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# THE POLICYHOLDER ADVOCATE/IP COUNSELOR

## NEWSLETTER

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### PRE-TENDER FEES MAY BE RECOVERABLE AGAINST AN INSURER WHO DENIES A DEFENSE

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#### I. INTRODUCTION

It makes little sense that an insurer, which has denied a defense on grounds other than late notice, should be a beneficiary of the policyholder's error in delaying notice. Delayed notice often accompanies complex intellectual property and antitrust lawsuits. Insurance coverage is rarely foremost in either the risk manager's or the insurance broker's calculus for such lawsuits. Corporations with self-insured retentions may be less severely impacted than corporations with first-dollar coverage by the absence of pre-tender fee recovery. Indeed, neither intellectual property nor general counsel may evaluate the company's insurance coverage when confronted with these claims.

It is especially inappropriate to have a "voluntary payments" provision included with other elements implementing the duty of cooperation to preclude recovery of pre-tender fees. Logically, the "voluntary payments" provision is only triggered once the insurer is notified of a lawsuit. It serves to assure that the insurer is informed of the fees and costs incurred which it is required to pay. This provision should not provide a windfall to an insurer where it would otherwise have denied a defense even had timely notice been provided.

#### II. A NUMBER OF STATES PERMIT RECOVERY OF PRE-TENDER FEES WHERE THE CARRIER DENIED POLICY BENEFITS ON GROUNDS OTHER THAN LATE NOTICE

##### A. An Insurer that Would Have Denied Defense Fees on Grounds Other than Late Notice Should Be Liable for Pre-Tender Fees

Many states addressing pre-tender fee recovery issues allow policyholders to recover fees expended prior to notifying their insurer of the claim, especially where the insurer has defined a defense. In such circumstances, precluding the insured from obtaining its complete policy benefits where an earlier notice would have been rejected simply provides the insurer a windfall to which it is not entitled. Recovery will be limited, however, by factors such as an insurer's proof that its vital interests were prejudiced by the late notice, due to the "voluntary payments" provision, lack of timely notice, and rules regarding waiver.

Courts favoring recovery of pre-tender fees have cited the reasonableness of a policyholder's response to the suit against it and the lack of prejudicial harm to the insurer caused by the lack of notice of the claim while the fees were being incurred. When policyholders have acted reasonably in spite of their late notice, and an insurer does not incur a larger burden because of the delay in notification, pre-tender fee recovery has been granted as part of an insurer's obligation to defend the policyholder.

## B. A “Voluntary Payments” Provision Often Will Not Bar Pre-Tender Fees

The “no voluntary payments” policy language usually applies only to “personal injury or property damage.” If “advertising injury” is not mentioned, pre-tender expenses for defending against allegations of advertising injury are fully recoverable. “In questions of insurance coverage the court's initial focus must be upon the language of the policy itself, not upon general rules of coverage that are not necessarily responsive to the policy language.”

Further, purportedly delayed tender does not excuse an insurer’s obligation to reimburse pre-tender expenses in the absence of insurer prejudice. “[T]o demonstrate actual, substantial prejudice from lack of timely notice, an insurer must show it lost something that would have changed the handling of the underlying claim.”

## C. Principles Underlying “No Voluntary Payments” Provisions Are Inapplicable in Many Cases

A typical “no voluntary payments” provision provides: “The insured shall not, except at his own cost, voluntarily make any payment, assume any obligation or incur any expense.” A “no voluntary payments” provision benefits the insurer because it “prevent[s] collusion [and] invest[s] the insurer with the complete control and direction of the defense or compromise of suits or claims . . . .” This presumes that upon tender the insurer would have defended, earning the right to participate in the defense.

But “no voluntary payments” provisions are not enforced where the insurer did not and never would defend. The waiver rule is “‘applicable where an insurer denies all liability under the policy and then seeks to raise, as a defense to the insured’s lawsuit, the insured’s failure to perform some previously unarticulated policy-based obligation.’” “[F]ailure to defend . . . bars [the insurer] from enforcing the notice and voluntary payments provision.”

Insurers may cite cases to argue against pre-tender defense expense obligations under the “no voluntary payments” provision even without insurer prejudice. But they are inapplicable where they ruled on non-breaching insurers’ contentions. In each, either a post-tender defense was provided or the insurer would have defended but there was no tender.

In *Faust v. The Travelers*, 55 F.3d 471 (9th Cir. (Cal.) 1995), the court enforced the “no voluntary payments” provision to protect the insurer because it would have defended had the insured’s late tender not frustrated its rights to participate in the defense and prevent collusion. Such provisions only protect defending insurers or those that would have defended if duly noticed. But there is no reason to protect an insurer that would never have defended under any circumstances.

A California court of appeal case addressed a non-defending insurer and a voluntary payments provision. There, defense expenses incurred five months before tender were awarded because the insurer never provided any defense despite the potential for coverage. This case also observed that whether the “no voluntary payments” language “embraces expenses of defense is unclear,” and that any ambiguity “must be resolved against [the insurer],” and further held that the only California case to construe standard voluntary payments language (rather than mechanically citing it to bar pre-tender fees) believed a reasonable insured would not understand it would bar pre-tender defense expenses.

But in fact, the only California case presenting the question [*Fiorito v. Superior Court*, 226 Cal.App.3d 433 (1990)] . . . not[ed] the [standard “no voluntary payments”] provision does not specifically refer to the costs of defense and there is a question what a reasonable insured would understand reading the provision.

Insurance policies ordinarily require prompt insurer notice when anyone within the entity insured knows of a policy-specified event. For example, a policy might provide, “You . . . must . . . [i]mmediately send us . . . notices . . . received in connection with the claim or ‘suit.’” However, although atypical, a company can negotiate an alternative notice provision, such as:

The Risk Management Department, upon receipt of notice of claim or “suit” against the Insured, shall immediately forward to the Insurer every demand, notice, or summons of other process so received.

“Some insurance policies contain a notice provision specifying that the obligation to give notice arises only where a particular person of a department within the insured, such as the corporate risk manager, becomes aware of the ‘occurrence . . . .’” While generously favorable to the insured, such a provision is unambiguous, so judicial construction would be improper. Cal. Civ. Code §1638 (contract’s “clear and explicit” language “governs its interpretation”).

## **D. Notice Is Not a Condition Precedent to Duty to Defend**

### **1. Cases Which Assume that No Insurer Defense Duty Arises Absent Notice Do Not Rely on Policy Language for Their Analysis**

California’s lower appellate courts require notice of claim or suit to comprehensive general liability policy insurers as a condition precedent to their duty to defend because “until the defense is tendered . . . there is no duty to defend.” This judicial “notice as condition precedent” assumption has been applied without analysis or explanation to bar CGL insurer reimbursement for pre-notice defense expenses.

Such cases are progeny of a California Supreme Court decision (*Gribaldo, Jacobs, Jones & Assocs. v. Agrippina Versicherungen A.G.*, 3 Cal. 3d 434, 448-49 (1970)) requiring such “condition precedent” notice under (1) the plain language of a professional liability indemnity policy that gave the insurer the right (but not the duty) to conduct the insured’s defense and (2) Cal. Civ. Code §2778(4), which requires an indemnitor to defend actions but only “on request of the person indemnified . . . .” Subsequent California Supreme Court cases involving CGL policies and stating in *dicta* that the duty to defend arises on tender have not explained why this should be so when the policy lacks limiting language as in *Gribaldo* or statutory constraints.

But most CGL policies contain a “Defense and Settlement” coverage provision imposing on the insurer, without stated preconditions, “the right and duty . . . to defend any suit against [the insured] . . . and [to indemnify the insured] for monies expended in the defense of any suit.” This policy language materially differs from *Gribaldo*’s, whose “condition precedent” ruling cannot validly be applied to a CGL policy that neither contains indemnity policy “condition” language nor is affected by the indemnity statute.

### **2. No Public Policy Justifications for Applying “No Voluntary Payments” Language to Bar Pre-Tender Defense Expenses**

Notice and “no voluntary payments” provisions are not routinely enforced in a vacuum. There are public policy and equitable reasons for ever allowing them to frustrate an insured’s reasonable expectations of a defense. They “invest the insurer with the complete control and direction of the defense or compromise of suits or claims . . . .” They are “designed to ensure that responsible insurers who promptly accept a defense tendered by their insureds thereby gain control over the defense and settlement of the claim . . . .”

But in the case of an insurer that strenuously avoided participating in control of its insured’s defense or settlement efforts by aggressively and consistently refusing to defend at all, none of the purposes ordinarily furthered by enforcing notice or “no voluntary payments” provisions would be furthered by enforcing them to benefit the insurer.

### **3. The Law Limits a Non-Defending Insurer’s Ability to Minimize Its Defense Obligation’s Scope**

In one case, the California Supreme Court required that:

the insurer must defend in some lawsuits where liability under the policy ultimately fails to materialize . . . . Any doubt as to whether the facts establish the existence of the defense duty must be resolved in the insured’s favor.

The Court rejected the “reasonable potential for coverage” standard urged by the insurer:

To prevail, the insured must prove the existence of a *potential for coverage*, while the insurer must establish *the absence of any such potential*. In other words, the insured need only show that the underlying claim *may* fall within policy coverage; the insurer must prove it *cannot*. Facts merely tending to show that the claim is not covered, or may not be covered . . . add no weight to the scales. Any seeming disparity in the respective burdens merely reflects the substantive law.

Thus, a defense is compelled by law when the “absence” of a “potential for coverage” is unclear. An insurer’s only lawful remedy if unsure of its defense duty is to seek declaratory relief while defending its insured. A nondefending insurer’s argument of prejudice from alleged late notice as grounds to avoid payment of pre-notice defense expenses is eviscerated by established California Supreme Court law:

[I]n the usual case the insurer’s denial of coverage demonstrates it would have acted no differently had it received timely notice under the policy, thus foreclosing reliance on the notice defense. (See *Clemmer v. Hartford Insurance Co.* (1978) 22 Cal.3d 865, 883 [151 Cal.Rptr. 285, 587 P.2d 1098].)

#### **4. Defense Expenses After Obligation to Tender Are Recoverable Regardless of Notice**

California courts do not automatically apply “no voluntary payments” or notice provisions to bar pre-tender defense costs that insureds are “compelled to incur . . . in order to respond to legal process and to protect their legal interests.”

The rule in California is that “substantial compliance” with the notice requirements of an insurance policy is sufficient to trigger an insurer’s defense obligations. “Strict compliance” is not required. The California Supreme Court refused to deny an insured benefits because he had mistakenly submitted notice and proof of loss to the insurer’s “accident division” under a liability policy, rather than the proper “disability division” of the applicable life insurance policy. The Court stated:

The defendant’s division of its business among several departments should not be permitted to work a hardship upon the insured.

Thus, an insurer issuing multiple policies cannot avoid its contractual obligations by claiming that the policyholder’s notice was made to the wrong department.

In a California court of appeal case, the defense of the insured was tendered merely by forwarding a copy of the summons and complaint to its insurance broker in an envelope with the return address of another insured. *The insurer denied the tender because the entity on the return address was not a defendant in the enclosed complaint. Affirming the jury’s verdict, the court held:*

[T]he facts confronting the claims manager Scott were such as to put him on notice of the contractual duty to make further inquiry. If he had made this further inquiry, he would have discovered that it was actually [its insured] who had tendered the summons and complaint for defense . . . .

#### **C. Courts Precluding Recovery of Pre-Tender Fees Have Adopted a Number of Distinct Rationales**

The Connecticut Supreme Court rejected the policyholder’s quest for recovery of pre-tender fees incurred in the underlying copyright infringement/unfair trade practices case regarding the design, manufacture, and sale of certain carpet tiles. Tender occurred six months after settlement of the federal action in which defense costs exceeded \$330,000.

The court noted two key cases in Georgia finding that authority binding. It ruled that no pre-tender fee recovery was available. The court observed that, apart from the “voluntary payments” provision, “the policies here require that the insured: (1) forward legal papers related to claims or lawsuits ‘immediately’ to the insurer; and (2) provide written notice of lawsuits or claims to the insurer ‘as soon as reasonably possible’ or ‘as soon as practicable.’” The failure to satisfy these requirements, the court suggests, would bar recovery of pre-tender fees even absent a “voluntary payments” provision.

A Georgia court of appeal denied a defense based on late notice. The underlying action addressed a suit for a

variety of alleged bad acts commencing in 1988 and continuing until the time of suit. The insured, Southeastern, alleged that George Barnes, principal of Southeastern and prior employee of Triad, had violated various confidentiality agreements with Triad not to use or divulge its proprietary or trade secrets or to seek its customers. Triad sued Southeastern and Barnes for selling pre-owned Triad computer hardware and pre-licensed Triad software products without paying any software license fee and without obtaining from the subsequent purchasers an agreement to be bound by Triad's license agreement.

In finding that no proper notice was provided, the court noted that Southeastern was not an insured as of the inception date of the alleged bad acts, but the complaint did include Barnes, also a named defendant. Southeastern became an insured for the first time on October 25, 1992, three years after the inception of the policy in place when the alleged claims arose. Southeastern was first sued along with Barnes on April 22, 1992.

## IV. CONCLUSION

Given the routine character of insurers' contention that pre-tender fees are not recoverable, it is surprising how few courts have actually addressed this issue. Policyholders who believe pre-tender fees are not recoverable and permit insurers to avoid paying them based on the effect of the "voluntary payments" provision should re-think readily accepting the insurer's flawed arguments and inapposite citations. Thoughtful policyholders may well succeed in attacks on insurer contentions that they are not responsible for pre-tender fees where a defense would have been wrongfully denied if notice had been provided earlier.

### 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.

Mr. Gauntlett's *Intellectual Property Practitioner's Handbook on Insurance Coverage*, to be published by the Intellectual Property Section of the American Bar Association is scheduled for release in conjunction with the August 2009 ABA Annual Meeting in Chicago. The handbook is designed to enable intellectual property practitioners to readily determine whether a client's IP lawsuit may be amenable to insurance coverage.

### UPCOMING PUBLICATIONS BY DAVID A. GAUNTLETT

- ◆ *Intellectual Property Due Diligence in Corporate Transactions*: § 12A (West 2007) (contributor)
- ◆ *Assets & Finance: Audits and Valuation of Intellectual Property - Internal Controls, Materiality and Investment* (West/Thompson Reuters) (Westlaw AFAVIP) (contributor)
- ◆ Also soon to be published are three books:
  - *A Primer on Insurance Coverage Law, and Intellectual Property Claims Under Commercial General Liability Policies* (Insurance of IP assets) (contributing authors for Chapter 7) (Tod Zuckerman, Bob Chesler, Mary Hildebrand and Christopher Keegan)
  - *Free and Open Source Software and Content Desk Reference: A Legal and Risk Management Guide* (Browntree Publications) (contributing author of chapters on F/OSS and F/OC adoption and corporate risk management policies and procedures)
  - *Intellectual Property Practitioner's Handbook on Insurance Coverage* (ABA 2009)
- ◆ *The Licensing Journal* regularly features articles written by Mr. Gauntlett, the latest entitled *A Product Can Be "An Advertisement For Itself" So As to Trigger "Advertising Injury" Coverage* (West/Thompson Reuters 2009) (publication pending)
- ◆ *TIPS-ICLC 2009 Annual Survey* will also feature an article by Mr. Gauntlett on latest developments in Insurance Coverage Litigation.

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

Mr. Gauntlett was recently named a *Super Lawyer* (Southern California) for the following practice areas:  
**Insurance Coverage, Intellectual Property and Antitrust Litigation**

**April 19-23, 2009** Risk and Insurance Management Society, Inc. Annual Conference - Orlando, FL - Attending  
**June 9-10, 2009** The 21st Annual General Counsel Conference - New York, NY - Attending  
**July 30 - Aug. 4, 2009** 2009 ABA Annual Meeting - Chicago, IL - Attending

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*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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