Whose defense is this anyway? Questions remain about allocating defense costs

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By design, the duty to defend is extremely broad. In many jurisdictions, if a single allegation could be covered by the relevant insurance policy, the insurer has to pay defense costs for the entire suit. But what happens when a policyholder's defense costs are inextricably intertwined with a non-insured co-defendant's (often referred to as "non-segregable" defense costs)?

In other words, if the policyholder would have incurred the defense costs even if the non-insured were not in the case, may the insurer avoid a portion of those costs because the non-insured benefited from the defense? As most lawyers will tell you, it depends.

Courts around the country have reached different conclusions on whether insurers may allocate their defense obligation.

Policyholders typically argue that, where the text of the insurance policy does not give the insurer a right to allocate its defense obligation, then no such right should be inferred. The rationale is that it complies with the parties' written agreement: Insurers contractually agree to provide their policyholders with a full defense, and where there is no exception based on the presence of a co-defendant, courts should not infer one. 3 New Appleman on Insurance Law Library Edition § 17.01[3][c] (2022).

Thus, when the policyholder is sued, the insurer must provide all that it promised — 100% of defense costs — even if another defendant incidentally benefits from the promise. Otherwise, the policyholder is deprived of a portion of its defense coverage and the insurer receives an unbargained-for discount on its duty to defend.

Put differently, the insurer is only being required to provide the defense it would have provided had there not been an uninsured co-defendant — the only difference is that the policyholder is sharing the defense coverage it purchased with its co-defendant, which is at no added cost to the insurer.

Consider an analogy: If Thomas pays James to bake a cake, and then Thomas tells Maria she can eat half of it, James can't bake just half a cake. And like the ingredients in a cake, it's often impossible to separate which portion of defense costs benefitted which defendant in a multi-defendant case. For example, whether there is a single defendant or multiple, certain costs cannot be avoided, such as drafting and answering written discovery, attending status conferences, taking and defending depositions, and motion practice.

Just like how James must fulfill his promise to bake a full cake for Thomas even where Maria benefits, an insurer should fulfill its promise to pay for all defense costs — a promise that the policyholder paid a substantial premium to secure — even if doing so benefits a non-insured co-defendant.

Policyholders also often point out that joint representation may benefit the insurer by decreasing the likelihood that the insurer will be on the hook for a judgment. If the same firm handles the litigation, and the uninsured co-defendant cooperates by providing key evidence and input on strategy, defense counsel will be better off and therefore have a greater chance of winning (i.e., relieving the insurer's obligation to pay a judgment).

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Insurers, though, often disagree, claiming that it is inequitable for the non-insured to get a free ride at the insurer's expense. Insurers have argued, for example, that the only reason the non-insured is not contributing to the defense is because the insurer is paying and, if there were no insurance, the policyholder and non-insured would likely work out some other arrangement. Thus, principles of equity require an allocation based on factors intended to mimic what the parties would have done if they were both uninsured, such as which defendant is the principal target of the underlying action and which gained the most from the defense.

Courts around the country have reached different conclusions on whether insurers may allocate their defense obligation. The 9th U.S. Circuit Court of Appeals, for example, has held that the insurer is responsible for all defense costs "reasonably related" to the policyholder's defense, regardless of whether these costs helped defend a non-insured co-defendant. *Safeway Stores, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 64 F. 3d 1282 (9th Cir. 1995) (involving a directors' and officers' policy).

The 4th U.S. Circuit Court of Appeals adopted a similar approach in affirming an award of reasonable and necessary defense costs to defend the policyholder as well as non-insured co-defendants because the claims against both were "not only reasonably related but [also] inextricably intertwined." *Charter Oak Fire Ins. Co. v. Am. Cap., Ltd*., 760 Fed. Appx. 224 (4th Cir. 2019) (involving a commercial general liability policy).

Other courts have held that the insurer could allocate segregable from non-segregable costs and pay only non-segregable costs. See, e.g., *Watts Water Techs., Inc. v. Fireman's Fund Ins. Co.*, No. 05-2604-BLS2, 2007 WL 2083769, at *7 (Mass. Super. Ct. July 11, 2007). Courts so holding have not imposed a uniform method of allocation; they have considered various factors, analyzed billing records, or simply picked a number deemed fair. See id. (suggesting allocation based on "all the surrounding circumstances, considering the relative exposure of the parties to liability, the size of the parties, and the parties most benefitting from the joint defense work"); *KB Home Orlando LLC v. Mid-Continent Cas. Co.*, No. 6:19-cv-1573, 2022 WL 3136866, at *5 (M.D. Fla. May 27, 2022) (at insurer request, allocating based on percentage of project policyholder participated in); *Lyman Morse Boatbuilding, Inc. v. N. Assur. Co. of Am., Inc*., No. 2:12-cv-313, 2014 WL 901445, at *4 (D. Maine. Mar. 6, 2014) (rejecting proposed allocation methods by whole numbers or factors; instead, awarding to the insured half of defense costs).

Other courts, recognizing the difficulty of allocating costs that benefit both the insured and another party, have simply suggested the insurer and policyholder resolve the issue through negotiation. See, e.g., *Dobson v. Twin City Fire Ins. Co.,* No. 11-0192, 2015 WL 12698443, at *10 (C.D. Cal. Aug. 5, 2015) (listing cases).

Of course, these approaches are relevant only when the insurance policy does not prescribe a contrary approach. An insurance policy may contain language requiring allocation and describing how allocation (between claims or parties) will be made, or requiring the insurer and policyholder to use their "best efforts" to negotiate an allocation formula. See, e.g., *Safeway*, 805 F. Supp. at 1490. Policyholders should carefully scrutinize their contracts to understand and agree with any allocation provision.

Allocation of non-segregable defense costs may seem a simple enough concept, but policyholders, insurers, and courts in many jurisdictions around the country disagree on whether and how an insurer may allocate non-segregable defense costs. Policyholders are well advised to seek counsel whenever an insurer denies or limits coverage, including when an insurer purports to limit coverage for defense costs because of a non-insured co-defendant.

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