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Does the Duty to Defend Include an Obligation to Fund Counterclaims?

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Recently, the First Circuit, in the matter of *Mount Vernon Fire Insurance Company* v. *VisionAid, Inc.,* certified to the Massachusetts Supreme Judicial Court the question of whether an insurer may be required, as part of its defense of a claim against its policyholder, to provide and to pay for counsel to prosecute its policyholder's counterclaim against the claimant. 825 F.3d 67 (1st Cir. 2016). VisionAid is a defendant in a state court lawsuit filed by a former employee, who alleged that his termination was the product of illegal age discrimination. VisionAid's defense includes, among other bases, a claim that it terminated the claimant not because of his age, but instead, because it discovered that he had misappropriated several hundred thou sand dollars of corporate funds. However, VisionAid does not want simply to rely on this as a defense. Rather, VisionAid wants to assert a counterclaim for misappropriation in an attempt to recover those funds. VisionAid argues that its liability insurer, Mt. Vernon, which is covering the defense against the age-discrimination claim, must also cover the prosecution of the misappropriation claim. In response, Mt. Vernon brought an action against VisionAid, seeking a declaratory judgment that it had no duty to cover the costs of prosecuting and paying for the misappropriation counterclaim. The district court granted summary judgment in favor of Mt. Vernon. In short, it found that according to the plain language of VisionAid's policy, which "covers only those Claims first made against the Insured during the Policy Period," Mt. Vernon was not required to fund an affirmative counterclaim. VisionAid appealed. In support of its appeal to the First Circuit, VisionAid contended that Mt. Vernon's duty to defend included prosecuting the counterclaim in accordance with Massachusetts's "in for one, in for all" or "complete defense" rule, under which "an insurer must defend the *entire* lawsuit if it has a duty to defend any of the underlying counts in the complaint." *Liberty Mut . 1115. CO. v. Metro. Life 1115. Co. ,* 260 F.3d 54, 63 (1st Cir. 2001) (emphasis added). Recognizing that the dispute "has potentially wide-reaching implications for how liability insurers must conduct themselves in the Commonwealth of Massachusetts," the First Circuit determined that the "most prudent course" was to have this question of "first impression" decided by the Massachusetts Supreme Judicial Court.

As recognized by the district court in the *Mount Vernon* case, courts in other jurisdictions are split on the issue of whether an insurer's duty to defend includes an obligation to prosecute counterclaims for affirmative relief. While the majority of courts do not impose such a duty, some jurisdictions do impose a duty, in limited circumstances, to prosecute counterclaims for affirmative relief that are "inextricably intertwined" with the defense. In determining whether the counterclaim is "inextricably intertwined," courts have often looked to whether the counterclaim would offset liability in the underlying claim. Courts have been less persuaded that a counterclaim is inextricably intertwined by arguments that resolution of the counterclaim would hasten settlement of the main claim . Thus, there are potential issues that an insurer defending a claim against its policyholder may face in settling the claim when it does not fund a counterclaim prosecution. Majority Rule: No Duty to Prosecute Counterclaims The majority of both federal and state cases to consider the issue of whether an insurer's duty to defend includes an obligation to prosecute counterclaims for affirmative relief have declined to impose such a duty upon insurers. *See, e.g., Spada v. Unigard Ins. Co.,* 80 Fed. Appx. 27, 29 (9th Cir. *2003); Vansteen Marine Supply, Inc. v. Twill City Fire 1115. Co.,* 2008 WL 599850 (Tex. App. Mar. 6, 2008);

James 3 *Corp. v. Truck 1115. Exchange,* 91 Cal. App. 4th 1093, 1104 (Ca l. Ct. App. 2001); *Int'l Ins. Co. v. Rollprint Packaging Prods., Inc.,* 728 N.E.2d 680, 694 (Ill. App. Ct. 2000); *Red Head Brass, Inc. v. Buckeye Union 1115. Co., 735* N.E.2d 48 (Ohio Ct. App. 1999); *Towne Realty, Ill c. v. Zurich Ins. Co.,* 548 N.W.2d 64, 68-69 (Wis. 1996); *Goldberg v. Am. Home Assur. Co.,* 80 A.D.2d 409, 410 (N.Y. App. Div. 1981); *St. Paul Fire & Marine Ins. Co. v. Nat'l Computer Sys., Inc.,* 490 N.W.2d 626, 632 (Minn. Ct. App. 1992); *Duke Univ. v. St. Paul Mercury Ins. Co.,* 384 S.E.2d 36 (N.C. Ct. App. 1989).

Generally, courts are persuaded by the fact that the policies at issue do not provide coverage expressly for counterclaims. *See, e.g., Morgan, Lewis & Bockius LLP v. Hanover Ins. Co.,* 929 F. Supp. 764, 773 (D.N.J. 1996) (no coverage for counterclaim filed by policyholder because "[t]he insurance policies do not cover affirmative claims asserted by the insured .... "); *Reynolds v. Hartford Acc. & Indem. Co.,* 278 F. Supp. 331, 333 (S.D.N.Y. 1987) ("[a]s the insurance contract never contemplated the obligation to bring affirmative claims on behalf of its assured and the prosecution of the counterclaims would no doubt entail extra expenditures on the part of the insurance carrier, to imply an obligation on its part to bring counterclaims would be manifestly unfair"); *Barney v. Aetna Cas. & Sur. Co.,* 185 Ca l. App. 3d 966, 975 (Cal. Ct. App. 1986) (no duty to prosecute counterclaims, noting that "[the insurer] had no duty under the policy to file a cross-complaint on [the insured 's] behalf, for nothing in the policy provisions imposes upon the insurer the duty to prosecute claims of the insured against third parties"). For example, in *Duke Univ.,* the North Carolina Court of Appeals 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." 384 S.E.2d at 46 (emphasis added). In *Shoshone First Bank v. Pacific Employers Ins. Co., 2*!'.3d 510, 514 (Wyo. 2000), the Wyoming Supreme Court held that the insurer was not obligated to prosecute counterclaims that the insured had brought on its own behalf. Looking to the terms of the policy at issue, the court reasoned: "We invoke our rule that if an insurance policy fails to specify coverage for prosecuting counterclaims, the policy language will not be ' tortured' to create an ambiguity." *Id.* at 516. The policy issued to Shoshone did not obligate the insurer to prosecute any claims.

In *Red Head Brass, Inc.,* a case from the Court of Appeals of Ohio (Ninth District, Wayne County), the underlying suit involved a former employee of Red Head who secured employment at a competitor. 735 N.E.2d at 50. In this case, "Red Head believed that the former employee had taken Red Head's trade secrets with him and was using them to the benefit [of the competitor]." *Id.* Red Head hired an investigator to obtain employment at the competitor to investigate, but the competitor "uncovered the presence of Red Head's agent in their employ." *Id.* The competitor commenced a civil action against Red Head for "slander, libel, and tortious interference with business .... " *Id.* Red Head, in turn, filed a counterclaim, " alleging the misappropriation of trade secrets and demanding an accounting and punitive damages." *Id.* at 51.

Red Head argued that its insurer's duty to defend included a duty to prosecute Red Head 's compulsory counterclaim against its competitor. *Id.* at 56. After concluding that Ohio law does not require that an insurer prosecute a compulsory counterclaim on behalf of its insured, the court examined the language of the policy and determined that the policy similarly did not impose such an obligation on the insurer. Focusing on the absences of definitions of "defend" and "defense" in the policy, the court resorted to the dictionary and defined these terms to mean, in the context of a legal suit, "to deny or oppose the right of a plaintiff in regard to (a suit or wrong charged)I.]" *Id.* at 57 (alteration in original) (internal citation omitted).

Minority Rule: Duty to Prosecute "Inextricably Intertwined" Counterclaims

A minority of jurisdictions have extended the duty to defend to include a duty to prosecute counterclaims that are "inextricably intertwined with the defense" and necessary to the defense strategically. *Safeguard Scientifics, Inc. v. Liberty Mut. Ins. Co.,* 766 F. Supp. 324, 334 (E.D. Pa. 1991), *rev'd in part on other grounds,* 961 F.2d 209 (3d Cir. 1992). However, it is noteworthy that the Third Circuit in *Post v. St. Paul Travelers 1115. Co.,* 691 F.3d 500, 522 (3d Cir. 2012), applying Pennsylvania law, held that an "insurer has no duty to cover the expenses incurred by an insured in prosecuting an entirely new and separate action even if that action is related to the underlying case," irrespective of whether the separate action is "inextricably intertwined" with the covered claims. *See also Amquip Corp. v. Admiral Ins.* Co., 2005

WL 742457, at '7 (E.D. Pa. Mar. 31, 2005). In *Bennett v. St. Paul Fire & Marine Ins Co.,* 2006 WL 1313059 (D. Me. May 12, 2006), the United States District Court for the District of Maine acknowledged that Maine state courts have not addressed the issue of whether an insurer's duty to defend extends to prosecuting claims for affirmative relief. Nevertheless, the court held that the insurer in that case did not have a duty to prosecute the policyholder's counterclaim because even if Maine followed the minority of juris dictions imposing such a duty when the counterclaim was "inextricably intertwined with the defense," the facts in the case did not demonstrate such intertwining. The policyholder was a divorce attorney who sought a defense in a lawsuit filed by Scott Liberty, the ex-husband of the policyholder's client. Liberty alleged that the policyholder committed various torts between March 2000 and May 2003. The policyholder asserted a counterclaim against Liberty, alleging generally that Liberty intimidated and harassed him through threats and defamatory statements and by instituting frivolous proceedings against him. Based on these facts, the district court concluded that the policyholder's counterclaim was only tangentially related to Liberty's claims against him, and thus, it was not "inextricably intertwined with the defense." *Id.* at *4. The court also noted that the insured did not demonstrate that the allegations in his counterclaim would diminish or defeat the plaintiff's claims against him. *Id.* at *5.

Considering the *Bennett* decision, it is interesting that the First Circuit in *Mount Vernon* certified the issue of a duty to prosecute counterclaims to the Massachusetts Supreme Judicial Court. Similar to the court in *Bennett,* the district court in *Mount Vernon* determined that the counterclaim for misappropriation was not "inextricably intertwined" with the wrongful termination claims asserted against the policyholder. 91 F. Supp. 3d 66, 73 (D. Mass. 2015). The court reasoned that VisionAid 's misappropriation counterclaim was not necessary to defeat the age-discrimination claim. That is, under Massachusetts law, VisionAid need only present evidence of a legitimate, nondiscriminatory reason for terminating the employee, which could be accomplished by showing that VisionAid was on notice of the alleged misappropriation. To negate the wrongful termination claim, Vision Aid did not need to establish each of the elements of a misappropriation claim. The district court reasoned that alternatively, a jury could find that despite the employee's misappropriation, he was impermissibly terminated for discriminatory reasons. Thus, the misappropriation counterclaim would not automatically offset Vision Aid's potential liability. Were VisionAid to prevail with its counterclaim and to recoup misappropriated funds from the employee, Mount Vernon would not be entitled to such funds to offset its liability if the wrongful termination claim was successful. Thus, the First Circuit in *Mount Vernon* could have affirmed on the basis of the district court's reasoning that even if the Massachusetts Supreme Court ultimately followed the minority of jurisdictions and imposed a duty to prosecute "inextricably intertwined" counterclaims, Mount Vernon nevertheless did not have a duty to prosecute VisionAid's counterclaim.

As suggested by the district court in *Mount Vernon,* courts applying the "inexplicably intertwined" test are more likely to impose a duty to prosecute an affirmative claim that would offset liability if it was successful. *See Great West Cas. Co. v. Marathon Oil Co.,* 315 F. Supp. 2d 879, 882 (N.D. III. 2003) (holding that duty to defend requires insurer to cover claims and actions seeking third-party contribution as a "means of avoiding liability"). As observed by the court in *Great West Casually Co.,*

> [T]here is a class of affirmative claims which, if successful, have the effect of reducing or eliminating the insured's liability and that the costs and fees incurred in prosecuting such 'defensive' claims are encompassed in an insurer's duty to defend .... 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.

Id. at 881, 883.

Relying on *Great West,* the court in *Hartford Fire* Ins. *Co. v. Vita Craft Corp., 911* FSupp.2d 1164, 1183 (D. Kan. 2012), held that the counterclaim at issue fell within the insured's duty to defend. In that matter, the insured was sued for patent infringement. *Id.* The insured filed a counterclaim against the alleged patent holder, claiming that three of the subject patents were invalid. In imposing the duty to defend, the court observed that if the counterclaim was successful, then the insured could not possibly be held liable for the patent infringement claims that were based on the invalid patents. *Id.*

Extending the Duty to Prosecute to Affirmative Actions Commenced by a Policyholder

It is noteworthy that at least in one leading case, the court applied the "inexplicably intertwined" test to impose a duty to prosecute a lawsuit commenced by a policyholder. In *TIG Insurance Co. v. Nobel Learning Communities, Inc.,* 2002 WL 1340332, (E.D. Pa. June 18, 2002), the policyholder, Nobel Learning Communities, Inc., sued Dr. Deborah Levy, the previous owner of its assets, seeking a declaration of the parties' respective intellectual property rights. Levy counterclaimed for copyright infringement. 111e policy at issue provided for a defense against all claims of "personal and advertising injury" arising from "infringement upon another's copyright." Finding that the insurer had a duty to defend the copyright infringement counterclaim asserted against Nobel, the court ruled that insurer also had a duty to prosecute Nobel's affirmative claims against Levy. In finding that the two claims were "inextricably intertwined," the court was persuaded that "the prosecution of the affirmative claims was essential to the defense against the counterclaim." *Id.* at *15. The court further recognized that "[a]lthough 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.'" *Id.* at *14 (quoting *Safeguard Scientifics,* 766 E Supp. at 333-34). Significantly, *Nobel* has been widely cited by courts addressing the duty to fund counterclaims, although it arose in a different procedural setting. *See, e.g., Post,* 691 E3d at 521; *Bennett,* 2006 WL1313059, at *4; *Great West,* 315 E Supp. 2d at 882; *Hartford Fire Ins. Co.,* 911 E Supp. 2d at 1183.

Burden Shifting and Reimbursing Counterclaim Expenses After Coverage Denial

When a policyholder seeks to pursue counterclaims in addition to a defense for claims brought against it, insurers should be cognizant that in some jurisdictions, after a court has determined that an insurer wrongfully denied a defense, the courts in the jurisdictions require the insurer to reimburse the policyholder for its entire litigation costs, including the costs associated with the prosecution of counterclaims. In these jurisdictions, once an insurer is found to have denied a defense wrongly, the burden shifts to the insurer to then demonstrate that the fees sought by the insured, including those incurred prosecuting the counterclaims, were unreasonable and unnecessary. For example, in *Ultra Coachbuilders, Inc. v. Gell. Sec. Ins. Co.,* 229 E Supp. 2d 284 (S.D.N.Y. 2002), the court held that the insurer wrongfully declined coverage to the insured, and the court awarded the insured the attorney's fees and costs associated both with defending the claims that triggered coverage and with prosecuting three counterclaims. *Id.* at 289. In doing so, the court noted that because the insurer breached its duty to defend its insured, the insurer had the burden of establishing that the fees sought by the insured were unreasonable and unnecessary. *Id.* at 286. *See also the Oscar W Larson Co. v. United Capitol Ins. Co.,* 845 F. Supp. 458, 461 (W.O. Mich. 1993), *aff'd,* 64 E3d 1010 (6th Cir.1995) (insurer that breached its duty to defend must pay all defense costs incurred by insured's personal counsel, including costs incurred to assert counterclaims and cross-claims); *Aerosafe International, Inc. v. ITT Hartford of the Midwest,* 1993 WL 299372 (N.D. Cal. July 23, 1993) (insurer that breached its duty to defend gave up its right to control the litigation). Indeed, in its appellate brief in the *Mount Vernon* case, Mount Vernon distinguished its case from *Ultra Coach builders, In c.* on *the* basis that Mount Vernon "has never denied coverage to VisionAid and has been providing VisionAid with a full defense" against its former employee's claims.

The Non-Covered Counterclaim and Issues in Settlement

In *Bennett,* the U.S. District Court for the District of Maine was not persuaded that the counterclaim was "inextricably intertwined with the defense," although the district court recognized that the counterclaim "may put pressure on Liberty to abandon or settle his case .... " This begs the question of how to settle claims when the insurer is not funding the counterclaim. In settling litigation, neither the claims against a policyholder nor the counterclaims seeking affirmative relief can be considered in a vacuum. A plaintiff would be reluctant to settle a claim that would leave a counterclaim against him or her unresolved. In the event that an insurer disclaims any duty to fund a counterclaim, it gives up the right to control the litigation of the counterclaim. Thus, a problem could arise if a policyholder refuses to settle a

counterclaim, possibly effectively preventing resolution of the main, covered claim.

In most jurisdictions, an insurer has a good-faith obligation to consider a reasonable settlement demand within the policy limits and not to expose its insured to a judgment that is not covered by its policy. *See, e.g., Truck Insurance Exchange v. Prairie Framing, LLC,* 162 S.w.3d 64, 93 (Mo. Ct. App. 2005); *Comunale v. Traders and General Ins. Co.,* 328 P.2d 198(Cal. 1958). It could be argued that when a policyholder refuses to settle a counterclaim, if the insurer is willing to settle the underlying claim within policy limits, the policyholder is acting in bad faith if it unreasonably prevents the settlement of both the covered claim and non-covered counterclaim. Further, it can be argued that a policyholder's unreasonable refusal to settle a counterclaim that would facilitate settlement of the main claim might constitute a breach of the policy's cooperation clause. *See, e.g., Artan v. Liberty Mut. lns. Co.,* 302 A.2d 284 (Conn. 1972) (holding that a cooperation clause required the policyholder's assistance not only in defending a law suit but also in effecting settlements).

A possible solution to this problem could be for an insurer to tender its policy limits for the settlement of the main claim. However, some courts have read certain policy language as not terminating an insurer's duty to defend upon the insurer's tender of policy limits absent a judgment or settlement. *See, e.g., Keene Corp. v. Insurance Co. of N. America,* 597 F. Supp. 946, (D.D.C. *1984), vacated on other grounds by* 631 F. Supp. 34 (D.D.C. 1985); *Allstate Ins. Co. v. Montgomery Trucking Co. of Ga.,* 328 F. Supp. 415 (N. D. Ga. 1971); *Johnson v. Continental lns. Cos.,* 202 Cal.App.3d 477 (Cal. Ct. App. 1988).

Conclusion

It is well settled that there exists no duty to prosecute counterclaims and other affirmative claims that are unrelated to a covered defense. Most jurisdictions draw a line in the sand and have declined to broaden the duty to defend to include funding and prosecuting affirmative claims, whether they are related to a defense or not. However, a minority of jurisdictions impose a limited duty to fund and to prosecute affirmative claims, but only if they are "inextricably intertwined" with a defense. Where the law on this issue is unsettled, insurers have multiple paths to defeat a duty to fund counterclaims brought by a policyholder. As a threshold matter, insurers should consider arguing that (1) the policy terms "defense" and "defend" only apply to a claim brought against the policyholder, not to an affirmative cl aim brought by the policyholder; and (2) even if the court broadens the interpretation of "defense" to include an obligation to fund some affirmative claims, the counterclaim at issue is not "inextricably intertwined" to the defense. Arguments that an affirmative claim brought by a policyholder is not "inextricably intertwined" with the covered defense can include the following: (1) the counterclaim would not offset, shift, or negate liability; (2) the counterclaim could have been asserted as an affirmative defense; (3) the counterclaim and defense do not share common issues of fact and law; or (4) a combination of these. Of course, any insurer disclaiming coverage with respect to the prosecution and the funding of a counterclaim should be cognizant of the problems that such a disclaimer may impose on settlement. In the event that a policyholder's resistance to settle a non-covered counterclaim prevents a settlement of the main claim, an insurer can consider (I) tendering the policy limits on the underlying defense; (2) asserting a bad-faith claim against the policyholder; or (3) asserting a claim that the policyholder's unreasonable refusal to settle is in breach of the policy's cooperation clause.

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