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INSURANCE LAW ALERT

MAY 2010

This month's Alert highlights a number of significant federal court decisions affecting the landscape of insurance coverage litigation, including a United States Supreme Court decision which holds that a class action may proceed in federal court despite a specific state law to the contrary. We also report on two recent "advertising injury" decisions, a decision relating to a D&O insurer's obligation to advance defenses costs, a New York court allocation ruling, and an "occurrence" decision that focuses on a "location of occurrences" analysis. We hope that these Alerts continue to serve as a valuable resource.

Advertising Injury Alerts:

Ninth Circuit Rules Liability Insurer Owes Defense For Patent Infringement Claim Pursuant To Policy's Advertising Injury Provision

On April 5, 2010, the Court of Appeals for the Ninth Circuit reversed a district court's grant of summary judgment in favor of insurers, holding that where a CGL policy covered claims for advertising injury, insurers had a duty to defend a patent infringement suit against the policyholder. *Hyundai Motor America v. National Union Fire Ins. Co. of Pittsburgh, PA*, 2010 WL 1268234 (9th Cir. Apr. 5, 2010).

The matter arose out of two features on Hyundai's website: (1) a build your own vehicle ("BYO") element, and (2) a parts catalog component. Both allowed users to navigate through a series of menu options in order to create and display a customized vehicle image with corresponding pricing information. Orion IP, a patent-holding company, filed a patent infringement suit against Hyundai, alleging that Hyundai's BYO and sales parts catalog features infringed upon two patents held by Orion. Hyundai sought a defense from its insurers, claiming that Orion's patent infringement claims were "advertising injury" covered under the policy. The insurers denied a defense, and Hyundai commenced this suit.

The district court granted summary judgment in favor of the insurers, holding that allegations of patent infringement are not "advertising injury," and alternatively, that Hyundai failed to demonstrate a causal connection between its advertising and Orion's alleged injury. The Ninth Circuit disagreed. Applying a multi-part analysis under California law, the court held that (1) Hyundai's actions are "advertising"; (2) coverage for the "misappropriation

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of advertising ideas" encompassed Orion's patent infringement claims; and (3) there is a direct causal connection between the advertisement (Hyundai's BYO website feature) and the alleged advertising injury (the patent infringement).

The *Hyundai* decision appears to be the first in California to hold that patent infringement is advertising injury for purposes of insurance coverage. In several prior cases, California and Ninth Circuit courts have rejected this argument under distinguishable factual circumstances. And more recently, a federal court in Connecticut ruled that allegations of patent infringement and misappropriation did not satisfy the pre-requisite advertising activity necessary to trigger coverage. *See Gartner Inc. v. St. Paul Fire and Marine Ins. Co.*, 2010 WL 918075 (D. Conn. Mar. 11, 2010). But unlike those cases, the *Hyundai* court observed, the instant case presents clear allegations of a violation of a "method patent" (a patent relating to a method of displaying information to the public) that involved advertising (i.e., for the purpose of facilitating sales). 2010 WL 1268234, at *7.

Additionally, *Hyundai* addresses an important issue in advertising injury coverage disputes: the distinction between "advertising" and "one-on-one solicitation." The majority of courts have defined "advertising" as conduct to effect the widespread distribution of material to the public at large. In denying a defense, the *Hyundai* insurers argued that because the BYO feature created customized proposals specific to individual users, it essentially constitutes "high-tech one-on-one solicitation" rather than mass advertising. Although the BYO feature shares some similarities with individualized solicitation, it is nonetheless advertising activity, the court held. Even though the precise information presented to each user varies with user input, the BYO feature itself is widely distributed via Hyundai's internet site, and thus falls within the scope of "advertising." This particular legal point may prove to be significant in advertising injury coverage litigation involving policyholders' website features.

Companies and website designers are continuously developing innovative ways of marketing products on a person-specific, customer-driven basis, such as the BYO at issue here. Regardless of how individualized the ultimate presentation may be to each end user, *Hyundai* holds that the marketing feature itself is akin to mass advertising, not individualized solicitation.

On April 29, 2010, the Ninth Circuit denied the insurers' petition to certify to the California Supreme Court the question of whether "California law recognizes an exception to the rule that the 'misappropriation of advertising ideas or style of doing business' offense [ ] does not encompass patent infringement claims involving method patents, simply because the method patents could be used to advertise another's goods or services." The insurers have also petitioned for an en banc rehearing before the Ninth Circuit, which remains pending.

Insurer Need Not Defend Policyholder In False Advertising Suit, Says North Carolina Supreme Court

On April 15, 2010, the North Carolina Supreme Court ruled that a CGL insurer need not defend an action brought by a policyholder's competitor against

the policyholder alleging that the policyholder engaged in false advertising. *Harleysville Mutual Ins. Co. v. Buzz Off Insect Shield, L.L.C.*, 2010 WL 1492136 (N.C. Apr. 15, 2010). The *Harleysville Mutual* decision tracks the California appellate court's decision in *Total Call Int'l, Inc. v. Peerless Ins. Co.*, 2010 WL 188213 (Cal. App. 2d Dist. Jan. 21, 2010), discussed in our March 2010 Alert. Both cases held that "Failure to Conform" exclusions, which exclude coverage for personal and advertising injury "arising out of the failure of goods, products or services to conform with any statement of quality or performance made in your 'advertisement,'" preclude coverage for advertising injury to a third-party arising from statements by the policyholder about the policyholder's own products. 2010 WL 1492136, at *5.

Although policyholders may continue to turn to their general liability insurers for "advertising injury" coverage under a wide variety of factual circumstances, cases such as *Harleysville Mutual* and *Total Call* reinforce the principle that unambiguous policy language will negate even a duty to defend where the allegations in the underlying complaint fall within clearly worded policy exclusions.

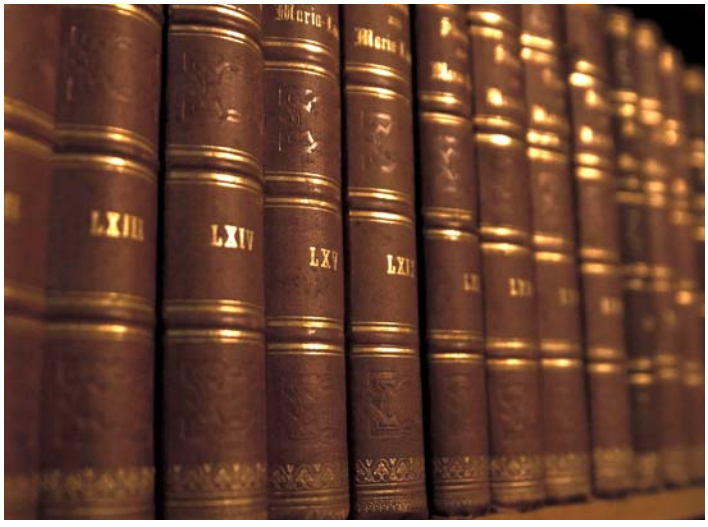
Class Action Alert:

A Divided U.S. Supreme Court Holds that States May Not Limit The Right To Bring Class Actions In Federal Court

In a divided decision, the United States Supreme Court ruled that a New York state statute that prohibits class action suits seeking penalties does not preclude a federal court sitting in diversity from entertaining a class action pursuant to Federal Rule of Civil Procedure 23 seeking penalties under New York statute. *Shady Grove Orthopedic Assocs. v. Allstate Ins. Co.*, 2010 WL 1222272 (U.S. Mar. 31, 2010).

Shady Grove filed this diversity case to recover unpaid interest from Allstate allegedly owed under a New York statute. Alleging that Allstate routinely refused to pay statutory interest on overdue benefits, Shady Grove sought relief on behalf of itself and a class of others similarly situated. The federal district court dismissed the suit, finding that the matter could not proceed as a class action. New York Civil Practice Law §901(b) precludes a suit to recover a "penalty," such as the statutory interest sought by Shady Grove, from proceeding as a class action. The court then dismissed the matter because Shady Grove's individual claim did not meet the amount in controversy requirement for diversity jurisdiction. The Second Circuit affirmed.

The Supreme Court reversed. The Court framed its two-part analysis as follows: First, do both Rule 23 and Section 901(b) seek to answer the same question in this dispute, such that they cannot be reconciled? And, second, if the two laws cannot be reconciled, does Rule 23 exceed statutory authorization or Congress's rule-making authority? *Id.* at *4. Writing for a majority, Justice Scalia answered the first question in the affirmative. By its terms, Rule 23 "creates a categorical rule entitling a plaintiff whose suit meets the specified criteria to pursue his claim as a class action." This "one-size-fits-all formula" empowers a federal court to certify a class action "in each and every case" where the Rule's criteria are met. *Id.* Section 901(b) seeks to answer the same question



because it sets forth which cases may *not* precede as class actions, despite satisfaction of the requirements of Rule 23. As such, the two laws conflict. In reaching this conclusion, the Court rejected as "artificial" Allstate's argument that the two rules did not conflict because Rule 23 addresses the criteria for certification, whereas Section 901(b) addresses an antecedent question of whether a particular claim is eligible for certification in the first place (a question that Rule 23 does not specifically address). *Id*.

Turning to the second question, Justice Scalia, joined by three other Justices, opined that Rule 23 falls within Congress' statutory authorization under the Rules Enabling Act, 28 U.S.C. §2072(b). The plurality held that the test under Section 2072(b) is whether the rule regulates "procedure." If the rule "governs only 'the manner and the means' by which the litigants' rights are 'enforced,' it is valid; if it alters 'the rules of decision by which [the] court will adjudicate [those] rights,' it is not." *Id*. at *8 (citations omitted). Applying this test, the plurality upheld the validity of Rule 23. The plurality noted that although Rule 23 has "some practical effect on the parties' rights," as most procedural rules do, it controls only how claims are processed and does not change plaintiffs' rights or entitlements. Justice Stevens' concurring opinion (which provided the fifth vote for the ruling that Rule 23 trumps New York Section 901(b)), however, seeks to limit the holding to the facts of this particular case. Rather than ruling categorically that federal procedural law, such as Rule 23, trumps state procedural law, Justice Stevens endorsed a legal standard that, on a case by case basis, looks to whether a federal procedural rule "would displace a state law that is procedural in the ordinary use of the term but is so intertwined with a state right or remedy that it functions to define the scope of the state-created right." *Id*. at *16. Under this middle-of-the-road approach, state laws that limit the use of the class action device (against insurers and other defendants), and which are inherently substantive in nature, would continue to bar putative class action lawsuits in federal court.

The long-term effect of *Shady Grove* on future conflicts between state laws governing class action suits and Rule 23 is uncertain given the differing views among the Justices in *Shady Grove*. A strict application of Justice Scalia's plurality opinion could potentially impact a long list of state laws which limit or eliminate class action remedies in certain circumstances (such a list, was, in fact, appended to Allstate's brief to the Court). Less than three weeks after the issuance of the *Shady Grove* decision, the Supreme Court vacated another Second Circuit decision that similarly dismissed a putative class action pursuant to New York Section 901(b) because the class claims sought "penalty" damages under the Telephone Consumer Protection Act. *See Holster v. Gatco, Inc*., 2010 WL 1525988 (U.S. Apr. 19, 2010).

D&O Alert:

Insurer Required To Advance Defense Costs To Participants In Alleged Ponzi Scheme, Fifth Circuit Rules

The Court of Appeals for the Fifth Circuit ruled that a directors and officers liability insurer must advance defense costs incurred in connection with an alleged Ponzi scheme unless and until a trial court determines that the alleged money laundering activity did "in fact" occur. *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, 2010 WL 909090 (5th Cir. Mar. 15, 2010).

Criminal and civil actions had been filed against certain individual executives, alleging that they had engaged in a $7 billion Ponzi scheme. The executives asserted claims for defense costs against their D&O insurers. The insurers initially agreed to advance defense costs for all executives, but subsequently denied all such payments after one of the executives pled guilty to criminal acts. The insurers argued that the policy's money laundering exclusion barred

coverage for the executives' conduct. The exclusion bars coverage for loss (including defense costs) resulting from any claims arising as a result of any act of money laundering. The policy further provides, however, that "[n]othwithstanding the foregoing Exclusion, Underwriters shall pay Costs, Charges and

Expenses in the event of an alleged act or alleged acts *until such time that it is determined that the alleged act or alleged acts did in fact occur.*" *Id*. at *3 (emphasis added). Importantly, this language differs from that in other policy exclusions, which contain an "as determined by a final adjudication" requirement. Given the specific language in the money laundering exclusion, the central issue in dispute was the meaning of the phrase "did in fact occur."

As a preliminary matter, the court noted that the "did in fact occur" exclusionary language does not require a final adjudication in the underlying criminal proceeding. The court also rejected the insurers' argument that the language empowers the insurers to make a unilateral (albeit judicially-reviewable) determination of coverage at any time. Rather, the court explained, the language requires a "judicial act" to determine whether the money laundering "did in fact occur." *Id*. at *8. This determination is to be made by a court in an independent, parallel coverage action, rather than in the underlying criminal proceeding, the court explained. Accordingly, the court remanded the matter (with instructions for assignment to a judge other than that hearing the underlying criminal matter) for a collateral determination of whether the money laundering "did in fact occur" so as to trigger the policy exclusion. The decision issued in this collateral action is subject to modification, however, pending an outcome in the criminal or SEC proceeding, as it relates to possible exoneration of the executives. As a final matter, the court noted that the policy also imposes an obligation on the executives to repay defense costs if it is determined that they did engage in money laundering. The "underwriters may seek this determination in a parallel action and, if successful, escape the obligation to make future reimbursements, subject to reconsideration following a favorable verdict in either [the civil or criminal] proceeding." *Id*. at *10.

The decision narrowly construes the wording of a coverage exclusion. In concluding that the determination of whether money laundering "did in fact occur" was to be made by a court (rather than the insurers) in the first instance, the court noted that as drafters of the policy, the insurers could have utilized the phrase "until *we* have determined" rather than the passive phrase "until it is determined." *Id*. at *6. Additionally, *Pendergest-Holt* leaves unanswered a question raised by the parties and addressed by the lower court: Does the Texas eight corners rule ("which requires courts to measure an insurer's duty to defend by examining only the policy's provisions as compared to the underlying complaint") apply to a case like the present one, involving a duty to advance defense costs? *Id*. at *8. However, the court found that it "need not venture a guess in this one" because the policy's terms "plainly state that the underwriters must advance defense costs 'until it is determined that the alleged act or alleged acts did in fact occur' and in so doing, require recourse to something more than mere allegations. The terms contemplate the use of extrinsic evidence in making the determination." *Id*.

Defense Alert:

Seventh Circuit Rules That Insurer Need Not Provide Defense For Lead Paint Claims

On April 5, 2010, the Court of Appeals for the Seventh Circuit ruled that an insurer need not defend numerous class action lawsuits by consumers against RC2 Corp. alleging negligence in connection with lead paint-containing toys tested and manufactured in China and sold in the United States. *Ace American Ins. Co. v. RC2 Corp., Inc.*, 2010 WL 1267293 (7th Cir. Apr. 5, 2010). Because Ace American's policies included a territory clause that excluded from coverage occurrences that took place in the United States, the court found that there was no possibility of coverage and thus no duty to defend.

RC2, a manufacturer of toys in China, was named as a defendant in a number of consumer class action lawsuits alleging that the toys, which contained lead paint, were negligently manufactured and tested. RC2 initially tendered its claims under domestic policies with lead paint policy exclusions. Subsequently, RC2 sought defense and indemnification from Ace American for these claims. Relying on the limiting territory clause in its policy, Ace American denied coverage and filed an action seeking a declaration that it had no duty to defend or indemnify. Ace American's policy provided coverage for "occurrences" that take place within the "covered territory," defined as anywhere in the world except for the United States and its territories. The parties did not dispute that the underlying lawsuits allege damages caused by exposure to lead paint which occurred exclusively within the United States. Accordingly, the central issue before the court was whether the operative "occurrence" was the "antecedent negligent act [ ]" of manufacturing and testing (which took place in China), or alternatively, the underlying claimants' exposure to the lead paint (which took place in the United States). *Id*. at *1-*3.

Finding Ace American's policies unambiguous,

the court concluded that coverage is triggered by the actual event that inflicts harm, which here, was the exposure to lead in the United States. The court held that: "[U]nder Illinois law and unless a particular policy contemplates a different definition, an accident occurs when and where all the factors come together at once to produce the force that inflicts injury and not where some antecedent negligent act takes place." *Id*. at *6. According to the Court, this conclusion is consistent with "the great weight of case law hold[ing] that it is the location of the injury—not some precipitating cause—that determines the location of the event for purposes of insurance coverage." *Id*. at *4 (citations omitted).

The *RC2* decision draws a distinction between a "number of occurrences" analysis and a "location of occurrences" analysis. The court acknowledged that Illinois law employs a cause-based analysis in determining whether a series of harms constitutes a single occurrence or multiple occurrences for purposes of calculating coverage limits or deductibles. And in mass tort/product defect cases, courts have concluded that where multiple injuries are caused by the common manufacture of a harmful product, there is but one occurrence for coverage purposes. Under this reasoning, RC2 argued that the triggering "occurrence" here, is too, the manufacture and testing of the products in China. Rejecting this contention, the court held the cause theory applies only to the determination of the number of occurrences, and is inapplicable to a determination of the location of the occurrence(s).

Business Interruption Alert:

Policyholder's Losses Are Determined Solely By Pre-Catastrophe Earnings, Holds Fifth Circuit

The Court of Appeals for the Fifth Circuit affirmed that, under Mississippi law, business interruption losses covered by a liability policy should be based only on pre-catastrophe sales figures. The court rejected the policyholder's contention that its business interruption loss should be calculated based on significantly higher, post-interruption sales attributable to the affect Hurricane Katrina had on the market. *Catlin Syndicate Ltd. v. Imperial Palace of Mississippi, Inc.*, 2010 WL 908731 (5th Cir. Mar. 15, 2010).

Imperial Palace, a casino operator, was forced to temporarily suspend business in the wake of Hurricane Katrina. Upon re-opening, its revenues were significantly greater than before the hurricane,

due in large part to the closing of several nearby competitor casinos as a result of the hurricane. Imperial Palace submitted a claim to its insurers, calculating its business interruption loss based on post-catastrophe sales figures. Catlin disputed the amount of business interruption loss.

The business interruption provision in Catlin's policy states that "[i]n determining the amount of Time Element loss as insured against by this policy, due consideration shall be given to experience of the business before the loss and the probable experience thereafter had no loss occurred." *Id.* at *1. The court granted Catlin summary judgment that this provision unambiguously requires that Imperial Palace's recovery be based solely on pre-hurricane sales. In reaching this conclusion, the court relied heavily on *Finger Furniture Co. v. Commonwealth Ins. Co.*, 404 F.3d 312 (5th Cir. 2005), involving interpretation of a nearly identical business interruption provision under Texas law. In *Finger Furniture*, the court held that "[h]istorical sales figures reflect a business's experience before the date of the damage or destruction and predict a company's probable experience had the loss not occurred." 404 F.3d at 314.

Imperial Palace argued that excluding post-hurricane sales data blurred the distinction between the terms "loss" and "occurrence" for purposes of interpreting the business interruption provision. Imperial Palace argued that Hurricane Katrina was the "occurrence" that inflicted "losses" on numerous parties, such as the temporary loss of business suffered by Imperial Palace. Because the business interruption provision requires consideration of profits "had no loss occurred," Imperial Palace argued that the correct hypothetical, for insurance coverage purposes, was one in which Hurricane Katrina struck (and caused damage to other casinos) but did not cause loss to Imperial Palace. Rejecting that argument, the court employed a hypothetical in which Hurricane Katrina never struck in the first place. Although the court acknowledged that "the loss is distinct from the occurrence—at least in theory," the court nonetheless "decline[d] to interpret the business-interruption provision in such a way that the loss caused by Hurricane Katrina can be distinguished from the occurrence of Hurricane Katrina itself." 2010 WL 908731, at *7.

The decision illustrates the principle of indemnity that undergirds all first-party property insurance. Property insurance returns the insured to the position it would have been had the loss

never occurred. The issue of whether inflated post-catastrophe losses should be taken into account in fixing business interruption losses has not been ruled upon by an overwhelming number of courts. And as the *Imperial Palace* court observed, this issue has "caused debate among courts and commentators." *Id*. at *1 n.1. Faced with policy language analogous to that presented in *Imperial Palace*, a few courts have similarly held loss should be measured solely by pre-interruption profits. As *Imperial Palace* makes clear, the determinative factor in any such dispute will likely be the specific policy language at issue. To that end, some insurers have begun to include explicit policy language precluding the consideration of post-catastrophe sales spikes in determining business interruption losses.

Allocation Alert:

New York Court Extends Allocation Period For Asbestos Claims, Regardless of Whether Proceeds From Policies Are Collectible

Applying New Jersey law, a New York court extended an allocation period for asbestos claims, finding it irrelevant whether or not insurance proceeds from certain later-issued policies were actually collectible. *Foster Wheeler LLC v. Affiliated FM Ins. Co.*, No. 600777/01 (N.Y. Sup. Ct. New York County Mar. 16, 2010). In this declaratory judgment action, the only issue before the court was the defendant insurers' defense and indemnity obligations with respect to asbestos-related bodily injury claims under the policies. Central to this determination is a fixed allocation period—a "period of time over which the costs associated with any covered claims must be spread." Slip op. at 2.

The court agreed with the defendant insurers that the allocation period should extend until at least 1985, rather than 1982, the end date advocated by Foster Wheeler. Foster Wheeler argued that although its excess policies in effect from 1982 to 1985 did not contain asbestos exclusions, the coverage provided by those policies was nonetheless "illusory and uncollectible." The insurers, in contrast, claimed that "the relevant inquiry is whether the coverage for the risk was actually purchased, not whether or not Foster Wheeler may ultimately collect insurance proceeds under the October 1, 1982 through October 1, 1985 policies." *Id*. at 5. Citing to well-established New Jersey precedent, the court ruled that the policies issued from 1982 through 1985 must be included in the allocation period. Analogizing these policies to those issued by a bankrupt insurer, the court concluded that triggered policies must be included in the allocation of costs, "regardless of whether or not the insurance proceeds from those policies will ever be collected by Foster Wheeler." *Id*. at 6.

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