the clean-up of a polluted site. The insured asserted a counterclaim against the defendant who had impleaded the insured into the action, and cross-claims against other parties for their role in contributing to the pollution. The court agreed with the insured that the costs of prosecuting the counterclaims and cross-claims were within the duty to

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was required to pay entirety of defense bills because sums incurred in defending corporation were reasonably related to defending directors and officers, who were entitled to defense under policy terms).

defend because they "are actually defensive in nature and prosecuted to limit or defeat plaintiff's liability in the state court action." 845 F. Supp. at 461. Cases that have followed *Oscar Larson* in the context of environmental actions include ***Great West Cas. Co. v. Marathon Oil Co.*, 315 F. Supp. 2d 879, 882 (N.D. Ill. 2003)** ("'Defense' is about avoiding liability. Claims and actions seeking third-party contribution and indemnification are a means of avoiding liability just as clearly as is contesting the claims …."); and ***Emhart Indus., Inc. v. Home Ins. Co.*, C.A. No. 02-53S, 2006 U.S. Dist. LEXIS 63144 at *7, 2006 WL 2460908 at *2 (D.R.I. Aug. 2, 2006)** ("[T]he duty to defend encompasses fees and costs incurred in counterclaims or third-party actions aimed at shifting liability for the claim as to which the duty to defend exists.").

***TIG Ins. Co. v Nobel Learning Communities, Inc.*, NO. 01-4708, 2002 U.S. Dist. LEXIS 10870, 2002 WL 1340332 (E.D. Pa. June 19, 2002**), was more procedurally complex. First, the insured filed a "Declaratory Action for Copyright Ownership" against the seller of certain assets acquired by the insured. The asset seller then asserted a copyright-infringement counterclaim against the insured. After ruling that the insurer had a duty to defend the infringement counterclaim, the court also held that TIG was required to pay the policyholder's litigation expenses in pursuing its affirmative claims – i.e., the declaratory action that the insured had filed first. The court reasoned that those affirmative claims were "inextricably intertwined" with and "necessary to the defense of the [copyright infringement] litigation as a strategic matter." 2002 U.S. Dist. LEXIS 10870 at *39.[10]

In ***Ultra Coachbuilders, Inc. v. General Security Ins. Co.*, 229 F. Supp. 2d 284 (S.D.N.Y. 2002) (Cal. law)**, the policyholder was sued for claims of trademark infringement, for which the insurer owed a defense. The policyholder brought a counterclaim, which included claims sounding in unfair competition and interference with competitive advantage. The court held that the insurer had a duty to pay the expenses of the counterclaim pursuant to the "inextricably intertwined" test from *Safeguard Scientifics* because the counterclaims mirrored the policyholder's defense of "unclean hands" in opposition to the underlying plaintiff's efforts to enjoin the policyholder's use of the marks. *Id.* at 288.[11]

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[10] However, the court did hold the insurer's duty to pay for the affirmative claims only incepted after the asset seller had filed its infringement counterclaim. It is unclear whether the policyholder had sought to recover its costs of the affirmative claims predating the counterclaim. *See* 2002 U.S. Dist. LEXIS 10870 at *41.

[11] Intermediate appellate courts in California have declined to apply the "inextricably intertwined" test in applying California law. *See, e.g., James 3 Corp. v. Truck Ins. Exch.,* 111 Cal. Rptr. 2d 181, 188-89 (Cal. Ct. App. 2001) (criticizing *Safeguard Scientifics*); *Gray v. Underwriters at Lloyd's, London*, No. A096189, 2002 Cal. App. Unpub. LEXIS 6621, 2002 WL 1587925 at *9 (July 19, 2002). The California Supreme Court evidently has not spoken on this issue.

In ***Hartford Fire Ins. Co. v. VitaCraft Corp.*, 911 F. Supp. 2d 1164, 1183 (D. Kan. 2012)**, the insured's competitor sued it for a variety of IP-related claims, including claims that insured's patent infringed its senior patent, trade secret misappropriation, and claims of unfair competition, including trade disparagement. The court held the disparagement claims were within the Personal Injury coverage of the policy, obligating the insurer to defend the entirety of the suit. The insured counterclaimed to invalidate the plaintiff's senior patent based on misconduct before the Patent Office. The court held the insurer had a duty to defend the counterclaim both because it was inextricably intertwined with principal action and because it was defensive in nature.

***D.R. Horton, Inc.–Denver v. Mountain States Mut. Cas. Co.*, 69 F. Supp. 3d 1179 (D. Colo. 2014)**, arose from an underlying construction dispute, in which the general contractor was named as an additional insured to general liability policies issued to each subcontractor. The general contractor and the subs were sued for alleged defects in the construction project. In addition to upholding the general contractor's right as an additional insured to a defense under the subcontractors' policies, the court held that those insurers were required to fund the general contractor's cross-claims for contribution and indemnity against the subcontractors who were the named insureds. Similar to the coverage disputes involving environmental claims, the court reasoned that the cross-claims were intended to eliminate or reduce the general contractor's liability and therefore were defensive in nature. *Id.* at 1198-1200. The court reached this conclusion even though it resulted in the insurers being required to fund both the general contractor's prosecution and subcontractors' defense of the cross-claims. *Id.* ***See also Nationwide Mut. Ins. Co. v. D.R. Horton, Inc.–Birmingham*, 15-351-CG-N, 2016 U.S. Dist. LEXIS 160148, 2016 WL 68282 (S.D. Ala. Nov. 18, 2016)** (In a parallel coverage action brought by a different insurer, the court followed the District of Colorado's holding that the insurer was required to pay the litigation expense of cross-claims asserted by the general contractor as additional insured against the named insured/sub).

2. Case law declining to require an insurer to fund the costs of counterclaims, cross-claims, and third-party claims.

Few courts follow an absolute, bright line rule that an insurer's defense obligations never encompass a duty to pay for the affirmative counterclaims, cross-claims, or third-party claims. Massachusetts is one of those few. *See* ***Mt. Vernon Fire Ins. Co. v. VisionAid, Inc.*, 477 Mass. 343 (2017).** The policyholder was sued by a former employee, alleging that he was terminated on account of age discrimination, as well as asserting common law claims for wrongful termination. *Id.* at 346. The insurer appointed panel counsel to defend the policyholder; the defense entailed establishing the employer had legitimate grounds for terminating the employment based on poor job performance and misappropriation of the employer's funds. *Id.*

However, the insurer refused to fund a counterclaim seeking to recover the misappropriated funds. On certified questions from the First Circuit, the Massachusetts Supreme Judicial Court held that neither the duty to defend nor the duty to pay defense costs required the insurer to fund the misappropriation counterclaim, based on dictionary definitions of the term "defend," which the court held unambiguously did not encompass prosecuting a counterclaim. *Id.* 347-54. The court specifically declined to adopt the test applied by some courts that looked to whether the counterclaim was "inextricably intertwined" with the insured's defense. The court rejected the "inextricably intertwined" standard based upon both the absence of such language in the policy and on public policy grounds–i.e., that the "inextricably intertwined" approach would "result in extensive preliminary litigation to determine what claims are sufficiently intertwined." *Id.* at 351.

Massachusetts is not alone in its hard-line position. Federal courts construing Texas law have held that the "duty to *defend* the entire suit does not give rise to a duty to prosecute claims helpful to or even inextricably intertwined with that defense." ***Aldous v. Darwin Nat'l Assur. Co.*, 851 F.3d 473, 483 (5th Cir. 2017) (citing *Mustang Tractor & Equip. Co. v. Liberty Mut. Ins. Co.*, No. H-91-2523, 1993 U.S. Dist. LEXIS 21277, 1993 WL 566032 at *9 (S.D. Tex. Oct. 8, 1993)** (denying insured's request for recovery of cost of prosecuting indemnity and contribution claim against third party, rejecting argument that "the 'best defense' against [covered] claim was a 'good offense'" against the third party), *aff'd*, 76 F.3d 89 (5th Cir. 1996)).

Similarly, the Supreme Court of Wyoming has held that "if an insurance policy fails to specify coverage for prosecuting counterclaims, the policy language will not be 'tortured' to create" such a duty, "no matter how factually intertwined the claims may be." ***Shoshone First Bank v. Pac. Employers Ins. Co.*, 2 P.3d 510, 516-17 (Wyo. 2000).**

However, most of the recently-decided cases (i.e., within the last 20 years) in which the courts have refused to impose a duty on the insurer to fund counterclaims, cross-claims, and/or third-party claims have done so on more narrow grounds – either because the affirmative claims are not "defensive" and/or because the insurer accepted the defense of the suit, which entitled it to dictate defense strategy, including whether to assert "defensive" affirmative claims. For example:

Similar to *VisionAid*, in ***International Ins. Co. v. Rollprint Pckg. Prod., Inc.*, 312 Ill. App. 3d 998 (2000)**, the underlying suit was brought by a former employee who alleged he had been subjected to employment discrimination and wrongful termination. The insurer refused to defend the suit, and this declaratory action ensued. While upholding the policyholder's position that the insurer had a duty to defend the claims asserted by the former employee, the court declined to order the insurer to pay the cost of a counterclaim, which sought to restrain the former

employee from using the employer's trade secrets. The court distinguished the situation from *Oscar Larson* because the trade secret counterclaim was not "defensive" as it did not seek merely "to limit a defendant's potential liability." *Id.* at 1015. Although *Rollprint* represented a loss for the policyholder in that case, subsequent courts treat *Rollprint* as supporting the broader proposition that affirmative claims that are "defensive" in nature are within the scope of an insurer's defense obligation. *See, e.g.,* ***Great West v. Marathon*, 315 F. Supp. 2d at 882** (discussed *supra* at pp. 3-4); ***Selective Ins. Co. v. Creation Supply, Inc.*, 2017 IL App (1st) 161899-U ¶¶ 44-47, 2017 Ill. App. Unpub. LEXIS 1368 at *21-*23, 2017 WL 2855984 (June 30, 2017)** (unpublished order).[12]

In ***Bennett v. St. Paul Fire & Marine Ins. Co.*, ME Civ. No. 04-CV-212-GNZ, 2006 U.S. Dist. LEXIS 29017, 2006 WL 1313059 (D. Me. May 12, 2006)**, the policyholder was a divorce attorney who was sued by the ex-husband of his former client for an order of protection for alleged harassment. The attorney's malpractice insurer accepted the defense of that claim. However, the policyholder also wanted to pursue both (a) a counterclaim against the ex-husband for his harassment of the attorney, and (b) a collection action against the former client's uncle, who had reneged on his agreement to pay the fees incurred in representing his niece. The insurer declined to fund either affirmative claim. The court agreed with the insurer, holding that neither affirmative claim was defensive in nature because neither would eliminate or reduce the policyholder's liability for alleged harassment of the ex-husband. 2006 U.S. Dist. LEXIS 29017 at *14-15. In this regard, it was not enough that the counterclaim would put pressure on the ex-husband to abandon suit or settle for less. Rather, the substance of the counterclaim must be "inextricably intertwined" with the principal action asserted against the insured. *Id.* at *14. Moreover, even if the affirmative claims had been "defensive," given that the insurer had accepted the defense of the claims asserted against the policyholder, the insurer controlled the defense, including whether to pursue the affirmative claims. *Id.* at *15. *See also James 3 Corp. v. Truck Ins. Exch.,* 111 Cal. Rptr. 2d 181, 188 (Cal. Ct. App. 2001) (insurer defending without reservation of rights controls defense, including decisions about affirmative claims).

***Spada v. Uniguard Ins. Co.*, 232 F. Supp. 2d 1155, 1163-64 (D. Ore. 2002), *aff'd on other grounds*, 80 F. App'x 27 (9th Cir. 2003)** (unpublished), entailed coverage for claims stemming from landslides that occurred on adjoining lots – one owned by the insureds and the other by "the McCormicks." The City sent a series of

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[12] Although Illinois Supreme Court Rule 23(e) forbids the citation in Illinois proceedings of unpublished appellate orders, that rule does not prevent citation in non-Illinois proceedings. A recent decision by the U.S. District Court for the Northern District of Illinois in fact cites the unpublished *Creation Supply* order to support a holding that an insurer owed a duty to defend "affirmative" claims. *See Great Am. E&S Ins. Co. v. Power Cell LLC*, 356 F. Supp. 3d 730, 749 (N.D. Ill. 2018).

demand letters to the insureds instructing them to stabilize their lot so as to prevent future damage. The McCormicks sued the insureds, alleging that the insureds were responsible for damage to their lot. The insurer accepted the defense of that suit. The insureds then counterclaimed against the McCormicks and impleaded the City as a third-party defendant, employing their own counsel when the insurer refused to fund the affirmative claims. The district court held that the insurer had no duty to fund the affirmative claims because it had accepted the defense of the principal action, and therefore was entitled to control the defensive strategy. On appeal, the Ninth Circuit affirmed the district court judgment but on different grounds – to wit, that the counterclaims were not defensive and thus there was no need to reach the broader question of whether an insurer must fund the prosecution of defensive counterclaims. 80 Fed. App'x at 29-30.

***National City Bank v. N.Y. Central Mut. Fire Ins. Co.*, 6 A.D.3d 1116, 775 N.Y.S.2d 679 (4th Dept. 2004),** likewise held that an insurer had no duty to fund prosecution of cross-claims by the insured against its co-defendants where the insurer had accepted the defense of the suit brought against the insured and therefore had the right to control the defense strategy.

B. Insurer's Duty to Pay for Anticipatory or Parallel Suits Filed by the Insured

Occasionally, policyholders are more ambitious in the "affirmative" claims for which they seek insurer funding, contending that preemptive or parallel suits that they initiate are essentially "defensive" to covered claims being asserted against the policyholder. As a policyholder seeking to obtain such funding, the actual wording of the insurance policy may be important. Whereas occurrence-based policies typically impose a duty to defend "suits," the defense obligation in claims-made policies typically applies to "claims." Where the insured has been the target of pre-suit demands – sufficient to constitute a "claim" under the policy definition – then a preemptive suit filed by the policyholder is rightfully understood as a "defense" to that "claim," even under the literalist definition of "defend" applied by cases like *VisionAid*.

We describe below some examples of case law addressing an insurer's obligation to fund parallel or anticipatory suits filed by the policyholder.

1. Case law holding that the costs of anticipatory or parallel suits are within the scope of the insurer's defense obligation

In ***Creation Supply, Inc. v. Selective Ins. Co.*, No. 14 C 08856, 2019 U.S. Dist. LEXIS 195456, 2019 WL 5892193 (N.D. Ill. Nov. 12, 2019), *app. dismissed*, No. 19-3430, 2019 U.S. App. LEXIS 39358, 2019 WL 9048966 (7th Cir. Dec. 26, 2019)**, the court upheld an insured's right to payment by its insurer of the costs of two lawsuits that the insured filed in the Northern District of Illinois in response to

a trade dress infringement action filed against it and its CEO in the District of Oregon. The Illinois suits consisted of (a) a declaratory action of non-infringement against the Oregon plaintiff, and (b) a suit against the insured's vendor that supplied the implicated products, seeking indemnity for the infringement claim.[13] The insured presumably was seeking a strategic advantage in having the dispute adjudicated in Chicago where it was headquartered; in fact, its initial response to the Oregon action was to seek dismissal for lack of personal jurisdiction. Ultimately, the Illinois federal court transferred the two underlying lawsuits to the District of Oregon, which then consolidated them with the earlier-filed suit against the insured. Meanwhile, the insured had filed a counterclaim and third-party claim in the Oregon suit that paralleled the suits it had filed in Illinois. In this coverage suit filed in the Northern District of Illinois, the court held the insurer was required to pay the fees incurred by the insured in Illinois before those actions were transferred to and consolidated with the Oregon action. *See* 2019 U.S. Dist. LEXIS 195456 at *8-*9. This result makes sense if you accept that an insurer has a duty to pay the fees for affirmative claims that are defensive in nature – i.e., that will reduce or eliminate the insured's liability in the principal action. Here, part of the insured's defense entailed objecting to

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[13] The procedural history of both the underlying litigation and the coverage dispute is complex, involving a series of rulings by the Northern District of Illinois and the District of Oregon in the underlying litigation and by both the Illinois Appellate Court and the Northern District of Illinois in the coverage dispute. As none of these decisions contains a comprehensive summary of the proceedings, the proceedings described in the text above is pieced together from these various decisions, including:

Creation Supply, Inc. v. Alpha Art Materials, Co., 2013 U.S. Dist. LEXIS 151292, 2013 WL 57299709 (D. Ore. Oct. 22, 2013) (denying insured's summary judgment against vendor in underlying third-party action seeking indemnity).

Too Markers Prod., Inc. v. Creation Supply, Inc., 2014 U.S. Dist. LEXIS 106226, 2014 WL 3818675 (D. Ore. Aug. 4, 2014) (denying vendor's motion for summary judgment in underlying third-party action filed by insured).

Selective Ins. Co. v. Creation Supply, Inc., 2015 IL App (1st) 140152-U (insurer had duty to defend claims asserted against insured in Oregon suit).

Selective Ins. Co. v. Creation Supply, Inc., 2017 IL App (1st) 161899-U (insured had right to recoup litigation expense from insurer of third-party claim prosecuted in Oregon).

See also other decisions issued in the Northern District coverage action: 2015 U.S. Dist. LEXIS 196400 (Aug. 15, 2015) (denying insurer's motion for summary judgment on bad faith and breach of contract claims); 2017 U.S. Dist. LEXIS 22614, 2017 WL 661587 (Feb. 17, 2017) (granting summary judgment to policyholder on breach of contract claim for failure to defend underlying Oregon suit); 2018 U.S. Dist. LEXIS 234977, 2018 WL 10498545 (Dec. 20, 2018) (findings of fact and conclusions of law on bad faith claims).

personal jurisdiction in Oregon, to force the infringement action to proceed in its home state of Illinois. This is a legitimate defensive strategy (even if unsuccessful).

The coverage dispute in ***IPB, Inc. v. Nat'l Union Fire Ins. Co.*, 299 F. Supp. 2d 1024, 1026 (D.S.D. 2003)**, arose in the context of a sale of a business. The insured seller was sued in Arkansas by the buyer to rescind the transaction based upon alleged fraudulent inducement. Meanwhile, a shareholder's suit had been filed in Delaware in which the insured and the buyer were both defendants. In lieu of actively defending the Arkansas action, the insured filed a cross-claim against the buyer in the Delaware suit. The buyer then counterclaimed against the insured in the Delaware action, raising essentially the same claims as it asserted in the Arkansas suit. The Delaware court's ruling included detailed findings, rejecting the buyer's claims of fraud and finding that the buyer's principal motivation for seeking rescission was remorse for the price paid, which precluded the buyer from pursuing its claims in the Arkansas action. The court in the coverage action rejected the insurer's effort to escape payment of the fees incurred by the insured in Delaware, noting that even one of the insurer's representatives agreed that Delaware was a more favorable forum than Arkansas for litigating the dispute.

In ***Great Am. E&S Ins. Co. v. Power Cell LLC*, 356 F. Supp. 3d 730, 749 (N.D. Ill. 2018)**, the insured, "Zeus," was the supplier of batteries used by "SWF" to manufacture battery-operated window shades. There were a series of customer complaints and incidents relating to electrical failures of the shades, including explosions, which led to SWF's recalling the shades. Correspondence between Zeus and SWF ensued, in which SWF blamed the recall and explosions on faulty batteries supplied by Zeus, while Zeus contended that the problems arose from SWF's faulty design of the shades. Zeus sued SWF preemptively, seeking a declaratory judgment that its batteries were not defective and for defamation arising out of the content of SWF's recall notices, blaming Zeus for the product failures. SWF then counterclaimed against Zeus, based on alleged defects in the batteries. Zeus's insurer refused to even defend SWF's claims against Zeus, based upon the policy definitions of "property damage" and "occurrence," and late notice. Not only did the court reject those coverage defenses as to the insurer's duty to defend Zeus against SWF's claims, it also held that the duty to defend encompassed the fees incurred by Zeus in its affirmative claims – including those that pre-dated the filing of SWF's counterclaim.

2. Case law holding that the costs of anticipatory or parallel suits are outside the scope of the insurer's defense obligation

***Post v. St. Paul Travelers Ins. Co.*, 691 F.3d 500, 522 (3rd Cir. 2012)**, adopted a bright-line rule that an insurer never has a duty to pay an insured's litigation expense for a separate lawsuit even if that separate suit is "defensive" of a claim within the scope of the insurer's defense obligations. The court adopted this rule while simultaneously recognizing that the insurer would have a duty to pay the cost of a defensive counterclaim asserted by the insured in an action for which the

insurer did owe a defense. *Id.* The court was persuaded by and followed the reasoning of ***Amquip Co. v. Admiral Ins. Co.*, 2005 U.S. Dist. LEXIS 5462 at *26-*27, 2005 WL 742457 at *7 (E.D. Pa., Mar. 31, 2005)**:[14]

> If courts were to consider the costs an insured incurred by instituting its own action for the purpose of bringing pressure on the other party under the guise of a litigation defense, it would encourage and endorse multiplicity of litigation. This is much different than requiring the insurer to reimburse the insured for the cost of prosecuting counterclaims raised in the same action.

Like *Post*, the court in *Amquip* adopted this bright-line rule against an insurer's duty to fund "defensive" parallel lawsuits while simultaneously recognizing that the insurer would have had a duty to pay the cost of a counterclaim as a "necessary litigation defense that is intertwined with the defense of the underlying complaint." 2005 U.S. Dist. Lexis 5462 at *26.

At least one California court likewise has held there is no duty to fund an offensive action in another court, even if it's "the best defense." ***Gray v. Underwriters at Lloyd's, London*, No. A096189, 2002 WL 1587925, *9 (Cal. App. July 19, 2002) (unpublished).** The court cited several cases for the proposition that "California cases have not imposed a duty to assert affirmative claims on an insurer who is defending an action." *Id.*

***Weinstein & Riley, P.S. v. Westport Ins. Corp.*, No. C08-1694JLR, 2011 U.S. Dist. LEXIS 26369, 2011 WL 887552 (W.D. Wash. Mar. 14, 2011)**, entailed a coverage dispute over a convoluted pair of underlying cases, arising out of a stock-sale of a business, "B-Line," in which the attorney/insured served as CEO, held an minority interest, and served as B-Line's outside attorney. The first underlying suit was filed in Oregon by B-Line's majority shareholders to compel the attorney to tender his shares, as well as asserting claims for breaches of contractual and fiduciary duties against him. 2011 U.S. Dist. LEXIS 26369 at *4. Subsequently, B-Line – now controlled by the acquiring shareholders – filed suit against the insured in Washington for both attorney malpractice and breach of fiduciary duties as CEO. *Id.* at *8-12. His malpractice carrier concluded that most of the claims in the Washington suit were outside the scope of coverage – because some arose from the insured's role as CEO and coverage for most of the attorney malpractice claims were barred by an exclusion arising from the insured's ownership stake in B-Line. However, the insurer concluded that one claim was potentially within the scope of coverage because it arose from the insured's refusal to follow the client's instructions to withdraw as its attorney, occurring after he no longer owned shares B-Line (the "failure-to-withdraw"

[14] The Third Circuit's opinion in *Post* incorrectly cites to a subsequent *Amquip* decision, reported at 231 F.R.D. 197, for this proposition.

claim). *Id.* at *13-16. The insurer therefore agreed to defend the Washington suit subject to a reservation of rights and subject to an allocation of fees between the failure-to-withdraw claim and the non-covered claims. *Id.* at *15-17. Meanwhile, the insured filed a third-party claim against B-Line in the Oregon action, mirroring the claims asserted by B-Line against the insured in Washington, including the failure-to-withdraw claim. *Id.* at *26-27. The insured then tried to bootstrap the inclusion of the failure-to-withdraw claim in the Oregon action to impose a duty on the insurer to fund the entirety of his fees in that suit. The coverage court denied this effort, holding that the third-party failure-to-withdraw claim in the Oregon action was "not inextricably interrelated" to the other claims in the Oregon suit, but rather a "discrete, stand-alone claim" and there were no claims asserted against the insured in the Oregon suit for which the insurer owed a defense. *Id.* at *39, *48-49. However, as discussed in the following section, the court did allow the insured, under allocation theories, to recoup a limited amount of the fees incurred in the Oregon action as reasonably related to his defense of the failure-to-withdraw claim asserted in the Washington suit.

C. The Back Door: Even if the Insurer has no Duty to Fund Affirmative Claims, Fees for such Claims May be Recoverable Under Allocation Theories.

Many courts follow the rule that, when the fees incurred in connection with non-covered claims represent legal services that were also reasonable and necessary to the defense of the covered claims, the entirety of those fees are within the scope of the covered defense costs. *See, e.g., Safeway Stores* (cited in footnote 9 *supra.*) Not all courts follow this rule, however. And, even as to courts that generally do, an exception is made when the policy contains explicit language dictating an allocation of fees between covered and non-covered fees, which is increasingly common. A full-blown discussion of court decisions addressing general principles for allocation of defense costs is beyond the scope of this paper.[15]

In jurisdictions where the rule is accepted that the insurer must pay all legal fees that were reasonably related to defense of covered claims, even if those fees also advanced the insured's position as to non-covered claims, the policyholder has a strong argument for requiring the insurer to pay fees incurred for affirmative claims, even if the court does not consider the affirmative claims themselves within the scope of the insurer's defense obligation. For example, in ***Potomac Elec. Power Co. v. California Union Ins. Co.*, 777 F. Supp. 980, 984 (D.D.C. 1991)**, the court held

[15] The subject of allocation of defense costs was discussed in a paper and presentation at the 2019 ACCC annual meeting. *See* F. Cordell, J. Bryan, M. Hamilton & S. Charlton, *"'Allocation – Is That a Thing?' – Navigating Disputes Over Allocation of Covered and Uncovered Claims,"* at 1-10 (ACCC 2019 Annual Meeting, Chicago, IL, May 8-10, 2019).

that the fees incurred by the insured in filing a "preemptive" action against the State Attorney General were fully recoverable from the insurer if the policyholder could show that those expenses "were reasonably related to the [defense of the] PCB civil suit," for which the insurer did owe a defense.[16]

Similarly, ***Etchell v. Royal Ins. Co.*, 165 F.R.D. 523, 563 (N.D. Cal. 1996)**, upheld the policyholder's right to recover the cost of a non-covered cross-claim asserted in a trespass action for which the insurer owed a defense obligation because

> [t]here was a great deal of overlap in the underlying action between the evidence and law made relevant by the claims in the Blasis' complaint and the evidence and law made relevant by the claims in the Etchells' cross-complaint. …
>
> In this setting, California courts would permit Safeguard to escape liability for fees or costs incurred in prosecution of the cross-complaint only if Safeguard could adduce undeniable evidence that the challenged fees or costs would not have been incurred but for the filing of the cross-complaint.

Accord ***MGA Entertainment, Inc. v. Hartford Ins. Group*, No. ED CV 08-0457-DOC(RNBx), 2012 U.S. Dist. LEXIS 24000 at *58-68 (C.D. Cal. Jan. 24, 2012)** (although fees incurred by insured in counterclaim did not constitute covered defense costs, insurer may not seek reimbursement from policyholder for those fees unless the insurer can show that "the fees and costs incurred for an insured's affirmative claims and defenses are separable and those fees and costs are allocated *solely* to the affirmative claims"); ***Amquip*, 2005 U.S. Dist. LEXIS 5462 at *27** (leaving open for trial a determination whether the insured "incurred costs common to both the defense of the Ohio action [for which the insurer owed a defense obligation] and the prosecution of the [parallel] Pennsylvania action [which was outside the insurer's defense obligation).

On the other hand, when the insurer is able "to separate the fees associated with preparing and asserting an affirmative counterclaim from other defensive fees," rules of allocation may defeat the policyholder's efforts to recoup the costs of pursuing affirmative claims in situations where the affirmative claims are outside the scope of the insurer's defense obligations. ***See Sullivan v. Am. Family Mut. Ins. Co.*, A06-1285, 2007 Minn. App. Unpub. LEXIS 750, 2007 WL 2106142 at *2 (July 24,**

[16] In addition to holding the insurer responsible for the fees incurred in its "preemptive" affirmative civil suit, the court relied upon the same allocation principles to hold the insurer responsible for its fees incurred in criminal grand jury proceedings. *See* 777 F. Supp. at 984.

2007) (quoting ***St. Paul Fire & Marine Ins. Co. v. Nat'l Computer Sys., Inc.*, 490 N.W.2d 626, 632 (Minn. App. 1992))**.

Further, even when the court follows the general rule that an insurer may be liable for the costs of non-covered affirmative claims where the legal services also overlapped and advanced the defense of covered claims, the court may deny or reduce the insured's recovery if those fees were disproportionate to the insured's exposure for the covered claim. This is illlustrated by ***Weinstein & Riley*, 2011 U.S. Dist. LEXIS 26369 at *57-68**, in which the court awarded a mere $40,000 out of the $1.8 million that the insured claimed as fees incurred in the separate Oregon lawsuit that were reasonably related to defense of the covered failure-to-withdraw claim asserted in the Washington action. Among the reasons cited by the court was that the "$1.8 million in attorney's fees is 'excessively disproportionate' to the [insured's] risk of liability on the 'failure to withdraw' malpractice claim," given that the underlying plaintiff had abandoned the failure-to-withdraw claim after concluding that the damages "would be negligible." *Id.* at *66-67

Conclusion

Courts that limit the insurer's obligation to fund affirmative claims, even where necessary for a complete defense, often rely on the perceived "plain meaning" or "common usage" of the word "defend." The Massachusetts court in *VisionAid* held "the plain meaning of the word 'defend' is clear" and does not obligate the insurer "to prosecute an affirmative counterclaim on behalf of its insured," based upon two selected dictionary definitions of the word. *See* 477 Mass. at 348-49 (quoting Webster's Third New Int'l Dictionary 591 (1993)); *see also Red Head Brass, Inc. v. Buckeye Union Ins. Co.*, 135 Ohio App. 3d 616, 628 (1999) (same).

There are, however, other definitions and common usages that suggest a less restrictive meaning for the "defend." For example, the word is also defined as "to act as attorney for" someone,[17] or to "represent the defendant."[18] This meaning is particularly apropos to the insurance context, as the insurer can only satisfy its duty to defend by retaining attorneys. And "to act as an attorney" logically includes taking actions a reasonable defense attorney would take—which in an appropriate case will include counterclaims or third-party claims.

As the dissenting justices in *VisionAid* observed, courts should "focus on what it means to defend a proceeding, which is the duty the insurer agreed to assume."

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[17] WEBSTER'S SEVENTH NEW COLLEGIATE DICTIONARY, at 216 (1971). *Accord Merriam-Webster.com Dictionary*, https://www.merriam-webster.com/dictionary/defend (accessed July 13, 2020). *See also* RANDOM HOUSE WEBSTER'S UNABRIDGED DICTIONARY, at 522 (2d ed. 1998) ("to serve as attorney for").

[18] BLACK'S LAW DICTIONARY, at 377 (5th ed. 1979).

> Because the duty to defend a "claim" under the contract means to defend the insured in any proceeding where a wrongful act is alleged, … the broader view of the duty to defend includes the duty to prosecute compulsory counterclaims that are intertwined with the insured's defense. This broader view is consonant with what any reasonable attorney representing the insured would do to defend a proceeding; the narrower view [adopted by the court] is not.

477 Mass. at 358 (Gants, C.J., dissenting).

More broadly, in common usage, "defend" means to "protect from attack," as in "you have the right to defend yourself if you are being attacked."[19] Defense in this example is obviously not limited to fending off blows or crouching in a defensive position. Self-defense includes striking back. Britain's airstrikes on Germany in 1940 were an integral part of Churchill's defense of the island.[20]

Indeed, the *VisionAid* court begs the question by declaring that "the essence of what it means to defend is to ***work to defeat*** a claim that could create liability against the individual being defended." 477 Mass. at 348-49 (emphasis added). On its face, "work[ing] to defeat a claim" may very well include offensive and preemptive actions. And, surely "defeat[ing] a claim" includes taking steps to "diminish liability," as was pointedly made clear in *Great West v. Marathon Oil*:

> "Defense" is about avoiding liability. Claims and actions seeking third-party contribution and indemnification are a means of avoiding liability just as clearly as is contesting the claims alleged to give rise to liability.

315 F. Supp. at 882.

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[19] *Macmillan Online Dictionary*, https://www.macmillandictionary.com/us/dictionary/american/defend (accessed July 13, 2020).

[20] *See* ERIK LARSON, THE SPLENDID AND THE VILE 306 (Crown 2020).