

The Duty to Defend “Inextricably Intertwined” Actions

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In most instances, when an insurer defends its insured against an action seeking damages that are potentially covered under the policy, the defense is relatively straight-forward – the insurer provides a defense to the action and ultimately indemnifies the insured for those portions of any judgment or settlement that are covered under the policy. However, during the course of that defense, the insured may be subjected to a separate action that, while not itself potentially covered under the policy, is related to the defense of the potentially-covered action. Or, it may be that the insured is compelled to file a counterclaim for affirmative relief in conjunction with the defense of the potentially-covered action. In either event, there is typically no coverage under the usual liability insurance policy for these tangential matters. Yet, policyholders have been heard to argue that the insurer should fund these otherwise non-covered actions as part of its defense obligation vis-à-vis its defense of the potentially-covered action. The argument heard in support of that position is the so-called “inextricably intertwined” theory, specifically, that the legal and factual issues to be litigated in the non-covered action are so “inextricably intertwined” with those to be litigated in the covered action that the defense of the former is reasonable and necessary for the defense of the latter.

While the majority of courts would appear to reject such an argument, there are courts in various jurisdictions that have at least entertained the notion that an insurer’s duty to defend may include costs related to “inextricably intertwined” actions. This article will present the decisions on both sides of this issue and note how, if at all, they can be reconciled.

The typical CGL policy¹ obligates the insurer to “defend” the insured against actions which seek damages potentially covered under the policy. The word “defend” is the key, as it connotes the concept of mounting a defense on behalf of an insured who has been sued in an action. A common scenario in which the “inextricably intertwined” theory presents itself is where the insured has filed a claim for affirmative relief in conjunction with the action in which it has sought a defense from its insurer. It may be that the insured started the action first by filing suit against the defendant, prompting a counterclaim from the defendant. Or, under the notion that “the best defense is a good offense”, perhaps the insured has filed a counterclaim against the plaintiff in response to being sued.

In either event, the insured now finds itself embroiled in two actions: one in which it is seeking affirmative relief; the other in which it is being sued for damages, and being defended by its carrier in that action. Under this scenario, it is not uncommon for an insured to demand that the defending insurer also pay the costs of prosecuting the affirmative relief claim, arguing that in order to defeat the covered claim, they must also win the affirmative relief claim. The problem, of course, is that numerous jurisdictions have held that the insurer's duty to defend generally does not extend to prosecuting claims for affirmative relief (see, e.g., Spada v. Unigard Ins. Co., 80 Fed. Appx. 27, 29 (9th Cir. 2003)(unpublished) - holding that counterclaims and cross-claims do not come within the common meaning of "defense"); James 3 Corp. v. Truck Ins. Exchange, 91 Cal. App. 4th 1093, 1104 (2001) - "[t]here is nothing in the policy that contractually obligates [the insurer] to fund and prosecute an insured's affirmative relief counterclaims or cross-complaints."); Int'l Ins. Co. v. Rollprint Packaging Prods., Inc., 312 Ill. App. 3d 998 (2000) - finding that insured's counterclaim was not defensive in nature; Red Head Brass, Inc. v. Buckeye Union Ins. Co., 135 Ohio App. 3d 616 (1999) - holding that insurer is not obligated to pay expenses for prosecuting compulsory counterclaim); see also Windt, Insurance Claims and Disputes § 4:41 (4th ed. 2001)("An insurer, being obligated only to defend claims brought 'against' the insured, is not required to bear the cost of prosecuting a counterclaim on behalf of the insured.").

Insurance companies who have denied coverage for the costs of prosecuting affirmative relief on behalf of its insureds, citing the general principles noted above, have been met with varying degrees of success by the courts when it appears to that court that the two actions are “inextricably intertwined” such that coverage for the affirmative relief claim is a “reasonable and necessary” item of defense costs for the potentially-covered claim.

One of the leading, and often-cited, cases in this regard is Safeguard Scientifics, Inc. v. Liberty Mutual Ins. Co., 766 F.Supp. 324 (ED PA 1991). That was a situation in which the insured was sued for breach of contract, defamation and other causes of action and the insured filed a counterclaim for similar relief. Liberty Mutual argued that the insured was not entitled to recover its expenses incurred in prosecuting the counterclaim. The court disagreed: “the pursuit of the counterclaims was inextricably intertwined with the defense of the Barnes’ claim and was necessary to the defense of the litigation as a strategic matter. Thus, Liberty Mutual’s duty to defend extends to the counterclaims raised in the same proceeding”.

¹ Although insurance policies come in all shapes and sizes, this Article will focus on the “standard” CGL policy and other similar policies which contain a duty to defend component.

In Great West Casualty Co. v. Marathon Oil Co., 315 F.Supp.2d 879 (ND Ill 2003), an Illinois federal court held that an insurer had a duty to fund the costs of an insured's prosecution of third party indemnification and contribution actions. The court held that prosecution of these cases falls within the insurer's defense obligation: "'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. A duty to defend would be nothing but a form of words if it did not encompass all litigation by the insured which could defeat its liability, including claims and actions for contribution and indemnification."

The court relied on an Illinois state court case, International Insurance Co. v. Rollprint Packaging Products, Inc., 312 Ill. App. 3d 998 (2000). In Rollprint, the insurer brought a declaratory judgment action seeking a declaration that it did not owe Rollprint a duty to defend and indemnify it in a federal employment discrimination lawsuit pursuant to a commercial general liability insurance policy. The trial court found, and the appellate court agreed, that the insurer's duty to defend was triggered by the allegations of the federal complaint. The underlying lawsuit dealt with the plaintiff's termination from Rollprint's employ, and in the course of defending the lawsuit, Rollprint counter-claimed, seeking a finding that it owned various trade secrets, the ownership of which the federal plaintiff's claim had put in issue. The court ruled that the insurer had no obligation to pay legal fees incurred in connection with this ownership of trade secrets counterclaim. Discussing cases from outside Illinois (due to lack of Illinois authority) which had held that an insurer which is obligated to defend is also obligated to provide coverage for certain counterclaims and cross-claims filed by the insured in the underlying action, the court noted that the insurer's duty with respect to affirmative claims brought by the insured depends upon whether such claims are "defensive" in nature, meaning "filed to limit a defendant's potential liability." Such claims are encompassed by the duty to defend whereas offensive claims, such as Rollprint's suit for a declaration as to its ownership of trade secrets, are not.

In Oscar W. Larson Co. v. United Capitol Insurance Co., 845 F. Supp. 458, 461 (W.D. Mich.1993), the court ruled that with respect to expenses relating to claims for affirmative relief, they are encompassed by the duty to defend if they "are expenses which are reasonable and necessary to limit or defeat liability."

In Tig Insurance Co. v. Nobel Learning Communities, Inc., 2002 U.S. Dist. LEXIS 10870, 2002 WL 1340332, at *1 (E.D.Pa. June 18, 2002), Nobel sued Dr. Levy, the previous owner of its assets, seeking a declaration of the parties' respective intellectual property rights. Levy and his associated entities counterclaimed for copyright infringement. In holding that Nobel's insurer had a duty to defend its affirmative claims, the court employed the same analysis, stating, "Although few courts have addressed the issue of an insurer's liability for affirmative claims by the insured, the courts that have found liability have done so where the claims could 'defeat or offset liability.'"

The issue was also discussed in Perchinsky v. State of New York, 232 A.D.2d 34 (N.Y. App. Div. 1997). There, an employee of Lemon Enterprises, Inc. which had been hired by Todd's Kite World, which in turn had been hired by Granny "G" Productions, Inc., to decorate an armory for a Lions Club home show, fell and was injured in the course of installing wiring. The employee sued the Lions Club and Granny "G," who in turn commenced third-party actions against Kite

World and Lemon Enterprises for contribution and/or indemnity. Granny "G" had an indemnification agreement with the Lions Club, pursuant to which the Lions Club sought indemnification for the costs and counsel fees it incurred in pursuing its third-party actions against Kite World and Lemon Enterprises. The court, while noting that the Lions Club could not recover for the expense of enforcing its contractual right to indemnification against Granny "G," ruled that the Lions Club was entitled not only to its costs of defense in the main claim, but its costs in pursuing the third-party actions against Kite World and Lemon Enterprises "because the filing of the third-party actions was an essential component of the defense of the main action"

In the case of Ultra Coachbuilders, Inc. v. General Security Ins. Co., 229 F.Supp.2d 284 (SD NY 2002), the insured prosecuted three counterclaims which the insurer refused to pay for. The court ordered payment, holding "the counterclaims, alleging unfair competition and interference with competitive advantage, were used to argue (albeit unsuccessfully) that the injunction application was barred by the doctrine of unclean hands and were thus 'inextricably intertwined' with the defense of [defendant's] claims and necessary to the defense of the litigation as a strategic matter."

Lastly, there is the case of Post v. St. Paul, 752 F.Supp.2d 499 (ED PAZ 2010). In Post, the insured/attorney (Post) was sued for malpractice by a client and for sanctions by the plaintiff's attorney in the underlying action. He filed separate actions for defamation against the attorney and for abuse of process against the client. Post's insurer agreed to defend Post against the malpractice and sanctions matters. Post sought to recover the fees and costs incurred in his separate actions for defamation and abuse of process.

The trial court, applying Pennsylvania law, held that the costs incurred in one of Post's separate actions were directly related to the defense of the covered action and in defense of the covered claims; the work was "part of the same dispute" as the legal malpractice claim. The two were "inextricably intertwined". However, a different result was reached as to the defamation claim, which the court found was not necessary to the defense of the litigation. They were not "inextricably intertwined". The court held that in order to meet the "inextricably intertwined" standard, "the two actions should be so related that it is difficult to separate the work completed for each, or to argue that the work done on the collateral litigation was not necessary to the defense of the litigation as a whole".

There are, of course, many decisions landing on the other side of the fence as well. For example, in Bennett v. St. Paul Fire & Marine Ins Co., 2006 WL 1313059 (D. Me. 2006), a federal trial judge rejected the "inextricably intertwined" argument. There, the insured argued that his counterclaim against the plaintiff arose from the "same core of operative facts" as the plaintiff's complaint and was therefore "inextricably intertwined" with his defense. The court disagreed. It closely examined the facts alleged in each pleading and concluded that the "counterclaim primarily seeks affirmative relief based on allegations that are only tangentially related to Liberty's complaint." The court did not find the actions to be "inextricably intertwined". The court also noted that the insured did not demonstrate that the allegations in his counterclaim will diminish or defeat plaintiff's claims against him.

In James 3 Corporation v. Truck Insurance Exchange, 91 Cal.App.4th 1093, 1104 (2001), the insured argued the insurer's agreement to "provide a defense" encompassed an obligation to file counterclaims for the insureds if the counterclaims are "factually intertwined with the affirmative defenses being asserted." The court disagreed and held "there is nothing in the policy that contractually obligates [the insurer] to fund and prosecute an insured's affirmative relief counterclaims or cross-complaints." Id.

In Duke Univ. v. St. Paul Mercury Ins. Co., 384 S.E.2d 36, 46 (N.C. Ct. App. 1989), the court held that "[a]n insurer, being obligated to defend claims brought 'against' the insured, is not required to bear the cost of prosecuting a counterclaim on behalf of the insured." Similarly, the Ohio Court of Appeals held in Red Head Brass, Inc. v. Buckeye Union Ins. Co., 735 N.E.2d 48, 57 (1999):

The terms of the insurance contract, which defined [the insurer's] duty to defend, in no way obligated [the insurer] to compensate [the insured] for the expense of prosecuting its counterclaim. [The insured], in its contract with [the insurer], bargained only for the insurer to pay for defending the insured against litigation. It did not bargain for legal representation where the insured is the plaintiff. Nor does Ohio law mandate such services by an insurer. [The insured] would like this court to expand the duty to defend in Ohio, but we decline to do so."

What ultimately emerges from this discussion is that the majority of courts do not recognize insurance coverage for the costs associated with bringing affirmative claims. However, where that question arises, some courts apply a two-part test to determine if those costs must be borne by the insurer as part of their defense obligation. The test is whether the offensive claims are defensive in nature and reasonable and necessary to limit or defeat liability. The courts will look at whether: 1) the counterclaims are so linked to the plaintiff's claims that they cannot be separated (Ultra Coachbuilders, Inc., *supra*; Safeguard Scientifics, *supra*; and 2) the counterclaims were asserted as a strategic defensive move to limit or defeat liability (125 Oscar W. Larson Co., *supra*; Safeguard Scientifics, *supra*). It remains the well-established rule that there is no coverage for the insured's costs of prosecuting an affirmative relief claim unconnected to the action being defended and designed simply to benefit the insured.

The cases discussed above focus on the scenario in which a counter-claim or third party claim is part and parcel of the "main action" to which the insurer is providing a defense. But what about a situation in which a separate and distinct action has been filed against the insured as a different case (perhaps even in a different forum or venue), and even though that separate action is clearly not covered, the insured is heard to argue that that action is "inextricably intertwined" with the action being defended such that a defense should also be afforded to the otherwise non-covered cause of action. For example, suppose an insured is being defended in a civil action arising out of an altercation between the insured and the plaintiff. Concurrently with that civil action, the insured is being prosecuted in a criminal action arising out of the same altercation. Logically speaking, the two actions are "inextricably intertwined" in that the same evidence, witnesses and facts will be presented, and the insured might argue that a successful defense of the criminal action is crucial to the successful defense of the civil action. Yet, at the same time, we know that there is no duty to

defend insureds in a criminal action (Stein v. Int'l Ins. Co., 217 Cal. App. 3d 609, 615 (1990); Perzik v. St. Paul Fire & Marine Ins. Co., 228 Cal. App. 3d 1273, 1275 (1991))

Courts have been less hesitant to embrace the duty to defend such clearly non-covered separate actions simply because the defense of that action might “benefit” the defense of the covered action in some way. In United Pacific Ins. Co. v. Hall, 199 Cal.App.3d 551 (1988), an elementary school sustained serious fire damage. Juvenile proceedings were instituted against the Halls' son pursuant to Welfare and Institutions Code § 602. It was ultimately determined that the minor was not responsible for the fire. While this proceeding was pending, the school district filed a civil action for damages against the Halls. The Halls tendered defense to their homeowners' insurance company, United Pacific. The policy obligated United Pacific to defend an action for damages against the insured. United Pacific paid for counsel to defend the civil suit, but not for his services rendered in the juvenile proceeding. United Pacific then commenced a declaratory relief action to obtain a determination of its obligation to pay counsel for the juvenile proceeding.

The Court of Appeal upheld summary judgment in United Pacific's favor. The court concluded that “[w]here the language of an insurance policy plainly obligates an insurer to defend an action for damages against the insured, the insurer has no obligation to defend an insured in criminal or administrative proceedings where damages are not sought. The obligation to defend, which is co-extensive with coverage under the policy, is plainly limited to actions seeking damages. Since the juvenile proceeding sought no damages from the Halls, United Pacific had no obligation to furnish them with counsel in that proceeding.” The court rejected the insured’s arguments that its counsel’s involvement in the juvenile proceeding was necessary for the defense of the civil action, noting other ways that counsel could have obtained the information.

It would appear that the notion of defending an insured in a separate and distinct, clearly non-covered, action simply because the defense of that action might be beneficial to the defense of the covered action is a bridge that courts are not yet ready to cross. However, the groundwork laid by courts which have adopted the “inextricably intertwined” theory may inch the discussion closer to a finding of a defense obligation for those separate, non-covered actions. We will all be looking at these scenarios closely to see what develops.