INSURANCE COVERAGE ISSUES FOR THE NEW MILLENNIUM

By:

GLENN. R. LEGGE
HEATHER S. VON STERNBERG
LEGGE, FARROW, KIMMITT, MCGRATH & BROWN, L.L.P.
6363 WOODWAY, SUITE 400
HOUSTON, TEXAS 77057
713-917-0888
WWW.LEGGEFARROW.COM

RECENT INSURANCE COVERAGE DEVELOPMENTS IN THE UNITED STATES

Any attempt to provide a meaningful insight into recent insurance coverage developments in the United States is faced with a number of difficulties. Initially, a decision must be made regarding which of the numerous developments and legal trends to include in the presentation. The topics of this presentation are:

$ The coverage of third-party breach of contract claims under a general liability policy;

$ Intellectual property coverage developments;

$ The relationship between e-commerce and insurance; and

$ The role of defence counsel, the insurer=s liability for acts of defence counsel, and insurance company litigation guidelines.

Although these topics are not particularly energy-related, the breadth and significance of their effect will undoubtedly be felt in the energy industry. Recent developments in these areas of insurance coverage have raised the concerns of both in-house risk managers and insurers of operators, contractors, and vendors in the energy industry.

The second challenge in presenting this paper is the American legal system itself. Generally speaking, insurance issues are determined through the application of the various states= laws, rather than a uniform federal law. Insurance issues can be determined by the courts of the fifty states and by the federal courts when hearing cases that provide a sufficient basis for federal jurisdiction. The variety of decisions emerging from the American legal system that affect insurers and insureds makes it very difficult for either group to chart a business plan with any reasonable degree of predictability.

The third challenge faced is the presentation of the topics in such a manner as to provide the broadest appeal without homogenizing the substance of the paper to the point where it provides little practical benefit. Considering the wide and varying range of experience of this audience, composed of insurance underwriters, insurance brokers, risk managers, and energy industry personnel, the goal of this presentation is to provide a brief glimpse of recent American legal developments that will significantly impact many facets of the energy and insurance industries.

I. THE COVERAGE OF THIRD-PARTY BREACH OF CONTRACT CLAIMS UNDER A GENERAL COMMERCIAL LIABILITY POLICY.

In *Vandenberg v. Superior Court. of Sacramento County*, 982 P.2d 229 (Cal. 1999), the Supreme Court of California dealt a blow to insurers by holding that, despite the general presumption that liability insurance covers tort claims rather than contract claims, a commercial general liability policy does not necessarily bar coverage for claims against the policyholder that are framed as breach of contract claims. Policyholder Vandenberg operated an automobile sales and servicing facility from 1958 to 1988 on land leased from the Boyds. In 1988, Vandenberg discontinued the business, and the Boyds again possessed the land. Subsequently, the Boyds discovered pollution damage on the land and sued Vandenberg, alleging that Vandenberg's installation and operation of waste oil storage tanks on the land created the pollution. For the years in question, Vandenberg was insured by several companies through standard commercial general liability insurance.

The Boyds and Vandenberg arbitrated issues relating to whether Vandenberg's oil waste activity constituted a breach of the lease. The arbitrator found in favor of the Boyds and against Vandenberg, awarding more than $4 million dollars in damages. The arbitrator found that the bulk of pollution damage to the land resulted from the underground waste storage tanks and was caused in part by Vandenberg's breach of long term lease agreement. Vandenberg sought coverage for the award under his commercial general liability policies. The insurers rejected the claim on the basis of the arbitrator's findings, prompting Vandenberg to sue for coverage. The insurers filed a motion for summary judgment, claiming that because the arbitrator had awarded damages to the Boyds for a breach of the lease, the damages owed by Vandenberg to the third party claimants were contractual rather than tortious and thus outside the scope of commercial general liability coverage. The trial court granted the insurers' motion for summary judgment.

The court of appeal reversed the trial court and ruled that coverage under the insurance policies in question could not be determined by reference to the general rule that damages for an insured's nonperformance of a contract are not covered under CGL insurance policies. Rather, the appellate court reasoned that when there is damage to property, the focus of the inquiry should be the nature of the property, the injury, and the risk that caused the injury, in light of the specific policy language. The form of action brought by the injured party should not control the determination of coverage. The Supreme Court of California affirmed.

The Supreme Court began its analysis by noting that liability insurance exists to cover fortuitous losses and not losses that are under the effective control of the policyholder. Thus, liability insurance has historically been regarded as providing coverage for tort-based liability but not contractual claims under the theory that breach of contract is not fortuitous but results from intentional misconduct. Agreeing with this proposition as a general matter, the court nevertheless found that coverage might exist under a CGL policy for breach of contract.

The Supreme Court used the following rationale to support its opinion. The CGL insurance policies at issue provided coverage for sums the insured was Alegally obligated to pay as damages@ because of property damage. The court noted that insurance policies must be construed in accordance with the parties= mutual intent at the time of contract formation, as inferred from the written provisions. The clear and explicit meaning of the provisions interpreted in their ordinary and popular sense controls judicial interpretation, unless terms are used in a technical sense or a special meaning is given to them by usage. If the meaning a layperson would ascribe to an insurance provision is not ambiguous, courts will apply that meaning. Even if a provision raises doubts as to coverage in the minds of legally trained observers due to a sophisticated legal distinction, courts will not assume the distinction was incorporated into the policy.

The court therefore held that a reasonable layperson would certainly understand Alegally obligated to pay@ to refer to ***any*** obligation which is binding and enforceable under the law, whether pursuant to contact or tort liability. Furthermore, the court reasoned that a layperson, cognizant that he or she is purchasing a ***general liability*** policy, would not conclude that such coverage only refers to liability pled in tort and thus entirely excludes liability pled on the theory of breach of contract. The *Vandenberg* court noted that Athe same act may constitute both a breach of contract and a tort. Predicting coverage upon an injured party=s choice of remedy or the form of action sought is not the law@ of California. *Id.* at 245. In holding that breach of contract may be covered under a CGL policy, the Supreme Court of California overruled a long line of decisions that distinguished between liability arising from tort and liability arising from contract.

Recently, the Supreme Court of California reaffirmed the *Vandenberg* opinion and clarified that coverage for breach of contract damages must be based upon a court ordered sum and/or liability imposed in a definite sum by a final judgment. *Certain Underwriters at Lloyd's, London v. Superior Court of California,* 16 P.3d 94 (Cal. 2001). In this opinion, the Supreme Court of California also held that such coverage does not necessarily extend to expenses assessed against an insured by an administrative agency pursuant to an environmental statute.

In November 2000 a federal court in Texas, applying Texas law, reached a similar conclusion concerning coverage of breach of contract and negligence damages without reference to the *Vandenberg* opinion. In *I.N.A. v. McCarthy Bros. Co.,* 123 F. Supp.2d 373 (S.D.Tex. 2000), the insured, McCarthy Brothers, was the general contractor performing construction on a hospital. The insured initially completed its work and the hospital complained of numerous leaks that caused substantial water damage throughout the hospital. The hospital sued McCarthy Brothers and the parties entered into a settlement agreement whereby the insured agreed to remedy the deficient work or pay a sum of $25,000 to the hospital. Ultimately, the hospital exercised its right under the settlement agreement to require

McCarthy Brothers to remedy the deficiencies and repair the damages. McCarthy Brothers refused to comply and a second lawsuit was filed by the hospital against the insured, alleging damages resulting from McCarthy Brothers' breach of the settlement agreement and negligent construction. The court ruled that the insured was required by the settlement agreement to fix all of the problems resulting from McCarthy Brother's faulty design and construction. McCarthy Brothers, in turn, sought indemnification from I.N.A., which had provided commercial general liability insurance to the insured.

In the coverage action, I.N.A. maintained a number of coverage defenses. Among these defenses, I.N.A. maintained that McCarthy Brothers' liability arose from the settlement agreement and that coverage was excluded for *"…property damage for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement."* The insured responded with an exception to this exclusion which stated that "*…this exclusion does not apply to liability for damages…that the insured would have in the absence of the contract or agreement."* McCarthy Brothers, urging this exception, alleged that coverage could not be excluded based upon a contractual obligation accepted by the insured which related to its own negligent conduct.

The court, in determining the existence of coverage, stated that McCarthy Brothers' construction of the policy terms was reasonable and therefore, under Texas law, the court must accept the insured's interpretation. In its analysis of the coverage issues, the court focused on the factual basis for McCarthy Brothers' liability and found that the insured would have remained liable to the hospital based upon the insured's negligence in the absence of the contractual settlement obligations. Although this opinion does not go quite as far as the Supreme Court of California in the *Vandenberg* matter, there is a similar recognition that the same act may constitute both a breach of contract and a tort and that a court must examine the factual basis of an allegation rather than the injured party's choice of remedy.

Although the State of California has traditionally been a trendsetter in the arena of insurance litigation, the holding of *Vandenberg* is gradually being recognized by other jurisdictions in the United States. The *Vandenberg* decision was a victory for the policyholder; however, it is unclear whether the holding will always benefit policyholders. If the key to coverage is the essential nature of the claim rather than the third party's framing of the claim, this principle may be used to the benefit of both policyholders and insurers. While policyholders may be able to recover under CGL policies for tort-like damage under the rubric of breach of contract, the *Vandenberg* holding may give insurers a basis to deny coverage where the claim is framed as a tort action but the underlying offense can be shown not to be fortuitous within the meaning of CGL policies.

II. INTELLECTUAL PROPERTY COVERAGE DEVELOPMENTS.

This portion of the paper addresses coverage issues posed by the use of advertising injury coverage under commercial general liability insurance policies as a means of responding to intellectual property claims. Most frequently, intellectual property claims arise from the use or communication of information in connection with the sale of services or goods. Specifically, the explosion of coverage litigation in this area centers on the interpretation of the "advertising injury" provisions contained in CGL policies and addressed below.

A. Coverage Under the 1986 Insurance Services Office (ISO) CGL Form

Under the 1986 ISO CGL policy form, "advertising injury" is defined as an injury arising out of one of the following "offenses", which must occur in the course of advertising the insured's goods, products, or services:

$ Oral or written publication of material that slanders or libels a person or organization or disparages a person's or organization's goods, products, or services;

$ Oral or written publication of material that violates a person's right of privacy;

$ Misappropriation of advertising ideas or style of doing business; or

$ Infringement of copyright, title, or slogan.

Thus, in order to be covered under a CGL policy, the claimant must suffer an injury caused by one of the foregoing enumerated offenses. Of these enumerated offenses, this portion of the paper focuses on misappropriation, which encompasses theft of some trade secrets, and infringement, which encompasses copyright infringement and arguably trademark infringement but appears to exclude coverage for patent infringement.

The courts are divided over their interpretation of what types of activities constitute "advertising" under the 1986 ISO CGL form and earlier forms. Some courts have held that "advertising" refers to the widespread distribution of promotional materials to the public at large. Other courts have embraced a broader interpretation of the term, holding that one-on-one solicitations also constitute "advertising" as contemplated by CGL policies. Recently, the California Court of Appeal held that an insured's attempt to market a product specifically manufactured for a single customer=s requirements through a competitive bidding process did not qualify as Aadvertising@ under a 1986 ISO CGL policy. *Peerless Lighting Corp. v. American Motorist Ins. Co.*, 82 Cal.App. 4th 995 (Cal. Ct. App. 2000).

1. Patent Infringement

The courts appear to be in agreement that patent infringement does not fall within Aadvertising injury@ coverage. Numerous courts have examined the enumerated offenses contained in the policy definition of Aadvertising injury@ and have concluded that patent infringement is not encompassed by any of the offenses. The term Amisappropriation@ has been interpreted as protecting quasi-property interests that are not protected by more traditional theories of intellectual property law. The United States Supreme Court first recognized this common-law commercial tort in its landmark decision of *International News Service v. Associated Press*, 248 U.S. 216 (1918). The Court recognized a quasi-property right in a process of news-gathering not otherwise protected by patent, copyright, or trademark laws and statutes. Based upon the historical origin of Amisappropriation,@ courts have generally rejected insureds= arguments that patent infringement constitutes misappropriation of an advertising idea or style of doing business.

Likewise, the term Ainfringement of title@ has a specific legal meaning and refers to a distinct name identifying a literary or artistic work, not to interference with title to property. The courts= common sense approach states that if the offense of Ainfringement@ was intended to encompass patent infringement as an Aadvertising injury@, the word Apatent@ would appear in the insurance contract, just as the terms Acopyright@, Atitle@, and Aslogan@ do. *See, e.g. Gencor Indus., Inc. v. Wausau Underwriters Ins. Co.*, 857 F. Supp. 1560 (M.D. Fla. 1994).

With respect to the offense of disparagement, which encompasses libel and slander, the majority of courts reject the idea that patent infringement is covered under this offense. The Supreme Court of Maine, however, recently held that an insurance contract providing coverage for Abelittling@ another=s products or works potentially encompassed claims for patent infringement. *Foundation for Blood Research v. St. Paul Marine & Fire Insurance Company*, 738 A.2d 175 (Me. 1999). The 1986 ISO CGL form provides coverage for the oral or written publication of material that libels or slanders a person or organization or disparages a person=s or organization=s goods, products, or services. According to the court, this enumerated offense could be analogized to the offense of belittlement. This theory has yet to be adopted by any other jurisdiction in the United States.

2. Copyright Infringement

The term “copyright” refers to the protection of another’s tangible medium of expression, and written words, sculptures, performances, and diagrams are all capable of copyright protection. Copyright infringement is expressly covered under the definition of “advertising injury” contained in the 1986 ISO CGL form. Among the jurisdictions that have readily found that copyright infringement is a covered offense under the 1986 ISO policy form are: Arizona, Arkansas, California, Georgia, Idaho, Michigan, New York, Texas, and

Washington. *See, e.g., Phoenix Control Sys., Inc. v. Insurance Company of North America*, 796 P.2d 463, 465 (Ariz. 1990); *Tri-State Ins. Co. v. B & L Prods., Inc.*, 964 S.W.2d 402 (Ark. Ct. App. 1986); *Zurich Ins. Co. v. Killer Music, Inc.*, 998 F.2d 674 (9th Cir. (Cal.) 1993), *Robert Bowden, Inc. v. Aetna Cas. & Surety Co.*, 977 F. Supp. 1475, 1479 (N.D. Ga. 1997); *Doron Precision Sys., Inc. v. United States Fidelity & Guar. Co.*, 963 P.2d 363 (Idaho 1998); *Irons Home Builders, Inc. v. Auto-Owners Ins. Co.*, 839 F. Supp. 1260 (E.D. Mich. 1993); *Farmington Cas. Co. v. Cyberlogic Techs., Inc.*, 996 F. Supp. 695 (E.D. Mich. 1998); *Poof Toy Prods., Inc. v. United States Fidelity & Guar. Co.*, 891 F. Supp. 1228, 1231 (E.D. Mich. 1995); *Stratford Homes, Inc. v. Lorusso*, 1995 U.S. Dist. LEXIS 19597 (W.D. N.Y. 1995); *Sentry Ins. Co. v. R.J. Weber Co., Inc.*, 2 F.3d 554 (5th Cir. 1993); and *Federal Ins. Co. v. Microsoft Corp.*, 1993 U.S. Dist. LEXIS 5468 (W.D. Wa. 1993), *vacated pursuant to settlement*, 1994 U.S. Dist. LEXIS 21073.

3. Trademark Infringement

Trademarks such as business names, brand names, trade names, slogans, and phrases are not subject to copyright protection and are generally protected through trademark laws. American courts are split on whether or not trademark infringement is a covered offense under the definition of Aadvertising injury@ contained in the 1986 ISO CGL form. Some courts, such as the United States Courts of Appeal for the Sixth and Eighth Circuits, have held that the Amisappropriation@ offense refers to the unauthorized taking or use of interests ***other*** than those which are eligible for protection under statutory or common law trademark law; therefore, trademark infringement is not covered. The analysis of these courts focused on the historical origin of the tort of misappropriation, as well as documents prepared by the drafters of the 1986 ISO form, which demonstrate the drafters= belief that none of the enumerated offenses in the 1986 form include trademark infringement. Therefore, the drafters believed that a specific trademark infringement exclusion, found in pre-1986 insurance contracts, was no longer necessary in the 1986 form. *See, e.g., Callas v. The Travelers Indemnity Company of America*, 193 F.3d 952 (8th Cir. 1999); *Scolodge, Inc. v. Travelers Indemnity Company of Illinois*, 168 F.3d 256 (6th Cir. 1999); *Diversified Investments Corporation v. Regent Insurance Company*, 226 Wis.2d 563, 596 N.W.2d 502 (Wisc. Ct. App. 1999).

On the other hand, many courts have found that trademark infringement is covered under the 1986 ISO CGL form as an advertising injury. For instance, Judge Kent in the Southern District of Texas, Galveston Division, recently held that an insurer was obligated to defend claims for trademark and trade dress infringement under the Aadvertising injury@ offense of Amisappropriation of style of doing business.@ *Bay Electric Supply, Inc. v. The Travelers Lloyds Insurance Company*, 61 F. Supp.2d 611 (S.D. Tex. 1999). Judge Kent interpreted the language contained in the 1986 ISO CGL form regarding Aadvertising injury.@ The insureds contended that the physical appearance of a product, the ornamental features which serve to identify its source and distinguish it from similar products, can reasonably be construed as either an Aadvertising idea@ or a Astyle of doing business.@ Accordingly, the insureds alleged that the insurer was required to defend them from allegations that the insureds had infringed the claimant=s product=s physical appearance, or trade dress and trademark.

While the term trademark is widely understood, Atrade dress@ is a technical term and refers to Athe total image of a product . . . including features such as shape, color or color combinations, texture, graphics, or even particular sales techniques.@ *John H. Harland Company v. Clarke Checks, Inc.*, 711 F.2d 966, 980 (11th Cir. 1983). The insurer contended that lack of an express reference to trade dress or trademark infringement indicated that coverage was not intended for trademark infringement under the 1986 ISO CGL form. Arguing by analogy, the insurer cited a series of cases holding that patent infringement does not fall within Aadvertising injury@ coverage. The court disagreed with the approach taken by the Sixth and Eighth Circuits and instead sided with numerous courts throughout the country which have held that coverage for trademark and trade dress infringement claims is provided under the Aadvertising injury@ offense of Amisappropriation or style of doing business.@ *See, e.g., Applied Bolting Tech. Products, Inc. v. United States Fidelity & Guaranty Company*, 942 F. Supp. 1029, 1034 (E.D. Pa. 1996), *aff=d*, 118 F.3d 1574 (3rd Cir. 1997); *American Econ. Insurance Company v. Reboans, Inc.*, 900 F. Supp. 1246, 1254-55 (N.D. Cal. 1994); *St. Paul Fire & Marine Insurance Company v. Advanced Interventional Systems, Inc.*, 824 F. Supp. 583, 585 (E.D. Va. 1993), *aff=d*, 21 F.3d 424 (4th Cir. 1994); *Poof Toy Products, Inc. v. United States Fidelity & Guaranty Company*, 891 F. Supp. 1228, 1233 (E.D. Mich. 1995).

Focusing on the understanding of the average insured, Judge Kent rejected the argument that the average insured is required to know the obscure distinctions between common law business torts; instead, the burden to identify such distinctions and incorporate them into the policy should fall upon the insurer. Therefore, if the drafters of the insurance policy wanted to limit their exposure to suits arising under the common law tort of misappropriation, they should have expressly stated this limitation in the policy.

While most courts holding that trademark infringement is covered as an Aadvertising injury@ so find under the offense of Amisappropriation@, several courts have expansively held that the offense of infringement of copyright, title, or slogan encompasses trademark infringement as well. These courts have interpreted Atitle@ to simply refer to an appellation, the name by which something is known, thereby creating coverage for trademark infringement claims under this offense. *See, e.g., American Employer=s Insurance Company v. DeLorme Publishing Company, Inc.*, 39 F. Supp.2d 64 (D. Me. 1999); *Morgan, Lewis & Bockius, L.L.P. v. Hanover Insurance Company*, 929 F. Supp. 764 (D. N.J. 1996); *A Touch of Class Imports, Ltd. v.*

Aetna Cas. & Surety Company, 901 F. Supp. 175 (S.D. N.Y. 1995).

On the other hand, the Supreme Court of California recently held that theAinfringement@ policy language only provided coverage for infringement of a name of a literary or artistic work or a name that was also a slogan. *Palmer v. Truck Ins. Exchange,* 988 P.2d 568 (Cal. 1999). The policy thus did not cover the plaintiff=s infringement, because the mark was neither the name of a literary or artistic work, such as a name given to a book, play, film, musical composition, or other work, nor a slogan.

It should be noted that many policies contain a specific exclusion for trademark infringement, such as the following:

> Infringement of trademark, service mark, or trade name, other than titles or slogans, by use thereof on or in connection with goods, products, or services sold, offered for sale or advertised.

4. Misappropriation of Trade Secrets

Based upon the various definitions of Atrade secret@, there are three fundamental characteristics that must be met before something can be classified as a trade secret: (1) limited availability, (2) economic value, and (3) reasonable efforts to maintain secrecy. Many insureds seek coverage for theft of trade secrets claims under the enumerated offense of Amisappropriation.@ Predictably, the courts are split on this issue as well. Several courts have held that Amisappropriation@ encompasses claims of misappropriation of property, such as customer lists, a pattern for a machine, or a process of manufacturing. *See, e.g., Sentex Systems, Inc. v. Hartford Accident & Indemnity Company,* 93 F.3d 578 (9th Cir. 1996).

More recently, however, the courts have rejected this broad reading and considered coverage for theft of trade secrets under a fact-intensive analysis. These courts have specifically examined the type of trade secret allegedly stolen. Therefore, theft of trade secrets that are unrelated to advertising, such as formulas, raw data, drawings, software, etc., falls outside the scope of coverage intended by the term Aadvertising injury.@ *Monarch E & S Insurance Services v. State Farm Fire & Casualty Company,* 38 F. Supp.2d 841 (C.D. Cal. 1999); *Clark Manufacturing, Inc. v. Northfield Insurance Company,* 1999 U.S. App. LEXIS 14133 (9th Cir. 1999).

B. Coverage Under the 1998 ISO CGL Form

In 1998, the ISO once again revised the terms and conditions of Aadvertising injury@ under the CGL form. Changes to the enumerated offenses as compared to the 1986 form include:

$ deleting Ainfringement of title@ as an offense;

$ deleting Amisappropriation of the style of doing business@ as an offense;

$ deleting Amisappropriation of advertising ideas@ as an offense;

$ adding Ainfringing upon another=s trade dress in your›advertisement=@ as an offense; and

$ adding Athe use of another=s advertising idea in your›advertisement=@ as an offense.

In addition, the 1998 form adds, for the first time, a definition of the term Aadvertisement@:

> a notice that is broadcast or published to the general public or specific market segments about your goods, products or services for the purpose of attracting customers or supporters.

These new offenses have yet to be addressed in the American judicial system.

C. Alternatives to the ISO CGL Form

Due to the continuing evolution in the policy terms and conditions governing coverage of Aadvertising injury@ in the ISO CGL form, the division between courts regarding the judicial interpretation of the offenses which comprise Aadvertising injury@, the gap between coverage afforded by CGL policies and laws intended to protect intellectual property interests, and the inventive theories advanced by policyholders= attorneys, new forms of intellectual property coverage are emerging. These include policies for the pursuit of various infringers, specifically:

$ Intellectual Property Infringement Abatement Insurance, underwritten by Intellectual Property Insurance Services Corporation (IPISC)

$ Patent Infringement Litigation Expense Indemnity Coverage, underwritten by Litigation Risk Management

In addition, specific insurance may be procured to protect against various intellectual property claims. In particular, patent infringement coverage may be obtained, especially in light of the trend in American courts to deny coverage for patent infringement under the Aadvertising injury@ language contained in the ISO CGL form. As of early 2000, potential providers of risk-specific intellectual property coverage include:

- $ Abbey Legal Protection, Ltd. (Certain Underwriters at Lloyd's of London - Minet Professional Services, Ltd. - Intellectual Property Insurance)

- $ American International Specialty Lines Insurance Company - Patent Infringement Indemnity Insurance

- $ Employers Insurance Company of Wausau - Commercial Lines Insurance - Defence

- $ Admiral Insurance Company - Technology Professional Liability & Commercial General Liability Insurance Coverage

In addition, the following entities offer advertising liability policies aimed at high technology insureds:

- $ AIG - American International Link Telecommunications and Multimedia Liability Policy

- $ Chubb Insurance Company - Multimedia Policy

D. Methods of Expanding Traditional Intellectual Property Coverage

There are several different commercial alternatives available to a policyholder attempting to expand coverage and minimize exposure for intellectual property transactions. First, a policyholder can negotiate to be added as an additional insured in contractual agreements with its distributors, suppliers, and advertising agencies. Obtaining additional insured status on a supplier's insurance policy would afford increased protection to the policyholder in the development of its products. Obtaining additional insured status on a distributor's insurance policy would afford increased protection to the policyholder in the marketing of its products to the public. Finally, when entering into a licensing agreement, policyholders may be able to obtain additional insured status on the licensee's insurance policy.

Second, as a corollary to obtaining additional insured status, a policyholder when entering into any of the aforementioned agreements should ensure that the agreements contain an indemnity provision that is backed by insurance. Third, certain opportunities for increased coverage for intellectual property exposure are presented in the context of mergers and acquisitions. For the acquiring or surviving company, it is beneficial to obtain coverage on both pre- and post-acquisition policies. The acquiring company should ensure that the acquired company has effectively assigned the pre-acquisition policies to the surviving company.

Although CGL policies frequently have clauses which prohibit such an assignment unless the insurer=s written consent is secured, some courts have disregarded this clause when the risk to the insurer is unaffected by the assignment. *See, e.g., Northern Ins. Co. v. Allied Mutual Insurance Co.,* 955 F.2d 1353 (9th Cir. (Cal.) 1992). All of the foregoing alternative methods of contractual risk shifting may be significant to policyholders and insurers in evaluating potential liabilities.

In summary, creative lawyers representing not only policyholders and claimants but also other insurers seeking contribution under an Aother insurance@ clause have been fairly successful in finding ambiguities in Aadvertising injury@ coverage for intellectual property claims. Although the ISO has been vigilant in modifying the terms and conditions of the coverage afforded to respond to these ambiguities, it is fairly certain that the creativity of these lawyers and policyholders will not be stifled.

III. THE RELATIONSHIP BETWEEN E-COMMERCE AND INSURANCE.

The Internet and the inevitable advent of what has come to be known as Ae-commerce@ have revolutionized the business world. E-commerce has been a source of extraordinary business opportunities and revenues to traditional Apaper, brick and mortar@ companies. In addition, the arrival of e-commerce has ushered in an entirely new type of company, the A.com@ or Adotcom@ company. These virtual companies rely almost exclusively on the Internet to conduct business and generate profit.

The various uses of the Internet are vast and include advertising, distribution, advice-giving and revenue generation, including sales of goods and services and use of a website as a media vehicle that sells advertising to third parties. As part of these e-commerce activities companies will often deal with confidential and proprietary information over the Internet. Consider the examples of NetworkOil, OilOnline, WellBid Inc., IndigoPool, PetroCosm and Upstreaminfo.com. These energy related e-commerce companies bring together buyers and sellers of equipment, services and interests in oil and gas prospects.

For example, IndigoPool, a Schlumberger entity, describes its services as "…provid[ing] a secure, neutral online workspace for oil and gas property acquisition and divestiture, data sales and online e services." Recently, IndigoPool formed an alliance with Veritas DGC and Western Geco, leaders in the geophysical industry, and will publish their respective data libraries on the IndigoPool.com website. IndigoPool is frequently used by businesses in the oil and gas sector and has more than $3.0 billion in oil and gas properties and exploration acreage on its website.

E-commerce opportunities are not risk-free, however. The question thus arises: What coverage exists for e-commerce risks under standard form property and liability policies? This portion of the paper attempts to put some Ahard edges@ on these otherwise amorphous types of risks and coverages.

A. Types of Claims Common to E-commerce

1. First Party

At the outset, it is important to note that e-commerce gives rise to both first party claims, such as property and business interruption claims, and third party claims, such as liability claims. Some of the types of first party e-commerce losses include:

$ Hardware, software, or data loss;

$ Remediation costs incurred by vandalism or hacking attacks upon websites;

$ Business interruption (due to Internet service provider failure, programming errors, or human error); and

$ Additional costs related to business interruption, such as the cost of public and media relations efforts and costs of recollecting lost data.

2. Third Party Liability

The wide range of third party liability losses generated by e-commerce includes:

$ Detrimental reliance on erroneous information posted on a website, including technical, medical, and financial advice;

$ The interruption of the provision of goods or services to a third party which relies upon such goods or services in the course of their own revenue-producing operations;

$ Transmittal of a computer virus to a third party;

$ Misuse of personal or corporate data;

$ Defamation;

$ Intellectual property claims, including copyright and trademark infringement and misappropriation; and

$ Negligent or intentional misrepresentation.

B. Analysis of Claims and Coverage

1. Property Damage - First Party

Computer hardware, software, and data are subject to numerous internal and external threats. Some of these are traditional property threats, such as natural disaster, fires, floods, and accident due to human error. Internal threats more inherent to e-commerce include static electricity, power failures, power surges, and product failure. In addition, there are external e-commerce related threats, such as intentional or malicious conduct of hackers.

AAll risk@ insurance policies provide broad coverage and may cover many of the foregoing perils. AAll risk@ insurance typically provides coverage for fortuitous Aphysical loss or damage to insured property, arising from any cause whatsoever.@

In order to establish first-party coverage for repair or replacement of damaged property under an Aall risk@ policy, an insured must demonstrate the following:

$ The damaged property (i.e. software, hardware, or data) constitutes Ainsured property@;

$ The property must have sustained Aphysical loss or damage@; and

$ The loss or damage occurred during the policy period such that the policy was triggered.

a. AInsured Property@

Although there are some circumstances where property damage involving e-commerce results in damage to tangible property, such as physical premises and high value equipment, the more frequent damage sustained by e-commerce would appear to be the loss of less tangible property, such as data. There are several American cases, which have discussed whether data, and the media on which the data is recorded, constitute Ainsured property@ under ***CGL*** policies. For example, in *Magnetic Data, Inc. v. St. Paul Fire & Marine Insurance Co.*, 442 N.W.2d 153 (Minn. 1989), the Supreme Court of Minnesota held that an insured=s liability policy did not extend coverage for the insured=s erasure of information stored on its customer=s disc cartridges. The insured was inspecting the cartridges to determine whether or not the cartridges were defective. In the process, the insured destroyed the information contained on the cartridges. The court found that the insured=s CGL policy did not cover the damages incurred as a result of the erasure of the information, without determining whether the information was tangible or intangible.

On the other hand, in *Retail Systems, Inc. v. CNA Insurance Company,* 469 N.W.2d 735 (Minn. Ct. App. 1991), the Court of Appeals of Minnesota held that computer tape and the data contained on the tape constitute tangible property. The court noted that the data on the tape was of permanent value and was integrated completely with the physical property of the tape.

Although the foregoing cases involved property damage claims under a liability policy, they are instructive on the courts= varying views of whether or not data constitutes Ainsured property@ and should translate to the first-party property context. The only significant distinguishing characteristic between first-party insured property and third-party insured property is that the standard Aall risk@ policy does not require injury to Atangible property@, unlike the standard CGL policy. *See also Texas Instruments v. United States,* 551 F.2d 599, 611 (5th Cir. 1977) (information stored on computer tapes was tangible property); *Ronnen v. Commissioner of the Internal Revenue Service*, 90 T.C. 74, 100 (1988) (information stored on duplicate computer discs was not tangible property); *Rockport Pharmacy, Inc. v. Digital Simplistics, Inc.*, 53 F.3d 195, 198 (8th Cir. 1995) (suggesting that data is not tangible property under a commercial general liability policy).

b. APhysical Loss or Damage@

In order to be covered under an Aall risk@ policy, the insured must sustain Aphysical loss or damage@ to its property. A policyholder seeking coverage for damage to data, computer software, or a website may be faced with difficulty in showing that the damage was actually Aphysical@ within the meaning of the policy. For instance, a hacker=s attack on a website does not physically destroy a computer in the same manner that a fire destroys a building. On the other hand, most hacker attacks, computer viruses, and other e-commerce related perils might in fact result in physical damage, if damage at the level of electronic particles is considered physical damage.

There are few cases that discuss the application of traditional property coverage to computer system failures or the Internet. Still, the widely accepted rule of policy interpretation requiring that language shall be strictly construed against the insurer may allow the policyholder to circumvent a strict interpretation of Aphysical@ loss. For example, some courts have interpreted the language Aphysical loss or damage@ to mean physical loss of, or damage to, property, based upon the disjunctive Aor@. *Garber v. Travelers Ins. Co.*, 421 A.2d 744, 745 (Pa. Super Ct. 1980). This interpretation would not require Aphysical@ damage and would allow coverage for damage of a less tangible nature. Thus, the policyholder could argue that the language is ambiguous and that the interpretation favoring coverage should be applied.

In *American Guaranty & Liability Insurance Company v. Ingram Micro, Inc.*, 2000 U.S. Dist. LEXIS 7299 (D.C. Az. 2000), a policyholder sought coverage under its Aall risk@ policy for a power outage, caused by a ground fault in the fire alarm panel, that disrupted operations. The policyholder was a computer products distributor. As a result of the power outage, some computers had to be manually reprogrammed due to a loss of memory. The court held that the computers were physically damaged under the terms of the policy, finding that physical damage under the policy was not limited to physical harm but included the loss of the computers' use or functionality. Because the policyholder's computer's data was unavailable, services were interrupted, and the programs were altered, the policyholder suffered physical damage within the meaning of the policy.

c. Trigger of Coverage

Trigger refers to whether a loss falls within a policy's effective term. There are differing theories applied by American in courts in determining if and when a policy is triggered. This is a complex subject and has many treatises devoted solely to discussion of this topic. Therefore, this topic will not be analyzed here except to point out that courts apply the following theories:

$ the manifestation theory B the time of occurrence is when a claimant sustains actual damage;

$ the injury in fact theory B the time of the occurrence is when the act or omission causing that damage is committed; and

$ the continuous trigger theory - all policies triggered from date of act or omission causing injury through date of manifestation of the damages.

d. Covered Cause of Loss

Unless the insured holds an Aall risk@ policy, then in addition to showing physical loss or damage to Ainsured property@ within the policy period, a policyholder in order to recover also must connect the loss to a covered cause of loss enumerated in the ISO basic, broad, or special form. The requirement that a loss stem from a covered cause is a significant restriction to the coverage afforded under standard or commercial property insurance.

With respect to commercial property insurance, the ISO property form contains three different types of property coverage:

$ The basic form, which lists traditional causes of loss such as fire, wind storm, and vandalism;

$ Broad form coverage, which contains several additional perils to those listed in the basic form; and

$ A special form, which covers all causes of loss except those specifically excluded.

The enumerated cause of loss Avandalism@ in all likelihood would provide coverage where the injury was caused by hackers. Certain other causes of loss, however, do not appear to be covered under the broad form, such as Internet service provider failure and programming errors or other human errors.

Furthermore, the combination of a covered cause and an excluded cause may result in a denial of coverage. In *Noonan, Astley & Pearce, Inc. v. Insurance Company of North America*, 1994 U.S. Dist. LEXIS 3803 (S.D. N.Y. 1994), the policyholder was a money market currency and option brokerage firm which was wholly dependent on its telecommunications system, including its computer network. An electrical power interruption disrupted Noonan's normal business operations. The insurer argued that the power interruption was the cause of the loss while Noonan claimed that a fire that caused the power outage was the actual cause. Whether the fire or the power interruption was the cause of loss was dispositive since the commercial property policy only covered damage due to fire, and not power interruptions. In addition, the policy specifically denied coverage where both a covered and an excluded cause contributed to the loss. Thus, the court concluded that Noonan=s loss was not covered under the policy.

2. Business Interruption

Property coverage is frequently linked to business interruption coverage, which is typically included through an endorsement to first-party property policies to insure against business losses sustained as a result of suspensions in business operations. Business interruption coverage may be the most significant type of coverage for many e-commerce businesses, as interruption in business operations is often the most costly impact of e-commerce related risks.

Generally, business interruption coverage is only as broad as the property insurance to which it is linked. Typical business interruption coverage requires the suspension of operations to be caused by Adirect physical loss or damage to property@ and addresses only interruptions arising from a particular, covered source. In addition, the business interruption endorsement may be subject to a long list of exclusions. Some of these exclusions have a less obvious application to e-commerce but nonetheless can be used to exclude coverage, such as an exclusion relating to an act or omission of the insured=s employee. Furthermore, as websites are frequently hosted by third parties, damage due to failure of one of these websites might not qualify as damage to the insured=s property.

Finally, coverage may hinge upon the length of the interruption to the insured=s business. While some policies may cover Apartial or complete@ suspensions of operations, other policies might only cover a Asubstantial@ interruption to business. This distinction would be crucial to a claim for business interruption based upon shutdown of a website. For example, in *The Home Indemnity v. Hyplains Beef*, 893 F. Supp. 987 (D. Kan. 1995), *aff=d*, 89 F.3d 850 (10th Cir. 1996), the court found that a computer system failure which rendered a production plant less efficient but did not halt production was not covered as a Abusiness interruption.@

3. Third Party Liability

a. Property Damage

CGL insurance typically covers amounts that the policyholder becomes legally obligated to pay as damages for property damage or personal injury sustained by a third party. AProperty damage@ is defined as Aphysical injury to tangible property, including all resulting loss of use of that property.@ Therefore, as discussed in section III.B.1.a. above, policyholders have a strong argument that data comprises tangible property, although the courts are divided on the issue. *See Centennial Insurance Co. v. Applied Health Care*, 710 F.2d 1288 (7th Cir. 1983) (holding that insurer was obligated to defend policyholder from claims seeking damage to a third-party=s computer data-processing system and loss of customer billing and patient information caused by the policyholder=s product); *Seagate Technology, Inc. v. St. Paul Marine & Fire Ins. Co.*, 11 F. Supp.2d 1150 (N.D. Cal. 1998) (holding that the incorporation of allegedly defective disc drives into personal computers did not cause physical damage to tangible property of others).

Other types of e-commerce related property which may be covered as Ainsured property@ include software and computer programs. Claims based upon loss of revenue or profits have been classified as purely economic by courts and therefore are not covered as property damage. *See, e.g., Lazzara Oil Co. v. Columbia Cas. Co.*, 683 F. Supp. 777 (M.D. Fla. 1988), *aff=d*, 868 F.2d 1274 (11th Cir. 1989).

b. Advertising Injury

Liability for Internet Aadvertising@ activities and alleged intellectual property infringement may be covered under CGL policies. The opportunity and ease of mass duplication and distribution over the Internet provides fertile ground for copyright violations. For example, Napster produces software that makes it simple for Internet users to share songs stored as MP3 files. The Recording Industry Association of America has filed a lawsuit against Napster, calling it an illegal tool for distributing pirated copies of popular music. Napster stands accused of violating the copyright of every song traded through its service. Because the company's software makes it easy to track down MP3 files made by other users, the entire Internet could conceivably listen to a compact disc if just one Napster user pays for the CD and copies it onto his hard drive. These types of cases and insurance claims arising from them will only increase proportionately with the spread of Internet access and use among consumers.

Whether or not alleged property damage such as that suffered due to activities like Napster=s is covered under a CGL policy is a different matter. In order to be covered as an Aadvertising injury,@ the damage must arise out of the policyholder=s advertising activities. Many e-commerce related activities might not be considered Aadvertising,@ such as maintenance of a webpage. If a website contains promotional materials and information about the policyholder=s products, the webpage almost certainly qualifies as Aadvertising.@ On the other hand, a webpage may function as a delivery vehicle for the insured=s products or may even ***be*** the insured=s product. Still, with respect to coverage for more traditional intellectual property claims as Aadvertising injuries,@ the courts have historically taken a fairly expansive view of activities that constitute Aadvertising.@ *See, e.g., Sentex Systems, Inc. v. Hartford Accident & Indem. Co.*, 93 F.3d 578, 581 (9th Cir. (Cal.) 1996).

Finally, it is important to note that many CGL policies contain a specific exclusion for acts Acommitted by an insured whose business is advertising, broadcasting, publishing or telecasting.@ Websites that post advertisements for a fee from third parties and websites that contain news and entertainment may fall under this exclusion as Apublishing.@

c. Location of AOccurrence@ for Internet Claims

Due to the large amount of traffic on U.S. websites originating from foreign domains, the location of the injury can be a significant coverage issue for Internet claims. Generally, CGL coverage is restricted to a geographical area. Several factors are therefore crucial to a determination of whether an occurrence is within the coverage territory:

$ The location of the insured=s principal place of business (where the damaging material may have generated);

$ The location of the injured consumer or client; and

$ The place of business of the server (where the damaging material was posted).

4. Other Types of Coverage

Errors and Omissions policies provide coverage for negligent acts, errors, and omissions arising out of the performance of a service. As CGL policies can contain an exclusion for the provision of professional services, coverage might instead be obtained under an E&O policy. Several example of e-commerce related E&O risks include the provision of medical, technical, or financial advice on a webpage, as well as professional liability insurance for Internet service providers, software designers, webpage designers, computer consultants, and electronic dataprocessors. Coverage generally extends to personal injury, property damage, economic loss, and intellectual property claims.

Directors= and Officers= policies provide coverage for loss arising from a wrongful act committed by a director or officer in the discharge of corporate duties. D&O policies are designed to cover mistakes in judgment and negligence. A type of e-commerce related loss that might be covered under a D&O policy is a shareholder=s derivative action. Considering the potential for great revenue and profit losses for damage caused by hackers and viruses, and furthermore due to the ability to prevent such losses through the use of firewalls and anti-virus programs, a shareholder=s derivative suit could be premised on a director=s or officer=s failure to implement such measures.

In addition, new products have been and continue to be developed to respond to the growing need for insurance of e-commerce risks. One example is Website and Internet Security Program (WISP), which is now underwritten by certain Lloyd=s syndicates. WISP provides two separate policies: Breach of Security Coverage and Crime and Internet Insurance.

It is apparent that the United States= legal system will continue to provide additional and disparate opinions concerning coverage of e -commerce activities under property and liability policies. The next few years will reveal the way in which the courts interpret coverage under new policy forms as applied to e-commerce causes of action. Unfortunately, it is unlikely that the judicial treatment of these issues will evolve in a uniform, predictable manner.

IV. THE ROLE OF DEFENCE COUNSEL, THE INSURER=S LIABILITY FOR ACTS OF DEFENCE COUNSEL, AND INSURANCE COMPANY LITIGATION GUIDELINES.

The relationship between an insurer and defence counsel is a fundamental element of any case handled by an attorney retained by an insurance company to defend the interests of the insured. Due to its complex nature, this relationship can provide for hundreds of pages of analysis, comment, and prognostication on a variety of topics from ethics to billing. Rather than engaging in a superficial review of a number of these worthy subjects, this portion of the presentation focuses on the following areas:

C Defence counsel=s relationship with the insured and the insurer in light of Texas case law and California case law and legislation; and

C The courts= treatment of insurers= use of litigation guidelines and requirements concerning auditing of fee bills.

While this portion of the paper primarily focuses on Texas courts= treatment of these issues, an attempt to discuss other jurisdictions= approach to these issues has been made whenever possible.

A. Defence Counsel Owe Loyalty to the Insured.

Most liability insurance policies obligate the insurer to defend the insured and pay for claims that fall within the terms and conditions of the insurance policy. Under this defence obligation, commonly referred to as the ***duty*** to defend, the liability insurer must pay the fees and expenses of counsel necessary to defend third-party claims against the insured. The liability policy is also characterized by the liability insurer=s ***right*** to defend, which protects the economic interest of the liability insurer who must incur costs to defend the claim and pay any settlement or judgment within policy limits. Under this right to defend, liability insurers typically select counsel to defend the insured and are frequently involved in decisions regarding the development of the defence strategy and whether to settle or proceed to trial.

A necessary condition of the liability insurer=s right to appoint defence counsel is the creation of an attorney-client relationship with little or no input from the insured. Defence counsel appointed by an insurer owe a fiduciary duty to the insured to protect the insured=s interests, whereas the relationship between defence counsel and the insurer is often regarded in the eyes of the law as a secondary or subordinate responsibility. For instance, the Texas Supreme Court has held that the ***only*** attorney-client relationship arising out of an insurer=s appointment of defence counsel is that between defence counsel and the insured. *American Physicians Ins. Exchange v. Garcia*, 876 S.W.2d 842, 844 n.6 (Tex. 1994).

1. Defence Under a Reservation of Rights.

This relationship is somewhat counterintuitive and is fraught with inherent tension to the extent that defence counsel owe loyalties to the insured but are compensated by the insurer. In situations where there are no qualifications of coverage by the insured, the peculiar nature of this relationship usually does not create any difficulties for defence counsel, as the interests of the insured and the insurer generally would be aligned. When the insurance company appoints and compensates defence counsel on behalf of the insured while asserting a reservation of rights concerning the ultimate coverage of the claims against the insured, the lines of distinction become less clearly defined.

Generally, an insurer=s reservation of rights should:

$ Identify the insurer;
$ Inform the insured of the conflict of interest;
$ Inform the insured that the insurer will provide a defence under the reservation of rights; and
$ Inform the insured that it may secure independent counsel.

J.E.M. v. Fidelity and Casualty Co. of New York, 928 S.W.2d 668 (Tex.App.CHouston [1st Dist.] 1996, no writ). When a reservation of rights is issued, the insured may properly refuse the appointment of defence counsel and pursue its own defence. In those instances, the insurer remains liable for reasonable attorney=s fees incurred by the insured and may not insist on conducting the defence. *Rhodes v. Chicago Ins., a Division of Interstate Nat=l,* 719 F.2d 116 (5th Cir. 1983).

In Texas, judicial consideration of the conflict of interests faced by defence counsel begins with the Texas Supreme Court=s decision in *Employers Casualty Co. v. Tilley,* 496 S.W.2d 552 (Tex. 1973). In *Tilley,* the court held that although the insurance company compensated defence counsel, counsel owed a duty of unqualified loyalty to the insured as if the counsel had been retained by the insured in the first instance. Further, the court found that the moment any conflict arises between the interests of the insurance company and the insured, defence counsel must immediately inform the insured of the conflict. The *Tilley* decision clearly prohibits defence counsel from simultaneously serving as coverage counsel for the insurer but fails to provide practical assistance in less obvious cases.

2. Disclosure of Conflicts to the Insured and Insurer.

The court in *Tilley* opined that defence counsel must advise ***both*** the insured and the insurer of any coverage problems or conflicts. On the other hand, the disciplinary rules of professional conduct in many states, which set forth ethical considerations for lawyers, almost always ***prevent*** defence counsel from revealing confidential information to the disadvantage of the client without the client=s consent. Furthermore, the disciplinary rules typically prohibit a lawyer from representing opposing parties to the same litigation. The most obvious pitfall for defence counsel in this precarious position is providing comments to the insurer on issues which may have a tangential impact on coverage, such as the date of the loss, the date of manifestation of the injury, the nature or cause of the loss, and/or damages. Moreover, the handling of a case can, in itself, create a conflict between the insured and the insurer if some theories of liability asserted by the claimant arguably fall within coverage while others are excluded. Finally, the existence of a cooperation clause in most insurance policies, which requires the insured to cooperate with the insurer in the investigation and defence of claims, further muddies the waters.

In most instances, where an insurer has issued a reservation of rights or has qualified coverage, the insurer will have its own coverage counsel to review the developments in the case and determine if they impact coverage. If defence counsel=s reports are insufficient or if defence counsel is required to provide further analysis, it is the role of the insurer or its own counsel to make such requests.

If an irreconcilable conflict arises during the pendency of a case, defence counsel may be forced to withdraw from the representation of the insured, which in and of itself raises the additional thorny issue of defence counsel=s communication to the insurer of the reasons necessitating withdrawal. If the basis for withdrawal is a coverage conflict that has been discovered during the case, then many states= disciplinary rules could arguably prohibit defence counsel from informing the insurer of this conflict.

Although Texas jurisprudence has many unresolved issues concerning defence counsel=s responsibilities under a reserving rights letter, other jurisdictions in the United States have identified clear guidelines applicable to defence counsel appointed by insurers under a reservation of rights to represent an insured. For example, in *San Diego Federal Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal.App. 3d 358, 208 Cal. Rptr. 494, 498 (Cal. Ct. App. 1984), the California Court of Appeals held that:

$ attorneys retained by an insurance company to defend an insured under a reservation of rights must fully explain to the insured and the insurer the implications of the defence counsel=s appointment;

$ if the insured does not consent to the appointment of defence counsel by the insurer under a reservation of rights, the insured can hire independent counsel and the insurer will be responsible for the reasonable costs incurred by the independent counsel in defending the insured; and

$ the insurer cannot compel the insured to surrender control of the litigation.

The California legislature codified the *Cumis* decision in California Civil Code ' 2860; thus, the *Cumis* opinion has been superceded. The California statute provides additional specific guidance regarding when a conflict arises, the extent of the insurer=s obligation to pay fees of the independent counsel, and the extent of the independent counsel=s obligation to the insurer. Although insurers and policyholders may differ on the effectiveness of the *Cumis* legislation, both sides must admit that it provides more structure and predictability to an otherwise Agray@ area of practice.

3. Insurer=s Liability for Acts of Defence Counsel.

In *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625 (Tex. 1998), the Texas Supreme Court held that an insurer is not vicariously liable for the malpractice of an independent counsel selected by the insurer to defend the insured. The court held that independent counsel appointed by an insurer owes unqualified loyalty to the insured and must at all times protect the interests of the insured if those interests would be compromised by the insurer=s instructions.

The court=s analysis focused on whether the insurer has the right to control the attorney. The court found that A[a] defense attorney, as an independent contractor, has discretion regarding the day-to-day details of conducting the defense, and is not subject to the [insurer=s] control regarding those details.@ The end result of the *Traver* opinion is that an insurer remains liable for appointed defence counsel=s unreasonable failure to settle a matter, but the liability does not extend to defence counsel=s negligent investigation, defence, or trial of a lawsuit.

The *Traver* decision cites cases from other jurisdictions, such as Pennsylvania, California, Florida, New York, and North Carolina, which emphasize that defence counsel appointed by an insurer should be free from interference by the insurer. *Ingersoll-Rand Equip. Corp. v. Transportation Insurance Co.*, 963 F. Supp. 452, 454-55 (M.D. Pa. 1997); *Merritt v. Reserve Insurance Co.*, 34 Cal.App.3d 858 (Cal. Ct. App. 1973); *Aetna Cas. & Sur. Co. v. Protective Nat=l Insurance Co.*, 631 So.2d 305, 306-7 (Fla. Ct. App. 1993); *Feliberty v. Damon*, 72 N.Y.2d 112, 527 N.E.2d 261, 265 (N.Y. 1988); and *Brown v. Lumbermen=s Mutual Cas. Co.*, 90 N.C.App. 464, 473, 369 S.E.2d 367, 372 (N.C. Ct. App. 1988).

B. Insurance Company Case Handling Guidelines and Requirements to Submit Fee Bills to Auditors.

In recent years, insurance companies have promulgated guidelines and billing practices, which appointed defence counsel, must adhere to when defending insureds under the insurers= policies of insurance. The apparent primary purpose of these guidelines is to contain or reduce costs. The concurrence and dissent in *Traver* focused on the possible negative effects of such guidelines by questioning the ability of an insurance company=s Acaptive law firm@ to provide an insured with unqualified loyalty and expressing concern that an insurer's understandable desire to control costs could nevertheless compromise defence counsel's autonomy and independent judgment. Other than the *Traver* decision, there appears to be a dearth of Texas cases or State Bar ethics opinions on the issue.

Some states, such as Texas, have promulgated disciplinary rules, which prohibit a lawyer from permitting a person who employs or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services. In addition, the California Court of Appeals has questioned the wisdom and propriety of "outside counsel guidelines" which limit or restrict the sort of work that can be performed by outside counsel retained to represent the insured. *Dynamic Concepts, Inc. v. Truck Ins. Exch.,* 61 Cal.App.4th 999, 71 Cal.Rptr. 882 (Cal. Ct. App. 1998). Additionally, one New York state court held that an insured's insistence on certain aspects of case handling was not a violation of the assistance and cooperation clause contained in the insurance policy. *Nelson Electrical Contracting Co. v. Transcontinental Insurance Co.*, 660 N.Y.S.2d 220, 231 A.D.2d 207 (N.Y. Ct. App. 1997).

A Texas state court recently ruled that an insurance company cannot use litigation guidelines to avoid paying the insured's reasonable and necessary costs of defence. *WNS Inc. v. American Motorist Ins. Co.*, 270th Judicial District of Harris County, Texas, Cause No. 98-49195. The insurer was permitted to use an outside legal auditing firm, however, to determine the reasonableness of the fees and costs. The case, which is currently pending in Texas state court, was filed by the insured against the insurer based upon fraud, breach of contract, violations of the Texas Insurance Code, and violations of the Texas Deceptive Trade Practices Act. Several similar cases have recently been filed in Texas state court on behalf of insureds that question whether the insurer's litigation guidelines are within the terms of the insureds' policies. Brenda Sapino Jeffreys, *Insurer Can't Use Litigation Guidelines to Avoid Paying Defense Fees*, TEXAS LAWYER, February 14, 2000, pp. 1, 20, 23.

In late 2000 the State Bar of Texas issued Ethics Opinion 533 on the subject of insurance company litigation guidelines. Ethics Opinion 533 states that it is impermissible under Texas Disciplinary Rules of Professional conduct 2.01 and 5.04(c) for a lawyer to agree with an insurance company to restrictions which interfere with the lawyer's exercise of his or her independent professional judgment in rendering such legal services to the insured client.

Occasionally, insurance company guidelines require defence counsel to submit legal bills to third party auditors. Some courts have held that such a requirement may result in a waiver of the attorney-client privilege and the protection afforded to attorney work product. In *United States v. Massachusetts Inst. of Technology,* 129 F.3d 681 (1st Cir. (Mass.) 1997), the First Circuit Court of Appeals held that a contractor's disclosure of documents, including billing statements, to an audit agency forfeited any attorney-client privilege covering such documents. The court based its holding, in part, upon the fact that the client chose to share communications with a third party outside the Amagic circle@ of the attorney-client relationship, thereby forfeiting the attorney-client privilege.

The Supreme Court of Montana recently held that disclosure by defence counsel of detailed descriptions of professional services to third-party auditors without first obtaining the contemporaneous, fully-informed consent of the insured violated the Montana Rules of Professional Conduct client confidentiality mandate. *In Re The Rules of Professional Conduct*, 2 P.3d 806 (Mont. 2000). Under Montana law, the insured is the sole client, and disclosure of billing statements to third-party auditors, which are agents of the insurers, constituted disclosure to a potential adversary. Therefore, the court barred insurers from hiring auditing firms to review defence counsel=s fee bills. Furthermore, the court ruled that insurers cannot require defence counsel to obtain prior approval before they perform legal services for policyholders, as such a practice inhibits the lawyers= ability to represent their clients, the insureds. More than two dozen state bar associations have issued advisory opinions similar to the Montana Supreme Court=s holding. Milo Geyelin, *Insurers Are Barred From Auditing Policyholder-Lawyer Fees in Montana*, THE WALL STREET JOURNAL, May 4, 2000, at B18. These include Michigan, New York, Pennsylvania, Arkansas, Tennessee, Texas and Kentucky.

The role of defence counsel and the effectiveness of insurance company guidelines will continue to be determined on a state by state basis. The only reasonable projection that can be made at this time is that the various states= courts and legislatures will tend to provide more guidance and structure to defence counsel and insurers on these issues.

Glenn R. Legge

Direct Dial: (713) 706-1941
Email: glennlegge@lfkm.com

Mr. Legge was born in Walnut Creek, California and obtained his undergraduate education at the University of Kent at Canterbury and the University of California at Santa Barbara, where he received a B.A. with honors in 1979. He attended the University of Houston Law Center where he received his J.D. in 1983. Mr. Legge is licensed to practice law in Texas and California and is admitted to the United States Court of Appeals for the Fifth Circuit, as well as the United States District Courts for the Southern, Eastern and Northern Districts of Texas. He is a member of the Maritime Law Association, Texas Association of Defense Counsel and International Association of Defense Counsel.

Mr. Legge focuses his practice in litigation and devotes a substantial portion of his time to insurance coverage and commercial litigation as well as representing the interests of companies in the marine, energy, and technology industries. He was a speaker at the 1996 and 1998 Liability Underwriters= Group Conferences in Oxford, England on the subjects of environmental claims, insurance coverage, and bad faith. He is the author of ARecent Legal Developments Effecting Liability Insurance in the U.S.A.@, Insurance Market Conference (1996); AInsurance Company and Defense Firm Relationship - Understanding and Resolving Potential Conflicts@, University of Houston Insurance Law Seminar (June 1999); ARelationships and Conflicts of Interest Among the Insured, the Insurer and the Defense Lawyer@, University of Houston Advanced Insurance Seminar (March 2000); AThe Role of Excess Insurers in Dispute Resolution@ Association of Attorney Mediators, Houston Chapter (January 1999); AMine, Yours and Ours - Insurance Law for Corporations,@ American Corporate Legal Assistants Association (October 1999); and co-author of AA Review of Recent Legal Developments in the U.S.A. Impacting Liability Insurers@, Fifth Liability Insurance Conference (1998); ACurrent Developments in Insurance Law in Texas@, International Journal of Insurance Law (January 1999); ACoverage of Punitive Damages in the United States; A Fifty State Survey@ International Journal of Insurance Law (January 1999); and AConcurrent Proceedings in Declaratory Judgment Actions in Federal and State Courts in the United States@, International Journal of Insurance Law (April 1999).

Heather S. von Sternberg

Direct Dial: (713) 706-1955
Email: hscilley@lfkm.com

Heather von Sternberg was born in Atlanta, Georgia and raised in Houston, Texas. She attended the University of Texas at Austin on a National Merit Scholarship and received her B.B.A. in Marketing. She then attended the University of Houston Law Center, where she graduated cum laude in 1996.

Ms. von Sternberg has experience in the specialized areas of maritime law, insurance litigation, including insurance coverage, and commercial litigation. A substantial portion of Ms. von Sternberg=s practice is devoted to representation of companies in the energy industry. In addition, she advises and represents insurers and P&I Clubs, both domestic and foreign, as well as their assureds. Her practice includes the representation of vessel owners, operators, agents, charterers, maritime employers, contractors, and other marine entities involved in offshore energy production. Ms. von Sternberg has gained expertise in defending personal injury and wrongful death claims arising under both the Jones Act and General Maritime Law. Moreover, she has extensively handled issues relating to allisions, collisions, cargo damage and loss, and maritime contracts. Ms. von Sternberg is also experienced in determining coverage issues pertaining to all aspects of various types of insurance policies. She is the co-author of AA Review of Recent Legal Developments in the U.S.A. Impacting Liability Insurers@, Fifth Liability Insurance Conference (1998); ACurrent Developments in Insurance Law in Texas@, International Journal of Insurance Law (January 1999); ACoverage of Punitive Damages in the United States; A Fifty State Survey@ International Journal of Insurance Law (January 1999); and AConcurrent Proceedings in Declaratory Judgment Actions in Federal and State Courts in the United States@, International Journal of Insurance Law (April 1999); and presented a paper on AInsurance Company and Defense Firm Relationship - Understanding and Resolving Potential Conflicts@, University of Houston Insurance Law Seminar (June 1999).