

THE POLICYHOLDER ADVOCATE/IP COUNSELOR

NEWSLETTER

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SPECIAL NEW YEAR'S OFFER

Received a **denial letter** for insurance coverage claims based on cases pending in **Texas**? The Texas Supreme Court¹ recently adopted the majority "notice prejudice" rule, which precludes insurers' denying a defense for late notice unless it was prejudicial to the insurer. This ruling permits **revisitation** of a number of coverage denials carriers have issued asserting notice was a "condition precedent" to coverage.

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CALIFORNIA DREAMING: STRIKING GOLD IN THE GOLDEN STATE: EXPANDED RIGHTS OF RECOVERY IN INSURANCE COVERAGE ACTIONS

I. INTRODUCTION

Policyholder counsel may be on the verge of a new gold rush in California. Case law in three significant areas has taken a recently favorable turn for policyholders in California, making it both a more attractive jurisdiction for pursuit of coverage claims as well as one in which greater benefits may arise for policyholders. These developments arise in three distinct areas: **First**, new case law makes the applicability of California coverage more likely. **Second**, it clarifies that in a number of business tort cases, the right to independent counsel in California has been expanded from previously perceived limits. **Third**, the California Supreme Court has clarified the "genuine dispute doctrine" so that an insurer's disagreement with the insured over the application of coverage law is not sufficient in and of itself to avoid bad faith exposure unless its position is reasonable in light of applicable law.

II. THE APPLICABILITY OF CALIFORNIA COVERAGE LAW UNDER CALIFORNIA CHOICE OF LAW RULES

California will rarely recognize a conflict of interest unless the policy issues behind the distinct rule would necessarily create a different result. *Western Int'l Syndication Corp. v. Gulf Ins. Co.*, 222 Fed. Appx. 589, 594 (9th Cir. (Cal.) 2007) highlights California's preference for application of its own law. Therein, the court conceded that the late notice rule in New York – the other possible forum – made late notice a condition precedent to limit recovery under the policy, where as California applied the "notice prejudice rule." The issue was not simply whether the law of the other forum is distinct from that of California, but whether, under the facts applicable in the case, the policy reasons behind the law applied by a distant forum were implicated so as to create a conflict. Thus, the Ninth Circuit reasoned:

One of the primary rationales for New York's no-prejudice rule is protecting insurers from fraud and collusion, but here there has been no collusion allegation, so this rationale cannot give rise to a true interest. . . . A second rationale behind New York's rule is facilitating settlements, *id.* at 813, but the record reflects that Western offered Gulf opportunities to participate in settlement discussions and Gulf declined.

Equally critical, assuming conflict of interest does arise, California coverage law will apply if the underlying suit is in California, as this is the "place of performance." Judge Croskey made place of performance pertinent where a California court addresses conflict of law issues by looking to a long-neglected California statutory provision, which in his view impelled this result. He thereby limited the government interest test typically applied by courts up to that point in time in that it was applicable only in tort disputes but not contract matters. *Frontier Oil Corp. v. RLI Ins. Co.*, 153 Cal. App. 4th 1436 (2007).

The court emphasized that Civil Code § 1646 is California's choice-of-law rule that determines the law governing the interpretation of contracts, and it calls for the governing law to be that of the place of performance. The court found that prior California opinions offered little guidance on the application of Civil Code § 1646 as a choice-of-law rule, nor did the government interest analysis supplant that statute as the law governing the interpretation of contracts.

The court found the intended place of performance where a defense duty arose to be where the legal services were rendered, i.e., the court in which an action was pending. "The insurer provides defense services in the jurisdiction where the suit is prosecuted. There is little doubt that this was the understanding of the parties at the time they entered into the insurance contract in this case." *Id.* at 1461.

III. RECENT CASE AUTHORITY CLARIFIES THE RIGHT TO INDEPENDENT COUNSEL IN CALIFORNIA

In two companion cases articulating concepts consistent with existent coverage case law, the court determined that the right to independent counsel was implicated where there was a **significant** conflict, although that **conflict** was a **potential** not an actual conflict. Indeed, the court found the actual versus potential distinction meaningless when distinguishing pertinent facts.

In the first case for the same entity, *J.R. Marketing, LLC. v. Hartford Casualty Ins. Co.*, No. A115472, 2007 WL 3154266 (Cal. Ct. App. Oct. 30, 2007), the court found that Hartford's reservation of rights disclaimed coverage for each and every possible basis for denial of coverage which it might subsequently assert. Where any of those bases created a substantial potential conflict, independent counsel rights were triggered. It was, therefore, Hartford's duty to notify the insured when a conflict arises, not the reverse.

Where Hartford misperceived that it had the right to appoint counsel and did not advise its insured that it might in fact have a right to independent counsel, it was estopped from seeking disqualification of its previously appointed

counsel to then serve as independent counsel. The court reasoned that Hartford agreed, under the reservation of rights, to allow appointed counsel to continue to defend the insured. *Id.* at *8.

The second case, *J.R. Marketing, LLC. v. Hartford Casualty Ins. Co.*, No. A115846, 2007 WL 4217443 (Cal. Ct. App. Nov. 30, 2007), expressly addressed “advertising injury” coverage claims. The court again agreed that Hartford’s argument that “its extensive reservation of rights was too ‘general’ to create a conflict of interest.” The insured argued that this broad and general reservation of rights included the potential assertion of the “first publication exclusion” and that this exclusion could create a conflict.

The court’s analysis of why the “first publication exclusion” reservation created a conflict is extremely critical because most insurers will seek to reserve their rights on this issue as it is not often clear from the face of the pleadings whether any publication of material that is the basis for the subsequently asserted liability preceded the policy and therefore it might implicate the exclusion to bar a defense or coverage.

Explaining why this provision created a conflict requiring the appointment of independent counsel, the court noted, at *8,

Hartford contends its reservation of rights created no conflict of interest because “the timing of [defamatory statements] ... cannot be controlled by defense counsel.” While we agree defense counsel cannot control the timing of such statements, as respondents point out, other key issues implicated by this coverage defense may indeed prove to be under defense counsel’s control. Hartford, for example, may benefit at trial – to respondents’ detriment – from developing a theory that the defamatory statements respondents allegedly made during the policy period were substantially the same as those they allegedly made before the policy period. . . . [T]he prior publication exclusion language “bars coverage of an insured’s continuous or repeated publication of *substantially the same* offending material previously published at a point of time before a policy incepts, while *not* barring coverage of offensive publications made during the policy period which *differ in substance* from those published before commencement of coverage.” As such, given the parties’ diverging interests in applying this rule, a conflict of interest exists based on Hartford’s reservation of rights under the prior publication exclusion.

The court advised that the expected or intended injury exclusion would also create a conflict of intent because appointed counsel would have an incentive to pursue a theory at trial that the defamatory statements were knowingly and intentionally made. This case therefore offers authority for why the typical reservation of rights by carriers in intellectual property and business tort cases, regarding “intended or expected injury” or the “first publication exclusion” triggers a right to independent counsel.

Equally significant, the *J.R. Marketing* court found that the appropriate remedy where independent counsel had been denied was prompt payment of all outstanding defense fees within 15 days, with all future reasonable and necessary defense costs paid within 30 days from receipt of invoices, at reasonable rates, not California Civil Code § 2860 rates. The court noted, at *10:

Hartford was not entitled to the protections of section 2860, subdivision (c), including those restricting rates paid to independent counsel to rates generally paid to the insurer's own counsel and providing for arbitration of fee disputes, based on Hartford's ongoing failure to immediately and fully defend respondents.

This is a key part of the decision since it permits an adjudication that 2860 limitations do not apply prospectively for a carrier that has wrongfully refused to defend through independent counsel. A carrier thus electing to choose appointed counsel runs the risk that the fees incurred by its paying appointed counsel will not have discharged its defense duty and that independent counsel fees must be paid in full where reasonable, and prospectively as well – at reasonable, not 2860 rates. This places a significant damper on the insurer's efforts to minimize the amount of legal fees paid in the typical IP coverage case where a defense arises.

IV. CALIFORNIA RECENTLY EXPANDED THE “GENUINE DISPUTE DOCTRINE” TO PERMIT ONLY REASONABLE WITHHOLDING OF BENEFITS BY INSURERS

Contract rights do not diminish the insurer's obligation under bad faith law to properly provide policy benefits to an insured. In *Wilson v. 21st Century Ins. Co.*, 68 Cal. Rptr. 3d 746 (Cal. 2007), the California Supreme Court clarified that, “To fulfill its implied obligation, an insurer must give at least as much consideration to the interests of the insured as it gives to its own interests. When the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort.” *Id.* at 751.

An insurer's reliance on a genuine dispute will not preclude its exposure to a claim for breach of the covenant of good faith and fair dealing where it has a questionable legal basis for such an assertion. “[A]n insurer is not entitled to judgment as a matter of law where, viewing the facts in the light most favorable to the plaintiff, a jury could conclude that the insurer acted unreasonably.’ Thus, an insurer is entitled to summary judgment based on a genuine dispute over coverage . . . only where the summary judgment record demonstrates the absence of triable issues as to whether the disputed position upon which the insurer denied the claim was reached reasonably and in good faith.” *Id.* at 754-55 (citations omitted).

The court disapproved statements in a number of earlier cases that the insurer need only show a legitimate dispute as to the insurer's liability rather than proof that the insurer's withholding of benefits is reasonable. It concluded, “In the insurance bad faith context, a dispute is not ‘legitimate’ unless it is founded on a basis that is reasonable under all the circumstances.” *Id.* at 754 n.7.

Thus, a disagreement between insurer and insured over the application of coverage law principles to undisputed facts, where an insurer's position is unreasonable because it is contrary to the weight of applicable authority likely to be applied by the pertinent court, may permit a finding that the insurer breached the covenant of good faith and fair dealing as a matter of law. *Concept Enters., Inc. v. Hartford Ins. Co.*, No. CV 00-7267 NM (JWJx), 2001 WL 34050685, at *7 (C.D. Cal. May 21, 2001) (“To date . . . Hartford has failed to pay for the entire mixed action, and has declined to pay even the costs it conceded from the outset that it owed. Accordingly, no reasonable jury could fail to conclude that Hartford's blatant intransigence has breached the covenant of good faith and fair dealing.”).

Where the issue is close, this will preclude summary judgment for the insurer, requiring a trial on the reasonableness of the insurer's position. Coverage counsel might serve as an expert witness in such a dispute to gauge the reasonableness of the insurer's position. *Cf. Arnette Optic Illusions, Inc. v. ITT Hartford Group*, 43 F. Supp. 2d 1088 (C.D. Cal. 1998) (Where Hartford breached duty to defend trademark action, sending bad faith issue to jury because law on which Hartford relied was unclear at time of coverage denial.)

V. CONCLUSION

For years, carriers have fallen into one of three camps in addressing coverage issues.

The **first** approach avoids assertion of any reservation of rights so as to permit their right to appoint counsel to go unchallenged. This is the typical strategy in trademark infringement actions where there is little damage exposure in most matters and the principal issue is avoidance of an injunction. Where defense fees are the major part of a carrier's obligation, controlling the defense through counsel retained at lower rates than it would typically have to pay to independent counsel limits the insurer's expense. However, trademark infringement suits often involve other claims which, whether or not covered, must be defended. Where a disparagement or defamation claim is joined on which the damage exposure might be higher, carriers will be inclined to rethink agreeing to defend and indemnify by avoiding any reservation of rights.

The **second** group of carriers, recognizing that some "mixed" actions pose a greater risk of indemnity exposure to the insurer for covered claims, tailor their reservation of rights in such a way as to avoid creating a conflict of interest. Prior to *J.R. Marketing*, many carriers would believe that neither of the exclusions identified as creating a conflict in *J.R. Marketing* would have that effect. Thus, there are a number of cases pending where the insurer's refusal of independent counsel may now be subject to challenge, with significant financial consequences to insurers.

The **third** camp is adopted by carriers who simply do not believe any fact scenario creates a right to independent counsel. Like Hartford, they avoid taking a position on any particular exclusion or exception to coverage, simply generally reserving all rights that until forced to explain why reservation evidences an actual conflict, no right to independent counsel can arise. This is the approach debunked in *J.R. Marketing*. Again, such reservations are subject to challenge, and significant exposure may be visited on carriers having taken this approach.

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¹See *PAJ, Inc. v. The Hanover Ins. Co.*, ___ S.W.3d ___, 2008 WL 109071, at *5 (Tex. 2008).

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 PUBLICATIONS BY DAVID A. GAUNTLETT

Mr. Gauntlett continues to be a contributing author to L.M. Brownlee's *Intellectual Property Due Diligence in Corporate Transactions* § 12A (West 2007) and the soon-to-be-published *Intellectual Property Assets: Banking and Due Diligence* handbook (West 2008). Also soon to be published is a book on IP assets (West 2008), which features material from an interview of Mr. Gauntlett conducted by Tod Zuckerman for the *US Insurance Law Report*.

The Licensing Journal regularly features articles written by Mr. Gauntlett, the latest entitled *The Right to Select Independent Counsel Paid for by the Insurer in Intellectual Property Disputes*.

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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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