

# THE POLICYHOLDER ADVOCATE/IP COUNSELOR

## NEWSLETTER

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## G&A OBTAINS \$51 MILLION JUDGMENT AGAINST INSURER

*HP v. ACE, U.S.D.C., N.D. Cal., San Jose Div., Case No. C-99-20207 JW*

The U.S. District Court for the Northern District of California entered judgment August 22, 2007 for G&A's client, Hewlett-Packard Company, and against ACE Property & Casualty Insurance Company (*HP v. ACE, U.S.D.C., N.D. Cal., San Jose Div., Case No. C-99-20207 JW*). The judgment is for the principal amount of \$28,418,671.72 plus prejudgment interest and costs and followed the approval of a Special Master's finding that ACE had breached its duty to pay defense expenses in that amount. The court approved all of the post-tender fees sought by G&A. After approval of the amount of interest and costs, the **total judgment** is expected to be more than **\$51.6 million** for our client.

G&A filed the insurance coverage action for HP seeking expenses incurred in defending a counterclaim for antitrust violations and patent invalidity (*HP v. Nu-kote Int'l, Inc., U.S.D.C., N.D. Cal., Civil Case No. 94-20647 JW*). In 1999 the federal court found that ACE had a duty to defend HP in the Nu-kote Action (*HP v. Cigna, 1999 U.S. Dist. LEXIS 20655, 53 U.S.P.Q.2d 1846 (1999)*) but ACE refused to do so. HP successfully defended the Nu-kote claims after a sixteen-week jury trial. But ACE continued its refusal to reimburse the defense expenses, challenging whether the substantial defense expenses were objectively reasonable and necessary in defending the Nu-kote counterclaim.

The Nu-kote Action had been initiated by HP against Nu-kote for patent infringement, federal and state trademark infringement, trade dress infringement, and related causes of action arising out of Nu-kote's sale of printer cartridges, use of deceptive packaging mimicking HP's trade dress, and falsely advertising that its inkjet cartridge refill products were approved by HP. The action took a dramatic turn when Nu-kote launched a massive counterattack alleging antitrust claims against HP and seeking to invalidate all of HP's patents which represented over a decade of HP's development of inkjet printers. Nu-kote continued to pursue its claims seeking potentially billions of dollars in damages, even after filing bankruptcy and obtaining permission from the bankruptcy court to press the suit against HP.

G&A successfully argued that the costs incurred in **prosecuting** the patent infringement and related claims were "reasonable and necessary" as "**defense costs**," even though HP sought affirmative relief. HP's defense strategy and proof of its affirmative claims of patent and trademark infringement were found by the Special Master and the District Court to be objectively reasonable and necessary to defend against Nu-kote's counterclaims for antitrust violations and patent invalidity. HP's strategy was vindicated when the jury found that Nu-kote infringed HP patents and trademarks and also found that HP had not violated antitrust laws.

G&A successfully showed that the expenses for prosecuting affirmative claims could not and should not be separated out from defense expenditures. The bad faith claim against ACE is still pending.

## REPRESENTATIONS AND WARRANTIES INSURANCE NEW OPPORTUNITIES TO ADDRESS RISKS FROM MERGERS/ACQUISITIONS

### I. INTRODUCTION

A growing number of insurers, following the lead of AIG (through its subsidiary AIG Mergers & Acquisitions Insurance Group) and Hartford (through its Nutmeg Insurance and Hartford Financial Products, Transactional Risk Group), offer insurance coverage for “representations and warranties” in connection with a merger and acquisition. Although typically issued to buyers, seller’s coverage is also available. As yet, no litigation has arisen over its terms and conditions. Nevertheless, negotiating these policies presents a number of challenges.

### II. DOCUMENTS TYPICALLY REQUIRED FOR “REPRESENTATION AND WARRANTY” INSURANCE

#### A. List of Documents

The following checklist from AIG’s exploration of its policy application highlights that information which underwriters will require to evaluate the “representation and warranty” risk:

1. Draft acquisition agreement and related disclosure schedules;
2. Financial statements of the seller and the acquired company or business;
3. Any offering memorandum or other informational material prepared in connection with the transactions contemplated by the acquisition agreement;
4. Any proxy statement or information statement prepared in connection with the transactions contemplated by the acquisition agreement;
5. Buyer’s due diligence request list and responses thereto, if in writing;
6. Data room index or other due diligence document index prepared in connection with the transactions contemplated by the acquisition agreement;
7. Third party reports, studies or opinions;
8. Working group lists; and
9. Transaction time line.

#### B. Identifying and Supervising the Delivery of Only Necessary Documents to Underwriting

Typically a warranty and representations insuring agreement will provide, “The Insurer shall indemnify the Insureds for, or pay on their behalf, any Loss in excess of the Retention that is reported by the Named Insured to the Insurer during the Policy Period in accordance with Section 5 of this Policy.” The pertinent coverage is for a breach of a representation warranty. This can occur where there is either an inaccurate statement or a false or misleading one. Thus, AIG defines the breach as an “inaccuracy in the representation.”

There may be many documents that the insurer does not specifically request and the insured need not provide and still meet proper compliance with the information required by underwriting. Coverage counsel’s ability to interact with the underwriter and evaluate the basis for its inquiry can clarify what documentation is essential to meet its needs and what need not be provided. Underwriting has not always encountered policyholder coverage counsel in this context, but ultimately finds it speeds resolution of issues and permits prompt issuance of a policy more likely to serve the insured’s objectives.

One of the more onerous tasks is actual completion of the application form. Delegation of this task to policyholder counsel assures that the information provided is appropriate, accurate, and in accord with the needs of the underwriter but not overly intrusive upon the business operations.

## III. ISSUES RAISED BY REPRESENTATIONS AND WARRANTY INSURANCE

### A. The Key Role of Insurance Coverage Counsel in Facilitating Acquisition of Policies for Representations and Warranty Insurance Coverage

Coverage counsel's principal role in the acquisition of representations and warranties insurance is to clarify what information must be provided to the underwriter to help tailor the actual representations and warranties so they are more likely to be insurable, as well as to assist in drafting the particular representations and warranties which customize the policy to the transaction. As with most forms of insurance, the more open-ended the insurer's obligation, the greater the cost or the less likelihood that underwriting will sell the policy. This challenge requires a thorough understanding of the needs of underwriters and the deal makers, and a fine-tuning in the correlation of these interests.

### B. Seller's Insurance

Seller's insurance addresses the indemnity obligations of the seller in a merger or acquisition. Where a seller is forced to indemnify and may not have the capital to meet and indemnify obligations, but is willing to purchase an insurance policy to permit the deal to go forward, such policies can be of great value. A seller may have different motivations than a buyer, seeking the representations and warranties to be less clear and more unspecific. The underwriter would seek the reverse.

### C. Analysis of Different Insurance Policy Forms

#### (1) AIG

- The AIG policy includes broader language regarding the coverage provided. It defines the terms "breach," "third party demand" and "loss" broadly, which allows greater coverage.
- The exclusions in the AIG policy are limited and narrowly drawn which makes denying coverage more difficult for the insurer.

Exclusions included in the AIG policy are for:

- (a) any (i) breach of which any of the Deal Team Members had actual knowledge prior to inception or (ii) material inaccuracy in the No Claims Declaration or Application;
- (b) any (i) purchase price, net worth or similar adjustment provisions of the Acquisition Agreement or (ii) indemnification provisions set forth in Section 5 of the Acquisition Agreement.
- AIG policies typically have an arbitration provision that can be eliminated by endorsement. Hartford does not require arbitration in its policy if the party wishes to opt out. Follow-form policies issued out of London for higher limits beyond those available through AIG or Hartford are also typically part of the structure in these matters.

#### (2) The Hartford

- Hartford substitutes the term "actual breach" or "actual misrepresentation" without definition. It is unclear what this standard would require. Under this latter policy form, the insured might have to prove the case against the party that was in breach. Thus, proof of the liability sought to be asserted against the insured in order to obtain the very benefit of the policy it seeks to secure would present a significant conflict of interest. In a typical defense

scenario under a CGL policy, a stay of the coverage action would be essential until the underlying action could be resolved – presumably with the insurer forced to provide the defense required.

- Hartford also is permitted to deduct any “tax benefits” that are obtained. It is unclear what this means and without further clarification this clause could engender litigation.
- The claims procedures under the Hartford policy are difficult to construe and may require further clarification to better understand the procedure to be adopted. Coverage counsel’s overview and potential negotiation of issues arising out of lack of clarity in the policy language is essential.
- A troublesome Hartford exclusion is for “anything known but not disclosed.” It is unclear what would be within the scope of this exclusion, but after the fact it may likely be broader in the insurer’s view than in the insured’s. Thus, any communications sent by or received by members on the team list identified in the application form would be within this exclusion. Where the character of the negotiations is such that these communications may be problematic, the Hartford policy would not be acceptable.

### **(3) Common Issues**

- Hartford’s policy offers a reduction in self-insured retention by a factor of 3:1 after a year since the expectation of a breach of a warranty diminishes over time.
- Typically, policies are from three to six years’ duration. This is also a heavily negotiated issue.
- It is common for the broker representing the interests of the insured but also seeking to secure a policy to ask for extensive disclosures which may include confidential, proprietary and even information subject to trade secret. These emanate from the underwriter’s requests which are typically included with the policy application form. Many of these requests are somewhat vague and require clarification.
- This coverage is inclusive of defense fees, judgment, settlement, etc.

### **D. Application Fees and Timing of Commitments to Insure Policies**

Application fees for warranties and representation insurance are substantial (\$20,000-\$25,000). The premium for issuance of such coverage is also significant.

Thus, a \$40,000,000 AIG policy would require a premium of \$1.5 Million if there is seller indemnity; \$1.9 Million without.

Hartford’s premiums are comparable, though perhaps in a bidding contest better terms may be secured assuming Hartford’s form is otherwise acceptable. For example, Hartford bid \$1.25 Million for a \$25,000,000 policy; with the excess coverage to meet the \$40,000,000 layer it appeared likely that the Hartford bid would be equivalent.

Because of the critical, fast-paced character of mergers and acquisitions, the carriers were willing to give indications of premiums and their interest in writing such coverage within two (2) days of request upon receiving generalized information about the merger and acquisition. This is because specialized departments have been set up by AIG and the Hartford to address these kinds of issues.

## **E. Policy Limits and Scope of Coverage**

The typical limit on this coverage is \$40,000,000. From AIG in extremely favorable circumstances it is perhaps \$50,000,000. Hartford's limits of \$25,000,000 require access to the London market to obtain excess coverage.

## **IV. ISSUES TO ADDRESS IN NEGOTIATING REPRESENTATIONS AND WARRANTIES INSURANCE**

### **A. Checklist for Negotiations**

- Specificity in representations and warranties is essential to avoid lack of clarity about whether provisions have been breached when representing a buyer (sellers prefer uncertainty).
- Typical drafting of such representations and warranties that are unclear places the risk on the insured to establish breach in the event insurance is to be accessed.
- Where a seller does not offer indemnity, the self-insured retention will be higher, as will the premium. On the other hand, the absence of indemnity means more affirmative and vigorous representations and warranties by the seller are available and thus a heightened opportunity to obtain coverage for alleged breach.
- A key consideration is whether the party offering seller's indemnity has the wherewithal to supply it. If not, such indemnity or even partial indemnity may be of little value and is less helpful for procuring the full insurance available from the representations and warranty insurance.
- Representations and warranties can become extremely meaningful to the party that is forced to honor them, i.e., the insurer.

### **B. Typical Scenario Where Policy May Be of Use**

Suits related to class action suits asserting unfair competition or patent infringement lawsuits which might otherwise fall outside typical insurance coverage, but nevertheless pose a serious risk to the acquiring company based on operational activity tied to representations and warranties, would be an example of a possible covered claim. Although many forms of insurance today typically exclude claims for patent infringement or unfair competition, there is none attached to the warranty and representation insurance issued in standard forms by either AIG or Hartford.

### **C. The Role of the Insurance Broker**

Few brokers have had experience in accessing these particular policy forms, or in understanding the underwriter's needs in this area. Specialized departments at Aon or Marsh & Willis that deal with representations and warranties insurance issues may present good contacts. One regional broker with experience in negotiating those policies is Lou Albertini, Risk Management Associate—Diversified Risk Insurance Brokers, 5900 Christie Ave., Emeryville, CA 94608; telephone: (510) 547-3203; lalbertini@drib.com.

## **V. CONCLUSION**

This developing area of insurance coverage involves an intersection of insurance with fast-paced mergers and acquisitions activity. Assistance from skilled business-savvy policyholder counsel can create value. Many transactions that place great risks upon buyers can be moderated and the cost of the insurance adjusted as an expense of the acquisition through the transaction. Careful and continued contact between policyholder counsel and outside merger and acquisition specialists can minimize the time necessary to get up to speed to interact on future transactions and give an added-value edge to mergers and acquisitions departments who have procured this specialized knowledge.

## PUBLICATIONS BY DAVID A. GAUNTLETT

David A. Gauntlett is the author of *Insurance Coverage of Intellectual Property Assets* published by Aspen Law & Business. The book and supplements are available for \$160.00 plus tax where applicable; shipping and handling are free when full payment is enclosed with the order. To order, call Aspen Law & Business at **1-800-638-8437**.

## UPCOMING SEMINARS ON INSURANCE COVERAGE AND INTELLECTUAL PROPERTY WHERE DAVID A. GAUNTLETT IS SPEAKING OR ATTENDING

- **September 9-11, 2007 - IPO Annual Meeting** - New York, NY - Attending/Speaking
- **February 28-29, 2008 - ALI/ABA Program: "The Role of Insurance in Trademark and Unfair Competition Law"** - New Orleans, LA - Attending/Speaking

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## GAUNTLETT & ASSOCIATES – THE POLICYHOLDER ADVOCATE

*Gauntlett & Associates specializes in policyholder insurance coverage and litigation re copyright, antitrust, patent, trademark, trade secret, business and general coverage disputes. Including:*

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*If you have a topic you would like to see addressed in future issues, please feel free to contact us with your suggestions.*

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