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RECENT DEVELOPMENTS IN ADMIRALTY AND MARITIME LAW

Michael J. Daly, Timothy W. Hassinger, Christopher Nolan, Scott Richards, and Laurie Sands

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This article discusses several significant decisions issued by admiralty courts across the country between October 1, 2009, and September 30, 2010. This article is not intended to provide an exhaustive description of all maritime cases issued during that time period. Rather, cases were

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selected based on their treatment of critical or unsettled issues of law, or their unique factual backdrops.

I. JURISDICTION

In an interesting decision of a decidedly international flavor, the Fifth Circuit recently addressed the question of whether a U.S. court could exercise admiralty jurisdiction over a maritime tort committed by one Mexican company against another Mexican company in the Mexican Exclusive Economic Zone (EEZ). In *Perforaciones Exploracion Y Produccion v. Maritimas Mexicanas, S.A. DE C.V*,[1] the owner of a Mexican-flagged mobile operating drilling unit brought suit against the owner and operator of a Mexican-flagged supply vessel that allided with the drilling unit in the Mexican EEZ.[2] The owner of the vessel argued that a U.S. federal court does not have jurisdiction over an allision that occurred in Mexico's EEZ given that jurisdiction is based in part on the locality of the incident.[3] The court explained that there are "no clear territorial limits to federal maritime tort jurisdiction."[4] The owner of the vessel also argued there could be no jurisdiction unless there was some clear link to the United States. The court stated that although links to the United States may be relevant for a forum non conveniens or choice of law analysis, it has no bearing on whether a court had admiralty jurisdiction.[5] Accordingly, the court found that it had jurisdiction in the case.

The Admiralty Extension Act took center stage in *Oliver v. Omega Protein, Inc*,[6] where the plaintiff was injured on shore when he was filling the defendant's propane tank and it exploded. The defendant used the tank on its fishing vessels for cooking. The plaintiff alleged, and it was supported by expert testimony, that the explosion was caused by the defendant's negligent storage of propane tanks on the vessels.[7] The plaintiff asserted admiralty jurisdiction under the Admiralty Extension Act on the grounds that the tank was an appurtenance of the vessel that proximately caused the injury on land.[8] The plaintiff argued that his injury flowed from negligent acts regarding the tank while the tank was on the ship on navigable waters.[9] The court agreed with the plaintiff and found the location test for

1. 356 Fed. App'x 675 (5th Cir. 2009).
2. *Id.* at 676.
3. *Id.* at 678.
4. *Id.*
5. *Id.* at 679.
6. 2010 WL 2976522 (E.D. Va. July 19, 2010).
7. *Id.*
8. *Id.*
9. *Id.* at *4

admiralty jurisdiction was met.[10] The court also explained that although propane tanks have other uses, the one at issue was used for the sole purpose of cooking in the ship's galley, and, therefore, would be considered an appurtenance to the ship.[11] The court also found that the accident involved a traditional maritime activity. The court stated that a vessel's commercial purposes would go unfulfilled if the crew was unable to eat.[12] The ship providing food for the crew on a fishing vessel is integral to the operations of that vessel and implicates a traditional maritime activity necessary to trigger admiralty jurisdiction.

The courts in the following cases were less willing to extend admiralty jurisdiction to the facts before them. In *Casas v. U.S. Joiner, LLC*,[13] the Fifth Circuit refused to extend admiralty jurisdiction to a negligence claim arising out of an injury that the plaintiff suffered while working on a ship under construction in navigable waters. The plaintiff, Casas, was an employee of a subcontractor that the defendant, J.S. Joiner, hired to install insulation on an amphibious transport dock under construction.[14] During the job, Casas tripped, fell, and was injured. He then sued defendants for negligence in federal court, alleging admiralty jurisdiction because the incident involved the construction of a vessel. Conceding that Casas was injured on navigable waters, defendants argued that his claim was not significantly related to a traditional maritime activity to invoke admiralty jurisdiction.[15] The Fifth Circuit agreed with the defendants and reiterated that an injury to a shipbuilder while working on a vessel under construction does not give rise to a maritime tort.[16] Accordingly, there was no maritime tort and, consequently, no admiralty jurisdiction.[17]

In one of the more colorful cases issued by any court over the past year, the U.S. District Court for the District of South Carolina in *Gossett v. McMurtry*[18] considered whether admiralty jurisdiction extended to a defamation case stemming from antics on a fishing trip. In *Gossett*, the plaintiff went on a fishing trip off the coast of South Carolina with defendants. During the trip, the plaintiff feel asleep and, while he was sleeping, one the defendants pulled his own shorts down and placed his buttocks by the plaintiff's face.[19] Another defendant took pictures of the incident. The

10. *Id*. at *5.
11. *Id*.
12. *Id*.
13. 372 Fed. App'x 440 (5th Cir. 2010).
14. *Id*.
15. *Id*. at 441.
16. *Id*.
17. *Id*.
18. 2010 WL 2985808 (D.S.C. July 26, 2010).
19. *Id*. at *1.

pictures were then e-mailed to other individuals who posted them as a screen saver on a business computer.[20] The plaintiff asserted claims against the defendants for defamation, negligence, and intentional infliction of emotional distress. The plaintiff alleged that the claims were subject to admiralty jurisdiction because the pictures were taken on navigable waters.[21] The court, however, concluded that the alleged defamation did not occur on navigable waters. The court reasoned the publication of the allegedly defamatory pictures was the basis for the plaintiff's claim and that publication did not occur until the parties were on land.[22] The court also held that the negligence and emotional distress claims stemmed from a defendant placing his buttocks near the plaintiff's face and this was not an incident that could disrupt maritime commerce.[23] Consequently, the court found that the attenuated relationship of the plaintiff's claims to the objectives of maritime jurisdiction cannot invoke such jurisdiction.[24]

In re Complaint of MLC Fishing, Inc.[25] concerned whether a ramp extending to a floating dock used to access a vessel constitutes a part of the vessel. In that case, a patron was injured when he slipped on the ramp while in the process of boarding MLC's vessel. Seeking exoneration or limitation of liability, MLC contended that the patron's claim against it sounded in admiralty and limitation (or exoneration) was available because the accident occurred on the vessel. The patron countered that because the accident did not occur on the vessel there was no admiralty jurisdiction.[26] In considering whether the ramp was part of the vessel, the court noted that the ramp was not physically attached to the vessel, but rather, was separated from it by a floating dock. In this sense, the ramp was distinguishable from a gangway leading directly to a vessel. Thus, although the ramp was used to access the vessel, it was not an appurtenance to it and the injury did not occur on a "vessel."[27] MLC Fishing also argued that the Admiralty Extension Act, which extends admiralty jurisdiction to cases where a vessel on navigable waters causes injury on land, applied to the case.[28] The court found that conclusory allegations regarding the crew's maintenance of a ramp, not connected to the vessel, was not sufficiently similar to the operation of a vessel to invoke jurisdiction under the Admiralty Extension Act.[29]

20. *Id.*
21. *Id.* at *2.
22. *Id.* at *3.
23. *Id.* at *4.
24. *Id.*
25. 2010 WL 582570 (E.D.N.Y Feb. 16, 2010).
26. *Id.*
27. *Id.*
28. 2010 WL 582570, at *3.
29. *Id.*

II. CHOICE OF LAW/PREEMPTION

In one of the most important decisions this year, a full panel of the Fifth Circuit clarified a conflicting area of the law impacting oil field contractual indemnity clauses. *Grand Isle Shipyard Inc. v. Seacor Marine, LLC*[30] concerned a dispute between two contractors of BP American Production Company arising out of a slip and fall incident on a vessel. The person who sustained injuries was employed by Grand Isle, a contractor, which was responsible for the repair and maintenance of BP's offshore platform, while the other contractor, Seacor, was responsible for transporting BP workers and its contractors to and the oil platform.[31] Reversing a panel of the circuit court, the full panel found Louisiana law applied to the dispute and rendered the indemnity provision at issue unenforceable.[32]

It was undisputed that the Grand Isle employee injured himself in 2005 when falling aboard a Seacor vessel heading from the oil platform to the living quarters platform; the accident was thus in open waters.[33] The injured Grand Isle employee sued Seacor, and Seacor in turn sought to invoke the indemnity provision so that Grand Isle would be responsible for defense of the suit. As is customary in the industry, the contracting parties' contracts contained reciprocal indemnity provisions involving employee injuries on the job. The purpose of the indemnity provisions was for each contractor who has an employee injured to hold harmless and indemnify BP for all liability suffered as a result of injuries or death of said employee.[34] In addressing the crux of the action, the Fifth Circuit stated, "the ultimate legal issue before the district court and the panel, and now before the full court, is whether the adjacent state law of Louisiana, including the LOIA[35], applies to this case. The parties agree that if the LOIA does apply, it invalidates Grand Isle's indemnity obligations to Seacor, but if Louisiana law and the LOIA does not apply, the indemnity agreement is enforceable."[36]

The district court and panel differed as to how to interpret a key Supreme Court decision concerning the Outer Continental Shelf Lands Act (OCSLA) to ultimately resolve if the OCSLA mandated the application of state law to the dispute. The three-part test in *Rodriguez v. Aetna Casualty*

30. 589 F.3d 778 (5th Cir. 2009).
31. *Id*. at 781.
32. *Id*.
33. *Id*.
34. *Id*. at 782.
35. The LOIA is the Louisiana Oilfield Indemnity Act, La. Rev. Stat. Ann. § 9:2780(A). The LOIA was established to even the playing field between rig operators and companies. Oil exploration companies had the negotiating advantage with operators in the Gulf of Mexico, before the passage of the LOIA, and would seek broad indemnity clauses.
36. *Grand Isle Shipyard*, 589 F.3d at 782.

& Surety Co.,[37] to determine if state law applies in place of federal law, requires: (1) the dispute arising in an area or situs covered by the OCSLA; (2) federal maritime law does not apply of its own force; and (3) the state law proffered is not inconsistent with federal maritime law.[38] It is the situs factor that has proven difficult to determine both in this dispute and previous actions. A full panel of the circuit granted en banc review of the issue because both the district court and a panel found support in Fifth Circuit case law for their respective situs positions, which the full panel acknowledged was "conflicting and confusing."[39]

The conflicting trains of thought on the situs issue revolves around tort and contractual principles. Some courts have looked to the exact site of the tort to determine the situs of the dispute for contractual indemnity purposes while others employ a "focus-of-the-contract" test for situs purposes. The distinction is critical because, as the panel found, if the tort-based test is employed, the accident occurred on navigable waters above the Outer Continental Shelf–not a situs covered by the OCSLA–and thus not in a covered situs. The LOIA would then not apply to the dispute and the indemnity clause would not be invalidated.[40] The full panel instead agreed with the district court in that the dispute arose on an OCSLA situs because the focus-on-the-contract test looks to the nature and purpose of the underlying contract and in this matter all parties agreed the majority of the work to be performed would occur on a stationary platform on the Outer Continental Shelf and thus within the OCSLA purview.[41] The full panel reached this conclusion for a rather simple reason: indemnity is a creature of contract. "Once we recognize that the claim for indemnity is a claim based in contract rather than in tort, we see no reason to apply tort analysis to determine where the contractual controversy arose."[42]

The reasoning of the full court was based on sound policy reasons. The use of tort rules, heavily reliant on the fortuitous nature of the location of the tort, is inconsistent with sophisticated parties who carefully allocate risks in the form of negotiated contracts containing indemnity clauses.[43] As a result of the situs finding, and with there being no challenge of the remaining two factors articulated in *Rodriguez*, the full panel held the adja-

37. 395 U.S. 352.
38. *Grand Isle Shipyard*, 589 F.3d at 783 (quoting Union Texas Petroleum Corp. v. PLT Eng'g Inc., 895 F.2d 1043, 1047 (5th Cir. 1990), in turn citing *Rodriguez*).
39. *Id.* at 787–88.
40. *Id.* at 783.
41. *Id.* at 789.
42. *Id.* at 787.
43. *Id.*

cent state law of Louisiana, in particular the LOIA, renders the indemnity agreements unenforceable.[44]

The recovery of attorney fees in maritime actions played critical role in two preemption cases this year. In *Misener Marine Constr., Inc. v. Norfolk Dredging Co.*,[45] the Eleventh Circuit determined whether a Georgia statute, the Georgia Prompt Pay Act (GPPA), was preempted by general maritime law, which has traditionally followed the American Rule forbidding the recovery of attorney fees by the prevailing party unless one of three narrow exceptions applied. When the Georgia Ports Authority needed to demolish a dock and build a new one in the Port of Savannah (the fourth largest container port in the United States), it turned to Misener.[46] Misener in turn subcontracted Norfolk to dredge a part of the Savannah River in the port. Misener and Norfolk entered into a pro-forma two page dredging contract, which failed to contain a choice of law or attorney fees provision.[47]

When a mooring apparatus failed, resulting in damage to a vessel, Misener brought suit for negligent dredging, among other causes, against Norfolk. Norfolk counterclaimed seeking payment for its work, interest, and attorney fees. After subsequent investigation, Misener was satisfied Norfolk was not to blame for its work product and voluntarily dismissed its claim. Norfolk nonetheless moved for summary judgment on its claims.[48] The district court granted Norfolk's motion, including attorney fees request, holding that the GPPA, which regulates construction contracts between contractors and subcontractors, was not preempted by federal maritime law and allowed for the recovery of fees. In so holding, the court ruled "there is not an established federal rule regarding attorneys' fees in maritime cases" and in any event, it is not the sort of rule where uniformity is necessary.[49]

Unfortunately for Norfolk, the presiding judge passed away before issuing a ruling on the quantum of fees to be awarded and the new judge reversed course, finding the GPPA conflicted with federal maritime law; Norfolk's appeal followed. The Eleventh Circuit had little trouble finding the general maritime law preempted the GPPA. Before doing so, the court first had to find that the dredging contract was a maritime contract. Besides noting the Supreme Court had previously held dredging is a traditional maritime activity, looking at the contract itself it was evident Norfolk's work had an effect on maritime services and commerce.[50] Such are

44. 589 F.3d at 789.
45. 594 F.3d 832 (11th Cir. 2010).
46. *Id.* at 835.
47. *Id.*
48. *Id.* at 836.
49. *Id.*
50. *Id.* at 837.

the benchmarks for finding a maritime contract under settled Supreme Court law. With the finding of a maritime contract, substantive admiralty law is applied. The Eleventh Circuit has consistently found the prevailing party in a maritime case is not permitted to recover attorney fees unless one of three situations is present: (1) a federal statute allows for it; (2) the nonprevailing party acted in bad faith; or (3) the contract has an attorney fees indemnity provision.[51]

None of the three exceptions applied, as the GPPA is not a federal statute; there was no claim of bad faith in the case; and the underlying dredging contract did not contain an attorney fees clause.[52] In closing, the court reaffirmed the wide application of the American Rule as substantive maritime law to maritime cases around the country. As such, the GPPA could not be used as a supplement to admiralty law; it is in direct conflict with it. In the end, the court refused "to alter the terms of [the] contract through the retroactive injection of a state law that contravenes a principle of substantive maritime law."[53]

In *Continental Insurance Co. v. Cota*,[54] a state statute faired much better than the GPPA did in the case above. *Cota* is one of many decisions arising out of the *M/V COSCO BUSAN* allision in San Francisco-Oakland Bay on November 7, 2007. John Joseph Cota was the pilot on the vessel that day and faced a number of civil actions.[55] Continental Insurance Company issued an insurance policy for the San Francisco Bar Pilots and therefore appointed defense counsel for Cota in the suits, which resulted in over $300,000 in' attorney fees before related vessel owner companies assumed the defense.[56] Cota and Continental brought suit to recover these fees incurred, relying on the California Harbors and Navigation Code §1198, which provides the vessel, its owner, or operator, must purchase trip insurance for the pilot or defendant, and indemnify and hold harmless the pilot should an accident occur due to his negligence when within the scope of his duties.[57] Owners of the vessel on partial summary judgment argued that § 1198(c) is preempted by federal maritime law while Cota and Continental sought the opposite finding.

In California, foreign vessels must use a pilot when traversing the Bay of San Francisco.[58] Section 1198(c) applies to a foreign flagged vessel unless and until a federal law is shown which is inconsistent with the state

51. 594 F.3d at 838.
52. *Id.*
53. *Id.* at 841.
54. 2010 WL 383367 (N.D. Cal. Jan. 27, 2010).
55. *Id.* at *1.
56. *Id.*
57. *Id.*
58. *Id.* at *2.

statute. This is based on the Supremacy Clause in the U.S. Constitution, which confers Congress with the power to preempt state law.[59] Pilotage is a supremely local endeavor. Navigating ships in and out of key waterways within a state takes great skill and expertise. This was recognized by the very first Congress, when in its first session it passed the Lighthouse Act of 1789, which essentially left the power to regulate pilots to the individual states.[60] California exercised this power when passing § 1198(c).

Though the court recognized it is well settled that a shipowner cannot be held personally liable for the negligence of a compulsory pilot (which Cota was), §1198(c) was not inconsistent with this settled rule because foreign owners were given a choice–trip insurance could be obtained to cover a pilot's negligence. The shipowner would then not be obligated to defend the pilot; the trip insurance company would.[61] The court noted that California's rule was consistent with other states which limit the liability of pilots or provide full indemnity.[62] In closing, the court found it was "Congress's intent to allow the states to regulate pilotage, and there is no danger that state regulation of pilotage interferes with federal maritime law's proper harmony and uniformity."[63]

The final preemption decision meriting emphasis concerns the interplay between federal and state statutes in the context of an employee slip and fall. In *Morrow v. Marinemax*,[64] the plaintiff employee was injured at an employee appreciation event. Plaintiff's employer was a dealer and distributor of yachts. On the day of the Atlantic City air show, plaintiff's employer invited him aboard the yacht to watch the event.[65] While acting within the scope of his employment, plaintiff was paralyzed when a fellow employee fell on him, fracturing his cervical vertebrae.[66]

Following the injury, plaintiff sought workers' compensation benefits and the employer commenced payments. The federal suit followed, seeking damages under general maritime law in negligence against the vessel owner and against the boat manufacturer for unseaworthiness; his wife made a final loss of services and consortium claim.[67] The vessel owner

59. *Id*. at *3.
60. *Id*. at *3–4.
61. *Id*. at *5.
62. *Id*. (citing laws around the country).
63. *Id*. at *6. The court also rejected a half-hearted argument that § 1198(c) was preempted by the Oil Pollution Act of 1990 by noting that statute concerns pollution removal costs, not pilotage, and it nonetheless provides indemnity provisions are freely allowed thereunder. *Id*. at *7.
64. 731 F. Supp. 2d 390 (D.N.J. 2010).
65. *Id*. at 392.
66. *Id*. at 393.
67. *Id*.

moved for summary judgment on the negligence claim and spousal claim, arguing the claims were barred by the New Jersey Workers' Compensation Act and its exclusive remedy provision.[68] The owner argued that because plaintiff filed a workers' compensation claim and collected payments under the Act, the exclusive remedy provision was triggered preempting plaintiff's claims.[69] Owner's position was consistent with the Eleventh Circuit, differed with the Fifth and Ninth Circuits, and was an issue of first impression in the Third Circuit.[70]

In deciding the motion, the court analyzed the differing circuit court decisions that considered whether a true conflict existed between the general maritime negligence claim and the state's workers' compensation law. Ultimately, the court opined that when sitting in admiralty, it would not allow a state statute to preclude a plaintiff's claim when such a claim is expressly recognized in the general maritime law.[71] In so holding, the court found that when an injured worker is not covered under the Jones Act or LHWCA based on the circumstances of the injury, as was the case there, the worker has an option of claiming under state workers' compensation law or under general maritime law principles.[72] The plaintiff here did not file suit relying on the New Jersey workers' compensation statute, only general maritime law. Thus, the court found this claim must be "preserved" notwithstanding the state-law exclusivity provision.[73]

III. CARGO

In one of the most anticipated decisions in the area of admiralty law in years, the Supreme Court decided a cargo matter that will have substantial ramifications for through bills of lading throughout the world. *Kawasaki Kisen Kaisho Ltd. et al. v. Regal-Beloit Corp*.[74] involved a number of companies, a host of amicus curiae interests, and a divided court featuring a spirited dissent penned by Justice Sotomayor. The Court was called upon to bring uniformity and predictability to admiralty law concerning multimodal carriage of goods.

A circuit split is often looked upon as the easiest way to predict whether certiorari will be granted and in this area of admiralty law a real schism existed. The Fourth, Sixth, Seventh, and Eleventh Circuits had ruled the Carmack Amendment did not apply to the U.S. inland portion of through

68. N.J. Stat. Ann. § 34:15–8 (2010).
69. *Morrow*, 731 F. Supp. 2d at 393.
70. *Id*. at 397–99.
71. *Id*. at 398.
72. *Id*. at 399 (quoting Chandris, Inc. v. Latsis, 515 U.S. 347, 356 (1995)).
73. *Id*.
74. 130 S. Ct. 2433 (2010).

carriage from a foreign country to various locations in the United States while the Second and Ninth Circuits applied the Carmack Amendment.[75] Ultimately, the majority sided with the majority of circuits finding the Carmack Amendment not applicable.

The main issue revolved around railroads demanding contractual indemnity. The Second and Ninth Circuits had, to the surprise of most maritime practitioners, opined that a trucking or railroad company was deprived of contractual protections if the shipper of the cargo did not offer full Carmack liability.[76] They found the Carmack Amendment applied to the U.S. inland portion of a multimodal shipment and that a carrier was mandated under Carmack to offer full Carmack liability in the first instance. The stakes are substantial. Under the Carmack Amendment, the carrier could face unlimited liability if it does not offer complete Carmack liability.[77] This differs from the familiar protections of the Carriage of Goods by Sea Act,[78] where a carrier's liability is limited to $500 per package, or with goods not shipped in packages, the expected freight unit.[79] It also impacts where the dispute would be decided: in the United States or Japan based on a forum selection cause contained in the through bill of lading.[80]

The majority opinion, authored by Justice Kennedy, rejected the Ninth and Second Circuit's Carmack Amendment interpretations. In finding the Carmack Amendment did not apply to a shipment that originated overseas rather than in the United States, it stated ocean carrier K-Line took hold of the cargo directly from the "receiving" shipper in China and that there could only be one receiving carrier in a multimodal shipment.[81] As such, if the receiving carrier is not a U.S. based carrier, the Carmack should not be applicable to that portion of the cargo carriage in the United States. Just as important, the scope of the Carmack Amendment was specifically delineated: it only concerns cargo carried from one U.S. state to another U.S. state and from one place in the United States to another point in a foreign country.[82]

The majority's decision can be interpreted as recognizing the importance of freedom of contract among sophisticated parties. It stated, "Congress has decided to allow parties engaged in international maritime commerce to structure their contracts, to a large extent, as they see fit. It has not

75. 49 U.S.C. § 11706; 130 S. Ct. at 2440.
76. *Kawasaki*, 130 S. Ct. at 2440.
77. *Id*. at 2441.
78. 46 U.S.C. § 30701.
79. The Court focused on the Carmack Amendment statutory scheme and liability issues, not the COGSA limitation. A brief description of COGSA is provided at 130 S. Ct. at 2440.
80. *Kawasaki*, 130 S. Ct. at 2449.
81. *Id*. at 2443.
82. *Id*. at 2445.

imposed Carmack's regime, textually and historically limited to the carriage of goods received for domestic rail transport, onto what are 'essentially maritime' contracts."[83] With Carmack not applying, the Court found the cargo owners bound by the contracts agreed upon and thus the agreement to litigate in Tokyo, Japan, stood.[84]

It should be noted the dissent excoriated the majority for failing to interpret the text of the Carmack Amendment properly and as such, the decision as to whom was the receiving carrier differed. That difference resulted in the dissent finding the Carmack Amendment should have applied to the U.S. inland rail portion of the shipment.[85] This would be regardless of whether domestic bills of lading were issued.[86]

IV. SEAMAN'S CLAIMS

A. *Right to a Jury Trial*

In *Endicott v. Icicle Seafoods, Inc.*,[87] the Washington Supreme Court sitting en banc considered whether a defendant in a Jones Act and general maritime suit filed in state court has a right to a jury trial. After a fish cart crushed plaintiff's arm while working in the freezer aboard a ship, he filed suit under the Jones Act for negligence and under general maritime law for unseaworthiness. The trial court struck defendant's demand for a jury trial and found in favor of plaintiff following a bench trial. On appeal, the court of appeals certified the case to the Washington Supreme Court for direct review.[88]

In reversing the decision below, the Washington Supreme Court examined the history of claims brought "in admiralty" or "at law." The U.S. Constitution extends the judicial power of the federal courts to "all cases of admiralty and maritime jurisdiction," but preserves general maritime law as a species of federal common law.[89] In turn, Congress has provided federal courts with exclusive jurisdiction over all cases of "admiralty or maritime jurisdiction," with the "saving to suitors clause" of 28 U.S.C. § 1331(1) affording plaintiffs the right to sue on maritime causes of action in state court as well. However, the state court must proceed *in personam* and not *in rem*.[90]

83. *Id.* at 2449 (quoting Norfolk Southern Ry. Co. v. Kirby Pty Ltd., 543 U.S. 14 (2004)).
84. *Id.*
85. *Id.* at 2449–50.
86. *Id.* at 2451.
87. 224 P.3d 761 (Wash. 2010).
88. *Id.* at 763.
89. *Id.* at 764.
90. *Id.* (citing Madruga v. Superior Court, 346 U.S. 556, 560–61(1954).

The *Endicott* court observed that the Jones Act, by its terms, allows seamen to sue at law for their employers' negligence, but not in admiralty.[91] However, in an early case interpreting the Jones Act, the U.S. Supreme Court "adopted a fictitious reading of the Act to save it from constitutional challenge."[92] In *Pan. R.R. Co. v. Johnson*, the U.S. Supreme Court interpreted the Jones Act as allowing negligence suits both in admiralty and at law, with the former yielding a bench trial and the latter a jury trial.[93] However, the Washington Supreme Court explained that the *Johnson* decision "left ambiguous" whether a plaintiff's election between different forms of action is a statutory right to elect the mode of trial (jury versus nonjury) or a right to select merely the jurisdictional basis of trial (at law versus in admiralty).[94]

Recognizing a split among federal and state courts as to the correct interpretation of *Johnson*, the *Endicott* court sided with the Fifth and Seventh Circuits, along with prior decisions from state courts in Louisiana and Illinois. The court held that the "jurisdictional" interpretation was the proper interpretation—namely, that a plaintiff's Jones Act election is limited to choosing the jurisdictional basis for his suit (either in admiralty or at law). As the court explained, "[o]nce the plaintiff makes his choice of jurisdiction, procedural rights flow as normal incidents of the suit."[95] Since there is no substantive federal right to elect the mode of trial directly, state procedural law governs whether a party has a right to a jury trial in state court.[96] After recognizing that the Washington Constitution confers a right to a jury trial in Jones Act cases, the Washington Supreme Court vacated the lower court's judgment and remanded the case for a trial by jury.[97]

B. *Negligence Per Se*

Webb v. Teco Barge Line, Inc. involved plaintiffs who were allegedly injured after being required to remain on defendant's vessel during the onslaught of Hurricane Katrina.[98] They filed suit alleging negligence under the Jones Act and unseaworthiness under general maritime law, as well as that defendant's violation of OSHA constituted negligence per se.

In response, defendant filed a motion to dismiss or, alternatively, to strike the claim of negligence per se, arguing that allowing a violation of OSHA to constitute negligence per se would contravene 29 U.S.C. § 653(b)(4) by

91. *Id.* at 764.
92. *Id.* at 764–65.
93. 264 U.S. 375, 390–91 (1924).
94. 224 P.3d at 765.
95. *Id.* at 767.
96. *Id.*
97. *Id.*
98. 2010 WL 552309 (S.D. Ill.).

enlarging employer liabilities. This statute provides that OSHA cannot be construed to "enlarge, diminish or affect in any other manner the common law or statutory rights, duties or liabilities of employers and employees under any law with respect to injuries . . ."[99]

The court disagreed with the defendant, however, explaining that the Jones Act incorporates the terms of the Federal Employers' Liability Act (FELA), under which violations of safety statutes constitute negligence per se.[100] Meanwhile, the Supreme Court has extended the negligence per se doctrine to the Jones Act and all safety statutes.[101] Given that OSHA applies to ships that are not inspected by the Coast Guard, such as the vessel at issue in *Webb*, and is a safety statute whose fundamental purpose is to ensure "safe and healthful working conditions," a violation of OSHA constitutes negligence per se under the Jones Act.[102] Moreover, allowing a violation of OSHA to constitute negligence per se does not expand the liabilities of employers, but serves as a guide for determining the applicable standard of care.[103] In short, it "simply allows the presence of a statutory regulation to serve as irrefutable evidence that particular conduct is unreasonable."[104] Since the doctrine of negligence per se applies to violations of Coast Guard regulations on inspected vessels, the rights of employees will be diminished unless OSHA is allowed to "fill the regulatory gap" in cases involving uninspected vessels.[105]

C. *Maintenance and Cure*

The court in *Royal Caribbean Cruises, Ltd. v. Whitefield* discussed the appropriate forum for deciding whether a plaintiff is entitled to maintenance and cure when the filing of a federal court declaratory judgment action precedes a related state court action for damages.[106] After the decedent's employment with the cruise line ended, he received maintenance and cure benefits from Royal Caribbean for various health reasons.[107] When plaintiff reached maximum medical improvement, Royal Caribbean terminated benefits and then filed suit seeking a declaratory judgment that no further benefits were owed.[108] Nine days later, plaintiff filed a separate lawsuit in state court under the Jones Act and general maritime law for failure to

99. *Id.* at *2.
100. *Id.*
101. Kernan v. Am. Dredging Co., 355 U.S. 426, 438–39 (1958).
102. 2010 WL 552309, at *3 (citations omitted).
103. *Id.*
104. *Id.* (citing Practico v. Portland Terminal Co., 783 F.2d 255, 265 (1st Cir. 1985)).
105. *Id.* at *4.
106. 664 F. Supp. 2d 1270 (S.D. Fla. 2009).
107. *Id.* at 1274.
108. *Id.*

provide maintenance and cure, along with negligent failure to provide adequate medical care.[109] The plaintiff died approximately three months later and his wife, who was substituted as his representative, moved to dismiss the declaratory judgment action in federal court, arguing that the federal court should exercise its discretion under the Declaratory Judgment Act to decline to hear the matter since a parallel action was pending in state court.

The federal court noted that the Eleventh Circuit's decision in *Ameritas Variable Life Ins. Co. v. Roach*[110] provides nine factors to evaluate in deciding whether to entertain a declaratory judgment action or to dismiss the action in favor of a pending state court action that will resolve the same issues. However, when the issue involves maintenance and cure in federal court compared to a Jones Act claim pending in state court, other unique factors also should be considered. The first is the propriety and practicality of conducting a trial on the maintenance and cure claim without a jury under the district court's admiralty jurisdiction as compared to the Jones Act claim in state court that would be tried with a jury, along with the proper weight to be afforded a plaintiff's choice of forum under the Saving to Suitors Clause.[111] For example, since the state court trial may occur after the federal trial, it creates the likelihood that some findings in the federal case could be res judicata in the state court case, which "could potentially implicate an award of damages in whichever case goes to trial last."[112] Another concern is one of efficiency, as the federal and state cases may involve duplicative evidence and witnesses.[113] Additionally, if a district court conducts a bench trial in a declaratory judgment action on the issue of maintenance and cure while a state court Jones Act suit is pending, it would undermine the Saving to Suitors Clause since the federal court's findings are res judicata in the state court case, thereby depriving the seaman of a jury on such issues.[114] Under Supreme Court precedent, however, the federal court noted that the seaman could simply file a counterclaim in the federal proceeding, which would entitle the seaman to a jury trial on the maintenance and cure claim that would not otherwise be triable before a jury.[115] Another significant consideration is whether the parties are acting in bad faith in selecting one forum versus the other.[116] However, the court

109. *Id.*
110. 411 F.3d 1328, 1331 (11th Cir. 2005).
111. *Whitefield*, 664 F. Supp. 2d at 1276.
112. *Id.* (citing Fitzgerald v. U.S. Lines Co., 374 U.S. 16, 18 (1963); Belle Pass Towing Corp. v. Cheramie, 763 F. Supp. 1348 (E.D. La. 1991)).
113. *Id.* at 1276.
114. *Id.* at 1277.
115. *Id.* (citing *Fitzgerald*, 374 U.S. at 21).
116. *Id.* at 1277.

noted that bad faith is generally a question of intent such that the circumstantial evidence "can be plausibly interpreted in either direction."[117]

In applying these additional criteria to the facts of the case, the *Whitefield* court held that the factors weighed in favor of dismissing the declaratory judgment action. For instance, the court noted that even with a special verdict form, it is difficult or impossible to determine whether the damages awarded by the jury in the state court proceeding would be duplicative of any damages awarded by the court in the federal matter.[118] Similarly, the evidence and witnesses concerning denial of maintenance and cure would likely be duplicative of the witnesses and evidence concerning damages under the Jones Act claim.[119] And while a seaman can certainly file a counterclaim in the federal proceeding, it does not "ensure that the party will have his choice of forum" under the Saving to Suitors Clause.[120]

Moreover, although there was no evidence of bad faith by either party, the *Ameritas* factors weighed in favor of dismissing the federal court action as well. Admittedly, the state of Florida did not have a significant interest in deciding the case, but the majority of the *Ameritas* factors weighed in favor of declining federal jurisdiction: a judgment as to maintenance and cure would not completely resolve the controversy; the declaratory judgment action would create issues concerning res judicata that would not fully clarify the legal relations of the parties; issues concerning res judicata, particularly as to damages, would be alleviated if one finder of fact considered all issues; a superior remedy would exist in state court before a single fact finder; and Florida state courts are equipped to handle all of the claims, especially since there is ample jurisprudence on the issue of maintenance and cure to serve as a guide.[121]

D. *Arbitration*

In *Harrington v. Atlantic Sounding Co., Inc.*,[122] the Second Circuit considered the enforceability of an arbitration agreement between a seaman and his employer. After plaintiff allegedly suffered a back injury while working for Weeks Marine, he signed a "Claim Arbitration Agreement" in which his employer agreed to pay sixty percent of his gross wages as an advance against settlement until plaintiff reached maximum medical improvement or was declared fit for duty provided plaintiff agreed to arbitrate any claims that may arise from his personal injury or illness.[123] After plaintiff filed

117. *Id.* (citing Lady Deborah, Inc. v. Ware, 855 F. Supp. 871, 876 (E.D. Va. 1994)).
118. *Id.* at 1278.
119. *Id.*
120. *Id.*
121. *Id.* at 1280–81.
122. 602 F.3d 113 (2d Cir. 2010).
123. *Id.* at 116.

suit under the Jones Act instead of a claim in arbitration, the district court denied defendant's motion to dismiss or, alternatively, to stay the Jones Act proceeding or to compel arbitration.[124] Plaintiff argued that the arbitration agreement was unenforceable under the Federal Employers' Liability Act and was unconscionable under New Jersey law.[125]

The Second Circuit disagreed, holding that seamen arbitration agreements are not unenforceable as a matter of law and that §§ 5–6 of the Federal Employers' Liability Act are inapplicable to such agreements. While the Supreme Court in *Boyd v. Grand Trunk Western Railroad Co*. invalidated an agreement limiting an injured party's "right to bring the suit in any eligible forum,"[126] the Second Circuit noted that *Boyd* was not decided under the Federal Arbitration Act, which applies to maritime transactions and commerce with a liberal policy in favor of arbitration agreements.[127] Moreover, §6 by its terms and purposes is inapplicable to arbitration agreements.[128] In upholding the agreement, the court also noted the federal policy favoring arbitration as but an additional factor.[129]

With respect to plaintiff's argument that the agreement was unconscionable, the *Harrington* court held that a party to an arbitration agreement seeking to avoid arbitration bears the burden of establishing that the agreement is inapplicable or invalid.[130] While the burden rests with the party attempting to obtain a release of a seaman's claims to show that it was executed freely, without deception or coercion, and with a full understanding by the seaman of his rights, this principle does not apply to an agreement to arbitrate those rights, only a release.[131] Instead, the court found the agreement at issue neither procedurally nor substantively unconscionable under New Jersey law, as waivers of jury trials are fully enforceable under the Federal Arbitration Act and the agreement at issue did not entail an "exchange of obligations so one-sided as to shock the court's conscience."[132] For these reasons, the Second Circuit vacated the district court's decision and remanded for a determination of the merits of plaintiff's contractual defenses of lack of mental capacity and intoxication when the agreement was signed.[133]

124. *Id*. at 115.
125. *Id*. at 116.
126. 338 U.S. 263, 265 (1949) (per curiam).
127. *Harrington*, 602 F.3d at 121.
128. *Id*. at 121–22.
129. *Id*.
130. *Id*. at 124 (citing Green Tree Fin. Corp.-Ala. v. Randolph, 531 U.S. 79, 91–92 (2000)).
131. *Id*.
132. *Id*. at 126 n.7.
133. *Id*. at 127.

V. DAMAGES

A. *Punitive Damages*

In *Borkowski v. F/V Madison Kate*,[134] three commercial fishermen filed suit seeking unpaid wages and damages under federal maritime law and Massachusetts state wage laws. At the end of a voyage, each fisherman and the other crewmembers were paid pursuant to an unwritten "lay-share system" in which net proceeds of the catch were divided into shares that were distributed based on the experience and performance of the crewmembers.[135] Two of the fishermen received a full share, while another received a three-quarter share.[136] The fishermen filed suit alleging that the lack of written wage agreements for fishermen violated 46 U.S.C. § 10601; unlawful seamen engagements entitled them to damages under 46 U.S.C. § 11107 for either the highest rate of wages at the port or the amount agreed to be given the seamen, whichever was higher; egregious conduct on the part of the employer entitled them to punitive damages; and state wage laws were violated.[137] The district court awarded the one fisherman his remaining one-quarter share, but dismissed the remaining claims.

On appeal, the First Circuit noted that it was not required to decide whether the remedy of § 11107 is the exclusive remedy for violations of § 10601 or whether federal maritime law preempts Massachusetts wage laws. Instead, the court affirmed on two grounds: plaintiffs failed to establish any other measure of compensatory damages or entitlement to punitive damages.[138] With respect to their compensatory damage claim, the court explained that plaintiffs conducted little or no discovery to gather evidence in support of their claims, including how deductions for expenses should be made or wages should be divided.[139] Meanwhile, although federal courts sitting in admiralty have the power to award common-law punitive damages to supplement statutory remedies, the circumstances are limited to "cases . . . of enormity, where a defendant's conduct is outrageous, owing to gross negligence, willful, wanton, and reckless indifference for the rights of others, or behavior even more deplorable."[140] In this case, however, defendant's violation of the writing requirement was "unknowing and commonplace."[141] As punitive damages do not automatically follow every statutory violation, "[i]gnorance of the law sometimes can be an ex-

134. 599 F.3d 57 (1st Cir. 2010).
135. *Id.* at 58.
136. *Id.*
137. *Id.* at 59.
138. *Id.* at 60.
139. *Id.* at 61.
140. *Id.* at 61–2 (citing Exxon Shipping Co. v. Baker, 129 S. Ct. 2561, 2621 (2008)).
141. *Id.* at 62.

cuse when it comes to punitive damages."[142] Finding nothing in the record to support a claim for punitive damages, the Second Circuit affirmed the district court's ruling.

The court in *Wagner v. Kona Blue Water Farms, LLC* considered whether punitive damages were recoverable for a Jones Act negligence claim as a matter of law.[143] In that case, plaintiff alleged he suffered ear trauma while working as a diver for defendant and filed suit for negligence under the Jones Act; unseaworthiness, maintenance, and cure under general maritime law; and for vessel negligence.[144] He also sought an award of punitive damages due to the "aggravated acts and omissions" of his employer, arguing that the Supreme Court's decision in *Atlantic Sounding Co. v. Townsend*[145] entitled him to such relief.

The district court recognized that courts have uniformly interpreted the Supreme Court's decision in *Miles v. Apex Marine Corp.*[146] as precluding plaintiffs from recovering punitive damages in Jones Act claims since such damages are nonpecuniary in nature.[147] However, the court questioned such decisions in light of the Supreme Court's recent holdings in *Exxon Shipping Co. v. Baker*[148] and *Townsend*. For example, the Supreme Court in *Baker* upheld a punitive damage award based solely on federal maritime common law for commercial fishermen who suffered economic damages following the Exxon oil spill off Alaska's coast in 1989. Meanwhile, the Supreme Court in *Townsend* allowed punitive damages in the context of a maintenance and cure claim, finding that the Jones Act did not preclude such preexisting remedies and leaving open the question of whether such damages are recoverable under the Jones Act. After examining the history of case law on this issue, the court disagreed with plaintiff's expansive interpretation of *Townsend*, finding that *Townsend* allowed punitive damages in the context of maintenance and cure because the general maritime cause of action for maintenance and cure, and the remedy of punitive damages, were "well established" before the Jones Act was enacted.[149] Instead, a Jones Act negligence cause of action is limited by the terms and conditions of the Act, including the limitation on nonpecuniary damages.[150] Accordingly, the district court dismissed plaintiff's claim for punitive damages under the Jones Act.

142. *Id*. (citation omitted and emphasis in original).
143. 2010 WL 3566730 (D. Haw. 2010).
144. *Id*. at *1.
145. 129 S. Ct. 2561 (2009).
146. 498 U.S. 19 (1990).
147. *Wagner*, 2010 WL 3566730, at *3 (citations omitted).
148. 128 S. Ct. 2605 (2008).
149. *Wagner*, 2010 WL 3566730, at *7.
150. *Id*. at *8.

B. *Emotional Distress*

In *Stacy v. Rederiet Otto Danielsen, A.S.*,[151] the Ninth Circuit reversed the dismissal of a claim for negligent infliction of emotional distress brought by a fisherman who sustained no direct physical impact during a collision. Plaintiff was trolling for salmon aboard his vessel amid the fog of the Pacific Coast when he noticed defendant's ship headed on a collision course toward his vessel. When plaintiff signaled the danger to the freighter, it avoided striking his vessel, but passed close enough for plaintiff to hear the vessel's engine and feel its wake.[152] After passing plaintiff, the freighter then collided with another vessel and killed the latter's captain. Plaintiff filed suit under general maritime law for emotional distress that purportedly caused him to be disabled and need psychiatric treatment.

The Ninth Circuit explained that under maritime jurisdiction and Supreme Court precedent, courts should employ a "zone of danger" test allowing recovery for plaintiffs who sustain physical impact from the defendant's negligent conduct or who are placed in immediate risk of physical harm by the same.[153] In sum, those within the "zone of danger" of physical impact can recover for fright, but those outside of it cannot.[154] While the dissent argued at length that Ninth Circuit precedent in *Chan v. Society Expeditions, Inc*.[155] limited the contours of the test to situations where an individual witnessed harm or peril to another and was threatened with physical harm as a result of a defendant's negligence, the majority disagreed, explaining that *Chan* did not concern a claim for emotional damages by someone directly endangered by a vessel.[156] Instead, the majority held that the test enunciated by the Supreme Court in *Gottshall* remained the applicable test in this context. Although plaintiff did not witness the collision, he nonetheless had stated a cause of action since he allegedly was in immediate risk of physical harm from defendant's vessel.[157]

VI. LONGSHOREMAN'S CLAIMS

As a matter of first impression, the Ninth Circuit had before it the issue of whether psychological injuries arising from legitimate personnel actions were compensable under the Longshore and Harbor Worker's Compen-

151. 609 F.3d 1033 (9th Cir. 2010).
152. *Id*. at 1034.
153. *Id*. at 1035 (citing Consol. Rail Corp. v. Gottshall, 512 U.S. 532, 547–48 (1994).
154. *Gottshall*, 512 U.S. at 548 (quotation omitted).
155. 39 F.3d 1398 (9th Cir. 1994).
156. *Stacy*, 609 F.3d at 1037.
157. *Id*. at 1035.

sation Act (LHWCA).[158] In *Pedroza v. Benefits Review Bd.*,[159] an employee petitioned for review of an order of the Benefits Review Board (BRB) denying benefits under the LHWCA for psychological injuries due to his employer's legitimate adverse personnel actions.[160] In finding substantial evidence supporting the findings that the employee's psychological injuries were a result of legitimate personnel actions, the Ninth Circuit affirmed the BRB's ruling.[161]

In *Pedroza*, the employee was a load handler. While unloading a ship, he struck an electrical wire and caused an explosion, but he did not seek medical attention. One year later, the employee's department manager wrote him a letter about the accident that informed the employee that the accident was caused by the employee's negligence. The employee refuted the letter, and he ultimately informed his union supervisor that his immediate supervisor's actions adversely affected his ability to perform his job. At that time, the employee's immediate supervisor issued a verbal warning that if the employee was unable to improve his performance, he would be demoted.[162]

Approximately six months later, the employee was informed of his poor performance, and he went on leave from work for three months. Upon his return, the employee was demoted for his poor work performance and his failure to fill out the proper safety forms after the accident. One month thereafter, the employee's doctor placed him on medical leave. While on leave, the employee filed a workers' compensation claim for psychological injuries caused by his stressful working conditions.[163]

During the administrative hearing, the administrative law judge (ALJ) denied the employee's workers' compensation claim because the medical evidence provided by both parties supported the employer's contention that the employee's disability was a result of the disciplinary action and not the accident.[164] Upon review, the Ninth Circuit announced that to be eligible, a claimant must have sustained an injury within the meaning of the LHWCA.[165] For example, a psychological impairment, which is work related, is presumed to be compensable under the LHWCA.[166] However, the court distinguished that layoffs or a reduction in force do not constitute "working conditions" that would give rise to a compensable injury under the LHWCA.[167]

158. *See* 33 U.S.C. §§ 901–950.
159. 583 F.3d 1139 (9th Cir. 2009).
160. *Id*. at 1140.
161. *Id*.
162. *Id*. at 1141.
163. *Id*.
164. *Id*. at 1142 (relying on Marino v. Navy Exch. Serv., 20 B.R.B.S. 166 (1988)).
165. *Id*. at 1143 (citing 33 U.S.C. § 903(a)).
166. *Id*. (internal citations omitted).
167. *Id*. at 1144 (internal citations omitted).

The Ninth Circuit ultimately held that "the psychological injury resulting from a legitimate personnel action is not the type of injury that was intended to be compensable under the [LHWCA]."[168] In citing to a doctrine developed through case law,[169] the Ninth Circuit held that the distinction between "legitimate" and "illegitimate" personnel actions is not about fault; it is about whether the employer's actions created an environment of poor working conditions to trigger psychological injuries.[170]

Similarly, the Ninth Circuit also analyzed a petition brought on behalf of an employer for review of a decision by the BRB affirming the grant of disability benefits under the LHWCA.[171] The issue for the court to examine was whether notice of an alleged work-related injury filed more than six months after the injury in any way affected the employee's ability to receive compensation under the LHWCA.[172] Importantly, the court confirmed that the harmless error analysis applies to petitions for review brought under the LHWCA.[173] The Ninth Circuit went on to hold that the LHWCA excuses late notice under several circumstances, including instances where the employer was not prejudiced by the failure to give proper notice.[174]

In *Hawaii Stevedores, Inc. v. Ogawa*, the employee worked as the storeroom maintenance clerk at the employer's marina terminal in Honolulu, Hawaii, for twenty-five years.[175] During that time, the employee found the work to be stressful, working up to fifteen unpaid hours per week from home and experiencing friction with co-workers resulting from the employee's cost-cutting efforts. The employee was eventually admitted to the emergency room after suffering a slow-developing stroke that left him with limited fine motor skills in his right hand and arm. The employee never fully regained his pre-stroke proficiency. Eventually, the employee, after being offered an opportunity to take a medical retirement, filed an accident report that gave notice to the employer that the employee believed his stroke was work related. Shortly thereafter, the employee chose medical retirement over termination.[176]

The Ninth Circuit proceeded to announce that the LHWCA creates a presumption that a disabling injury suffered by a maritime worker is work

168. *Id.* at 1145.
169. *Id.* at 1146 (citing the Marino-Sewell doctrine from *Marino*, 20 B.R.B.S. at 166 n.2; Sewell v. Noncommissioned Officers Open Mess, 32 B.R.B.S. 134 (1998)).
170. *Id.* at 1146.
171. *See* Haw. Stevedores, Inc. v. Ogawa, 608 F.3d 642 (9th Cir. 2010).
172. *Id.* at 649.
173. *Id.* at 648.
174. *Id.* at 649.
175. *Id.* at 647.
176. *Id.*

related and compensable.[177] The statutory presumption may be invoked by the claimant upon a prima facie showing that (1) the claimant suffered a harm and (2) a work-place condition could have caused, aggravated, or accelerated the harm.[178] If the claimant successfully invokes the presumption at the first step, the employer may rebut the presumption at the second step by presenting substantial evidence that is "specific and comprehensive enough to sever the potential connection between the disability and the work environment."[179] The court announced that if the employer carries its evidentiary burden at step two, the presumption in favor of the claimant falls out of the case, and the issue then is whether the evidence demonstrates that the claimant has established the necessary causal link between the injury and employment.[180]

In the underlying proceeding, the ALJ reached a conclusion that the totality of the evidence showed a relationship between the stressful working conditions and the employee's stroke.[181] Following its endorsement of the harmless error doctrine, the Ninth Circuit affirmed that the employee's stroke qualified as a compensable injury under the LHWCA.[182]

In one of the more controversial cases decided this year, the Fifth Circuit had the occasion to examine the issue of whether an undocumented worker is entitled to benefits under the LHWCA.[183] In relying on the statutory definition of "employee"[184] as well as the Supreme Court opinion of *Sure-Tan, Inc. v. NLRB*[185] and the Fifth Circuit opinion of *Hernandez v. M/V Rajaan*,[186] the Fifth Circuit found that the undocumented worker "was an employee within the intent of the statute and is thus eligible to recover workers' compensation benefits under the LHWCA."[187]

In *Bollinger Shipyards, Inc. v. Dir., Office of Workers' Comp. Programs*, the BRB awarded benefits under the LHWCA to an undocumented immigrant who fell and injured himself while employed as a pipefitter. At the time of the injury, the employee had been working for the employer for approximately eight months, having initially obtained employment after stating falsely that he was a U.S. citizen and providing the employer with

177. *Id.* at 650 (citing 33 U.S.C. § 920(a)).
178. *Id.* at 651 (citing Ramey v. Stevedoring Servs. of Am., 134 F.3d 954, 959 (9th Cir. 1998); Amerada Hess Corp. v. Dir.of Workers' Comp., 543 F.3d 755, 761 (5th Cir. 2008)).
179. *Id.* (quoting *Ramey*, 134 F.3d at 959).
180. *Id.* (citing Bath Iron Works Corp. v. Fields, 599 F.3d 47, 53 (1st Cir. 2010)).
181. *Id.* at 652.
182. *Id.*
183. *See* Bollinger Shipyards, Inc. v. Dir.of Workers' Comp., 604 F.3d 864, 867 (5th Cir. 2010).
184. *See* 33 U.S.C. § 902(3).
185. 467 U.S. 883 (1984).
186. 841 F.2d 582, amended after rehearing, 848 F.2d 498 (5th Cir. 1988).
187. *Bollinger*, 604 F.3d at 873–74.

a false Social Security number. The employer contended that the employee's undocumented status and his use of false information to obtain employment precluded the employee from recovering any LHWCA-related benefits.[188]

The Fifth Circuit, in examining cases looking to similar federal labor and employment laws, went on to hold that because the plain statutory text of the LHWCA broadly defines the term "employee" and specifies that nonresident "aliens" are entitled to benefits in the same amount, an undocumented worker is similarly entitled to recover benefits under the LHWCA.

In distinguishing a line of cases reviewing backpay-reinstatement orders by the National Labor Relations Board (NLRB), the Fifth Circuit announced:

> (1) unlike discretionary backpay under the [National Labor Relations Act (NLRA)], workers' compensation under the LHWCA is a non-discretionary, statutory remedy; (2) unlike the NLRA, the LHWCA is a substitute for tort law, abrogating fault of either the employer or the employee; and (3) awarding death or disability benefits *post hoc* to an undocumented immigrant under the LHWCA does not "unduly trench upon" the [Immigration Reform and Control Act], as Congress chose to include a provision in the LHWCA expressly authorizing the award of benefits "in the same amount" to nonresident aliens.[189]

Accordingly, the Fifth Circuit felt compelled by Supreme Court precedent, and its own prior cases, to find that the undocumented worker was entitled to receive benefits under the LHWCA.[190] As the ALJ had ruled correctly on the issue, the Fifth Circuit denied the employer's petition.[191]

VII. COLLISION/ALLISION

In *Combo Maritime, Inc. v. U.S. United Bulk Terminal, LLC*,[192] the Fifth Circuit addressed the presumption of fault based on the rule articulated in *THE LOUISIANA* (Louisiana Rule).[193] The Louisiana Rule, much like the Oregon Rule,[194] creates a presumption of fault that shifts the burden of production and persuasion to a moving vessel that drifts into an allision with a stationary object.[195] To rebut the presumption, the defendant can dem-

188. *Id*. at 867.
189. *Id*. at 877
190. *Id*. at 879.
191. *Id*. at 880.
192. 615 F.3d 599 (5th Cir. 2010).
193. 3 Wal. (70 U.S.) 164 (1865).
194. 158 U.S. 186 (1895).
195. *THE LOUISIANA*, 3 Wall. (70 U.S.) at 173.

onstrate that the allision was the fault of the stationary object (essentially contributory negligence), that the moving vessel acted with reasonable care (negate negligence), or that the allision was an unavoidable accident (superseding causation).[196] In addition to these presumptions of fault, maritime law recognizes another presumption of fault for a passing vessel when its wake causes damage to a properly moored vessel.[197] The passing vessel may rebut the presumption by showing that it took reasonable care in passing or demonstrate that the stationary vessel was improperly moored.[198]

In *Combo Maritime*, a vessel owner brought an action against a barge owner to recover damages sustained when several barges broke free of their moorings and allided with the vessel. The barge owner filed a third-party complaint against a cruise line for negligent navigation seeking contribution and indemnity for the damages from the allision and the recovery of damages to its equipment.[199] The cruise line moved for summary judgment under the Louisiana Rule.[200] The district court granted the cruise line partial summary judgment and dismissed the third-party complaint with prejudice.[201]

On appeal, the Fifth Circuit found that the district court had improperly applied the Louisiana Rule when it "(1) applied the presumption between co-defendants; (2) applied the wrong standard of proof for rebutting the presumption; and (3) interpreted the presumption as a presumption of *sole* liability."[202] The Fifth Circuit found that the district court incorrectly applied the Act of God test instead of the reasonableness test for negating negligence. Additionally, the district court's application of the drifting vessel presumption as a presumption of sole fault "simply cannot square with the case law and '[t]he rule in admiralty . . . that joint tortfeasors are entitled to allocate a plaintiff's damages among themselves in accordance with their relative fault.' "[203] In addressing the issue of the passing vessel presumption, the Fifth Circuit announced that the passing vessel presumption first requires the moored vessel to demonstrate that it was properly moored before the burden is shifted to the passing vessel.[204]

196. *Combo Maritime*, 615 F.3d at 605 (quoting Fishcer v. S/Y NERAIDA, 508 F.3d 586, 593 (11th Cir. 2007)).
197. *Id*. at 606 (internal citations omitted).
198. *Id*.
199. *Id*. at 601–02.
200. *Id*. at 602 (citing *THE LOUISIANA*, 3 Wall. (70 U.S.) at 173, which creates the rebuttable presumption that a drifting vessel that comes into an allision with a stationary object is at fault.).
201. *Id*.
202. *Id*. at 608.
203. *Id*. at 608 (quoting Rodi Yachts, Inc. v. Nat'l Marine, Inc., 984 F.2d 880, 885 (7th Cir. 1993)).
204. *Id*.

Interestingly, the dissent pointed out that the majority opinion relied heavily on a document received by the courtroom deputy at oral argument.[205] Recognizing that appellate courts have the ability to supplement the record on appeal, the dissenting judge opined that it should not be considered until formally submitted and accepted into the record.[206]

The Sixth Circuit had the opportunity to examine the presumption created under the Oregon Rule in *Bessemer & Lake Erie R.R. Co. v. Seaway Marine Transport*.[207] In *Bessemer*, a ship with its own 250-foot unloading boom at its stern was taking on a cargo of coal. In order to permit the loading of cargo into another hold, the vessel was advanced to allow the dock's overhanging loading arm to be in place for loading. During the advancement process, the ship's unloading boom struck the dock's overhanging loading arm, which took five weeks to repair.[208] The shipowner conceded that it bore some liability for the allision, but it argued that it should not be held solely liable under the Oregon Rule.[209]

The Sixth Circuit held that not unlike the doctrine of res ipsa loquitur, the Oregon Rule creates a prima facie case of negligence, not a final case of sole negligence.[210] The court went on to hold that comparative negligence is not abrogated in a particular case simply because the Oregon Rule is imposed. Rather, the court stated "[i]t would be odd . . . to transform a modest evidentiary presumption into a rule that wiped away a longstanding tradition of shared fault in allision cases."[211]

The Sixth Circuit also affirmed the district court's dismissal of the dock operator's claim for lost profits because of the dock operator's failure to comply with Fed. R. Civ. P. 26(a)(1)(A)(iii).[212] When a party fails to provide information to support a claim, the party is not allowed to use that information to supply evidence on a motion, at a hearing, or at a trial, unless the failure was substantially justified or is harmless.[213] The dock operator challenged the district court's standard used in evaluating whether discovery sanctions were appropriate, but the court stated the test for exclusion under Rule 37(c) is a simple one: "the sanction is mandatory unless there is a reasonable explanation of why Rule 26 was not complied with or the mistake was harmless."[214]

205. *Combo Maritime*, 615 F.3d at 609 (Garza, C.J., dissenting).
206. *Id*. (internal citations omitted).
207. 596 F.3d 357 (6th Cir. 2010).
208. *Id*. at 361.
209. *Id*. at 362.
210. *Id*. (internal citations omitted).
211. *Id*. at 363.
212. *Id*. at 369.
213. *Id*. (citing Fed. R. Civ. P. 37(c)(1)).
214. *Id*. at 370 (internal citations omitted).

In another case, the Fifth Circuit examined the negligence standard that applies to the captain of an alliding vessel.[215] In *Crescent Towing & Salvage Co. v. CHIOS BEAUTY*, owners of barges and tugboats sued CHIOS BEAUTY in rem and her owners and operators for damages sustained when the ship allided with plaintiffs' barges and tugboats, which were moored in the Mississippi River near New Orleans, Louisiana, during Hurricane Katrina. The district court found the defendants to be negligent when they brought CHIOS BEAUTY into New Orleans in the face of the impending storm.[216] In so finding, the district court applied a regular negligence standard of care, rather than the heightened in extremis standard, in judging whether the captain was negligent in continuing to New Orleans instead of running for safety elsewhere in the Gulf of Mexico.[217]

The Fifth Circuit first addressed the standard of care applicable to the captain's negligence. The court opined that where a vessel is put in the very center of destructive natural forces, without prior negligence, and a hard choice between competing courses must be made immediately, "the law requires that there be something more than mere mistake of judgment by the master in that decision *in extremis*."[218] The court quickly pointed out, however, that the in extremis standard of care should not apply to the actions of a captain who had ample time to avoid the peril.[219] In *CHIOS BEAUTY*, the Fifth Circuit recognized the district court's finding that the captain had ample time to find a safer berth and was not in a position of peril at the time he decided to proceed to New Orleans ahead of Hurricane Katrina. Accordingly, the Fifth Circuit affirmed that the district court's dismissal of the in extremis standard of care.

CHIOS BEAUTY also permitted the Fifth Circuit to address the issue of interest on a bond or stipulation filed under Rule E(5) of the Supplemental Rules for Admiralty and Maritime Claims.[220] The Fifth Circuit acknowledged that by rule, once the bond or stipulation amount is set and the vessel is released by a letter of undertaking, that letter shall be conditioned for the payment of interest at six per cent per annum. This provision constitutes a gap-filling provision in any bond or letter of undertaking issued to secure the release of an arrested vessel. The court went on to hold that "[r]egardless of whether this provision of Rule E(5) can be

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215. *See* Crescent Towing & Salvage Co. v. CHIOS BEAUTY MV, 610 F.3d 263 (5th Cir. 2010).

216. *CHIOS BEAUTY*, 610 F.3d at 265.

217. *Id*. at 267.

218. *Id*. at 267–68 (quoting Emp'rs Ins. of Wausau v. Suwannee River Spa Lines, Inc., 866 F.2d 752, 771 (5th Cir. 1989)).

219. *Id*. at 268 (citing Boudoin v. J. Ray McDermott & Co., 281 F.2d 81, 84–86 (5th Cir. 1960)).

220. *Id*. at 269.

waived by consent of the parties, it was not waived here."[221] The Fifth Circuit affirmed the district court's denial of the plaintiffs' request to increase the value of the letter of undertaking to include the prejudgment interest because the security provided by a letter of undertaking cannot exceed the value of the vessel.[222]

221. *Id*. at 270.
222. *Id*.

RECENT DEVELOPMENTS IN ANIMAL TORT AND INSURANCE LAW

Adam P. Karp, Yvonne C. Ocrant, and Steven R. Bonanno

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I. INTRODUCTION

Decisions regarding animal tort and insurance law between October 2009 and October 2010 covered a broad range of disparate cases, including the definition of *business day* for a life-and-death decision of when the stray animal hold expires; whether sovereign and statutory immunity applies to the Society for the Prevention of Cruelty to Animals; a dispute between naturopathic and allopathic veterinarians at a major veterinary college; cattle rustling in Texas; dog bite claims; equine liability; and other cases noted below.

II. ANIMAL TORT LAW

A. *Government and Humane Society Defendants*

In *Maldonado v. Municipality of Barceloneta*,[1] twenty-seven families, all residents of three public housing complexes, sued under 42 U.S.C. §§ 1983, 1985, and 1986 for the summary seizure and cruel killings of their pet cats and dogs, asserting violations of their Fourth, Fifth, and Fourteenth Amendment rights.[2]

At issue was whether occupants of public housing may keep pets in their homes. In 1999, Congress passed 42 U.S.C. § 437z-3, allowing public housing residents to have one or more household pets in their dwelling.[3] However, the Municipality of Barceloneta in 2000 passed an ordinance that did not allow residents to keep pets "in urbanizations, the town center, and [] housing developments."[4] In 2007, the Puerto Rico Public Housing Authority approved a pet policy consistent with federal regulations.[5] Yet shortly after the municipality began managing the three public housing complexes where plaintiffs resided, they received a letter saying they had to remove all pets or be in breach of their lease contracts.[6] Five days later, the mayor visited each complex and executed an operation to seize pets owned by the residents. On October 8, 2007, in a scene reminiscent of the movie *District 9*, the mayor and municipal staff knocked on residents' doors, brutally seized between fifty and eighty animals, inhumanely killed them, and disposed of the bodies.[7] Two days later, another pet seizure took place.[8]

1. 682 F. Supp. 2d 109 (D.P.R. 2010).
2. *Id*. at 119.
3. Pub. L. No. 105-276, tit. V, 112 Stat. 2568.
4. *Maldonado*, 682 F. Supp. 2d at 120.
5. *Id*.
6. *Id*.
7. *Id*. at 121.
8. *Id*.

The federal district court for Puerto Rico found that some of the plaintiffs were entitled to a predeprivation hearing under the Fourteenth Amendment, the pets were "effects" protected against unreasonable seizure under the Fourth Amendment, and the mayor's conversations preceding "consensual" relinquishment of the pets was a "trial-worthy issue."[9] The method of killing the seized animals and *Monell* liability also remained triable issues with respect to some of the families.[10]

In *Purifoy v. Howell*,[11] a dog owner and an animal rights organization sued the operator of a county animal shelter for damages and declaratory and injunctive relief for violating a four-business-day stray hold on killing or adopting out impounded animals.[12] The plaintiffs also sought a writ of mandamus to compel the shelter to comply with California Food and Agriculture Code § 31108(a), which states that a public or private shelter must hold stray impounded dogs for "six business days, not including the day of impoundment."[13] Under § 31108(a)(1), if the shelter "has made the dog available for owner redemption on one weekday evening until at least 7:00 p.m. or one weekend day, the holding period shall be four business days, not including the day of impoundment."[14] Animal control impounded Purifoy's dog Duke on Thursday, October 5, 2006, and adopted him out on Wednesday, October 11, 2006, the equivalent of three full business days (if Saturday is not counted).[15] The trial court granted summary judgment to defendants, concluding that § 31108(a), as incorporated into the Contra Costa County Code, properly counted Saturday as a business day.[16] The California Court of Appeal reversed, finding that the term *business days* does not include Saturdays, even though the shelters operating in Contra Costa are closed Sundays and Mondays, but open on Saturdays.[17]

In *Skinner v. Chapman*,[18] an animal control officer issued a noncustodial appearance ticket to David Skinner for obstructing governmental administration because of Skinner's refusal to surrender his dog for a rabies quarantine. After the trial court dismissed the criminal charge against Skinner, he sued the animal control officer and a police officer under 42 U.S.C. § 1983 (2006) for false arrest, malicious prosecution, unreasonable seizure, and retaliation under the First Amendment.[19] Skinner had repeatedly asked the

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9. *Id*.
10. *Id*. at 134 (citing Monell v. NYC Dep't of Soc. Servs., 436 U.S. 658 (1978)).
11. Cal. Rptr. 3d 213 (Ct. App. 2010).
12. *Id*. at 215.
13. *Id*. (quoting Cal. Food & Agric. § 31108(a)).
14. *Id*. (quoting Cal. Food & Agric. § 31108 (a)(1)).
15. *Id*.
16. *Id*. at 217.
17. *Id*. at 226.
18. 680 F. Supp. 2d 470 (W.D.N.Y. 2010).
19. *Id*. at 473.

animal control officer to produce a warrant before entering his home and removing the unvaccinated and unlicensed dog, which allegedly had bitten a child.[20] In the absence of a warrant, Skinner eventually surrendered custody of the dog, at which point the officer cited him for obstruction. The dog was subsequently held for eleven days and released.[21] A jury convicted Skinner for obstruction, and the trial court sentenced him to a year in jail. The state appellate court overturned his conviction on the grounds that the officer was not engaged in "authorized conduct" when she ordered the dog's confinement and seizure and because Skinner did not "physically interfere[] with [defendants'] efforts to take custody of the dog."[22] The federal judge dismissed the case at issue on grounds of qualified immunity, noting that defendants had probable cause to arrest plaintiff even though the conviction was ultimately vacated.[23]

In *Smith v. City of New York*, the New York Appellate Division reversed a trial court decision that had found a police officer strictly liable for dog bites sustained by several infants.[24] The court noted that in the "very brief time" that Officer Smith spent with the abandoned dog, he observed "the dog was friendly, playful, and 'rambunctious.'"[25] A statement by the plaintiff's husband to the trial court that the dog needed additional restraint while inside his car was not enough to support the conclusion that the police officer "knew or should have known of the dog's vicious propensities."[26]

In *Young v. City of Visalia*,[27] officers from the Visalia (California) Police Department allegedly exceeded the scope of a search warrant by entering and searching an adjacent shop that was occupied by Nathan Young "without exigent circumstances."[28] The officers escorted Young out of his shop at gunpoint, denied him access to his medications and the bathroom for hours, compelled him to sign a document that he could not read without his glasses, required him to forfeit $2,000 that had been found during the search, and pepper sprayed his dogs over his protests.[29]

Although the case was not fundamentally related to animals, the federal district court for the District of Eastern California dismissed the Youngs' claims that the officers violated an implied civil cause of action under two

20. *Id.* at 474.
21. *Id.*
22. *Id.* at 474–75.
23. *Id.* at 478.
24. 889 N.Y.S.2d 187 (N.Y. App. Div. 2009).
25. *Id.*
26. *Id.*
27. 687 F. Supp. 2d 1155 (E.D. Cal. 2010).
28. *Id.* at 1162.
29. *Id.* at 1159.

provisions of the California Penal Code that concerned animals.[30] The decision turned on the inapplicability of the prima facie tort doctrine, which sought to circumvent the statutory immunity of public officials by proving intentional harm arising from generally culpable conduct, even if not within the traditional arc of tort liability.[31] Instead, the court allowed the Youngs to proceed on the established torts of trespass to chattels and conversion.[32]

In a case more directly related to animals, the Eastern District of California denied defendants' motion for summary judgment, holding that plaintiffs' allegations, if proven, established a violation of the Fourth Amendment, based on the use of excessive force.[33] In *Bailey v. County of San Joaquin*, parents and their five-year-old daughter sued a deputy sheriff for discharging his firearm at the family dog without provocation.[34] His shots hit the dog's paw, causing bullet fragments to ricochet and hit the mother and her child.[35]

The circumstances surrounding the shooting can be described as confusing at best. Responding to a citizen complaint of possible drug use, the deputy and his fellow officers approached the wrong address, i.e., the Baileys', without making a visual inspection of the property or confirming the address on the complaint prior to arrival.[36] However, the officers were aware that another court had issued an arrest warrant for Eddie Bailey for failure to comply with community service terms of a misdemeanor traffic violation. Bailey was not at home at the time, but officers saw a family friend taking out the trash through the back door and feared someone might escape.[37] As other officers secured the rear, the deputy went to the front door alone, navigating through piles of children's toys. Kari Bailey, with her five-year-old daughter and the dog in tow, opened the front door, and the dog started to leave.[38] Startled, the deputy shot the dog, who had posed no threat to him, and in the process wounded Mrs. Bailey and her child. The Baileys unfortunately had to take out a loan to pay for the dog's veterinary fees, and the deputy received no discipline or training.[39]

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30. Cal. Penal Code § 596 (1941) (willfully poisoning an animal); *id*. § 597 (1998) (malicious wounding of an animal).

31. *Young*, 687 F. Supp. 2d at 1166 (citing Cal. Gov't Code § 820.4 (1963) (excuses acts or omissions, where due care is exercised, in enforcing any law)).

32. *Id*. at 1168 n.11.

33. Bailey v. County of San Joaquin, 671 F. Supp. 2d 1167 (E.D. Cal. 2009).

34. *Id*. at 1170.

35. *Id*.

36. *Id*.

37. *Id*. at 1171.

38. *Id*.

39. *Id*.

The court first denied defendants' motion for summary judgment, noting that a reasonable jury would find that the deputy's actions were unreasonable and violated plaintiffs' rights under the Fourth Amendment.[40] Further, the court also refused to dismiss the substantive due process claim based on the officer's actions. Qualified immunity was not applicable in this case because "no reasonable officer in [the officer's] position could believe that his actions were constitutional."[41] Finally, the court also considered the state tort claim of conversion arising from shooting the dog, taking her to the veterinarian without the Baileys' consent, and refusing to pay the veterinary bill.[42] The conversion claim survived based on the court's finding that a reasonable jury could conclude that the deputy took the dog to the veterinarian, a decision that Mrs. Bailey did not ratify.[43] The absence of her husband at the time was irrelevant.[44]

In *Snead v. Society for the Prevention of Cruelty to Animals of Pennsylvania*,[45] the Superior Court of Pennsylvania noted that "this court clearly recognizes that dogs as pets hold a unique place in many people's lives as friend, companion, and family member,"[46] even though they are treated as property under Pennsylvania law. In *Snead*, animal control officers seized several dogs from plaintiff's residence as evidence pending resolution of dogfighting charges against her.[47] When the charges were dropped, plaintiff attempted to recover her dogs from the shelter.[48] Although staff at the shelter told her that they euthanized the animals because she failed to claim them within the forty-eight-hour hold period, euthanasia in fact occurred three days after she inquired.[49] A jury found the defendant shelter liable in the sum of $154,926.37, $100,000 of which constituted exemplary damages.[50]

On appeal, the court found that the facts established a due process violation and affirmed the jury's finding of conversion, agreeing with the trial court that defendant deprived plaintiff of the use and possession of her dogs by euthanizing them without providing an opportunity for her to retrieve them.[51] Further, the SPCA could not claim sovereign immunity as a Commonwealth agency even though it exercised a governmental function

40. *Id.* at 1173.
41. *Id.* at 1174.
42. *Id.* at 1178.
43. *Id.* at 1178–79.
44. *Id.* at 1179.
45. 929 A.2d 1169 (Pa. Super. Ct. 2007), *aff'd*, 985 A.2d 909 (Pa. 2009).
46. *Id.* at 1174.
47. *Id.* at 1175.
48. *Id.*
49. *Id.*
50. *Id.* at 1174.
51. *Id.* at 1181.

(i.e., enforcement of animal control laws),[52] or as a local agency immune under the Political Subdivision Tort Claims Act.[53]

B. *Private Individual Defendants*

The Vermont Supreme Court held that under state common law, dog owners could not recover noneconomic damages for emotional distress caused by defendant's intentional shooting of their dog.[54] In *Scheele v. Dustin*,[55] the Scheeles had stopped in a parking lot at a church in Northfield, Vermont, while on a trip from their home in Maryland and unleashed their dog for some exercise.[56] The dog, posing no threat, wandered onto the adjacent property, only to be shot and killed by Lewis Dustin, who was preparing his pellet gun to shoot squirrels.[57] The case was tried on stipulated facts, and the Scheeles expressly waived any right to punitive damages.[58] Refusing to award any noneconomic and loss of companionship damages, the trial court limited economic damages to $155 market value, an amount that was not disputed at trial.[59]

On appeal, the Scheeles sought reversal, in one of "a growing string of cases pushing for recognition of special damages for pet owners where a pet is injured or dies."[60] The Vermont Supreme Court affirmed the lower court decision, based in part on its ruling in *Goodby v. Vetpharm*,[61] noting that

> [p]laintiffs fail to demonstrate a compelling reason why, as a matter of public policy, the law should offer broader compensation for the loss of a pet than would be available for the loss of a friend, relative, work animal, heirloom or memento—all of which can be prized beyond measure, but for which this state's law does not recognize recovery for sentimental loss.[62]

Plaintiffs also cited decisions from other jurisdictions to support their position that "noneconomic damages can be awarded following the wrongful death of a pet, even though [they are] considered property,"[63] notably a decision by the Washington Court of Appeals, *Womack v. von Rardon*,[64]

52. *Id.*
53. *Id.* at 1179 (citing 42 Pa. Cons. Stat. § 8501 (2000)).
54. Scheele v. Dustin, 998 A.2d 697 (Vt. 2010).
55. *Id.*
56. *Id.* at 698–99.
57. *Id.* at 699.
58. *Id.* at 698.
59. *Id.*
60. Am. Veterinary Med. Law Ass'n, http://www.avmla.org/displaycommon.cfm?an=1&subarticlenbr=92.
61. 974 A.2d 1269 (Vt. 2009).
62. *Scheele*, 998 A.2d at 703.
63. *Id.* at 702.
64. 135 P.3d 542, 546 (Wash. Ct. App. 2006). Mr. Karp represented the appellant in this case.

which created the "common law cause of action of malicious injury to a pet."[65] The Vermont high court dismissed the Washington State case, stating that "[w]ith little analysis or coherence, and citing no authority supporting their spontaneous creation of this unique cause of action, *Womack* provides us with little legal reasoning to follow."[66] The *Scheele* court held that the slaying of a nonvicious dog with a pellet gun, though intentional, does not give rise to emotional damages under intentional or malicious tort theories.[67] It also disallowed loss of companionship.[68]

In *Ashburn v. Caviness*,[69] Spencer Caviness sued Steve Ashburn for allegedly shooting and killing his Labrador retriever. A jury found Ashburn liable for having "unlawfully appropriated property of Spencer Caviness, to wit: a dog, with the intent to deprive Spencer Caviness of said property, without the effective consent of Spencer Caviness, the owner."[70] Caviness appealed, challenging the verdict form's failure to use the definition of "appropriate" as construed in criminal cases.[71] In affirming, the appeals court held that "one who kills an animal belonging to another, without removing the animal, unlawfully appropriates the animal so as to commit theft."[72]

C. *Custody-Related Claims*

Mireles v. Morman[73] involved a custody dispute over a Bullmastiff puppy who had wandered away from its owner's property during a storm and was "adopted" by a neighbor. The appellant sought reversal of a lower-court decision that required her either to pay $800 or return the puppy, plus $6,800 in damages and $3,500 in fees. Mireles had agreed to pay $800 pursuant to a promissory note.[74] When she failed to pay or return the puppy, Morman sued under the theory of conversion and statutory theft under the Texas Theft Liability Act (TTLA).[75] Mireles counterclaimed for emotional distress damages.[76] Morman then filed a motion for summary judgment based on Mireles's admissions.[77]

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65. *Scheele*, 998 A.2d at 700.
66. *Id*. at 703.
67. *Id*. at 701.
68. *Id*.
69. 298 S.W.3d 401 (Tex. App. 2009).
70. *Id*. at 402.
71. *Id*.
72. *Id*. at 401.
73. 2010 WL 3059241 (Tex. App. Aug. 6, 2010) (not reported).
74. *Id*. at *1.
75. *Id*. at *2 (citing Tex. Civ. Prac. & Rem.Code Ann. § 134.005 (West 2005) ("[A] person who has sustained damages resulting from theft may recover . . . the amount of actual damages found by the trier of fact and, in addition to actual damages, damages awarded by the trier of fact in a sum not to exceed $1,000," plus court costs and reasonable and necessary attorney fees)).
76. *Id*.
77. *Id*.

The court resolved the errors raised by the appellant as follows: (1) a pro se defendant's deemed admissions, arising from her failure to respond to requests for admissions on a timely basis, did not violate due process where she failed to show the required good cause and undue prejudice;[78] (2) the deemed admissions established summary judgment liability, except as to the TTLA claim, which Morman never pleaded and was not tried by consent;[79] (3) the summary judgment of $6,800 in damages wrongly included the $1,000 TTLA penalty and $4,800 in double recovery for the alleged market value of the dog;[80] (4) the court reversed the attorney fees award as not viable, except under the TTLA;[81] and (5) the court reinstated Mireles's counterclaims after finding that they were not foreclosed by procedural irregularity.[82]

D. *Veterinary Malpractice*

In a case more notable for showing the rift between naturopathic and allopathic veterinary medicine than for its legal analysis, naturopathic veterinarian Margo Ronan sued Tufts University as well as two faculty and one staff member at its Cummings School of Veterinary Medicine, asserting claims for defamation, violations of the Massachusetts Civil Rights Act (MCRA), emotional distress, negligence, and breach of contract.[83] Ronan unsuccessfully treated her horse for a pin-sized lesion with homeopathy. The lesion grew to the point where Ronan took him to Tufts for evaluation of a possible enucleation of the eye. The Tufts veterinarian diagnosed metastasized squamous cell carcinoma in the left eye and recommended euthanasia.[84]

During her visit, Ronan allegedly heard a number of derogatory comments regarding holistic treatment methods. Infuriated, she refused to pay for the services rendered, and Tufts advised that until the debt was paid, she could not benefit from any of Tufts' services, including continuing education. She subsequently was denied access to a lecture that was "open to the public."[85]

After noting that "the nonmoving party cannot defeat a motion for summary judgment by merely asserting that facts are disputed," the court proceeded to analyze each of Ronan's assertions, essentially concluding that

78. *Id*. at *4.
79. *Id*. at *5.
80. *Id*. at *9.
81. *Id*.
82. *Id*.
83. Ronan v. Trs. of Tufts Univ., 2009 WL 4894318 (Mass. Super. Ct. Oct. 26, 2009) (not reported).
84. *Id*. at *1.
85. *Id*. at *2.

none of them was substantiated by evidence.[86] The defendants' motion for summary judgment was allowed.[87]

In *Reed v. Vickery*,[88] the Reeds, residents of Colorado, sued veterinarians and a veterinary hospital in Ohio for an allegedly fraudulent presale examination of a horse and concealment of records showing that the horse had been treated for lameness.[89] They bought the horse for $25,000 and spent $20,000 on veterinary bills for treatment of chronic lameness.[90]

The defendants filed a motion for judgment on the pleadings that was granted in part and denied in part.[91] The federal court for the Southern District of Ohio rejected the statute of limitations defense, noting that the two-year period may have been tolled until discovery of the undisclosed prior treatment.[92] It also refused to dismiss the fraud and negligence claims.[93] The court overruled the defendants' objection to the demand for $20,000 in veterinary bills, given that animals are personalty under Ohio law and damages are limited to the difference in market value before and after loss.[94] Pointedly noting that the market value rule applies to family pets, the court observed that the animal in this case was a show horse whose lameness markedly reduced its value.[95] Further, "[e]ven if Ohio law would cap economic damages at the horse's market value," the vet bills do not exceed the amount paid for the horse.[96] The court also refused to dismiss punitive damages as a matter of law, acknowledging that they exist for sufficiently egregious, intentionally false representations.[97]

One of the veterinarians was dismissed from suit due to lack of facts to prove he intended to mislead the Reeds by administering injections to mask chronic lameness symptoms or concealing records of that treatment.[98] Of interest was the veterinarian's claim that he was legally and ethically prohibited from disclosing prior treatment records to the Reeds, a point apparently ultimately rejected by the court but that is likely to arise in future veterinary disputes.[99] The other defendants did not succeed in gaining dismissal of fraud and negligence.

86. *Id.* at *3 (quoting Mass. R. Civ. P. 56(e)).
87. *Id.* at *1.
88. 2009 WL 3276648 (S.D. Ohio Oct. 9, 2009).
89. *Id.* at *1–2.
90. *Id.* at *2.
91. *Id.* at *1.
92. *Id.* at *2–3.
93. *Id.* at *7.
94. *Id.*
95. *Id.*
96. *Id.*
97. *Id.* at *8.
98. *Id.* at *5.
99. *Id.* at *5–6.

In *Newman v. Washington Veterinary Board of Governors*,[100] after the death of their Pekingese, the Newmans filed complaints with the Washington Veterinary Board of Governors against Drs. Michael Harrington and Kobi Johnson for a series of alleged licensing violations, including, but not limited to, malpractice, recordkeeping deficiencies, and misrepresentation.[101] After completing its investigation, the board closed the complaints, reporting to the Newmans that "to take disciplinary action, the Board must be able to prove, by clear and convincing (highly likely) evidence that unprofessional conduct occurred."[102] The Newmans submitted a petition for reconsideration that introduced expert testimony, challenged the standard of review used by the board, emphasized recordkeeping omissions, and reasserted the grounds in their original complaint.[103] The board rejected the reconsideration request.

As the result of misleading statements from board staff, the Newmans did not file an appeal under the Washington Administrative Procedure Act (WAPA),[104] but instead filed a motion for a statutory writ of review and constitutional writ of certiorari with the Thurston County Superior Court.[105] The attorney general argued that the Newmans should have sought judicial review under the WAPA, rendering the request for a writ meritless.[106] The two veterinarians intervened, arguing that the Newmans had no right to judicial review, whether under the WAPA or by writ.[107] The trial court found standing under WAPA but noted that the petition was untimely.[108] It also denied both writs, thereby terminating the case.[109] The appellate court affirmed the trial court's decision due to lack of standing.[110]

Kaufman v. Langhofer,[111] a veterinary malpractice case about the death of a scarlet macaw named Salty, involved an appeal of a jury verdict that found the veterinarian to be thirty percent liable and the owner seventy percent liable.[112] No damages were awarded.[113] The owner claimed error in not allowing the jury to consider emotional distress and loss of consortium damages.[114] The Arizona Court of Appeals rejected these sums when

100. 231 P.3d 840 (Wash. Ct. App. 2010).
101. *Id.* at 843.
102. *Id.*
103. *Id.*
104. Wash. Rev. Code § 34.05.
105. *Newman*, 231 P.3d at 844.
106. *Id.* at 847.
107. *Id.* at 844.
108. *Id.* at 849.
109. *Id.*
110. *Id.*
111. 222 P.3d 272 (Ariz. Ct. App. 2009).
112. *Id.* at 274.
113. *Id.*
114. *Id.* at 277–78.

arising from negligent injury or death to a companion animal.[115] It further found no requirement to decide whether Kaufman was entitled to "value to owner" or sentimental value (as opposed to market value) as Kaufman did not pursue either theory at trial.[116]

In *Smith v. University Animal Clinic, Inc.*,[117] an animal clinic inadvertently switched name tags on one of the Smiths' hospitalized cats and released the cat to another clinic client.[118] The cat subsequently escaped and was never found. The trial court ruled that plaintiffs could recover emotional damages but awarded none, after finding that damages would not exceed $800 in boarding and other charges that the clinic waived.[119] The appellate court reversed in part, finding that statutory emotional damages apply only

> (1) when the property was damaged by an intentional or illegal act; (2) when the property was damaged by acts giving rise to strict or absolute liability; (3) when the property was damaged by activities amounting to a continuous nuisance; and (4) under circumstances where the owner was present or nearby at the time the damage occurred and suffered psychic trauma in the nature of or similar to a physical injury as a direct result of the incident itself.[120]

Although the court found that plaintiffs satisfied none of these criteria, it did agree with their argument that the 2004 revisions to the Louisiana Civil Code created a fifth category, i.e., a depositary in breach of what amounts to be a nonpecuniary contract.[121] Deeming a cat to be "corporeal movable property," the court agreed that the Smiths had a contract of deposit with the clinic for the safekeeping and return of their cats.[122] Significantly, the court found the contract of deposit was to gratify a nonpecuniary interest and the clinic knew or should have known that failure to perform would cause a nonpecuniary loss.[123] However, the court did not disturb the trial court's finding that $800 was "in line with awards made for similar losses in this state as well as nationally."[124]

E. *Dog Bite Litigation*

In *Miletich v. Kopp*,[125] the victim of a dog bite appealed dismissal on summary judgment on the basis that triable issues of fact existed with respect

115. *Id.* at 278–79.
116. *Id.* at 277.
117. 30 So. 3d 1154 (La. Ct. App. 2010).
118. *Id.* at 1155–56.
119. *Id.* at 1156.
120. *Id.* (citing Frank L. Maraist & Thomas C. Galligan Jr., Louisiana Tort Law § 7.02[6] (2d ed. 2004)).
121. *Id.* (citing La. Civ. Code Ann. arts. 2926, 2930 (2004)).
122. *Id.* at 1157.
123. *Id.*
124. *Id.* at 1158.
125. 895 N.Y.S.2d 557 (N.Y. App. Div. 2010).

to scienter.[126] After the owners established prima facie entitlement to judgment as a matter of law, plaintiff failed to create a material factual dispute, despite offering evidence that (1) the owners routinely restrained the dog to keep him from running away; (2) the dog was "nippy" or "territorial" when he was several weeks old (the dog was about four at the time of the bite); (3) one of defendants had seen that the Chow Chow breed was identified as potentially aggressive and was aware of incidents of aggressiveness involving that breed; and (4) the manner of the bite in question was aggressive.[127]

In *Underhill v. Hobelman*,[128] the parties were friends. Dinner plans were foiled, however, when a dog belonging to Hobelman's mother playfully ran up to Underhill and knocked her over, resulting in injury requiring surgery.[129] Underhill sued Hobleman for strict liability under Nebraska Revised Statute § 54-601 and negligence.[130] After dismissal of the negligence claim, the only remaining issue was strict liability arising from the legislature's 1992 insertion of the word "injuring" in the following provision:

> [T]he owner or owners of any dog or dogs shall be liable for any and all damages that may accrue (1) to any person . . . by reason of having been bitten by any such dog or dogs and (2) to any person . . . by reason of such dog or dogs killing, wounding, injuring, worrying, or chasing any person or persons.[131]

Relying on its 1975 decision in *Donner v. Plymate*,[132] the court recalled its statutory interpretation of § 54-601 and found that it excluded strict liability for damages caused by "playful and mischievous acts of dogs."[133] At issue was whether the legislature intended to abrogate *Donner* through the 1992 amendment. The amendment's legislative history strongly indicated that it arose in response to a court decision where an injured person failed to recover from a broken hip because it was not a deemed a "wound" within the meaning of § 54-601.[134] With a lengthy dissent by two justices, the court found Hobelman not liable for the dog's mischievous run to Underhill.[135]

In *Tatman v. Space Coast Kennel Club, Inc.*,[136] a spectator at a dog show in which her own dog participated received a severe bite from a competitor's

126. *Id.*
127. *Id.* at 558.
128. 776 N.W.2d 786 (Neb. 2009).
129. *Id.*
130. *Id.*
131. *Id.* at 787.
132. 228 N.W.2d 612 (Neb. 1975).
133. *Underhill*, 776 N.W.2d at 788.
134. *Id.* at 787–88.
135. *Id.* at 789.
136. 27 So. 3d 108 (Fla. Dist. Ct. App. 2010).

dog. The trial court dismissed her suit against the kennel club on summary judgment by enforcing the exculpatory clause she signed at entry.[137] The Florida District Court of Appeal reversed, finding the clause to be ambiguous and, therefore, unenforceable. The phrase in question—"I agree to not hold [defendant kennel club] or Brevard County Parks & Rec. Dept. liable for any accident or injury"—was "actually most easily understood to be a release from liability for injury to a dog entered in the show, as opposed to the dog's owner."[138] The court apparently found significant the fact that the owner, but not handlers, spectators, groomers, or anyone else in attendance at the show, signed the form.[139]

Courts defined the terms *keeper* and *harborer* in *Waters v. Powell*[140] and *Pawlowski v. American Family Mutual Insurance Co*.[141] In *Waters*, the Utah Court of Appeals deemed a dog kennel manager to be the dog's keeper under a strict liability statute, resulting in dismissal of suit by the manager against the owner for dog bite injuries.[142] In *Pawlowski*, the Wisconsin Supreme Court held a homeowner strictly liable as a statutory owner (satisfying the role of harborer) as defined in Wisconsin Statute § 174.02 (2000).[143] *Owner* is defined as including "any person who owns, harbors or keeps a dog."[144] A homeowner who allows the dog to stay in the household as a favor to the dog's owner may constitute an "owner" in the sense of a keeper or harborer.[145] The court defined each term differently, with "keeper" as one "exercising some measure of care, custody or control over the dog" and "harborer" as one "sheltering or giving refuge to a dog."[146] Harboring required "something more than a meal of mercy to a stray dog or the casual presence of a dog on someone's premises. Harboring means to afford lodging, to shelter or to give refuge to a dog."[147] According to the court, such an expansion of liability did not violate public policy.[148]

In *Dougan v. Nunes*,[149] when defendants left their dog, Einstein, at plaintiffs' residence to mate with the plaintiffs' Rottweiler, Einstein bit the female plaintiff on her face. Finding liability under New Jersey's strict liability statute, the court rejected defendants' arguments that plaintiffs

137. *Id*. at 109.
138. *Id*.
139. *Id*. at 111.
140. 232 P.3d 1086 (Utah Ct. App. 2010).
141. 777 N.W.2d 67 (Wis. 2009).
142. *Waters*, 232 P.3d at 1087.
143. *Pawlowski*, 777 N.W.2d at 69.
144. *Id*. at 72 (quoting Wis. Stat. § 174.001(5)).
145. Wis. Stat. Ann. § 174.02.
146. *Pawlowski*, 777 N.W.2d at 73.
147. *Id*.
148. *Id*. at 81.
149. 645 F. Supp. 2d 319 (D.N.J. 2009).

were independent contractors who had assumed the risk of being bitten by Einstein.[150]

F. *Miscellaneous Claims*

In *Lucas v. Riverside Park Condominiums Unit Owners Association*,[151] unit owner A. William Lucas sued the association under the federal Fair Housing Act[152] and the North Dakota Housing Discrimination Act,[153] alleging failure to reasonably accommodate his therapy dog and intentional infliction of emotional distress. On appeal from summary judgment dismissal, the North Dakota Supreme Court reversed and affirmed in part.[154]

The saga began when the association sued Lucas for violating a prohibition against domestic animals after his ex-wife periodically visited with her dog. Lucas counterclaimed, expressly not requesting a reasonable accommodation but reserving the right to do so if the court upheld the ban.[155] The court held that Lucas had voluntarily waived any fair housing act claim, and that unless his health deteriorated, the association was under no obligation to honor his future requests for accommodation.[156] The North Dakota Supreme Court affirmed the decision in *Lucas I*.[157] While *Lucas I* was pending, Lucas continued to make requests for reasonable accommodation of an "assistive therapeutic companion animal" and included a psychologist's recommendation.[158] The psychologist did not report a significant change in Lucas's mental health, and the association refused the request three times.[159]

In 2007, Lucas again sued the association for violating his rights under federal and state law.[160] The association moved to dismiss and sought Rule 11 sanctions.[161] A few months after filing *Lucas II*, Lucas made a fourth accommodation request, and when the association's attorney asked for additional information, Lucas imposed what the attorney viewed as unacceptable conditions.[162] The court dismissed the case and awarded over $22,000 in sanctions.[163]

150. *Id.*
151. 776 N.W.2d 801 (N.D. 2010) (*Lucas II*), *reh'g denied* (Feb. 10, 2010).
152. 42 U.S.C. § 3601 *et seq.*
153. N.D. Cent. Code. § 14-02-.5-06 *et seq.* (1999).
154. *Lucas II*, 776 N.W.2d at 804.
155. *Id.*
156. *Id.*
157. Lucas v. Riverside Park Condos. Unit Owners Ass'n, 691 N.W.2d 862 (N.D. 2005) (*Lucas I*).
158. *Lucas II*, 776 N.W.2d at 804.
159. *Id.*
160. *Id.* at 805.
161. *Id.*
162. *Id.* at 805–06.
163. *Id.* at 806–07.

In *Lucas II*, court clarified its earlier decision, holding that (1) a plaintiff's failure to respond to a reasonable request for additional information by a defendant can lead to dismissal on the basis that the latter cannot know the plaintiff's disability and need for a service animal, and that awaiting additional information is not, in fact, a denial of the request; (2) the certifications submitted in 2007 failed to sufficiently raise genuine issues of material fact due to their conclusory and ambiguous nature; (3) defendant reasonably rejected plaintiff's added conditions for review of its request for additional medical information; and (4) the sanctions pertaining to the fourth request for accommodation were untenable and reversed.[164]

In *Friedman v. Intervet Inc.*,[165] Lawrence Friedman, asserting liability under the Ohio and New Jersey product liability statutes,[166] claimed that veterinary insulin produced by Intervet killed his companion animal. The federal district court for Northern Ohio rejected defendant's motion to dismiss the Ohio claim for failing to follow the strict Rule 12(b)(6) tests of *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*.[167] The court found that Friedman asserted sufficient factual allegations to state a claim of manufacturing defect.[168] That he relied upon FDA statements that issued a warning concerning the drug's safety prompted the court to respond:

> So? What matters is that plaintiff has asserted facts, not conclusions or theories. Nothing in *Twombly* or *Iqbal* casts a shadow over the sources of factual allegations. Indeed, facts derived from an authoritative governmental source and formally published by that source as part would appear to be a solid, hefty basis on which to rest a complaint.[169]

As to the Ohio design defect claim, the court similarly denied the motion, premised on the FDA warning and subsequent halt of the drug's production as enough "at this stage to give rise to a plausible inference that the foreseeable risks associated with the design or formulation of the [product] outweighed its benefits."[170]

Turning to the New Jersey Product Liability Act, the court found that the Ohio law does not preempt product liability claims brought under another state's statute and that Friedman, not a New Jersey resident, nonetheless had standing to pursue the NJPLA claim.[171] The court next looked

164. *Id.* at 801.
165. 2010 WL 2817257 (N.D. Ohio July 16, 2010).
166. Ohio Rev. Code §§ 2307.74, 2307.75; N.J. Stat. Ann. § 2A:58C-2.
167. *Friedman*, 2010 WL 2817257 (citing Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007), and Ashcroft v. Iqbal, 129 S. Ct. 1937 (2009)).
168. *Id.*
169. *Id.* at *4.
170. *Id.* at *5 (citing Redinger v. Stryker Corp., 2010 WL 1995829 (N.D. Ohio 2010)).
171. *Id.* at *6.

at which law governed Friedman's attempted class action. Finding more contacts in Ohio than New Jersey, Ohio law applied.[172]

That "the Lone Star State [ ] looks unkindly on cattle theft" is a fact of life that Thomas O. Bennett Jr. learned to his detriment in *Bennett v. Reynolds*.[173] At trial, defendants Bennett and James B. Bonham Corp. were acquitted of felony theft charges, but a jury did find them liable for conversion with malice of thirteen bovines that wandered onto the corporation's land.[174] The award of $5,327.11 in actual damages raised no eyebrows, but even the Texas Supreme Court balked at exemplary damages that were forty-seven and 188 times over the compensatory award. The court found that the ratio analysis must be "assiduously followed," notwithstanding the evidence of malicious cattle rustling and furtive acts of concealment, and remanded for remittitur.[175]

III. EQUINE-RELATED CLAIMS

A. *Negligence*

In *Everett v. State Farm Fire & Casualty Insurance Co.*,[176] plaintiff was injured when he fell from a horse owned by defendants. The jury found in favor of defendants and plaintiff appealed, alleging that the court improperly instructed the jury on the standard applicable to an injury caused by a domesticated animal.[177] Applying the standard provided by the Louisiana Civil Code,[178] the jury instruction in part stated that in order to recover, plaintiff must prove that

> (a) the animal in question was owned by the defendant; (b) the animal presented an unreasonable risk of harm; (c) the defendant knew or in the exercise of reasonable care, should have known, the risk of harm; (d) the damage could have been prevented by the exercise of reasonable care, and defendant failed to exercise such reasonable care; and (e) he was damaged as a result of the animal's behavior.[179]

Applying this strict liability standard, the jury found in favor of defendants, concluding that the horse involved did not present an unreasonable risk of harm.[180] On appeal, plaintiff argued that the jury instruction was erroneous and that the trial court erred: (1) in not instructing the jury on

172. *Id.* at *7–8.
173. 315 S.W.3d 867, 868 (Tex. 2009).
174. *Id.* at 869.
175. *Id.* at 877, 880.
176. 37 So. 3d 456 (La. Ct. App. 2010).
177. *Id.* at 460–61.
178. *Id.* at 459–60 (citing La. Civ. Code art. 2321).
179. *Id.* at 460.
180. *Id.*

the legal definition of unreasonable risk of harm, (2) in requiring plaintiff to prove the horse presented an unreasonable risk of harm, and (3) by not including the ordinary negligence standard on the verdict form.[181]

The appellate court agreed, finding the trial court erred in failing to reference the duty/risk analysis, or the five elements necessary in order for liability to attach in an ordinary negligence claim—i.e., duty, breach of duty, cause and fact, legal cause, and actual damages.[182] Because this case did not involve a dog, which is specifically exempted by Louisiana Civil Code, the appellate court concluded that the trial court erred by requiring a finding that the animal in question posed an unreasonable risk of harm. The instructions given tainted the jury's verdict, which the court set aside.[183]

The court next examined the case de novo.[184] Plaintiff had the burden of proving that defendants knew or, in the exercise of reasonable care, should have known that the horse's behavior would cause damage, that the damage could have been prevented with the exercise of reasonable care, and that defendants failed to exercise that reasonable care.[185] Stating that plaintiff failed to meet this burden, the court found nothing in the record to indicate that the horse was anything but a gentle animal.[186] Furthermore, an expert veterinarian, after examining the horse and watching a rider take it through a number of moves, testified that the horse, which had a prior history of barrel racing, was similar to other barrel racing horses used by his association in therapy sessions with mentally and physically disabled children.[187]

At the time of the incident, the horse was in the control of plaintiff, who had an opportunity to stop and dismount. None of the evidence suggested that defendants had knowledge of the horse's alleged previous and vicious temperament. Therefore, there was no breach of duty under a duty/risk analysis. Although the appellate court applied a different standard than that of the jury in the trial court, namely duty/risk analysis rather than strict liability, it affirmed the judgment of the trial court and assessed cost of the appeal against plaintiff.[188]

In a pair of decisions issued by New York courts, *Stanislav v. Papp*[189] and *Johnson v. City of New York*,[190] the injured plaintiffs sued the owner of the

181. *Id.*
182. *Id.* at 463–64.
183. *Id.* at 463.
184. *Id.*
185. *Id.* at 464.
186. *Id.* at 465–66.
187. *Id.*
188. *Id.*
189. 2009 WL 2929772 (N.Y. Sup. Ct. Sept. 9, 2009) (unreported).
190. 2009 WL 4282859 (N.Y. Sup. Ct. Nov. 30, 2009) (unreported).

horses they were riding for injuries suffered while on a trail ride.[191] Both plaintiffs, who were experienced riders, claimed they fell when their horses were spooked and moved unexpectedly.[192] The court in both cases granted summary judgment for defendants on the basis that plaintiffs were riding voluntarily and assumed the known risks of injury. In *Johnson*, the court further found that defendant had no duty of care to prevent plaintiff from the risks associated with horseback riding.[193]

The New York courts also addressed the issue of duties owed by operators of hansom cabs. In *Figueroa v. Tornabene*,[194] a runaway horse pulling a hansom cab struck another vehicle. The driver and passenger of the vehicle brought an action against the hansom cab operator for personal injuries.[195] The appellate court reversed the trial court's decision and found that the operator of the hansom cab exercised reasonable diligence in its care and operation. Defendant established a prima facie case that he was entitled to judgment as a matter of law by submitting testimony that the operator did not drive the hansom cab negligently at the time of the accident.[196] The court further stated that no rule of law compels a person driving a horse on a highway to keep the horse under absolute control; the driver is bound to exercise a reasonable degree of diligence and care.[197]

In *Phillips v. North Carolina State*,[198] plaintiff's rare broodmare died due to the negligence of the defendant's horse breeding management facility. The Industrial Commission awarded damages to plaintiff for the value of the horse, $50,000, and compensatory damages in the amount of the profit for a single breeding cycle, $9,000, for a total of $59,000. Plaintiff appealed, claiming that the proper measure for compensatory damages was the lost profits from the future opportunity to breed the mare over her remaining reproductive years, not just a single cycle.[199] The defendant cross-appealed arguing that plaintiff was not entitled to any compensatory damages.[200]

The court reiterated that the proper measure for consequential damages for reproducing livestock is (1) the value of the animal under North Carolina law at the time of death and (2) the consequential damages, if any, that a plaintiff may incur between the time of the death of the animal until such time that a replacement of the like kind and quality can be found

191. *Stanislav*, 2009 WL 2929772, at *2; *Johnson*, 2009 WL 4282859, at *1.
192. *Stanislav*, 2009 WL 2929772, at *2; *Johnson*, 2009 WL 4282859, at *1.
193. *Johnson*, 2009 WL 4282859, at *2.
194. 902 N.Y.S.2d 637 (N.Y. App. Div. 2010).
195. *Id.* at 638.
196. *Id.* at 639.
197. *Id.*
198. 697 S.E.2d 433 (N.C. Ct. App. 2010).
199. *Id.* at 435.
200. *Id.* at 434–35.

and purchased.[201] The court found that the evidence in the case demonstrated that the mare likely could have produced one foal during the year of replacement and therefore plaintiff was entitled to loss of profits for one breeding cycle in addition to the value of the mare.[202] Plaintiff has a duty to mitigate damages and therefore must exercise reasonable care and diligence to avoid or lessen the consequences of the defendant's wrong. Under this principle, plaintiff proved that he was entitled to the value of one breeding cycle, but not to the value of her lost breeding.[203]

Finally, in *Morrissey v. Arlington Park Racecourse*,[204] plaintiff, a professional thoroughbred exercise rider, sued defendant, alleging the defendant negligently maintained the premises. Plaintiff argued that the defendant permitted standing water and soap to accumulate on the asphalt next to a training track exit, and plaintiff was injured when the horse slipped on the soapy asphalt.[205] Defendant moved for summary judgment, arguing that the soapy area was obvious to jockeys traversing the area and that plaintiff assumed the risks riding the horse on defendant's premises. The motion was granted and plaintiff appealed.[206] On appeal, plaintiff argued that (1) the trial court erred when it refused to apply the deliberate encounter exception to the open and obvious rule and (2) as a professional jockey, plaintiff assumed the inherent risks of riding his horse under these conditions.[207]

The deliberate encounter exception allows liability where a landowner should reasonably expect that his invitees will proceed in the face of open and obvious dangers when the advantages of doing so would outweigh the apparent risks.[208] The defendant argued that the deliberate encounter exception did not apply because reasonable alternative routes around the soapy asphalt were available. The court rejected this argument, finding a question of fact on the issue because the question was not whether alternative routes existed but rather whether a landowner could reasonably foresee that plaintiff would nevertheless have chosen to encounter that condition. In reaching this holding, the court noted that track employee witnesses testified that numerous horses had to be moved quickly back and forth through this area throughout the day to exercise the horses on the training track.[209]

The court also rejected defendant's arguments that plaintiff assumed the risk of injury. The court noted that a plaintiff did not assume risk of injury

201. *Id.* at 438.
202. *Id.*
203. *Id.* at 437.
204. 935 N.E.2d 644 (Ill. Ct. App. 2010).
205. *Id.* at 646–48.
206. *Id.*
207. *Id.*
208. *Id.* at 657.
209. *Id.* at 658–60.

that was created by defendant's negligence as opposed to the nature of the activity itself.[210] The court also concluded that plaintiff's assumption of risks associated with riding a horse would not necessarily escape the application of the deliberate encounter exception. Accordingly, the court reversed the trial court's granting of summary judgment, finding that there were legitimate questions of fact to present to a jury.[211]

B. *Equine Activity Liability Statutes*

The Tennessee Court of Appeals recently interpreted the scope of the Tennessee Equine Activities Act (TEAA).[212] In *Smith v. Phillips*,[213] on an informal trail ride with other friends, plaintiff was bitten by defendant's horse when plaintiff dismounted and walked his horse close to defendant's horse.[214] The trial court granted defendant's motion for summary judgment. Plaintiff appealed, contending that the trial court improperly ruled that the TEAA provided defendant immunity from liability.

Defendant would have immunity under the TEAA if plaintiff was a "participant" whose injury resulted from risks inherent in an "equine activity."[215] The court, therefore, addressed whether the TEAA applied to injuries arising out of a "completely informal, social recreational activit[y] involving horses or other equines."[216] The TEAA defines an equine activity as "rides, trips, hunts or other equine activities of any type however formal or impromptu 'that are sponsored by an equine activity sponsor.' "[217] Relying upon the sponsorship portion of the definition, the court found that the TEAA did not cover plaintiff's trail ride because neither of the parties was an equine activity sponsor under the TEAA.[218] The trial court judgment was reversed and the case remanded for further proceedings.[219]

In a case of first impression, the court in *Perry v. Whitley County 4H Club, Inc.*[220] interpreted provisions of the Indiana Equine Act (IEA).[221] Plaintiff was unexpectedly kicked by a horse while assisting children during a competition sponsored by the local 4H club at its facilities.[222] Plaintiff sued the 4H club for negligence in "allowing horse activities to be conducted on

210. *Id.* at 661–62.
211. *Id.*
212. Tenn. Code Ann. §§ 44-20-101–05 (1992).
213. 2010 WL 1221436 (Tenn. Ct. App. Mar. 29, 2010).
214. *Id.* at *1.
215. *Id.* at *4 (citing Tenn. Code Ann. § 44-20-102(3)).
216. *Id.*
217. *Id.* at *4–5.
218. *Id.*
219. *Id.* at *6.
220. 931 N.E.2d 933 (Ind. Ct. App. 2010).
221. Ind. Code § 34-31-5-5 (1998).
222. *Perry*, 931 N.E.2d at 934–35.

premises unsuitable for such activities."[223] The court found that the club was a sponsor of an equine activity; plaintiff was a participant in the equine activity; and the cause of plaintiff's injury, being kicked by a horse, is an inherent risk of an equine activity. The trial court granted summary judgment in favor of defendants based on the IEA.[224]

As a threshold issue, the appellate court noted that IEA immunities apply only if a warning sign was properly posted and maintained in at least one location on the grounds or in the building where the equine activity occurred.[225] The sign must be clearly visible, printed in black letters at least one inch in height, and in proximity to the equine activity. The appellate court found undisputed evidence, namely the affidavit of the 4H club board president, that the club maintained the equine activity warning signs, and therefore the IEA applied.[226]

As in other state equine activity liability acts, an equine sponsor in Indiana is not liable for injury or death of a participant from the inherent risk of equine activities.[227] The IEA identifies liability exceptions[228] but is silent on the issue of sponsor negligence in the overall scheme of equine liability. The court opined that the IEA was not intended to abrogate causes of action for common law negligence of an equine activity sponsor.[229] If none of the statute's liability exceptions apply, a sponsor is not liable for failing to use reasonable care to mitigate an already inherent risk of equine activity that ultimately results in the participant's injury.[230] The appellate court found no genuine issue of material fact that the 4H club complied with the IEA's warning sign requirements and that plaintiff's injury resulted from inherent risks of equine activities. If the club was negligent, it was only for failing to mitigate those inherent risks. Therefore, the IEA barred plaintiff's claim.[231]

In *Zuckerman v. Camp Laurel*,[232] plaintiff was injured during her riding lesson at the defendant camp. Plaintiff alleged that her saddle slipped and caused her to fall because her instructor failed to properly tighten the girth.[233] The camp's witnesses testified that the saddle did not slip, but rather plaintiff simply lost her balance.[234] The camp filed a motion for sum-

223. *Id.* at 935.
224. *Id.* at 935–36.
225. *Id.* at 936–37.
226. *Id.* at 937–38.
227. Ind. Code § 34-31-5-5.
228. *Id.* at § 34-6-2-69; *Perry*, 931 N.E.2d at 937–40.
229. *Perry*, 931 N.E.2d at 940.
230. *Id.*
231. *Id.* at 940–41.
232. 2010 WL 746049 (D. Me. Mar. 1, 2010).
233. *Id.* at *3.
234. *Id.* at *3–4.

mary judgment claiming immunity under Maine's Equine Activity Statute (MEAS).[235] The camp asserted that plaintiff had actual knowledge of the inherent risks of the activity and that no exception under the MEAS applied to the cause of plaintiff's injury.[236] Plaintiff argued that a question of fact existed as to the application of the statute's faulty tack exception.[237]

In a case of first impression, the court examined the MEAS, noting that

> [the] statute defines inherent risks with examples that all pertain to the unpredictable nature of equine behavior, the unpredictable conduct of other individuals, and certain natural hazards, rather than the more predictable behavior of sponsors or instructors (such as decisions related to tack, which are elsewhere excluded).[238]

The court denied the camp's motion for summary judgment concluding that the record raised a genuine issue of fact concerning faulty tack. Therefore, the MEAS did not preclude the plaintiff's claim.

In *Beattie v. Mickalich*,[239] the plaintiff was injured on a horse that was "green broke." The Michigan Supreme Court majority found that the plaintiff was not required to plead a claim in avoidance of the limitations on liability explicitly provided by the Michigan Equine Activity Liability Act (MEALA).[240] The court further stated that the MEALA "abolished strict liability for horse owners" but not negligence actions against them.[241] The court noted that since plaintiff offered admissible documentary evidence supporting her argument that defendant was negligent, the trial and appellate courts erroneously granted defendant's motion for summary judgment.[242] The court reversed the judgment of the appellate court and remanded the case to the trial court for further proceedings.[243]

One concurring opinion disagreed that the MEALA permits a negligence claim only when it involves something other than inherently risky equine activity.[244] The concurring justice wrote that the appellate court and the dissent ignored the fact that horse owners were strictly liable at common law.[245] Although the MEALA signifies that a horse owner is no longer subject to strict liability, it does not immunize a defendant from an action in which a plaintiff alleges a defendant was negligent in failing to warn him

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235. *Id.* at *1; Me. Rev. Stat. tit.7 §§ 4101–4103-A (1991).
236. *Zuckerman*, 2010 WL 746049, at *7.
237. *Id.* at *8.
238. *Id.* at *9.
239. 784 N.W.2d 38 (Mich. 2010).
240. *Id.* at 39; Mich. Comp. Laws § 691.1661–67 (1995).
241. *Beattie*, 784 N.W.2d at 39.
242. *Id.*
243. *Id.* at 38.
244. *Id.* at 39 (Markman, J., concurring).
245. *Id.* at 40.

about dangerous propensities of a horse, including its history of throwing other riders.[246]

The dissenting justices concurred in part and dissented in part. Specifically, they would uphold the portion of the appellate judgment that affirms dismissal based on the MEALA.[247] The dissent provides a lengthy explanation of the statutory construction and interpretation of the four limitations on liability enumerated in the Act.[248] The dissent found that plaintiff cannot establish that defendant committed a human error, above and beyond the inherent or essential risk of the equine activity, in saddling the "green broke" horse, such that defendant increased the danger involved in the activity.[249]

The New Jersey Supreme Court interpreted the provision of its New Jersey Equine Activity Liability Act (NJEALA)[250] in *Hubner v. Spring Valley Equestrian Center*.[251] In *Hubner*, plaintiff sued the riding facility, alleging that she was injured when the horse she was riding backed up and tripped over a cavaletti.[252] The horse fell and plaintiff was thrown, landing on a portable mounting block that caused her injuries. Plaintiff submitted an expert report that opined that defendant was negligent because the cavaletti was unsecured and set up near a mounting area behind the horse. Plaintiff's expert also opined that the portable mounting block had been negligently left behind the horse.[253]

The trial court granted summary judgment for defendant, concluding that the NJEALA's faulty tack exception was not applicable because the cavaletti was not faulty, but simply part of the riding ring.[254] The appellate court reversed, relying on the NJEALA's faulty tack exception[255] and the plaintiff's expert opinion, i.e., that placement of equipment in a position that creates an unnecessary risk of personal injury may constitute negligent disregard for the participant's safety.[256]

The New Jersey Supreme Court disagreed, stating that the faulty equipment exception does not encompass equipment in good working

246. *Id.*

247. *Id.* at 41 (Young, J., concurring in part and dissenting in part).

248. The exceptions include faulty tack, rider's ability not matching the horse's personality, and dangerous latent conditions of the land, and that these are all inherent risks of an equine activity. *Id.* at 40.

249. *Id.* at 42.

250. N.J. Stat. Ann. § 5:15-1–12 (1998).

251. 1 A.3d 618 (N.J. 2010).

252. For nonequestrians, according to merriam-webster.com, a cavaletti is a "series of timber jumps that are adjustable in height for schooling horses."

253. *Hubner*, 1 A.3d at 622.

254. *Id.*

255. *See* N.J. Stat. Ann. § 5:15-1(a)(b) (1998).

256. *Hubner*, 1 A.3d at 622.

order.[257] Based on the evidence in the case, the court found that the cavaletti was in good condition and was on the ground in the middle of the riding ring where it was part of the equipment intended for rider training and was therefore not faulty under the NJEALA.[258] The court concluded that "[t]o the extent that the operator of the facility might be liable based on the manner of [the cavelleti] placement, it would not be because they were faulty, but because the operator acted with negligent disregard for the participant's safety within the meaning of [the NJEALA]."[259]

The negligent disregard exception requires the plaintiff to demonstrate that the injury arose not because of one of the inherent dangers of the sport, but because the facility's operator breached one of the duties it owes to the participant, as defined in the statute's exceptions.[260] The plaintiff in this case was facing the cavaletti before and after she mounted the horse and then the horse turned around and tripped over the cavaletti when backing up.[261] These undisputed facts are within the defined inherent risks of an equine activity and therefore, according to the court, within the risks that plaintiff assumed.[262] Thus, the New Jersey Supreme Court reversed the appellate court and reinstated the trial court's entry of summary judgment in favor of defendant.

C. *Liability Releases*

In *Glenn v. Annuzjata*,[263] plaintiff was injured when she fell from a horse during her riding lesson at defendants' facility. Plaintiff alleged she fell when her horse moved sideways after corrugated metal fell from the roof.[264] Defendants alleged that the horse was startled by the squeaking sound of two pieces of metal that rubbed together due to high winds.[265] The trial court found the liability release signed by plaintiff released defendants from liability and granted defendants' motion for summary judgment.[266] The appellate court reversed, finding that the liability release did not insulate the stable defendants from liability for their own negligent acts.[267] The appellate court also found a question of fact regarding whether the roof was in a defective condition on the date of the accident and whether the stable

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257. *Id*. at 632.
258. *Id*.
259. *Id*. at 630–31.
260. *Id*. at 626.
261. *Id*. at 632.
262. *Id*. at 631–32.
263. 898 N.Y.S.2d 265 (N.Y. App. Div. 2010).
264. *Id*. at 266.
265. *Id*.
266. *Id*.
267. *Id*.

defendants were negligent in failing to remedy the defect.[268] The court further determined a question of fact remained as to whether plaintiff assumed the risk of falling from the horse. The court observed that "[w]hile the plaintiff assumed the risk that she could be thrown by a frightened horse, the stable defendants offered no evidence that the plaintiff assumed the heightened risk created by the alleged defective condition of the roof of the indoor riding arena."[269] The case was therefore reversed and remanded for further proceedings.[270]

In *Dow–Westbrook, Inc. v. Candlewood Equine Practice, LLC*,[271] plaintiff's horse was boarded at the Candlewood Equine Practice Clinic for breeding by artificial insemination.[272] The plaintiff's witness testified at trial that the clinic was instructed to not turn the horse out with other horses. However, the horse was severely injured by another horse in turnout, rendering it valueless for any use other than a companion animal.[273] Plaintiff sued the clinic for negligently turning the horse out and failing to care for and supervise it in breach of the boarding agreement. The clinic filed a counterclaim seeking indemnification for breach of the agreement's hold harmless provision.[274]

The appellate court affirmed the trial court's finding that the clinic did not violate any standard of care,[275] after finding credible the testimony of the clinic's witness denying that the clinic received any instructions regarding the horse's turnout.[276] Furthermore, the boarding agreement did not include any turnout restrictions in the special instructions section.[277]

Turning to the defendant's counterclaim, the court acknowledged that although Connecticut courts generally disfavor hold harmless provisions as against public policy,[278] they have recognized the enforceability of these provisions where both parties to the contract are commercial entities and of equal bargaining power.[279] In *Dow–Westbrook*, both plaintiff and defendant were commercial entities with similar experience and sophistication.[280] Plaintiff required its own riding and horse show clients to sign documents containing similar hold harmless provisions.[281] Moreover,

268. *Id*.
269. *Id*. at 266–67.
270. *Id*. at 267.
271. 989 A.2d 1075 (Conn. App. Ct. 2010).
272. *Id*. at 1078.
273. *Id*.
274. *Id*.
275. *Id*. at 1075.
276. *Id*. at 1079.
277. *Id*.
278. *Id*. at 1082.
279. *Id*.
280. *Id*.
281. *Id*. at 1083.

plaintiff could have had the horse inseminated at a different stable. These facts led the appellate court to find that the plaintiff and defendant had equal bargaining power and that the hold harmless provision did not violate public policy.[282]

In another artificial insemination case, plaintiff was kicked and injured by his stallion while assisting with the semen collection process at defendant's breeding facility.[283] In *Wilson v. Davis*,[284] plaintiff sued defendant for negligence, breach of contract, fraud, and misrepresentation. In denying defendant's motion for summary judgment, the court ruled that the liability waiver contained in the breeding contract signed by plaintiff lacked consideration specific to the waiver.[285] The court also found that defendant had a duty to exercise reasonable care in breeding the stallion and that a question of fact existed whether he was in fact negligent.[286]

The California Court of Appeal enforced a liability release in *Pendergrass v. Diamond Bar & Circle K Horse Rentals*.[287] In this case, plaintiff sued defendant alleging she broke her right ankle and leg when she was thrown from a horse that she had rented from defendant's commercial riding stable. The appellate court found that the action was barred by the primary assumption of risk doctrine and express assumption of risk based on a written release of liability signed by plaintiff.[288]

Plaintiff signed a participant agreement acknowledging her assumption of risk prior to her participating in the trail ride.[289] She also signed an addendum that stated in essence that she refused to wear a helmet against the advice of defendant and assumed a risk of injury.[290] During her deposition, the plaintiff admitted that she read and signed both agreements. She testified that she had informed the staff at the stable that she had never ridden a horse before and that she asked if she could ride her horse with high-heeled sandals.[291]

Plaintiff sued the defendant for negligence and gross negligence. In opposition to defendant's motion for summary judgment, plaintiff submitted expert testimony stating that new riders should be given a demonstration on how to ride and control their horses and that proper riding attire, including well-fitting closed-toe shoes or boots, is essential.[292]

282. *Id*. at 1085.
283. Wilson v. Davis, 2010 WL 2228262 (W.D. Ky. 2010).
284. *Id*. at *1.
285. *Id*. at *3.
286. *Id*.
287. 2010 WL 3387541 (Cal. Ct. App. Aug. 30, 2010).
288. *Id*. at *1.
289. *Id*.
290. *Id*. at *2.
291. *Id*.
292. *Id*. at *3.

Under California law, the defendant moving for summary judgment has the burden to establish that defendant owes no legal duty to plaintiff to prevent harm in which the plaintiff complains in support of the primary assumption of risk doctrine.[293] The commercial operator of a trail ride business geared toward inexperienced riders has a duty to "ensure the facilities and related services which are provided do not increase the risk of injury above the level of inherent in such a trail ride."[294] The court found that undisputed evidence confirmed that the participant agreement signed by plaintiff stated that saddles may slip and other tack/saddle problems may develop as a result of normal use and wear.[295] The court also noted that there is no legal duty to protect a participant from the careless conduct of others who are participating in the sporting activity.[296] Plaintiff failed to show that any additional factors substantially contributed to her accident, including the fact that defendant allowed her to wear inappropriate footwear and defendant's alleged failure to show riders how to lead and control their horses.

D. *Breach of Contract*

In *Dixon v. Herman*,[297] after plaintiffs bought a horse from defendants for $100,000, they requested, among other things, a bill of sale.[298] The bill of sale listed the horse's approximate age as eleven but plaintiffs later learned from the U.S. Equestrian Federation that the horse was actually thirteen years old.[299] Plaintiffs brought the age discrepancy to the attention of defendants, who again confirmed the horse was eleven, and the plaintiffs continued to show the horse.[300] After learning from a reliable third party that the horse was in fact thirteen years old, plaintiffs demanded a full refund, and defendants refused to return the money. Plaintiffs filed suit for breach of implied warranty, violation of the Texas Deceptive Trade Practices Act, breach of contract, fraud, fraudulent misrepresentation, and rescission.[301]

The trial court granted defendants' motion for summary judgment, and the appellate court affirmed, on the grounds that the defendants made no representations concerning the horse's age, health, or history prior to the sale.[302] Furthermore, the court pointed out that "the bill of sale was not

293. *Id.* at *4.
294. *Id.*
295. *Id.* at *5.
296. *Id.*
297. 2010 WL 3038598 (Tex. App. Aug. 5, 2010), *reh'g denied* (Oct. 20, 2010).
298. *Id.* at *1.
299. *Id.*
300. *Id.* at *2.
301. *Id.*
302. *Id.* at *2–3.

discussed prior to the sale and was not a condition for the formation of the contract."[303] The appellate court affirmed summary judgment on the breach of contract claim, claims under the DTPA, and claims of fraud and fraudulent misrepresentation.[304] As to the plaintiffs' breach of warranty claim, the appellate court affirmed summary judgment because there were no representations by the defendants, the bill of sale was not part of the contract, defendants made no warranties to the plaintiffs, and the "as is" provision in the bill of sale was not necessary to defeat the plaintiffs' breach of warranty claims.[305]

In *Curry v. Bennett*,[306] the Kentucky Court of Appeals allowed testimony showing that defendant reasonably relied on the apparent authority of plaintiff's trainer to negotiate a breeding contract. The court further found that testimony by the owner and trainer regarding the colt's lost prize-winning potential as the basis for calculating damages was not "too speculative."[307] The court held that, in Kentucky, evidence of habit or routine practice of an organization is admissible to prove that the conduct of a person on a particular occasion was in conformity with his or her stated habit or routine practice.[308]

E. *Insurance Cases*

1. Racetrack Insurance Coverage

In *Giacomelli v. Scottsdale Insurance Co.*,[309] the Montana Supreme Court reviewed the applicability of racetrack insurance coverage to injured jockeys. Jockeys who suffered injuries in horse races at a park owned and operated by the county brought a declaratory judgment action seeking a declaration that the commercial general liability (CGL) policy obtained by the track operator covered their negligence claims.[310]

The first issue on appeal was whether the relevant Montana statute mandated liability insurance coverage for jockeys.[311] The jockeys argued that the statute mandated coverage for exhibitors of a race and therefore mandated coverage for them.[312] After looking at the dictionary definition of *exhibitors*, as well as similar statutes in neighboring jurisdictions, the court determined that the statutory protection afforded exhibitors did

303. *Id* at *3.
304. *Id*.
305. *Id*.
306. 301 S.W.3d 502 (Ky. Ct. App. 2009).
307. *Id*. at 506.
308. *Id*. at 504–05 (citing Ky. R. Evid. 406).
309. 221 P.3d 666 (Mont. 2009).
310. *Id*.
311. *Id*. at 696.
312. *Id*.

not include jockeys but was meant to cover race organizers.[313] Although some case law suggested that horse riders could be considered exhibitors, these cases were factually distinguishable because they dealt with displays of horsemanship at county fairs, not pari-mutuel wagering.[314]

Next, the jockeys argued that the athletic or sport participants exclusion in the CGL did not bar coverage because the exclusion itself was ambiguous and should be construed against the insurance company that drafted the clause.[315] The court disagreed, finding that the language used in the exclusion at issue was not ambiguous and was thus enforceable.[316] The court declined to accept any other interpretation of the sport and athletic participant exclusion because to do so would "do violence" to the language of the policy.[317] Even though authorities were split as to the construction of similar provisions, the court determined that this fact, by itself, did not create a conclusive presumption of ambiguity.[318]

Finally, the jockeys argued that the sport and athletic event participant exclusion violated their reasonable expectations of coverage.[319] The court ultimately dismissed this argument, stating that because the terms of the policy at issue clearly demonstrated the intent to exclude coverage, the reasonable expectations doctrine was inapplicable because expectations contrary to a clear exclusion are not objectively reasonable.[320] Therefore, the jockeys' claim was barred.

2. Business Pursuit Insurance Exclusion

In *May v. Holzknecht*[321] and *Holzknecht v. Kentucky Farm Bureau Mutual Insurance Co.*,[322] the Kentucky Court of Appeals reviewed companion cases addressing tort liability for injuries to a child pursuant to a dog-bite statute and insurance coverage issues relating to a business pursuit. The plaintiff's mother brought an action against the defendants and their homeowners' insurer for injuries sustained by her two-year-old daughter from a dog attack at a home-based child care business.

In the first case, the appellate court found the dog owners liable pursuant to the Kentucky dog-bite statute and held that the daycare operator's husband was liable by virtue of his status as keeper of the dog.[323] However,

313. *Id.* at 670.
314. *Id.* at 671.
315. *Id.* at 672.
316. *Id.* at 674.
317. *Id.* at 673.
318. *Id.* at 674.
319. *Id.*
320. *Id.*
321. 320 S.W.3d 123 (Ky. Ct. App. 2010).
322. 320 S.W.3d 115 (Ky. Ct. App. 2010).
323. *May*, 320 S.W.3d at 127–28.

the court explained that the dog-bite statute did not impose strict liability on the keepers of the dog, but rather the defendants were liable because neither the two-year-old nor any third party was at fault to exculpate the defendants.[324]

In the companion insurance coverage case, decided the same day, the court ruled that the homeowner's insurance policy held by the daycare provider specifically excluded coverage for the child's injuries because they arose out of the daycare business.[325] Further, the court found the insurance policy was not severable with regard to the business pursuit exclusion and thus coverage was not preserved for the daycare provider's husband because he was minimally involved in the business.[326] The court concluded that the only clear protection for the defendants was a business risk endorsement that they chose not to add to their policy.[327]

3. Resident–Relative Exclusion

In *Farm Bureau Insurance Co. of Idaho v. Kinsey*,[328] plaintiff was injured when the defendant's dog jumped out of the defendant's truck, ran across the road, and collided with the plaintiff motorcyclist. The accident occurred outside the home of the defendant's grandmother, and the plaintiff sued the defendant for his damages.[329] Plaintiff appealed the trial court's grant of summary judgment, arguing that the court erred in finding the defendant was not covered as a resident under his grandmother's home insurance policy.[330]

The Idaho Supreme Court discussed how the facts of the case supported a reasonable inference that the defendant was not a resident of his grandmother's home for policy purposes. The defendant's grandmother paid some of his bills and renewed his vehicle registration, and he received some mail and stored some belongings at his grandmother's, but the defendant lived at his girlfriend's home nearly all of the time.[331] As such, the court upheld the district court's determination that the defendant was not a resident of his grandmother's home and was therefore not covered under her home insurance policy for purposes of the dog collision accident.[332]

4. Farm and General Liability Policies

In *Farmers Elevator, Inc. v. Hartford Fire Insurance Co.*,[333] plaintiff sued Hartford Fire Insurance Co. and Continental Western Insurance Co. for

324. *Id.* at 126–27.
325. *Holzknecht*, 320 S.W.3d at 119.
326. *Id.* at 121–22.
327. *Id.* at 122.
328. 234 P.3d 739, 741 (Idaho 2010).
329. *Id.*
330. *Id.*
331. *Id.* at 745.
332. *Id.* at 746.
333. 2009 WL 3654739 (Neb. Ct. App. 2009) (not reported).

damages incurred from the death of 223 hogs in plaintiff's care. The hogs died from excessive heat after a temperature-sensitive thermostat in the hog barn ruptured and failed to properly regulate air ventilation.[334]

Plaintiff's insurance policy with Hartford provided coverage for confined swine lost because of windstorm, explosion, smoke, and collapse. Losses directly caused by mechanical breakdown, electrical breakdown, or malfunction were excluded from coverage. Plaintiff's policy with Continental provided coverage for commercial property and commercial general liability. This policy covered losses due to explosion, windstorm, and smoke while excluding loss or damage caused by mechanical breakdown, unless the mechanical breakdown resulted in a covered cause of loss.[335]

The Nebraska Court of Appeals affirmed the lower court's finding that the hot hog death was not a covered loss under either the Hartford or Continental policy.[336] The appellate court reasoned that the loss was not covered by the policies because a "strong wind" on the night in question did not amount to a "windstorm," the metal tubing rupture on the thermostat was not an "explosion," and the thermostat failure was not a "collapse" as defined by the Nebraska Supreme Court.[337] The court also explained that the thermostat failure, was explicitly excluded on the basis of the mechanical breakdown exclusion in both policies.[338]

334. *Id*.
335. *Id*.
336. *Id*. at *3, *7.
337. *Id*. at *4–6.
338. *Id*. at *7.

RECENT DEVELOPMENTS IN APPELLATE ADVOCACY

Mary R. Vasaly, Daniel R. Deutsch, and Jennifer B. Anderson

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This article reviews the past year's significant developments related to appellate advocacy and procedure. Part I reviews the change in personnel on the U.S. Supreme Court with the retirement of Justice John Paul Stevens

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and the appointment of Justice Elena Kagan. Part II examines important opinions issued by that Court, including the controversial decision in *Citizens United v. Federal Election Commission*.[1] Part III summarizes amendments to the Federal Rules of Appellate Procedure, the most noteworthy of which requires disclosure of authorship and funding of briefs filed by amici curiae.

I. AN ERA OF CHANGE IN THE U.S. SUPREME COURT: WILL CHANGES IN PERSONNEL MAKE A DIFFERENCE?

It is always risky to make predictions about trends in the Supreme Court's decisions based on the makeup of its personnel. As some presidents have discovered, the appointment of an individual who appears to have a specific ideological bent does not always mean that the decisions of that individual will reflect that ideology, particularly over the course of many terms on the Court.[2] It is fair to say, however, that the recent resignation of Justice John Paul Stevens and confirmation of Justice Elena Kagan will affect the Court's decisions, even though these two justices might be characterized as politically similar.

A. *Justice John Paul Stevens' Term on the Court*

Justice John Paul Stevens made significant contributions to the development of the law in every legal area as a Supreme Court justice serving for well over three decades.[3] Not everyone agreed with Justice Stevens' decisions. Nevertheless, he was universally admired for his keen intelligence, integrity, and the respect he showed to his colleagues and the advocates who came before him.

He came from the heartland of the country, having been born in 1920 and raised in Illinois, the youngest of four children.[4] He attended the University of Chicago's private elementary school and high school, known as the Lab Schools, which were made famous by John Dewey's experiments in child education. Justice Stevens' family, which was quite conservative, was involved in the insurance and hotel management businesses and had amassed considerable wealth by the 1920s.[5] He attended college at the University of Chicago, where he excelled, achieving Phi Beta Kappa. He also played on the college's unbeaten tennis team and wrote for the student

1. 130 S. Ct. 876 (2010).
2. *See generally* Lee Epstein et al., *On the Perils of Drawing Inferences About Supreme Court Justices from their First Few Years of Service*, 91 Judicature 168 (2008).
3. *See generally* William Michael Treanor, *Symposium: The Jurisprudence of Justice Stevens*, 74 Fordham L. Rev. 1557, 1558 (2006).
4. Bill Barnhart & Gene Schlickman, John Paul Stevens: An Independent Life 22 (2010).
5. *Id.* at 23–24.

newspaper.[6] After graduating in 1941, he began graduate studies in English while taking classes in cryptanalysis. He joined the Naval Reserve in 1941 and was stationed in Hawaii, earning the Bronze Star.[7] After completing his tour of duty, he returned to Chicago to attend law school at Northwestern University School of Law.[8] He practiced at Poppenhusen, Johnston, Thompson & Raymond, developing an antitrust expertise. He later served on the U.S. Court of Appeals for the Seventh Circuit, having been appointed by Richard M. Nixon.[9]

Justice Stevens was nominated to the Supreme Court in 1975.[10] The confirmation process at that time bore little resemblance to the televised political production it has now become. Although it was the first confirmation after *Roe v. Wade* was decided in 1973, Justice Stevens was questioned about capital punishment and discrimination against women, but not abortion.[11] At the time, the average length of the transcript of confirmation hearings was 232 pages. The transcript of Justice Stevens' confirmation hearings was 229 pages long.[12] Three special interest groups participated.[13] This number is remarkable when compared with the statistics for the confirmation hearings that followed. For the next eight nominations, the average transcript was 1,845 pages in length and an average of eighteen special interest groups participated.[14] Forty-three special interest groups participated in the Clarence Thomas confirmation hearings.[15] That Justice Stevens' confirmation process was so brief is also remarkable when one considers that it could have been controversial. He is the only Supreme Court justice nominated by a president who was not chosen by voters in a national election. Gerald Ford, who nominated him, had been appointed by President Nixon to replace Spiro Agnew and became president when Nixon resigned.[16] Nevertheless, Justice Stevens was confirmed 98–0.[17]

During his tenure on the court, Justice Steven's judicial philosophy became more sharply defined. Always an independent thinker, he was elevated to the bench, not because of any political point of view, but because he was a political and judicial independent.[18] Some have called him an advocate for pragmatism in the law, referring to what "may be," as against Justice Scalia's

6. *Id*. at 37.
7. *Id*. at 42–43, 51.
8. *Id*. at 53.
9. *Id*. at 135.
10. *Id*.
11. *Id*. at 182.
12. *Id*.
13. *Id*. at 183.
14. *Id*. at 182–83.
15. *Id*. at 183.
16. *Id*. at 182–83.
17. *Id*. at 183.
18. *Id*. at 222.

advocacy of tradition.[19] Justice Stevens' rejection of tradition as a philosophy was based on his view that Americans had fought the Revolution and enacted the Constitution to protect individual citizens against entrenched institutions and majority values.[20] He viewed "traditions"–especially traditions in the law–"as likely to codify the preferences of those in power, as they are to reflect necessity or proven wisdom."[21]

He became more liberal and more pragmatic throughout his tenure and came to believe that a willingness to change is "a critical element of a justice's job."[22] Four decisions show the contours of his general approach to decision making. In 1984, the Court decided *Chevron USA, Inc. v. National Resources Defense Council, Inc.*,[23] a 6–0 ruling that established rules under which courts and litigants must defer to the interpretation of regulatory agencies of laws governing their work. In the decision, Justice Stevens restated a view of judicial restraint based on the premise that judges are not experts in the field and are not part of the political branches of government. He believed that government agencies are entitled to make judgments based on the incumbent administration's policies and that courts should not impose their own policy preferences. Thus, *Chevron* was a conservative decision.[24]

Also decided that year, *Sony Corp. v. Universal City Studios, Inc.*[25] was a 5–4 majority decision, authored by Justice Stevens. There, the Court held that no violation of copyright was involved in the home use of Sony Betamax videotape recorders. This liberal decision, which benefited consumers over business, helped launch the home entertainment industry. The decision was based on Justice Stevens' considerable antitrust expertise.[26]

In 2001, Justice Stevens authored an opinion for the 7–2 majority that is a classic example of judicial pragmatism.[27] In *PGA Tour, Inc. v Martin*,[28] the Court decided that a professional golfer with disabilities had a right under the Americans with Disabilities Act (ADA) to ride the course in a golf cart in violation of tour rules. Justice Stevens wrote that the ADA had no value if it did not open doors for the disabled to engage in new and untried opportunities. Justice Stevens' opinion advanced social progress by holding that the ADA applied because both spectators and golfers were "customers" of the tour.[29]

19. *Id.* at 234.
20. *Id.* at 235.
21. *Id.* at 237.
22. *Id.* at 223.
23. 467 U.S. 837 (1984).
24. Barnhart & Schlickman, *supra* note 4, at 223–34.
25. 464 U.S. 417 (1984).
26. Barnhart & Schlickman, *supra* note 4, at 224.
27. *Id.* at 225.
28. 532 U.S. 661 (2001).
29. Barnhart & Schlickman, *supra* note 4, at 225–26.

In *Atkins v. Virginia*,[30] Justice Stevens wrote a majority opinion that was clearly a traditional liberal opinion in terms of its outcome.[31] In *Atkins*, the Court ruled that the mentally impaired were not subject to capital punishment.[32] The decision overruled a 1989 precedent that addressed the scope of the Eighth Amendment. He later issued other liberal decisions on gay rights,[33] affirmative action,[34] and habeas corpus in the war on terror.[35] These decisions were not pragmatic; they were based instead on what Justice Stevens believed were evolving standards of decency. *Martin* and *Atkins*, for example, reflect his long-held belief that the law must protect individual dignity, including that of criminal defendants. Then Solicitor General Ted Olson gave him credit for the liberal bent in the Court's 2003–04 term: "Justice Stevens led the charge. . . . The crafty and genial hand of Justice Stevens . . . was everywhere evident."[36]

But despite the fact that Justice Stevens authored a number of liberal decisions, his work cannot be characterized as uniformly liberal. For example, one would think of Chief Justice Roberts as leading the conservative wing of the Court, but five of twelve opinions holding a bare majority for the conservative justices were led by Stevens. Thus, a majority of the Court's twelve 5–4 conservative decisions were authored by Justice Stevens.[37]

Over the years, Justice Stevens' ability to affect outcomes grew as he began to draw the votes of his colleagues toward his pragmatic approach to the law.[38] Nevertheless, he remained a leading writer of dissents and concurrences throughout his tenure.[39]

With Justice Stevens' retirement, we lose not only the benefit of his lengthy tenure on the Court but also the long view that comes with experience. One aspect of this is Justice Stevens' wisdom about the interplay between politics and the judicial role. Throughout his tenure on the Court, he refused to attend presidents' State of the Union addresses, explaining that

> [the] political aspect of a federal judge's career should end when his or her nomination is confirmed. It is, in my judgment a serious matter to replace an important symbol of the independence of the federal judiciary with an event that tends to blur the critical distinction between political and judicial services.[40]

30. 536 U.S. 304 (2002).
31. Barnhart & Schlickman, *supra* note 4, at 226.
32. *Atkins*, 536 U.S. at 321.
33. Lawrence v. Texas, 539 U.S. 558 (2003).
34. Grutter v. Bollinger, 539 U.S. 306 (2003).
35. Hamdi v. Rumsfeld, 542 U.S. 507 (2004); Rasul v. Bush, 542 U.S. 466 (2004); Rumsfeld v. Padilla, 542 U.S. 426 (2004).
36. Barnhart & Schlickman, *supra* note 4, at 226–27.
37. *Id.* at 229.
38. *Id.* at 228.
39. *Id.* at 229.
40. *Id.* at 254.

The importance of separating politics from judicial decision making was also evident in his harsh dissent in *Bush v. Gore*,[41] in which he wrote, "[a]lthough we may never know with complete certainty the winner of this year's Presidential election, the identity of the loser is perfectly clear. It is the Nation's confidence in the judge as the impartial guardian of the rule of law."[42] Justice Stevens clearly revered the idea that an independent judiciary created a check on undue majority power, whether in the form of unconstitutional legislation or activist judges.

Similarly, in the Court's recent decision in *Citizens United*,[43] he wrote a powerful ninety page dissent, warning that corporate money could undermine the political process:

> At bottom, the Court's opinion is thus a rejection of the common sense of the American people, who have recognized the need to prevent corporations from undermining self-government since the founding, and who have fought against the distinctive corrupting potential of corporate electioneering since the days of Theodore Roosevelt. It is a strange time to repudiate that common sense. While American democracy is imperfect, few outside the majority of this Court would have thought its flaws included a dearth of corporate money in politics.[44]

Justice Stevens observed that the decision would undermine the confidence of citizens in our democratic system:

> When citizens turn on their televisions and radios before an election and hear only corporate electioneering, they may lose faith in their capacity, as citizens, to influence public policy. . . . Politicians who fear that a certain corporation can make or break their reelection chances may be cowed into silence about that corporation.
>
> . . .
>
> The marketplace of ideas is not actually a place where items—or laws—are meant to be bought and sold. . . .[45]

The loss of Justice Stevens also represents a loss in the diversity of the members of the Court in terms of their backgrounds. None of the current justices has served in the military. None has served in the legislature. And, for the first time in the history of the Court, there will no longer be a Protestant on the court.[46] It cannot be known whether this will matter,

41. 531 U.S. 98 (2000).
42. *Id.* at 128–29.
43. Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876 (2010).
44. *Id.* at 979.
45. *Id.* at 974–77.
46. John M. Scheb II et al., *A Supreme Court Without Protestants: Does It Matter?*, 94 Judicature 12, 14 (2010).

although it is clear that justices' personal experiences do bear on their decisions. Certainly, Justice Stevens' experience in the military provided the Court with a richer background for understanding the many cases involving issues connected to the armed services. Similarly, it could only help the Court to have a justice who viewed the work of the legislative branch from having had first-hand experience with the process.

The question of religious background is more complex. In a recent article, one commentator concludes that "in terms of Supreme Court decision making, the absence of Protestants does not appear to be significant in terms of Court outputs."[47] However, he also explains that religion matters in a more general way: Jewish justices have been more liberal than their counterparts and Catholic justices more conservative but more important is the ideological orientation of the justices, which is determined by politics.[48]

B. *Appointment of Justice Elena Kagan to the Court*

Justice Elena Kagan, the newest member of the Supreme Court, is also the youngest. She was born in New York on April 28, 1960.[49] After graduating from Princeton with a degree in history, she attended Oxford on a Sachs scholarship and received a degree of master of philosophy.[50] Then she attended Harvard Law School where she was supervising editor of the *Harvard Law Review*.[51] After graduation in 1986, she clerked for Judge Abner Mikva, a judge on the D.C. Circuit.[52] She then went on to clerk for Justice Thurgood Marshall.[53] After her clerkship, she was hired as an associate by Williams & Connolly in Washington, D.C.[54] After a three-year stint at the law firm, she commenced her career in academia, beginning at the University of Chicago, where she taught administrative and constitutional law.[55] She also briefly served as special counsel to Senator Joseph Biden, who

47. *Id*. at 40.

48. *Id*. Interestingly, Justice Stevens has been seen by some as anti-religion because of his singular nonliberal, nonconservative stance on two issues. He tended to oppose government support for religion (state aid) and exemptions for individual exercise of religious beliefs (the yarmulke). Barnhart & Schlickman, *supra* note 4, at 247.

49. *Biographies of Current Justices of the Supreme Court*, Supreme Court of the United States, http://www.supremecourt.gov/about/biographies.aspx.

50. *Office of the Solicitor General: Elena Kagan*, U.S. Dep't of Justice, http://www.justice.gov/osg/aboutosg/osghistpage.php?id=45 (last visited Dec. 21, 2010) [hereinafter *DOJ Kagan*].

51. Tom Goldstein et al., *9750 Words on Elena Kagan*, SCOTUSBlog (May 8, 2010), http://www.scotusblog.com/2010/05/9750-words-on-elena-kagan/.

52. *Id*.

53. *Id*.

54. *Id*.

55. *Id*.

then chaired the Judiciary Committee, during the confirmation hearings for Justice Ruth Bader Ginsberg.[56]

In 1995, Justice Kagan joined the Clinton administration, first as associate White House counsel and later as deputy assistant to the president for domestic policy and deputy director of the Domestic Policy Council.[57] In those positions, she focused on the executive branch's formulation, advocacy, and implementation of law and policy in areas ranging from education to crime to public health.[58] She worked closely with Domestic Policy Adviser Bruce Reed. John Podesta, then President Clinton's chief of staff, said Clinton "viewed her as an independent source of advice and wisdom in grappling with those difficult policy questions."[59] As part of her primary role to address policy issues, she worked on gun control; defended Clinton's economic policies; and worked to promote campaign finance reform, abortion rights, and affirmative action policies.[60] She worked particularly hard on the passage of antismoking legislation.[61]

In 1999, she accepted a teaching position at Harvard Law School and was named dean in 2003.[62] During her six-year tenure as dean, the school expanded and enhanced its faculty, modernized its curriculum, developed new campus facilities, promoted public service, and improved the student experience.[63] She left Harvard in 2009, after President Obama nominated her to serve as the first woman Solicitor General of the United States. Her first argument was in *Citizens United*,[64] a case the government lost.[65]

Her confirmation hearings were relatively uneventful, although it had been anticipated that they might be particularly revealing. She is well known to have criticized confirmation hearings as a "vapid and hollow charade" and called for nominees to be more forthcoming.[66] Indeed, she even suggested that senators dig deeply by asking the nominee straightforward questions about her judicial philosophy and substantive views on constitutional issues.[67] She commented further that it should not be necessary

56. *Id.*; *see also* Tony Mauro, *Justice Ginsburg Eager for Kagan's Arrival*, BLT: The Blog of Legal Times (July 9, 2010), http://legaltimes.typepad.com/blt/2010/07/justice-ginsburg-eager-for-kagans-arrival.html.

57. *DOJ Kagan*, *supra* note 50.

58. *Id.*

59. James Oliphant, *Kagan a Veteran of Clinton White House*, L.A. Times, May 10, 2010, *available at* http://articles.latimes.com/2010/may/11/nation/la-na-kagan-profile-20100511.

60. *Id.*

61. *Id.* (citing Dana Milbank, *Wonderwonk*, New Republic, May 18, 1998).

62. Goldstein et al., *supra* note 51.

63. *DOJ Kagan*, *supra* note 50.

64. Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876 (2010).

65. Goldstein et al., *supra* note 51.

66. Sheryl Gay Stolberg, *At Kagan Hearings, the Topic May Be Obama and Roberts*, N.Y. Times, June 27, 2010, at A1.

67. Goldstein et al., *supra* note 51.

for a nominee to refrain from expressing her views, as long as she did not express a settled intent to vote a particular way on a particular case that might come before her.[68]

Before the hearings began, her judicial philosophy was not clear because she had never served as a judge. The committee had access to 160,000 pages of records from the nominee's tenure as an advisor to President Clinton and as a clerk for Justice Marshall, but admittedly these papers could not directly reflect on her personal judicial philosophy as she was serving others in those roles.[69] In the hearings, however, Justice Kagan laid out a clear judicial philosophy that, according to one commentator, "sees courts as having an obligation to defer to the choices of elected officials except in the most extreme cases."[70]

In her opening statement she made clear her view that the Court had an obligation to defer to other branches: "[T]he Supreme Court is a wondrous institution. But the time I spent in the other branches of government remind [sic] me that it must also be a modest one—properly deferential to the decisions of the American people and their elected representatives."[71] Carrying on this theme, she spoke to statutory interpretation in similar tones: "the most important thing in interpreting any statute, in fact, the only thing that matters is Congress' intent."[72] When the text of the statute is ambiguous, she endorsed the idea of using

> whatever evidence is at hand to understand Congress' intent—including the statute's history—and that includes exploration of Congress' purpose by way of looking at the structure of the statute, by way of looking at the title of the statute, by way of looking at when the statute was enacted and in what circumstances and by way of looking at legislative history.[73]

She also explained her views on interpreting the Constitution:

> The Constitution is a document that does not change, that is timeless, and timeless in the principles that it embodies. But it, of course, is applied to new situations, to new facts, to new circumstances all the time. And in that process of being applied to new facts and new circumstances and new situations, development of our constitutional law does indeed occur.[74]

She continued, "in [some] cases, the original intent is unlikely to solve the question. And that might be because the original intent is unknowable

68. *Id.*
69. Stolberg, *supra* note 66.
70. E.J. Dionne Jr., *A Judicial Change to Believe In*, Wash. Post, July 5, 2010.
71. Alliance for Justice, Report on Elena Kagan's Testimony 1 (2010), *available at* http://www.fed-soc.org/docLib/20100701_reportonkagantestimony.pdf.
72. *Id.* at 2.
73. *Id.*
74. *Id.* at 1–2.

or it might be because we live in a world that is very different from the world in which the framers lived. . . ."[75] She has also candidly written that courts should not engage in activism: "I think a judge should try to the greatest extent possible to separate constitutional interpretation from his or her own values and beliefs. In order to accomplish this result, the judge should look to constitutional text, history, structure and precedent."[76]

In another analysis of the confirmation hearings, a commentator said that the hearings were about two men not even present, President Obama and Chief Justice Roberts.[77] With "an eye on the midterm elections," the Democrats tried to put the Roberts Court on trial by painting it as beholden to corporate America. Republicans, on the other hand, used the hearings to put Obama "on trial over what they view as his Big Government agenda" and raise questions about whether his solicitor general would be sufficiently independent to keep that agenda in check.[78] During the confirmation hearings, Republicans expressed concern, not that nominee Kagan would be a judicial activist, but that she would be too reluctant to strike down laws. Of course, their concerns centered around Democrat-sponsored laws, such as health care reform.

One senator asked Justice Kagan whether the government could pass a law requiring Americans to eat fruits and vegetables. She initially gave a flip response: "It sounds like a dumb law."[79] But she followed that with a cautious analysis that appeared to satisfy Republicans. After demonstrating her comprehensive body of knowledge on constitutional law, by the second day of hearings, Republicans no longer questioned her obviously deep and comprehensive legal experience.[80] And although she refused to promise Republicans that she would curtail congressional power, she also refused to criticize the current Court at the invitation of Democrats.[81]

Interestingly, commentators have observed that it may be difficult for the Court to assimilate her. Indeed, some have suggested that the tension between Justice Kagan and Chief Justice Roberts was obvious when she came before the Court as solicitor general.[82] Both are "savvy, ambitious,

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75. *Id.* at 2.

76. *Kagan's Notable Statements and Writings*, N.Y. Times, May 9, 2010, *available at* http://www.nytimes.com/interactive/2010/05/10/us/politics/20100505-kagan-opinions.html.

77. Stolberg, *supra* note 66.

78. *Id.*

79. James Oliphant, *Kagan Slips on Fruits and Vegetables in Senate Panel Questioning*, L.A. Times, July 1, 2010.

80. *Id.*

81. *Id.*

82. Dahlia Lithwick, *Roberts v. Kagan? Will There Be Friction Between the Chief Justice and Elena Kagan on the Supreme Court*, Slate, July 20, 2010, *available at* www.slate.com/id/2261947/.

and brilliant, as well as charming, outgoing, and persuasive,"[83] and neither is known for deference to the opinions of others.[84] This could make their service on the same court, which has been truly Roberts' Court, with him in the majority 91 percent of the time, interesting.[85] Justice Kagan referred directly to the chief justice at her confirmation hearing, commenting on his suggestion that judging was like being an umpire:

> Judging is not a robotic or automatic enterprise, especially on the cases that get to the Supreme Court. A lot of them are very difficult. And people can disagree about how the constitutional text or precedent, how they apply to a case. But it's the law all the way down, regardless.[86]

She did agree with Roberts, however, that both judges and umpires should be free from bias.[87] She also observed that judges have a limited role in a democracy.

Many have observed that she is actually very like Chief Justice Roberts in many respects. Both are highly intelligent, and both appeared at their confirmation hearings "extremely relaxed, smart, and self-confident."[88] Like Justice Roberts, she used a mix of humor and moderation to avoid revealing much real substance. Both are Harvard Law School graduates, both clerked for iconic justices–Rehnquist and Marshall–and both are well connected to the White House, making them comfortable around Washington lawmakers and giving them a platform for their legal and policy positions.[89]

Although some say she has declared herself a progressive, she is not expected to change the balance on the Court because she is replacing Justice Stevens, whose decisions tended to be liberal.[90] Still, her experience at Harvard suggests she may be a consensus builder. Her legal writings have been described as "dense, hedged and moderate."[91]

Justice Kagan's confirmation to the Court filled some of the gaps in the experience of the Court's other personnel. Unlike the rest of the justices,

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83. *Id.*

84. *Id.*

85. *Id.*

86. Alliance for Justice, *supra* note 71, at 2.

87. As noted in Stolberg, *supra* note 66, before the hearings, Republicans said that it would be necessary to embrace the Roberts standard to win their support. "It's a powerful, correct description of what a judge does," said Senator Jeff Sessions. *Id.*

88. Bill Mears, *Kagan and Roberts United at Confirmation Hearings*, CNN Politics, June 30, 2010, *available at* http://articles.cnn.com/2010–06–30/politics/senate.kagan.roberts_1_youngest-justice-chief-justice-john-roberts-supreme-court?_s=PM:POLITICS.

89. *Id.*

90. Warren Richey, *Elena Kagan Confirmed to Supreme Court*, Christian Sci. Monitor, Aug. 5, 2010, *available at* http://www.csmonitor.com/USA/Politics/2010/0805/Elena-Kagan-confirmed-to-Supreme-Court.

91. Adam Liptak, *Obama's Choice for Solicitor General Has Left a Breach in a Long Paper Trail*, N.Y. Times, Jan. 6, 2009, *available at* http://www.nytimes.com/2009/01/07/us/07kagan.html.

she has never served as an appellate circuit judge, coming instead directly from academia and the executive branch. Her experience as a clerk for Justice Marshall and law school dean add to her unique background. She definitely tilts the Court toward the younger generation. At fifty, Justice Kagan will be the youngest justice on the Court.

Given her background, it will be interesting to see how her term plays out. Some observers are anxious to see whether the religion and class,[92] issues that concerned some during Justice Kagan's confirmation process, will be a factor. Regarding Second Amendment issues, she has already said that she will follow the precedents set in *McDonald v. City of Chicago*[93] and *District of Columbia v. Heller*,[94] indicating unequivocally that when the Court has decided a case, she considers the decision to be binding.[95] Regarding abortion rights, she has indicated that she agrees with *Roe v. Wade*[96] that there is a constitutional right to privacy covering the right to terminate a pregnancy.[97]

There are a number of cases in the executive power area in which her background as an aid to President Clinton may be important. Given her background in the executive branch, it would not be surprising if she tilted the Court to the right on issues involving executive branch power.[98] In a 2001 *Harvard Law Review* article, she contended that the idea of the unitary executive expanded under Clinton and defended that expansion because "Congress generally has declined to preclude the President from controlling administration in this manner."[99] In the article, however, she makes clear that she believes that this power is not unlimited. She urges courts to allow "presidential control of administration in its most attractive, which means its most public, form while still appropriately bounding the presidential role."[100]

She also has some background in the law of war. Once again, her support of executive power may lead to conservative majorities in this area. She has noted that it is relatively clear that the Constitution grants the president detention authority in wartime but that questions remain regarding the extent of the government's detention authority and the definition

92. *See, e.g.*, Larry Abramson, *The Harvard-Yalification of the Supreme Court*, NPR, May 16, 2010, *available at* http://www.npr.org/templates/story/story.php?storyId=126802460 ("the half-nelson grip on entry to the high court by top-ranked Yale and Harvard is a little odd to some observers").

93. 130 S. Ct. 3020 (2010).

94. 554 U.S. 570 (2008).

95. Alliance for Justice, *supra* note 71, at 3.

96. 410 U.S. 113 (1973).

97. Alliance for Justice, *supra* note 71, at 3.

98. *Id*. at 3–4.

99. Elena Kagan, *Presidential Administration*, 114 Harv. L. Rev. 2245, 2384 (2001).

100. *Id*. at 2385.

of an enemy where someone is captured outside the battlefield. She has commented that habeas rights should not extend to detainees at military bases like Bagram, Afghanistan.[101] Similarly, she is likely to support strong federal authority on immigration issues, which she will likely have to address in the Arizona cases that may come before the Court. Turning to campaign finance, she believes that Congress has established a compelling interest in preventing corruption sufficient to justify restrictions in the McCain-Feingold Act. She has indicated, however, that she will accept *Citizens United* as binding on the Court: "[I]t's entitled to all the weight that precedent usually gets."[102]

One drawback of her background as solicitor general is that she is likely to recuse herself from many cases, particularly in her initial years on the Court. Indeed, she had already disqualified herself in about half of the fifty-four cases on the docket as of October 2, 2010.[103] Some fear that these recusals increase the likelihood of 4–4 deadlocks that automatically affirm the ruling below.[104] She recused herself from two important preemption cases. One involves whether federal law preempts a lawsuit filed by a plaintiff who was injured in a car that met federal seatbelt requirements; the other was filed by the parents of a girl injured by a vaccine seeking to recover under a state law, despite the existence of a federal statute protecting vaccine makers.[105] She will likely recuse herself from fewer cases than did her mentor Thurgood Marshall, who was the last solicitor general appointed to the Court. He had to recuse himself from a majority of cases in his first term.[106] In his second term, Marshall recused from an additional eight cases.[107] If she must recuse herself less often, it will be due in part to the reduction in the number of merits cases involving the United States as a party since 1967.[108]

C. *Postscript on Justice Sotomayor*

It has now been more than a year since Justice Sotomayor joined the Supreme Court. According to the *Los Angeles Times*, "[t]he early returns are in, and Justice Sonia Sotomayor is proving herself to be a reliable liberal vote on the Supreme Court."[109] In cases involving campaign speech, religion,

101. Alliance for Justice, *supra* note 71, at 4.
102. *Id.*
103. Adam Liptak, *Supreme Court Term Offers Hot Issues and Future Hints*, N.Y. Times, Oct. 3, 2010, at A1.
104. *Id.*
105. *Id.*
106. Goldstein et al., *supra* note 51.
107. *Id.*
108. *Id.*
109. David G. Savage, *Sotomayor Votes Reliably with Supreme Court's Liberal Wing*, L.A. Times, June 8, 2010.

juvenile crime, federal power, and *Miranda* warnings, she voted with the liberal bloc. She wrote dissents only in cases where, in her view, the conservative majority failed to follow the law. This was the case in *Berghuis v. Thompkins*,[110] which concerned a suspect who was warned of his rights but unambiguously failed to call for a halt in questioning. She wrote that the decision "turns *Miranda* upside down."[111]

The Court decided a number of important cases in her first term and she participated in most of them. She wrote the decision in *Krupski v. Costa Crociere S.p.A.*,[112] a unanimous decision in which the Court held that the determination of whether an amended complaint should relate back to the filing of the original complaint depends on when the defendant knew or should have known it was a proper party. In *Mohawk Industries, Inc. v. Carpenter*,[113] she once again wrote the decision for a unanimous court, holding that orders deciding attorney-client privilege issues do not fall within the collateral order doctrine and are not immediately appealable as a matter of right.

In *Astrue v. Ratliff*,[114] Justice Sotomayor concurred in a decision in which the Court determined that in an Equal Access to Justice Act (EAJA) case, the fees awarded by the court belong to the plaintiff, not to the lawyer, and therefore can be offset by the plaintiff's debt to the government. In her concurrence, which was joined by Justices Ginsberg and Stevens, Justice Sotomayor wrote as follows:

> I join the Court's opinion because I agree that the text of the [EAJA] and our precedents compel the conclusion that an attorney's fee award under [this statute] is payable to the prevailing litigant rather than the attorney. . . . That conclusion, however, does not answer the question whether Congress intended the Government to deduct moneys from EAJA fee awards to offset a litigant's pre-existing and unrelated debt. . . . In my view, it is likely both that Congress did not consider that question and that, had it done so, it would not have wanted EAJA fee awards to be subject to offset.
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> . . .
>
> The EAJA's admirable purpose will be undercut if lawyers fear that they will never actually receive attorney's fees to which a court has determined the prevailing party is entitled. . . . Subjecting EAJA fee awards to administrative offset for a litigant's debts will unquestionably make it more difficult for persons of limited means to find attorneys to represent them.[115]

110. 130 S. Ct. 2250 (2010), *reh'g denied*, 131 S. Ct. 33 (2010).
111. *Id*. at 2278.
112. 130 S. Ct. 2485 (2010).
113. 130 S. Ct. 599 (2009).
114. 130 S. Ct. 2521 (2010).
115. *Id*. at 2529–31.

She also joined a number of dissents. In *Purdue v. Kenny A. ex rel. Winn*,[116] Justice Sotomayor joined a four-justice dissent. The majority held that lodestar fees can be enhanced only in exceptional circumstances when the attorney's hourly rate does not measure the market value of the services or when the attorney has financed expenses for a significant period of time or there has been an unusual delay in payment.

In two arbitration decisions, Justice Sotomayor also joined the dissents. In *Rent-a-Center*, *West*, *Inc. v Jackson*,[117] the majority ruled that if a clause in the agreement says the arbitrator is to decide the enforceability of the agreement, the court determines the enforceability of that clause. In *Granite Rock Co. v. International Brotherhood of Teamsters*,[118] the Court held that courts, not arbitrators, determine whether an agreement has been ratified. In both decisions, the dissents argued that the arbitrator should make these decisions.

The addition of Justice Sotomayor to the Court, while not causing it to lean further in any particular direction, has served to keep its jurisprudence ideologically balanced. More importantly, her appointment has had the long-lasting benefit of diversifying the Court at a time when the country itself has become more diverse.

II. PRAGMATIC JURISPRUDENCE (OR NOT) IN THE SUPREME COURT

The Supreme Court's decisions this year centered heavily on corporate and criminal law. Two rulings in particular represent major departures from established doctrine and illustrate the boundaries of sharp disagreement within the Court on matters of constitutional interpretation and jurisprudence, as Justice Stevens contemplated retirement and Justice Sotomayor found her bearings. Both decisions will have lasting consequences for Americans, the conduct of the Court, and appellate argument generally.

A. *Free Speech*, *Campaign Finance*, *and Stare Decisis: The Court Giveth and the Court May Taketh Away*

In one of its most controversial and momentous decisions of recent years, the Supreme Court reversed course in the field of corporate independent political expenditures by invalidating a federal ban on such expenditures for electioneering communications. It did so on the basis that political speech cannot be suppressed because of the speaker's corporate identity. Writing for a bare majority in *Citizens United*,[119] Justice Kennedy inspired a blister-

116. 130 S. Ct. 1662 (2010).
117. 130 S. Ct. 2772 (2010).
118. 130 S. Ct. 2847 (2010).
119. Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876 (2010).

ing ninety-page dissent by Justice Stevens and multiple concurrences. The Court's decision triggered a rare comment and open antagonism during President Obama's first State of the Union address, new legislation, public calls for a constitutional amendment to reinstate the finance restriction that the Court declared unconstitutional, at least one state court decision invalidating a long-standing campaign finance restriction, and a surge of corporate expenditures and editorials leading up to the midterm elections.

This turmoil has flowed not only from the considerable political implications of the decision but also from its procedural unorthodoxy. The Court reached its decision after sua sponte ordering supplemental briefing and reargument on a facial challenge claim that had been dismissed by stipulation.[120] Its ruling turned on a technical treatment of stare decisis and renunciation of *Austin v. Michigan Chamber of Commerce*.[121]

As remarkable as the majority's procedural maneuver, however, is the dissent's impassioned advocacy of a pragmatic jurisprudence. Fueled by his distress over the shifting balance between individual and corporate power, Justice Stevens invoked not only the thrust of the Court's previous decisions in the field but every conceivable mode of circumspection: the multiplicity of relevant policy interests, the public's inevitable focus on the Court's bottom line, the fallacy of the majority's concern with the impact of a contrary outcome, unintended consequences of the ruling, and a missed opportunity to remand for evidentiary proceedings.

The backdrop of the case included several election finance decisions by the Court and, more immediately, its defense of judicial impartiality in *Caperton v. A.T. Massey Coal Co*.[122] *Caperton* had mandated the recusal of a state supreme court judge where, due to the litigant's massive earlier contributions to his election campaign, there was a constitutionally intolerable probability of actual bias.[123]

At issue in *Citizens United* was § 203 of the Bipartisan Campaign Reform Act of 2002 (BCRA).[124] That law had prohibited nonmedia corporations from using their general treasury funds to support preelection advocacy that referred to any clearly identified candidate for federal office, in this case Hillary Clinton. Under implementing regulations, such an "electioneering communication" was prohibited only if it was "publicly distributed," meaning, in the case of a presidential primary, that it could be received by

120. *Id.* at 888.
121. 494 U.S. 652 (1990), *overruled by* Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876 (2010).
122. 129 S. Ct. 2252 (2009).
123. *Id.* at 2263–64. *Caperton* is discussed more fully in Mary R. Vasaly et al., *Recent Developments in Appellate Advocacy*, 45 Tort Trial & Ins. Prac. L.J. 179, 191–94 (2010).
124. 2 U.S.C. § 441b(b)(2) (2006).

50,000 or more persons in the primary state.[125] The law did not prohibit the use of political action committees (PACs) funded by corporate shareholders and employees or union members, expenditures more than thirty days before a primary or sixty days before a general election,[126] or issue-directed advertising. It did not address direct campaign contributions by corporations and unions, which are prohibited separately by BCRA.[127]

The nonprofit appellant, Citizens United, was financed primarily by individuals but also by for-profit corporations. It had produced and promoted a polemic, *Hillary: The Movie* (*Hillary*), in theaters, on DVD, and through free-of-charge video-on-demand. Fearing the criminal penalties of § 203, Citizens United had sought declaratory and injunctive relief to air *Hillary* just before the 2008 presidential primary.[128] The federal court for the District of Columbia denied a preliminary injunction and granted the Federal Election Commission's motion for summary judgment. The district court held that § 203 was both facially constitutional under *McConnell v. Federal Election Commission*[129] and constitutional as applied to *Hillary*. It also upheld the statute's disclosure and disclaimer requirements.[130] Following initial briefing and argument, the Supreme Court asked the parties to address "whether we should overrule either or both *Austin* and the part of *McConnell* which addresses the facial validity of 2 U.S.C. § 441b."[131]

Justice Kennedy first disposed of narrower grounds of decision. He declined to split hairs among different forms of media for fear that such fine-tuning would chill the exercise of protected speech and yield questionable decisions.[132] The Court likewise rejected as lukewarm and unworkable the alternative argument that an exception should be carved out for nonprofit corporations that, like Citizens United, are funded overwhelmingly by individuals. Rather, it insisted that a bright line be drawn because breathing room is needed for speech to survive[133] and because the Court "must give the benefit of any doubt to protecting rather than stifling speech."[134]

The majority proceeded to the facial challenge of § 203, even though that claim had been dismissed by stipulation. It defended its prerogative to

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125. 11 C.F.R. § 100.29(a)(2), (b)(3)(ii).
126. 2 U.S.C. § 434(f)(3)(A).
127. *Id.* § 441b(b)(2); *id.* § 434(f)(3)(A); 11 C.F.R. § 100.29(a)(2).
128. Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876, 887 (2010).
129. 540 U.S. 93 (2003).
130. Citizens United v. Fed. Election Comm'n, 530 F. Supp. 2d 274, 279–81 (D.D.C. 2008).
131. *Citizens United*, 130 S. Ct. at 888 (citations omitted).
132. *Id.* at 891.
133. *Id.* at 892 (quoting Fed. Election Comm'n v. Wis. Right to Life, Inc., 551 U.S. 449, 468–69 (2007) (Roberts, C.J.)).
134. *Id.* at 891 (quoting *Wis. Right to Life*, 551 U.S. at 469 (Roberts, C.J.)).

review an issue that was "not pressed [below] so long as it has been passed upon . . ." even minimally.[135] Remarkably, the Court reasoned that facial and as-applied challenges are variants of a single contention that need not be separately pleaded and go only to the breadth of a remedy.[136] Justice Kennedy explained: "[t]he parties cannot enter into a stipulation that prevents the Court from considering certain remedies if those remedies are necessary to resolve a claim that has been preserved."[137] In other words, in the view of the dissent, a patient who is admitted for surgery by scalpel may not complain when his doctor insists on using a machete.[138]

Deciding the matter on this broader basis, the Court stressed the importance of expanding rather than contracting the universe of information available to the voting public.[139] The majority derided restrictions based on the identity of a speaker as a surrogate for control of content[140] and found in its precedents no basis to distinguish among corporations, other associations, and individuals.[141] Justice Kennedy highlighted the value of all contributions to the democratic process, in which ostensibly well-informed citizens exercise ultimate electoral power.[142]

The majority read its pre-*Austin* decisions as validating this identity neutrality. *Buckley v. Valeo*[143] had upheld the ban on direct corporate campaign contributions based on a compelling concern with political corruption and the appearance of corruption. The *Citizens United* majority clung to *Buckley*'s focus on the potential for quid pro quo corruption raised by direct contributions, in contrast to independent expenditures, a ban on which was not then at issue.[144] The majority read *First National Bank of Boston v. Bellotti*,[145] which struck down a Massachusetts prohibition on corporate expenditures relative to referenda, as further demonstrating that the circumstances of speech, not the identity of the speaker, are decisive.[146]

Against this background, Justice Kennedy painted *Austin*, from which he had dissented, as an aberration. *Austin* "interfere[d] with the 'open market-

135. *Id*. at 892 (citation omitted). The district court had rejected the facial challenge summarily in the injunctive phase, before the stipulation was entered, because it could not ignore the precedent of *McConnell*.
136. *Id*. at 893 (citations omitted).
137. *Id*.
138. *Id*. at 933.
139. *Id*. at 899 (noting the need of voters for diverse sources of information).
140. *Id*.
141. *Id*. at 900.
142. *Id*. at 910 ("The appearance of influence or access, furthermore, will not cause the electorate to lose faith in our democracy.").
143. 424 U.S. 1 (1976).
144. *Citizens United*, 130 S. Ct. at 901–02.
145. 435 U.S. 765 (1978).
146. *Citizens United*, 130 S. Ct. at 902–03.

place' of ideas protected by the First Amendment"[147] because it recognized a new antidistortion interest arising from the corporate form. *Austin* had "found a compelling governmental interest in preventing 'the corrosive and distorting effects of immense aggregations of wealth that are accumulated with the help of the corporate form and that have little or no correlation to the public's support for the corporation's political ideas.' "[148] The *Citizens United* majority considered this economic postulate to be misleading and immaterial, rejecting any qualitative distinction between wealth amassed by a corporation and that of an individual.[149] The Court further reasoned that the traditional economic function of a corporation should not constrain its participation in the electoral process.[150]

Having concluded that *Austin* was wrongly decided, the majority was quick to find that stare decisis, a mere principle of policy, did not compel adherence to it.[151] The majority noted that the government's argument all but abandoned reliance on *Austin*'s antidistortion rationale, in favor of the governmental interests in preventing corruption and protecting the interests of corporate shareholders.[152] The Court concluded that other stare decisis interests were not at stake; it weakly asserted that technological changes cut against application of the principle and dismissed as inconsequential any reliance interest arising from legislative bans on corporate expenditures following *Austin*.[153]

In his concurrence, Chief Justice Roberts also addressed stare decisis and judicial restraint. Judicial restraint is not justified for its own sake, he maintained, and does not "trump our obligation faithfully to interpret the law."[154] In other words, the Court must not adhere to precedent in the interest of developing the law in a principled fashion where such adherence will do more to damage the rule of law than to advance it.[155] The Chief Justice supplemented the majority's grounds to disengage from *Austin* by replacing to the destabilizing effect of that decision, evidenced by the spirited dissents and internal disagreement that it triggered and the difficulty of limiting *Austin*'s rationale to its facts.[156] He reiterated the error of *Austin*'s rationale, i.e., the efficacy of a speaker's participation should

147. *Id*. at 906 (citations omitted).
148. *Id*. at 903 (quoting Austin v. Mich. Chamber of Commerce, 494 U.S. 652, 660 (1990)).
149. *Id*. at 905.
150. *Id*. at 904.
151. *Id*. at 912.
152. *Id*.
153. *Id*. at 912–13.
154. *Id*. at 919.
155. *Id*. at 920–21.
156. *Id*. at 922–23.

be irrelevant to the validity of its speech,[157] and declared that adherence to such erroneous precedent cannot be justified by the new principles espoused by the government.[158]

In an acerbic concurrence, Justice Scalia attacked the dissent for indulging in a dubious, extratextual historiography of the Framers' dislike of the corporate form. The dissent, he wrote, had "dredged up" "corporation-hating quotations,"[159] ignored the lack of a textual exception for speech by corporations,[160] and discounted the right of an individual to speak in association with other individuals.[161] It would be wrong and unnecessary to a strict reading of the Free Speech Clause to "muzzle the principal agents of the modern free economy."[162]

In turn, the dissent castigated the majority for its procedural dereliction and cavalier dismissal of stare decisis.[163] The Court abandoned not only plausible narrower grounds of decision but also all pretense of judicial restraint.[164] Justice Stevens argued that the majority had impermissibly reconceptualized the litigant's claims, upending "the basic relationship between litigants and courts,"[165] in that Citizens United had dropped its facial challenge in the district court, its subsequent jurisdictional statement did not even mention *Austin*, and its merits brief did not seek facial invalidation.[166] The majority did not cite any exceptional circumstances to justify its expansion of the claim on appeal.[167] Yet, having made that procedural leap, the Court then hypocritically complained about the lack of an evidentiary record to validate a fear of electoral distortion—a record that, the dissent remarked, was thin precisely because the facial challenge had been abandoned.[168]

One major casualty in the process was stare decisis. In an "amalgamation of resuscitated dissents,"[169] the Court had rushed to the merits, ignoring both its own previous adherence to *Austin*[170] and a diverse chorus of corporate, labor, and nonprofit amici that favored that steady course.[171] The resulting procedural detour disrespected a co-equal branch of government.[172]

157. *Id*. at 923.
158. *Id*. at 924.
159. *Id*. at 925.
160. *Id*. at 926–27.
161. *Id*. at 928.
162. *Id*. at 929.
163. *Id*. at 931.
164. *Id*. at 937–38.
165. *Id*. at 935.
166. *Id*. at 931–32.
167. *Id*. at 932.
168. *Id*. at 933, 966–67.
169. *Id*. at 942.
170. *Id*. at 957.
171. *Id*. at 941 nn.23–26.
172. *Id*. at 940.

The dissent painted the Court's ruling as no less misguided on the merits. The decision had trashed Congress's "careful adjustment of electoral laws" based on legitimate concerns with corporate funding.[173] Justice Stevens repeatedly characterized § 203 as an appropriate time, place, and manner restriction on political speech that did not preclude the use of PACs.[174] He rejected the majority's insistence that precedent precluded distinctions based on the identity of the speaker, pointing out that even the disclaimer and disclosure provisions of the BCRA, which the Court simultaneously upheld, themselves embody such distinctions.[175]

According to the dissent, several perspectives support this different treatment of corporate and individual electoral participation: the Framers focused on speech by individuals, not corporate entities, which were few and disfavored;[176] since corporations cannot vote, corporate electoral financing is speech by proxy;[177] more than individuals' political speech, corporate participation is motivated less by ideology than by practical considerations;[178] and the deployment of huge corporate wealth inhibits the free trade in ideas that is so vital to the electoral process.[179] On the last point especially, Justice Stevens was insistent. He rejected the majority's "crabbed view of corruption" as grossly unrealistic and expounded on the fluid nature of political corruption.[180] Soft money has more potential to distort democratic process than the odd bribe.[181] Unlike the majority, Justice Stevens pointed to the explicit recognition of that reality in *Caperton* and the need for prophylactic measures against such corruption.[182] To advance this pragmatic analysis, he pointed to the enactment of the very restrictions at issue and opinion polls[183] as evidence that the large majority of voters, the listeners whose rights so concerned the majority,[184] believe that soft corporate money is a corrupting influence.[185]

The dissent predicted that the Court's ruling would immediately open the "floodgates of corporate and union general treasury spending."[186] In

173. *Id*. at 954–55 (quoting Fed. Election Comm'n v. Nat'l Right to Work Comm., 459 U.S. 197, 209 (1982) (Rehnquist, J.)).

174. *Id*. at 930, 941, 943.

175. *Id*. at 946 n.47 (citing Aristotle, Poetics 43–44 (M. Heath, trans., Penguin Books 1996)).

176. *Id*. at 949.

177. *Id*. at 972.

178. *Id*. at 955.

179. *Id*.

180. *Id*. at 961 (quoting McConnell v. Fed. Election Comm'n, 540 U.S. 93 152 (2003) (Kennedy, J.)).

181. *Id*. at 962.

182. *Id*. at 968.

183. *Id*. at 963 n.64.

184. *Id*. at 974, 976.

185. *Id*. at 962.

186. *Id*. at 968.

fact, *Citizens United* not only opened the floodgates of corporate spending before the midterm elections, but also those of political rhetoric and judicial anxiety. President Obama's now famous, televised castigation of the Court during his first State of the Union address provoked a real-time retort by Justice Alito, not to mention subsequent, public criticism by the chief justice of the breach of protocol by the chief executive.[187]

While it has heated political rhetoric and activity, the ruling has chilled judicial practice. Of the twenty-four state laws that prohibit or restrict corporate or union spending on candidate elections,[188] Montana's has the most colorful roots. It arose from disgust following the political blackmail exercised by nineteenth-century Copper Kings, who suspended thousands of workers after an unfavorable court ruling in order to force new legislation.[189] Constrained by *Citizens United*, a Montana judge granted summary judgment to corporate plaintiffs, declaring the law unconstitutional as applied to independent corporate expenditures.[190] The State of Montana had joined twenty-five other states urging affirmance of *Austin* in *Citizens United*.[191]

Defenders and detractors of *Citizens United* undoubtedly will further extend the Court's internal debate into the lower courts, state and federal legislatures, and the media.[192] Though far less certain, the implications of the decision for Supreme Court decision making may well be more significant.

B. *Ineffective Assistance Appeals and Immigration Law: Justice Stevens Prevails upon the Court*

While it was thwarted in *Citizens United*, Justice Stevens' pragmatic jurisprudence prevailed in a different context. Countermanding the consistent approach of federal and state appellate courts throughout the country, the Supreme Court this term declared the effective assistance guarantee applicable to immigration-related consequences of criminal plea agreements. In *Padilla v. Kentucky*,[193] the Court held 7–2 that every noncitizen criminal

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187. *See* Andrew Malcolm, *Very Troubling: Chief Justice Roberts on Obama's Court Criticism to Joint Session of Congress*, L.A. Times, Mar. 9, 2010; Peter Baker, *Obama v. Roberts: The Struggle to Come*, N.Y. Times, Apr. 18, 2010 (addressing the tensions between the president and chief justice and the implications of *Citizens United* on the choice of successor for Justice Stevens), *available at* http://www.nytimes.com/2010/04/18/weekinreview/18baker.html.

188. *See Citizens United and the States: Life After* Citizens United, Nat'l Conference of State Legislatures (Oct. 19, 2010), http://www.ncsl.org/default.aspx?tabid=19607 (tabulating and comparing state laws).

189. W. Tradition P'ship, Inc. v. Att'y Gen. of Montana, No. BDV-2010-238, at 2 (Mont. Jud. Dist. Ct. Oct. 18, 2010), *available at* http://www.mtstandard.com/article_bc78c824-dba8–11df-aef6–001cc4c03286.html.

190. *Id.*

191. Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876, 941 n.26 (2010).

192. *Citizens United and the States*, *supra* note 188 (noting the introduction of congressional and state legislation to amend in various ways the laws affected by *Citizens United*).

193. 130 S. Ct. 1473 (2010).

defendant has a constitutional right to be advised by his or her defense attorney that a proposed plea would render the defendant deportable or that the plea creates a risk of serious immigration consequences about which the defendant may wish to consult an immigration attorney.[194] The ruling creates a new and powerful avenue of appeal for nonresident aliens whose criminal case dispositions unwittingly have jeopardized their immigration status.

The now familiar standard for determining ineffective assistance of counsel was established in *Strickland v. Washington*.[195] "First, the defendant must show that counsel's performance was deficient. . . . Second, the defendant must show that the deficient performance prejudiced the defense."[196] Deficiency requires a showing that the representation "fell below an objective standard of reasonableness . . . under prevailing professional norms."[197] Prejudice requires a showing of a "reasonable probability that, but for counsel's unprofessional errors, the result of the proceeding would have been different."[198]

The Sixth Amendment guarantee is equally applicable to plea agreements. In the context of a guilty plea, a defendant must show that, but for counsel's error, the defendant would have rejected the plea, and that a decision to reject the plea would have been rational under the circumstances.[199]

In the years since *Strickland*, numerous courts of appeal have held that deportation is a collateral concomitant to criminal conviction.[200] Moreover, most courts have held that counsel's failure to advise a defendant of a plea's collateral consequence is not a legally sufficient ground for the plea to be withdrawn or vacated.[201] Thus, federal courts have held that erroneous advice or a lack of advice by defense counsel concerning deportation consequences does not constitute ineffective assistance of counsel.[202] Nor have most courts been willing to revisit those holdings in light of changes

194. *Id.* at 1486.

195. 466 U.S. 668 (1984).

196. *Id.* at 687.

197. *Id.* at 688.

198. *Id.* at 694.

199. *See* Roe v. Flores-Ortega, 528 U.S. 470, 480 (2000); *see also* Hill v. Lockhart, 474 U.S. 52, 59 (1985) ("a reasonable probability that, but for counsel's errors, [defendant] would not have pleaded guilty and would have insisted on going to trial"); United States v. Isom, 85 F.3d 831, 837 (1st Cir. 1996); Knight v. United States, 37 F.3d 769, 774 (1st Cir. 1994).

200. *See* Padilla v. Kentucky, 130 S. Ct. 1473, 1481 n.9 (2010) (listing jurisdictions); United States v. Quin, 836 F.2d 654, 655 (1st Cir. 1988).

201. *See, e.g.*, *Quin*, 836 F.2d at 655; United States v. George, 869 F.2d 333, 337 (7th Cir. 1989) (deportation is a civil proceeding that is not enmeshed in the criminal proceeding); United States v. Cariola, 323 F.2d 180, 186 (3d Cir. 1963); United States v. Parrino, 212 F.2d 919, 921–22 (2d Cir. 1954).

202. *See, e.g.*, *Quin*, 836 F.2d at 655; United States v. Yearwood, 863 F.2d 6, 7 (4th Cir. 1988); United States v. Campbell, 778 F.2d 764, 766–67 (11th Cir. 1985); Sanchez v. United States, 572 F.2d 210, 211 (9th Cir. 1977).

in immigration law concerning the relationship between deportation and conviction.[203]

The standard for ineffective assistance under state constitutional provisions appears equivalent to the federal standard.[204] Following the lead of federal circuits, state courts have distinguished between direct and collateral consequences in evaluating such claims. For example, the Massachusetts Appeals Court has held that, but for state statute,[205] "there would be no obligation on a judge to warn or inform the defendant of such [adverse immigration] consequences in order to render the plea a voluntary and intelligent one."[206]

However, the Court this term rejected that approach to immigration-related ineffective assistance claims. Laying the historical groundwork for a fresh analysis and displaying again his devotion to a pragmatic jurisprudence, Justice Stevens reviewed sea changes in immigration law during the past century that "have dramatically raised the stakes of a noncitizen's criminal conviction. . . . [D]eportation is an integral part—indeed, sometimes the most important part—of the penalty that may be imposed on noncitizen defendants who plead guilty to specified crimes."[207]

The Court eschewed lower courts' distinction between direct and collateral consequences in defining the scope of constitutionally required professional assistance. Instead, the Court reasoned that, because deportation is "uniquely difficult to classify as either a direct or a collateral consequence" of conviction, it is "not categorically removed from the ambit of the Sixth Amendment right to counsel."[208]

In *Padilla*, counsel affirmatively and erroneously had advised the defendant that his pleading guilty to transportation of a controlled substance posed no immigration problem.[209] However, the Court explicitly did not restrict its historic holding to cases of affirmative misadvice by counsel. It declared that "there is no relevant difference 'between an act of commission and an act of omission' in this context."[210]

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203. *See, e.g.*, United States v. Gonzalez, 202 F.3d 20, 26–27 (1st Cir. 2000).

204. *See, e.g.*, Smiley v. Maloney, 422 F.3d 17, 21 (1st Cir. 2005).

205. *See* Mass. Gen. Laws ch. 278, § 29D (1989).

206. Commonwealth v. Hason, 545 N.E.2d 52, 54 (Mass. App. Ct. 1989) (citing Commonwealth v. MacNeil, 505 N.E.2d 558, 559 (Mass. App. Ct. 1987)).

207. Padilla v. Kentucky, 130 S. Ct. 1473, 1480 (2010) (footnote omitted) (noting that a 1990 law abolished criminal trial judges' long-standing prerogative to recommend against deportation while sentencing a defendant).

208. *Id.* at 1482.

209. *Id.* at 1477.

210. *Id.* at 1484 (quoting Brief for Respondent at 30, *Padilla*, 130 S. Ct. 1473 (2010) (No. 08–651)).

The constitutional entitlement to effective assistance is not undermined or satisfied where a defendant receives notice of possible immigration consequences on a plea form or in a colloquy with the trial judge, as occurs in many jurisdictions.[211] The Court reasoned that such notice only underscores the severity of the immigration consequences and the need for consultation.[212] Although the Court did not so state, it also is clear that, unlike advice of counsel, notice in the plea form or colloquy occurs when a plea is entered and does not allow the defendant a meaningful opportunity to inquire and deliberate about the contemplated plea and its crucial implications.

The Court thus concluded that the failure of Padilla's defense counsel to advise him of adverse immigration consequences abridged his constitutional right to effective assistance. It remanded to afford Padilla an evidentiary hearing on the issue whether he had been prejudiced by that error under *Strickland*.[213]

Although the facts of *Padilla* involved a guilty plea, the Court's holding turns not on the form of the disposition but on its immigration impact. The ruling therefore applies equally to a continuance without a finding upon an admission of sufficient facts, which under immigration laws constitutes a conviction, even if it leaves the defendant with no conviction for purposes of state law and criminal record information systems.[214] Thus, appellate relief now may be available for any alien who once admitted to sufficient facts to avoid trial and potential incarceration, received a continuance without a finding, served an uneventful probation, believed he was left with no criminal record, and unhappily has learned that he is deportable and cannot become a naturalized citizen.[215]

Indeed, it may be easier to demonstrate prejudice and obtain relief where the underlying disposition was a continuance than where it was a plea. As the Court noted, most ineffective assistance claims are asserted

211. *Id*. at 1486 n.15 (citing twenty state laws).

212. *Id*. at 1486.

213. *Id*. at 1487.

214. *See* 8 U.S.C. § 1101(a)(48)(A) (defining "conviction"). Contrast, for example, Commonwealth v. Jackson, 700 N.E.2d 848, 851–52 (Mass. App. Ct. 1998) (continuance without finding is not a conviction for purposes of Massachusetts law).

215. As the Court noted, deportable offenses include crimes of moral turpitude if the disposition occurred within five years of arrival and carried a sentence of one year or more. *Padilla*, 130 S. Ct. at 1479; *see also* 8 U.S.C. §§ 1101(a), 1227(a)(2)(A)(i). Congress last amended § 1227, which enumerates the grounds of deportability, in 1996 by the Illegal Immigration Reform and Responsibility Act of 1996, Pub. L. No. 104–208, div. C., 110 Stat. 3009–546 (1996). Admission to sufficient facts, though not guilt, under these circumstances permanently prevents the alien from establishing good moral character necessary to naturalize and will deny him admission to this country after traveling abroad. *See* 8 U.S.C. §§ 1182(a)(2)(A)(i)(I), 1225(b)(1)(A)(i).

in habeas petitions and fully seventy percent of habeas proceedings result from convictions at trial.[216] Since proving prejudice is harder once a defendant has been adjudged guilty or has admitted guilt,[217] the Court concluded that ineffective assistance claims are self-limiting and rejected the dissent's concern that its holding would open appellate floodgates.[218] Unlike a defendant who pleads guilty, one who admits to sufficient facts has not thereby admitted legal guilt. *Padilla*'s already wide path to relief is therefore better paved in such a case.

The Court does not elaborate on the standard for proving prejudice due to unconstitutional misadvice or silence of defense counsel. *Strickland*'s progeny speaks of prejudice, i.e., a different outcome, as a lost opportunity to try the case.[219] However, proof that a case reasonably might have been resolved by plea or continuance based upon an immigration-neutral lesser offense[220] also might constitute a different result of the proceeding, so as to satisfy the prejudice requirement for new trial.[221]

Chief Justice Roberts and Justice Alito in their dissent took issue only with the breadth of the Court's holding. They would have held unconstitutional not the mere silence of defense counsel concerning the immigration consequences of a plea but only affirmative misadvice by counsel, as occurred in *Padilla*.[222] Justice Alito reasoned that immigration law is specialized, that evaluating immigration consequences of a plea is not a simple matter, that such consequences are not what defense attorneys are retained to address, and that defense counsel should be required only to avoid misstatement.[223] Justices Alito and Roberts neither noted nor rejected the pragmatic jurisprudence that Justice Stevens reasserted, this time for the majority.

III. RECENT DEVELOPMENTS IN FEDERAL APPELLATE PROCEDURE

On December 1, 2010, amendments to the Federal Rules of Appellate Procedure took effect. These include new disclosure requirements in briefs filed by amici curiae, a new definition of *state*, and a revised affidavit accompanying motions for permission to appeal in forma pauperis.

216. *Padilla*, 130 S. Ct. at 1485 nn.13–14 (collecting statistics).
217. *Id*. at 1485 n.12.
218. *Id*. at 1485.
219. Hill v. Lockhart, 474 U.S. 52, 58 (1985).
220. For example, a continuance without a finding or plea as to simple assault and battery, unlike indecent assault and battery, entails no moral turpitude or aggravating element, hence no risk of deportation.
221. Strickland v. Washington, 466 U.S. 668, 694 (1984).
222. *Padilla*, 130 S. Ct. at 1487.
223. *Id*. at 1488–90.

A. *New Disclosures in Briefs Filed by Amici Curiae*

The most significant amendment for appellate practitioners is a new subdivision (c)(5) to Rule 29. Subdivision (c)(5) adds disclosure requirements regarding authorship and funding for briefs filed by all amici curiae except the United States, its officers and agencies, and states.[224] Private party amici will be required to include a separate statement in the brief indicating whether (1) "a party's counsel authored the brief in whole or in part";[225] (2) "a party or a party's counsel contributed money that was intended to fund preparing or submitting the brief";[226] and (3) "a person—other than the amicus curiae, its members, or its counsel—contributed money that was intended to fund preparing or submitting the brief."[227]

The statement must identify any person other than the amicus who contributed money toward preparing or submitting the brief.[228] The Advisory Committee Note to the amendment clarifies that the word *person* as used in subdivision (c)(5) "includes artificial persons as well as natural persons."[229]

The new disclosure requirement is modeled on Supreme Court Rule 37.6,[230] and according to the Advisory Committee Note, "serves to deter counsel from using an amicus brief to circumvent page limits on the parties' briefs."[231] The note cites an observation by one court "that amicus briefs are often used as a means of evading the page limitations on a party's briefs."[232] The note goes on to state that the amendment "may help judges to assess whether the amicus itself considers the issue important enough to sustain the cost and effort of filing an amicus brief."[233]

The amendment raises questions regarding what it means to author an amicus brief in part. The Advisory Committee Note provides some guidance in explaining that the disclosure requirement does not extend to "mere coordination" between an amicus and a party, including "sharing drafts of

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224. Fed. R. App. P. 29(c)(5); *see also* Fed. R. App. P. 29(a).

225. Fed. R. App. P. 29(c)(5)(A).

226. Fed. R. App. P. 29(c)(5)(B).

227. Fed. R. App. P. 29(c)(5)(C).

228. *Id.*

229. Fed. R. App. P. 29(c)(5) advisory committee's note.

230. The only significant difference between the two rules is the placement of the disclosure. In amicus briefs filed in the Supreme Court, the disclosure must be "made in the first footnote on the first page of text." Sup. Ct. R. 37.6. In briefs filed in the circuit courts of appeals, the disclosure must be made in a separate statement following the statement of the identity and interest of the amicus. Fed. R. App. P. 29(c)(4)–(5).

231. Fed. R. App. P. 29(c)(5) advisory committee's note.

232. *Id.* (citing Glassroth v. Moore, 347 F.3d 916, 919 (11th Cir. 2003)); *see also* Voices for Choices v. Ill. Bell Tel. Co., 339 F.3d 542, 544 (7th Cir. 2003) (noting that "amicus briefs, often solicited by parties, may be used to make an end run around court-imposed limitations on the length of parties' briefs").

233. Fed. R. App. P. 29(c)(5) advisory committee's note.

briefs."[234] This does not necessarily resolve all ambiguities arising from the rule, however. One commentator observed with regard to an earlier version of the amendment that

> proposing specific language is a normal part of the coordination between lawyers. If a party's counsel sends the amicus's counsel a proposed point of 10 pages for inclusion in the amicus brief and the amicus includes it, either verbatim or with editorial revisions, did the party "author" the amicus brief "in part" within the meaning of the proposed rule? If not, then the rule will be toothless. By contrast, what about proposing one paragraph? Or a sentence?[235]

The Advisory Committee Note indicates that interpretations of Supreme Court Rule 37.6 may be instructive in clarifying the disclosure requirement.[236] A leading treatise on Supreme Court practice suggests that party counsel's review of an amicus brief for inaccuracies or repetition of argument would not constitute authoring the brief in part, even if this review "result[s] in advice by party counsel that the amicus counsel rewrite, delete, or add certain matter. . . ."[237] On the other hand, authoring an amicus brief in part would "include any instance in which party counsel takes an active role in writing or rewriting a substantial or important 'part' of the amicus brief, with the word 'part' interpreted to mean something more substantial than editing a few sentences."[238] Despite this guidance, the precise boundary between mere coordination and authoring the brief in part remains hazy. Appellate attorneys must use common sense in light of the circumstances and should contact the clerk's office for advice in borderline situations.[239]

Other questions arise from the requirement to disclose the identities of persons other than the amicus who have contributed money to fund preparation or submission of the brief.[240] The language of the rule does not appear to require disclosure of the dollar amount of any contribution, but merely the identity of the person who made it.[241] The Advisory Committee Note further instructs that "[a] party's or counsel's payment of general

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234. *Id*. Indeed, the note characterizes such coordination as "desirable, to the extent that it helps to avoid duplicative arguments." *Id*.

235. Steven Finell, *Amendments to the Federal Rules of Appellate Procedure*, App. Prac. J., Winter 2009, at 5, *available at* http://www.abanet.org/litigation/litigationnews/trial_skills/amendments-federal-rules-appellate-procedure.html.

236. *See* Fed. R. App. P. 29(c)(5) advisory committee's note (citing Eugene Gressman et al., Supreme Court Practice 739 (9th ed. 2007), for proposition that mere coordination between amicus counsel and party counsel need not be disclosed).

237. Gressman, *supra* note 236, at 739.

238. *Id*.

239. *Id*.

240. *See* Fed. R. App. P. 29(c)(5)(B)–(C).

241. *See id*.; *see also* Gressman, *supra* note 236, at 740 (reaching same conclusion with respect to Sup. Ct. R. 37.6).

membership dues to an amicus need not be disclosed."[242] The note seems to anticipate a situation where, for example, a trade association files an amicus brief in an appeal to which one of its existing members is a party. But suppose the amicus conditions filing a brief upon the party's joining the organization and paying for a new membership? Although this may raise doubts as to whether "the amicus itself considers the issue important enough to sustain the cost and effort of filing an amicus brief,"[243] disclosure would likely be unnecessary unless the payment is "specifically earmarked to defray the expense of the amicus brief."[244] Once again, appellate attorneys must exercise common sense and refer borderline situations to the clerk's office.

B. *New Definition of State*

The amendments add a new subsection (b) to Rule 1 defining the term *state* to include "the District of Columbia and any United States commonwealth or territory."[245] The amendments also revise Rule 29(a) in accordance with this new definition.[246] Rule 29(a) had previously provided that "[t]he United States or its officer or agency, or a State, Territory, Commonwealth, or the District of Columbia may file an amicus-curiae brief without the consent of the parties or leave of court."[247] The new definition of state in Rule 1(b) makes redundant the reference to a "Territory, Commonwealth, or the District of Columbia" in Rule 29(a).[248] Rule 29(a) is accordingly amended to refer simply to "[t]he United States or its officer or agency or a state."[249]

C. *Revised Affidavit Accompanying Motions for Permission to Appeal in Forma Pauperis*

The new amendments revise Form 4 to comply with privacy requirements.[250] Form 4 is the affidavit accompanying motions for permission to appeal in forma pauperis. Earlier rule amendments had revised Rule 25(a)(5) to incorporate the new privacy protections of Federal Rule of Bankruptcy Procedure 9037, Federal Rule of Civil Procedure 5.2, and Federal Rule of Criminal Procedure 49.1.[251] These protections were added in response

242. Fed. R. App. P. 29(c)(5) advisory committee's note.
243. *See id.* (noting that this is one purpose of the disclosure requirements).
244. *See* Gressman, *supra* note 236, at 740.
245. Fed. R. App. P. 1(b).
246. Fed. R. App. P. 29(a).
247. Fed. R. App. P. 29(a) (2009) (amended 2010).
248. Fed. R. App. P. 29(a) advisory committee's note.
249. Fed. R. App. P. 29(c); *see also* Fed. R. App. P. 29(a) advisory committee's note.
250. Fed. R. App. P. Form 4.
251. *See generally* Paul K. Sun Jr., *New Federal Rule of Appellate Procedure 25(a) Adopts Privacy Provisions of Bankruptcy, Civil, and Criminal Rules*, App. Prac. J., Winter 2008, at 19.

to § 205(c)(3)(A)(i) of the E-Government Act of 2002, which required the Supreme Court to prescribe rules "to protect privacy and security concerns relating to electronic filing of documents and the public availability . . . of documents filed electronically or converted to electronic form."[252]

The prior rule amendments, however, did not revise Form 4, which required the inclusion of information that Rule 25(a)(5) forbids: (1) the full names of minors who rely on the movant or the movant's spouse for support; (2) the full address of the movant's legal residence; and (3) the movant's full Social Security number.[253] The new Form 4 is revised to comply with Rule 25(a)(5) by requiring only (1) the initials of minors; (2) the city and state of the movant's legal residence; and (3) the last four digits of the movant's Social Security number.[254]

252. E-Government Act of 2002, Pub. L. No. 107-347, 116 Stat. 2914, as amended by Pub. L. No. 108-281, 118 Stat. 889 (2004); *see* Fed. R. App. P. 25(a)(5) advisory committee's note, 2007 amendments; *see also generally* Sun, *supra* note 251, at 19.

253. Fed. R. App. P. Form 4 (2009) (amended 2010).

254. Fed. R. App. P. Form 4.

RECENT DEVELOPMENTS IN AVIATION AND SPACE LAW

Paula L. Wegman

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I. INTRODUCTION

Aviation law with respect to tort and insurance practice has been constant with respect to certain topics of law that frequently arise. That same law, however, has also been fluid because new interpretations and opinions challenge the way the law is, and perhaps should be, applied. As expected, this past year has resulted in many aviation tort and insurance law legal opinions, some of which confirm established law and some of which cast established law in a new light. This past year has also given rise to at least one novelty, the first U.S.-published decision interpreting the Tokyo Convention. This article addresses some but certainly not all of the notable decisions during the period October 1, 2009, to September 30, 2010.

II. GENERAL AVIATION REVITALIZATION ACT

The General Aviation Revitalization Act of 1994 (GARA)[1] was designed to protect general aviation aircraft manufacturers against "the long tail of liability attached to those aircraft, which could be used for decades after they were first manufactured and sold."[2] The "bill strikes a fair balance between manufacturers, consumers, and persons injured in aircraft accidents. It is extremely unlikely that there will be a valid basis for a suit against a manufacturer of an aircraft that is more than 18 years old."[3] Since the inception of GARA more than fifteen years ago, debate from both sides of the bar regarding the scope, applicability, and fairness of the Act has been continually addressed by courts across the nation. As evidenced by the issues considered by the courts in 2010, debate regarding GARA continues, particularly over the definition of a "part."

1. 49 U.S.C §§ 40101–50101 (2000).
2. Lyon v. Agusta S.P.A., 252 F.3d 1078, 1084 (9th Cir. 2001) (citing H.R. Rep. No. 103-525(I), at 1–4, *reprinted in* 1994 U.S.C.C.A.N. 1638, 1638–41).
3. H.R. Rep. No. 103-525(I), at 2, *reprinted in* 1994 U.S.C.C.A.N. at 1640.

A. Rogers v. Bell Helicopter Textron, Inc.

In June 2010, the California Court of Appeal held that a maintenance manual is not a "part" for purposes of GARA.[4] In *Rogers v. Bell Helicopter Textron, Inc.*, a pilot sued multiple defendants, including the helicopter's manufacturer, after she was injured when her helicopter crashed in 2005.[5] The helicopter had been in operation for more than fifty years, and while its maintenance manual was originally issued in 1969, it was revised in 1975.[6] Plaintiff asserted that the maintenance manual's instructions for blade balancing were improper.[7] The manufacturer, in turn, claimed that the manual should be excluded from evidence because it was covered by GARA's eighteen-year statute of repose.[8] The trial court agreed and granted the manufacturer's motion in limine to exclude the manual as well as its motion for nonsuit.[9] Both decisions were reversed on appeal.[10]

The California appellate court noted that GARA does not specifically define the term *part* and looked to the Ninth Circuit's decision in *Caldwell v. Engstrom Helicopter Corp*. for guidance.[11] The court determined that the helicopter's maintenance manual was not a part under GARA because, unlike the circumstances in *Caldwell*, no federal regulation required that a maintenance manual to be provided when selling a helicopter.[12] The court noted that there was currently a federal regulation requiring the seller of a helicopter to provide a maintenance manual if its application for an airworthiness certificate was made after 1981.[13] Although this regulation did not apply to the case at hand and played no role in the reversal, this court's reasoning suggests that a maintenance manual provided by a manufacturer for a helicopter manufactured after 1981 might be deemed a part under

4. Rogers v. Bell Helicopter Textron, Inc., 112 Cal. Rptr. 3d 1, 2 (Ct. App. 2010), *modified on reh'g*, 2010 Cal. App. LEXIS 1019 (Ct. App. June 30, 2010).

5. *Id*. at 1–2.

6. *Id*. at 2.

7. *Id*.

8. *Id*.

9. *Id*.

10. *Id*.

11. *Id*. at 3–4 (citing Caldwell v. Engstrom Helicopter Corp., 230 F.3d 1155 (9th Cir. 2000)). *Caldwell* ultimately held that a flight manual is a part under GARA because a flight manual was required by federal statute to be furnished with each helicopter and is "an integral part of the general aviation aircraft product that a manufacturer sells." *Caldwell*, 230 F.3d at 1157. As such, the flight manual "is the 'part' of the aircraft that contains the instructions necessary to operate the aircraft and is not separate from it." *Id*.

12. *Rogers*, 112 Cal. Rptr. 3d at 4.

13. *Id*.

GARA.[14] An Illinois appellate court faced directly with this argument, however, found it to be unpersuasive.[15]

B. South Side Trust & Savings Bank of Peoria v. Mitsubishi Heavy Industries, Ltd.

In this case, the Illinois Appellate Court was confronted with several GARA issues, one of which was whether a maintenance manual is a part for purposes of GARA's statute of repose.[16] The court expressly stated that it is not.[17] In response to the argument that federal regulations now require a maintenance manual to be provided with the sale of a new aircraft, the court stated that because "there is no federal regulation requiring that a maintenance manual be on board every plane or that a mechanic use only the methods prescribed in the current manufacturer's maintenance manual,"[18] a maintenance manual is not integral to an aircraft and thus not a part under GARA.[19]

South Side Trust also dealt with the applicability of GARA's statute of repose to foreign manufacturers.[20] The lower court granted the defendant Mitsubishi Heavy Industries, Ltd.'s motion for summary judgment based upon GARA protection.[21] Plaintiff appealed, claiming that GARA did not apply to foreign manufacturers.[22] Although the appellate court agreed with plaintiff's assertion that the legislature's intent in passing GARA was to benefit American manufacturers, it refused to read that intent into the language of the statute.[23] Relying on the plain language of the statute, the court held that GARA applies to all manufacturers, both domestic and foreign.[24]

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14. The current regulation states:

> The holder of a design approval . . . for which application was made after January 28, 1981, shall furnish at least one set of complete instructions for Continued Airworthiness, to the owner of each [aircraft or part] upon its delivery, or upon issuance of the first standard airworthiness certificate for the affected aircraft, whichever occurs later.

14 C.F.R. § 21.50(b) (2009).

15. S. Side Trust & Savs. Bank of Peoria v. Mitsubishi Heavy Indus., Ltd., 927 N.E.2d 179, 197 (Ill. App. Ct. 2010).
16. *Id*. at 196–98.
17. *Id*. at 196.
18. *Id*. at 197.
19. *Id*.
20. *Id*. at 198–99.
21. *Id*. at 198.
22. *Id*.
23. *Id*. at 198–99.
24. *Id*. at 199 ("Looking to GARA's plain language, it refers only to a 'manufacturer' of 'general aviation aircraft' and components. . . . It does define 'general aviation aircraft' [as] '*any* aircraft.' "). Additionally, the district court in *Castillo v. Cessna Aircraft Co*., 2010 U.S. Dist.

III. MONTREAL CONVENTION

The Montreal Convention, an international treaty ratified by the United States, was the result of the attempt by the United Nations to reform the Warsaw Convention "so as to harmonize the hodgepodge of supplementary amendments and intercarrier agreements of which the Warsaw Convention system of liability consists."[25] The Montreal Convention covers "all international carriage of persons, baggage or cargo performed by aircraft for reward."[26] The Convention provides the exclusive avenue for recovery for personal injuries suffered on board an aircraft or in the course of embarking or disembarking from an airplane.[27] The Montreal Convention's liability limitations were recently adjusted for inflation pursuant to article 24, which requires a review every five years.[28] The new limits, which took effect on December 30, 2009, resulted in a thirteen percent increase in the limits, as follows:

- Passenger death or bodily injury—art. 21(1): 113,100 special drawing rights (SDRs)[29] per passenger
- Passenger delay—Art. 22(1): 4,694 SDRs per passenger
- Baggage liability—Art. 22(2): 1,131 SDRs per passenger in case of destruction, loss, damage, or delay
- Cargo liability—Art. 22(3): 19 SDRs per kilo in case of destruction, loss, damage, or delay.[30]

LEXIS 40678 (S.D. Fla. Apr. 26, 2010), dealt with the applicability of GARA under foreign law. *Castillo* involved the crash of an aircraft in Guatemala, but suit was brought in the Southern District of Florida. *Id.* at *3. Applying Florida's choice of law rules, the court found that Guatemalan law applied to the case. *Id.* at *16. As GARA's statute of repose is a substantive law, it was superseded by Guatemalan laws. *Id.*

25. Sompo Japan Ins., Inc. v. Nippon Cargo Airlines Co., 522 F.3d 776, 780 (7th Cir. 2008) (quoting Erlich v. Am. Airlines, Inc., 360 F.3d 366, 371 n.4 (2d Cir. 2004)).

26. Convention for the Unification of Certain Rules for International Carriage by Air, art. 1(1), May 28, 1999, S. Treaty Doc. No. 106-45, (2000), 1999 WL 33292734 [hereinafter Montreal Convention].

27. *Id.*; *see also* Nobre v. Am. Airlines, Inc., 2009 U.S. Dist. LEXIS 122668 (S.D. Fla. Dec. 21, 2009).

28. Montreal Convention, *supra* note 26, art. 24; *see* Inflation Adjustments to Liability Limits Governed by the Montreal Convention Effective December 30, 2009, 74 Fed. Reg. 59,017 (Nov. 16, 2009).

29. The currency value of the SDR is determined by summing the values in U.S. dollars, based on market exchange rates, of a basket of major currencies (the U.S. dollar, euro, Japanese yen, and pound sterling). As of November 18, 2010, one SDR was equivalent to U.S. $1.55680. *See SDR Valuation*, INT'L MONETARY FUND, http://www.imf.org/external/np/fin/data/rms_sdrv.aspx (last visited Nov. 18, 2010).

30. *See* Inflation Adjustments, 74 Fed. Reg. 59,017.

A. *International Requirement*—Borges-Santiago v. American Airlines, Inc.

One of the requisites for application of the Montreal Convention is that the travel be international.[31] Despite this requirement, plaintiff in *Borges-Santiago v. American Airlines, Inc.* attempted to sue defendant, based in part upon the Convention, for injuries that arose from a flight from New York to Puerto Rico.[32] The Northern District of Texas dismissed the count of plaintiff's complaint that was based upon the Montreal Convention because the complaint did not allege any facts showing that the flight made any international stops.[33]

B. *Liability and Compensation Provisions*—Wright v. American Airlines, Inc.

In *Wright v. American Airlines, Inc.*, plaintiff was injured when another passenger left his seat during takeoff while the "fasten seatbelt sign was still illuminated" and opened an overhead bin.[34] An item fell from the overhead bin and struck plaintiff on the head.[35] Plaintiff sued the other passenger and American Airlines.[36] Claiming that American Airlines was negligent in allowing the other passenger to leave his seat during takeoff, plaintiff sought damages exceeding 100,000 SDRs as provided in article 21 of the Montreal Convention.[37] In seeking partial summary judgment, the airline contended that it was not liable for any damages beyond 100,000 SDRs because plaintiff's injuries were not caused by any negligence, omission, or wrongful act on its part but rather plaintiff's injuries were caused by the other passenger.[38] Article 21 of the Convention provides, in part, as follows:

> The carrier shall not be liable for damages arising under paragraph 1 of Article 17 to the extent that they exceed for each passenger 100,000 Special Drawing Rights if the carrier proves that:
> (a) such damage was not due to the negligence or other wrongful act or omission of the carrier or its servant or agents; or
> (b) such damage was due to the negligence or other wrongful act or omission of a third party.[39]

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31. Borges-Santiago v. Am. Airlines, Inc., 685 F. Supp. 2d 289, 291 (N.D. Tex. 2010).
32. *Id.* at 290.
33. *Id.* at 291.
34. 2010 U.S. Dist. LEXIS 10516, at *1–2 (N.D. Tex. Feb. 8, 2010).
35. *Id.* at *2.
36. *Id.* at *1.
37. *Id.* at *4.
38. *Id.* at *5.
39. *Id.* at *8 (quoting Montreal Convention, *supra* note 26, art. 21).

The court held that because the flight crew had made all preflight safety announcements and was unable to see the other passenger leave his seat, American Airlines was not at fault and was not liable for any of plaintiff's damages in excess of 100,000 SDRs.[40]

C. *Preemption*—Cosgrove-Goodman v. UAL Corp.*;* Nankin v. Continental Airlines, Inc.

Reaching the same conclusion, two recent cases have ruled on the use of the Montreal Convention as a basis for federal question jurisdiction.[41] In *Cosgrove-Goodman v. UAL Corp.*,[42] plaintiff suffered injuries after slipping on a "greasy substance" on the jetway as she disembarked an international flight.[43] Defendant UAL removed the case to federal court, claiming federal question jurisdiction due to the applicability of the Montreal Convention.[44] The court looked to the language of the Convention and found that "Article 29 specifically contemplates that actions for damages may be 'founded . . . under this Convention or in contract or in tort or otherwise.'"[45] The court held that because the language of the Convention specifically recognizes that claims may be brought by other methods than through the Convention, it did not preempt all other claims.[46] Additionally, because there is no preemption, there is no federal question jurisdiction,[47] and the court remanded the case.[48]

The second case to grapple with preemption under the Montreal Convention was *Nankin v. Continental Airlines, Inc.*[49] In *Nankin*, plaintiffs sued Continental for damages arising out of an employee's refusal to expedite their wait in immigration and customs despite the fact that they had only a one-hour layover.[50] This incident eventually led to an altercation where one of the plaintiffs was banned from boarding any Continental Airlines flight.[51] Ultimately, plaintiffs missed their flight and booked a replacement

40. *Id.* at *10–11.
41. *See* Cosgrove-Goodman v. UAL Corp., No. 10-cv-1908, 2010 U.S. Dist. LEXIS 54825, at *1 (N.D. Ill. June 2, 2010); Nankin v. Cont'l Airlines, Inc., No. CV 09–07851 MMM (RXz), 2010 U.S. Dist. LEXIS 11879, at *4 (C.D. Cal. Jan. 29, 2010).
42. The author and her firm, Adler Murphy & McQuillen LLP, was and continues to be involved in this litigation.
43. *Cosgrove-Goodman*, 2010 U.S. Dist. LEXIS 54825, at *1.
44. *Id.* at *1–2.
45. *Id.* at *9 (citing Montreal Convention, *supra* note 26).
46. *Id.*
47. *Id.* at *11.
48. *Id.*
49. No. CV 09–07851 MMM (RXz), 2010 U.S. Dist. LEXIS 11879, at *4 (C.D. Cal. Jan. 29, 2010).
50. *Id.* at *2–4.
51. *Id.* at *19–20.

flight with another airline.[52] Plaintiffs brought claims for breach of contract, breach of warranty, negligent infliction of emotional distress, and unlawful and unfair business practices against Continental.[53] Continental removed the action to federal court claiming that the Montreal Convention completely preempted plaintiffs' claims and presented federal question jurisdiction.[54] As in *Cosgrove-Goodman*,[55] the Central District of California looked to the plain language of the Convention and came to the same conclusion: the Montreal Convention does not provide complete preemption to state law claims.[56] The court added that while the Convention does not completely preempt such claims, "it controls the remedies available and liabilities that can be imposed via those causes of action."[57]

D. *Limitation of Liability (Cargo)*—Nastych v. British Airways PLC

In *Nastych v. British Airways PLC*, the Southern District of New York ruled on the limitation of liability for cargo under the Montreal Convention.[58] The facts of the case involved two separate incidents.[59] The first incident occurred when British Airways lost plaintiff's luggage when her flight from New York landed in Budapest.[60] Although the luggage was eventually recovered, she missed her connecting flight and had to take a train at her own expense.[61] The second incident occurred on the plaintiff's return trip from Budapest to New York.[62] Once again British Airways lost the plaintiff's luggage, but this time it was not recovered.[63]

British Airways moved for partial summary judgment, limiting plaintiff's damages to the 1,000 SDRs limit under the Montreal Convention.[64] The court granted the motion in part.[65] Instead of capping the damages at 1,000 SDRs total, it held that plaintiff was entitled to recover up to 1,000 SDRs per incident, for a capped total of $3,108.38.[66]

52. *Id.* at *3.
53. *Id.* at *3–4.
54. *Id.* at *4.
55. Cosgrove-Goodman v. UAL Corp., No. 10-cv-1908, 2010 U.S. Dist. LEXIS 54825, at *9 (N.D. Ill. June 2, 2010).
56. *Nankin*, 2010 U.S. Dist. LEXIS 11879, at *11–17.
57. *Id.* at *16.
58. No. 09 Civ. 9082 (AJP), 2010 U.S. Dist. LEXIS 8522, at *2–6 (S.D.N.Y. Feb. 2, 2010).
59. *Id.* at *1–2.
60. *Id.* at *1.
61. *Id.*
62. *Id.* at *1–2.
63. *Id.* at *2.
64. *Id.* at *1.
65. *Id.* at *6.
66. *Id.*

E. *Jurisdiction*—Javier v. Philippine Airlines, Inc.

In *Javier v. Philippine Airlines, Inc.*, a woman and her adult son brought claims under the Montreal Convention.[67] The mother sued for injuries she sustained on an international flight.[68] The son sued for emotional damages he allegedly suffered by watching his mother get injured.[69] Plaintiffs brought suit in California, where the mother was a resident; however, the son resided in Canada.[70] Defendant Philippine Airlines raised the affirmative defense that the court did not have jurisdiction under the Montreal Convention to hear the son's claim.[71] The airline argued that the Montreal Convention allows plaintiffs to bring suit in the place of their permanent residence, but the son was not a resident of California.[72] Without hearing oral argument, the Northern District of California dismissed the son's claims for lack of jurisdiction.[73] In so holding, the court stated that it could not exercise supplemental jurisdiction over the son's claims because the Convention did not grant the court the power to do so.[74]

F. *Notice*—Meteor AG v. Federal Express Corp.

Although the Montreal Convention requires the timely notice of claims, it does not specify how notice must be given.[75] Customarily, courts allow parties to "gap fill" the details of required notice.[76] In *Meteor AG v. Federal Express Corp.*, the Southern District of New York considered to what extent the gap may be filled by an air waybill.[77] Plaintiff Meteor contracted with defendant Federal Express to ship a piece of machinery from Switzerland to Texas.[78] The machinery was damaged during shipment and Meteor sent notice to Federal Express at a Texas address.[79] In its motion for summary judgment, Federal Express claimed that the air waybill used for the shipment incorporated Federal Express's Service Guide, which required notice to be sent to a Pennsylvania address.[80] The court granted the motion for summary judgment, holding that the air waybill represented

67. No. C 09–03398 JSW, 2010 U.S. Dist. LEXIS 49571, at *2 (N.D. Cal. Apr. 26, 2010).
68. *Id.*
69. *Id.*
70. *Id.* at *4.
71. *Id.*
72. *Id.*
73. *Id.* at *2, 7.
74. *Id.* at *6–7.
75. Meteor AG v. Fed. Express Corp., 08 Civ. 3773 (JGK), 2009 U.S. Dist. LEXIS 107674, at *2 (S.D.N.Y. Nov. 18, 2009).
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.* at *3.
80. *Id.* at *2–3.

a contract between the parties and that Meteor had failed to provide adequate notice to Federal Express.[81] Meteor subsequently filed a motion for reconsideration.[82]

Although the court did not find any of Meteor's arguments persuasive, it was troubled by an argument made by Federal Express.[83] Federal Express claimed that the shipment was an "airport-to-airport" shipment.[84] The service guide referred the reader to another, nonexistent service guide to find the terms of the shipment.[85] Federal Express argued that this actually referred to the air waybill.[86] The court was unconvinced and held that the terms were too unclear to be allowed as a gap filler under the Montreal Convention's notice provision.[87] Accordingly, the court granted Meteor's motion for reconsideration and reversed the summary judgment ruling.[88]

G. *Accident Defined (Warsaw Convention)*—Murillo v. American Airlines, Inc.

The Southern District of Florida recently ruled upon the meaning of the word *accident* for the purpose of the Warsaw Convention in *Murillo v. American Airlines, Inc*.[89] Plaintiff complained that defendant American Airlines failed to help an elderly and disabled woman who was suffering from dementia to her destination and allowed her to exit the airport unaccompanied.[90] Once outside the airport, she was hit by a car.[91] Plaintiff originally filed suit in state court, but American Airlines removed the case to federal court claiming federal question jurisdiction under the Warsaw Convention.[92] Plaintiff argued in his motion for remand that the Warsaw Convention did not apply since the passenger was hit by a car outside of the airport, and the Convention would cover her in this instance only if she were embarking on or disembarking from a flight.[93] The court acknowledged that "the car was *a* cause" of the plaintiff's injuries but that, under

81. *Id*. at *3.
82. *Id*. at *4.
83. *Id*. at *10–12.
84. *Id*. at *10–11.
85. *Id*. at *11.
86. *Id*.
87. *Id*. at *12.
88. *Id*. at *13.
89. No. 09–22894-Civ, 2010 U.S. Dist. LEXIS 52607, at *4 (S.D. Fla. Apr. 28, 2010) (citing Convention for the Unification of Certain Rules Relating to International Transportation by Air, concluded at Warsaw, Poland, Oct. 12, 1929, 49 Stat. 3000, 137 L.N.T.S. 11 (entered into force in the United States in 1934), *reprinted in* note following 49 U.S.C. § 40105 (2002) [hereinafter Warsaw Convention]).
90. *Id*. at *4.
91. *Id*.
92. *Id*. at *2.
93. *Id*. at *5.

the law, an "accident for purposes of Warsaw Convention applicability, takes place when some link in the [causal] chain was an unusual or unexpected event external to the passenger."[94] The court reasoned that the "link in the causal chain that ultimately resulted in plaintiff's injuries, is in fact, the very link which gives rise to plaintiff's claims against these particular defendants—the airline's alleged failure to safely escort [plaintiff] to her connecting flight."[95] Thus, for jurisdictional purposes, the accident was the airline's alleged failure to assist plaintiff to her connecting flight.

Looking to the scant facts of the case, the court reasoned that passenger had only an hour-and-a-half to deboard her first flight, go through customs, and board her second flight.[96] The court reasoned that she could only have been disembarking from her old flight or embarking on her new one, and, in either instance, the Convention governs her claims against American Airlines.[97]

IV. FORUM NON CONVENIENS

Generally, much of the doctrine of forum non conveniens (FNC) has not changed over the course of 2010. Many courts continue to adhere to the typical balancing scheme of public and private factors in issuing or affirming FNC dismissals; however, decisions from Cook County, Illinois, continue to provide exceptions to the general rule of FNC when dealing with products liability cases arising out of foreign accidents.

A. *FNC Dismissals*

The Second Circuit has been busy in the area of FNC rulings. In December 2009, the Second Circuit affirmed a FNC dismissal in *Lleras v. ExcelAire Services, Inc*.[98] In *Lleras*, more than 100 Brazilian claimants filed suit for wrongful death claims after Gol Linhas Inteligentes S.A. Boeing 737-800 Flight 1907 collided with an Embraer EMB-135BJ Legacy 600 jet operated by ExcelAire[99] and crashed in a remote part of the Amazon.[100] All of the claims were consolidated in the Eastern District of New York. The Legacy pilots, both of whom were named defendants, were residents

94. *Id*. (emphasis in original).
95. *Id*. at *6.
96. *Id*. at *7.
97. *Id*. at *7–8.
98. 354 F. App'x 585 (2d Cir. 2009).
99. The Legacy 600 safely made an emergency landing at a Brazilian military base. *See In re* Air Crash Near Peixoto de Azeveda, Brazil, on Sept. 29, 2006, 574 F. Supp. 2d 272, 275 (E.D.N.Y. 2008), *aff'd sub nom*. Lleras v. ExcelAire Servs., Inc., 354 F. App'x 585 (2d Cir. 2009).
100. *Lleras*, 354 F. App'x at 586–87; *In re Air Crash Near Peixoto*, 574 F. Supp. 2d at 275.

of New York, and various defendant U.S. companies had their principal places of business scattered throughout the United States.[101]

The district court granted the FNC dismissal[102] and the Second Circuit affirmed,[103] finding that the circumstances in this matter did not lend deference to a foreign-citizen plaintiff's choice of a U.S. forum and that Brazil provided a better, alternative forum.[104] Although the Legacy pilots refused to submit to Brazil's jurisdiction,[105] the district court found that Brazil's interest in the "deadliest air disaster in Brazilian history at the time"[106] would be best addressed by the Brazilian court system,[107] and the Second Circuit afforded the district court great discretion in deciding the FNC issue.[108] The district court, along with the Second Circuit, also found persuasive the complexity and difficulty in obtaining jurisdiction over certain Brazilian entities, regardless of the multiple U.S.-based companies named in the complaint:

> [T]he important factors of lack of jurisdiction in this forum over potentially liable parties and the lack of compulsory process over witnesses and evidence in Brazil, together with other considerations, swing the balance sufficiently to make [the United States] forum "genuinely inconvenient" and a Brazilian forum "significantly preferable."[109]

As a result of Brazil's being the "significantly preferable" forum, the FNC dismissal was affirmed.[110]

Additionally, in *Seales v. Panamanian Aviation Co.*, the Second Circuit once again affirmed a district court's granting of a FNC motion.[111] This case arose out of personal injuries Seales sustained while being arrested and detained in Jamaica for illegal importation and possession of a firearm and ammunition.[112] Aside from Seales's contention that he was a U.S. resident, there were no other ties to the United States.[113]

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101. *In re Air Crash Near Peixoto*, 574 F. Supp. 2d at 276.
102. *Lleras*, 354 F. App'x at 587.
103. *Id.*
104. *In re Air Crash Near Peixoto*, 574 F. Supp. 2d at 289–90.
105. *Id.* at 283. The Second Circuit also noted that the pilots, although refusing to submit to the jurisdiction of Brazil, did agree to "submit to videotaped depositions in the United States, and . . . not object in Brazilian proceedings to the admissibility of those depositions . . . ." *Lleras*, 354 F. App'x at 587.
106. *In re Air Crash Near Peixoto*, 574 F. Supp. 2d at 277.
107. *Id.* at 283.
108. *Lleras*, 354 F. App'x at 586.
109. *Id.* at 587 (quoting *In re Air Crash Near Peixoto*, 574 F. Supp. 2d at 289).
110. *Id.*
111. 356 F. App'x 461 (2d Cir. 2009).
112. *Id.* at 462.
113. *Id.* at 464 n.2 ("[T]he United States is not the domicile of the carrier, the principal place of business of the carrier, the place where the contract was made, the place of destination, or the principal and permanent residence of the passenger.").

Although Seales represented that he was a resident of the United States for the purposes of the FNC motion, the court found otherwise. Because Seales had spent most of his time in Jamaica since 2006, his wife and children lived in Jamaica, and other actions indicated he intended to and did in fact reside in Jamaica, Seales's residence was not in the United States.[114] Although the FNC motion was initially denied by the district court, once it came to light that Seales's passport, which was produced after the court's original FNC denial, revealed that Seales was not a U.S. resident, the district court was well within its authority to reconsider the FNC motion, as the passport was sufficient to alter the FNC balance.[115] The Second Circuit affirmed the district court's decision to grant Panamanian Aviation's FNC motion.[116]

In May 2010, the District of the Virgin Islands also granted a FNC motion in *Francois v. Hartford Holding Co*.[117] *Francois* involved a wrongful death action brought on behalf of four Dominican nationals and a Dutch citizen arising out of a flight from St. Maarten to Dominica that crashed in Dominica during approach.[118] Because the defendants consented to jurisdiction in Dominica, and waived any defense based upon the statute of limitations,[119] and because "Dominican courts have recently indicated that they will, in fact, entertain plaintiffs' cause of action based on the defendants' waiver of the statute of limitations,"[120] the court found that Dominica was an adequate alternative forum.[121]

After determining the adequacy of the forum, the court went on to recognize that "even a foreign plaintiff's choice is entitled to deference, albeit less than a domestic plaintiff's."[122] The court found that the plaintiffs' choice of the District of the Virgin Islands as the forum was not entitled to a strong presumption of convenience because none of the plaintiffs "were United States citizens at the time the action was filed and only one of

114. *Id*. at 463.
115. *Id*. at 465.
116. *Id*.
117. 2010 U.S. Dist. LEXIS 44115 (D.V.I. May 5, 2010).
118. *Id*. at *2.
119. The *Francois* court also noted the applicability of the Transnational Causes of Action (Product Liability) Act of 1997 (TCAA) under Dominica law. *Id*. at *11. The purpose of the TCAA is to "remedy the harsh consequences of dismissal of a foreign case on the grounds of *forum non conveniens*." *Id*. Section 14(2)(c) of the TCAA "provides that the limitation period is six years from the date the action is dismissed in the foreign forum [under forum non conveniens]." *Id*. (citing Transnational Causes of Action (Products Liability) Act, No. 16, § 14(2)(c) (Dominica 1997)).
120. *Id*. at *14.
121. *Id*. at *16.
122. *Id*.

whom . . . purportedly became a citizen since then,"[123] none of the acts regarding liability or damages occurred in the Virgin Islands, their attorney did not have an office in the Virgin Islands, and the sole connection to the forum was the one office that defendant Air Anguilla had in St. Thomas.[124] As a result, the court afforded only "some deference" to the plaintiffs' choice of forum,[125] and after weighing the public and private interests in favor of the Dominican forum,[126] the court granted defendants' FNC motion.[127]

Recently, the Eastern District of New York granted a FNC motion in *Khan v. Delta Airlines, Inc*.[128] Here, the district court "became concerned about using judicial resources to adjudicate a case with seemingly little or no connection with [New York], and *sua sponte* raised the issue of forum non conveniens and directed the parties to show cause why this case should not [have been] dismissed."[129] In *Khan*, plaintiff Mahmood Khan, a citizen of Canada, departed John F. Kennedy International Airport in New York for Toronto after visiting his daughter in Jericho, New York.[130] Before his flight home, Khan requested wheelchair assistance at both JFK and Toronto airports.[131] Khan, missing his originally scheduled flight to Toronto, was issued a new ticket for a subsequent flight, but the Delta counter agent forgot to include Khan's request for wheelchair assistance.[132] Absent the wheelchair assistance, Kahn was forced to walk upon his arrival in Toronto and subsequently fell and fractured his hip in the baggage claim area.[133] Thereafter, Kahn filed claims under the Montreal Convention, as well as New York state law claims for breach of contract and negligence.[134]

The district court in *Kahn* began with finding that the doctrine of FNC was available under the Montreal Convention because the text of the Convention itself "provides for a district court to employ its own procedural rules, which include the doctrine of forum non conveniens."[135] Interest-

123. *Id*. at *17–18.
124. *Id*. at *18.
125. *Id*.
126. *Id*. at *18–23.
127. *Id*. at *26.
128. 2010 U.S. Dist. LEXIS 82293 (E.D.N.Y. Aug. 12, 2010).
129. *Id*. at *1.
130. *Id*. at *2.
131. *Id*. at *2–3.
132. *Id*. at *3.
133. *Id*.
134. *Id*.
135. *Id*. at *9 (citing Pierre-Louis v. Newvac Corp., 584 F.3d 1052, 1058 (11th Cir. 2009)). In addition, the *Kahn* court stated that "Article 33 of the Montreal Convention also clearly, and without limitation, sets forth that '[q]uestions of procedure shall be governed by the law of the court seised of the case.' " *Id*. (citing Montreal Convention, *supra* note 26, art. 33(4)).

ingly, although the court would later find that the Montreal Convention did not preclude application of the FNC doctrine,[136] the court subsequently refused to determine whether or not the accident even qualified under the Convention, leaving it up to the Canadian forum to figure out.[137]

In continuing with its FNC analysis, the district court found that Kahn, as a Canadian citizen, should be afforded less deference to his choice of a New York forum.[138] The court specifically noted that the availability of witnesses, evidence, and the convenience of the parties were decisively in favor of a Canadian forum.[139] More potential witnesses would be located in Canada and "if any of the Canadian witnesses are not willing to participate in this litigation, defendants [were] without compulsory process to require them to do so."[140] After finding Canada to be an available and adequate forum,[141] the court went on to balance the private and public interest factors.[142]

First, the court found that the case was not centered in New York (i.e., where Kahn bought his ticket and where the Delta agent failed to transfer Kahn's wheelchair request); rather, because the "facts of what happened in New York [were] undisputed,"[143] the case "center[ed] on what transpired once Khan arrived in Canada."[144] This led the court to find that the private factors "overwhelming[ly] weigh[ed] in favor of adjudicating this dispute in Canada."[145]

Next, in weighing the public factors, the court stated that although it could accommodate this case on its docket, "the general interests of our society and government in protecting 'disabled passengers utilizing New York [and United States] airports'" was not enough to favor a New York forum as "New York is not 'home' to any of the parties to this action."[146]

136. *Id*. at *11–12.

137. *Id*. at *29–30.

138. *Id*. at *15.

139. *Id*. at *16.

140. *Id*. at *17. The court also noted that the availability of witnesses is not "simply a numbers game predicated on where more witnesses are located" and found that the "bigger problem" was the lack of compulsory process in New York against Canadian witnesses that would not be present in the Canadian forum. *Id*. at *16–17.

141. *Id*. at *19–20.

142. *Id*. at *20–25.

143. *Id*. at *22 (noting that defendants "conceded that their agent did not carry over Khan's wheelchair request when he was re-ticketed"). The court, in addressing Khan's argument that the case should be centered in New York, went on to state that "[a]lthough plaintiff is arguably correct that the first domino dropped in New York, it is how the rest of the dominoes fell that is the crux of this case." *Id*.

144. *Id*.

145. *Id*. at *27.

146. *Id*. at *28–29.

Accordingly, New York was a "genuinely inconvenient" forum and the Canadian forum was "significantly preferable."[147]

The Northern District of Illinois granted yet another FNC dismissal in a case arising out of the crash of a Kenya Airways flight shortly after takeoff from Douala, Cameroon.[148] The accident resulted in the death of all 114 occupants.[149] None of the occupants were U.S. residents or citizens, but thirty-seven were citizens of Cameroon.[150] Various tort claims were filed by personal representatives of the decedents against aircraft and component manufacturers in Illinois federal court.[151] In granting the defendants' FNC motion, the court found the Cameroon court system to be an available and adequate forum, even though its procedural rules were different than those provided by U.S. courts.[152] Cameroon law would provide a remedy to plaintiffs, and no reliable evidence was presented to establish that Cameroon courts were unjust or corrupt.[153] In considering the private interest factors, the court determined that Kenya Airways was an essential party to the litigation; however, there would be no jurisdiction over it in the United States, but there would be jurisdiction in Cameroon.[154] The court also gave less deference to plaintiffs' choice of forum because plaintiffs and decedents were not Illinois or even U.S. residents or citizens.[155] The public interest factors also supported a FNC dismissal because a U.S. court's interest is much less when "the action is a crash that occurred in a foreign country, resulting in the death of foreign individuals and the aircraft as maintained and crewed by a foreign [airline]."[156]

B. *FNC Denials—A Perspective from Cook County, Illinois*

In 2009, the Illinois Appellate Court affirmed the denial of a FNC dismissal in *Vivas v. Boeing*,[157] and subsequent cases relying on *Vivas* have done so as well.[158] The *Vivas* case represents a departure from FNC dismissals

147. *Id*. at *31.
148. Patricia v. Boeing Co., No. 1:09-CV-03728, 2010 U.S. Dist. LEXIS 102237 (N.D. Ill. Sept. 28, 2010).
149. *Id*. at *3.
150. *Id*. at *4.
151. *Id*.
152. *Id*. at *8–9.
153. *Id*. at *9–10.
154. *Id*. at *12–13.
155. *Id*. at *14.
156. *Id*. at *18.
157. 911 N.E.2d 1057 (Ill. App. Ct. 2009).
158. *See*, *e.g.*, Thornton v. Hamilton Sundstrand Corp., No. 1-08-2734 (Ill. App. Ct., Aug. 31, 2009); Arik v. Boeing Co., No. 08 L 012539 (Ill. Cir. Ct., Cook Cty. Feb. 18, 2010); Sabatino v. Boeing Co., No. 09 L 1056 (Ill. Cir. Ct., Cook Cty. May 27, 2010). Adler Murphy & McQuillen LLP was and continues to be involved in all three cases.

granted or affirmed by other courts in the past year involving foreign aviation accidents; however, the application of both the analytical framework and resulting decision by the Illinois Appellate Court seems to remain isolated to the confines of Illinois, at least for now.[159] Counsel arguing FNC motions for products liability cases in Illinois will need to clear a high hurdle because the rule there is that "when trial witnesses and evidence are scattered throughout different states . . . no single forum can be more convenient than another."[160] This statement by the court would seem to completely eviscerate any kind of true balancing when a court in Cook County is confronted with a FNC motion concerning a products liability case and a defendant manufacturer that has its principal place of business in Chicago.

Subsequent cases in both the Illinois appellate court and circuit courts of Cook County have adhered rather strictly to the reasoning of the *Vivas* court.[161] Before *Vivas*, Illinois followed the majority approach of comparing whether Illinois was an appropriate state to litigate the controversy when compared to the proposed alternative forum. With Boeing headquartered in Chicago, FNC dismissals surrounding aviation accidents will be hard to come by because of this perspective.

In *Arik v. Boeing Co.*,[162] the Cook County Circuit Court denied a FNC motion involving a commuter plane that crashed into mountainous terrain on its approach to Isparta, Turkey.[163] Plaintiffs brought claims for product liability, wrongful death, and negligence.[164] After finding that Turkey was an adequate forum[165] and plaintiffs' choice of the Cook County forum deserved less deference, as only one Turkish citizen resided in Cook County,[166] the trial court found that the private and public factors did not support a FNC dismissal.[167] The court, in two places in this short opinion,

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159. As of the date of this article, no other appellate court on record has employed *Vivas* in its analysis, although certain parties have brought *Vivas* up in their appellate briefs. *See, e.g.*, Brief of Appellees at 39, Tazoe v. Airbus S.A.S., Nos. 09-14847, 09-14860, 09-14875, 09-14878, 09-14879, 09-14880, 09-14881, 09-14898, 09-14908, 09-14911 (11th Cir. 2010); Brief of Appellants at 25, Tazoe v. Airbus S.A.S., Nos. 09-14847, 09-14860, 09-14875, 09-14878, 09-14879, 09-14880, 09-14881, 09-14898, 09-14908, 09-14911 (11th Cir. 2010); Appellants Reply Brief at 5, Finzsch v. Aereas, No. 09-14898-H (11th Cir. Jan. 27, 2010).

160. *Arik*, No. 08 L 012539, slip op. at 7. Interestingly, the court did not cite the *Vivas* case in the *Arik* opinion. *Id.*

161. *See Thornton*, No. 1-08-2734, slip op. at 8; *see also Arik*, No. 08 L 012539, slip op. at 5, 7; *Sabatino*, No. 09 L 1056, slip op. at 5–7.

162. No. 08 L 012539, slip op.

163. *Id.* at 1.

164. *Id.*

165. *Id.* at 2.

166. *Id.* at 3.

167. *Id.* at 4–6.

stated that because potential trial witnesses were scattered among various states and countries, no single forum could be more convenient than another.[168] The court also reiterated the view of an accident site in a products liability case is "generally unnecessary." Moreover, Illinois residents have an interest in litigation involving corporations like Boeing and McDonnell Douglas that take advantage of Illinois law.[169]

In addition to the FNC denial, the *Arik* court also denied defendants' motion to transfer to the State of Washington.[170] Although Washington was also an adequate forum and a "majority of documents and witnesses related to the design and manufacture of the Enhanced Ground Proximity Warning System are in or near Washington," the court again stated that "trial witnesses and evidence are scattered throughout different states" and "no single forum can be more convenient than another."[171] As a result, both FNC motions were denied. On September 29, 2010, the Illinois Supreme Court denied the defendants' petition for leave to appeal, but in an interesting twist has instructed the Illinois Appellate Court to review the trial court's decision.[172]

In *Sabatino v. Boeing Co.*,[173] the Cook County Circuit Court denied yet another FNC motion in a case involving personal injury claims brought by residents of the United Kingdom who were allegedly injured from exposure to fumes while on board a flight from London, England, to Orlando, Florida.[174] Plaintiffs alleged that defendants—Boeing, United Technologies, and Hamilton Sundstrand—were strictly liable and negligent in the design of the aircraft, its engines, and its bleed air system.[175]

In *Sabatino*, defendants argued for FNC dismissal based on the United Kingdom's being a significantly more convenient forum, as Illinois has no

168. *Id.* at 5, 7.

169. *Id.* at 5–6.

170. *Id.* at 7. The idea of "transferring" the case to another state was brought up in the Illinois Appellate Court's opinions in both *Vivas* and *Thornton*. Vivas v. Boeing Co., 911 N.E.2d 1057, 1072 (Ill. App. Ct. 2009) ("[I]n the case at bar, defendants did not seek to transfer this case either to Connecticut or Washington, where the aircraft and its engines were designed, manufactured and assembled. That motion would have posed a different question, and may have received a different answer."); Thornton v. Hamilton Sundstrand Corp., No. 1-08-2734, slip op. at 14–15 (Ill. App. Ct., Aug. 31, 2009) ("Here, the defendants' only proposed alternative forum is Australia, not Washington, Colorado, or Texas, where the aircraft components were designed, manufactured and sold. As we recently held, a motion seeking to transfer to relevant domestic forums rather than a foreign jurisdiction 'would have posed a different question and may have received a different answer." (quoting *Vivas*, 911 N.E.2d at 1072)).

171. *Arik*, No. 08 L 012539, slip. op. at 7.

172. *Id.*, slip op., *appeal denied*, No. 1-10-0750 (Ill. App. Ct. Apr. 29, 2010), *denial vacated and remanded*, 935 N.E.2d 515 (Ill. Sept. 29, 2010).

173. No. 09 L 1056 (Ill. Cir. Ct., Cook Cty. May 3, 2010).

174. *Id.* at 1.

175. *Id.*

significant connection to this case.[176] The court determined that because all plaintiffs were residents of the U.K., they were entitled to less deference; "[h]owever, less deference is not the same as no deference."[177] The court further noted that Illinois was not necessarily inconvenient to any of the defendants, and potential evidence did not favor one forum over the other because such evidence existed in multiple forums.[178] The court found that the "ease of access to evidence" to be an outdated factor because "[i]n this day and age the access to documentary and real evidence is a less significant factor in *forum non conveniens* analysis due to the availability of e-mail, internet, copy machines, interstate highways, bustling airways, telecommunications, etc."[179] The court did not address the ability to compel the presence of unwilling witnesses located outside of the United States.

Moreover, because this was "a products liability action, the situs of the accident is less important."[180] In applying the reasoning of *Vivas*, the court found that this case had "international implications," and "the United Kingdom, Illinois, and Florida have equal interests in deciding the controversy surrounding the fume event."[181] Specifically, "[r]esidents of Illinois have just as much interest as those in the United Kingdom or Florida in the safety of aircraft that fly in our skies,"[182] and they should be "concerned with the operations of companies that conduct business within Illinois and take advantage of Illinois law."[183] Because the court found that it was "evident that no forum enjoys a predominant connection to the litigation," defendants' FNC motion was denied.

C. *FNC—Something to Consider*

One factor U.S. courts look at in considering a FNC motion is the likelihood of the need to apply foreign law. These courts presume foreign courts can better apply foreign law than U.S. courts can. Particularly, when a foreign air carrier takes off and crashes overseas with all non-U.S. passengers, it would seem that U.S. law would be very unlikely to be applicable, although this is not always the case. As a result of a successful FNC motion in the United States, an aviation accident case has been tried to conclusion

176. *Id*. at 2. The defendants alternatively argued that if the court were to find that the United States was the more appropriate forum, then the court should transfer the case to Florida instead, as Illinois has no significant connection to this case. *Id*.

177. *Id*. at 5 (citing Vivas v. Boeing, 911 N.E.2d 1057, 1069 (Ill. App. Ct. 2009)).

178. *Id*. at 6 (listing the forums of Illinois, Florida, Connecticut, Washington, Germany, and the United Kingdom).

179. *Id*.

180. *Id*. at 7.

181. *Id*. (citing *Vivas*, 911 N.E.2d at 1071).

182. *Id*.

183. *Id*.

in Spain. The litigation concerned the 2002 mid-air collision of a Boeing B757-200 and a Tupolev TU154M over Germany, which resulted in the deaths of seventy-one people. Plaintiffs were comprised of the estates of thirty deceased occupants, none of whom were U.S. citizens. Plaintiffs' wrongful death claims, pending in the District of New Jersey, asserted products liability claims against U.S. defendants.[184] The defendants' motions to dismiss based upon FNC were granted.[185] The district court determined that the evidence was "more easily accessible in Spain" and that "given the interest of the European countries involved in this litigation, it is likely that the law of a jurisdiction other than New Jersey would apply to this case."[186] The case was subsequently reinstated in the trial court of Barcelona, Spain, where a bench trial concluded on April 22, 2009, and a decision (written in Spanish) issued in March 2010.[187] Ultimately, pursuant to the 1973 Hague Convention on the Law Applicable to Products Liability, the Spanish judge applied U.S. law—and not local law—to damages and liability issues, despite the fact that the United States was not a party to the Hague Convention.[188] The Spanish court applied the laws of two different U.S. states because the Convention required the application of the law of the principal place of business for each defendant.[189] The differences in the law of damages and liability apportionment in their respective states led to separate judgments being entered for each U.S. defendant.[190]

V. Death on the High Seas Act

In 1920, Congress passed the Death on the High Seas Act (DOHSA),[191] an admiralty law originally intended to permit the recovery of damages against a shipowner by the spouse or dependents of a seaman killed in international waters. DOHSA provides "the exclusive remedy for a wrongful death action based on an individual's death occurring on the high seas beyond three nautical miles from the shore of the United States."[192] When

184. Fatkhiboyanovich v. Honeywell Int'l Inc., 2005 U.S. Dist. LEXIS 23414, at *1–2 (D.N.J. Oct. 5, 2005). The author's firm, Adler Murphy & McQuillen LLP, was and continues to be involved in this litigation.

185. *Id*. at *1.

186. *Id*. at *12–13, *20–21.

187. Familiares de Dinislamov Dinis Rafaelyevich v. Honeywell Int'l Inc., S. Juz. Prim., Mar. 3, 2010 (R.J., No. 34) (Barcelona, Spain Full Trial 424/2007-1D).

188. *Id*. at 144–49; Convention on the Law Applicable to Products Liability, Oct. 2, 1973, 11 I.L.M. 1283, 1056 U.N.T.S. 18 [hereinafter Hague Convention on Products Liability].

189. *Honeywell Int'l*, at 144–49.

190. *Id*.

191. 46 U.S.C. §§ 30301–30308 (2010).

192. Gund v. Pilatus Aircraft, Ltd., 2010 U.S. Dist. LEXIS 22434, at *6 (N.D. Cal. Mar. 11, 2010); *see also* Zicherman v. Korean Air Lines Co., 516 U.S. 217, 231 (1996) (finding that DOHSA applies where "an airplane crash occurs on the high seas").

applicable, DOHSA preempts all other remedies.[193] Under DOHSA, recovery is generally limited to pecuniary damages with no recovery available for punitive damages or pain and suffering prior to death.[194] DOHSA does, however, have a commercial aviation accident exception that provides for recovery of both pecuniary and nonpecuniary damages (loss of care, comfort, and companionship) where "the death resulted from a commercial aviation accident occurring on the high seas beyond 12 nautical miles from the shore of the United States."[195]

A. *Commercial Aviation Accident*—Gund v. Pilatus Aircraft, Ltd.

In *Gund v. Pilatus Aircraft, Ltd.*, a small, single-engine aircraft crashed in Costa Rica during a sightseeing tour, killing the pilot and all five passengers.[196] The issue before the court was whether DOHSA preempted plaintiffs' claims, and if DOHSA did indeed apply, whether the expanded remedies for nonpecuniary losses under the commercial aviation accident exception applied.[197]

The Northern District of California found that DOHSA was applicable to this situation because the crash occurred more than three nautical miles from the shore of the United States and accordingly fell within the scope of DOHSA's "high seas."[198] After establishing DOHSA applicability, the court went on to determine whether a commercial aviation accident occurred.[199] By relying on dictionary definitions[200] and Federal Aviation Regulations (FAR),[201] the court found that DOHSA applied not only to commercial airline mass disasters, but also to this private sightseeing flight.[202] After stating that "[t]here [was] no need to reach legislative history given the clear meaning of 'commercial aviation accident,'"[203] the court found that "[t]he plain meaning of the statutory text—and the definitions in the regulations—clearly demonstrate that a flight's 'commercial' character hinges

193. *See, e.g.*, Dooley v. Korean Air Lines Co., 524 U.S. 116, 123 (1998) (noting that by enacting DOHSA, "Congress provided the exclusive recovery for deaths that occur on the high seas").

194. 46 U.S.C. §§ 30302, 30303; *see also* Bergen v. F/V St. Patrick, 816 F.2d 1345, 1350 (9th Cir. 1987) (holding that "loss of support, services, and inheritance are pecuniary damages available under DOHSA").

195. 46 U.S.C. § 30307.

196. 2010 U.S. Dist. LEXIS 22434, at *2.

197. *Id*. at *4.

198. *Id*. at *8.

199. *Id*. at *10.

200. *Id*. at *13 (quoting Black's Law Dictionary 270 (6th ed. 1990); Webster's Ninth New Collegiate Dictionary 119 (1990)).

201. *Id*. at *14 n.6 (citing Brown v. Eurocopter S.A., 111 F. Supp. 2d 859, 863 (S.D. Tex. 2000) (quoting 14 C.F.R. § 1.1)).

202. *Id*. at *18–19.

203. *Id*. at *18.

on profit or compensation."[204] As a result, "[b]ecause the passengers paid for the flight and the passengers and pilot did not share a bona fide common purpose, the crash at issue here constituted a 'commercial aviation accident' under DOHSA."[205]

The *Gund* court then considered whether Costa Rican or U.S. law should apply under choice of law principles applicable to DOHSA. The court rejected plaintiffs' argument that Costa Rican law, which permitted recovery for economic and moral damages, should apply to this action because the *Lauritzen* factors indicated that "the interests of the United States are 'sufficiently implicated to warrant the application of United States law.'"[206]

B. *Personal Representative*—In re Air Crash Disaster off the Coast of Nantucket Island, Massachusetts

This case involved the crash of EgyptAir Flight No. 990 about sixty miles from Nantucket Island.[207] Plaintiff Moataz Mohamed initially filed his complaint on behalf of the estates of his parents, who died in the crash.[208] Defendants argued that plaintiff lacked capacity to sue because, under DOHSA, "only a court-appointed personal representative of the deceased may bring suit for wrongful death."[209] Although plaintiff filed "individually and as personal representative"[210] of his parents' estates, he "only became a personal representative of his deceased parents' estate almost seven years after the limitations period expired."[211] A personal representative must be empowered by the law to administer decedent's estate and "commence the action within the three year DOHSA statute of limitations period, which accrues at the time of death."[212] The court specifically found that "[o]nly

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204. *Id*. at *16. The court also addressed the holding of the Southern District of Florida case, *Eberli v. Cirrus Design Corp*., 615 F. Supp. 2d 1369 (S.D. Fla. 2009), which held that the "commercial aviation accident" exception did not apply to a crash of an aircraft being ferried for delivery to a purchaser. *Id*. at 1374. The *Eberli* court noted that "commercial purposes" was defined by the transportation code as "the transportation of persons or property for compensation or hire." *Id*. (quoting 49 U.S.C. § 40125). Accordingly, *Eberli* found that ferrying an aircraft could not by definition be commercial, and, therefore, the crash could not be considered a "commercial aviation accident." *Id*. at 1373. Rather than distinguish *Eberli*, the *Gund* court used *Eberli* to support its use in applying definitions of "commercial" in order to find that "commercial aviation accident" had a plain meaning and was not subject to defendants' legislative history argument. *See Gund*, 2010 U.S. Dist. LEXIS 22434, at *16–18.

205. *See Gund*, 2010 U.S. Dist. LEXIS 22434, at *18–19.

206. *Id*. at *20–23 (citing Lauritzen v. Larsen, 345 U.S. 571 (1953)).

207. *In re* Air Crash Disaster off the Coast of Nantucket Island, Mass., on Oct. 31, 1999, 2010 U.S. Dist. LEXIS 30075, at *3 (E.D.N.Y. Mar. 29, 2010).

208. *Id*. at *14.

209. *Id*.

210. *Id*.

211. *Id*.

212. *Id*. at *16.

the personal representative has a cause of action under DOHSA, not the beneficiaries named in the statute or any other beneficiary of the decedent's estate."[213]

Interestingly, the fault in not completing the appointment process was that of plaintiff's attorney; however, such failure by his attorney did "not justify tolling the statute of limitations period. Having chosen to retain his attorney, plaintiff is responsible for his attorney's negligent conduct or bad advice in connection with the action."[214] As defendants asserted lack of capacity in their initial answer to plaintiff's complaint, defendants did not waive their right to challenge on such grounds. Consequently, defendants' motion to dismiss under DOHSA's statute of limitations was granted.[215]

VI. FEDERAL TORT CLAIMS ACT

In *Metro Aviation, Inc. v. United States*, Metro Aviation, a Louisiana corporation, brought an action against the United States under the Federal Tort Claims Act (FTCA), seeking damages for loss of property and wrongful death that allegedly occurred when a plane owned by Metro crashed while flying from Great Falls, Montana, to Belgrade, Montana.[216] Metro alleged that during the flight the Salt Lake Center Air Traffic Control failed to warn the pilot of a minimum safe altitude alert when the plane was descending into Belgrade.[217] The United States moved to dismiss or in the alternative to transfer the case to Utah on the premise that venue was improper in Montana.[218]

Because none of the plaintiffs resided in Montana, the issue of proper venue hinged on whether "the act or omission complained of occurred" in Montana.[219] In opposition to the motion, Metro argued that Montana was an appropriate forum because the relevant act or omission was "when the pilot failed to receive the warnings that allegedly would have prevented the crash."[220] The United States argued that the relevant act or omission would be in Utah because the Salt Lake Center Air Traffic Control center

213. *Id.*
214. *Id.* at *18.
215. *Id.* at *20–21, *37. It should also be noted that the defendants in *Gund* similarly argued that the estates of the six decedents were not proper plaintiffs. However, because the issue was not raised by plaintiffs for the purposes of appeal from the summary judgment motion, the court did not address the lack of capacity argument. Gund v. Pilatus Aircraft, Ltd., 2010 U.S. Dist. LEXIS 22434, at *24 (N.D. Cal. Mar. 11, 2010).
216. 2010 U.S. Dist. LEXIS 45321, at *1–2 (D. Mont. May 10, 2010).
217. *Id.* at *2.
218. *Id.*
219. *Id.* at *3 (quoting 28 U.S.C. § 1402(b)).
220. *Id.* at *4.

is located there.[221] In granting the motion to transfer to Utah, the district court found that under the venue provision of the FTCA, "it is where the acts or omissions take place, not where they have their 'operative effect' that is important."[222] Accordingly, the relevant act or omission alleged in the complaint was a failure to transmit a warning.[223] Therefore, the court found that the act "took place where the air traffic controllers were located, although their alleged omissions had a final effect in Montana."[224]

In another failure to warn action, *United States Aviation Underwriters Inc. v. United States* dealt with an alleged negligent handling of the approach and landing of a Gulfstream jet by an air traffic controller at William P. Hobby Airport in Houston, Texas.[225] The United States defended on the grounds that the crash occurred because of pilot error rather than any negligence on behalf of the air traffic controller.[226] Following a bench trial, District Court Judge Melinda Harmon found that air traffic controllers are held to a standard of ordinary care with respect to their responsibilities, and these responsibilities are "concurrent with the duties of pilots."[227] The court found persuasive the fact that the pilots were aware that their navigational instruments were not working properly and the weather was unusually bad, which would have led a reasonable pilot "to notify air traffic control of the problem and ask for assistance and/or rerouting."[228] However, the pilots "persisted with the Hobby landing."[229]

Moreover, air traffic controllers "are not to get into the cockpit and fly the plane for the pilot"[230] and have "no duty to warn a pilot of a condition of which he would ordinarily know or of which he should be aware based on his training, experience, and personal observations."[231] Here, the pilots "had all the information about what had gone wrong, while the air traffic controllers had none."[232] By continuing their approach, rather than "climb to a safe altitude, check the instruments again, and only then return for

221. *Id*. at *3–4.
222. *Id*. at *7.
223. *Id*. at *8.
224. *Id*.
225. 682 F. Supp. 2d 761, 763 (S.D. Tex. 2010).
226. *Id*. Additionally, Texas has a comparative negligence statute, which provides that claimants "may not recover damages if [their] percentage of responsibility is greater than 50 percent." *Id*. at 767 (quoting Tex. Civ. Prac. & Rem. Code § 33.001).
227. *Id*. at 768.
228. *Id*. at 768–69.
229. *Id*. at 769.
230. *Id*. at 768 (quoting *In re* Aircrash Disaster at Boston, Mass., July 31, 1973, 412 F. Supp. 959, 981 (D. Mass. 1976)).
231. *Id*. (quoting Beech Aircraft Corp. v. United States, 51 F.3d 834, 840 (9th Cir. 1995)).
232. *Id*. at 769.

the landing," the court found that the pilots were reckless.[233] Additionally, the court found that the air traffic controller here did not notice the problem, he was reasonable in relying on the pilots' assurance that they were navigating relative to the Instrument Landing System approach to runway four, and he immediately issued the safety alert once the Mode C Automatic altitude reports system alerted him to the dangerously low altitude of the jet.[234] The court also found that the pilots' descent below the minimum decision altitude without visual confirmation of the runway required the pilots to abort the landing.[235] Because the pilots did not abort the landing, the court found that "this error was the sole proximate cause of the accident."[236] According to the court, the air traffic controller's duty of care, in the absence of some other kind of notice that something is wrong, did not extend to intensive monitoring of an aircraft's altitude.[237] Because the air traffic controller did not breach the legal duty of care it owed to the pilots, the court found in favor of the United States.[238]

VII. PREEMPTION

Elassaad v. Independence Air, Inc.[239] provided a way for the Third Circuit to revisit its 1999 decision in *Abdullah v. American Airlines, Inc.*[240] In *Elassaad*, plaintiff fell down the airstairs of a Dornier 328 commuter jet while he was disembarking a flight operated by Independence Air.[241] Plaintiff, who was disabled, suffered injury and filed suit against Independence Air and Delta Airlines.[242] The case was removed to the Eastern District of Pennsylvania on the basis of diversity, and, ultimately, the sole liability issue remaining was, in the words of the district court, "whether Independence negligently failed to assist Elassaad in disembarking the airplane, including, without limitations, making available all appropriate safety measures and devices."[243] Independence Air sought summary judgment on the basis that the Air Carrier Access Act (ACAA) dictated the applicable standard of care and preempted state law negligence standards.[244] The standard of care set forth by the ACAA obligates a carrier to provide assistance only upon

233. *Id.* at 768–69.
234. *Id.*
235. *Id.* at 770.
236. *Id.*
237. *Id.*
238. *Id.*
239. 613 F.3d 121 (3d Cir. 2010).
240. *See id.* at 121 (citing Abdullah v. Am. Airlines, Inc., 181 F.3d 363, 365 (3d Cir. 1999)).
241. *Id.* at 122.
242. *Id.*
243. *Id.* at 123.
244. *Id.* (citing 14 C.F.R. §§ 382.1–.70 (2004)).

request, and it was undisputed that plaintiff did not ask for assistance.[245] The district court concluded that, based upon *Abdullah*, federal law preempted state law standards with respect to the standard of care for plaintiff's claim and, due to plaintiff's inability to meet such standard, granted summary judgment in favor of Independence Air.[246]

On appeal, the Third Circuit reaffirmed its ruling in *Abdullah* that "there was implied field preemption 'of the entire field of aviation safety' as a result of the [Federal] Aviation Act and its implementing regulations."[247] The court noted, however, that its "analysis of field preemption in *Abdullah*—specifically the 'field' of 'aviation safety'—was in the context of in-flight safety."[248] The court found that "the supervision of the disembarkation process by a flight crew" fell outside the scope of the field they considered to be preempted in *Abdullah*.[249] The Federal Aviation Act preempts "the entire field of aviation safety" from state regulation, but the court limited its "use of the term 'aviation safety' in *Abdullah* to describe the field preempted by federal law" as being that of in-air safety.[250] In reversing the grant of summary judgment to Independence Air, the Third Circuit held that its decision in *Abdullah* did not provide a basis to preempt state law negligence standards of care applicable to plaintiff Elassaad's claim because "a flight crew's oversight of the disembarkation of passengers once a plane has come to a complete stop at its destination" was not within the realm of "in-air safety" considered by the Third Circuit to be preempted in *Abdullah*.[251] The Third Circuit analyzed whether the Federal Aviation Act and the ACAA serve to preempt state tort law with respect to accidents that occur when a passenger is disembarking a plane and determined that they do not.[252] Plaintiff Elassaad's case was determined to be governed by state law negligence principles and the district court's order, which was based upon federal standards, was vacated and the case remanded for further proceedings.[253]

In *Sikkelee v. Precision Airmotive Corp.*,[254] the Middle District of Pennsylvania was faced with the issue of whether the manufacture of general

245. *Id.* (citing 14 C.F.R. § 382.39(a) (2004)).
246. *Id.* at 123–24.
247. *Id.* at 126.
248. *Id.*
249. *Id.* at 127. Given its determination that *Abdullah* did not apply, the court specifically declined to comment on what effect the Supreme Court's decision in *Wyeth v. Levine*, 129 S. Ct. 1187 (2009), might have upon the "continued vitality" of *Abdullah*. *Elassaad*, 613 F.3d at 127 n.7.
250. *Id.* at 126.
251. *Id.* at 121.
252. *Id.* at 131.
253. *Id.* at 134.
254. 2010 U.S. Dist. LEXIS 82735 (M.D. Pa. Aug. 13, 2010).

aviation aircraft parts falls within the "field of aviation," as expressed by *Abdullah* and subsequently refined by *Elassaad*, such that federal law would preempt any claims asserted by *Sikkelee* against carburetor manufacturers under a state law standard of care.[255] The district court acknowledged that other federal circuits have rejected the notion that federal law preempts any aspect of air safety in similar situations.[256] Ultimately, however, the court was compelled to follow the law as set forth by the Third Circuit.[257] The court noted that "although *Elassaad* slightly narrowed the broad definition of the 'field of aviation' that could be interpreted from *Abdullah*, it strongly, and perhaps explicitly, suggests that the manufacture of aircraft parts is nonetheless contained in this field and, thus, subject solely to federal standards of care."[258] Accordingly, plaintiff's claims that asserted duties under state common law standards of care against the carburetor manufacturers were dismissed.[259]

VIII. TOKYO CONVENTION

This year gave rise to the first case in the United States[260] and the second opinion anywhere to interpret the Convention on Offences and Certain Other Acts Committed on Board Aircraft[261] (commonly called the Tokyo Convention), which is an international treaty that entered into force on December 4, 1969.[262] In *Eid v. Alaska Airlines, Inc.*, the Ninth Circuit considered "when airlines may be held liable to passengers on international flights whom they force to disembark before the voyage is completed."[263] *Eid* concerned a September 29, 2003, incident aboard an international flight from Vancouver, British Columbia, to Las Vegas, Nevada.[264] Plaintiffs were comprised of nine passengers, "a group of Egyptian businessmen, their wives and a Brazilian fiancée," all of whom were traveling together to Las Vegas for a conference.[265] Verbal disputes arose between certain plaintiffs and flight attendants during the flight that resulted in the diversion of the

255. *Id.* at *29–30.
256. *Id.* at *21.
257. *Id.* at *30–31.
258. *Id.* at *30.
259. *Id.* at *32.
260. Eid v. Alaska Airlines, Inc., 2010 U.S. App. LEXIS 15777 (9th Cir. July 30, 2010).
261. Convention on Offences and Certain Other Acts Committed on Board Aircraft, Sept. 14, 1963, 20 U.S.T. 2941, 704 U.N.T.S. 219 [hereinafter Tokyo Convention].
262. The Tokyo Convention concluded at Tokyo on September 14, 1963, entered into force on December 4, 1969, and has been ratified by 185 parties. *See* Tokyo Convention, *available at* http://www.icao.int/icao/en/leb/Tokyo.pdf.
263. *Eid*, 2010 U.S. App. LEXIS 15777, at *2.
264. *Id.* at *2–3.
265. *Id.*

aircraft to Reno, Nevada, and the subsequent removal of the plaintiffs from the aircraft.[266] The plaintiffs were quickly cleared by the local Reno police and the Transportation Safety Administration to continue flying; however, the Alaska Airlines captain refused to let them reboard the flight.[267] Plaintiffs proceeded to another airline, purchased tickets, and continued to their destination.[268]

Plaintiffs subsequently sued Alaska Airlines for delay damages pursuant to article 19 of the Warsaw Convention as well as several state law defamation and intentional infliction of emotional distress claims.[269] The district court found the plaintiffs' state law claims were preempted by the Warsaw Convention and dismissed them.[270] The court subsequently granted the airline's motion for summary judgment on the Warsaw Convention delay claims on the basis that the airline was entitled to immunity under the Tokyo Convention.[271]

On appeal, the Ninth Circuit examined both the Warsaw and Tokyo Conventions and noted that, as to international flights, the liability of an air carrier for claims asserted by passengers is governed and limited by the Warsaw Convention.[272] The Tokyo Convention limits a carrier's liability further "when a passenger's claim results from actions taken by the pilot or crew to preserve order and safety on board."[273] Pursuant to the Tokyo Convention, pilots are authorized to "deplane passengers, deliver passengers to law enforcement and forcibly restrain passengers during flight; the airline is immune from any liability if the pilot has 'reasonable grounds' to support his actions."[274]

The central issue in *Eid* was the interpretation of the standard of care set forth in the Tokyo Convention with respect to the actions taken by airline captains when exercising the powers granted to them under the Convention.[275] The airline (and its supporting amici) argued that it "should not be held liable for its treatment of passengers under the Tokyo Convention unless [its captain] acted in an arbitrary and capricious manner."[276] The Ninth Circuit disagreed. Neither the Tokyo Convention nor its drafting history

266. *Id*. at *3–10.
267. *Id*. at *11.
268. *Id*. at *12.
269. *Id*. at *13.
270. *Id*.
271. *Id*. at *14 (citing Warsaw Convention, *supra* note 89; Tokyo Convention, *supra* note 261).
272. *Id*. at *14–19.
273. *Id*. at *15.
274. *Id*. at *15–16.
275. *Id*.
276. *Id*. at *16.

makes any mention of "arbitrary and capricious," but rather adopts the standard of reasonableness.[277] The court found support for application of a reasonableness standard in several contexts, including the Convention's negotiation and drafting history, presidential and senatorial communications that recommended ratifying the Tokyo Convention, and the Israeli decision of *Zikry v. Air Canada*, where aircrews were required to act reasonably in order to secure immunity pursuant to the convention.[278] The court also noted that its interpretation was consistent with its earlier decision in *Cordero v. Cia Mexicana de Aviacion, S.A.*,[279] which considered the analogous statute providing immunity for domestic flights and held that "airlines don't have immunity when they bar passengers from boarding on the basis of 'unreasonably or irrationally formed' beliefs."[280]

In the words of the court:

> [R]easonableness is a well-established and easily-understood standard, one that American courts are accustomed to applying in a wide variety of situations involving the behavior of individuals. "Arbitrary and capricious," by contrast, is a standard normally applied to actions of government agencies or judicial officers; it is seldom used to judge the conduct of individuals in the real world.[281]

The Ninth Circuit majority concluded that airlines are immune from liability for the conduct covered by the Tokyo Convention only to the extent that airline captains act reasonably when availing themselves of the powers provided to them under the Convention.[282] The court reversed the grant of summary judgment on the Warsaw delay claims and, because "reasonableness is a jury question," remanded them for trial.[283]

The Ninth Circuit also reversed the dismissal of plaintiffs' defamation claim arising from an in-flight announcement made after the airplane departed Reno without them on the basis that the Warsaw Convention does not "extend[] to lawsuits filed by former passengers for things that happen on planes long after they've disembarked."[284] The court affirmed the dismissal of the defamation claims for the statements made by the flight crew

277. *Id*. ("Article 8 of the Tokyo Convention empowers the captain to disembark anyone 'who[m] he has reasonable grounds to believe has committed' an act which 'jeopardize[s] good order and discipline on board.' Article 9 empowers a captain to turn passengers over to the police if he has 'reasonable grounds to believe' that they have committed a 'serious offence according to the penal law of the State of registration of the aircraft.' ").

278. *Id*. at *20 (citing CA (Hi) 1716/05 Zikry v. Air Canada, [2006] IsrDC).

279. 681 F.2d 669 (9th Cir. 1982).

280. *Eid*, 2010 U.S. App. LEXIS 15777, at *20–21 (citing *Cordero*, 681 F.2d at 671).

281. *Id*. at *21.

282. *Id*. at *22–23.

283. *Id*. at *24–25.

284. *Id*. at *39–40.

in the gate area shortly after plaintiffs were removed because the "Warsaw Convention applies to embarkation and disembarkation and all the activities following that were links in one's chain."[285]

The lengthy majority opinion was followed by an even longer response by Judge Otero, who recited the facts from the perspective of the captain and vehemently dissented from the majority's adoption of a reasonableness standard rather than a deferential arbitrary or capricious standard in order to properly analyze an airline captain's flight decisions.[286] Judge Otero noted that "the word 'reasonable' does not necessarily carry the same meaning across all legal systems."[287] Because the Tokyo Convention is a treaty among sovereign powers, it "would be an oversight on our part to assume that the phrase 'reasonable grounds' in the Tokyo Convention should be construed to mean the American reasonableness standard."[288] According to Judge Otero:

> [T]he unintended but probable consequence of the standard my colleagues adopt for judging the in-flight conduct of a pilot under the Tokyo Convention is risk to passenger and crew safety—an affront to the principal purpose of the Tokyo Convention. The majority misinterprets the standard and examines facts in hindsight that were unknown to the captain at the time of the event, concluding that [he] may have acted unreasonably.[289]

285. *Id*. at *38 (citing CA (Hi) 1716/05 Zikry v. Air Canada, [2006] IsrDC § 19).
286. *See id*. at *45–88 (Otero, J., dissenting).
287. *Id*. at *65.
288. *Id*. at *56.
289. *Id*. at *46.

RECENT DEVELOPMENTS IN BUSINESS LITIGATION

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This article highlights significant business litigation cases decided between November 2009 and October 2010 on (1) civil RICO, (2) covenants not to compete, (3) breach of contract, (4) remedies, (5) breach of fiduciary duty, and (6) fraud and misrepresentation.

I. CIVIL RICO

This past year, federal courts generally limited the extent to which plaintiffs can use civil RICO to impose liability on defendants.

In *Hemi Group, LLC v. City of New York*, the U.S. Supreme Court considered whether—to support New York City's § 1964(c) claim—the city's loss of tax revenue from cigarette sales "came about 'by reason of' " an out-of-state cigarette seller's failure to file its customer information with

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the state.[1] Writing for the Court, Chief Justice Roberts held the city could not show the cigarette seller's alleged failure to provide information to the state caused the lost revenue. Thus, the city could not state a civil RICO claim.[2]

The Jenkins Act mandates out-of-state cigarette sellers submit information to the states in which they ship cigarettes.[3] The State of New York agreed to forward this information to New York City. This information helps the city find cigarette buyers who have not paid the required taxes on the cigarettes. The city sued Hemi Group, LLC alleging Hemi's failure to provide the state the required information constituted the predicate offenses of mail and wire fraud.[4]

In analyzing whether the city's alleged injury—lost taxes—"came about by reason of" Hemi's allegedly fraudulent conduct, the Court noted a "plaintiff is required to show that a RICO predicate offense 'not only was a "but for" cause of his injury, but was the proximate cause as well.' "[5] Here, the city could not show Hemi's alleged fraud proximately caused the city's lost tax revenue. The individual customers' failure to pay taxes on their cigarette purchases caused the city's harm. On the other hand, the alleged fraud was Hemi's failure to file its Jenkins Act reports with the state. Because the conduct causing the city harm was separate and distinct from the fraudulent conduct, the alleged injury was not caused "by reason of" Hemi's alleged fraud.[6] The Court noted, "the City's theory of liability rests not just on separate *actions*, but separate actions carried out by separate *parties*."[7]

In *Chaney v. Dreyfus Service Corp.*, the Fifth Circuit held the plaintiffs, receivers of seven defrauded insurance companies, could not win civil RICO liability against Dreyfus Service Corporation.[8] Dreyfus is the investment company that unknowingly helped the now infamous money launderer Martin Frankel funnel the insurance companies' funds to Frankel's Swiss bank accounts. The plaintiffs' theory was, by deliberately turning "a blind

1. 130 S. Ct. 983 (2010).
2. *Id.* at 986.
3. 15 U.S.C. §§ 375–78.
4. *Hemi Group*, 130 S. Ct. at 987.
5. *Id.* at 989. "A link [between the alleged fraud and the injury] that is 'too remote,' 'purely contingent,' or 'indirec[t]' is insufficient." *Id.* (internal citation omitted).
6. *Id.* at 994.
7. *Id.* at 990. In summarizing its holding, the Court characterized this case as being "about the RICO liability of a company for lost taxes it had no obligation to collect, remit, or pay, which harmed a party to whom it owed no duty. It is about imposing such liability to substitute for or complement a governing body's uncertain ability or desire to collect taxes directly from those who owe them." *Id.* at 994.
8. 595 F.3d 219, 225 (5th Cir. 2010).

eye" to Frankel's suspicious activities, DSC effectively joined Frankel's conspiracy. DSC had no standards in place to identify the origin and legitimacy of the funds passing through its accounts, and DSC allegedly unknowingly transferred over $480 million of the insurance companies' funds to Frankel's Swiss bank accounts in 1994.[9]

The Fifth Circuit concluded the plaintiffs' RICO claims should be dismissed because "there [was] no evidence that anyone at DSC knew or purposely contrived to avoid knowing that Frankel was engaged in money laundering."[10] To recover under a RICO conspiracy theory, the receivers had to show "(1) that two or more people agreed to commit a substantive RICO offense and (2) that [DSC] knew of and agreed to the overall objective of the RICO offense."[11] The court focused on the second element, stating, "[a] conspirator must at least know of the conspiracy and 'adopt the goal of furthering or facilitating the criminal endeavor.' "[12] Although there was no evidence DSC knew of the money laundering scheme, the plaintiffs claimed knowledge could be established through DSC's "deliberate ignorance" of the situation. The court determined the plaintiffs had not established deliberate ignorance. DSC acted recklessly at worst. As such, DSC could not be liable under the plaintiffs' civil RICO conspiracy claim.[13]

The Tenth Circuit held in *Bixler v. Foster* that corporate shareholders have no standing to sue their directors and officers for injuries based on civil RICO.[14] The plaintiffs, minority shareholders, sued, claiming the directors and officers violated RICO by transferring the corporation's assets to a foreign company.

The Tenth Circuit concluded the plaintiffs did not have standing under RICO to assert their shareholder derivative claims. A plaintiff has standing under RICO only if his injuries are "proximately caused by the RICO violation."[15] The injuries must be "direct and personal."[16] Generally, conduct harming a corporation "confers standing on the corporation, not its shareholders."[17] The *Bixler* plaintiffs only asserted a diminution in value of their shares. Because that harm is only against the corporation, the plaintiffs' claims were derivative of the corporation and not "direct and personal." Thus, the shareholders did not have standing to sue under RICO.[18]

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9. *Id*. at 227–28.
10. *Id*. at 226.
11. *Id*. at 239 (citing United States v. Sharpe, 193 F.3d 852, 869 (5th Cir. 1999)).
12. *Id*. (citing Salinas v. United States, 522 U.S. 52, 65 (1997)).
13. *Id*. at 242.
14. 596 F.3d 751, 754 (10th Cir. 2010).
15. *Id*. at 756.
16. *Id*. at 757.
17. *Id*.
18. *Id*. at 758.

Also, the court determined the shareholders' claims must fail for several additional reasons. First, the Private Securities Litigation Reform Act (PSLRA) amended RICO so "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation" of RICO.[19] The shareholders claimed the PSLRA amendment did not apply because their claims did not involve "the purchase or sale of securities." The court concluded the PSLRA amendment applied to prevent the RICO claims, as the shareholders' claims of diminution in value of their shares involved the "purchase" and "sale" of securities.[20]

Second, the court concluded the dismissal of the shareholders' claims was proper because they did not state a claim of "continuity" of the alleged RICO scheme. A RICO claim must allege, among other things, a "pattern of racketeering activity" requiring at least two predicate acts.[21] And the two or more predicate acts must "amount to" or "otherwise constitute a threat of, *continuing* racketeering activity."[22] The shareholders' claim failed to allege continuity because the complaint described a single scheme to defraud the shareholders, with no threat of future criminal conduct.[23]

In *American Dental Association v. CIGNA Corp.*,[24] several dentists brought a RICO claim against insurance companies alleging the insurance companies "engaged in a systematic, fraudulent scheme to diminish payments to Class Plaintiffs" through automatic downcoding, code manipulation, and improper bundling.[25] The question before the court was whether the plaintiffs sufficiently pleaded their factual allegations in their RICO complaint pursuant to Federal Rule of Civil Procedure 9(b) and the Supreme Court precedent set by *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*.[26] The court concluded the plaintiffs had not done so and affirmed the dismissal of the complaint.[27]

The Eleventh Circuit first looked to the pleading standard set forth by *Twombly* and *Iqbal*. To state a RICO claim, a complaint must state sufficient

19. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 758 (amending 18 U.S.C. § 1964(c)).

20. *Bixler*, 596 F.3d at 760.

21. *Id*. at 761. *See also* Am. Dental Ass'n v. CIGNA Corp., 605 F.3d 1283 (11th Cir. 2010), *infra* (also discussing the required "continuity" of RICO schemes).

22. *Bixler*, 596 F.3d at 761 (internal citation omitted).

23. *Id*.

24. 605 F.3d 1283 (11th Cir. 2010).

25. *Id*. at 1286. The American Dental Association also asserted representational standing on its members' behalf. *See id*.

26. Bell Atlantic Corp. v. Twombly, 50 U.S. 544 (2007); Ashcroft v. Iqbal, 129 S. Ct. 1937 (2009).

27. *See Am. Dental Ass'n*, 605 F.3d at 1286.

factual allegations to "state a claim to relief that is plausible on its face."[28] The court then analyzed the plaintiffs' factual allegations against the requirements of the RICO statutes.

The court concluded the plaintiffs failed to allege sufficient facts under § 1962(c). Section 1962(c) requires a plaintiff prove "a defendant participated in an illegal enterprise 'through a pattern of racketeering activity.' "[29] To show a "a pattern of racketeering activity," a plaintiff must show "at least two racketeering predicates that are related, and that they amount to or pose a threat of continued criminal activity."[30] The plaintiffs alleged only that the insurance companies' advertising, agreements, and fee schedules were fraudulent. This was a single scheme among all the insurance companies. The plaintiffs did not allege "parallel schemes among competing dental insurers."[31] Thus, the plaintiffs would need to "plausibly and particularly allege facts" showing the alleged predicate act (mail and wire fraud), and also "plausibly allege facts showing that a conspiracy created the alleged scheme."[32] The court found the plaintiffs failed to plead a pattern of racketeering activity predicated on a scheme to commit mail and wire fraud.[33]

The court also determined the plaintiffs failed to allege sufficient facts to support a § 1962(d) RICO conspiracy claim. Section 1962(d) makes it illegal for anyone to conspire to violate one of the substantive RICO provisions. A RICO conspiracy claim is established by showing (1) the defendant agreed to the objective of the conspiracy or (2) the defendant agreed to commit two or more predicate acts.[34] Again, however, the plaintiffs' complaint did not support an inference of a RICO conspiracy when considered under the "plausibility" pleading standard set forth by *Twombly* and *Iqbal*. At most, the plaintiffs' alleged conduct rose to "parallel conduct," which by itself is not sufficient to prove a conspiracy.[35]

Finally, *In re Insurance Brokerage Antitrust Litigation* was one of the few RICO cases this year to rule, to a certain extent, for the plaintiffs.[36] This

28. *Id*. at 1289 (citing *Twombly*, 50 U.S. at 570).
29. *Id*. (citing 18 U.S.C. § 1962(c)).
30. *Id*. at 1290–91 (internal citations omitted).
31. *Id*. at 1291.
32. *Id*.
33. *Id*. at 1296. *See also* US Airline Pilots Ass'n v. AWAPPA, LLC, 615 F.3d 312 (4th Cir. 2010) (dismissing the plaintiffs' RICO claim because they failed to allege "a pattern" of "at least two acts" of racketeering activity when they alleged that defendants engaged in activity to achieve a "single goal").
34. *Am. Dental Ass'n*, 605 F.3d at 1293–94.
35. *Id*. at 1295.
36. Nos. 07-4046, 08-1455, 08-1777, 2010 U.S. App. LEXIS 17107 (3d Cir. Aug. 16, 2010). Although most of the claims in this case alleged Sherman Act violations, the court also thoroughly analyzed the RICO claims.

class action followed the New York State attorney general's 2004 complaint against insurance broker Marsh & McLennan alleging "Marsh had solicited rigged bids for insurance contracts, and had received improper contingent commission payments in exchange for steering its clients to a select group of insurers."[37] The class action alleged the defendants, insurance companies and brokers, entered into unlawful schemes to allocate purchasers among certain groups of insurers, ultimately inflating prices for the plaintiffs' insurance coverage and denying them the benefits of a competitive market.[38]

The district court dismissed the plaintiffs' § 1962(c) claims. Noting § 1962(c) requires the plaintiffs to prove (1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity,[39] it found the plaintiffs failed to plead facts plausibly suggesting the "conduct" and "enterprise" elements of RICO.[40] But the Third Circuit disagreed and held the plaintiffs adequately pleaded "enterprise" and "conduct" for certain of their § 1962(c) claims.[41]

The plaintiffs alleged two types of enterprises for its RICO claims: (1) broker-centered enterprises, involving collusion between the brokers and their insurer-partners, and (2) a legal entity enterprise, the Council of Insurance Agents & Brokers (CIAB) trade association. The court determined that as for the RICO claims based on the Marsh-centered enterprise, the plaintiffs adequately pleaded the enterprise. Specifically, the plaintiffs alleged Marsh was active in deciding what each insurer's sham bid would be, and Marsh and the insurers had a common interest: increasing profits.[42] The plaintiffs also adequately pleaded "conduct" on the part of the Marsh-centered enterprise by averring, among other specific allegations in the complaint, that Marsh and the insurers "conduct[ed] or participat[ed], directly or indirectly, in the conduct of such enterprise's affairs" by collaborating in the bid-rigging to deceive insurance purchasers.[43]

As for the CIAB enterprise, although the district court acknowledged the complaint adequately pleaded the "enterprise" element because CIAB was a legal entity, it concluded the complaint failed to properly allege the "conduct" element because it did nothing more than allege CIAB provided a forum for the defendants to discuss their schemes.[44] But the Third Cir-

37. *Id.* at *232 (internal citations omitted).
38. *See id.* at *229.
39. *See id.* at *181.
40. *Id.* at *184–85.
41. *Id.* at *232.
42. *See id.* at *223–24.
43. *Id.* at *229–32 (internal citation omitted).
44. *Id.* at *234.

cuit read the complaint more broadly, concluding the complaint might be read to assert additional facts from which one could infer the brokers participated in the conduct of the CIAB enterprise. For this reason, the court also vacated the district court's dismissal of the CIAB-based claims and remanded the claims back to the district court for further consideration.[45]

II. COVENANTS NOT TO COMPETE

Facts play an exceptionally large role in a noncompete case. This last year's cases demonstrate the significance of facts.

In *Bimbo Bakeries USA, Inc. v. Botticella*,[46] the court enjoined Botticella from working with Bimbo's competitor, Hostess Brands, Inc. He was also enjoined from divulging trade secrets and other information.[47] The court preliminarily found Botticella violated a Confidentiality, Non-Solicitation and Invention Assignment Agreement with Bimbo.[48]

Botticella was a vice president.[49] He had access to sensitive and confidential information, including strategic plans.[50] Botticella agreed to join Hostess three months before he left Bimbo.[51] He first disclosed to Bimbo his plans to work for Hostess at approximately 10:00 A.M. on January 13, 2010.[52] At 10:12 A.M. the same day, he accessed twelve company documents containing highly confidential information (including strategic planning).[53] He had at least three external storage devices—such as flash drives—attached to his computer.[54] Botticella explained at deposition that his computer activity was practicing for his new job.[55] He chose not to testify at the injunction hearing.[56] On these facts, the court enjoined Botticella.[57]

Similarly, Keymon's pre-termination acts in *The Hamilton-Ryker Group, LLC v. Keymon*[58] weighed heavily when the court enjoined her. The court enjoined Keymon despite the lack of a territorial restriction that could have rendered the noncompete unenforceable.

45. *Id*. at *240–42. Because the Third Circuit held the plaintiffs failed to adequately plead their § 1962(c) claims, it likewise vacated the dismissal of the conspiracy claims relating to the substantive § 1962(c) claims. *See id*. at *245.
46. No. 10-0194, 2010 WL 571774 (E.D. Pa. Feb. 9, 2010).
47. *Id*. at *17.
48. *Id*. at *14.
49. *Id*. at *1.
50. *Id*.
51. *Id*. at *5.
52. *Id*.
53. *Id*.
54. *Id*. at *6.
55. *Id*.
56. *Id*. at *8.
57. *Id*. at *17.
58. No. W2008-00936-COA-R3-CV, 2010 WL 323057 (Tenn. Ct. App. Jan. 28, 2010).

Hamilton-Ryker employed Keymon in Memphis.[59] Hamilton-Ryker considered her an invaluable employee, and she supervised the Memphis facility for years.[60] Memphis primarily consisted of providing "dot prep" services to Federal Express.[61] Hamilton-Ryker expanded to other clients after losing the Federal Express account.[62] One of those clients was Oasis, Inc.[63] Oasis had a contract with Verizon Communications to deliver telephone directories.[64] Hamilton-Ryker contracted with Oasis and worked with Verizon to put address labels on the directories before Oasis delivered the directories. Keymon was the person in charge of this work.[65]

Hamilton-Ryker eliminated Keymon's position, but it offered her another position the company thought would be more desirable at Keymon's same salary.[66] Keymon objected and she was temporarily laid off until there was a final determination as to whether she could have another position or be terminated.[67] During this layoff, Keymon approached Oasis and Verizon and proposed that she work with Oasis to serve Verizon and, thereby, take the business away from Hamilton-Ryker.[68] In preparation to move the Verizon work from Hamilton-Ryker to Oasis, Keymon used her Hamilton-Ryker e-mail to send about fifty-six documents on Hamilton-Ryker's Verizon work to Keymon's personal e-mail address.[69] The documents included Verizon's anticipated production schedule, profit-loss analysis, and Verizon mail address listings.[70] Hamilton-Ryker did not learn of Keymon's arrangement with Oasis and Verizon until later.[71]

Keymon executed an Employment Agreement that had been updated and signed by her numerous times.[72] Keymon claimed the agreement did not specify a geographic boundary as required by Tennessee law.[73] But, the trial court found the agreement specified Keymon could not compete with Hamilton-Ryker for existing clients or customers.[74] The court found Oasis was Hamilton-Ryker's existing client or customer and, by specifying cus-

59. *Id*. at *1.
60. *Id*. at *2.
61. *Id*.
62. *Id*.
63. *Id*. at *3.
64. *Id*.
65. *Id*.
66. *Id*. at *4.
67. *Id*.
68. *Id*. at *5.
69. *Id*. at *4.
70. *Id*.
71. *Id*. at *5.
72. *Id*. at *1.
73. *Id*. at *12.
74. *Id*.

tomers, obviated the need for a specific geographic limit.[75] The trial court awarded Hamilton-Ryker $948,356.[76]

A Texas intermediate appellate court also considered the issue of geographic limits to covenants not to compete. In *Cobb v. Caye Publishing Group, Inc.*,[77] the court examined the case of Cobb leaving Caye to work for a competitor in Aledo and Weatherford counties.

The court found Cobb's covenant not to compete had no geographical restriction.[78] "A covenant not to compete with a broad geographical scope is unenforceable, particularly when no evidence establishes that the employee actually worked in all areas covered by the covenant."[79]

The court then considered whether the agreement could be reformed.[80] Hewing closely to its earlier statement that a restraint is unreasonable if it is broader than necessary, the court examined whether it was reasonable to reform the agreement to include a geographical restriction that would include Aledo and Weatherford counties.[81]

Once again, facts became important. Cobb never worked in Aledo or Weatherford county for Caye.[82] Cobb sold advertising for Caye only in Johnson County.[83] Thus, an agreement restricting Cobb from competition in Aledo and Weatherford counties would be overbroad.[84]

The facts also worked against the former employer in *Jones v. United Propane Gas, Inc.*[85] Jones and a co-worker, Maples, left Ocoee River Propane Gas, an affiliate of United Propane Gas, Inc., to work for Hydratane of Athens.[86]

Jones began working for Ocoee as a delivery driver on January 15, 2007.[87] Three days later, he signed a covenant not to compete and employment agreement.[88] The day Jones signed the agreement, he also attended orientation.[89] Jones became disgruntled and left Ocoee the day after his orientation.[90] During his employment, the entirety of his activities included

75. *Id.*
76. *Id.* at *10.
77. No. 2-09-426-CV, 2010 WL 3303831 (Tex. App. Aug. 19, 2010).
78. *Id.* at *2
79. *Id.*
80. *Id.*
81. *Id.* at *3.
82. *Id.* at *4.
83. *Id.*
84. *Id.*
85. No. E2009-00364-OA-R3-CV, 2009 WL 5083476 (Tenn. Ct. App. Dec. 28, 2009).
86. *Id.* at *1.
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*

reporting to work, riding along on one delivery, sitting in the office, and reporting for orientation.[91]

While one might question the wisdom of suing to enforce a covenant not to compete against an employee who had only worked at a company for four days, Ocoee did not have the luxury of this decision because Jones and Maples sued first.[92] Ocoee argued all of its employees, including delivery drivers, were key employees because they were exposed to confidential customer information.[93] Ocoee also cited a similar case involving a delivery driver, *Amerigas Propane, Inc. v. Crook*.[94] But the court distinguished *Crook*. In *Crook*, the employees took 106 customers from Amerigas.[95] In *Jones*, Ocoee did not lose any customers to Hydratane and Maples did not solicit any Ocoee customers.[96] Thus, the noncompetes were unenforceable.

Noncompete cases inherently involve legal principles because they rely on contracts and statutes. But these principles do not exist in a vacuum. Clients should carefully consider the facts and decide whether suing employees who are minor employees, have worked for a short period of time, and did not take any clients warrants spending legal resources. Departing employees should recognize that the actual theft of true trade secret information used in directly competitive activities may tip the balance in favor of the employer.

III. Breach of Contract

This year, several cases explored contract formation, interpretation, and breach by e-mail.

In *DiFolco v. MSNBC Cable, LLC*,[97] DiFolco asked via e-mail to meet with her supervisor about repeated cancellations of her scheduled television appearances. The district court concluded DiFolco repudiated her two-year employment contract as an entertainment correspondent for MSNBC in the e-mail and therefore MSNBC had no financial obligations to DiFolco under her contract. Thus, MSNBC did not breach her employment contract.[98] The district court found the contract was "unambiguous in its requirement that [DiFolco] be at MSNBC's disposal for a two-year period" and that "[p]laintiff's 8/23 e-mail is equally unambiguous

91. *Id.*
92. *Id.*
93. *Id.* at *17.
94. *Id.* (citing Amerigas Propane, Inc. v. Crook, 844 F. Supp. 379 (M.D. Tenn. 1993)).
95. *Id.*
96. *Id.*
97. No. 09-2821-CV, 2010 U.S. App. LEXIS 20739 (2d Cir. Oct. 7, 2010).
98. *Id.* at *4.

in expressing [DiFolco's] intention to leave before the completion of said period."[99] After referring to another e-mail, the district court determined "[b]oth of these e-mails from [DiFolco] constituted repudiation of the contract and relieved MSNBC of future obligations."[100]

The court of appeal held DiFolco's complaint alleged on its face a breach of her employment contract with MSNBC.[101] She alleged she was subjected to intolerable working conditions and that she was fired when she complained about them.[102] She also asserted defendants improperly interpreted certain of her e-mails as notices of resignation.[103] The court observed that although DiFolco wrote she wished to "discuss [her] exit from the shows" and to give MSNBC "ample time to replace [her]," these statements could be indicative of her desire to get out from under the direction of the people with whom she had problems, rather than to leave MSNBC altogether.[104] Also, writing she wanted to "be a part of [MSNBC's] team for a long time to come" and requesting a meeting with her supervisor to discuss matters further showed her desire to continue employment differently.[105] And the court considered DiFolco's e-mail to her supervisor the very next day, in which DiFolco asked about the cancellation of an assignment:

> [T]o be clear, I did not resign yesterday and was really giving you significant notice of my intention so you could begin thinking about alternatives for next year. [A]s always, count on my continued professionalism.[106]

Under New York law, "[a] repudiation can be either a statement by the obligor to the obligee indicating that the obligor will commit a breach that would of itself give the obligee a claim for damages for total breach or a voluntary affirmative act which renders the obligor unable or apparently unable to perform without such a breach."[107] But a repudiation only occurs when "the announcement of an intention not to perform was positive and unequivocal."[108]

The court of appeal explained that generally, "[t]he issue of repudiation or abandonment is an issue of fact,"[109] except if the repudiation is written, in which case the court may resolve the issue "as a matter of law."[110] Even

99. *Id*. (citation omitted).
100. *Id*. (citation omitted).
101. *Id*. at *6.
102. *Id*.
103. *Id*.
104. *Id*. at *7.
105. *Id*.
106. *Id*.
107. *Id*. at *6 (citation omitted).
108. *Id*. (citation omitted).
109. *Id* at *7 (citation omitted).
110. *Id*.

if the repudiation is written, where the writings are ambiguous, "then such determination [i.e., repudiation] is to be made by the jury."[111]

The court of appeal held DiFolco's e-mail was not unambiguous as a matter of law, and that there were factual issues as to whether DiFolco made a final and definite communication of an intent to forgo performance or indicated her refusal to perform in a clear and unqualified way such as to justify a conclusion that she had repudiated her contract.[112]

For many years, the Preston Law Firm represented Mariner in numerous litigation matters.[113] Mariner fell behind on its legal fees.[114] The parties discussed a payment plan for approximately $2 million in legal fees and for all future legal fees.[115] The partner negotiating the fee dispute, Lemmon, sent Mariner's general counsel, Ehrlich, an e-mail setting forth an agreement regarding payment of the legal fees:[116]

> [Ehrlich], Paul asked that I put my understanding of the proposal in writing so that we all have a clear and consistent understanding. Bills submitted through February 28, 2005 will be paid out in 12 equal monthly payments. By way of example, if Mariner owes P&C $1.5 million in bills submitted during this time frame, monthly payments in the amount of $125,000 will be made until the bills are paid in full. No reduction of the bills will be made. Going forward from March 1, 2005, bills will be paid within 90 days. Please let me know if my understanding is correct. Thanks. [Lemmon][117]

Ehrlich replied the same day: "We have never discussed reductions in bills, but otherwise your understanding is correct."[118]

Pursuant to the March 21 e-mails, an initial contract for payment by Mariner of legal fees was formed.[119] Following additional telephone discussions, Ehrlich sent Lemmon an e-mail setting forth an agreement with different terms:

> This will confirm we will pay all fees incurred as of February 28, 2005 as follows:
>
> The total will be discounted by 25 percent.
>
> - $300,000 will be paid on or before March 31
> - $300,000 will be paid on or before April 30

111. *Id.* (citation omitted).
112. *Id.*
113. Preston Law Firm, L.L.C. v. Mariner Health Care Mgmt. Co., No. 09-31016, 2010 WL 3816093, at *1 (5th Cir. Oct. 1, 2010).
114. *Id.*
115. *Id.*
116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.*

> - $400,000 will be paid on or before May 31
> - $500,000 (or whatever the true balance is) will be paid on or before June 30
>
> All fees incurred from March 1 forward will be paid on a 90 day basis.
>
> Please let me know if your understanding differs. Thanks. Devin M. Ehrlich.[120]

Each installment payment was made according to this schedule, except the May installment (paid on May 27, 2005) was for only $300,000, with the remaining $100,000 being paid on June 10, 2005. Payments for legal fees incurred after February 28, 2005, and subject to a ninety-day payment schedule, were made by Mariner prior to this lawsuit, but most were late.[121]

More than one month after $1.5 million had been paid as scheduled, Lemmon sent Ehrlich an e-mail with the subject line "Payment of Overdue P&C Bills"[122]:

> Dear Devin
>
> At some point last fall, our bills simply stopped being paid without any warning or explanation whatsoever . . . Long overdue bills remained unpaid notwithstanding repeated inquiries. Negotiations began and we finally and reluctantly agreed to reduce the total amount owed by 25% for all time incurred through the end of February 2005, with the further understanding that all time incurred from the end of February 2005 forward would be paid on a ninety (90) day cycle . . . Very truly yours, Roslyn Lemmon.[123]

The next relevant communication was an e-mail by Lemmon to Ehrlich, included in an e-mail chain, which had the subject line "RE: Preston & Cowan Revised Proposal" and read in full:

> Devin, The timing is not great, but at some point soon, we need to reach an agreement. With the upcoming trial dates, we need to talk about a retainer for payment. As an additional request, we would also ask that Mariner consider paying at least a portion of the amount previously compromised. In other words, we took $1.5 million out of $2 million owed, and now request that Mariner consider paying the debt in full. Thank you, Roslyn[124]

The final relevant communication between the Firm and Mariner was an e-mail sent by Lemmon to one of Ehrlich's colleagues, copying Ehrlich:

> Marty, [W]e conditionally accepted a partial payment of $1.5 million on a debt of $2 million to accommodate Mariner during its merger/acquisition

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120. *Id*. at *2.
121. *Id*.
122. *Id*.
123. *Id*.
124. *Id*.

> with SAVA. In accordance with my previous e-mail and discussions with Devin, we would ask that Mariner now consider paying the debt in full . . . Thanks and best regards, Roslyn.[125]

No further communications concerning payment of legal fees occurred until the firm threatened and then brought this lawsuit.[126]

The Fifth Circuit held that under Louisiana law, a "contract is formed by the consent of the parties established through offer and acceptance. Unless the law prescribes a certain formality for the intended contract, offer and acceptance may be made orally, in writing, or by action or inaction that under the circumstances is clearly indicative of consent."[127] The e-mails and the prior related telephone discussions between Lemmon and Ehrlich formed an initial contract for the payment of 100% of the legal fees.[128]

In the later e-mails, Lemmon acknowledged the firm "finally and reluctantly agreed to reduce the total amount owed by 25% for all the time incurred through the end of February 2005."[129] Together, these e-mails formed a valid compromise.[130] The firm's reluctance did not diminish the fact that it "agreed to" and recited the discounted terms.[131]

In *Todd v. Kohl's Department Store*, Kohl's sued to enforce an agreement reached through a series of e-mails to settle Todd's employment discrimination suit against Kohl's, even though the employee developed second thoughts.[132] Kohl's argued the agreement, consisting of e-mails between the parties' counsels, is enforceable because it included all of the material terms and the parties' mutual assent to those terms is undeniably evidenced in the e-mails.[133] Brady, Kohl's counsel, e-mailed Clarke, Todd's counsel, stating the two discussed settlement over the phone, and acknowledging Todd extended an offer for Kohl's consideration.[134] The e-mail concluded by stating Brady would notify Clarke as soon as she discussed it with her client.[135]

Brady sent a second e-mail to Clarke indicating Kohl's acceptance: "Please allow this correspondence to confirm that the parties have reached a settlement agreement . . . ."[136] All the agreement's material terms were

125. *Id.*
126. *Id.* at *3.
127. *Id.* at *5 (citation omitted).
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. No. 08-CV-3827, 2010 WL 3720265 (N.D. Ill. Sept. 15, 2010).
133. *Id.* at *1.
134. *Id.*
135. *Id.*
136. *Id.* at *2.

contained both in the e-mail's body and in the attached draft Confidential Settlement Agreement and General Release.[137]

Brady made minor revisions to the agreement at Clarke's request and the two exchanged e-mails reflecting those changes.[138] The revisions primarily concerned the agreement's language and did not alter any material terms.[139] Brady also sent a Stipulation for Dismissal and a proposed Order of Dismissal.[140]

The same day, Clarke e-mailed Brady to inform her Todd would be coming into his office that day to sign the Confidential Settlement Agreement and General Release, and asked that Brady expedite the document preparation.[141] By mid-morning, Brady e-mailed Clarke the final version of the Confidential Settlement Agreement and General Release, as well as a neutral reference letter on Kohl's letterhead.[142]

Later that afternoon, Clarke left a voice-mail message with Brady indicating Todd was reconsidering the settlement.[143] Brady responded by e-mail stating, "we have already reached an enforceable settlement agreement, and we will seek to enforce it if necessary."[144] Afterward, Clarke told Brady he had not yet received instructions from Todd on whether he would now accept the agreement he authorized, but advised her Todd was leaning toward the settlement.[145] Clarke finally informed Brady Todd wanted to reject the settlement.[146] In response, Kohl's filed a Motion to Enforce Settlement asking that the court "find[ ] that the parties entered into a binding settlement agreement" and sought a declaration of enforceability.[147]

Todd responded *pro se*, claiming the negotiations were made without his consent.[148] The court held that even where a client informs his counsel of some reservation regarding settlement, but counsel fails to communicate that reservation and executes a settlement agreement, the uncommunicated mental reservation on the part of one party is ineffectual and is not a valid reason for avoiding an otherwise binding agreement.[149] Settlement agreements—whether oral or written—are contracts.[150] "Secret hopes and

137. *Id*.
138. *Id*.
139. *Id*.
140. *Id*.
141. *Id*.
142. *Id*.
143. *Id*.
144. *Id*.
145. *Id*.
146. *Id*.
147. *Id*.
148. *Id*. at *3.
149. *Id*. at *6.
150. *Id*.

wishes count for nothing because the status of a document as a contract depends on what the parties express to each other and to the world, not on what they keep to themselves."[151] Whether there is "meeting of the minds" is based on an objective appraisal of the parties' conduct, not their subjective beliefs.[152]

The court held the attorneys' e-mails reflect sufficiently concrete and definite terms sufficient to constitute an enforceable agreement, and Todd did not argue to the contrary.[153] Todd stated he was informed of every detail of the agreement and his counsel at his instruction agreed on all of the material terms.[154] The court held although Brady and Clarke continued to exchange e-mails making small changes to the settlement documents, that correspondence did not affect the enforceability of the parties' oral agreement.[155] The court further held Brady's e-mail to Clarke confirming the parties' settlement was unambiguous in reflecting the parties' intent to form a binding agreement.[156] The court determined the circumstances precluded a finding that the parties merely engaged in preliminary negotiations.[157]

IV. REMEDIES

This year has seen the economic loss rule's continued expansion and contraction.

In *Flagstaff Affordable Housing Ltd. Partnership v. Design Alliance, Inc.*,[158] the Arizona Supreme Court expanded the economic loss rule by limiting a property owner to his contractual remedies when an architect's negligent design causes economic loss but no physical injury to persons or other property.[159]

Flagstaff Affordable Housing Ltd. Partnership hired Design Alliance, Inc. to design apartment buildings and a community center. Flagstaff separately hired Butte Construction Company to build the apartments.

Later, the U.S. Department of Housing and Urban Development complained against Flagstaff, alleging the apartments violated federal accessibility guidelines. Flagstaff settled with HUD and sued Design Alliance

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151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.*
155. *Id.* at *8 ("The March 3–4 e-mails amount to little more than a tinkering with the language of the contract, and do not seek to alter any of the material terms of the agreement, to which Mr. Todd voluntarily agreed.").
156. *Id.*
157. *Id.*
158. 223 P.3d 664 (Ariz. 2010).
159. *Id.* at 665.

for breach of contract and professional negligence.[160] Flagstaff dismissed its contract claim because of Arizona's eight-year statute of repose and proceeded on its professional negligence claim. The trial court dismissed Flagstaff's complaint and held the economic loss rule barred Flagstaff's negligence claim in a construction defect case. The court of appeals reversed, holding the economic loss doctrine does not bar negligence claims against design professionals.[161] The Arizona Supreme Court vacated and held "the policy concerns that justify applying the doctrine to construction defect cases do not justify distinguishing between contractors on the one hand and design professionals, including architects, on the other."[162]

Indianapolis-Marion County Public Library v. Charlier Clark & Linard, P.C. is another construction lawsuit.[163] To renovate and expand certain structures, the library hired an architect, Woollen Molzan and Partners, Inc., and a general contractor, Shook, LLC. WMP entered into subcontracts with two of the defendants, Thornton Tomasetti Engineers and Charlier Clark and Linard, P.C. A managing principal of TTE, Joseph G. Burns, served as "engineer of record" for the project.[164] When it became apparent there were construction and design defects, the library sued WMP, Shook, TTE, CCL, and Burns for repair costs, project delay settlements, expert fees, utilities, rental fees, increased insurance premiums, and costs associated with seeking additional public funding. The library settled with WMP and Shook and pursued its negligence claims against the subcontractors, TTE, CCL, and Burns.[165]

The subcontractors moved for partial summary judgment asserting the economic loss rule barred the library's claims. The trial court granted the motion and the court of appeals affirmed.[166] The Indiana Supreme Court affirmed, acknowledging the economic loss rule was clearly implicated in the case because "the Library looked to a series of contracts to establish the relative expectations of the parties."[167] The "network or chain of contracts" used by the parties for the construction project meant contract law, rather than tort law, governed.[168]

In response to the library's arguments that the damages were to "other property," which would make the economic loss rule inapplicable, the court

160. *Id.*
161. Flagstaff Affordable Hous. Ltd. P'ship v. Design Alliance, Inc., 212 P.3d 125 (Ariz. Ct. App. 2009).
162. *Flagstaff Affordable Hous.*, 223 P.3d at 673.
163. 929 N.E.2d 722 (Ind. 2010).
164. *Id.* at 725.
165. *Id.* at 726.
166. *Id.*
167. *Id.* at 730.
168. *Id.* at 736.

found the services the library purchased indirectly from the subcontractors were an integral part of the overall "'product' the Library purchased"—i.e., the renovated and expanded library—and thus the damages caused by the subcontractors constituted a failure of the product or service itself to perform as expected.[169]

In response to the library's claims that the library's damages were physical, not commercial, and, even if not physical, should be treated as such because they created an imminent risk of personal injury, the Indiana Supreme Court held, "[a]lthough the repairs have a component of physical destruction, the repair and reconstruction of the garage and other portions of the project are economic losses that arose from the Library's complaint that it did not receive the benefit of its bargain."[170]

In response to the library's clams that the subcontractors were professionals subject to malpractice claims not barred by the economic loss rule, the court stated:

> We perceive no significant policy distinction that would drive us to permit tort-based claims to recover economic losses against design professionals, such as architects and engineers, who provided their professional services in the commercial property development and improvement process, when we have concluded that such claims are barred under the economic loss doctrine if brought against contractors and subcontractors involved in physically constructing improvements to real property.[171]

In *U.S. Bank, N.A. v. Integrity Land Title Corp.*, Texcorp loaned money to a buyer to buy certain real estate.[172] Texcorp also hired Integrity Land Title Corp. for a title commitment showing Texcorp had a superior mortgage lien. Integrity's title commitment formed the basis for a title policy issued to Integrity by Southern National Title Insurance Corporation.[173] Unfortunately, Integrity's title search did not discover LPP Mortgage Ltd.'s foreclosure judgment on the property, and LPP sued the buyer and Texcorp to foreclose its judgment lien. U.S. Bank—as Texcorp's successor in interest—intervened with a third-party claim against Integrity (on the title commitment) and Southern (on the title policy) alleging breach of contract and negligent closing of a real estate transaction.[174] When LPP won its foreclosure suit and Southern became insolvent, U.S. Bank was left with its contract and negligence claims against Integrity. On Integrity's motion

169. *Id.* at 731.
170. *Id.* at 732.
171. *Id.* at 735 (citation omitted).
172. 929 N.E.2d 742 (Ind. 2010).
173. *Id.* at 744.
174. *Id.*

for summary judgment, the trial court held (i) Integrity was not in breach of contract to U.S. Bank because Integrity was not a party to the title policy issued by Southern to Texcorp (now U.S. Bank) and (ii) Integrity was not negligent because it owed no duty to U.S. Bank, as Texcorp's successor, in tort. The court of appeals affirmed.[175] Indiana's supreme court reversed on the negligence claim and held the economic loss rule did not preclude U.S. Bank from pursuing its negligence claim against Integrity. "Were there to be a contract between Integrity and U.S. Bank, [Integrity] in all likelihood would be relegated to their contractual remedies" because of the economic loss rule.[176]

Given the absence of privity, the court next focused on whether a cause of action for negligent misrepresentation should be imposed on Integrity. The court noted a split of authority on this point, but then reviewed Indiana's adoption of the Restatement (Second) of Torts § 552(1).[177] It states:

> One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Applying these factors, the Indiana Supreme Court concluded title commitment issuers like Integrity owed duties to communicate accurately the state of title when issuing its preliminary title commitment.[178] But the supreme court emphasized the lack of contractual privity between Integrity and U.S. Bank and cautioned, "we do not adopt the proposition that a tort claim for negligent misrepresentation may be brought where the parties are in contractual privity."[179]

In *Sapp v. Ford Motor Co.*,[180] the South Carolina Supreme Court dealt with two truck buyers whose negligence claims were dismissed because of the economic loss rule. The first buyer bought used a Ford truck "as is." The truck later caught fire, damaging only the vehicle itself. The second buyer bought a Ford truck, which also caught fire and was destroyed. Both buyers sued Ford for negligence, strict liability, breach of warranty, fraud, and negligent misrepresentation. Both buyers had their claims dismissed by the trial courts based on the economic loss doctrine.[181] The South Carolina

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175. *Id.* at 745.
176. *Id.*
177. *Id.* at 746.
178. *Id.* at 749.
179. *Id.* at 749 n.6.
180. 687 S.E.2d 47 (S.C. 2009).
181. *Id.* at 48.

Supreme Court affirmed the dismissal of both lawsuits based on the economic loss rule.[182] Notably, the South Carolina Supreme Court overruled its former decision in *Colleton Preparatory Academy, Inc. v. Hoover Universal, Inc.*[183] to the extent it expanded the narrow exception to the economic loss rule beyond the residential builder context.[184] In *Kennedy v. Columbia Lumber & Mfg. Co.*,[185] the court held the economic loss rule does not preclude a homebuyer from recovering in tort against the developer or builder where the builder violates an applicable building code, deviates from industry standards, or constructs a house that he or she knows or should know will pose a serious risk of physical harm.[186] In *Colleton Preparatory Academy*, the court expanded this exception to allow a products liability suit in tort where only the product itself is injured if the plaintiff alleges a breach of duty accompanied by a clear, serious, and unreasonable risk of bodily injury or death.[187] The court in *Sapp* held *Colleton Preparatory Academy* too broadly expanded the exception to the economic loss rule and "completely altered the law on products liability in South Carolina."[188]

In *Davencourt at Pilgrims Landing Homeowners Ass'n v. Davencourt at Pilgrims Landing, LC*, the Utah Supreme Court dealt with a homeowners association's lawsuit against the developer, Davencourt at Pilgrims Landing, LC, and builder, Michael D. Parry Construction Company, Inc.[189] Before selling any of the townhomes, Davencourt formed a homeowners association. Initially, Davencourt controlled the association. After a certain percentage of the townhomes had been sold, Davencourt yielded control of the association to the townhomes' owners.[190] When the townhomes suffered water intrusion, dryrot, mold, staining, and stucco degradation, arguably caused by faulty design, faulty workmanship, defective materials, improper construction, and noncompliance with building codes, the association sued Davencourt and Michael D. Parry for breach of contract, breach of warranties, negligence, nuisance, negligent misrepresentation, and breach of fiduciary duty. The defendants moved successfully to dismiss the negligence, negligent misrepresentation, negligence per se, and nuisance counts based on the economic loss rule.[191] On appeal, the Utah Supreme Court held the economic loss rule applied despite the association

182. *Id.* at 51.
183. 666 S.E.2d 247 (S.C. 2008).
184. *Sapp*, 687 S.E.2d at 50.
185. 384 S.E.2d 730 (S.C. 1989).
186. *Sapp*, 687 S.E.2d at 49.
187. *Id.* at 50.
188. *Id.*
189. 221 P.3d 234 (Utah 2009).
190. *Id.* at 240.
191. *Id.* at 241 (citations omitted).

having no contract or opportunity to negotiate with Davencourt, Michael D. Parry, or the unit owners. The court focused instead on the contractual expectations of Davencourt and Michael D. Parry:

> We cannot ignore the contract expectations that exist among the Unit Owners, the Developer, and the Builder. To conclude otherwise would essentially impose the plaintiff's economic expectations upon parties whom the plaintiff did not know and with whom it did not deal and upon contracts to which it was not a party.
>
> Furthermore, the association's argument erodes the basis for the existence of the economic loss rule—the distinction between tort and contract law. Exempting strangers to a contract from the economic loss rule would convert a contract cause of action into one for tort.[192]

The court also held water intrusion to the common areas controlled by the association was not damage to "other property," for purposes of the "other property" exception to the economic loss rule. Rather, the " 'property' was the entire complex itself that was constructed as an integrated unit under one general contract."[193] The supreme court further held Davencourt and Michael D. Parry did not owe a duty to the association based on disparity of knowledge, for purposes of the economic loss rule. "Knowledge and expertise alone do not establish an independent duty; privity or a direct relationship is also required. The Association has no privity of contract or a direct relationship that would lead it to rely on any of the Defendants."[194] The supreme court did, however, create a new limited fiduciary duty because Davencourt once owned and controlled the association.[195] The court limited the association's recovery to the common areas and Davencourt's failure to maintain the common areas while it controlled the association, but the court clarified "the [Association's] claims of negligence per se and nuisance, which the Association predicated respectively on noncompliance with the building code and the intrusion of water, do not arise from the fiduciary duty and are thus precluded by the economic loss rule."[196]

V. Breach of Fiduciary Duty

This year, the Delaware Court of Chancery further refined the duties owed by managers of limited liability corporations, addressing whether parties to an LLC agreement need to explicitly negate default fiduciary duties

192. *Id*. at 243.
193. *Id*. at 244 (citing Am. Towers Owners Ass'n v. CCI Mech., Inc., 930 P.2d 1182, 1191 (Utah 1996)).
194. *Id*. at 245.
195. *Id*. at 247.
196. *Id*.

or whether it is sufficient to include language clearly expressing a nonfiduciary duty. Based on *Related Westpac LLC v. JER Snowmass LLC*, a clear expression of a nonfiduciary duty will suffice.[197]

In 2006, Related Westpac LLC and JER Snowmass LLC formed two LLCs—Base Village Snowmass Center Associates LLC and Snowmass Mountain Village Associations LLC—to redevelop vacation real estate.[198] Westpac, JER, and the two new LLCs entered into two operating agreements. Westpac would run the day-to-day operations and JER would fund the project.[199] Westpac also agreed to submit an annual business plan and budget to JER for approval. The agreements further stated JER's consent was required for any "Major Decisions" Westpac might make in its managerial role.[200] JER was not to unreasonably withhold consent for any "Major Decision," except with relation to "Major Decisions" also constituting a "Material Action."[201] "Major Decisions" included approving, disapproving, or amending the business plan or budget; making expenditures; and borrowing funds.[202] The operating agreement defined "Material Actions" as anything requiring additional capital or involving a material change in the budget.[203] Finally, Westpac—as operating manager—had the right to issue capital calls to other members. But the sole remedies for defaulting on a capital call were withdrawal of the capital call or funding by the nondefaulting members.[204]

Not surprisingly, the project's funding needs soon exceeded the annual budget Westpac and JER had agreed upon. On several occasions, Westpac sought consent for and issued capital calls for additional funding to JER, but JER either refused to make any more capital contributions or conditioned its acceptance on JER receiving certain commercial benefits in return.[205] Westpac sued JER, alleging, among other things, JER breached its fiduciary duties to Westpac by unreasonably refusing consent and failing to answer the capital calls.[206]

197. C.A. No. 5001-VCS, 2010 WL 2929708 (Del. Ch. July 23, 2010).

198. *Id*. at *3.

199. *Id*. at *3–4.

200. *Id*. at *4.

201. *Id*. at *5.

202. *Id*. at *4–5.

203. *Id*. at *5.

204. *Id*. at *6.

205. *Id*. at *8. For example, JER withheld consent to sell a property for $15 million, but then consented to a sale of the note securing the property at a price of $12.5 million on the condition that its subsidiary receive one percent interest. *Id*. at *8 n.19.

206. *Id*. at *11. Westpac also pleaded breach of contract and breach of the implied covenant of good faith and fair dealing based on the same conduct. Westpac further alleged JER was unjustly enriched because Westpac made capital infusions into the LLC that JER should have made. *Id*.

In dismissing the complaint, the court determined JER did not owe Westpac any fiduciary duty, citing the LLC agreement and noting the contractual freedom of the parties to avoid such duties.[207] Although the contractual freedom to waive fiduciary duties is unremarkable, previous cases have always stressed the importance of clear drafting to take advantage of this freedom.[208] But this case is notable because there was no express waiver of fiduciary duty in the LLC agreement. Rather, the court relied on the fact that the LLC agreement allowed JER to withhold its consent unreasonably with respect to Major Decisions involving Material Actions[209] and to act in its own self-interest.[210] To impose a fiduciary duty to act in the best interests of the LLC under such circumstances, the court reasoned, would "nullify the parties' express bargain."[211] The court continued, "When a fiduciary duty claim is plainly inconsistent with the contractual bargain struck by [the] parties . . . , the fiduciary duty claim must fall, otherwise 'the primacy of contract law over fiduciary law in matters involving . . . contractual rights and obligations [would be undermined].' "[212] This court's willingness to find waiver of fiduciary duties without explicit language, and the brevity of the opinion in which it did so, suggests Delaware is further expanding its already broad contractual freedoms.

Also dealing with duties owed by LLC members, the Supreme Court of New York County issued an interesting opinion in *Pappas v. Tzolis*.[213] There, Vrahos LLC was a Delaware-based LLC formed by Steve Tzolis, Steve Pappas, and Pappas's co-plaintiff Constantine Ifantopolous to lease and renovate a commercial office space.[214] Despite being organized under Delaware law, the operating agreement chose New York law to govern the agreement.[215] The agreement also provided: "Other Activities of Members: Any Member may engage in business ventures and investments of any nature whatsoever, whether or not in competition with the LLC,

207. *Id*. at *19.

208. *See*, *e.g.*, Kelly v. Blum, C.A. No. 4516-VCP, 2010 WL 629850, at *10 n.70 (Del. Ch. Feb. 24, 2010) (requiring "clear and unambiguous provisions when [parties] desire to expand, restrict, or eliminate the operation of traditional fiduciary duties"); Bay Ctr. Apartments Owner LLC v. Emery Bay PKI, LLC, C.A. No. 3658-VCS, 2009 WL 1124451, at *9 (Del. Ch. Apr. 20, 2009) (holding that "drafters of chartering documents must make their intent to eliminate fiduciary duties plain and unambiguous").

209. *Related Westpac LLC*, 2010 WL 2929708, at *5. There was no dispute Westpac's requests of JER were Material Actions. *Id*. at *9.

210. *Id*. at *5, *19–21.

211. *Id*. at *21.

212. *Id*. (second and third alterations in original).

213. Mem. Dec., Index No. 6011115/09 (N.Y. Sup. Ct. Mar. 3, 2010), *available at* http://www.nycourts.gov/courts/comdiv/lawreport/Vol13_No1/gammerman-pappas.pdf.

214. *Id*. at *1.

215. *Id*. at *2.

without obligations of any kind."[216] A year after the LLC was formed, Tzolis bought out Pappas and Ifantopolous's interests for $500,000 each while allegedly secretly negotiating with Charleston-Soho, a third party, to assign the lease.[217] Shortly after the buyout, Tzolis assigned the lease to Charleston-Soho for $17.5 million.[218] Pappas (and Ifantopolous) sued Tzolis, alleging breach of fiduciary duty based on Tzolis's failure to disclose the negotiations at the time of the buyout. Pappas also asserted New York law applied based on the operating agreement's terms.[219] Tzolis responded that Delaware law should apply because § 801(a) of New York's LLC law provided that "'the laws of the state where the LLC is formed govern its . . . internal affairs and the liability of its members . . . .'"[220] He also argued that under Delaware law, he had no fiduciary duty because the parties were free to contractually eliminate fiduciary duties.

The court avoided the choice of law issue by holding that Delaware law was equivalent to New York's. In reaching this conclusion, the court cited to Delaware's freedom-of-contract provision in its LLC Act and stated, without citing to any case law or statute, "under New York law, parties are free to contract as they wish, so long as the terms of their contract are neither unlawful, nor in violation of public policy."[221] But not only is there is no equivalent explicit freedom-of-contract statute in New York's LLC law, but § 409 of the same law requires a manager "to perform his or her duties as a manager . . . in good faith and with that degree of care that an ordinary prudent person in a like position would use under similar circumstances."[222] Nothing in the statute suggests it is an optional or default provision. Because the court did not mention this requirement, it is unclear whether the court intended to imply that the statute should be construed as a waivable requirement or thought it applies only with respect to those duties of good faith and of care that are explicitly mentioned in the statute.[223]

In *Berg & Berg Enterprises, LLC v. Boyle*, the California Court of Appeals addressed the scope of a director's duties to creditors when a corporation is

216. *Id.*
217. *Id.* at *1.
218. *Id.*
219. *Id.*
220. *Id.* at *2 (alteration in original; quoting N.Y. Ltd. Liab. Co. Law § 801(a) (2010)).
221. *Id.* at *3 (quoting Del. Code Ann. tit. 6, § 18–1101(c) (2010)).
222. N.Y. Ltd Liab. Co. Law § 409(a) (2010). This statutory language is identical to the language found in § 717 of New York's Business Corporation Law, which governs directors of corporations. N.Y. Bus. Corp. Law § 717(a) (2010). Based on this, it seems that New York intended the managing members of LLCs to have the same fiduciary duties as a corporate director.
223. Of course, a third alternative is that the court simply overlooked the statute in drafting its decision.

insolvent or in the "zone of insolvency."[224] By materially limiting the scope of the duties owed to creditors, the *Berg* court offered clarification, and perhaps some comfort, to directors struggling to choose among various alternatives when a corporation is in financial distress.

Berg & Berg Enterprises LLC and Pluris, Inc, a California corporation, were involved in a litigation dispute about a lease allegedly repudiated by Pluris. In February 2002, Pluris informed Berg that, due to financial difficulties, it was attempting to secure outside financing to continue its operations and that settling the dispute with Berg was a condition precedent to obtaining the financing.[225] Berg and Pluris reached a settlement through which Berg became Pluris's largest creditor.[226] Berg then informed Pluris, through its board of directors, that if the financing was not successful, it wanted "'to explore ways to derive additional value'" from Pluris's net operating losses, a plan requiring Pluris to be reorganized under federal bankruptcy laws.[227] Ultimately, Pluris could not secure financing. Rather than pursue Berg's plan, however, Pluris entered into an assignment for the benefit of creditors instead.[228] Berg sued the former directors, alleging the directors owed a fiduciary duty to Berg as a creditor once Pluris entered the "zone of insolvency," and by failing to consider Berg's proposed plan, they breached that duty.[229] After several amendments to the complaint, the directors demurred because it failed to state facts sufficient to constitute a cause of action. The trial court sustained the demurrer without leave to amend and Berg appealed.

California law is clear that corporate directors owe a duty to the corporation's shareholders to serve "in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders."[230] While there is no analogous California statute or law creating a fiduciary duty to creditors, Delaware courts recognize a duty to the "corporate enterprise" when a corporation is insolvent[231] and suggest such a duty may even arise when a corporation is in the "zone of insolvency."[232] But the

224. 178 Cal. App.4th 1020 (2009).

225. *Id.* at 1029–30.

226. *Id.* at 1026.

227. *Id.* at 1029.

228. *Id.* at 1030. An assignment for the benefit of creditors provides a less comprehensive alternative to liquidation in bankruptcy under the California Code of Civil Procedure. Cal. Code Civ. Proc. §§ 493.010, 1802.

229. *Berg*, 178 Cal. App.4th at 1025.

230. Cal. Corp. Code § 309(a) (2009).

231. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992) ("When the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors.").

232. The idea of a duty arising in the "zone of insolvency" or "vicinity of insolvency" first appeared in a now-famous footnote in *Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613 at *34 n.55 (Del. Ch. Dec. 30, 1991) ("[W]here a

Berg court rejected the Delaware common law in two ways. First, the court rejected the corporate enterprise theory, holding, "there is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency."[233] Instead, the court limited the duties owed by a director to "the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditor claims."[234] Second, the *Berg* court held, "there is no fiduciary . . . duty owed to creditors by directors of a corporation solely by virtue of its operating in the 'zone' or 'vicinity' of insolvency."[235] And, although unnecessary in light of its holding, the court held that even if a duty did exist, the directors would have been protected by the business judgment rule.[236]

While *Berg*'s long-term effect is not yet clear,[237] at the very least, creditors' ability to bring fiduciary duty claims in California will be severely limited by the narrow trust fund doctrine and the deferential business judgment rule.

VI. FRAUD AND MISREPRESENTATION

The past year has both illuminated and expanded several areas of fraud and misrepresentation law.

Contracts for the delivery of natural gas typically fall into one of two types: (1) a fixed-price contract and (2) a contract in which price is determined by reference to a published price index.[238] The price index for the transactions at issue in *Rio Grande Royalty Co., Inc. v. Energy Transfer Partners, L.P.*—deliveries to the Houston Ship Channel—was published monthly by *Platts Inside FERC's Gas Market Report*.[239] The index was based on fixed-price transactions made during a monthly "bid-week."[240] Buyers and sellers of natural gas voluntarily reported to *Platts* the volume and

corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."). Although Delaware was a pioneer in suggesting the existence of a duty in the "zone of insolvency," it seems Delaware might now be backing away from this idea. *See* N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla, 930 A.2d 92, 101–03 (Del. 2007) (limiting the applicability of the "zone of insolvency" theory and holding that creditors could not bring a direct suit against directors for breach of fiduciary duty, regardless of a corporation's solvency).

233. *Berg*, 178 Cal. App.4th at 1041.

234. *Id.* This holding applies the "trust fund" doctrine established in *Pepper v. Litton*, 308 U.S. 295, 306 (1939).

235. *Berg*, 178 Cal. App.4th at 1041.

236. *Id.* at 1044–48.

237. The California Supreme Court denied review on February 3, 2010.

238. Rio Grande Royalty Co., Inc. v. Energy Transfer Partners, L.P., No. 09-20607, 2010 WL 3565192, at *1 (5th Cir. Sept. 15, 2010).

239. *Id.*

240. *Id.*

price data for transactions taking place during bid week, and *Platts* used those data to calculate the price index.[241]

The plaintiffs alleged that between December 2003 and December 2005, the defendants manipulated the HSC price index by making bid-week sales at artificially low prices.[242] This suppressed the HSC price index to the defendants' benefit (who were buyers of natural gas) and the detriment of plaintiffs and other sellers bound by index-based contracts.[243]

In support of their fraud claim, the plaintiffs alleged the defendants misrepresented and omitted material facts by (a) intentionally misstating the true market price of natural gas sold at HSC and (b) failing to disclose that the prices for the transactions they reported to *Platts* did not represent—and were not intended to represent—the true market forces of supply and demand.[244] Importantly, the plaintiffs did not allege the defendants misreported their sales data to *Platts*. Rather, the allegation was the truthful sales data the defendants provided to *Platts* was misleading because of market manipulation.[245]

The trial court held the plaintiffs' allegations failed to state a claim.[246] The plaintiffs appealed to the Fifth Circuit Court of Appeals, arguing "the truthful reporting of transactions tainted by market manipulation may amount to fraudulent misrepresentation and that failure to disclose this misrepresentation may amount to a fraudulent omission of material fact."[247]

The Fifth Circuit held that to show either affirmative misrepresentation or failure to disclose, the plaintiffs must establish a defect in the defendants' reports to *Platts*.[248] The plaintiffs claimed the reports did not represent "the true market price of natural gas sold at HSC," which created a false impression the defendants were obligated to correct.[249]

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241. *Id.*
242. *Id.*
243. *Id.* These allegations apparently had merit. In March 2008, the Commodities Futures Trading Commission announced a consent order under which the defendants would pay a $10 million penalty to settle charges that defendants manipulated the price of natural gas at HSC and the HSC index. *Id.* at *4. In September 2009, the defendants settled related claims brought by FERC. *Id.*
244. *Id.* at *1.
245. *Id.*
246. *Id.* at *2.
247. *Id.*
248. *Id.*
249. Under Texas law, "silence may be equivalent to a false representation only when the particular circumstances impose a duty on the party to speak and he deliberately remains silent." Bradford v. Vento, 48 S.W.3d 749, 755 (Tex. 2001). "Generally, no duty of disclosure arises without evidence of a confidential or fiduciary relationship." Ins. Co. of N. Am. v. Morris, 981 S.W.2d 667, 674 (Tex. 1998). Outside of such a relationship, a duty to disclose may arise "when one makes a partial disclosure and conveys a false impression." Brown & Brown of Texas, Inc. v. Omni Metals, Inc., 317 S.W.3d 361, 384 (Tex. App. 2010).

The court concluded the index did not necessarily reflect the "true market price" of natural gas, but was merely "representative of transactions."[250] "The 'true' market price is that at which buyers are willing to buy and sellers are willing to sell, and an index does no more than provide a window into their commerce."[251] Based on this, the court determined the defendants made no affirmative misrepresentations to *Platts* and had no duty to disclose that their price reports did not reflect the true market price of natural gas at HSC.[252] The court pointed out several examples of situations in which price reports could be fraudulent, such as where a report misstated the terms of the transaction or contained a transaction that was completely fabricated. But here:

> [T]he defendants engaged in real transactions of real economic substance and reported the details of those transactions accurately. That these transactions may have been carried out at artificially low prices does not render the *reporting* of those prices a misstatement. . . . For the same reason, the defendants were not obliged to disclose that their price reports did not represent "the true market forces of supply and demand." If the Platts index is "representative of transactions," and if the defendants' transactions were properly reported, then there could be no false impression—at no point did the index cease being "representative of transactions"—and hence no duty to disclose.[253]

Thus, the Fifth Circuit upheld the trial court's ruling that the plaintiffs failed to state a claim for which relief could be granted.[254]

In *Merck & Co. v. Reynolds*, the U.S. Supreme Court answered the question of when the statute of limitations begins to run for a shareholder derivative suit based on fraud or misrepresentations under 28 U.S.C. § 1658(b).[255]

Merck's primary argument focused on whether the shareholders knew of or could have discovered the fraud with "reasonable diligence" outside the limitations period. This issue is intertwined with whether a plaintiff must discover evidence of each element of the cause of action, or if plaintiffs are on notice to sue based solely on knowledge of a false statement. To reach this issue, the Court had to determine if Congress accounted for the definition of the word "discover" used in relevant case law before enacting § 1658(b)(1). Finally, Merck argued in the alternative "inquiry notice" is sufficient to put shareholders on notice.

250. *Rio Grande Royalty Co*., 2010 WL 3565192, at *3.
251. *Id*. (citing E. & J. Gallo Winery v. EnCana Corp., 503 F.3d 1027, 1031 (9th Cir. 2007)).
252. *Id*.
253. *Id*.
254. *Id*. at *3–4.
255. 130 S. Ct. 1784 (2010).

First, Merck argued that in enacting § 1658(b)(1), Congress narrowed rather than codified the holding in *Lampf v. Gilbertson*[256] (requiring discovery of the facts constituting the violation to begin the statute of limitations).[257] The Supreme Court rejected this argument and pointed to examples where Congress accounted for prior case law when drafting.[258]

After arguing "discovery" under § 1658(b)(1) is different than in *Lampf*, Merck argued the "storm warnings" of the alleged fraud had been available to the plaintiffs, putting them on notice of the "facts constituting the violation."[259] The Court rejected this view. Instead, the plaintiff must have possessed, or could have discovered, evidence of every element of the fraud, including scienter.[260] Facts showing scienter are facts that "constitute the violation."[261] The Court emphasized the need for awareness or access to facts showing scienter because of the heightened pleading of § 10(b) of the Securities Exchange Act.[262]

Similarly, the Court held even shareholders' knowledge of false statements does not start the running of the statute of limitations.[263] Arguing the difference between factual falsity and state of mind is "context specific," the Supreme Court reiterated scienter is a "fact constituting the violation," not a "storm warning."[264]

Finally, the Court rejected Merck's proposed "inquiry notice" standard: beginning the limitations period when a plaintiff would have discovered facts showing scienter using a reasonably diligent investigation.[265] The Court said "starting the clock" before the fraud is actually discovered would be too complicated for judges to undertake, as opposed to determining what a reasonably diligent plaintiff would have known and done.[266] The distinction is subtle: in one case, the reasonably diligent plaintiff would have investigated further, but may or may not have discovered the fraud.[267] The test the Court adopted begins the statute of limitations when a reasonably diligent plaintiff would have discovered the facts constituting the violation.[268]

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256. 501 U.S. 350 (1991).
257. Petitioner's Brief at 17–20, *Merck*, 130 S. Ct. 1784 (2010) (No. 08-905).
258. Edelman v. Lynchburg College, 535 U.S. 106, 116–17 n.13 (2002).
259. Petitioner's Brief, *supra* note 257, at 13.
260. *Merck*, 130 S. Ct. at 1786–91.
261. *Id*.
262. *Id*. at 1788–92.
263. *Id* at 1788.
264. *Id*.
265. Petitioner's Brief, *supra* note 257, at 16–19.
266. *Merck*, 130 S. Ct. at 1786–89.
267. *Id*.
268. *Id*. at 1790 (citing Lampf v. Gilbertson, 501 U.S. 350, 363 (1991)).

The Texas Supreme Court recently considered an auditor's liability to third parties in *Grant Thornton LLP v. Prospect High Income Fund*.[269] The court held auditors are not required to provide accurate accounting to anyone who reads and relies on the auditor's report, only to those for whom the report is intended.[270] As a matter of first impression, the court also held absent personal and direct communication with the auditor, a "holder" claim of fraud fails.

In *Grant Thornton*, a group of bond and hedge funds bought bonds from Epic Resorts, LLC over a five-year period.[271] Epic registered its bonds with the SEC and sold them on the open market. Epic's bonds were governed by an indenture and an escrow and disbursement agreement with U.S. Trust.[272] The indenture required Epic to (1) file audited financial statements, an annual report, and an independent auditor's report with the SEC; (2) pay bondholders semiannual interest payments; (3) acquire a "negative assurance" statement from its auditor confirming Epic's compliance with the indenture terms; and (4) maintain an account sufficient to pay the bondholders' next interest payment.[273] If Epic failed to maintain this minimum amount in the account for more than sixty days, it would be in default.[274] U.S. Trust would operate as the trustee for the bonds and the escrow agent.[275] Epic opened an account with U.S. Trust.

Epic paid the required interest to its bondholders in 1999.[276] The next March, Epic hired Grant Thornton, LLP to audit its 1999 financial statements and review its statements for the first three quarters of 2000.[277] Grant Thornton discovered Epic had opened a cash management account instead of the required escrow account and Epic's balance in the account was too low.[278] Despite these findings, Grant Thornton confirmed Epic's compliance.[279] Months after the report, Epic's primary lender did not renew its credit arrangement with Epic. Without the credit facility, Epic could not operate or meet its obligations to its bondholders.[280] Epic missed its June 2001 payment due to the bondholders despite Grant Thornton stating sufficient funds were in escrow only two months before.[281] Shortly after, Epic

269. 314 S.W.3d 913 (Tex. 2010).
270. *Id*. at 915.
271. *Id*.
272. *Id*.
273. *Id*.
274. *Id*.
275. *Id*. at 916.
276. *Id*.
277. *Id*.
278. *Id*.
279. *Id*.
280. *Id*.
281. *Id*. at 917.

was forced into bankruptcy.[282] After uncovering the discrepancies, the purchasers in bankruptcy sued Grant Thornton for several causes of action, including fraud and negligent misrepresentation.[283]

The court began with the Second Restatement of Torts to determine an auditor's liability to third parties.[284] The court also reviewed its decision in *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*,[285] holding an attorney liable for negligent misrepresentation to a third party in the absence of an attorney-client relationship when that attorney transfers information to a "known party" for a known purpose.[286] A "known party" is one in a *limited class* of potential claimants "for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it."[287] Under *McCamish*, the professional may be liable based on information provided if the professional knows of the nonclient and intends that the nonclient rely on the information.[288] The court affirmed *McCamish*.[289]

Cayman, one of the funds purchasing Epic's bonds, claimed it bought Epic's bonds relying on Grant Thornton's audit. Grant Thornton argued Cayman was like every other unknown potential investor and therefore fell outside the scope of liability.[290] Cayman claimed it was a "known party" because so few investors purchase high-yield debt like those bonds.[291] The court rejected Cayman's argument, emphasizing Epic sold its bonds on the open market and Cayman had no prior connection to Epic or Grant Thornton.[292] The court determined assigning liability based upon the general knowledge that investors would purchase Epic bonds would "eviscerate the Restatement rule in favor of a de facto foreseeability approach. . . ."[293]

Fraud is more difficult to prove than negligent misrepresentation because it also requires intent. Intent is a party's reason to expect its representations will affect another parties' conduct.[294] The *Grant Thornton* court rejected Cayman's claims as failing to show intent.[295]

282. *Id.*
283. *Id.*
284. *Id.* at 920.
285. 991 S.W.2d 787, 791 (Tex. 1999).
286. *Id.* at 794.
287. *Id.* (quoting Restatement (Second) of Torts § 552(2)(a)).
288. *Grant Thornton*, 314 S.W.3d at 920 (quoting *McCamish*, 991 S.W.2d at 794).
289. *Id.*
290. *Id.* at 921.
291. *Id.*
292. *Id.*
293. *Id.*
294. Ernst & Young, L.L.P. v. Pac. Mut. Life Ins. Co., 51 S.W.3d 573, 575 (Tex. 2001).
295. *Grant Thorton*, 314 S.W.3d at 921.

A "holder claim" arises when a defendant wrongfully induces a plaintiff to continue holding his stock.[296] The damages sought by the plaintiff are in the nature of the diminished value of the stock, or the value of the forfeited opportunity caused by the defendant's misrepresentations.[297] Holder claims are not universally recognized. Some jurisdictions consider "holder" claims to be speculative in nature and difficult to prove. In *Blue Chips Stamps v. Manor Drug Stores*, the U.S. Supreme Court refused to recognize holder claims under federal securities law for this reason.[298] In a holder claim:

> Plaintiff's proof would not be that he purchased or sold stock, a fact which would be capable of documentary verification in most situations, but instead that he decided not to purchase or sell stock. Plaintiff's entire testimony could be dependent upon uncorroborated oral evidence of many of the crucial elements of his claim, and still be sufficient to go to the jury. . . . The very real risk in permitting those in respondent's position to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer, that he paid any attention to it, or that the representations contained in it damaged him.[299]

Although the Court refused to allow holder claims under federal law, it recognized individual holder's claims under state law.[300]

In *Grant Thornton*, the funds brought a "holder" claim against Grant Thornton alleging they held the bonds based on the auditor's report when they otherwise would have sold the securities. The funds claimed Grant Thornton's misrepresentation induced them to refrain from taking action; and that but for Grant Thornton's misleading report, the funds would have sold their bonds sooner or forced Epic into bankruptcy sooner while there were more assets to liquidate.[301] In deciding this matter of first impression, the court concluded holder claims must involve a direct communication between the plaintiff and the defendant.[302] The court went on to reason those claims are less like ordinary holder claims and more like the ordinary case of deceit described by the U.S. Supreme Court in *Blue Chips*.[303] The court ultimately denied the holder claims because the funds had no direct communications with Grant Thornton, and the claimed misrepresentations upon which the funds relied.

296. *Id*. at 926.
297. *Id*.
298. 421 U.S. 723, 734–35 (1975).
299. *Id*. at 746.
300. *Id*.
301. *Grant Thorton*, 314 S.W.3d at 926.
302. *Id*. at 930.
303. *Id*.

RECENT DEVELOPMENTS AFFECTING CORPORATE COUNSEL

Fredrick H.L. McClure, Joshua S. Sohn, E. Colin Thompson, Laura E. Ward, and Michael M. Sevi

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This article reviews the past year's significant cases relevant to in-house and outside counsel in the areas of honest services fraud, securities litigation, attorney–client privilege and corporate employees, as well as electronic discovery. Section I discusses the recent U.S. Supreme Court decision in *Skilling v. United States*[1] regarding honest services fraud, and Congress's reaction to that decision. Section II summarizes the recent U.S. Supreme Court decision in *Merck & Co. v. Reynolds*[2] regarding the statute of limitations defense in securities litigation. Section III addresses the Ninth Circuit's decision in *United States v. Graf*,[3] regarding the applicability of the attorney–client privilege to communications between corporate employees and corporate counsel regarding personal legal matters. Section IV provides an update on recent case law concerning electronic discovery and summarizes two recent opinions that provide additional guidance on both standards for the preservation of evidence and available sanctions for failure to meet those standards.

I. Honest Services Fraud

In *Skilling v. United States*, the Supreme Court drastically scaled back a favorite tool of prosecutors pursuing corruption crimes.[4] The Court held that 18 U.S.C. § 1346, the so-called honest services statute, properly criminalizes *only* schemes to defraud involving bribes or kickbacks. According to the decision, corporate executives who use corporate funds for business transactions intended to secretly benefit themselves or their personal interests, although possibly guilty of other federal crimes, can no longer be guilty of honest services fraud. This dramatic paring of the law has stripped prosecutors of a flexible doctrine frequently invoked in fraud prosecutions of public officials and corporate executives, including the prosecutions of former Illinois governor Rod Blagojevich and former Hollinger International CEO Conrad Black. It has also led to calls on Capitol Hill to restore the honest services statute and to reinvigorate the prosecutorial discretion it represents.

A. *Honest Services Fraud Doctrine*

The theory of honest services fraud has its roots in the intangible rights doctrine enunciated in *Shushan v. United States*.[5] There, the Fifth Circuit held that a city official committed mail fraud by accepting bribes even

1. 130 S. Ct. 2896 (2010).
2. 130 S. Ct. 1784 (2010).
3. 610 F.3d 1148 (9th Cir. 2010).
4. 130 S. Ct. 2896 (2010).
5. *Id.* (citing Shushan v. United States, 117 F.2d 110 (5th Cir. 1941).

though the city suffered no loss as a result and even benefited from the official's actions. The court held that "[i]t is not true that because the [city] was to make and did make a saving by the operations there could not have been an intent to defraud."[6]

Shushan stimulated the development of an honest services theory under which corruption could be prosecuted even when the betrayed party suffered no deprivation of money or property.[7] For example, if an employee accepted a kickback from a vendor in exchange for awarding a contract, the employer would not necessarily suffer a loss if the terms of the contract were no worse than those it normally accepts.[8] If the terms were actually better than other vendor contracts, the employer could even gain from the employee's scheme. Nonetheless, courts reasoned, an actionable harm exists in the elimination of the employer's right to the employee's "honest services."[9]

Early honest services cases primarily involved public officials, but a handful of cases also recognized private-sector honest services fraud.[10] Over time, honest services prosecutions against private parties increased as more courts recognized that "a recreant employee [could] be prosecuted if he breache[d] his allegiance to his employer by accepting bribes or kickbacks in the course of his employment since such conduct defrauds the employer of his right to the employee's honest and faithful services."[11] By 1982, the honest services theory of fraud was universally accepted by federal courts as applying to private-sector employees.[12]

The development of the honest services fraud doctrine continued piecemeal in common law fashion until 1987 when the Supreme Court decided *McNally v. United States*.[13] *McNalley* involved a Kentucky state official who engaged in a kickback scheme that, according to prosecutors "defraud[ed] the citizens and government of Kentucky of their right to have the Commonwealth's affairs conducted honestly."[14] Prosecutors did not allege, however, that the scheme overcharged or otherwise harmed the Commonwealth.[15] The Supreme Court held that the scheme did not qualify as mail fraud. The Court held that the mail-fraud statute, 18 U.S.C. § 1341, did not criminalize honest services fraud but was "limited in scope to the

6. *Id*. (citing *Shushan*, 117 F.2d at 119).
7. *Id*.
8. *Id*.
9. *Id*. (citing United States v. Dixon, 536 F.2d 1388, 1400 (2d Cir. 1976)).
10. *Skilling*, 130 S. Ct. at 2927.
11. *Id*. at 2927 (quoting United States v. McNeive, 536 F.2d 1245, 1249 (8th Cir. 1976)).
12. *Skilling*, 130 S. Ct. at 2927.
13. *Id*. (citing McNally v. United States, 483 U.S. 350 (1987)).
14. *Id*. (quoting *McNally*, 483 U.S. at 353).
15. *Id*.

protection of property rights," and said that "[i]f Congress desires to go further [by, *e.g.*, outlawing intangible rights] it must speak more clearly than it has."[16]

In an attempt to do just that, in 1988 Congress passed the honest services fraud statute, 18 U.S.C. § 1346. In its entirety, § 1346 provides: "For the purposes of this chapter, the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services."[17]

With these amorphous terms at their disposal, prosecutors proceeded to invoke the "intangible right" to "honest services," as a catch-all crime in high-profile cases, including the Enron cases, the Rod Blagojevich indictment, and the prosecutions of Conrad Black and other executives at Hollinger International. The law became a favorite of prosecutors pursuing cases in which the behavior was unseemly or unpopular. As Justice Scalia observed:

> Without some coherent limiting principle to define what "the intangible right of honest services" is, whence it derives, and how it is violated, this expansive phrase invites abuse by headline-grabbing prosecutors in pursuit of local officials, state legislators, and corporate CEOs who engage in any manner of unappealing or ethically questionable conduct.[18]

This sentiment, shared by pundits and criminal defendants alike, left the honest services statute open to challenge as unconstitutionally vague. In *Skilling*, the Supreme Court had occasion to weigh in on honest services fraud and determine whether § 1346 could in fact withstand a void-for-vagueness challenge.[19]

B. Skilling v. United States

In late 2001, the seventh largest company in America, Enron, went bankrupt in a matter of weeks.[20] Jeffrey Skilling, a longtime Enron executive, had assumed the reins as chief executive officer (CEO) in February 2001, and resigned just six months later.[21] Within four months of his departure, the company was on the verge of bankruptcy.[22] In 2004, Skilling was indicted, together with Enron chairman and CEO Kenneth Lay and Enron chief

16. *Skilling*, 130 S. Ct. at 2927 (quoting *McNally*, 483 U.S. at 360).
17. 18 U.S.C. § 1346 (2009).
18. Sorich v. United States, 129 S. Ct. 1308, 1310 (2009) (Scalia, J., dissenting from denial of certiorari).
19. *Skilling*, 130 S. Ct. 2896.
20. *Id.* at 2907.
21. *Id.*
22. *Id.*

administrative officer Richard Causey.[23] The indictment charged Skilling with conspiracy to commit securities and wire fraud; in particular, it alleged that Skilling had sought to "depriv[e] Enron and its shareholders of the intangible right of [his] honest services."[24] The indictment further charged Skilling with twenty-eight substantive counts of "securities fraud, wire fraud, making false representations to Enron's auditors, and insider trading."[25] Skilling was never charged with stealing from Enron or with using company funds for his own personal purposes.[26]

Skilling's defense invoked the soundness of many of his business judgments and claimed that his actions were taken to further Enron's rather than his personal interests.[27] Skilling presented evidence showing, for example, that "the subject transactions and business decisions were lawful, the risks were fully vetted by outside advisors and Enron's Board, his alleged misstatements were accurate, and all relevant information was disclosed to investors."[28] In response, the government pressed its theory of honest services fraud as the basis for the alleged fraud conspiracy.[29] At trial, the government described Skilling's honest services fraud as a violation of his duty to Enron's employees: "a duty of good faith and honest services, a duty to be truthful, and a duty to do [his] job . . . and do it appropriately."[30]

After a four-month trial, the jury found Skilling guilty of nineteen counts, including the honest services fraud charge, and not guilty of nine insider-trading counts.[31] He was sentenced to 292 months in prison and $45 million in restitution.[32] On appeal to the Supreme Court, Skilling challenged, among other things, the Fifth Circuit's affirmation of his conviction for honest services fraud. Skilling argued that the honest services fraud statute was unconstitutionally vague and it required private gain.[33] In light of the Fifth Circuit's finding that Skilling's actions were not intended to harm Enron or to enrich himself, he argued that his conviction must be reversed.[34]

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23. Press Release, Dep't of Justice, Former Enron Chief Executive Officer Jeffrey K. Skilling Charged with Conspiracy, Securities Fraud, Insider Trading (Feb. 24, 2004) (on file with authors).
24. *Skilling*, 130 S. Ct. at 2908.
25. *Id.*
26. Brief for Petitioner at 3, *Skilling v. United States*, 130 S. Ct. 2896, 2926 (2010).
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.*
31. *Skilling*, 130 S. Ct. at 2911.
32. *Id.*
33. Petition for Writ of Certiorari, *Skilling v. United States*, 130 S. Ct. 393 (2009),
34. *Id.*

In large part, the Supreme Court agreed. Writing for the majority, Justice Ginsburg held that Skilling's conviction for honest services fraud could not stand. The honest services fraud statute, however, could survive Skilling's vagueness challenge if the law were pared down to its "solid core."[35] Given the origins of honest services fraud, and the pre-*McNally* precedents, the Court held that the core conduct Congress sought to outlaw through 18 U.S.C. § 1346 involved "offenders who, in violation of a fiduciary duty, participated in bribery or kickback schemes."[36] Thus, she concluded, "there is no doubt that Congress intended § 1346 to reach *at least* bribes and kickbacks."[37] Construing §1346 to cover this behavior, and only this behavior, the Court held that the statute could survive Skilling's void-for-vagueness challenge. But, the Court cautioned, expanding the doctrine any further than its core would implicate the due process concerns underlying Skilling's vagueness challenge.[38]

Justice Ginsburg's majority opinion allowed § 1346 to survive, but in a truncated and well-defined form. As a result, honest services fraud is now limited to only those actions involving kickback schemes and bribes, i.e., the core of the pre-*McNally* case law.[39] Since Skilling was never alleged to have engaged in bribery or kickback schemes, the Court held that it was "clear that . . . Skilling did not commit honest services fraud."[40]

Notably, the majority rejected the government's plea to interpret § 1346 as criminalizing undisclosed self-dealing.[41] Reviewing pre-*McNally* precedents once again, the Court concluded that while honest services fraud had been used for "some schemes of non-disclosure and concealment of material information,"[42] pre-*McNally* courts never agreed on which schemes qualified.[43] Given the relative infrequency of these prosecutions in comparison to bribery and kickback cases, the Court held that § 1346 does not outlaw self-dealing.[44]

35. *Skilling*, 130 S. Ct. at 2931.
36. *Id*. at 2930.
37. *Id*. at 2931.
38. *Id*.
39. *Skilling*, 130 S.Ct. at 2930–31.
40. *Id*. at 2934. This does not mean, however, that Skilling's convictions were entirely overturned. Skilling was convicted of several other counts of securities, wire, and mail fraud. Because the jury returned a general verdict, Skilling's conviction was remanded to the Fifth Circuit to determine whether the government's honest services fraud theory infected their entire case, in which case Skilling would have to be retried, or whether the inclusion of honest services fraud charges amounted to harmless error on the government's part, in which case his convictions on all but the honest services count will stand. *Id*. at 2934–35.
41. *Id*. at 2932.
42. *Id*. at 2934 (quoting United States v. Mandel, 591 F.2d 1347, 1361 (4th Cir. 1979)).
43. *Id*. at 2932.
44. *Id*.

Justice Scalia, concurring in the result, and with whom Justices Thomas and Kennedy joined, wrote separately to note his preference for holding § 1346 unconstitutional in its entirety. Justice Scalia noted that the pre-*McNally* precedents were in no way limited to bribery and kickbacks.[45] To focus on those two areas as the solid core of honest services fraud was, in his view, historically inaccurate.[46] Regardless, even with such a limitation, vital questions remained unanswered. For example, what precisely is the criterion of guilt for breach of fiduciary duty? To whom does this standard apply? Must the fiduciary duty be defined by positive state or federal law?[47] All of these questions were left unanswered by the majority's opinion.

Moreover, Justice Scalia noted that although Congress may have intended to criminalize at least kickbacks and bribes, that assumption provided no basis for the majority's conclusion that the law criminalized only that conduct. In his view, the Court's result, therefore, "require[d] not interpretation but invention."[48] By rewriting the honest services statute into something that could survive a constitutional vagueness challenge, "the Court today [has added to its] functions the prescription of criminal law."[49] Thus, the majority's reformation of § 1346, while couched in terms of judicial deference, actually constituted, according to Justice Scalia, an act of judicial lawmaking.

Despite Justice Scalia's forceful dissent, § 1346 survives to this day in the limited form enunciated by Justice Ginsburg. But federal prosecutors have not viewed the survival of § 1346 as a victory. Rather, prosecutors have responded to *Skilling* with calls for legislative action to restore the full scope of the honest services fraud statute.

C. *Next Salvo*

Responding to the calls, Senator Patrick Leahy in September 2010 conducted hearings in the Senate Judiciary Committee on the need for legislation to restore the powers prosecutors lost in *Skilling*. Hearing testimony from four current and former federal prosecutors, the Committee was urged to act to restore the widest possible latitude in federal fraud prosecutions.[50] Much of the testimony centered on the Court's decision to strike self-dealing behavior from the types of fraud outlawed by the honest services statute. Nearly all witnesses commented, however, on the need

45. *Id.* at 2937.
46. *Id.*
47. *Id.*
48. *Id.* at 2939.
49. *Id.* at 2940.
50. *Restoring Key Tools to Combat Fraud and Corruption After the Supreme Court's Skilling Decision: Hearing Before Senate Judiciary Comm.*, 111th Cong. (2010).

for Congress's legislation to include clear and specific definitions, given the Court's warning that if "Congress were to take up the enterprise of criminalizing 'undisclosed self-dealing by a public official or private employee,' . . . it would have to employ standards of sufficient definiteness and specificity to overcome due process concerns."[51]

Senator Leahy has now introduced Senate Bill 3854, the Honest Services Restoration Act.[52] The Act, designed to expand the definition of "scheme or artifice to defraud" with respect to mail and wire fraud, would outlaw actions by public officials, as well as by corporate officers and directors, to engage in undisclosed private self-dealing.[53] In an effort to address the Supreme Court's vagueness concerns, the Act includes several new definitions.

The term *undisclosed private self-dealing* is implicated if a corporate "officer or director performs an act which causes or is intended to cause harm to the officer's or director's employer, and which is undertaken in whole or in part to benefit . . . a financial interest" of the officer or director or of his or her family or business partners.[54] Additionally, the law requires that the officer or director knowingly falsify, conceal, or cover up

> material information . . . required to be disclosed regarding [his or her] financial interest by any Federal, State, or local statute, rule, regulation, or charter applicable to the officer or director, or knowingly fail[] to disclose material information regarding that financial interest in a manner that is required by any Federal, State, or local statute, rule, regulation, or charter applicable to the officer or director.[55]

The Act applies to all publicly traded corporations and to private charities organized under § 501(c)(3) of the Internal Revenue Code.[56]

Senate Bill 3854 would restore the power to prosecute self-dealing as a federal crime but would do so under specific terms. Congress's proposed new clear definitions indicate that it will strengthen any future honest services legislation against potential vagueness challenges, and the swiftness with which Congress has acted sends a clear signal that the fight against public and corporate corruption will continue without interruption.

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51. *Skilling*, 130 S. Ct. at 2933 n.44.
52. S. 3854, 111th Cong. (2010).
53. *Id.* § 2.
54. *Id.*
55. *Id.*
56. *Id.*

II. SECURITIES LITIGATION: *MERCK & CO. V. REYNOLDS*

In defending private securities litigation claims brought under § 10(b) of the Securities Exchange Act of 1934, defendants often assert a statute of limitations defense. They invoke the applicable two-year statute, arguing that a previous public statement or disclosure made put the plaintiff on "inquiry notice." The Supreme Court recently limited the availability of this defense. In its opinion in *Merck & Co. v. Reynolds*, the Court rejected the inquiry notice concept, and narrowed the circumstances in which defendants may assert a viable statute of limitations defense in cases that involve alleged misstatements made more than two years before a plaintiff files a complaint.[57]

In *Merck*, the Supreme Court held that the two-year limitations period applicable to claims brought under § 10(b) and Rule 10b-5 of the Securities and Exchange Act of 1934 begins to run when: (1) the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, the facts constituting the alleged securities fraud, and that the underlying discoverable facts include those showing scienter.[58] The Court further held that inquiry notice will not necessarily trigger the running of the limitations period.[59]

Merck was a securities fraud class action filed on November 6, 2003, by plaintiffs who purported to represent a class of shareholders of Merck & Co., the pharmaceutical giant.[60] The plaintiffs alleged that Merck misled investors about the risk of heart attacks associated with the drug Vioxx and its commercial viability and therefore violated § 10(b) and Rule 10b-5.[61]

Merck moved to dismiss the complaint arguing that the plaintiffs' claims were barred by the statute of limitations provided in 28 U.S.C. § 1658 (b)(1).[62] Section 1658(b)(1), provides, in relevant part, that any complaint alleging securities fraud or manipulation under § 10(b) or Rule 10b-5 must be brought "not later than the earlier of: (1) 2 years after discovery of the facts constituting the violation; or (2) 5 years after such violation."[63]

Merck argued that there was enough publicly available information more than two years before the plaintiffs filed their action in November 2003 such that the plaintiffs were on "inquiry notice" of the underlying

57. 130 S. Ct. 1784 (2010).
58. *Id*. at 1797–98.
59. *Id*. at 1798.
60. *Id*. at 1790.
61. *Id*.
62. *Id*. at 1792.
63. *Id*. at 1790.

facts no later than November 2001.[64] In its argument, Merck pointed to the warning letter the FDA sent Merck that was released to the public on September 21, 2001, stating that Merck's Vioxx marketing was "false, lacking in fair balance, or otherwise misleading" in light of conflicting views within the industry about whether Vioxx increased heart attack risk;[65] a *New York Times* article printed on October 9, 2001, that reported "Merck had reexamined its own data and 'found no evidence that Vioxx increased the risk of heart attacks;' "[66] and pleadings filed in several products liability lawsuits that alleged that Merck concealed material facts concerning Vioxx's danger.[67]

On this evidence, the district court granted Merck's motion to dismiss. That court found the plaintiffs' complaint untimely on the ground that the plaintiffs should have been alerted to "a *possibility* that Merck had knowingly misrepresented material facts no later than October 9, 2001, the date of the *New York Times* article, thus placing the plaintiffs on 'inquiry notice' to look further."[68] The plaintiffs appealed the dismissal to the Third Circuit.

The Third Circuit reversed the district court's ruling. In doing so, the Third Circuit held that the pre-November 2001 information available to the plaintiffs constituted "storm warnings" but did not suggest Merck's scienter.[69] Accordingly, the court reasoned, the plaintiffs were not put on "inquiry notice."[70] Merck appealed the Third Circuit's decision to the Supreme Court.

In its opinion authored by Justice Breyer, the Supreme Court affirmed the Third Circuit's reversal of the district court, concluding that the plaintiffs' complaint against Merck was indeed timely filed.[71] The Court's decision was based on three considerations. First, the Court held that a plaintiff's claim accrues and the two-year limitations period commences, either when the plaintiff actually discovers "the facts constituting the violation," or when a "reasonably diligent plaintiff" would have discovered such facts, "whichever comes first."[72] The Court determined that allowing constructive discovery, that is, that "a reasonably diligent plaintiff" would have discovered the facts, was consistent with the applicable statutory lan-

64. *Id.* at 1792.
65. *Id.* at 1791.
66. *Id.* at 1792–93.
67. *Id.* at 1799.
68. *Id.* at 1793 (quoting *In re* Merck & Co. Sec., Derivative & "Erisa" Litig., 483 F. Supp. 2d 407, 423 (D.N.J. 2007)).
69. *Id.*
70. *Id.*
71. *Id.* at 1790.
72. *Id.* at 1798.

guage.[73] In its analysis, the Court noted that the appellate courts that had addressed this issue were in agreement that "the discovery of facts constituting the violation" occurs "not only once a plaintiff actually discovers the facts, but also when a hypothetical reasonably diligent plaintiff would have discovered them."[74]

Second, the Court unanimously held that for § 10(b) claims, "facts showing scienter are among those that 'constitute the violation.' "[75] The Court noted that a § 10(b) claim will fail unless a plaintiff can demonstrate in his complaint that "it is at least as likely as not that the defendant acted with the relevant knowledge or intent."[76] The Court further reasoned that a contrary holding would prevent plaintiffs from bringing any claims if the defendant was able to successfully conceal for two years that it had made a misstatement.[77]

Finally, the Court held that inquiry notice does not start the two-year limitations clock.[78] Merck argued that the statute of limitations period had run prior to November 2001 because by then the plaintiffs were on inquiry notice.[79] The Court used the term *inquiry notice* to refer to "the point where the facts would lead a reasonably diligent plaintiff to investigate further."[80] In this regard, the Court distinguished the point at which a plaintiff may be on inquiry notice from the point where "the plaintiff would . . . have discovered facts showing scienter or 'other facts constituting the violation.' "[81] Although the Court rejected the concept of inquiry notice as it relates to § 10(b) claims, the Court stated that terms *inquiry notice* and *storm warnings* may be useful in identifying the point in time when a reasonably diligent plaintiff would have been prompted to begin an investigation.[82] The Court specifically reserved ruling on the question of whether the "facts constituting the violation" include other elements of a § 10(b) claim, including reliance, economic loss, and loss causation.[83]

The Court further addressed Merck's concern that the limitations period may excuse a plaintiff's lack of diligence if a plaintiff is on inquiry notice and chooses not to investigate.[84] Accordingly, the Court reasoned that such plaintiffs would still be disadvantaged because the limitation period lapses

73. *Id*. at 1795–96.
74. *Id*. at 1795.
75. *Id*. at 1796.
76. *Id*. (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007)).
77. *Id*. at 1796.
78. *Id*. at 1798.
79. *Id*. at 1797–98.
80. *Id*. at 1797.
81. *Id*. at 1798.
82. *Id*.
83. *Id*. at 1796.
84. *Id*. at 1797–98.

> two years after a reasonably diligent plaintiff would have discovered the necessary facts. A plaintiff who fails entirely to investigate or delays investigating may well not have discovered those facts by that time or, at least, may not have found sufficient facts by that time to be able to file a § 10(b) complaint that satisfies the applicable heightened pleading standards.[85]

The Court concluded that the complaint in Merck was timely because the information publicly available about the risks of Vioxx, including the FDA warning letter and assertions in various products liability complaints, did not suggest the necessary relevant scienter, that is that Merck knew at the time it made the statements at issue that those statements were false.[86]

Justice Scalia filed a concurring opinion in which Justice Thomas joined, disagreeing with the majority's analysis on constructive discovery. Justices Scalia and Thomas read the two-year limitations period to begin only upon a plaintiff's actual discovery of the violation.[87]

Justice Stevens filed an opinion concurring in part and in the judgment. He reasoned that the Court need not reach the actual and constructive discovery issue based on the case before them. Justice Stevens would have reserved on that issue.[88]

As a result of the Court's opinion in *Merck*, the number of securities fraud complaints dismissed as untimely under the two-year limitations period may decrease. Through its holding in *Merck*, however, the Court reaffirmed the principles that in order to survive a motion to dismiss, it is necessary for plaintiffs to specifically plead that the defendant acted with scienter and that scienter may not be inferred merely from the existence of materially misleading statements.

III. Attorney–Client Privilege and Corporate Employees

In *United States v. Graf*, the Ninth Circuit clarified who holds the attorney–client privilege with respect to corporate counsel and joined several circuits in applying a five-part test for determining the nature of the attorney–client relationship in the corporate context.[89] The *Graf* court also clarified that the onus is on individuals seeking to avail themselves of the attorney–client privilege as to communications regarding matters that are personal to the individual, as opposed to solely germane to the corporation, to establish that the attorney–client relationship extended to the individual. Ul-

85. *Id*. at 1798.
86. *Id*. at 1799.
87. *Id*. at 1803.
88. *Id*. at 1800.
89. 610 F.3d 1148, 1159–60 (9th Cir. 2010).

timately, the *Graf* decision provides additional consistency among circuits and clarity with regard to communications protected under the attorney–client privilege in the corporate context.

In *Graf*, defendant James Graf was the founder of Employers Mutual LLC, a Nevada corporation that purported to provide health care coverage to more than 20,000 plan members.[90] He was not listed as an officer or employee of Employers Mutual, presumably because he had been previously banned from transacting insurance business in California for misconduct in violation of state insurance laws, but billed himself as an outside consultant to the company.[91]

In May 2001, the Employee Benefits Security Administration of the U.S. Department of Labor (DOL) began investigating Employers Mutual.[92] According to the DOL complaint, Graf obstructed the investigation in several ways, including: (1) asking Employers Mutual's attorneys to lie about the continued marketing of the fraudulent insurance plans; (2) telling Employers Mutual employees to hide documents and information from a DOL investigator conducting an onsite visit; and (3) providing knowingly false information in response to DOL subpoenas.[93] In December 2001, the DOL filed a civil suit to remove Graf from Employers Mutual. It also sought to install an independent fiduciary to operate Employers Mutual and to freeze the assets of Employers Mutual and Graf.[94]

On April 29, 2004, Graf was indicted for his role in the Employers Mutual fraud.[95] The independent fiduciary appointed to run Employers Mutual then waived the attorney–client privilege for Employers Mutual "with regard to all communications between Employers Mutual and the company's legal counsel."[96] Graf moved to exclude the testimony of corporate counsel at his trial.[97] Graf argued that he was an outside consultant, and as such, he was a joint holder of the attorney–client privilege.[98] The district court held that Graf did not have a personal attorney–client relationship with the corporate counsel because he had not sought personal legal advice from the corporate attorneys.[99] Additionally, the district court found no extension of the attorney–client privilege to Graf. His subjective belief that he was represented by Employers Mutual's counsel was insufficient to

90. *Id*. at 1152.
91. *Id*. at 1153.
92. *Id*. at 1154.
93. *Id*.
94. *Id*.
95. *Id*.
96. *Id*.
97. *Id*. at 1155.
98. *Id*. at 1157.
99. *Id*. at 1155.

create a privilege because his belief was either unreasonable or not made known to corporate counsel.[100]

After a jury trial, Graf was found guilty of: conspiracy to commit mail fraud; four counts of mail fraud; nine counts of misappropriation in connection with a health care benefit program; six counts of conducting unlawful monetary transactions; and one count of obstruction of justice.[101] Graf was sentenced to 300 months imprisonment, with three years of supervised release, ordered to pay a $2,300 special assessment, as well as restitution of nearly $20.5 million.[102]

Graf appealed his conviction and argued that the attorney–client privilege extended to him, he did not waive it, and that the attorney testimony presented at trial was privileged.[103] The Ninth Circuit affirmed Graf's conviction.[104] In determining whether privilege applied, the court first analyzed Graf's role within Employers Mutual and held that it "was that of a functional employee . . . Graf communicated with insurance brokers and agents on behalf of Employers Mutual, and managed company employees. More importantly, Graf was the company's primary agent in its communications with corporate counsel."[105]

Next, the Ninth Circuit considered "whether Graf, as a functional employee of Employers Mutual, held a personal attorney–client privilege over any or all of his communications with the named attorneys."[106] In its analysis, the court adopted a standard by which to determine whether a corporate employee shares a joint privilege with the company over their communications with corporate counsel. The court joined the First, Second, Third, and Tenth Circuits, and several districts within the Ninth Circuit, in applying the *Bevill* test to decide the privilege issue.[107]

The test set forth by the Third Circuit in *In re Bevill, Bresler & Schulman Asset Management Corp*.[108] provides that privilege extends to officers or employees in an individual, personal capacity only when the employee satisfies the following five-factor test: (1) the individual must show that he approached counsel for the purpose of seeking legal advice; (2) when he approached counsel, the individual made it clear that he was seeking legal advice in his individual capacity rather than in his representative capacity;

100. *Id*.
101. *Id*.
102. *Id*. at 1156.
103. *Id*.
104. *Id*. at 1152.
105. *Id*. at 1159.
106. *Id*.
107. *Id*. at 1160.
108. 805 F.2d 120, 123 (3d Cir. 1986).

(3) the attorneys saw fit to represent him in his individual capacity, recognizing that a potential conflict could arise; (4) that his conversations with counsel were confidential; and, (5) that "the substance of [the] conversations with [the attorneys] did not concern matters within the company's general affairs."[109]

In *Graf*, the Ninth Circuit noted three strong policy reasons to adopt the *Bevill* test. First, the test "ensur[es] that a corporation is free to obtain information from its officers, employees, and consultants about company matters and then control the attorney–client privilege, waiving it when necessary to serve corporate interests."[110] Second, the court found the *Bevill* test protects an individual's ability to claim privilege when that individual makes it clear to corporate counsel that "he or she is seeking personal legal advice and the communications relate to personal legal affairs, not to the company's business."[111] Finally, the court adopted *Bevill* to promote consistency. Quoting *Upjohn Co. v. United States*, the court stated "a[n] uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all."[112]

Applying the *Bevill* factors in *Graf*, the court held that Graf failed to establish the second, third, and fifth factors.[113] With respect to the second and third *Bevill* factors, the court noted that the time records maintained by Employers Mutual's attorneys did not reflect any advice given to Graf about personal matters.[114] Further, the attorneys testified that Graf never advised counsel that he was seeking personal legal advice.[115] Also, the court stated that Graf's admission at the pretrial motion hearing that he did not request that the law firm represent him personally "causes him to fail the second and third *Bevill* factors."[116] The court found that Graf failed the fifth *Bevill* factor, because Graf's conversations with the attorneys "related to his official duties at Employers Mutual and the general affairs of the company."[117] In sum, even though Graf was found to be a "functional employee" of Employers Mutual, the attorney–client relationship did not extend to protect those communications between Graf and Employers Mutual's attorneys that related to Graf's personal legal matters.

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109. *Id*.
110. *Id*. at 1160–61.
111. *Id*. at 1161.
112. *Id*. (quoting Upjohn Co. v. United States, 449 U.S. 383, 393 (1981)).
113. *Id*.
114. *Id*. at 1162.
115. *Id*.
116. *Id*.
117. *Id*.

IV. E-DISCOVERY UPDATE

Although e-discovery has been well covered, including in last year's version of this article, two e-discovery opinions during the past year warrant particular discussion and consideration. In *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC*,[118] Judge Shira Scheindlin from the Southern District of New York, and author of the *Zubalake* opinions, revisited those opinions and clarified the standards she first enunciated as well as examples of appropriate sanctions when those standards are breached. In *Victor Stanley, Inc. v. Creative Pipe, Inc.*,[119] the federal district court in Maryland attempted to lessen the anxiety felt by practitioners and litigants caused by the lack of a national standard governing the duty to preserve, the level of culpability required to justify sanctions, and the nature and severity of appropriate sanctions. The court analyzed the law on preservation and spoliation in every federal circuit and created a chart to provide quick reference answers to the most important preservation and spoliation questions on a circuit-by-circuit basis.

A. Zubalake *Revisited:* Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC

From May 2003 through July 2004, Judge Scheindlin issued five watershed opinions in *Zubalake v. UBS Warburg, LLC* that raised the bar on the obligation of litigants and their attorneys to preserve and collect electronic discovery materials.[120] The *Zubalake* opinions have since been frequently cited in opinions imposing sanctions against parties that failed to recognize and meet their discovery obligations. In January 2010, Judge Scheindlin issued an opinion in *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC* that provides clear guidance on the standards for preserving, collecting, and producing both paper and electronic documents, as well as examples of what constitutes varying degrees of culpability for failure to meet those standards.[121]

Judge Scheindlin titled her *Pension Committee* opinion, "*Zubalake* Revisited: Six Years Later."[122] In the introduction of the opinion, she quotes George Santanya's famous observation that " '[t]hose who cannot remem-

118. 685 F. Supp. 2d 456 (S.D.N.Y 2010).
119. 269 F.R.D. 497 (D. Md. 2010).
120. Zubalake v. UBS Warburg LLC, 217 F.R.D. 309 (S.D.N.Y. 2003) (*Zubalake I*); 230 F.R.D. 290 (*Zubalake II*); 216 F.R.D. 280 (*Zubalake III*); 220 F.R.D. 212 (*Zubalake IV*); 229 F.R.D. 422 (S.D.N.Y. 2004) (*Zubalake V*).
121. 685 F. Supp. 2d 456.
122. *Id.* at 461.

ber the past are condemned to repeat it.' "[123] According to the court, "[b]y now, it should be abundantly clear that the duty to preserve means what it says and that failure to preserve records—paper or electronic—and to search in the right places for those records, will inevitably result in the spoliation of evidence[,]"[124] which harms the judicial process and requires courts to fashion a remedy. In the remainder of the "long and complex opinion," the court provided a comprehensive analytical framework for considering issues related to preservation and spoliation of evidence, applied that framework to facts at issue, and analyzed the sanctions available for the parties' varying degrees of culpability with regard to their discovery violations.

The facts of *Pension Committee* did not involve "egregious examples of litigants purposefully destroying evidence."[125] Rather, the case involved thirteen plaintiffs that "failed to timely institute written litigation holds and engaged in careless and indifferent collection efforts after the duty to preserve arose."[126] Ultimately, the court found the plaintiffs to be "either negligent or grossly negligent in meeting their discovery obligations."[127]

The plaintiffs were part of a group of ninety-six investors who brought suit in February 2004 to recover $550 million in losses that arose from the liquidation of two hedge funds in which they each held shares.[128] In 2007, one of the defendants claimed that "substantial gaps" were found in plaintiffs' document production.[129] As a result, depositions were taken and declarations were submitted over the next nine months.[130] Following the close of discovery, the defendants moved for dismissal of the complaint, "or any lesser sanction the Court deems appropriate," and alleged that the thirteen offending plaintiffs failed "to preserve and produce documents—including those stored electronically—and submitted false and misleading declarations regarding their document collection and preservation efforts."[131] Based on the evidence presented, the court found that "there can be little doubt that some documents were lost or destroyed" and set out to answer "whether plaintiffs' conduct requires this Court to impose a sanction for the spoliation of evidence."[132]

123. *Id*. at 462 (quoting George Santayana, *Reasons in Common Sense*, *in* 1 The Life of Reason 82 (1905) (Prometheus Books 1998)).
124. *Id*. at 462.
125. *Id*. at 463.
126. *Id*.
127. *Id*.
128. *Id*. at 462.
129. *Id*.
130. *Id*.
131. *Id*. at 463.
132. *Id*.

With the stage set, the court presented "An Analytical Framework and Applicable Law," in which it painstakingly detailed the essential elements and obligations for all discovery.[133] Four concepts were "carefully reviewed and analyzed" within that framework: (1) the alleged offender's level of culpability, i.e., "was their conduct of discovery acceptable or was it negligent, grossly negligent, or willful"; (2) the "interplay between the duty to preserve evidence and the spoliation of evidence"; (3) "which party should bear the burden of proving that evidence has been lost or destroyed and the consequences resulting from that loss"; and (4) the "appropriate remedy for the harm caused by the spoliation."[134]

1. Negligence, Gross Negligence, and Willfulness

Although the concepts of negligence, gross negligence, and willfulness are often discussed in terms of discovery, the *Pension Committee* court found that none of them previously had been clearly defined.[135] The court, therefore, began with the definition each term has been given in tort law and then "explore[d] the conduct, in the discovery context, that causes certain conduct to fall in one category or another."[136] The court next explained that *negligence* is the failure to adhere to the standard of "what a party must do to meet its obligation to participate meaningfully and fairly in the discovery phase of a judicial proceeding."[137] Instead, "a failure to conform to this standard is negligent even if it results from a pure heart and an empty head."[138] *Gross negligence is* "a failure to exercise even that care which a careless person would use" and "'differs from ordinary negligence only in degree, and not in kind.'"[139] The court noted that willful, wanton, and reckless are often grouped into one category

> that requires that "the actor has intentionally done an act of an unreasonable character in disregard of a known or obvious risk that was so great as to make it highly probable that harm would follow, and which thus is usually accompanied by a conscious indifference to the consequences."[140]

After defining the terms, the court turned to the task of applying those definitions to the two steps of the of the discovery process: (1) preserva-

133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.* at 463–64.
137. *Id.* at 464.
138. *Id.*
139. *Id.* (quoting W. Page Keeton et al., Prosser and Keeton on the Law of Torts § 34 at 211–12 (5th ed. 1984)).
140. *Id.* (quoting Keeton § 34 at 213).

tion of relevant information and (2) collection and review. Addressing the first step, the court remarked that "a failure to preserve evidence resulting in the loss or destruction of relevant information is surely negligent, and, depending on the circumstances, may be grossly negligent, or willful."[141] As an example of what constitutes gross negligence, and reiterating the importance of a properly crafted and timely litigation hold letter, the court proclaimed, "after July, 2004, when the final relevant *Zubalake* opinion was issued, the failure to issue a *written* litigation hold constitutes gross negligence because that failure is likely to result in the destruction of relevant information."[142]

The culpability of litigants and their attorneys for failing to satisfy their obligations with regard to the second step of the discovery process, collection and review, is also a matter of degree. The court explained, "depending on the extent of the failure to collect evidence, or the sloppiness of the review, the resulting loss or destruction of evidence is surely negligent, and, depending on the circumstances may be grossly negligent or willful."[143] Examples of gross negligence or willfulness include

> the failure to collect records—either paper or electronic—from key players . . . the destruction of email or certain backup tapes after the duty to preserve has attached . . . [and] the failure to collect information from the files of former employees that remain in a party's possession custody or control after the duty to preserve has attached.[144]

Examples of negligence include

> the failure to obtain records from all those employees who had any involvement with the issues raised in the litigation or anticipated litigation, as opposed to just the key players, . . . the failure to take all appropriate measures to preserve ESI . . .[and] the failure to assess the accuracy and validity of selected search terms.[145]

141. *Id*. (internal citations omitted).

142. *Id*. at 465 (citing *Zubalake V*, 229 F.R.D. 422; *comparing* Adorno v. Port Auth. of N.Y. & N.J., 258 F.R.D. 217, 228–29 (S.D.N.Y. 2009) (holding that defendants were only negligent where they instituted some form of a litigation hold-albeit limited in scope-when the duty to preserve arose in 2001); *with* Treppel v. Biovail, 249 F.R.D. 111, 121 (S.D.N.Y. 2008) (holding that the failure to preserve backup tapes after December 2003 was sufficient to constitute gross negligence or recklessness); *In re* NTL, Inc. Sec. Litig., 244 F.R.D. 179, 198–99 (S.D.N.Y. 2007) ("[T]he Court finds that [the] utter failure to preserve documents and ESI [electronically stored information] relevant to plaintiffs' allegations in this case . . . to be at least grossly negligent.") (collecting cases)).

143. *Id*.

144. *Id*.

145. *Id*. at 465 (citing Victor Stanley, Inc. v. Creative Pipe, Inc., 250 F.R.D. 251, 259–62 (D. Md. 2008); *Treppel*, 249 F.R.D. at 121; Cache La Poudre Feeds, LLC v. Land O'Lakes, Inc., 244 F.R.D. 614, 627–28 (D. Colo. 2007)).

2. Duty to Preserve and Spoliation

Moving on to the next concept in its framework, the court defined *spoliation* and discussed its interplay with the duty to preserve. According to the court, "[s]poliation refers to the destruction or material alteration of evidence or to the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation."[146] The "well-established" duty to preserve evidence "arises when a party reasonably anticipates litigation."[147] Once the duty arises, the party "must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents."[148] A breach of this duty resulting in the spoliation of evidence "may result in the imposition of sanctions by a court because the court has the obligation to ensure that the judicial process is not abused."[149]

3. Burdens of Proof

The third concept analyzed under the court's framework was "what can be done when documents are no longer available."[150] This step necessarily requires consideration of who "should bear the burden of establishing the relevance of evidence that can no longer be found" and "who should be required to prove that the absence of the missing material has caused prejudice to the innocent party."[151] The answer to these questions in any particular case depends on the sliding scale of the severity of the possible sanctions that may be imposed. According to the court, "[f]or less severe sanctions such as fines and cost-shifting, the inquiry focuses more on the conduct of the spoliating party than on whether documents were lost, and, if so, whether those documents were relevant and resulted in prejudice to the innocent party."[152] For those sanctions up the severity scale, "such as dismissal, preclusion, or the imposition of an adverse inference—the court must consider, in addition to the conduct of the spoliating party, whether any missing evidence was relevant and whether the innocent party has suf-

146. *Id.*

147. *Id.* at 461 (citing Fujitsu Ltd. v. Fed. Express Corp., 247 F.3d 423, 436 (2d Cir. 2001)).

148. *Id.* (citing *Treppel*, 249 F.R.D. at 118 (quoting *Zubalake IV*, 220 F.R.D. at 218).

149. *Id.* at 466 (citing Chambers v. NASCO, Inc., 501 U.S. 32, 45–46 (1991).

150. *Id.*

151. *Id.* at 466–67.

152. *Id.* at 467. In this context, the court noted, the term "relevant" means "'*something more than sufficiently probative to satisfy Rule 401* of the Federal Rules of Evidence.'" *Id.* (quoting Residential Funding Corp. v. DeGeorge Fin. Corp., 306 F.3d 99, 108–09 (2d Cir. 2002)). Rather, the innocent party must demonstrate prejudice by showing that the missing evidence would have been helpful in proving its claims or defenses. *Pension Comm.*, 685 F. Supp. at 467.

fered prejudice as a result of the loss of evidence."[153] To warrant the imposition of sanctions against the spoliating party, the innocent/complaining party must prove three elements:

> that the spoliating party (1) had control over the evidence and an obligation to preserve it at the time of destruction or loss; (2) acted with a culpable state of mind upon destroying or losing the evidence; and that (3) the missing evidence is relevant to the innocent party's claim or defense.[154]

Depending on the degree of the spoliator's failures, the innocent party's proof of these elements may be made easier. When the spoliator is found to have acted in bad faith or in a grossly negligent manner, relevance and prejudice may be presumed.[155] However, "[w]hen the spoliating party was merely negligent, the innocent party must prove both relevance and prejudice."[156] The court warned that "[c]ourts must take care not to 'hold[] the prejudiced party to too strict a standard of proof regarding the contents of the destroyed [or unavailable] evidence,' because doing so 'would . . . allow parties who have . . . destroyed evidence to profit from that destruction.' "[157] "[T]o ensure that no party's task is too onerous or too lenient," the court employed the following burden-shifting test:

> When the spoliating party's conduct is sufficiently egregious to justify a court's *imposition* of a presumption of relevance and prejudice, or when the spoliating party's conduct warrants *permitting* the jury to make such a presumption, the burden then shifts to the spoliating party to rebut that presumption. The spoliating party can do so, for example, by demonstrating that the innocent party had access to the evidence alleged to have been destroyed or that the evidence would not support the innocent party's claims or defenses. If the spoliating party demonstrates to a court's satisfaction that there could not have been any prejudice to the innocent party, then no jury instruction will be warranted, although a lesser sanction might still be required.[158]

4. Remedies

Determination of the appropriate remedy was the final concept under the court's framework and begins with the premise that the appropriate sanctions for spoliation should be determined on a case-by-case basis.[159] Whether to impose sanctions, and if so, to what degree, are decisions

153. *Id.* at 467.
154. *Id.*
155. *Id.*
156. *Id.* at 467–68.
157. *Id.* at 468 (quoting *Residential Funding Corp.*, 306 F.3d at 109).
158. *Id.* at 468–69.
159. *Id.* at 469.

within the sound discretion of the judge.[160] If a court decides sanctions are warranted, the appropriate sanction in any case should

> (1) deter the parties from engaging in spoliation; (2) place the risk of an erroneous judgment on the party who wrongfully created the risk; and (3) restore 'the prejudiced party to the same position [it] would have been in absent the wrongful destruction of evidence by the opposing party.[161]

The menu of sanctions from which a court may choose to accomplish these goals is expansive. As examples of available sanctions from the least to the most harsh, the court offered: "further discovery, cost-shifting, fines, special jury instructions, preclusion, and the entry of default judgment or dismissal (terminating sanctions)."[162] When selecting from available sanctions, the court noted, "a court should always impose the least harsh sanction that can provide an adequate remedy."[163] In this regard, "a terminating sanction is justified only in the most egregious cases, such as where a party has engaged in perjury, tampering with evidence, or intentionally destroying evidence."[164] Considering the facts before it, the court concluded that they did not warrant a terminating sanction, but rather, among other things, adverse inference instructions.

According to the court, adverse inference instructions "can take many forms, again ranging in degrees of harshness . . . the more egregious the conduct, the more harsh the instruction."[165] The court explained the range of available adverse instructions as follows:

> In its most harsh form, when a spoliating party has acted willfully or in bad faith, a jury can be instructed that certain facts are deemed admitted and must be accepted as true. At the next level, when a spoliating party has acted willfully or recklessly, a court may impose a mandatory presumption. Even a mandatory *presumption*, however, is considered to be rebuttable.
>
> The least harsh instruction *permits* (but does not require) a jury to *presume* that the lost evidence is both relevant and favorable to the innocent party. If it makes this presumption, the spoliating party's rebuttal evidence must then be considered by the jury, which must then decide whether to draw an adverse inference against the spoliating party. This sanction still benefits the innocent party in that it allows the jury to consider both the misconduct of the spoliating party as well as proof of prejudice to the innocent party. Such a charge should be termed a "spoliation charge" to distinguish it from a charge where

160. *Id.*
161. *Id.* (quoting West v. Goodyear Tire & Rubber Co., 167 F.3d 776, 779 (2d Cir. 1999).
162. *Id.* (collecting cases).
163. *Id.*
164. *Id.* at 469–70.
165. *Id.*

> the a jury is *directed* to presume, albeit still subject to rebuttal, that the missing evidence would have been favorable to the innocent party, and from a charge where the jury is *directed* to deem certain facts admitted.[166]

In addition to adverse inference instructions, the court found that considering the facts before it, monetary sanctions were also appropriate. "Monetary sanctions are appropriate 'to punish the offending party for its actions [and] to deter the litigant's conduct, sending the message that egregious conduct will not be tolerated.' "[167] Further, "[a]warding monetary sanctions serves the remedial purpose of compensating [the movant] for the reasonable costs it incurred in bringing [a motion for sanctions]."[168]

Concluding its analytical framework, the court offered "[t]hree final notes."[169] First, it stressed that a judge's decision whether to award sanctions in any particular case is "inherently subjective" and a judgment call based on the court's experience "as to whether a litigant has complied with its discovery obligations and how hard it worked to comply."[170] Second, it recognized that evaluating parties' discovery conduct involves "inherently fact intensive" inquiries but offered some guidance for doing so.[171] The court advised that "[a]fter a discovery duty is well established, the failure to adhere to contemporary standards can be considered gross negligence."[172] According to the court,

> after the final relevant *Zubalake* opinion in July 2004, the following failures support a finding of gross negligence, when the duty to preserve has attached: to issue a written litigation hold; to identify all of the key players and to ensure that their electronic and paper records are preserved; to cease the deletion of e-mail or to preserve the records of former employees that are in a party's possession, custody, or control; and to preserve backup tapes when they are the sole source of relevant information or when they relate to key players, if the relevant information maintained by those players is not obtainable from readily accessible sources.[173]

Third, the court noted the risk that sanctions motions would be increasingly sought by litigants, which, it remarked, was "not a good thing."[174] "For this reason alone," the court cautioned, courts should give the most careful

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166. *Id*. at 470–71 (internal citations omitted).
167. *Id*. at 471 (citing Green (Fine Paintings) v. McClendon, 262 F.R.D. 284, 291–92 (S.D.N.Y. 2009)).
168. *Id*. (citing *Green*, 262 F.R.D. at 291).
169. *Id*.
170. *Id*.
171. *Id*.
172. *Id*.
173. *Id*.
174. *Id*.

consideration before finding a party violated its discovery obligations and should be sanctioned.[175] Parties, it advised, should likewise "anticipate and undertake document preservation with the most serious and thorough care, if for no other reason than to avoid the detour of sanctions."[176]

5. Applying the Analytical Framework to the Facts of the Case

Pronouncing that "because the stakes are high for both sides, and because sanctions should not be awarded lightly nor should discovery misconduct by tolerated," the court carefully reviewed the conduct of each allegedly offending plaintiff to determine if it did indeed engage in culpable conduct and, if so, what level of culpability should be assigned.[177] Based on the facts before the court, including "[t]he paucity of records produced by some plaintiffs and the admitted failure to preserve some records or search at all for others by all plaintiffs," the court found that it could reach but one conclusion: "that relevant records have been lost or destroyed."[178] This resulted from the "gross negligence" of six of the offending plaintiffs, and the "negligence" of seven offending plaintiffs.[179]

With regard to the offending plaintiffs the court found to have been "grossly negligent in their discovery efforts," the court cited the following examples of their conduct:

- performing "severely deficient" searches for relevant documents soon after the case was filed;[180]
- failing to institute a timely written litigation hold;[181]
- "fail[ing] to collect or preserve *any* electronic documents prior" to engaging new counsel three years after the Complaint had been filed;[182]
- "continu[ing] to delete electronic documents after the duty to preserve arose;"[183]
- failing to request documents from "key players;"[184]
- "delegat[ing] search efforts without any supervision from management;"[185]
- "destroying backup data potentially containing responsive documents of key players that were not otherwise available;"[186] and/or

175. *Id*. at 471–72.
176. *Id*. at 472.
177. *Id*. at 479.
178. *Id* at 476.
179. *Id*. at 478.
180. *Id*. at 480.
181. *Id*.
182. *Id*.
183. *Id*.
184. *Id*.
185. *Id*.
186. *Id*.

- "submitt[ing] misleading or inaccurate declarations," regarding their efforts to comply with their discovery obligations.[187]

Turning to the offending plaintiffs the court found to have been "negligent in their discovery efforts," the court cited the following examples of their conduct:

- failing to institute a written litigation hold in a timely manner;[188]
- delegating the responsibility to search for relevant documents to assistants, but failing "to provide any meaningful supervision;"[189]
- failing to conduct a thorough search of computer systems;[190]
- failing to direct all those persons under the control of the plaintiff who may be in possession of relevant documents to preserve those documents;[191]
- failing to search backup tapes;[192]
- failing to search a "palm pilot, which may have contained e-mails;"[193]
- failing to collect documents from all those persons under the control of the plaintiff who may be in possession of relevant documents;[194]
- permitting "key players" to search their own files without supervision from management or counsel;[195] and
- failing to search the electronic files of all employees, instead searching only one particular subfile on plaintiff's server that was known to contain relevant documents;[196]

6. Sanctions

The court imposed sanctions of varying degrees against the plaintiffs that engaged in grossly negligent and negligent discovery conduct. With regard to the "grossly negligent" conduct, the court concluded that "[f]rom this conduct, it is fair to presume that responsive documents were lost or destroyed. The relevance of any destroyed documents and the prejudice caused by their loss, may also be presumed."[197] Accordingly, the court held that the jury would "be permitted to presume, if it so chooses, both the relevance of the missing documents and resulting prejudice to the [defendants], subject to the plaintiffs' ability to rebut the presumption to the satisfaction of the trier of fact."[198]

187. *Id*.
188. *Id*. at 488.
189. *Id*. at 489.
190. *Id*. at 490.
191. *Id*.
192. *Id*. at 491.
193. *Id*. at 492.
194. *Id*. at 493, 494.
195. *Id*. at 494.
196. *Id*. at 495.
197. *Id*. at 480.
198. *Id*.

With regard to those plaintiffs that were negligent, the court held that the defendants were required to "demonstrate that any destroyed documents were relevant and the loss was prejudicial."[199] As evidence of the satisfaction of this burden, the court pointed to the negligent plaintiffs' complete loss or destruction of an unknown quantity of e-mails and documents.[200] The court found that "it is plaintiffs' misconduct that destroyed the emails and documents."[201] Accordingly, and "given the facts and circumstances presented," the court concluded that the defendants had "carried their limited burden of demonstrating that the lost documents would have been relevant . . . [and that] [t]here can be no serious question that the missing material would have been relevant."[202]

"Prejudice," the court found, "is another matter."[203] Noting that the defendants had gathered "an enormous amount of discovery," the court concluded that unless the defendants could show at trial "through extrinsic evidence that the loss of the documents has prejudiced their ability to defend the case, then a lesser sanction than a spoliation charge is sufficient to address any lapse in the discovery efforts of the negligent plaintiffs."[204]

The court also imposed monetary sanctions against each of the grossly negligent and negligent plaintiffs.[205] These sanctions included an award of the defendants' "reasonable costs, including attorneys' fees, associated with reviewing the declarations submitted, deposing these declarants and their substitutes where applicable and bringing [their sanctions] motion."[206]

The court provided some final advice to all litigants: "While litigants are not required to execute document productions with absolute precision, at a minimum they must act diligently and search thoroughly at the time they reasonably anticipate litigation."[207] When they fail to do so, as did the plaintiffs in *Pension Committee*, they should be sanctioned accordingly.

B. Victor Stanley, Inc. v. Creative Pipe, Inc.

While *Pension Committee* involved sloppy discovery on the part of the plaintiffs, *Victor Stanley, Inc. v. Creative Pipe, Inc.*[208] involved a defendant's outrageous, willful, and bad faith discovery violations. The opinion is newsworthy

199. *Id.* at 478.
200. *Id.*
201. *Id.*
202. *Id.* at 478–79.
203. *Id.* at 479.
204. *Id.*
205. *Id.* at 497.
206. *Id.*
207. *Id.*
208. 269 F.R.D. 497 (D. Md. 2010), *adopted with modifications by Order of the District Court*, Case No. 06-CV-02662-MJG (ECF No. 381) (Sept. 30, 2010).

due to one of the extraordinary sanctions imposed by the court—imprisonment for not less than two years of one of the offending defendants—and is noteworthy because of its detailed synthesis of the current state of the law on preservation and spoliation issues in every federal circuit.[209]

In *Victor Stanley*, Victor Stanley, Inc. (VSI) filed an action alleging violations of copyrights and patents as well as unfair competition against Creative Pipe, Inc. (CPI) and against its president, Mark Pappas, and Stephanie Pappas.[210] VSI claimed that the defendants downloaded VSI design drawings and specifications from the VSI website and then used them improperly in competition with VSI.[211] After four years of frustrating discovery efforts, four court orders ordering preservation of electronically stored information (ESI), and plaintiff's three previous motions for sanctions, the plaintiff filed its Motion for Terminating and Other Sanctions Arising Out of Defendants' Intentional Destruction of Evidence and Other Litigation Misconduct (Plaintiff's Fourth Motion for Sanctions).[212] All discovery motions were referred to the magistrate judge, who issued an extensive Memorandum, Order and Recommendation on Plaintiff's Fourth Motion for Sanctions, which ultimately imposed harsh sanctions against the defendants.[213]

The court painstakingly set forth the "convoluted" events underlying plaintiff's final motion.[214] In great detail, the court described each of the "ways in which Defendants willfully and permanently destroyed evidence related to this lawsuit, as well as their failed attempts to destroy evidence that was later discovered."[215] The court discussed and cited as discovery violations the following:

> (1) Pappas's failure to implement a litigation hold; (2) Pappas's deletions of ESI soon after VSI filed suit; (3) Pappas's failure to preserve his external hard drive after Plaintiff demanded preservation of ESI; (4) Pappas's failure to preserve files and e-mails after Plaintiff demanded their preservation; (5) Pappas's deletion of ESI after the Court issued its first preservation order; (6) Pappas's continued deletion of ESI and use of programs to permanently remove files after the Court admonished the parties of their duty to preserve evidence and issued its second preservation order; (7) Pappas's failure to preserve ESI when he replaced the CPI server; and (8) Pappas's further use of programs to permanently delete ESI after the Court issued numerous production orders.[216]

209. *Id.* at 500.
210. *Id.* at 502.
211. *Id.*
212. *Id.* at 500.
213. *Id.*
214. *Id.* at 501. Charting the facts, the court advised, "has consumed, collectively, hundreds of hours of my time and my law clerk's time." *Id.*
215. *Id.* at 515.
216. *Id.* at 501–02. Before enumerating the specific violations, the court wryly commented that this was a "case of the 'gang that couldn't spoliate straight.'"

After discussing the defendants' egregious conduct in eight detailed sections, the court concluded:

> [t]aken individually, each section demonstrates intentional misconduct done with the purpose of concealing or destroying evidence. Collectively, they constitute the single most egregious example of spoliation that I have encountered in any case that I have handled or in any case described in the legion of spoliation cases I have read in nearly fourteen years on the bench.[217]

Not surprisingly, the court concluded that that the lost or destroyed ESI was relevant and that its absence was prejudicial to the plaintiff and warranted severe sanctions.[218] The defendants conceded these conclusions.[219]

"Having chronicled what happened and the effect it had on Plaintiff's ability to prosecute its claims and the Court's ability to ensure a fair trial," the court turned to a discussion of the law governing spoliation claims.[220] Applying the applicable law, the court ordered that as for the defendants' willful and egregious discovery violations, the defendants would be required to pay "monetary sanctions equivalent to Plaintiff's attorney's fees and costs . . . which will include fees and costs associated with all discovery that would not have been undertaken but for Defendants' spoliation, as well as the briefings and hearings regarding Plaintiff's [Fourth] Motion for Sanctions."[221] The court further recommended that the district court judge enter a default judgment as to liability on the plaintiff's copyright claim and grant the plaintiff's motion for injunctive relief as to that claim.[222] Finally, based on Mark Pappas's "pervasive and willful violation of serial Court orders to preserve and produce ESI evidence," the court ordered that "Pappas's spoliation be treated as contempt of this Court, and as a sanction, he shall be imprisoned for a period not to exceed two (2) years, unless and until he pays to Plaintiff the attorneys' fees and costs that will be awarded."[223]

The court, before it came to its conclusion for the appropriate sanctions, recognized that given the egregious facts and the defendants' own concessions, it could simply apply the applicable law of the Fourth Circuit and impose the appropriate sanctions, "without considering the broader legal context in which preservation/spoliation issues are playing out in litigation across the country."[224] "Such a narrow analysis," however, the court re-

217. *Id.* at 515.
218. *Id.*
219. *Id.*
220. *Id.*
221. *Id.* at 541.
222. *Id.* at 538.
223. *Id.* at 500, 540.
224. *Id.* at 516–17.

marked, "would be of little use to lawyers and their clients who are forced, on a daily basis, to make important decisions in their cases regarding preservation/spoliation issues, and for whom a more expansive examination of the broader issue might be of some assistance."[225] Accordingly, the court in its opinion set out to "synthesize not only the law of [the District of Maryland] and [the Fourth] Circuit, but also to put it within the context of the state of the law in other circuits as well," with the "hope that this analysis will provide counsel with an analytical framework that may enable them to resolve preservation/spoliation issues with a greater level of comfort that their actions will not expose them to disproportionate costs or unpredictable outcomes of spoliation motions."[226]

The "analytical framework" provided by the court presents most of the same concepts as did Judge Scheindlin in her *Zubalake Revisited* opinion. The *Victor Stanley* opinion, however, goes further in that it provides a thorough and extensive analysis of the concepts and law governing preservation of evidence and spoliation in each federal circuit.[227] In addition, the court created and appended to its Memorandum a twelve-page chart entitled "Spoliation Sanctions by Circuit" that succinctly identifies the most important preservation and spoliation concepts and issues on a circuit-by-circuit basis, including such issues as the "scope of the duty to preserve"; "can conduct be culpable per se without consideration of reasonableness?"; "culpability and prejudice requirements"; "what constitutes prejudice?"; and "culpability and corresponding jury instructions."[228]

Although the *Victor Stanley* court's extreme sanction of imprisonment may be that for which the opinion will be most remembered, a copy of the opinion and its appendix should be kept handy by those who find themselves engaged in discovery, as a party or counsel, to reference its thorough synthesis of and quick-reference guide to the applicable law regarding preservation of evidence and spoliation in each federal jurisdiction.

225. *Id.*
226. *Id.* at 517.
227. *Id.*
228. *Id.* at appendix.

RECENT DEVELOPMENTS IN EMPLOYMENT LAW

Pamela J. Moore, Thomas F. Doherty, Patrick M. Collins, Rebecca Brenia, and Tiffany R. Hubbard

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We discuss below our view of the most significant cases, regulations, and developments in employment law during the survey period from October 1, 2009, to September 30, 2010. As usual, the Supreme Court delivered key rulings, including on the right to privacy regarding text messages, the timeliness of disparate impact claims, and the scope of employment

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arbitrations. With the shift to a Democratic administration, we expected the regulatory pendulum to shift back toward protection of employees; developments in 2010 confirmed this trend. The National Labor Relations Board weighed in with two decisions expanding the scope of protected employee comments, which are certain to influence the Board's recent complaint addressing postings and employer social media policies. The complaint was filed just outside the survey period but is discussed for context and its significance given the ubiquity of social media. The Department of Labor also promulgated its new plan/prevent/protect philosophy and increased efforts on wage and hour enforcement. In addition, the department issued new administrator interpretations that rule more broadly than previous opinion letters, and in fact reversed two rules established by two earlier opinion letters. The department also promulgated regulations implementing one of the first acts of the Obama administration, an executive order relating to workplace posting of federal labor rights. Finally, the Genetic Information Nondiscrimination Act took effect for employers on November 21, 2009; implementing regulations were finalized by the Equal Employment Opportunity Commission during the survey period and finally issued in November 2010.

I. Employment-Related Privacy Issues

On June 17, 2010, the U.S. Supreme Court issued its much-anticipated decision in *City of Ontario v. Quon*,[1] addressing an employer's right to review private text messages sent by an employee using employer-owned electronic devices during working time.

Quon was a SWAT officer working for the City of Ontario, California. He was issued a city-owned pager and used the pager to send sexually explicit text messages to both his wife and his girlfriend. He regularly incurred overage charges because of his personal use of the pager but was told by his superior officer that he could continue to use the pager to send personal messages if he paid the overage charges. At some point, the city undertook an investigation into excessive overage charges for the purpose of determining whether its text messaging plan was sufficient and whether its policy on overage charges was appropriate. The city then discovered Quon's excessive and inappropriate personal use of the pager during working hours and implemented disciplinary measures. Quon, his wife, and his girlfriend all sued the city and the city's service provider, Arch Wireless, for alleged violations of the Stored Communications Act, the Fourth Amendment, and California privacy laws.[2]

1. 130 S. Ct. 2619 (2010).
2. *Id*. at 2621–22.

The district court ruled that the city had not violated Quon's Fourth Amendment rights. The Ninth Circuit reversed, holding that the city had violated those rights because "less intrusive means" were available for the city to determine if its text messaging program was appropriate, i.e., it could have made this determination without reviewing personal text messages sent by Quon. The Supreme Court agreed to review this determination and reversed the Ninth Circuit decision.[3]

Intentionally limiting its opinion to the facts presented, the Court held that the city's review of Quon's text messages was not an unlawful search or seizure because the review was "reasonable under all the circumstances." In reaching this conclusion, the Court noted that the city had a legitimate reason for undertaking the investigation and reviewed only a sample of Quon's text messages that were sent during working hours. The Court also noted that Quon, as a police officer, should have known that his text messages might come under scrutiny and that a reasonable employee would anticipate that an employer might audit pager messages.[4] The Court rejected the Ninth Circuit's reliance on the conclusion that less intrusive means existed to determining the propriety of its text messaging plan and its overage policy, noting:

> This Court has "repeatedly refused to declare that only the least intrusive search practicable can be reasonable under the Fourth Amendment." That rationale could raise insuperable barriers to the exercise of virtually all search and seizure powers because judges engaged in post hoc evaluations of government conduct can almost always imagine some alternative means by which the objectives of the government might have been accomplished.[5]

The Court steadfastly refused to undertake a broader discussion of privacy rights in the employment context, particularly when electronic communications devices are being used. In fact, the Court cautioned that

> the Court must proceed with care when considering the whole concept of privacy expectations in communications made on electronic equipment owned by a government employer. The judiciary risks error by elaborating too fully on the Fourth Amendment implications of emerging technology before its role in society has become clear.[6]

Accordingly, although it was greatly anticipated by employers throughout the country, the *Quon* decision is perhaps more significant for what the Court did not say. Indeed, the Court's opinion makes clear that the use

3. *Id.* at 2622.
4. *Id.* at 2631.
5. *Id.* at 2619 (citations omitted).
6. *Id.* at 2629.

of electronic communications devices in the workplace and an employer's right to review messages sent on such devices will continue to be a source of controversy that will inevitably have to be determined by the judiciary.[7] As Justice Scalia pointed out in a concurring opinion:

> The Court's implication that where electronic privacy is concerned we should decide less than we otherwise would (that is, less than the principle of law necessary to resolve the case and guide private action)—or that we should hedge our bets by concocting case-specific standards or issuing opaque opinions—is in my view indefensible. The-times-they-are-a-changin' is a feeble excuse for disregard of duty.[8]

Despite Justice Scalia's rebuke, the Court persisted and issued a rigorously fact-specific opinion.[9] As a result, the privacy rights of employees with respect to electronic communications are far from settled, and attorneys practicing in this area must remain vigilant with respect to the state of case law in the relevant jurisdiction and the particular facts involved in the situation at issue.

II. Social Networking and Unfair Labor Practices

Employment practitioners on both the employer and union side were keenly awaiting the outcome of an unfair labor practice complaint issued by the acting regional director of the Hartford regional office of the National Labor Relations Board (NLRB) in *American Medical Response of Connecticut, Inc*.[10] For the first time, the NLRB sought to apply the protections of the National Labor Relations Act to an employee's work-related comments on a personal social media webpage (in this case, Facebook).[11] Although the matter was recently settled without a ruling on the merits of the NLRB's position, that the complaint continues a trend in recent NLRB decisions holding that employees do not lose the protections of the Act notwithstanding their premeditated use of profane or obscene language toward a supervisor.[12] Nevertheless, the now settled case is a useful reminder for employers about the potential risks of a policy that too broadly prohibits employee disparagement of the employer or its supervisors.

7. *Id*.
8. *Id*. at 2635.
9. *See id*. at 2629–30.
10. Complaint at 3, Am. Med. Response of Conn., Inc. & Int'l Bhd. of Teamsters, Local 443 (N.L.R.B. Oct. 27, 2010) (Case No. 34-CA-12576).
11. *Id*. at 3.
12. *See, e.g.*, *id*. at 3–4. Press Release, National Labor Relations Board, Settlement reached in case involving discharge for Facebook comments (Feb. 8, 2011), available at www.nlrb.gov/news/settlement-reached-case-involving-discharge-facebook-comments.

In this case, the employer, American Medical Response (AMR), asked an employee, Dawnmarie Souza, to write a report in response to a customer complaint about her work. Souza requested and was denied representation from her union, Teamsters Local 443, to assist her in preparing the report. According to the NLRB, Souza's supervisor threatened her with discipline because of her request for union representation. Later that day, Souza vented her anger in a number of comments posted on her personal Facebook page. Souza first referred to her supervisor as a "17," which, according to news reports, is an AMR code for a psychiatric patient. After a number of other people, some of whom were not AMR employees, posted comments and questions on her Facebook page, Souza posted additional personal attacks against her supervisor, calling him a four-letter obscenity and a "scumbag." The NLRB complaint alleged that AMR fired Souza a few weeks later for violating its "Blogging and Internet Posting Policy," which stated in part that "[e]mployees are prohibited from making disparaging, discriminatory or defamatory comments when discussing the Company or the employee's superiors, co-workers and/or competitors." AMR denied that Souza was fired for her Facebook postings; it maintained that she was discharged due to "multiple, serious complaints about her behavior."[13]

The questions raised by the NLRB's complaint are whether Souza's Facebook postings were protected "concerted activity" under the Act, making her discharge on that basis illegal under § 8(a)(1), which prohibits both union and nonunion employers from interfering with, restraining, or coercing employees with respect to such activities; whether AMR's blogging/Internet posting policy was overly broad and, therefore, coercive under § 8(a)(1); and whether AMR improperly denied Souza assistance from her union.[14]

Although most employers would view Souza's comments about her supervisor to be flagrantly disparaging and inappropriate, the NLRB has developed a four-part test to determine whether an employee's activities lose their protected status due to insubordinate statements. Specifically, under *Atlantic Steel Co.*,[15] the board considers (1) the place of the discussion, (2) the discussion's subject matter, (3) the nature of the employee's outburst, and (4) whether the outburst was provoked by the employer's unfair labor practices. The standard provides some leeway for impulsive outbursts in the context of labor relations and balances that consideration against the employer's need to preserve appropriate order through respect for supervisors.[16]

13. Complaint, *supra* note 10, at 2–3.
14. *Id.* at 3–4.
15. 245 N.L.R.B. 814 (1979).
16. *Cf.* Complaint, *supra* note 10, at 4–5.

Souza's denigrating comments, broadcast in a highly public electronic forum, were arguably not spontaneous or directly related to terms or conditions of employment common to others in the workplace. Yet, NLRB Acting General Counsel Lafe Solomon has told the media that he equates Souza's Facebook postings with a conversation about working conditions among co-workers "at the water cooler."[17] Due to the recent settlement of the *American Medical Response* case, employment law practitioners must await the inevitable future litigation over whether NLRB's views on social media postings will be validated by the courts. However, the attitude reflected by Mr. Solomon's comment is consistent with other NLRB cases where work-related criticism has been deemed to be protected, no matter how crudely or profanely expressed and no matter what the forum.

In *Kiewit Power Constructors Co.*,[18] the board rejected the recommendation of its own administrative law judge and held that the Act protected an employee who complained about being warned for taking excessive breaks, even though he told his supervisor in front of co-workers that if he were terminated it would "get ugly" and that the supervisor "better bring his boxing gloves." Similarly, in *Plaza Auto Center, Inc.*,[19] again despite a contrary recommendation from the administrative law judge who acted as a fact-finder, the NLRB held that a nonunion car salesman was protected from discharge after he bluntly told the owner of the dealership what he thought of him in a highly offensive and profane manner during a dispute over a commission payment.

The NLRB's interpretation of the *Atlantic Steel* criteria, as reflected in these recent decisions, will inevitably be the subject of judicial scrutiny. Kiewit Power Constructors has already appealed the NLRB's decision.[20] If an appellate court accepts the NLRB's holdings as a valid interpretation of the Act, it appears that there is little short of explicit, direct, and premeditated threats of physical harm that would strip employee conduct of its protected status.

III. TITLE VII DISPARATE IMPACT CLAIMS

In *Lewis v. Chicago*,[21] the Supreme Court granted certiorari to determine whether the Title VII disparate impact claims of African-American firefighters were time-barred. The Court held that a plaintiff who does not challenge an employer's adoption of an employment practice by filing a

17. Nora FitzGerald Meldrum, *Facebook Firing? NLRB Complaint Alleges Employer Violated Employee's Rights*, Nat'l L. Rev., Nov. 14, 2010, *available at* http://www.natlawreview.com/article/facebook-firing-n.l.r.b.-complaint-alleges-employer-violated-employee-s-rights.

18. 355 N.L.R.B. 150, at *2 (Aug. 27, 2010).

19. 355 N.L.R.B. 85, at *3 (Aug. 16, 2010).

20. Kiewit Power Constructors Co. v. Nat'l Labor Relations Bd., No. 10–1289 (D.C. Cir.).

21. 130 S. Ct. 2191 (2010).

timely charge with the Equal Employment Opportunity Commission may nonetheless assert a timely disparate impact claim challenging the employer's subsequent use of that practice.[22]

In 1995, the City of Chicago administered an entrance exam to firefighter applicants and created an "eligible list" based on test scores, sorting applicants into those who were "well qualified," those who were "qualified," and those who failed the exam.[23] Starting in 1996, the city for years hired individuals from the list, drawing first from the well-qualified group to fill openings in the department. African-American applicants challenged the city's use of the eligible list as having a disparate impact.[24] Although the city stipulated that the cutoff score did result in a disparate impact, it argued that the plaintiffs' claims were time-barred because more than 300 days had passed since the discriminatory employment practice, i.e., sorting the test scores and creating the eligibility list, had been implemented.[25]

The unanimous Court analyzed the claim under the plain language of 42 U.S.C. § 2000e-2(k) and concluded that the city's use of the eligible list each time it selected candidates to fill open positions was a use of an employment practice that could be the basis for a disparate impact claim and that the plaintiffs had established a prima facie case sufficient to proceed.[26]

IV. ARBITRATION

Two recent Supreme Court decisions provide guidance on the role of arbitration in the context of labor and employment law. The decisions indicate that the Court will enforce broad contractual language providing that the arbitrator will decide all disputes relating to the enforceability of an arbitration agreement, including questions of unconscionability. The Court will not, however, enforce arbitration provisions in situations where class actions are in issue unless the arbitration clause specifies that it is applicable to class actions.

In *Stott-Nielsen v. AnimalFeeds International Corp.*,[27] the Supreme Court held that a panel of arbitrators had impermissibly considered public policy in determining that a class action arbitration could go forward in the absence of contractual language expressly permitting class action arbitration. The contract included broad language calling for arbitration of *any* dispute under the contract. The Court reasoned that "because class action arbitration changes the nature of the arbitration to such a degree . . . it cannot

22. *Id*. at 2197.
23. *Id*. at 2195.
24. *Id*. at 2195–97.
25. *Id*. at 2196.
26. *Id*. at 2198–99.
27. 130 S. Ct. 1758 (2010).

be presumed the parties consented to it by simply agreeing to submit their disputes to an arbitrator."[28]

In *Rent-a-Center West, Inc. v. Jackson*,[29] the Court considered another arbitration agreement that contained broad language to the effect that the arbitrator, not a court, would have the exclusive authority to resolve any dispute relating to the contract. The petitioner, a former Rent-a-Center employee, filed suit in federal district court, arguing that the arbitration agreement that he signed was unconscionable because, inter alia, it required him to pay an equal share of the arbitration costs, it limited discovery, and it was unenforceable because he was forced to sign the agreement as a condition of his employment.[30]

The trial court held that the language requiring disputes about arbitrability was clear, finding that the contract "clearly and unmistakably" delegated to the arbitrator authority to determine enforceability.[31] Thus, the court held that an arbitrator can properly determine the issue of arbitrability and enforceability, provided there is no ambiguity in the contractual language relating to the arbitrator's authority to do so.[32] The Supreme Court agreed, at least in part, because it found that the petitioner had not specifically contested the validity of the delegation provision.[33]

V. CHANGES TO THE DEPARTMENT OF LABOR UNDER THE OBAMA ADMINISTRATION

During the survey period, the U.S. Department of Labor (DOL) has increased its enforcement activities, including implementing a new "plan/prevent/protect" regulatory strategy, increasing its enforcement staff, and broadening the scope of the Wage and Hour Division's interpretive guidance.

A. *Plan/Prevent/Protect Strategy*

In April 2010, the DOL announced its new plan/prevent/protect regulatory philosophy.[34] Although the DOL acknowledged that "many employers and other regulated entities have a culture of compliance" in their day-to-day practices, the department was imposing its plan/prevent/protect strategy

28. *Id.* at 1775.
29. 130 S. Ct. 2772 (2010).
30. *Id.* at 2775.
31. *Id.* at 2775–76.
32. *Id.* at 2776.
33. *Id.* at 2780–81.
34. U.S. Dep't of Labor, Regulatory Agenda Narrative (Spring 2010), *available at* http://www.dol.gov/regulations/2010RegNarrative.htm.

on all employers, rather than focusing its efforts on those with a "catch me if you can" mentality.[35]

The DOL has warned employers that they "must take responsibility to find and fix problems rather than wait for a Labor Department investigator to inspect, discover the problems, and enforce the law."[36] Under the strategy, each agency will propose regulations that require an employer to develop a compliance program in response to identified compliance issues, namely:

> Although the specifics will vary by law, industry and regulated enterprise, this "Plan/Prevent/Protect" strategy will require all regulated entities to take three steps to ensure safe and secure workplaces and compliance with the law:
>
> - **Plan:** The Department will propose a requirement that employers and other regulated entities create a plan for identifying and remediating risks of legal violations and other risks to workers—for example, a plan to search their workplaces for safety hazards that might injure or kill workers. The employer or other regulated entity would provide their employees with opportunities to participate in the creation of the plans. In addition, the plans would be made available to workers so they can fully understand them and help to monitor their implementation.
> - **Prevent**: The Department will propose a requirement that employers and other regulated entities thoroughly and completely implement the plan in a manner that prevents legal violations. The plan cannot be a mere paper process. The employer or other regulated entity cannot draft a plan and then put it on a shelf. The plan must be fully implemented for the employer to comply with the "Plan/Prevent/Protect" compliance strategy.
> - **Protect**: The Department will propose a requirement that the employer or other regulated entity ensures that the plan's objectives are met on a regular basis. Just any plan will not do. The plan must actually protect workers from violations of their workplace rights.[37]

B. *Wage and Hour Division: Misclassification*

In line with the DOL's efforts for increased enforcement and its plan/prevent/protect strategy, the Wage and Hour Division (WHD) is focusing on the misclassification of employees.

The Obama administration's FY 2011 budget includes $25 million for the DOL to address the misclassification of employees, $12 million of which is designated for enforcement of wage and overtime laws.[38] Secretary

35. *Id.*
36. *Id.*
37. *Id.*
38. News Release, U.S. Dep't of Labor, Statement of U.S. Secretary of Labor Hilda L. Solis on Introduction of Legislation Regarding Issue of Misclassification (Apr. 22, 2010), *available at* http://www.dol.gov/opa/media/press/whd/WHD20100541.htm.

of Labor Hilda Solis has greatly increased WHD staff and hired an additional 250 wage and hour investigators.[39]

The WHD's regulatory agenda also includes a proposed rule regarding record-keeping requirements under the Fair Labor Standards Act.[40] This rule would require an employer to inform each worker how his or her pay is calculated and require an employer to perform a classification analysis for independent contractors, disclose that analysis to the worker, and keep a copy available upon request for WHD enforcement personnel.[41]

1. Administrator Interpretations Replace Fact-Specific Opinion Letters

In March 2010, the DOL announced that the WHD would no longer issue opinion letters but would issue broader administrator interpretations. Rather than limiting its opinions to fact-specific situations, the WHD's "[a]dministrator [i]nterpretations will set forth a general interpretation of the law and regulations, applicable across-the-board to all those affected by the provision in issue."[42] This shift to broader interpretations of the law is intended "to provide meaningful and comprehensive guidance and compliance assistance to the broadest number of employers and employees."[43] Since March 2010, the WHD has issued three administrator interpretations, each of which is summarized below.

a. Administrator Interpretation No. 2010-1

The first administrator interpretation concluded that a mortgage loan officer does not meet the Fair Labor Standards Act's (FLSA) administrative exemption because a mortgage loan officer's primary duty is making sales.[44] To arrive at this conclusion, the interpretation discusses a mortgage loan officer's typical job duties and analyzes case law to determine whether a mortgage loan officer's primary duty is directly related to the employer's management and general business operations.[45] This interpretation rejected the 2006 Bush-era opinion letter that concluded that mortgage loan officers were exempt under the FLSA.[46]

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39. News Release, U.S. Dep't of Labor, Statement by U.S. Secretary of Labor Hilda L. Solis on Wage and Hour Division's Increased Enforcement and Outreach Efforts (Nov. 19, 2009), *available at* http://www.dol.gov/opa/media/press/whd/whd20091452.htm.

40. Regulatory Agenda Narrative, *supra* note 34.

41. *Id.*

42. *Id.*

43. U.S. Dep't of Labor, Wage and Hour Division, Rulings and Interpretations, *available at* http://www.dol.gov/whd/opinion/opinion.htm (last visited Jan. 15, 2011).

44. Administrator Interpretation No. 2010-1 (Dep't of Labor Mar. 24, 2010), *available at* http://www.dol.gov/whd/opinion/adminIntrprtn/FLSA/2010/FLSAAI2010_1.htm; *see* 29 U.S.C. § 213(a)(1).

45. Administrator Interpretation No. 2010-1.

46. *Id.* (citing Opinion Letter FLSA 2006-31 (Dep't of Labor, Wage & Hour Div. Sept. 8, 2006)).

b. Administrator Interpretation No. 2010-2

The second administrator interpretation concluded that an employee's time changing clothes can be a "principal activity" under the Portal to Portal Act.[47] This means that, even where changing clothes is not compensable by mutual agreement between the employer and employees, subsequent walking or waiting time would be compensable because the principal activity of changing clothes starts the continuous workday.[48] The interpretation rejected a 2007 opinion letter that reached the contrary conclusion.[49]

c. Administrator Interpretation No. 2010-3

The most recent administrator interpretation concluded that under the Family and Medical Leave Act (FMLA) an employee need not have a legal or biological relationship with the child to be eligible for child-related FMLA leave rights.[50] In reaching its conclusion, the interpretation states that "either day-to-day care or financial support may establish an *in loco parentis* relationship where the employee intends to assume the responsibilities of a parent with regard to a child."[51]

VI. GENETIC INFORMATION NONDISCRIMINATION ACT

The Genetic Information Nondiscrimination Act (GINA) was signed into law by President George W. Bush in 2008 and took effect for employers on November 21, 2009.[52] Title II of GINA, which applies to employers, unions, employment agencies, and joint apprenticeship programs, prohibits covered entities from requesting, requiring, or purchasing an individual's genetic information and making employment decisions based on such data.[53] The law contains limited exceptions for inadvertent acquisition of genetic information, either through casual conversations or through an employer's request for medical data under the FMLA, the Americans with

47. Administrator Interpretation No. 2010-2 (Dep't of Labor June 16, 2010), *available at* http://www.dol.gov/whd/opinion/adminIntrprtn/FLSA/2010/FLSAAI2010_2.htm; *see* 29 U.S.C. § 203(o).

48. Administrator Interpretation No. 2010-2.

49. *Id.* (citing Opinion Letter FLSA 2007-10 (Dep't of Labor, Wage & Hour Div. May 14, 2007)).

50. Administrator Interpretation No. 2010-3 (Dep't of Labor June 22, 2010), *available at* http://www.dol.gov/whd/opinion/adminIntrprtn/FMLA/2010/FMLAAI2010_3.htm; *see* 29 U.S.C. § 2611(12).

51. Administrator Interpretation No. 2010-3.

52. Genetic Information Nondiscrimination Act of 2008, Pub. L. No. 110-233, 122 Stat. 881 (codified at 42 U.S.C. §§ 2000ff–2000ff-11); *see* 42 U.S.C. § 2000ff note (setting forth effective date).

53. 42 U.S.C. §§ 2000ff-1, -2, -3, -4.

Disabilities Act (ADA), or in connection with a leave request not covered by state or federal statute.[54]

Implementing regulations for GINA Title II were proposed in March 2009.[55] In November 2010, the Equal Employment Opportunity Commission (EEOC) issued a final rule interpreting the federal law banning employment discrimination based on an individual's genetic information and family medical history.[56] The EEOC regulations took effect on January 10, 2011.[57]

Concerned with the risk of employers acquiring protected information through routine FMLA and ADA requests, the EEOC regulations contain specific model language for employers to use when requesting such information from an employee's health care provider. This safe harbor, found in § 1635.8(b)(1)(i)(B) of the regulations, provides that any receipt of genetic information in response to a lawful request for medical information will be deemed inadvertent and not in violation of GINA if the request contains a warning not to provide the employer with genetic information.[58] GINA requires employers who inadvertently receive an employee's genetic information to store the information in a confidential medical file, separate from the employee's personnel file.[59] The EEOC regulations also address the issue of fitness for duty physicals, instructing employers that physicians conducting such physicals may not inquire as to the employee's family medical history.[60]

GINA incorporates by reference certain definitions, enforcement mechanisms, and remedies found in Title VII of the 1964 Civil Rights Act, and the EEOC regulations adopt the definition of *dependent* from the Employee Retirement Income Security Act (ERISA) to define *family member* as used in GINA.[61] As a result, *employee* is defined to include former employees and *family member* includes "persons who are or become related to an individual through marriage, birth, adoption, or placement for adoption," through

54. *Id.* §§ 2000ff-1(b), -2(b), -3(b), -4(b).

55. Regulations Under the Genetic Information Nondiscrimination Act of 2008, 74 Fed. Reg. 9056 (proposed Mar. 2, 2009).

56. Regulations Under the Genetic Information Nondiscrimination Act of 2008, 75 Fed. Reg. 68,912 (Nov. 9, 2010) (codified at 29 C.F.R. pt. 1635).

57. *Id.*

58. 29 C.F.R. § 1635.8(b)(1)(i)(B).

59. *Id.* § 1635.9. Christopher Kuczynski, EEOC assistant legal counsel and director of the agency's ADA Policy Division, has said that employers may store genetic information in an employee's confidential ADA file if such a file already exists. Statement of Christopher J. Kuczynski, Assistant Legal Counsel (Feb. 25, 2009), *available at* http://www.eeoc.gov/eeoc/meetings/2–25–09/kuczynski.cfm.

60. *See* 29 C.F.R. § 1635.8(d).

61. *See generally* 42 U.S.C. §§ 2000ff–2000ff-11; 29 C.F.R. § 1635.3(a).

the fourth degree.[62] This includes an employee's great-grandparents and the children of an employee's first cousins.[63]

The EEOC has interpreted Congress's incorporation of Title VII's antiretaliation language as an indication that the standard for GINA retaliation claims should be the standard set forth in *Burlington Northern & Santa Fe Railway Co. v. White*.[64] GINA does not preempt any state or local law that provides equal or greater protection.[65] Employers should note that more than thirty states currently have laws addressing genetic bias in employment.

VII. EXECUTIVE ORDER 13496

In January 2009, President Obama signed Executive Order 13496 entitled "Notification of Employee Rights Under Federal Law."[66] Among other things, this executive order requires that federal contractors and subcontractors inform their employees of rights under the National Labor Relations Act (NLRA) to form or join a union and bargain collectively with an employer. The president also ordered that, with some exceptions, every government contract must include provisions requiring federal contractors to post a notice regarding employee rights under the NLRA. Similarly, government contractors must include provisions mandating the posting of the notice of employee rights in all subcontracts.[67]

In May 2010, the DOL's Office of Labor-Management Standards (OLMS) promulgated regulations to implement and enforce the executive order.[68] The OLMS regulations took effect on June 21, 2010.[69] In connection with the new regulations, the OLMS released a new notice that must be posted conspicuously by federal contractors and subcontractors in plants and offices where employees covered by the NLRA perform government contract-related activity, including in all places where notices to employees are customarily posted.[70] The notice informs employees of their right to organize and bargain collectively with their employers and

62. 29 C.F.R. § 1635.3(a)(1), (2).
63. *Id.* § 1635.3(a)(2)(iv).
64. Regulations Under the Genetic Information Nondiscrimination Act of 2008, 75 Fed. Reg. 68,912, 68,918 (Nov. 9, 2010) (citing Burlington N. & Santa Fe Ry. Co. v. White, 548 U.S. 53, 57–58 (2006)).
65. 42 U.S.C. § 2000ff-8.
66. Exec. Order No. 13,496, 74 Fed. Reg. 6107 (Feb. 4, 2009).
67. *Id.* § 1.
68. Dep't of Labor, Office of Labor-Mgmt. Standards, Notification of Employee Rights Under Federal Labor Laws, 75 Fed. Reg. 28,368 (May 20, 2010) (codified in 29 C.F.R. pt. 471).
69. *Id.*
70. 29 C.F.R. § 471.2.

to engage in other protected concerted activity.[71] It also contains examples of illegal conduct by employers and unions and provides employees with information for contacting the National Labor Relations Board with questions or for assistance in the event of a violation of their rights.[72] Additional information about this requirement is contained in an OLMS fact sheet.[73]

71. 29 C.F.R. pt. 471, subpt. A, app. A.
72. *Id.*
73. Dep't of Labor, Office of Labor-Mgmt. Standards, *Fact Sheet: Obligation of Federal Contractors to Notify Employees of Their Rights Under Federal Labor Laws* (May 2010), *available at* http://www.dol.gov/olms/regs/compliance/EO13496.htm.

RECENT DEVELOPMENTS IN EXCESS INSURANCE, SURPLUS LINES INSURANCE, AND REINSURANCE LAW

Richard C. Mason, Leah M. Quadrino, Sarah D. Gordon, Richard M. Bouhan, John P. Dearie Jr., Robert W. Diubaldo, John. D. Hughes, Jonathan Toren, and Geoffrey E. Rosenblat

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The period from 2009 to 2010 witnessed many important developments in excess insurance, surplus lines insurance, and reinsurance law and regulation. Most notably, the Dodd-Frank Wall Street Reform Bill included a series of new regulations aimed at establishing uniformity for significant features of nonadmitted and surplus lines regulation. In excess insurance, courts in New York and Illinois continued to clarify how allocation rules impact whether coverage by excess insurers will be triggered for long-tail claims. In reinsurance law, a series of important decisions included *Travelers Casualty & Surety Co. v. Insurance Co. of North America*, in which the Third Circuit affirmed a district court's ruling that the follow-the-fortunes doctrine obligated a reinsurer to pay its portion of a $137 million settlement, but only as to that portion of the settlement within the limits of the policies the reinsurer agreed to cover.[1]

I. EXCESS INSURANCE

A. *Regulatory Developments*

On April 12, 2010, the Florida Office of Insurance Regulation issued Information Memorandum OIR-10–01M. The memorandum provides guidance to Florida property insurers regarding their coverage of catastrophe risk. Specifically, it asks that property insurers evaluate their catastrophe risks for the 2010 hurricane season and assess whether their amount of reinsurance, including excess of loss, is adequate. It also recommends that property insurers consider employing other risk transfer mechanisms in combination with traditional reinsurance to adequately limit exposure.

Additionally, the Washington legislature enacted Chapter 48.164 of the Washington Insurance Code, which will be effective March 29, 2010, through December 31, 2016.[2] The new chapter allows the Washington State Office of the Commissioner to establish a temporary joint underwriting association for excess flood insurance if either: (1) excess flood insurance of a particular class or type is not available from the voluntary

1. 609 F.3d 143, 158, 165 (3d Cir. 2010).
2. Wash. Rev. Code § 48.164 (2010).

market; or (2) there are so few insurers selling excess flood insurance that a competitive market does not exist.[3] The association is funded primarily through premiums paid by insureds; however, the association may assess member insurers to the extent necessary to meet its financial obligations.

B. *Case Law Developments*

1. Excess Insurer Rights

Several courts issued opinions this year that affect excess and umbrella insurers' right to obtain reimbursement of defense costs. In *Cargill, Inc. v. Ace American Insurance Co.*,[4] the Supreme Court of Minnesota reversed a prior decision and ruled that a defending insurer has an equitable right to recoup defense costs from other insurers with at least a co-equal duty to defend. There, government and private entities had sued the insured in connection with alleged environmental contamination. The insured submitted the costs of defense of the lawsuits to several insurers, including Liberty Mutual.

The supreme court adopted the majority view that "where more than one primary insurer covers the same risk and an insurer discharges a common obligation also belonging to another insurer . . . a right to equitable contribution should exist."[5] The court noted that Liberty Mutual's policy covered only harm occurring "during the policy period," and "although Liberty Mutual may have an obligation to defend Cargill, there is a common liability among all of the primary insurers that have a duty to defend."[6] The court observed that the *Iowa National* rule[7] encouraged insurers to deny a defense "and, essentially, play the odds that, among all the insurers on the risk, it will not be selected by the insured to defend."[8]

The Minnesota Supreme Court did not address contribution claims by excess insurers. However, if a policyholder sought defense costs under one tower of insurance (i.e., the excess policies in a single year), an excess carrier in that tower would be only *secondarily* liable for defense costs versus primary insurers in other triggered years. Therefore, it stands to reason that under *Cargill*, an excess insurer would have grounds to seek contribution from those other primary insurers.

3. *Id.*
4. 784 N.W.2d 341, 343 (Minn. 2010).
5. *Id.* at 353.
6. *Id.* at 351 (emphasis omitted).
7. The *Iowa National* rule was the rule in place prior to this decision and was ultimately overruled by the court. *See* Iowa Nat'l Mut. Ins. Co. v. Univ. Underwriters Ins. Co., 150 N.W.2d 233 (Minn. 1967).
8. 784 N.W.2d at 352.

2. Excess Insurer Duties

A few courts examined coverage defenses asserted by excess insurers, independent of the coverage obligations of the primary insurers. In *Metropolitan Property & Casualty Insurance Co. v. Marshall*,[9] the insured was sued by the family of a woman who was murdered by the insured's son. The son was on a weekend pass from a rehabilitation facility at the time of the murder. While the insured's primary carrier was providing a defense, the insured learned of another insurer that provided excess homeowners coverage. The excess insurer denied coverage based on late notice and the contention that there was no "occurrence" as defined by the policy. The excess insurer denied coverage for the insured's son, meanwhile, because he was not an insured.[10]

The court agreed that the son was not an insured because he was only visiting for the weekend and was not a resident of the insured's home.[11] The court found, however, that from the mother's perspective, the murder was an accident, and therefore, constituted an occurrence.[12] Furthermore, the court found that the insured's notice was timely. Both her attorney and the primary insurer had advised her that she was not liable, and even her excess insurer assessed her exposure as "zero."[13] Accordingly, she had no reason to believe that her primary insurance would be exhausted.

In *Cincinnati Insurance Co. v. Oblates of St. Francis De Sales, Inc.*,[14] the Archdiocese of Oklahoma sought coverage for a lawsuit arising from allegations of child molestation by a priest. The claim was settled for $5,000,000. Although it initially denied coverage, the primary general liability insurer paid its $1,000,000 policy limit toward the settlement. The Archdiocese then sought coverage from the excess insurer. The excess insurer, however, maintained that the allegations did not constitute an "occurrence" under the policy and filed a declaratory judgment action on those grounds. The Ohio Court of Appeals upheld the grant of summary judgment to the excess insurer. Evidence in the lawsuit revealed that before the priest in question was assigned to the Oklahoma church, the Archdiocese knew of repeated past acts of sexual abuse and had been advised that the priest's "disorder" was not curable. Because the Archdiocese failed to warn the Oklahoma church regarding the priest's history, the priest was allowed access to children. The court found that the victim's injuries were thus "expected" and not a covered "occurrence."[15]

9. No. 020058/2008, 2010 WL 2651638, *1 (N.Y. Sup. Ct. July 6, 2010).
10. *Id.* at *2.
11. *Id.*
12. *Id.* at *3.
13. *Id.*
14. No. L-09–1146, 2010 WL 3610451, *1 (Ohio Ct. App. Sept. 17, 2010).
15. *Id.* at *4.

The question of the number of "occurrences" also often affects whether excess insurance is triggered. In *Bausch & Lomb Inc. v. Lexington Insurance Co.*,[16] the insured manufacturer of contact lens solution was sued in various products liability suits for injuries allegedly sustained by thousands of users. The insurer had issued three successive umbrella policies that were excess of large retained limits, or self-insured retentions. Two of these policies required exhaustion of a $2 million retention for each occurrenceuntil an aggregate $4 million. retention was exhausted.[17] The insured argued that the suits all arose out of a single occurrence, i.e., the design or manufacture of the solution. Therefore, the insured said, it only needed to exhaust $2 million total in each policy year to trigger the insurer's defense obligation. On the other hand, the insurer maintained that each claimant's injury constituted a distinct occurrence. Since no individual claimant alleged damages approaching $2 million, the insurer argued that coverage in each year was not triggered until judgments or settlements exceeded the aggregate retention of $4 million.

The court applied New York's "unfortunate events" test and determined that each claim of injury constituted a separate occurrence. The unfortunate events test provides that "[a]n accident is an event of an unfortunate character that takes place without one's foresight or expectation."[18] The court noted that "a product that is intentionally formulated, and intentionally manufactured as formulated, as were the solutions in this case, is not itself the 'accident.'"[19] In the underlying lawsuits, there was no allegation or evidence that the solutions were accidentally tainted in the course of manufacture or that the solutions were not manufactured as intended. Therefore, the court stated that "it is the individual exposure to the product" that constituted the accident or occurrence.[20] "Because the incident that gave rise to liability was the exposure to the product itself, there was no need to look to some point further back in the causal chain such as the manufacture, sale, or distribution of the product."[21] Consequently, exhaustion of the $4 million aggregate retentions for the applicable policy years was required as a condition precedent to coverage.

Courts also ruled on cases involving application of prior notice exclusions. In *Executive Risk Indemnity Inc. v. Pepper Hamilton LLP*,[22] the insured law firm assisted a client in the securitization of student loans. Later, se-

16. 679 F. Supp. 2d 345 (W.D.N.Y. 2009).

17. The third policy contained retentions of $2 million both per occurrence and in the aggregate; therefore, the issue of number of occurrences was irrelevant for that year.

18. *Id*. at 351 (citing Arthur A. Johnson Corp. v. Indemnity Ins. Co., 164 N.E.2d 704, 707 (N.Y. 1959) (internal quotations omitted)).

19. *Id*. at 352.

20. *Id*.

21. *Id*. at 353 (internal quotations omitted).

22. 891 N.Y.S.2d 1, 1 (N.Y. 2009).

curities fraud claims were brought against the client in connection with the student loan securities. The client then went bankrupt. The bankrupt estate brought malpractice claims against the law firm. After the securities fraud claims were brought, but before the law firm was sued, the law firm submitted its application for the insurance policy for the year in question. The law firm's general counsel issued a memorandum to the law firm regarding pending litigation against the firm. In response, the attorney working for the student loan securitizer stated that two lawsuits had been filed in connection with the client, but "to date," the law firm had not been sued. He said, "I am not certain as to whether we will be joined in the future."[23] The law firm, however, did not disclose this information in its insurance application.

The primary policy excluded "any act, error, omission, circumstance or personal injury" occurring before its effective date if "any insured at the effective date knew or could have reasonably foreseen that such act, error, [or] omission . . . might be the basis of a claim."[24] The primary insurer accepted the defense of the malpractice claims against the law firm, but the follow-form excess carriers denied coverage based on this exclusion.

The New York Court of Appeals held that the claims were excluded. The court found that the law firm both "subjectively" and "reasonably" believed that it could be subject to a lawsuit arising from that particular client but did not provide that information to the insurers.[25] The court noted that the terms of the exclusion did not require awareness of wrongful conduct on the part of the insured, only *some* act or omission that could form the basis of a claim against the insured.

In *Murphy v. Allied World Assurance Co*,[26] directors of a bankrupt brokerage firm sought coverage under their directors' and officers' liability policies. The excess insurers denied coverage under their prior notice exclusion. The directors argued that the exclusion did not apply to them because they had no personal knowledge of the possible claim; only others at the company did. As discussed in last year's survey, the U.S. District Court of the Southern District of New York previously held that the exclusion applied.[27] This year, the Second Circuit affirmed. The Second Circuit agreed that the exclusion applied if *any insured* had knowledge of the facts giving rise to a possible claim, not just the particular insureds seeking coverage. Although the primary policy contained a severability provision, it could

23. *Id.* at 4.
24. *Id.* at 3.
25. *Id.* at 5.
26. 370 Fed. App'x 193 (2d Cir. 2010).
27. Murphy v. Allied World Assur. Co., No. 08 Civ. 3821, 2009 WL 1528527, *1 (S.D.N.Y. May 29, 2009).

not be reconciled with the language of the exclusion in the excess policies; therefore, the latter language controlled. The court also agreed that the claims "arose out of" the fraudulent concealment scheme of which certain insureds were aware, as the phrase "arising out of" is interpreted broadly by New York courts.[28]

3. Exhaustion

A number of courts addressed the question of whether there was proper exhaustion of underlying insurance or self-insurance such that an excess or umbrella liability insurance policy was required to respond to a claim. In *Great American Insurance Co. v. Bally Total Fitness Holding Corp.*,[29] the defendant-insureds sought a declaration that they were entitled to coverage under excess directors' and officers' liability insurance policies issued by ACE American Insurance Company and Fireman's Fund Insurance Company. ACE and Fireman's Fund opposed the defendants' motion and sought a declaration that defendants' settlement with certain underlying excess insurers did not satisfy the conditions precedent to coverage under the ACE and Fireman's Fund policies.[30]

The ACE excess policy provided that its liability for a covered loss attached only after the underlying insurers paid their limits for a loss and the insureds paid any self-insured retention.[31] The Fireman's Fund excess policy also required, as a condition precedent to coverage, that all underlying insurance be exhausted by actual loss payment before the limits of that policy could be reached.[32]

The settlement between the insureds and their first and second layer excess insurers was for an amount less than the total amount of coverage limits provided by those policies ($30 million).[33] Although the underlying insurers had not paid their full policy limits, the insureds asserted that the ACE and Fireman's Fund excess policies were implicated because the insureds incurred defense costs that exceeded the limits of those policies.[34]

Applying Illinois law, the U.S. District Court for the Northern District of Illinois ruled that the ACE and Fireman's Fund policies clearly and unambiguously required the underlying excess insurers to pay the full amount of their policy limit before ACE and Fireman's Fund had any obligation to provide coverage.[35]

28. *Murphy*, 370 Fed. App'x at 195.
29. No. 06-C-4554, 2010 WL 2542191, *1 (N.D. Ill. June 22, 2010).
30. *Id*. at *1.
31. *Id*.
32. *Id*.
33. *Id*. at *2.
34. *Id*.
35. *Id*. at *5.

Rosciti v. Liberty Mutual Insurance Co. arose out of negligence and product liability claims that plaintiffs brought against a bankrupt corporation named Monaco Coach.[36] Pursuant to Rhode Island's "direct action" statute, plaintiffs sought to recover directly from an excess insurance policy issued to Monaco by the Insurance Company of the State of Pennsylvania (ICSOP).[37] ICSOP contended that Monaco was required to exhaust its $500,000 retained limit under the excess policy before plaintiffs could access the coverage limits. There was no dispute that the retained limit was not (and would not be) reached as a result of Monaco's insolvency.[38]

The issue before the court was whether the Rhode Island statute nullified the retained limit exhaustion requirement in ICSOP's excess policy.[39] The U.S. District Court for the District of Rhode Island held that it did not, and that the ICSOP policy had no obligation to respond to plaintiffs' claims as a result of Monaco's failure to pay its retained limit.[40] Applying Rhode Island law, the court noted that the ICSOP excess policy clearly and unambiguously required exhaustion of Monaco's retained limit by payments for "judgments, settlements, or defense costs," regardless of whether plaintiffs' claims exceeded that amount.[41] Further, the ICSOP policy provided that "under no circumstances, shall the bankruptcy, insolvency, or inability of [Monaco] to pay require [ICSOP] to drop down or in any way replace [Monaco's] retained limit or assume any obligation associated with [Monaco's] retained limit."[42]

In *Furnace & Tube Service, Inc. v. Westchester Surplus Lines Insurance Co.*, the plaintiff settled a claim brought against it by Mississippi Phosphates Corp. for $4.2 million.[43] Furnace was insured by three policies issued by Gray Insurance Company: (1) a primary policy, with a policy period from October 1, 2006, to October 1, 2009, and a $1 million annual limit of liability; (2) an excess policy, with a policy period of October 1, 2006, to October 1, 2007, and a $4 million per occurrence limit; and (3) an excess policy effective from October 1, 2007, to October 1, 2008, which also had a per occurrence limit of liability of $4 million.[44] Westchester provided umbrella coverage above the Gray policies for the relevant policy periods.[45]

36. No. C.A. 09–338 S, 2010 WL 3432305, *1 (D.R.I. Aug. 30, 2010).
37. *Id.* at *1 (citing R.I. Gen. Laws 1956 § 27–7-2.4 (2010)).
38. *Id.* at *1–2.
39. *Id.* at *1.
40. *Id.* at *3–8.
41. *Id.* at *3–5.
42. *Id.* at *4.
43. 1:09CV374 LG-RHW, 2010 WL 1427590, *1 (S.D. Miss. Apr. 8, 2010).
44. *Id.* at *2.
45. *Id.*

As part of the settlement, plaintiff contributed $100,000 and Gray paid $4.1 million.[46] While Mississippi Phosphates released Gray from any further liability, it sought additional damages from Furnace, which tendered the claim to Westchester.[47] Westchester disclaimed any duty to defend or indemnify under the umbrella policy, arguing that plaintiff's settlement failed to exhaust the underlying coverage provided by Gray. According to Westchester, the Mississippi Phosphates claim constituted an occurrence in two policy periods during which Gray provided coverage, requiring it to pay two limits (or $10 million) before the Westchester umbrella policy could be reached.[48] Furnace then commenced a declaratory judgment action.[49]

Applying Louisiana law, the court found in Westchester's favor and held that the Mississippi Phosphates claim constituted a separate occurrence under each of the Gray policies in effect during the 2006–2007 and 2007–2008 policy periods.[50] Therefore, two Gray policy periods were implicated by the claim, each with its own $5 million limit that had to be exhausted before coverage under the Westchester umbrella policy attached.[51] As such, the court held that Westchester's obligations to Furnace began after $10 million in underlying insurance was exceeded.[52]

4. Allocation

Several courts also addressed allocation disputes between insureds and excess/umbrella insurers. In *Foster Wheeler LLC v. Affiliated FM Insurance Co.*,[53] plaintiff sought a declaration that certain primary and first-layer excess insurers were obligated to provide defense and indemnity coverage with respect to asbestos-related bodily injury claims. Foster Wheeler contended that the allocation period for any covered asbestos claim should end no later than October 1, 1982.[54] The insurers, on the other hand, argued that the allocation period should extend until at least October 1, 1985, because Foster Wheeler's excess policies in effect from October 1, 1982, to October 1, 1985, were triggered by the asbestos claims.[55]

Because New Jersey law governed the parties' dispute, the court applied the New Jersey Supreme Court's holding in *Owens-Illinois, Inc. v. United*

46. *Id.* at *1.
47. *Id.*
48. *Id.* at *2–3.
49. *Id.* at *1.
50. *Id.* at *2–3.
51. *Id.*
52. *Id.* at *3.
53. No. 60777/01, 2010 WL 1945774, *1 (Sup. Ct., N.Y. Mar. 16, 2010).
54. *Id.* at *1–3.
55. *Id.*

Insurance Co.[56] to determine the proper method of allocation.[57] The court noted that, under the *Owens-Illinois* test, where multiple policies provide coverage for an insured's loss, an insurer's obligations are determined by length of time in which the insurer provided coverage and that policy's limit of liability.[58] Moreover, the insured is responsible for its portion of loss attributable to a period in which it was self-insured or chose not to purchase coverage that was available in the marketplace.[59]

Foster Wheeler admitted that it chose not to pursue coverage for the asbestos claims from certain umbrella and higher-layer excess policies that provided coverage for the October 1, 1982, through October 1, 1985, policy period, because it believed that those insurers would deny coverage on the ground that a material concealment had occurred during the application process (and have a reasonable chance of prevailing on this defense).[60] Specifically, Foster Wheeler had represented to the umbrella policies' brokers that certain primary policies issued for that period covered asbestos claims when, in fact, those policies contained an asbestos exclusion.[61] The defendant-insurers argued that costs associated with the asbestos claims against Foster Wheeler should nonetheless be allocated to the October 1, 1982, through October 1, 1985, period and that whether Foster Wheeler could collect from other insurance policies was immaterial to the insurers' proposed allocation.[62]

The court agreed with the defendant-excess insurers, noting that, under New Jersey law,[63] Foster Wheeler was required to pay its share of both defense costs and indemnity for policy years implicated by a loss in which it was self-insured or uninsured, as well as for years in which coverage was (or might be) precluded.[64] The court held that the umbrella policies in effect from October 1, 1982, through October 1, 1985, were triggered, and thus, had to be included for purposes of allocating liability for the asbestos claims at issue regardless of whether Foster Wheeler could potentially collect on those policies.[65]

In *Crucible Materials Corp. v. Certain Underwriters at Lloyd's London & London Market Cos.*,[66] plaintiff sought coverage under a second-layer excess

56. 138 N.J. 437, 450 (1994).
57. *Foster-Wheeler*, 2010 WL 1945774, at *4 (citations omitted).
58. *Id.*
59. *Id.*
60. *Id.* at *3.
61. *Id.*
62. *Id.* at *4.
63. *Id.* (citing Benjamin Moore & Co. v. Aetna Cas. & Sur. Co.,179 N.J. 87, 99 (2004)).
64. *Id.* at *5.
65. *Id.*
66. 681 F. Supp. 2d 216, 220 (N.D.N.Y. 2010).

liability insurance policy issued by defendants. Lloyd's argued that Crucible's loss did not exceed the limits of the underlying primary and first-layer excess policies, and thus there was no coverage.[67]

The parties disagreed as to whether New York or Pennsylvania law governed their dispute.[68] Lloyd's asserted that New York law applied, and under the allocation principles set forth in *Consolidated Edison Co. of N.Y., Inc. v. Allstate Insurance Co.*,[69] Crucible's loss should be prorated evenly across all implicated policy periods with each insurer bearing responsibility based upon their "time on the risk."[70] Crucible argued that Pennsylvania law, which rejected the time on the risk allocation formula, should be applied.[71]

The court held that New York law applied, and under the allocation methodology set forth in *Consolidated Edison*, the plaintiff's loss did not trigger the coverage provided by Lloyd's excess policy.[72] Specifically, the court noted that even the most "conservative" interpretation of Crucible's liabilities resulted in thirteen policy periods being triggered, and that after dividing Crucible's highest projection of damages across this period, the attachment point of the Lloyd's policy would not be reached.[73]

Likewise, in *Boston Gas Co. v. Century Indemnity Co.*,[74] the First Circuit certified the following allocation questions to the Supreme Judicial Court of Massachusetts:

1. Where an insured covered by standard CGL policy language incurs loss as a result of ongoing environmental contamination occurring over more than one policy period, and the insurer provided coverage for less than the full period of years in which contamination occurred, should the insured's loss be prorated in some manner among all insurers on the risk?

2. If some form of pro rata method is called for under such circumstances, what allocation formula should be employed?[75]

The insured, Boston Gas Company, was covered by certain CGL policies for the policy periods of December 1, 1951, through December 1, 1969, as well as three different first-layer excess policies issued by Century Indemnity Company.[76] The policies provided coverage for property

67. *Id.* at 231–32.
68. *Id.* at 224–26.
69. 98 N.Y.2d 208 (2002).
70. *Crucible*, 681 F. Supp. 2d at 226.
71. *Id.*
72. *Id.* at 230–32.
73. *Id.* at 231–32.
74. 910 N.E.2d 290, 292 (Mass. 2009).
75. *Id.* at 292–93 (paraphrasing).
76. *Id.* at 294–95.

damage caused by an occurrence, subject to the exhaustion of certain self-insured retentions.[77] Occurrence was further defined as an "accident" that happened during the policy period or resulted in property damage during the policy period.[78] Moreover, the policies provided that "all damages arising out of such exposure to substantially the same general conditions shall be considered as arising out of one occurrence."[79]

Boston Gas sought indemnification from Century for costs associated with the investigation and cleanup of contaminated soils and groundwater at facilities operated by Boston Gas.[80] After it filed a declaratory judgment action, Century counterclaimed and brought third-party claims against other Boston Gas insurers that provided coverage during the relevant periods.[81] The jury found that Century was obligated to indemnify Boston Gas for certain amounts incurred in the investigation and cleanup of the environmental contamination.[82]

The parties disagreed as to how the amounts owed to Boston Gas should be allocated among the various insurers whose policies had been triggered.[83] Boston Gas argued that a "joint and several" allocation methodology should be applied under Massachusetts law, such that Boston Gas could recover the entire damages award from Century; Century would then be entitled to seek contribution from other insurers that provided coverage during the relevant periods.[84] By contrast, Century argued that a pro rata allocation based on each insurer's time on the risk should be applied.[85]

The court agreed with Century, holding that a pro rata allocation based upon each insurer's "time on the risk" was required by the language of the policies at issue, since those policies only provided coverage for property damage that occurred "during the policy period," not before or after a relevant period.[86] The court noted that the phrase "during the policy" period was a limiting one, both with respect to trigger of coverage and Century's indemnity obligations.[87] Because Boston Gas did not present any evidence illustrating that property damage occurred any more or less in a specific policy year, the court found that the time-on-the-risk method of apportionment was appropriate.[88] However, the court stated that a differ-

77. *Id.* at 295–96.
78. *Id.*
79. *Id.* at 295.
80. *Id.* at 296.
81. *Id.*
82. *Id.* at 297.
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.* at 306–07.
87. *Id.* at 307.
88. *Id.* at 314.

ent method of pro rata allocation may be applied in cases where a party can establish a more accurate loss allocation.[89]

Moreover, the court found that Boston Gas was required to satisfy "only a prorated amount of its per occurrence self-insured retention for each triggered policy period, to be prorated on the same basis as Century's liability."[90] The court characterized this portion of its holding as an "equitable result," since the policy language at issue did not clearly or unambiguously provide how the self-insured retentions should be calculated where multiple policy periods were implicated by a claim.[91] Notably, in certain jurisdictions, such as New York and New Jersey, courts examining similar policy language have held that an insured cannot prorate its deductible or self-insured retention obligations.[92]

II. SURPLUS LINES INSURANCE

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act.[93] This new law will bring numerous changes to the regulation of financial services in the United States. Within this 2,319 page bill, eight pages—entitled the Nonadmitted and Reinsurance Reform Act (NRRA)—affect excess and surplus lines insurance and reinsurance. The provisions of the NRRA are designed to bring about efficiencies in the manner in which excess and surplus lines insurance transactions are taxed and regulated. They also define which state has regulatory authority to oversee the solvency of a reinsurer and to recognize the credit for reinsurance of a ceding company.

The common concept embedded in the surplus lines/nonadmitted insurance and reinsurance provisions of the bill is that of *one state* regulation. Under the NRRA, the home state of the insured is the only state that can regulate and tax surplus lines/nonadmitted insurance transactions.[94] Additionally, only *one state*, the reinsurer's state of domicile, can regulate a reinsurer for solvency.[95] And if an insurer's state of domicile has recognized credit for reinsurance, no other state can deny the insurer the credit for

89. *Id*. at 315–16.
90. *Id*.
91. *Id*. at 316.
92. *See*, *e.g.*, Olin Corp. v. Ins. Co. of N. Am., 221 F.3d 307, 328 (2d Cir. 2000) (applying New York law); Long Island Lighting Co. v. Allianz Underwriters Ins. Co., No. 604715/97, at *8 (Sup. Ct., N.Y. Cty Dec. 30, 2003), *modified on other grounds*, 1006A 6 Misc. 3d (Jan. 11, 2005) (same); Benjamin Moore & Co. v. Aetna Cas. & Surety Co., 179 N.J. 87 (2004).
93. H.R. 4173, 111th Cong. (2010), Pub. L. No. 111–203, 124 Stat. 1376 (2010) (codified at 12 U.S.C.A. § 5301, *et. seq*.).
94. 15 U.S.C.A. § 8201(a); 8202(a) (Home State Authority).
95. 15 U.S.C.A. § 8222(a) (Domiciliary State Regulation).

the reinsurance.[96] This one state approach seeks to eliminate the current overlapping, multiplicative, inconsistent, and sometimes conflicting rules among the states in regard to surplus lines/nonadmitted placements and regulation of reinsurers and reinsurance transactions.

Through the NRRA, the U.S. Congress created a new regulatory framework for the excess and surplus lines insurance and the reinsurance businesses. In regard to excess and surplus lines insurance transactions, the NRRA:

(1) Gives sole regulatory and enforcement authority to the home state of the insured for the placement[97] and taxation[98] of surplus lines/nonadmitted insurance. The bill defines the home state of the insured as the state of the insured's principal place of business, or, if it is an individual, the state where the individual's principal residence is located;[99]

(2) Provides a structure for creating a uniform system to collect, allocate, and distribute a surplus lines/nonadmitted premium tax among the states;[100]

(3) Establishes uniform eligibility requirements for U.S.-based (domestic) surplus lines insurers by applying two provisions of the National Association of Insurance Commissioners' (NAIC) Model Nonadmitted Insurance Act;[101]

(4) Prohibits states from preventing surplus lines licensees from placing or procuring insurance from an alien insurer that is listed on the NAIC International Insurance Department's *Quarterly Listing of Alien Insurers*;[102]

(5) Allows a large, sophisticated commercial buyer of insurance or an "exempt commercial purchaser"[103] to have its insurance placed directly in the surplus lines market without a "diligent search" of the licensed market being performed;[104]

(6) Expresses a congressional intent that the states establish uniformity in the payment, collection and remittance of surplus lines premium tax through the establishment of an interstate compact or other similar procedure; and[105]

96. 15 U.S.C.A. § 8221(a) (Credit for Reinsurance).
97. 15 U.S.C.A. § 8202(a) (Home State Authority).
98. 15 U.S.C.A. § 8201(a) (Home State's Exclusive Authority).
99. 15 U.S.C.A. § 8206(6((A)(i) (Home State).
100. 15 U.S.C.A. § 8201(b) (Allocation of Nonadmitted Premium Taxes).
101. 15 U.S.C.A. § 8204 (Uniform Standards for Surplus Lines Eligibility).
102. *Id.*
103. 15 U.S.C.A. § 8206(5) (Exempt Commercial Purchaser).
104. 15 U.S.C.A. § 8205 (Streamlined Application for Commercial Purchasers).
105. 15 U.S.C.A. § 8201(b) (Allocation of Nonadmitted Premium Taxes).

(7) Encourages each state to participate in the NAIC national producer database or another national database in the licensing of excess and surplus lines brokers. The NRRA fosters this participation by prohibiting the states from collecting any licensing fee in the licensing of an excess or surplus lines broker or in renewing an excess or surplus lines broker's license after July 21, 2012, unless the state participates in a national producer database.[106]

The surplus lines reforms are a direct result of an industry effort to simplify and rationalize the surplus lines premium tax allocation and payment procedures. For years, the surplus lines industry was plagued with conflicting, inconsistent, and confusing tax allocation formulas and payment procedures in and among the various states. Except for the last requirement, which becomes effective on July 21, 2012,[107] the provisions of the Act take effect on July 21, 2011, one year from the day the bill was signed by the president.[108]

The NRRA gave the states one year from the date of enactment to change their surplus lines laws to bring them into conformance with its provisions. To do this by July 21, 2011, states must amend their surplus lines laws to:

(1) Require a tax payment on the surplus lines premium[109] that may either be on the "gross" premium or on the portion of the premium representing the surplus lines exposure in the state;
(2) Apply the required surplus lines premium tax only when the state is the home state of the insured as defined in the Act;[110]
(3) Allow the state, if it is the home state of the insured, to license surplus lines brokers to sell, solicit, or negotiate surplus lines insurance with respect to such insureds;[111]
(4) Establish eligibility requirements for U.S.-based surplus lines insurers that are consistent with two provisions, §§ 5A(2) and 5C(2)(a), of the NAIC Nonadmitted Model Act.[112] These provisions require that: (1) each insurer is authorized to write the type of insurance (it wishes to write on a surplus lines basis) in its domiciliary jurisdiction; and (2) meet capitalization requirements consisting of the greater of: (a) $15 million in capital and surplus; (b) the state's own capitalization requirements for surplus lines insurers; or (c) other stated

106. 15 U.S.C.A. § 8203 (Participation in National Producer Database).
107. *Id.*
108. 15 U.S.C.A. § 8201. note: Effective date upon expiration of the 12-month period beginning on 7/21/10 (Effective Date).
109. 15 U.S.C.A. § 8201(a) (Home State's Exclusive Authority).
110. *Id.*
111. 15 U.S.C.A. § 8202(b) (Broker Licensing).
112. 15 U.S.C.A. § 8204(1) (Uniform Standards for Surplus Lines Eligibility).

levels of capitalization.[113] Two states, California and New York, have recently moved to increase in their capitalization requirement for surplus lines insurer eligibility to $45 million;

(5) Prohibit the state from preventing a licensed surplus lines broker from placing insurance with an alien insurer listed on the NAIC International Insurance Division's *Quarterly Listing of Alien Insurers*.

(6) Incorporate the definitions of an "Exempt Commercial Purchaser"[114] and "Qualified Risk Manager"[115] as set forth in the NRRA in the state surplus lines code to enable surplus lines brokers to place insurance for "Exempt Commercial Purchasers" in the surplus lines market without having to fulfill a "diligent search" requirement;[116]

(7) Either participate in an interstate compact or establish procedures of a similar nature to allocate and distribute the surplus lines tax to other states when appropriate.[117] Congress expressed its intent in the NRRA for "each state to establish nationwide uniform requirements, forms and procedures, such as an interstate compact, that provide for the reporting, payment, allocation and collection" of surplus lines premium taxes; and[118]

(8) Have the state participate in the NAIC producer database or some other national insurer producer database for the licensure and renewal of surplus lines broker licenses or forego collection of any licensing fees for the licensing of surplus lines brokers.[119] The effective date of this provision is two years from the enactment of the bill.[120] Thus, each state must participate in a national producer database by July 21, 2012, or will be preempted from charging surplus lines licensing and licensing renewal fees.

Although the NRRA requirements are mandatory for the states, one provision of the NRRA reflects Congress's "intention" that each state adopt "nationwide uniform requirements, forms and procedures such as an interstate compact that provides for reporting, payment, collection and allocation of premium taxes for nonadmitted/surplus lines insurance."[121] Since the passage of the NRRA, the fulfillment of congressional intention has been the focus of most of the post-NRRA enactment activity. In fact, even before the NRRA was passed, efforts to create an interstate compact

113. Model Act § 5C(2)(a) (Uniform Standards for Surplus Lines Eligibility).
114. 15 U.S.C.A. § 8206(5) (Exempt Commercial Purchaser).
115. 15 U.S.C.A. § 8206(13) (Qualified Risk Manager).
116. 15 U.S.C.A. § 8205 (Streamlined Application for Commercial Purchasers).
117. 15 U.S.C.A. § 8201(b) (Allocation of Nonadmitted Premium Taxes).
118. 15 U.S.C.A. § 8201(b)(4) (Nationwide System).
119. 15 U.S.C.A. § 8203 (Participation in National Producer Database).
120. *Id.*
121. *Id.*

for surplus lines tax allocation and distribution had received a great deal of attention.[122]

Whether the states can amend their laws to become compliant with the NRRA and implement a compact or agreement to share revenue on multistate surplus lines transactions by July 21, 2011, is questionable, as it is seemingly a herculean task. The first half of 2011 will be very interesting as the states wrestle with becoming NRRA compliant. In any event, things will change in the taxation and regulation of surplus lines and reinsurance as a result of NRRA's passage.

III. Recent Developments in Reinsurance Law

A. *Regulatory Developments*

The Dodd-Frank Wall Street Reform and Consumer Protection Act[123] launched a variety of initiatives in response to the nation's financial crisis, but it did not reshape the insurance industry as dramatically as some may have initially predicted. Rather, it created a foundation from which increased regulation could later emerge, should the political and economic climate support such change. The provisions of interest to the reinsurance industry are discussed briefly below.

Title V of the Dodd-Frank Act created a Federal Insurance Office (FIO) within the Department of the Treasury. The Act expressly reserves the regulation of the insurance industry to the states,[124] but it vests the FIO with multiple monitoring and consultation functions.[125] Those functions are aimed at monitoring risks that could pose a "systemic crisis in the insurance industry or the United States financial system,"[126] monitoring the pricing and accessibility of insurance products,[127] and consulting with state regulators,[128] among other activities. In performing these functions, the FIO is permitted to require insurers and reinsurers[129] to submit "data or information as the Office may reasonably require."[130] To that end, the FIO is vested with subpoena power to enforce its data collection efforts.[131]

122. Arthur D. Postal, *Surplus Lines Compact Drafted*, PropertyCasualty360.com, Oct. 1, 2007, *available at* http://www.property-casualty.com/News/2007/10/Pages/Surplus-Lines-Compact-Drafted.aspx.

123. Pub. L. No. 111–203, 124 Stat. 1376 (2010) (codified at 12 U.S.C.A. § 530 *et. seq*.).

124. 31 U.S.C.A. § 313(k) (Retention of Existing State Regulatory Authority).

125. 31 U.S.C.A. § 313(c) (Functions).

126. 31 U.S.C.A. § 313(c)(1)(A).

127. *Id*.

128. 31 U.S.C.A. § 313(c)(1)(G).

129. 31 U.S.C.A. § 313(c)(1)(E)(2) (defining "insurers" to include "reinsurers" for purposes of this provision).

130. 31 U.S.C.A. § 313(e)(2).

131. 31 U.S.C.A. § 313(e)(6) (Subpoenas and Enforcement). Part of the FIO's directive involves generating certain reports on the insurance industry to be provided to Congress.

The provisions defining the role of the FIO also touch on the longstanding issue of the differential treatment often accorded foreign insurers and reinsurers doing business in the United States. For example, certain limited preemption provisions are triggered where a state insurance measure results in "less favorable treatment of a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a U.S. insurer domiciled, licensed, or otherwise admitted in that State" and where such measure is "inconsistent with a covered agreement."[132] Additionally, although a "savings clause" seeks to guard against federal preemption of many state insurance measures, those measures governing the capital or solvency of an insurer that result in less favorable treatment of a non-U.S. insurer than a U.S. insurer are specifically *not* protected from preemption.[133]

Section 511 of the Dodd-Frank Act contains the much-anticipated Nonadmitted and Reinsurance Reform Act of 2010. The reinsurance provisions are not extensive, but they do address issues regarding credit for reinsurance and reinsurer solvency concerns. Specifically, if a ceding insurer is domiciled in an NAIC-accredited state or a state that has "financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance for the insurer's ceded risk, then no other State may deny such credit for reinsurance."[134] Additionally, certain key preemption provisions apply as follows:

> (b) ADDITIONAL PREEMPTION OF EXTRATERRITORIAL APPLICATION OF STATE LAW.—In addition to the application of subsection (a) all laws, regulations, provisions, or other actions of a State that is not the domiciliary State of the ceding insurer, except those with respect to taxes and assessments on insurance companies or insurance income, are preempted to the extent that they—
>
> (1) restrict or eliminate the rights of the ceding insurer or the assuming insurer to resolve disputes pursuant to contractual arbitration to the extent such contractual provision is not inconsistent with the provisions of title 9, U.S. Code;

Of particular interest will be the forthcoming report, due no later than September 30, 2012, on the "breadth and scope of the global reinsurance market and the critical role such market plays in supporting insurance in the United States." *Id.* § 313(k). Additionally, the Act requires a report no later than January 1, 2013, regarding "the impact of part II of the Nonadmitted and Reinsurance Reform Act of 2010 on the ability of state regulators to access reinsurance information for regulated companies in their jurisdictions." *Id.*

132. 31 U.S.C. § 313(f) (Preemption of State Insurance Measures). Generally speaking, a "covered agreement" is defined as a treaty between the United States and a foreign government regarding the business of insurance or reinsurance "that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation." 124 Stat. 1587.

133. 31 U.S.C. § 313(j).

134. 15 U.S.C.S. § 8221(a) (Credit for Reinsurance).

(2) require that a certain State's law shall govern the reinsurance contract, disputes arising from the reinsurance contract, or requirements of the reinsurance contract;

(3) attempt to enforce a reinsurance contract on terms different than those set forth in the reinsurance contract, to the extent that the terms are not inconsistent with this part; or

(4) otherwise apply the laws of the State to reinsurance agreements of ceding insurers not domiciled in that State.[135]

Although the cedent's domicile governs credit for reinsurance, a reinsurer's domicile is "solely responsible for regulating the financial solvency of the reinsurer."[136] As with the credit for reinsurance framework, the Act preempts the application of laws of other nondomiciliary states laws with respect to the disclosure of financial information, mandating only that the reinsurer be in compliance with the requirements of its own domicile.[137]

B. *Case Law Developments*

In addition to witnessing the landmark federal legislation discussed above, last year saw the continued development of reinsurance case law addressing a variety of issues, including the follow-the-fortunes/follow-the-settlements doctrine, the ability of a policyholder to bring a direct action against a reinsurer, the duties and potential liability of reinsurance intermediaries, the ability of a policyholder to seek access to its insurer's reinsurance information, and general contract analysis of reinsurance-specific terms.[138] It also witnessed numerous arbitration decisions of particular importance to the reinsurance industry. The following summary highlights key decisions in many of these areas.

1. Follow-the-Fortunes/Follow-the-Settlements Doctrine

The limits of the follow-the-fortunes/follow-the-settlements doctrine continued to be tested over the last year, as reflected in case law across multiple jurisdictions. Although courts generally did not allow a reinsurer

135. *Id.*

136. 15 U.S.C.S. § 8222(a) (Domiciliary State Regulation).

137. 15 U.S.C.S. § 8222(b) (Limitation on Financial Information Requirements).

138. *See, e.g.*, Pac. Emp'rs Ins. Co. v. Global Reins. Corp., No. 09–6055, 2010 WL 1659760, *1 (E.D. Pa. Apr. 23, 2010) (analyzing language in a facultative certificate purportedly capping reinsurer's exposure); Ohio Ins. Co. v. Emp'rs Reins. Corp., 694 F. Supp. 2d 794, 800–01 (S.D. Ohio 2010) (interpreting agreements to determine whether a cedent's payments of prejudgment and post-judgment interest and legal expenses were covered by a reinsurance agreement); Gulf Ins. Co. v. Transatl. Reins. Co., 886 N.Y.S.2d 133, 137–38 (N.Y. App. Div. 2009) (interpreting the phrases, "net retained insurance liability" and "policies attaching during the term," and analyzing a variety of extrinsic evidence offered by the parties regarding same).

to second guess good faith, reasonable settlement decisions of a cedent, they did not universally hold in favor of cedents. Rather, courts limited the application of follow-the-settlements clauses to those settlements that were clearly covered by reinsurance agreements. Where settlements were inconsistent with the terms of the cedent's underlying policy, courts generally did not enforce follow-the-settlements provisions. Several significant decisions are discussed below.

In *Travelers Casualty & Surety Co. v. Insurance Co. of North America*, the Third Circuit affirmed a district court's ruling that the follow-the-fortunes doctrine obligated a reinsurer to pay its portion of a $137 million settlement, but only as to that portion of the settlement within the limits of the policies the reinsurer agreed to cover.[139] At issue were allegations that Travelers had allocated settlement amounts in order to maximize its reinsurance coverage.[140] Specifically, Insurance Company of North America (INA), the reinsurer, argued that Travelers: (1) manipulated its allocation of a settlement to reach the layer of insurance that INA reinsured; and (2) improperly treated a three-year policy as subject to three separate per occurrence limits, as opposed to a single per occurrence limit.[141] The Third Circuit explained that it would apply the majority rule that the follow-the-fortunes doctrine applies to post-settlement allocations.[142] It further explained that, for a reinsurer to prevail in contesting those allocations, it "must either provide direct evidence that the insurer was motivated primarily by reinsurance considerations, or show that the after-the-fact rationales offered by the insurer are not credible."[143]

On the first issue, whether Travelers had improperly manipulated its allocation to reach the excess layer, INA argued that Travelers' allocation decisions were motivated solely by reinsurance considerations and therefore were made in bad faith. Specifically, INA argued that Travelers: (1) improperly bypassed certain policies in allocating the settlement; (2) failed to conduct a detailed analysis of a certain category of claims; (3) improperly allocated to indemnity only, not defense; and (4) utilized a legal memorandum that addressed the reinsurance implications of certain coverage deci-

139. 609 F.3d 143, 148 (3d Cir. 2010). The court also addressed the district court's conclusion that prejudgment interest on the award should be calculated according to the Pennsylvania rate. *Id*. The Third Circuit disagreed, stating "[h]owever, because we believe that Travelers' award of prejudgment interest should be calculated according to the higher New York rate, we remand on that issue only so that the prejudgment interest can be recalculated." *Id*.

140. *Id*.

141. *Id*. at 155–56.

142. *Id*. at 158.

143. *Id*. at 159.

sions.[144] The Third Circuit disagreed and held that INA failed to "meet its burden at trial of showing that the allocation decisions it was challenging were driven primarily by reinsurance considerations."[145] The court concluded that Travelers' decisions were reasonable in light of the net nature of the settlement and the other evidence presented at trial.[146]

As to the second issue, whether Travelers improperly applied per occurrence limits on each year of multiyear policies, the Third Circuit agreed with INA. INA argued that the follow-the-fortunes doctrine was inapplicable because Travelers' allocation decision with regard to multiyear policies improperly "enlarged the limits of those policies beyond what INA agreed to reinsure."[147] The district court concluded that "'under Michigan law the three-year XN policies clearly and unambiguously have a single per-occurrence limit for the entire policy period.'"[148] On appeal, Travelers did not challenge the district court's interpretation of the policies.[149] Rather, Travelers argued that, regardless of the current state of Michigan law, INA could be bound because the Michigan courts had not unequivocally addressed the issue of per occurrence limits when the allocation was made. Therefore, Travelers' approach was arguably authorized by the underlying policies.[150] The Third Circuit rejected this argument, finding it unsupported by Third Circuit precedent.[151] Further, the court found no evidence in the record indicating that it was reasonable for Travelers to expect that, had the coverage dispute been litigated, the insured would have successfully pressed the annualization issue.[152]

In another analysis of the follow-the-settlements doctrine, a New York trial court granted summary judgment to a cedent because it found no evidence that the cedent acted in bad faith, and any further inquiry would de-

144. *Id*. INA also argued that the district court's order should be vacated because the court based its ruling on evidence that should have been excluded. *Id*. at 164 ("INA's argument is that, because Travelers invoked the attorney-client and work-product privileges to shield the substance of [lawyer] consultations, it should not have been allowed to defend its conduct with reference to those consultations."). The Third Circuit rejected this argument because the district court's ruling did not depend on the inferences. *Id*. Therefore, it was unnecessary for the Third Circuit to reach the merits on this issue. *Id*.

145. *Id*. at 165.

146. *Id*. at 161–64.

147. *Id*. at 165.

148. *Id*. at 166–67 (quoting J.A. at 95 (unpublished district court opinion)).

149. *Id*. at 167.

150. *Id*.

151. *Id*. at 168–69.

152. *Id*. ("In sum, Travelers has pointed to nothing in the policy language, its prior assessments of its potential liability, or its interactions with Acme to indicate that, when it performed its allocation, it was reasonable to expect that, had the coverage dispute been litigated, Acme could have successfully pressed the annualization issue against it, or even that it would have had any reason to do so.").

feat the purpose of the follow-the-settlements doctrine.[153] The treaties at issue covered a large group of asbestos risks that U.S. Fidelity & Guaranty Company (USF&G) insured and settled in a coverage action.[154] American Re-Insurance Company, among other reinsurers, declined to indemnify USF&G for the settlements in the amounts required by its treaty language.

Specifically, American Re sought a declaratory judgment that its reinsurance liability was limited to: "(i) amounts over $100,000 and up to $200,000 of USF&G's money paid to each claimant; (ii) who USF&G [could] prove was exposed to asbestos before July 1960; and (iii) who USF&G [could] prove was exposed to the asbestos products or operations of its insured."[155] Further, American Re sought to avoid payments of attorneys fees as well as the administrative expenses associated with the trust that ensured proper payments to the claimants.[156] The court rejected American Re's claims because it found no evidence that USF&G settled in bad faith, and therefore, the follow-the-settlements doctrine prohibited American Re from relitigating coverage issues.[157]

Additionally, other reinsurers challenged USF&G's settlements on several grounds.[158] They contended that USF&G improperly allocated reinsurance amounts to them based on a continuous occurrence trigger when USF&G had received the benefit of an accident trigger from its insured.[159] The court disagreed, concluding that USF&G's allocation was entirely proper, and nothing in the follow-the-settlements rule dictated a different result.[160] The other reinsurers also asserted that the asbestos claims should be treated as one loss under the treaty, but the court rejected that claim as inconsistent with the underlying settlement and governing law.[161]

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153. U.S. Fid. & Guar. Co. v. Am. Re-Ins. Co., No. 604517/02, 2010 WL 3536828 (N.Y. Sup. Ct. Aug. 20, 2010).

154. *Id.* at 1–3.

155. *Id.* at 9.

156. *Id.* at 10.

157. *Id.* at 11–13. The court also rejected similar claims from other reinsurers, stating:

> Here, again, while the . . . defendants may challenge USF&G's good faith in settling the underlying action, and whether the settlement payments made by USF&G were ex gratia, or outside the scope of the underlying policy, the follow-the-fortunes doctrine prevents them from challenging the actual disbursement of funds to various claimants.

Id. at 23–24.

158. In addition to the issues noted above, the other reinsurers argued that their coverage should be limited because the parties had agreed to amend the reinsurance amendments to include a greater retention for USF&G. *Id.* at 16–21. The court rejected this contention. *Id.* Finally, the reinsurers attempted to avoid liability on a portion of the settlement amount they alleged was attributable to a bad faith claim. *Id.* at 21–22. The court also rejected this contention, stating "[n]or have the . . . defendants presented any further evidence that a portion of the settlement amount was attributable to . . . [a] bad faith claim." *Id.* at 22.

159. *Id.* at 13.

160. *Id.* at 13–16.

161. *Id.* at 25. The court explained:

In a different matter, another New York trial court declined to apply a follow-the-settlements provision upon finding that the cedent had settled claims outside the bounds of the policy.[162] There, the cedent entered into a settlement agreement with its insured regarding certain third-party claims arising from environmental contamination.[163] The reinsurer declined to cover the claims because the settlement included monies paid for items that were well outside the policy terms.[164] The court found that, in evaluating the claims at issue, the cedent improperly focused on the terms of a prior settlement agreement with its insured, as opposed to the terms of the policies.[165] Accordingly, the court held that the reinsurer was not bound to follow-the-settlements.[166]

Similarly, a federal district court in Connecticut declined to allow a cedent to use a follow-the-fortunes clause to recover from the reinsurer because the losses occurred beyond the time frame of the reinsurance agreement.[167] In that case, however, the court focused on whether the claim was within the coverage of the reinsurance agreement, as opposed to the underlying agreement.[168] The cedent argued that the settlement should be covered pursuant to the following follow-the-fortunes provision: "all reinsurance under this agreement shall be subject to . . . the same modifications, alterations and interpretations the respective policies of the REINSURED . . . and the liability of the [reinsurer] shall follow that of the REINSURED in every case."[169] The cedent argued that this provision

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> This manner of allocating the loss is, as already noted, contrary to the manner in which the Underlying Coverage Action was settled because each asbestos claimant therein was considered a separate accident or occurrence. Further, under both New York and California law, each asbestos-related injury is considered a separate 'occurrence' or 'accident' since each claimant is separately exposed to asbestos at different points in time.

Id. (citations omitted).

162. Am. Home Assurance Co. v. Am. Re-Ins. Co., No. 602485/06, slip op. at 7 (N.Y. Sup. Ct. May 24, 2010) ("[T]he reinsurers have demonstrated that the 2004 Billings call for payments beyond the scope of coverage provided by the Policies, and thus, they are not bound to AIG's settlement of the Anniston Site claims under the follow the settlements doctrine.").

163. *Id.* at 1–5.

164. The settlement amounts covered punitive damages, environmental damage that would have been excluded by the pollution exclusion, losses outside the policy periods, and losses paid before the insured exhausted its self-insured retention. *Id.* at 9–14.

165. *Id.* at 11–12.

166. *Id.* at 14 ("[T]he Reinsurers have demonstrated that the 2004 Billings, that stem from the settlement of the Anniston Site claims, are not payments made within the scope of the Policies, and that AIG failed to conduct a reasonable investigation as to coverage, to which AIG fails to raise a triable issue in opposition. Therefore, the Court determines that the Reinsurers are not bound to follow AIG's settlement of the Anniston Site claims.").

167. Arrowood Surplus Lines Ins. Co. v. Westport Ins. Corp., No. 3:08CV01393 (AWT), 2010 WL 56108, at *4 (D. Conn. Jan. 5, 2010).

168. *Id.* at *3. The losses occurred between December 15, 2000, and December 15, 2002, but the reinsurance agreement only covered policies in effect between February 1999 and August 2000. *Id.* at *1–3.

169. *Id.* at *3. (alterations omitted).

should apply because "its settlement with the insured was based on the risk that the court hearing [the insured's] claims against it would 'modify' the policies [the cedent] issued to be three-year policies."[170] The court rejected this argument because, even if the policy was modified to a three-year term, it would not have come under the terms of the reinsurance agreement, as the agreement was terminated in August 2000 and multiyear policies " 'became effective' " at each anniversary date of the policy.[171] The second anniversary date of the policy would have postdated the terms of the reinsurance agreement, and therefore, could not have been covered.[172]

2. Direct Actions and Third-Party Rights

Courts also addressed another common reinsurance topic this year: direct actions and third-party rights. In what appears to be a growing trend, many of these claims arose where one of the parties was in liquidation or receivership. Even in cases of insolvency, however, most courts declined to permit direct actions against reinsurers. Outside the context of insolvency, one federal district court permitted a direct action where the company's status as a reinsurer was ambiguous. Cases of particular interest are addressed below.

The Third Circuit addressed an interesting direct action issue in *G-I Holdings, Inc. v. Reliance Insurance Co*.[173] There, G-I Holdings, Inc. obtained from Reliance Insurance Co. a liability policy covering claims made against G-I directors and officers between July 1, 1999, and July 1, 2002.[174] Reliance, however, experienced financial difficulties and terminated the directors and officers policy as of July 15, 2000, with Hartford covering the remainder of Reliance's original policy period.[175] Additionally, Hartford and Reliance entered into a series of reinsurance agreements, among other agreements, pertaining to the risks covered during the remaining Reliance policy period.[176]

Director and officer claims later arose, which related back to January 3, 2000, a date within Reliance's shortened policy period.[177] Nonetheless, G-I sought coverage from Hartford for the suits, asserting, among other reasons, that the reinsurance relationship between Hartford and Reliance was sufficiently close to allow G-I to bring a direct action against Hartford.[178]

170. *Id*.
171. *Id*. at *4.
172. *Id*.
173. 586 F.3d 247, 251 (3d Cir. 2009).
174. *Id*.
175. *Id*. at 251–52.
176. *Id*. at 250–52.
177. *Id*.
178. *Id*. at 253, 258–60.

The Third Circuit rejected G-I's arguments.[179] The court reasoned that Hartford's reinsurance relationship with Reliance did not entitle G-I to bring a direct action against it because Hartford did not exercise a significant level of control over Reliance, nor were there any allegations that the Reliance agreement was a fronting policy.[180]

A Missouri appellate court also addressed direct action issues with insolvency.[181] In *J.C. Penney Life Insurance Co. v. Transit Casualty Co.*, the reinsurer had entered into receivership, and the cedent sought to obtain higher priority in the dissolution proceedings, as claim payments receive higher priority under Missouri law.[182] The cedent, therefore, attempted to categorize the agreement between the parties as permitting a direct right of action by the policyholders against the reinsurer.[183] The cedent argued that a direct action right existed because the reinsurer had accepted 100 percent liability on the policies as well as responsibility for investigating, defending, and adjusting claims.[184]

The court rejected the cedent's contentions on multiple grounds. First, the court reasoned that policyholders were not third-party beneficiaries of the reinsurance agreement at issue because the reinsurer had not agreed to deal directly with the policyholders.[185] Second, the reinsurer had not agreed to service and handle the reinsured policies.[186] Third, the agreement at issue did not contain any reference to direct actions.[187] In short, the agreement at issue did not contain sufficient evidence to demonstrate that it was anything other than an indemnity reinsurance agreement, which could not be prioritized.[188]

A Pennsylvania trial court also addressed a case this year regarding third-party rights with respect to reinsurance agreements and insolvency.[189] At issue in *General Reinsurance Corp. v. American Bankers Insurance Co. of Flor-*

179. *Id*. at 258 ("Contrary to what G-I argues, however, none of those agreements creates direct liability of Hartford for the amended Reliance policy.").

180. *Id*. at 259–60.

181. J.C. Penney Life Ins. Co. v. Transit Cas. Co., 299 S.W.3d 668, 670 (Mo. Ct. App. 2009).

182. *Id*. at 670–71.

183. *Id*. at 673–76.

184. *Id*. at 674.

185. *Id*. at 674–75.

186. *Id*. In contrast, in *O'Hare v. Pursell*, 329, S.W.2d 614, 621–22 (Mo. 1959), a case relied upon by the court, the reinsurer had agreed to service and handle all policies and to deal directly with the original insureds in good faith. *Transit Cas. Co*., 299 S.W.3d at 675.

187. *Id*. at 674–75.

188. *Id*. at 676 ("[W]e agree with the special master's finding that it is a contract for reinsurance, and not an insurance contract, because it does not directly and clearly create third-party liability.").

189. Gen. Reins. Corp. v. Am. Bankers Ins. Co., 996 A.2d 26, 28 (Pa. Commw. Ct. 2010).

ida was whether an insolvent cedent's liquidator or a governmental third party, the Mississippi Insurance Guaranty Association (MIGA), was entitled to certain reinsurance proceeds from a terminated reinsurance agreement.[190] The court held that the liquidator was entitled to the reinsurance proceeds.[191]

The liquidator asserted that MIGA was not entitled to the reinsurance proceeds because, among other reasons,[192] MIGA was not entitled to assert third-party beneficiary rights as to the proceeds of the reinsurance agreements.[193] MIGA argued that the Mississippi Code authorized it to act as a policyholder with respect to the reinsurance agreement, which, in turn, permitted it to assert third-party beneficiary rights to the reinsurance agreements.[194] The court rejected this argument at the threshold because no statute assigned MIGA rights with regard to reinsurance agreements.[195] Nonetheless, the court addressed the substance of MIGA's third-party beneficiary argument.[196]

The court recognized "[t]he general rule that reinsurance recoveries are general assets of the estate,"[197] but that, "where a policyholder can assert third-party beneficiary rights to reinsurance proceeds, the effect is to find those reinsurance proceeds not to be assets of the insolvent insurer estate."[198] This type of recovery, however, is limited to those situations where the reinsurance agreement or other compelling circumstances clearly demonstrate the third-party's right to reinsurance proceeds.[199] Not only were such circumstances not present in this case, but the reinsurance agreement contained explicit language prohibiting third-party beneficiary

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190. *Id.*

191. *Id.* at 39.

192. The liquidator also asserted that MIGA was not entitled to recover because: (1) collateral estoppel barred the claim; and (2) no statute entitled MIGA to claim that it was the "insurer" as to the claims. *Id.* at 30. The court rejected the collateral estoppel argument, but agreed with the liquidator on the statutory argument. *Id.* at 32 (concluding that a Mississippi decision did not preclude the court from considering MIGA's claim); *id.* at 36. ("A guaranty fund is the 'insurer' for purposes of claims administration but not for purposes of estate administration, including the pursuit of proceeds to a reinsurance agreement to which the 'insurer' had been a party.").

193. *Id.* at 30; *see also id.* at 36 ("MIGA asserts . . . that it is the statutory successor to every Legion policyholder, or insured, whose . . . claims have been paid by MIGA. As such, MIGA is entitled to assert any third-party beneficiary rights enjoyed by Legion policyholders to the . . . Reinsurance Agreement. Further, MIGA contends that . . . it should be found a third-party beneficiary of the Gen Re Agreements.") (internal citations omitted).

194. *Id.* at 36.

195. *Id.* at 36–37. MIGA only had rights with respect to policies, and, in fact, those rights were limited in scope.

196. *Id.* at 37.

197. *Id.*

198. *Id.* at 38 (citation omitted).

199. *Id.* (citation omitted).

recovery in the event of insolvency.[200] The court concluded that this case did not present unusual circumstances that would warrant departing from the general insolvency procedures or the plain language of the reinsurance agreements.[201] The court focused on the following facts: this arrangement did not involve a fronting agreement; the reinsurance agreement was not facultative; the reinsurer did not assume 100 percent of the risk; and the policyholders were unaware of the reinsurer.[202] Thus, the court concluded that MIGA could not assert third-party beneficiary rights to the reinsurance proceeds.[203]

At least one court, however, permitted an insured to proceed directly against a party asserting to be a reinsurer based on a finding that the insurance contract was ambiguous as to the reinsurer's role under the policy.[204] In *Felman Production v. Industrial Risk Insurers*, Industrial Risk Insurers (IRI), an unincorporated association, issued a policy to Felman Production, Inc. that covered property damage and business interruption losses associated with a metals plant.[205] Felman suffered a loss and sought insurance coverage from IRI as well as two of its member companies.[206]

One of IRI's member companies moved to dismiss, arguing that it could not be held directly liable to Felman because it was a reinsurer, not an insurer, under the contract.[207] In support of this argument, the company pointed to a portion of the policy where it was identified as the reinsurer.[208] Felman, in turn, pointed to the following evidence demonstrating that the company was an insurer: (1) the policy contained signature lines for each of the member companies of IRI; (2) the insurer was referred to as "the Companies" throughout the policy; (3) "the Companies" were defined as the members of IRI applicable to the policy; and (4) the insurer was defined simply as IRI.[209] The court recognized that a reinsurer typically cannot be

200. *Id*. The agreements provided: "[i]n no instance shall any insured of the Company or any claimant against an insured of the Company have any rights under this Agreement," and "[i]n the event of the insolvency of [the cedent], the reinsurance proceeds will be paid to [the cedent] or the liquidator . . ." *Id*. (alteration in original omitted).

201. *Id*. at 38–39.

202. *Id*. at 39.

203. *Id*. ("In short, MIGA has not identified any compelling circumstances of the type identified in *Legion* that would allow the court to find Legion policyholders in Mississippi to be the intended third-party beneficiaries of the 1993 Reinsurance Agreement.").

204. Felman Prod. v. Indus. Risk Insurers, No. 3:09–0481, 2009 WL 3380345, at *2 (S.D.W. Va. Oct. 19, 2009) ("[T]he Court finds that the terms of the original insurance contract are ambiguous as to [the company's] role under the Policy and, thus, that it was reasonable for Felman to expect [the company] to act as a direct insurer and to join [the company] as a defendant in the instant suit.").

205. *Id*. at *1.

206. *Id*.

207. *Id*. at *2.

208. *Id*. at *3.

209. *Id*.

held directly liable to a policyholder.[210] Nonetheless, it found in favor of Felman, because the contract was, "at a minimum, ambiguous as to [the member company's] role" and, therefore, "must . . . be construed against [the member company] and liberally in favor of Felman."[211] Thus, the district court never reached the question of whether an insured could proceed directly against its reinsurer because the contract was unclear as to whether the company was, in fact, a reinsurer.

3. Intermediary Liability

Parties continue to litigate a broker's liability for damages arising out of a breach of its duties in connection with a reinsurance transaction.[212] One opinion from an intermediate New York appellate court is of particular interest. In *American Home Assurance Co. v. Nausch, Hogan & Murray, Inc.*, the court allowed an insurer to proceed against its broker with a contribution claim because the insurer was subject to liability for damages, not purely economic loss, as a result of the broker's actions.[213] More particularly, an arbitration panel had previously adjudicated the rights of the insurer and reinsurer and rescinded a reinsurance contract between the parties because the insurer's broker violated the duty of utmost good faith.[214] The panel had found that the broker breached the duty by trying to "slip one by the reinsurer" regarding a fundamental contract change as well as by failing to disclose a problem about the insurer's data.[215]

The insurer then sued the broker in New York state court seeking indemnity from the broker for the entire repayment to the reinsurers.[216] In the alternative, the insurer sought pro rata contribution from the broker

210. *Id.* at *2 ("Generally, an insured party cannot maintain a direct action against a reinsurer because the insured is neither a party to the reinsurance policy nor in privity therewith.") (citation omitted). The court also recognized two exceptions to the general rule: (1) "A reinsurer may become directly liable to the insured based on the terms of the reinsurance contract[;]" and (2) "A reinsurer may also become directly liable to the insured via conduct; generally by directly handling an insured's claim." *Id.* (citations omitted). The court, however, did not need to address these specific issues as the terms of the insurance contract were ambiguous as to whether the company was, in fact, a reinsurer under the policy.

211. *Id.* at *3.

212. *See, e.g.*, Aldrich v. Marsh & McLennan Co., Inc., 901 N.Y.S.2d 897 (N.Y. Sup. Ct. 2009) (granting, in part, a motion to dismiss as to certain brokers who had previously been released from liability for losses in connection with asbestos claim and failure to disclose critical information regarding reinsurance policies covering same).

213. 897 N.Y.S.2d 413, 413 (N.Y. App. Div. 2010).

214. *Id.* at 415. Surprisingly, few cases addressed the duty of utmost good faith this past year. Another decision of interest is Guarantee Trust Life v. Ins. Admin. Corp., No. 09 C 5129, 2010 WL 3834026, at *3 (N.D. Ill. Sept. 24, 2010) (dismissing claim because Illinois does not recognize a separate cause of action for breach of the duty of utmost good faith).

215. *Aldrich*, 897 N.Y.S.2d at 415 (quotations omitted).

216. *Id.*

to the extent the insurer may have participated in the misrepresentation.[217] The broker moved to dismiss on both causes of action.[218] The court denied the motion on both counts.

The court permitted the indemnity claim to proceed because the record supported a theory that the insurer's liability was vicarious only.[219] As to the contribution claim, the broker argued that it should be dismissed because the rescission claim lay in contract, and a party may not proceed with a contribution claim for purely economic loss.[220] The court disagreed, stating that the broker "ignore[d] the realities of how insurance operates and therefore overlook[ed] that plaintiffs have been subject to liability for damages."[221] The court concluded that the insurer was "not merely deprived of the benefit of their bargain, but have actually had to cover far more of the underlying losses than they would have but for defendants' tortious conduct."[222]

4. Discovery of Reinsurance Information

In the last year, policyholders have continued their quest to gain access to their insurers' reinsurance information, even where the reinsurers have no involvement in the dispute. Although federal courts have often required the disclosure of reinsurance agreements as part of Rule 26(a) initial disclosures,[223] it is the compelled disclosure of communications between cedents and reinsurers that often sparks the most controversy.

The Supreme Court of New York addressed such a case in the context of a declaratory judgment action where a policyholder sought access not only to its insurer's reinsurance agreements, but also to communications between the plaintiff insurers and their reinsurers, which were not parties to the dispute.[224] The policyholder argued that the communications would reveal the insurers' analysis of the risks they were insuring at the time they

217. *Id.*
218. *Id.* at 415–16.
219. *Id.* at 416.
220. *Id.*
221. *Id.*
222. *Id.* at 417 (citations omitted).
223. *See, e.g.*, Hartman v. Am. Red Cross, No. 09–1302, 2010 WL 1882002, *1 (C.D. Ill. May 11, 2010) (recognizing that many federal courts have required the disclosure of reinsurance agreements as part of Rule 26 initial disclosures and mandating their disclosure); Sunnen Prods. Co. v. Travelers Cas. & Sur. Co., No. 4:09CV00889 JCH, 2010 WL 743633, *1 (E.D. Mo. Feb. 25, 2010) (in the context of a discovery hearing addressing a variety of categories of documents on a motion to compel, court ordered production of any reinsurance agreement that would be applicable to the underlying insurance policy at issue in the dispute).
224. Mt. McKinley Ins. Co. v. Corning Inc., No. 602454/2002, slip op. (N.Y. Sup. Ct. Feb. 25, 2010).

issued the underlying policies and their understanding of the policy language at issue. The policyholder further argued it was entitled to know whether the insurers had taken inconsistent positions in communications with their reinsurers.[225]

In rejecting the policyholder's arguments, the New York Supreme Court declined to adopt a per se rule that reinsurance agreements are always relevant. Instead, it found that the policyholder failed "to assert the relevance between reinsurance information and a material issue in this action,"[226] and that its "assertion of relevance [wa]s purely conclusory and without authority from the cases it cites."[227] Accordingly, the court declined to grant the requested discovery of reinsurance information.

5. Arbitration

Arbitration continues as the usual method for resolving reinsurance disputes, but courts are increasingly called to resolve disputes arising out of those arbitrations. Over the last year, courts addressed disputes arising out of every phase of reinsurance arbitrations—from the initial arbitrability of the dispute, to intersections of state and federal law, allegations of arbitrator misconduct, arbitrator resignation,[228] and the limits of a panel's authority in rendering an award.[229] Detailing each of these cases is beyond the scope of the present article, but cases of particular interest to reinsurance practitioners are discussed below.

225. *Id.* at 21.

226. *Id.* at 23.

227. *Id.* at 24.

228. In *Insurance Co. of North America v. Public Service Mutual Insurance Co.*, the Second Circuit declined to extend the rule it articulated in *Marine Products Export Corp. v. M.T. Globe Galaxy*, 977 F.2d 66 (2d Cir. 1992), regarding how to fill a panel vacancy arising from the death of an arbitrator. 609 F.3d 122, 122 (2d Cir. 2010). The *Marine Products* rule requires that " 'absent special circumstances,' if a vacancy arises on an arbitral panel due to the death of an arbitrator prior to the rendering of an award, a new panel should be convened." *Id.* at 123–24. In *Public Service Mutual*, the panel vacancy arose from an arbitrator's resignation, as opposed to death. The court concluded that requiring an entirely new panel to be convened whenever an arbitrator resigns would carry the risk of manipulation by parties who were unhappy with how their arbitration was proceeding—and who may then encourage their party-appointed arbitrator to resign for the purpose of forcing the creation of a new panel. Accordingly, the court held that "in dealing with vacancies resulting from resignations, the *Marine Products* rule does not apply, and district courts should use their power pursuant to 9 U.S.C. § 5 in deciding how to proceed." *Id.* at 130.

229. *See, e.g.*, Amerisure Mut. Ins. Co. v. Global Reins. Corp., 927 N.E.2d 740 (Ill. Ct. App. 2010) (finding that panel had exceeded its authority by awarding attorney fees where panel had relied on Illinois law as the source of its authority for granting such fees); Nat'l Union Fire Ins. Co. v. Odyssey Am. Reins. Corp., No. 05 Cv. 7539 (DAB), 2009 WL 4059183 (S.D.N.Y. Nov. 18, 2009) (denying motion to vacate a supplemental arbitral award of attorney fees upon finding that none of the statutory bases for vacatur applied and that the award was not in manifest disregard of the law).

a. Arbitrability of a Dispute

In a case that has migrated between federal district and appellate courts for a number of years, the Second Circuit issued a significant decision in *Axa Verischerung AG v. New Hampshire Insurance Co*.[230] The underlying dispute involved claims by AXA that various AIG subsidiaries fraudulently induced it to participate in two reinsurance facilities. After a jury rendered a judgment in AXA's favor for approximately $34 million, AIG appealed on several grounds. Among the arguments made were that AXA's claims were subject to mandatory arbitration and should not have been tried before a jury, and that AXA's claims were time-barred.

The Second Circuit remanded the question of arbitrability to the district court, which examined the following narrow language of the arbitration clause at issue: "All disputes or differences arising out of the interpretation of this Agreement shall be submitted to the decision of two arbitrators, one to be chosen by each party. . . ."[231] The district court adopted the premise that, if the claims sounded in fraud, they were not subject to arbitration, and further noted that the narrow language of this clause limited arbitration to disputes "arising out of the '*interpretation*' of the contracts."[232] The court concluded that AXA's allegations were grounded in alleged misrepresentations of "collateral aspects of how the arrangements between the parties would operate" as opposed to compliance with contractual provisions.[233] The claims, therefore, were not subject to arbitration. The court further held that, even if AXA's claims had been arbitrable, AIG waived any right to arbitration.[234] The Second Circuit subsequently adopted the district court's finding that AXA's claims sounded in fraud, and thus, were not subject to arbitration. As a result, the court decided that there was no need to reach the issue of whether AIG had waived its right to arbitrate.

Notably, however, the court then turned to AIG's statute of limitations defense and effectively rendered all prior rulings moot—it held that AXA's

230. No. 08–2521-cv, 2010 WL 3292927, *1 (2d Cir. Aug. 23, 2010).

231. AXA Verischerung AG v. N.H. Ins. Co., 708 F. Supp. 2d 423, 426 (S.D.N.Y. 2010) (citing the arbitration clause language) (emphasis in original).

232. *Id*. at 428 (citation omitted). It explained, "arbitration clauses limited to interpretive disputes are widely understood to cover only those disputes that can be resolved by reference to the terms of the contract."

233. *Id*. at 430.

234. *Id*. at 438. The court found that AIG was untimely in raising its arbitration demand during the litigation with AXA. Interestingly, however, in reaching this determination, the court also analyzed positions AIG had taken in a separate matter involving a different reinsurer, Farm Bureau, which had participated in the same reinsurance facilities. The court identified allegations raised by Farm Bureau in that litigation that the court felt were similar to those raised by AXA and noted that AIG had not asserted that such claims were subject to arbitration. The court noted that "[t]his alone may well constitute waiver, not just for the Farm Bureau action but for the instant action as well." *Id*. at 433.

claims of fraudulent inducement were in fact time-barred and vacated the $34 million jury award. In analyzing this affirmative defense, the court focused on AXA's duty of inquiry in the context of its allegations that it was misled into believing that the reinsurance facilities were facultative obligatory as opposed to purely facultative.[235] The court held that:

> AXA was confronted with a clear 'storm warning' in August 1998, as well as additional facts through 2000, 'such as to suggest . . . the probability that it had been defrauded,' thereby triggering a duty of inquiry. AXA's failure to engage in that inquiry imputed to it knowledge of the alleged fraud and renders its fraudulent inducement claims time-barred.[236]

Accordingly, the court found that the statute of limitations barred AXA's claims of fraudulent inducement.

In a different matter, the Third Circuit addressed several important questions regarding the reach and scope of arbitration in a reinsurance dispute in which the parties' own contract did not contain an arbitration clause. In *Century Indemnity Co. v. Certain Underwriters at Lloyd's, London*,[237] Lloyd's had served as Century Indemnity's retrocessionaire[238] and declined to reimburse Century for amounts Century claimed it was due under their treaties. Century brought suit against Lloyd's, and Lloyd's responded by seeking to compel arbitration. The retrocessional agreements between Lloyd's and Century did not contain arbitration clauses, but they referred to and incorporated all of the underlying reinsurance treaties, which did contain mandatory arbitration provisions.[239] The district court compelled arbitration.[240]

The parties proceeded to arbitrate their dispute, and after an award was rendered in favor of Lloyd's, Century moved to vacate the award in part on the ground that it should not have been compelled to arbitrate.[241] The district court declined to vacate the award, and Century appealed.

235. 2010 WL 3292927, at *3.

236. *Id.* (citations omitted) (alteration in original). The court further identified other alleged "storm warnings" related to AXA's percentage mix of business and increasing losses that, when "[t]aken together . . . contributed to the duty to inquire under which AXA already operated as a result of its receipt of the 1998 wordings." *Id.* at *4 (citation omitted).

237. 584 F.3d 513, 519–20 (3d Cir. 2009).

238. By way of background, the court explained the term "retrocessionaires" as follows:

> Reinsurance agreements covering classes or lines of business, rather than a particular policy, are called reinsurance treaties. Subsequently, reinsurers may seek to spread their exposure to risk through further reinsurance. The reinsurance of reinsurance is called a retrocession, and the reinsurers of reinsurers-that is, reinsurers who assume retrocession risk through retrocessional agreements-are called retrocessionaires.

Id. at 519 (citing Black's Law Dictionary 1432 (9th ed. 2009)).

239. *Id.* at 520.

240. *Id.* at 520–21.

241. *Id.* Century also moved to vacate the award on substantive and procedural grounds under 9 U.S.C. § 10. *Id.* at 522.

On appeal, the Third Circuit analyzed the retrocession agreement's language and structure and found that the federal policy favoring arbitration "probably does not apply" to the threshold question of whether an agreement to arbitrate exists.[242] In examining the reinsurance treaties and retrocession agreements, the court applied ordinary state-law based contract rules and noted the contracts' *lack of* any limiting or exclusionary language narrowing the application of the arbitration clause.[243] Century argued that arbitration was improper because: (1) the "incorporation-by-reference language" could not overcome the terms of the arbitration clause in the underlying reinsurance treaties, whose language specifically identified Century and its cedent as the parties subjecting their disputes to arbitration; and (2) the retrocession contained a service of suit clause, demonstrating that disputes were not arbitrable.[244] The Third Circuit disagreed, holding that "the retrocessional agreements incorporated the arbitration clause of the reinsurance treaties and thus formed an agreement between Century and Lloyd's to arbitrate disputes."[245] The court further held that the dispute at issue fell within the scope of the arbitration clause *without* applying the presumption favoring arbitration.[246] Accordingly, it upheld the district court's order compelling the parties to arbitrate.

b. Allegations of Evident Partiality and Arbitrator Misconduct

In the highly specialized reinsurance industry, the pool of potential arbitrator candidates is smaller than in other industries, and the likelihood of encountering the same individuals serving as arbitrators is correspondingly greater.[247] This situation naturally breeds debate over the types of relationships among parties, arbitrators, and counsel that could lead to "evident partiality" on the part of an arbitrator sufficient to overturn an award. Over the last year, multiple cases related to reinsurance have addressed these types of allegations with a wide range of outcomes.

In *Arrowood Indemnity Co. v. Trustmark Insurance Co.*,[248] the U.S. District Court for the District of Connecticut addressed the issue of whether an umpire's work as a party-appointed "advocate" for one party in unre-

242. *Id*. at 526 (citation omitted).

243. *Id*. at 551 ("'Subject to the percentage allocation in the preceding paragraph, *all terms and provisions of the Policy shall be applied to this agreement as if contained herein*, . . .'") (quoting the retrocession agreement) (emphasis in original).

244. *Id*. at 554.

245. *Id*. at 555.

246. *Id*. at 556.

247. *See*, *e.g.*, Ario v. Cologne Reins. (Barbados), Ltd., No. 1:CV-98–0678, 2009 WL 3818626, at *10 (M.D. Pa. Nov. 13, 2009) ("Reinsurance is a field sufficiently specialized that those with expertise can be expected to serve on multiple arbitration panels.").

248. Order on Pending Motions, No. 3:03-CV-1000 (PCD) (D. Conn. Feb. 2, 2010), ECF No. 100.

lated matters constituted bias such that the umpire could no longer serve as a neutral arbitrator in an arbitration involving the same party. Specifically, after the umpire was appointed in the arbitration at issue, the plaintiff selected him to serve as its party-appointed arbitrator in six unrelated matters. The defendant argued that the umpire's service as plaintiff's party-appointed arbitrator had led to a "'significant financial relationship'" that precluded his ability to remain neutral.[249] The court disagreed, stating "[s]ervice as a party-appointed arbitrator is not in and of itself evidence of partiality."[250] As a result, the court found no "evident partiality" within the meaning of the Federal Arbitration Act.[251]

In a matter involving arguably less potential partiality, the U.S. District Court for the Middle District of Pennsylvania addressed similar allegations and declined to vacate an arbitral award. In *Ario v. Cologne Reinsurance (Barbados), Ltd.*,[252] the umpire had been selected in the fairly traditional manner of being chosen by the two party-appointed arbitrators. After this appointment, the same umpire was selected to serve in a separate, unrelated dispute in which Cologne's party-appointed arbitrator was again involved in the umpire's selection. In seeking to vacate the arbitral award, Ario argued, among other points, that the umpire's service in the second arbitration, after having been selected (in part) by Cologne's party-appointed arbitrator, gave the umpire an improper pecuniary interest that was akin to having accepted business from a party itself.[253] Ario further alleged fault with his own party-appointed arbitrator for accepting a different and unrelated appointment as umpire in an arbitration with a Cologne affiliate while this dispute was pending.

In rejecting Ario's claims, the court concluded that the disclosures had been timely made while the proceedings were still pending before the panel. The court noted that:

> [T]here is no evident partiality from an arbitrator's accepting a position as an umpire in another, unrelated arbitration while the current arbitration is still ongoing, even if that position was partially obtained by the action of a party-appointed arbitrator, or is a position in an arbitration where one of the parties is an affiliate of a party to the current arbitration.[254]

249. *Id.* at 2.

250. *Id.* Indeed, the court noted that "[e]xperienced arbitrators often have professional relationships with the parties." *Id.* at 3.

251. *Id.* (citing 9 U.S.C. § 10).

252. *Ario*, 2009 WL 3818626, at *10 (holding that there was no evidence that either the umpire or Ario's party-appointed arbitrator "received any compensation directly either from a party or from a law firm for a party, or was compensated for any business services rendered for that entity. Instead, they acted only as arbitrators and any compensation received was for their roles as arbitrators").

253. *Id.* at *9.

254. *Id.* at *10.

In contrast, in *Scandinavian Reinsurance Company Ltd. v. St. Paul Fire & Marine Insurance Company*, the U.S. District Court for the Southern District of New York vacated an arbitral award.[255] In doing so, the court recognized that all three panel members were certified by the AIDA Reinsurance and Insurance Arbitration Society (ARIAS), and thus required to abide by the ARIAS guidelines for arbitrator conduct. Specifically, the court noted that "[t]he guidelines require arbitrators to 'disclose any interest or relationship likely to affect their judgment' and resolve all doubts in favor of disclosure."[256] It then concluded that two of the arbitrators failed to disclose the fact that they simultaneously presided over another arbitration involving what the court considered to be similar issues, related parties, and a common witness.[257] Although St. Paul urged that the arbitrators' involvement in the other arbitration was immaterial, the court found that the arbitrators:

> [P]laced themselves in a position where they could receive *ex parte* information about the kind of reinsurance business at issue in [the arbitration], be influenced by recent credibility determinations they made as a result of [the common witness'] testimony in the [other] arbitration, and influence each other's thinking on issues relevant to the [arbitration].[258]

Accordingly, the court found a "material conflict of interest" in the arbitrators' simultaneous service in the two arbitrations[259] and vacated the arbitral award.[260]

The U.S. District Court for the Northern District of Illinois also decided a pair of cases regarding whether an arbitrator was adequately "disinterested."[261] Although both cases addressed the same issue, whether a party could appoint the same arbitrator in a subsequent arbitration involving identical parties, the court reached different conclusions in each case. The cases are procedurally interesting in that the party opposing the appointment of the common arbitrator filed motions for preliminary injunctions to prevent the arbitrations from proceeding.

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255. No. 09 Civ. 9531 (SAS), 2010 WL 653481, *1 (S.D.N.Y. Feb. 23, 2010).

256. *Id*. at *2.

257. *Id*. at *8.

258. *Id*.

259. *Id*. at *9.

260. *Id*. Notably, the court did not reach the question of whether the arbitrators acted purposefully to conceal their involvement in the other arbitration, because the arbitrators' good faith in failing to disclose a conflict of interest would not have changed the outcome. *Id*. at *8–9.

261. Trustmark Ins. Co. v. John Hancock Life Ins. Co., 680 F. Supp. 2d 944 (N.D. Ill. 2010); Memorandum Opinion & Order, Trustmark Ins. Co. v. Clarendon Nat'l Ins. Co., No.09-C-1673, (N.D. Ill. Feb. 1, 2010), *available at* http://02ec4c5.netsolhost.com/blog/wp-content/uploads/2010/02/Trustmark-Clarendon-2.1.10.pdf.

In *Trustmark Insurance Co. v. John Hancock Life Insurance Co.*, plaintiff alleged breach of contract based on the confidentiality agreement governing the first arbitration and the underwriting agreement's requirement that the arbitrators be "disinterested."[262] The court enjoined the arbitration after finding breaches of both agreements. First, the court reasoned that the common arbitrator allegedly participated in deliberations regarding extending the confidentiality agreement covering the first arbitration to cover the second.[263] Second, the common arbitrator referenced information learned during the first arbitration while serving in the second arbitration.[264] The Seventh Circuit Court of Appeals, however, reversed the court on all grounds.[265] The court held that Trustmark had failed to demonstrate the touchstone requirement of the injunctive relief it sought—irreparable injury.[266] Moreover, the court held that Hancock's party-appointed arbitrator's service in the prior arbitration did not vest him with a disqualifying interest in the outcome of the present proceeding.[267] Rather, the requirement that an arbitrator be "disinterested" refers to "lacking a financial or other personal stake in the outcome," not to lacking financial knowledge of the dispute.[268]

In *Trustmark Insurance Co. v. Clarendon National Insurance Co.*, on the other hand, the court denied the preliminary injunction as premature,[269] noting that the requirement that an "arbitrator be disinterested is an issue of bias or qualification available for challenge only after an arbitration award issues."[270] The court further noted that the plaintiff "cannot avoid this outcome by merely restating the qualification challenge as a breach of contact claim."[271]

In a case involving a different type of allegation of arbitrator misconduct, after more than a decade of litigation regarding the reinsurance of certain workers' compensation policies, the Ninth Circuit affirmed an arbitration award against a reinsurer for more than $400 million, plus interest.[272] At issue was whether the arbitrators violated the Federal Arbitration Act by

262. 680 F. Supp. 2d 944, 947 (N.D. Ill. 2010).
263. *Id.* at 948–49.
264. *Id.*
265. Trustmark Ins. Co. v. John Hancock Ins. Co., 631 F.3d 869 (7th Cir. 2011).
266. *Id.* at 872.
267. *Id.* at 872–74.
268. *Id.* at 873.
269. *Clarendon Nat'l Ins. Co.*, No.09-C-1673, at 4. The plaintiff also filed a complaint against the defendant as part of its efforts to disqualify the common arbitrator and find a breach of the first arbitration's confidentiality agreement by virtue of having appointed the common arbitrator. The court dismissed plaintiff's claims in their entirety.
270. *Id.* at 6.
271. *Id.*
272. U.S. Life Ins. Co. v. Superior Nat'l Ins. Co., 591 F.3d 1167, 1170 (9th Cir. 2010).

holding an ex parte meeting with panel-retained expert witnesses to assess whether the insurers engaged in improper claim handling. The court held:

> The process employed by the arbitration panel, which included an ex parte meeting with panel-retained workers' compensation experts was unusual; however, after deferentially reviewing the panel's award, we determine that the arbitration process provided the parties with a fundamentally fair arbitration and that the arbitration award rested on a plausible interpretation of the governing arbitration documents.[273]

These cases suggest that, although opinions regarding "evident partiality" run strong, there is no clear consensus among courts or practitioners as to precisely what qualifies as "evident partiality." Until a consensus is reached, it is an issue likely to plague reinsurance practitioners for some time.

c. Intersection of State and Federal Law

Arbitration issues often provoke a complex intersection of state and federal law, and this past year was no exception. As discussed below, complicated questions of federal preemption and the application of the New York Convention and the McCarran-Ferguson Act have all arisen in the context of disputes involving arbitration.

In *Ario v. The Underwriting Members of Syndicate 53 at Lloyd's for the 1998 Year of Account*,[274] the Third Circuit analyzed the intersection of the Convention on Foreign and Arbitral Awards (the New York Convention),[275] the Federal Arbitration Act (FAA),[276] and the Pennsylvania Uniform Arbitration Act (PUAA).[277] The parties agreed that the arbitral award fell under the New York Convention, but they disagreed as to whether federal court jurisdiction applied to the proceeding seek-

273. *Id.* U.S. Life moved to stay the mandate pending a petition for a writ of certiorari in the Supreme Court of the United States, arguing in part that the decision was in conflict with "the decisions of the Fifth Circuit and the New York Court of Appeals on the important question whether arbitrators' ex parte receipt of evidence on the key issue in dispute constitutes prejudicial 'misbehavior,' and thus is grounds for vacatur of an arbitration award under Section 10(a)(3) of the Federal Arbitration Act. . . ." U.S. Life Ins. Co. v. Superior Nat'l Ins. Co., No. 07–55938, Appellant's Mot. to Stay the Mandate, at 1 (9th Cir. Mar. 25, 2010), ECF No. 56. Further, U.S. Life argued that the Ninth Circuit's decision was "in tension with Supreme Court decisions holding that reliance on secret evidence in the analogous context of administrative tribunals violates due process." *Id.* at 2. The Ninth Circuit granted the motion on March 26, 2010, but did not give its reasoning. U.S. Life Ins. Co. v. Superior Nat'l Ins. Co., No. 07–55938, Order (9th Cir. Mar. 26, 2010), ECF No. 57.

274. 617 F.3d 277, 283 (3d Cir. 2010).

275. The Convention on the Recognition & Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517.

276. Codified as amended in scattered sections of 9 U.S.C.

277. 42 Pa. Cons. Stat. § 7301 *et seq.* (2007).

ing to confirm or vacate the award. They further disagreed as to whether the FAA or the PUAA's vacatur standards should be applied to their dispute.

Ario contended that, because the reinsurance treaties indicated that "the arbitration shall be in accordance with the rules and procedures established by the Uniform Arbitration Act as enacted in Pennsylvania,"[278] the parties had affirmatively opted out of the FAA, including the provision allowing removal[279] to federal court of any disputes involving awards under the New York Convention.[280] On appeal, the Third Circuit held that it is not possible for parties to opt out of the FAA entirely, as it is the FAA itself that enables parties to incorporate state law standards to govern their arbitrations. Although parties can waive their right of removal under 9 U.S.C. § 205, this requires "clear and unambiguous language requiring such a waiver."[281] Opting to apply the PUAA is insufficient to affect this waiver.[282] Moreover, in this case, the reinsurance agreement's service of suit clause specifically preserved the right to remove an action to federal court, thereby undermining any contention that a right of removal had been clearly waived.[283]

The court also held that FAA vacatur standards would control in lieu of the New York Convention's vacatur standards.[284] For the FAA standards to be supplanted by those of the PUAA, the parties must express a "clear intent" to do so. Here, the court held that the arbitration clause's designation of the PUAA's "rules and procedures" did not evince a "clear intent" by the parties to invoke the PUAA's vacatur standards. Nor did the service of suit clause language show such intent where it did not affirmatively elect to apply the PUAA vacatur standards.[285]

In another decision involving the New York Convention and the application of state law, the Fifth Circuit considered the viability of a Loui-

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278. *Ario*, 617 F.3d at 284.
279. 9 U.S.C. § 205.
280. *Ario*, 617 F.3d at 286–88.
281. *Id.* at 289 (quotations and citations omitted).
282. *Id.* at 290.
283. *Id.*
284. *Id.* at 290–91. In addressing the vacatur standards for an award under the New York Convention, where both the arbitration and the enforcement action occurred in the United States, the Third Circuit adopted the Second Circuit's reasoning in *Yusuf Ahmed Alghanim & Sons v. Toys 'R' Us, Inc.*, 126 F.3d 15, 16 (2d Cir. 1997), and held that the New York Convention "specifically contemplates that the [country] in which, or under the law of which, the award is made, will be free to set aside or modify an award in accordance with its domestic arbitral law and its full panoply of express and implied grounds for relief." *Id.* at 292 (alteration in original) (quotations omitted).
285. *Id.* at 293.

siana law prohibiting arbitration clauses in insurance policies.[286] At issue was whether a Louisiana law preempted the New York Convention governing arbitrations where one party moved to compel arbitration pursuant to applicable reinsurance agreements and the other party moved to quash arbitration as being unenforceable under Louisiana law.[287] The court held that the McCarran-Ferguson Act did not apply to bar arbitration because it was the New York Convention that superseded state law and not its implementing legislation, the Convention Act.[288] The court found that "[t]he text of the McCarran-Ferguson Act does not support the inclusion by implication of 'a treaty implemented by an Act of Congress.' "[289] Thus, the court concluded that "implemented treaty provisions, self-executing or not, are not reverse-preempted by state law pursuant to the McCarran-Ferguson Act."[290]

286. Safety Nat'l Cas. Corp. v. Certain Underwriters at Lloyd's, London, 587 F.3d 714, 717 (5th Cir. 2009).

287. *Id*. at 717.

288. *Id*. at 724–25.

289. *Id*. at 731. In other words, a treaty that was implemented by an Act of Congress, such as the New York Convention, was not itself an "Act of Congress" within the meaning of the McCarran-Ferguson Act.

290. *Id*. The Fifth Circuit noted that its holding in *Safety National* puts it in direct conflict with a Second Circuit decision, which held that, because the New York Convention was not a self-executing treaty and depended on acts of Congress for its implementation, it was an "Act of Congress" for purposes of the McCarran-Ferguson Act. *See* Stephens v. Am. Int'l Ins. Co., 66 F.3d 41, 42 (2d Cir. 1995). The conflict between the circuits may position this issue as one for Supreme Court consideration.

RECENT DEVELOPMENTS IN FIDELITY AND SURETY LAW

Christopher R. Ward, Marc Domres, Carleton R. Burch, Deborah C. Duvin, James A. Knox, Jr., Darrell Leonard, Carol Z. Smith, Joseph S. Szary, and Tricia Wager

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I. FIDELITY LAW

A. *Employee Dishonesty*

In *Alerus Financial National Association v. St. Paul Mercury Insurance Co.*,[1] music promoter Louis Pearlman obtained credit from a group of banks through NACM, a loan placement broker. Some of the banks serviced the loans and some only participated in them. The broker arranged for an attorney to represent the servicing banks at the closing. As collateral, Pearlman pledged the stock of an airline he supposedly was operating.[2] The

1. No. 27-CV-09-3344 (Minn. Dist. Ct. Hennepin Cty., June 28, 2010).
2. *Id.*, slip op. at 3–6.

airline did not exist and Pearlman used the proceeds of the loans for a Ponzi scheme. The banks claimed coverage for their losses under financial institution bonds. The bonds included employee dishonesty coverage for losses caused by outside counsel.

A Minnesota state trial court found that the attorney was not an employee of the participating banks.[3] Although the participating banks benefited from his services, that was held not enough to establish the employee status.[4] The court also concluded there was no implied employment contract.[5] The participating banks had no communication with the attorney before the closing and received the loan documents only after the closing.[6] The participation agreements required the participating banks to do their own due diligence.[7]

The attorney did act, however, as an employee of the servicing banks. The court therefore examined whether he acted dishonestly and with intent both to cause a direct loss and to receive an improper financial benefit. The servicing banks accused him of failing to report that the airline's amended articles of incorporation had not been filed with the Florida Secretary of State.[8] The servicing banks also accused him of a conflict of interest by simultaneously representing NACM, the loan broker he admitted was acting as Pearlman's agent.[9] Construing dishonesty as a willful perversion of truth in order to deceive, cheat, or defraud, and applying the natural and probable consequences doctrine to ascertain the attorney's intent rather than ascertaining his specific intent, the court concluded an issue of material fact existed.[10] Although there was no evidence that the attorney stole anything, knew of the fraud, knowingly provided false information, or failed to do anything he claimed to have done, the court found it possible that his disregard of the bank's interest was dishonest and that the requisite intent could be inferred in that the loss was substantially certain to follow as a result of that disregard.[11]

As to whether the attorney received an improper financial benefit, the court found that his fees did not qualify as such; the financial benefit definition excluded payments made in the normal course of employment, including fees.[12] The exclusion applied even if the attorney induced the banks to

3. *Id.* at 11.
4. *Id.*
5. *Id.* at 12.
6. *Id.*
7. *Id.* at 14.
8. *Id.* at 15.
9. *Id.*
10. *Id.* at 21–23.
11. *Id.*
12. *Id.* at 25–27.

pay him for dishonest conduct. Nevertheless, the court found that a fact issue remained regarding whether the attorney had an expectation of future work, not from the banks, but from NACM or Pearlman. Mere hope for future work from the banks would have been normal, but an expectation of business from NACM or Pearlman might have been in the nature of a kickback.

In *St. Paul Mercury Insurance Co. v. FDIC*,[13] the chief executive officer (CEO) of the insured bank caused the bank to purchase Russian loans as investments. The bank later sold the loans to third parties in exchange for other debt. The sale was fraudulent. After the CEO was convicted of fraud and the bank failed, the FDIC pursued an employee dishonesty claim under the bank's financial institution bond.[14] The Southern District of Florida concluded that the bond's financial benefit requirement was not met.[15] Well in advance of the fraud, the CEO had transferred all of his interest in the bank's investments to valid and irrevocable trusts for his children. He retained no control and, at most, influenced the trusts' decision to sell the investments. As he received no personal financial benefit, the insurer was entitled to summary judgment.[16]

In *Employers-Shopmens Local 516 Pension Trust v. Travelers Casualty & Surety Co. of America*,[17] a claim was made under an ERISA endorsement of a commercial crime policy. The policy covered a trustee, officer, employee, administrator or manager, except an administrator or manager who was an independent contractor. The issue was whether the endorsement covered principals of a company who acted as the funds' investment advisor. The insured funds argued: (1) under ERISA, the principals handled plan assets and therefore had to be bonded; and (2) the coverage was illusory if it did not extend to an independent contractor administrator who would already have been an "employee" under the bond's general definition of "employee."[18] The Oregon Court of Appeals held that the bond had to be construed with reference to, but did not incorporate, ERISA.[19] Thus, it did not need to be construed to cover all persons who must be bonded; it was the insured's responsibility to obtain a complying policy. The administrators of the investment advisors also fell within the independent contractor exception to the coverage; yet the endorsement was not illusory

13. No. 08-cv-21192, 2010 WL 1332434 (S.D. Fla. Mar. 30, 2010).
14. *Id.* at *2–3.
15. *Id.* at *5–6.
16. *Id.* at *8.
17. 235 P.3d 689 (Or. Ct. App. 2010).
18. *Id.* at 693.
19. *Id.* at 700.

as it covered administrators who were neither employees nor independent contractors.[20]

B. *Forgery*

In *Great American Insurance Co. v. AFS/IBEX Financial Services, Inc.*,[21] AFS financed insurance premiums. An insurance agency did business with AFS in which it would submit applications for financing on behalf of insureds, and AFS would send checks to pay insurers the full premiums. The insureds would then send monthly payments to AFS.[22] The agency's officer manager submitted false applications to AFS, inducing AFS to send checks payable to the agency for nonexistent policies. The office manager endorsed the checks with an endorsement he was generally authorized to make and deposited the checks into his personal bank account, causing AFS to incur a loss.

AFS submitted a forgery claim under its crime protection policy. Applying Texas law, the Fifth Circuit affirmed a finding of coverage.[23] By signing the name of the agency on checks deposited into his personal account, the office manager intended a deception as to the identity of the signer. This may not be a forgery under the Uniform Commercial Code, but the policy defined forgery so that the U.C.C. definition did not apply.[24] Prior criminal case law, finding no forgery when the signer has general authority to sign, also did not apply.[25] The policy form definition excluded a signature of one's own name even in part, but the endorsements at issue did not include the definition. By referring to a signature of one's own name "in part," the definition meant a signature of both the signer's own name and the name of another.[26]

C. *Securities*

Bank of Bozeman v. Bancinsure, Inc.[27] is another case arising from Pearlman's fraud. The U.S. District Court of Montana considered whether Insuring Agreement (E) covered loan participation losses on the basis of forgeries of so-called written actions of directors authorizing Pearlman's fictitious airline to pledge its stock as collateral. The court held there was no coverage because the insured participating banks did not have actual physical

20. *Id.*
21. 612 F.3d 800 (5th Cir. 2010).
22. *Id.* at 802–03.
23. *Id.* at 806.
24. *Id.* at 804–05.
25. *Id.* at 806.
26. *Id.*
27. No. CV-08-05-BU-CSO (D. Mont. Dec. 9, 2009).

possession of, nor relied upon, original forged documents in advance of funding.[28] They did not have this through any lead bank or any lead bank's attorney as its authorized representative. The participation agreements disclaimed any such relationship.[29] In addition, there was no causation. The airline was a fictitious company that had no assets, so its stock had no value. Even if the signatures had been genuine, the loan losses would still have occurred.[30] The forgery did not cause the losses as the bond required. The bond is not credit insurance and does not cover loss resulting from worthless or nonexistent collateral."[31]

In *Alerus Financial National Ass'n v. St. Paul Mercury Insurance Co.*,[32] again relating to the Pearlman fraud, a Minnesota trial court also rejected the banks' Insuring Clause (E) claims.[33] The fictitious airline was a shell for the Ponzi scheme. Worthlessness of the airline stock caused the loss, not forgeries. Furthermore, there were no forgeries of covered documents. Written actions of directors did not qualify as negotiable instruments. They were not promises or orders to pay, nor were they instructions or advices of payment because they did not authorize or acknowledge fund transfers.

In *Beach Community Bank v. St. Paul Mercury Insurance Co.*,[34] the insured bank made a loan to a developer. He tendered a guaranty purportedly signed by his wife, who was not at the closing and the signature was not notarized. According to a handwriting expert and the wife herself, the signature was a forgery.[35] The Northern District of Florida determined there was no coverage under Insuring Clause (E). The requirement that the loss "result directly" from the forgery imposes a "but for" standard. The bank had to show it "would have been able to collect on the loan but for the forged signature" on the guarantee.[36] The bank could not carry this burden. The loss was caused not by the forged guaranty, but by the borrower's "diminished assets" and the "crashed real estate market."[37] The bank was insured against the risk of a forgery precluding collection of a loan, not the risk of its collateral becoming worthless or an unpredictable real estate market.[38] The bond could not be regarded as insurance that collateral was reliable. To hold otherwise would encourage sloppy banking and promote fraud against insurers.[39] Banks "would hope for forgeries

28. *Id.*, slip op. at 15.
29. *Id.* at 15–16.
30. *Id.* at 20.
31. *Id.* at 24–25.
32. No. 27-CV-09–3344 (Minn. Dist. Ct. Hennepin Cty., June 28, 2010).
33. *Id.*, slip op. at 32–34.
34. 5:09-cv-1061 (N.D. Fla. Feb. 26, 2010).
35. *Id.* at 2.
36. *Id.* at 5.
37. *Id.*
38. *Id.*
39. *Id.*

because forgeries would take all the economic risk out of the guarantee."[40] Insuring Clause (E) was only "a safeguard for bankers who, using their best business practices made a loan and were unable to collect on it—not because the guarantee proved worthless but because what otherwise would have been a valuable guarantee turned out to be forged."[41]

D. *Causation/Direct Loss*

In *Massachusetts Mutual Life Insurance Co. v. Certain Underwriters at Lloyds of London*,[42] fourteen investment funds lost $3.1 billion as a result of Bernard Madoff's fraud. The funds sought coverage against suits by their clients from a number of insurers. A fidelity insurer moved to dismiss on the basis that its bond did not cover an insured's liability to third parties.[43] A Delaware chancery court denied the motion. It held that misappropriation of a third party's property, while in the possession and control of the insured, can give rise to coverage.[44] Such claims differ from those involving liability for damages caused by an employee's fraud on a third party.[45] Misappropriation of a third party's property was addressed by the "ownership" provision of the bond.[46]

In *Loeb Properties, Inc. v. Federal Insurance Co.*,[47] a commercial real estate company sought coverage under a crime policy for an employee's theft of funds from the company's chairman. The chairman allowed the employee to keep his personal checkbook in her desk, maintain his account statements, and prepare checks for his signature.[48] The employee cashed checks drawn on this account and kept the proceeds.[49] She also used the chairman's personal checks to pay her own bills.[50] After discovering the theft, the company reimbursed the chairman and made an employee dishonesty claim under its commercial crime policy.[51]

The Western District of Tennessee granted the insurer's motion for summary judgment. The insured company did not suffer a direct loss as required by the policy.[52] Although the ownership provision extended cov-

40. *Id.* at 7.
41. *Id.*
42. No. 4791-VCL, 2010 WL 2929552 (Del. Ch. July 23, 2010).
43. *Id.* at *3.
44. *Id.* at *14.
45. *Id.*
46. *Id.* (citing Scott L. Schmookler, *The Compensability of Third-Party Losses Under Fidelity Bond*, 7 Fidelity L.J. 115, 115 (2001)).
47. 663 F. Supp. 2d 640 (W.D. Tenn. 2009).
48. *Id.* at 643.
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* at 649.

erage to property the insured owned, was legally liable for, or held in any capacity, the insured did not have any such relationship to the chairman's personal funds.[53] The insured did not have constructive possession of the funds.[54] Further, it did not hold the funds as a bailee,[55] as a bailment requires actual delivery of possession and control.[56] The insured did not assert possession or control to the exclusion of the chairman.[57] The insured also did not have "care, custody and control" of the funds,[58] because that phrase denotes "exclusive dominion over property." The insured did not have authority to direct how its chairman spent his own money, reflecting a lack even of "minimal rightful control."[59]

In *First Defiance Financial Corp. v. Progressive Casualty Insurance Co.*,[60] the insured bank's employee, an investment advisor, sold investment products to bank customers. A broker-dealer was supposed to hold the investments in accounts for the customers, but the employee diverted funds to an account he controlled by forging customer signatures on wire transfer requests that he faxed to the broker-dealer. Upon discovering this, the bank paid back the customers and submitted a fidelity claim.[61] The insurer argued the bank's loss did not result directly from the employee's actions.[62] The Northern District of Ohio applied a proximate cause test and concluded that the loss was covered.[63] The relationship between the employee's theft and the bank's reimbursement of the customers was "not so attenuated as to break the causal connection."[64]

In *Universal Mortgage Corp. v. Württembergische Versicherung, AG*,[65] a mortgage lender's employee supervised mortgage applications, monitoring compliance with Fannie Mae standards.[66] The employee processed thirty-five noncomplying mortgages in exchange for kickbacks from the applicants.[67] When these mortgages were sold to investors and went into default, the lender had to repurchase them.[68] The lender submitted a claim

53. *Id.* at 645.
54. *Id.*
55. *Id.*
56. *Id.* at 647.
57. *Id.*
58. *Id.* at 648.
59. *Id.*
60. 688 F. Supp. 2d 703 (N.D. Ohio 2010).
61. *Id.*
62. *Id.* at 707.
63. *Id.* at 708.
64. *Id.*
65. No. 09-CV-1142, 2010 WL 3060655 (E.D. Wis. July 30, 2010).
66. *Id.* at *1.
67. *Id.* at *2.
68. *Id.*

to its blanket bond insurer for the losses it incurred.[69] The insurer argued that the losses did not constitute a "direct financial loss" and were not "directly caused by" the dishonest acts of its employee.[70] The Eastern District of Wisconsin agreed. A direct loss cannot be contingent upon future events.[71] Losses occurred only when the loans went into default and the buy-back provision of the lender's contract was enforced. At the time of loan disbursement, the losses did not yet exist; rather, they were contingent upon default.[72] Accordingly, they were not "directly caused" by the employee's dishonest acts.[73]

E. *Standing*

In *Carteret Ventures, LLC v. Liberty Mutual Insurance Co.*,[74] Carteret sustained a tax loss when an intermediary stole funds.[75] Contending it had standing to pursue a claim as a designated loss payee, Carteret sought coverage under the intermediary's commercial crime policy.[76] The insurer denied coverage on the ground that Carteret did not have standing.[77] The U.S. District Court of New Jersey granted the insurer's motion to dismiss. Carteret could receive payment of a covered loss, but only the insured intermediary could trigger and establish a right to the payment.[78] Neither a settlement between Carteret and insured nor equity dictated otherwise.[79]

In *Peabody v. Davis*,[80] participants in an ERISA plan sought damages from the plan's administrator and trustees, citing violations of ERISA.[81] The participants also sought coverage under a fidelity bond issued to the administrator. The Northern District of Illinois held the participants did not have standing to sue because the insurer was not a fiduciary of the ERISA plan.[82]

F. *Exclusions*

In *Banner Lumber Co. v. Indiana Lumberman's Mutual Insurance Co.*,[83] an insured lumber yard's owner drove by the yard one evening and observed

69. *Id.*
70. *Id.*
71. *Id.* at *3.
72. *Id.* at *4.
73. *Id.*
74. No. 09–2831 (JLL), 2009 WL 3230844 (D.N.J. Oct. 2, 2009).
75. *Id.* at *1.
76. *Id.* at *4.
77. *Id.* at *2.
78. *Id.*
79. *Id.* at *5.
80. No. 05-C-5026, 2009 WL 2916824 (N.D. Ill. Sept. 2, 2009).
81. *Id.* at *6.
82. *Id.* at *15–16.
83. No. 07–13180, 2009 WL 3462510 (E.D. Mich. Oct. 22, 2009).

people putting lumber in a truck, possibly in connivance with the security guard. An inventory computation showed lumber was missing.[84] The insured made a claim under a policy with employee dishonesty coverage. The insurer invoked the property loss exclusion on the ground that the loss was an unexplained disappearance, inventory shortage, or other circumstance in which physical evidence was lacking.[85] The Eastern District of Michigan granted the insurer's motion for summary judgment.[86] There was no proof that the loss resulted from a criminal enterprise as opposed to a deficient inventory control system. Observation of one small theft did not establish that a larger one had occurred.[87]

In *Adirondack Trust Co. v. St. Paul Mercury Insurance Co.*,[88] the insured bank's customer deposited a large check in his account and asked the bank to wire the money to China.[89] The bank did so and sustained a loss because the check was fraudulent.[90] The bank sought coverage for "loss resulting directly from . . . forgery or alteration of, on, or in any Negotiable Instrument."[91] The insurer asserted an exclusion of loss resulting from "payments made or withdrawals from a depositor's account involving items of deposit which are not finally paid, for any reason."[92] The Northern District of New York granted the insurer's motion to dismiss.[93] The check was an item of deposit that was not finally paid, and the bank's loss arose from its payment before the check cleared.[94]

G. *Discovery of Loss*

In *Taylor Chrysler Dodge, Inc. v. Universal Underwriters Insurance Co.*,[95] a car dealer's salesman took cash from customers who could not obtain financing in exchange for false identification they could use to qualify for the financing. The dealer discovered the fraud, repossessed the cars, sold them at auction, paid the shortfall to the financing bank, and pursued an employee dishonesty claim.[96] The court found potential coverage.[97] The salesman aided and abetted the fraudulent taking of property, i.e., the cars, to the

84. *Id.*
85. *Id.* at *1.
86. *Id.* at *6.
87. *Id.* at *2.
88. No. 1:09-cv-1313, 2010 WL 2425915 (N.D.N.Y. June 11, 2010).
89. *Id.* at *1.
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.* at *4.
94. *Id.*
95. No. 08 C 4522, 2009 WL 3187234 (N.D. Ill. Sept. 30, 2009).
96. *Id.* at *2.
97. *Id.*

deprivation of the insured dealer. Even if the loss was to the bank, the policy covered vicarious liability.[98] The dealer did not suffer an immediate financial loss, but the policy did not require that to occur.[99] The dealer also did not need to own or possess the cars or amounts due because there was coverage if it was legally liable. However, whether the proof of loss and suit were timely remained issues.[100]

In *Diebold, Inc. v. Continental Casualty Co.*,[101] the insured serviced ATMs for banks. An armored car subcontractor began stealing ATM cash belonging to the banks. By August 2000, the insured was reimbursing banks, but it did not terminate the subcontractor. The insured's crime policy provided no coverage for loss caused by a wrongdoer after discovery of actual or potential loss by that wrongdoer. The court held there was no coverage for loss after August 2000. It did not matter that the head of the insured's risk management department did not know what was going on, as another employee in another department was the assigned risk manager for subcontractors handling cash. His awareness of facts that would lead a reasonable person to conclude that potential loss had been or would be incurred precluded coverage.[102]

H. *Proof of Loss and Cooperation*

In *Schupak Group, Inc. v. Travelers Casualty and Surety Company of America*,[103] the insured claimed Bernard Madoff was its employee after Madoff stole funds the insured had invested in a pension plan. The insured argued Madoff was a trustee within the employee definition by his handling of plan funds, given that the bond's independent contractor exception to the definition applied only to an administrator or manager, not to a trustee. The insurer contended Madoff was not a trustee because there was no document appointing him as such. The court did not reach the issue but dismissed the lawsuit because the insured failed to submit a signed and sworn proof of loss and did not sufficiently allege cooperation.[104]

I. *Limitations*

St. Paul Travelers v. Millstone[105] concerned § 12-104 of the Maryland insurance code,[106] which bars the contractual setting of a shorter time to sue on

98. *Id.*
99. *Id.* at *4–5.
100. *Id.* at *6–7.
101. No. 07-1991 (JEI/JS), 2010 WL 2539333 (D.N.J. June 21, 2010).
102. *Id.* at *12.
103. No. 10-cv-00209 (SAS), 2010 WL 1487737 (S.D.N.Y. Apr. 13, 2010).
104. *Id.* at *5.
105. 987 A.2d 116 (Md. 2010).
106. Md. Code Ann., Ins. § 12-104 (West 2010).

a policy than required by state law. A three-year statute of limitations governed, but the commercial crime policy at issue had an endorsement specifying the insured would have three years to sue after discovery of loss.[107] The court found the policy did not comply with § 12-104.[108] The time to sue had to run from the date the insurer was called upon to perform, i.e., from proof of loss, not from discovery of loss. The insurer could not contractually specify an earlier accrual date than the statute would allow.[109] Approval of the policy form by the insurance division did not bind the court.[110]

In *Taylor Chrysler Dodge, Inc. v. Universal Underwriters Insurance Co.*,[111] the court found a fact issue as to timeliness of the insured car dealer's proof of loss and filing of suit. The decision turned on when the insured discovered the loss. If it discovered the loss, not when it discovered the fraud, but when it learned how much it had to pay the financing bank, its filings were timely.[112] The court determined that because the bond only covered actual loss, the time to sue ought to run from the discovery of actual loss, not anticipated loss.[113] The court found the insured had not been dilatory.[114] It was also not a defense that the insured did not seek the insurer's consent before it reimbursed the bank. The insured was fulfilling a preexisting contract, not settling a dispute.[115]

J. *Number of Occurrences, Limits, and Stacking*

In *Fundquest, Inc. v. Travelers Casualty & Surety Co.*,[116] a technical support employee asked his employer to send direct deposits of his salary to a different bank. The employer mistakenly began depositing its CEO's salary into the employee's account. The employee not only failed to advise the employer of the error but demanded and started receiving his own salary in addition. He later quit, ending payment of his own salary, but he continued receiving the CEO's salary. The CEO discovered this sixteen months later. The employer reimbursed the CEO and made an employee dishonesty claim. The insurer paid for loss incurred before the employee quit but denied coverage of payments made after the employee left the company.[117]

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107. *Millstone*, 987 A.2d at 124–25.
108. *Id.* at 125.
109. *Id.* at 123.
110. *Id.* at 124–25.
111. No. 08 C 4522, 2009 WL 3187234 (N.D. Ill. Sept. 30, 2009).
112. *Id.* at *5.
113. *Id.* at *6.
114. *Id.*
115. *Id.* at *7.
116. No. 09-11471-RGS, 2010 WL 2223301 (D. Mass. June 4, 2010).
117. *Id.* at *1.

The insured maintained there was coverage for this as well because the employee did not do anything after he quit to add to the loss. The District of Massachusetts agreed. The employee committed acts that caused the entire loss while he was still employed. The court, however, rejected the insured's alternative argument that the loss qualified as a misplacement. The insured waived that argument by not checking the appropriate box on the proof of loss. The court also declined to provide extracontractual relief to the insured under Massachusetts' Consumer Protection Act.[118]

In *Superstition Crushing, LLC v. Travelers Casualty & Surety Company of America*,[119] an employee embezzled funds from the insured on multiple occasions over a number of years. The Ninth Circuit affirmed that five separate policies were in issue, not a single continuous policy.[120] The policy in force at the time of discovery governed and it defined occurrence as a series of acts by an employee. Thus, there was only one occurrence.[121] Moreover, only one limit for the one occurrence was available under that policy, even though the loss occurred in part during prior policy periods. The insured could not stack policies or limits, as the policies disallowed cumulation.[122] Loss occurring during prior policy periods could only be recovered up to the limit of the current policy.[123]

In *PBSJ Corp. v. Federal Insurance Co.*,[124] an employee stole $42 million from the insured between 1992 and 2005. The insured demanded the $2 million limit of each policy in force during the entire period, but the insurer offered a single limit of $2 million. The Eleventh Circuit affirmed summary judgment in favor of the insurer.[125] The insured argued the policy did not include its crime coverage in its list of claims made coverages so the crime coverage must have been occurrence based; thus, the insured could recover both under the policy in force when it discovered the loss and under prior policies.[126] The court looked instead to the specific wording of the crime coverage. Each policy specified that any prior polices were terminated and would not cover loss not discovered and reported before the inception of the current policy. Each policy also expressly terminated at the end of its own period and had a noncumulation clause and a clause limiting recovery to $2 million.[127]

118. Mass. Gen. Laws Ann. ch. 93A § 2 (West 2009).
119. 360 F. App'x 844 (9th Cir. 2009).
120. *Id*. at 846.
121. *Id*.
122. *Id*.
123. *Id*.
124. 347 F. App'x 532 (11th Cir. 2009).
125. *Id*. at 533.
126. *Id*.
127. *Id*. at 535–36.

In *Hartman & Tyner, Inc. v. Federal Insurance Co.*,[128] the insured owned and managed thirty-three apartment complexes. An accounts payable supervisor in collusion with outside contractors embezzled $4.6 million over several years from the insured. Applying the policy in force when the loss was discovered, the insurer offered a single $1 million limit. The insured contended it had three losses, one for each individual in the scheme. The Eastern District of Michigan disagreed. The supervisor was integral to the entire scheme; without her, it could not have been carried out. The policy stated all loss resulting from an employee's acts was a single loss, whether others were involved or not. Furthermore, prior loss provisions precluded recovery under more than one policy.[129]

In *Beckley Mechanical, Inc. v. Erie Insurance Property & Casualty Co.*,[130] a bookkeeper falsified records and embezzled money from the insured by issuing numerous checks to herself.[131] The bond defined all loss caused by an employee, "whether the result of a single act or a series of acts," as a single occurrence. The Fourth Circuit found a single occurrence. The fact that the employee was convicted on multiple counts of embezzlement was irrelevant. It also did not matter if she committed a continuing tort for limitations purposes. The policy effectively specified that multiple torts might give rise to only one occurrence.[132]

In *Tooling, Manufacturing & Technologies Association v. Hartford Fire Insurance Co.*,[133] the insured trade association owned an insurance agency but failed to make it an insured. The agency received commissions on policies sold to association members. The agency's general manager stole commissions payable to the agency.[134] The policy covered direct loss from employee theft and excluded indirect loss including unrealized income.[135] The agency incurred a direct loss, but it was not insured. It was a separate legal entity and there was no de facto identity either, even if the insured owned the agency and the agency's manager was also an employee of the insured.[136] The commissions belonged only to the agency at the time of the manager's theft. Thus, the theft occurred only in his capacity as an employee of the agency. The insured's loss as a result of the agency's failure to pass the commissions through was an indirect failure to realize income, and was excluded under the policy.[137]

128. No. 08–12461, 2009 WL 3152957 (E.D. Mich. Sept. 28, 2009).
129. *Id.* at *7.
130. 374 F. App'x 381 (4th Cir. 2010).
131. *Id.* at 383.
132. *Id.*
133. No. 08-cv-11812, 2010 WL 3464329 (E.D. Mich. Aug. 30, 2010).
134. *Id.* at *5–6.
135. *Id.* at *3–4.
136. *Id.* at *11–15.
137. *Id.* at *14–15.

K. *Rescission*

In *National Bank of Andover v. Kansas Bankers Surety Co.*,[138] the Kansas Supreme Court allowed the insurer to proceed with a third trial of its rescission and misrepresentation claims. In its application for a financial institution bond, the bank stated it required segregation of duties and balancing of accounts.[139] The court determined that evidence that the bank's written policy was not enforced should not have been excluded.[140] The court also held that the loss arose from checking account overdrafts, and that overdrafts are an extension of credit.[141] The loan-loss exclusion applied, unless the insured proved employee dishonesty coverage on remand, including proof of a manifest intent to obtain a financial benefit and proof that such a benefit was actually received.[142]

In *FDIC v. Great American Insurance Co.*,[143] a bank indicated in its application for fidelity coverage that it did not have prior losses, declinations or cancellations of insurance, or any other material information.[144] However, the bank had in fact suffered losses, employees were indicted, and its prior carrier had threatened to decline renewal unless the bank's officers went to London to meet with the underwriters.[145] The Second Circuit concluded that the requested disclosures were material and affirmed judgment against the FDIC, which had taken over the bank.[146] The FDIC was subject to the insurer's rescission defense because it was not a "secret defense" that would diminish the FDIC's receivership interest in the bond. The basis and right to rescind appeared in writing on the face of the bond.[147]

L. *Bad Faith*

In *Southern Worcester County Regional Vocational School District v. Utica Mutual Insurance Co.*,[148] the insured made claims for losses over several bond periods. The insurer conceded liability for a single bond period limit but conditioned payment on a release as to the other bond periods.[149] Contending that only one bond limit applied did not violate Massachusetts' Fair Claims Practices Act.[150] However, conditioning payment of that limit

138. 225 P.3d 707 (Kan. 2010).
139. *Id.* at 712–13.
140. *Id.* at 718–19, 724–25, 732–33.
141. *Id.* at 722.
142. *Id.* at 723–24, 730–31.
143. 607 F.3d 288 (2d Cir. 2010).
144. *Id.* at 290–91.
145. *Id.* at 294–96.
146. *Id.* at 297.
147. *Id.* at 292–94.
148. No. 06–40230-FDS, 2010 WL 3222015 (D. Mass. Aug. 13, 2010).
149. *Id.* at *13.
150. *Id.* at *13–14.

on a waiver of any claim for the limits in force during the other bond periods was a violation of the Act, as was requesting information to support the claim years after it was made, rather than paying the amount it had agreed was covered.[151] Nonetheless, because the insured's claim was time barred in part, and the conduct was not willful, the court only awarded attorney fees and not multiple damages.[152]

M. *Salvage*

In *Luvata Buffalo, Inc. v. Lombard General Insurance Co. of Canada*,[153] the insured sought coverage for a theft under both a marine insurance policy that referenced the stolen shipment and a general policy of crime insurance. The crime insurer paid the loss and sued the marine insurer. The court held that the crime insurer had standing to sue as a subrogee of the insured and allowed the claim to proceed.[154]

In *Travelers Casualty & Surety Co. of America v. Bancorp Bank*,[155] the insured's employee caused fraudulent checks to be issued payable to a bank for deposit into her personal account. The insured did not owe anything to the bank.[156] The insurer paid the loss and sued the bank on the basis that it had a common law duty to inquire about the purpose of the checks to the insured.[157] The court, however, held that the bank did not owe a duty to the insured as a noncustomer drawer of the checks. The court therefore granted the bank's motion to dismiss.[158]

In *Cincinnati Insurance Co. v. Wachovia Bank, National Ass'n*,[159] the federal district court for Minnesota addressed the effect of a deposit agreement between a bank that paid a forged check and the insured customer. The agreement required the insured to use a "positive pay" service.[160] Use of such service would have enabled the customer to detect that a check payee had been changed. The customer's subrogated forgery insurer could not recover from the bank.[161]

In *Hartford Fire Insurance Co. v. Clark*,[162] an insurer paid a fidelity loss resulting from an inflated invoicing kickback scheme and sought recov-

151. *Id.*
152. *Id.* at *15–16.
153. No. 08-CV-00034(A)(M), 2010 WL 826583 (W.D.N.Y. Mar. 4, 2010).
154. *Id.* at *3–4.
155. 691 F. Supp. 2d 531(D. Del. 2009).
156. *Id.* at 532–33.
157. *Id.*
158. *Id.* at 534–37.
159. No. 08-CV-2734, 2010 WL 2777478 (D. Minn. July 14, 2010).
160. *Id.* at *7–8.
161. *Id.* at *9.
162. No. 03-CV-3190, 2010 WL 2925050 (D. Minn. July 21, 2010).

ery from a coconspirator, the entity that received the inflated payments. The court allowed the claims to proceed under an unjust-enrichment theory.[163]

II. SURETY LAW

A. *Performance Bonds*

1. Right to Contract Balance

New York's Supreme Court Appellate Division in *Kemper Insurance Cos. v. State of New York*[164] ruled that a surety was entitled to summary judgment on its claim against the obligee for payment of contract balances that had been paid to the Internal Revenue Service instead of to the surety. The court noted that because the agreement between principal and obligee was a construction contract, all funds related to the contract were subject to a statutory trust.[165] As a result, use of trust funds for any purpose other than payment of claims under the construction contract constituted an improper diversion of the trust funds.[166] The court further found that the trust fund violation prevented the obligee from relying on the safe harbor immunity of 26 U.S.C. § 6332(e), which protects a person who makes a good-faith determination that the property in question has been levied upon.[167]

2. Condition Precedent

In *Breath of Life Christian Church v. Travelers Insurance Co.*,[168] the Tennessee Court of Appeals affirmed the trial court's finding that the process set forth in what appeared to be the A312 performance bond was not a mere technicality. The court disagreed with the obligee's characterization of Section 3 of the bond as being merely a notice requirement that had been satisfied because the surety had some indication of difficulties between the owner and contractor on the project. The court characterized Section 3 as providing "a mediation mechanism that seeks to avoid default."[169]

In *Hunt Construction Group, Inc. v. National Wrecking Corp.*,[170] the D.C. Circuit affirmed summary judgment to the surety, finding that the obli-

163. *Id.* at *11.
164. 892 N.Y.S.2d 596 (App. Div. 2009).
165. *Id.* at 599.
166. *Id.*
167. *Id.* at 600–01.
168. No. W2009-00284-COA-R3-CV, 2010 WL 1172080 (Tenn. Ct. App. Mar. 26, 2010).
169. *Id.* at *4.
170. 587 F.3d 1119 (D.C. Cir. 2009).

gee's failure to give the surety timely notice of its principal's default until after the principal's work was complete deprived the surety of its opportunity to exercise rights under the bond.[171] In its ruling, the court rejected the reasoning of *Colorado Structures, Inc. v. Insurance Co. of the West*,[172] which held that the AIA A311 bond did not require notice as a condition precedent to recovery under the bond because that holding would render paragraph C of the bond meaningless.[173] The court found that the first clause of paragraph C,[174] when read in context, contained true conditions precedent stating, "the provisions of paragraph C are nonsensical without an understanding that the surety's duties depend on the obligee's declaring the principal to be in default and giving notice of the declaration to the principal and the surety."[175]

Similarly, the Southern District of Florida, in *North America Specialty Insurance Co. v. Ames Corp.*,[176] found that an obligee's supplementation of the principal's work force (over the objection of the principal and surety), without providing the opportunity for the surety to perform, constituted a material breach of the bond, rendering it void.[177]

The surety in *Travelers Casualty & Surety Co. of America v. Crystal Towers, LLC*[178] obtained partial summary judgment on the obligee's performance bond claim. Although the obligee notified the surety that it was considering a contractor default and a meeting was held in accordance with § 3.1 of the A312 performance bond, the obligee failed to comply with the remaining two provisions of paragraph 3 of the bond.[179] The obligee argued that the surety had waived the remaining conditions by financially assisting its principal and arranging for a contractor to complete certain work.[180] The Southern District of Alabama concluded that the actions of the surety were not a "clear and unequivocal waiver" of the condition precedents of the bond even if some of the actions taken by the surety may have been similar to the actions it would have taken had its duty to perform under the bond been triggered.[181]

171. *Id.*
172. 167 P.3d 1125 (Wash. 2007).
173. *Hunt*, 587 F.3d at 1121.
174. The first clause of Paragraph C of the AIA A311 performance bond stated, "[w]henever Principal shall be, and be declared by Obligee to be in default under the subcontract, the Obligee having performed Obligee's obligations hereunder."
175. *Hunt*, 587 F.3d at 1121.
176. No. 08-80966-CIV, 2010 WL 1027866 (S.D. Fla. Mar. 18, 2010).
177. *Id.* at *9.
178. No. 08-0518-KD-C, 2009 WL 5068823 (S.D. Ala. Dec. 17, 2009).
179. *Id.* at *14.
180. *Id.*
181. *Id.* at *15.

3. Limitations Period

In *Adesta Communications, Inc. v. Utica Mutual Insurance Co.*,[182] the federal court for the District of Colorado addressed the issue of when the statute of limitations commenced for a performance bond claim involving latent defects.[183] The surety argued that the breach occurred when the principal failed to complete the work and the obligee contracted with another party to complete.[184] The court disagreed, holding that the obligee's damages were the result of defective work rather than the failure to complete the contract and that this condition was a latent defect that could not have been reasonably discovered until much later. Because the obligee filed suit within three years of discovering the latent defect, the court ruled that the suit was timely.[185]

In *City of Santa Fe v. Travelers Casualty & Surety Co.*,[186] the Supreme Court of New Mexico held that the suit limitation period contained in the performance bond was unenforceable against a governmental entity unless the governmental entity directly contracted for a shorter time than the applicable statute of limitations.[187] In reaching this decision, the court held the obligee was not a party to the bond, but rather a third-party beneficiary, and that allowing the surety and the contractor to shorten the time to sue without the governmental entity's direct consent was against public policy.[188]

In contrast, in *Five Star Lodging, Inc. v. George Construction, LLC*,[189] the Kentucky Court of Appeals concluded that the obligee was bound by the limitations provision of the bond even though it was not a party to the bond. The court held that as a third-party beneficiary of the bond, the obligee was bound by its terms, including the time limitations.[190]

In *Monreal Funeral Home, Inc. v. Ohio Farmers Insurance Co.*,[191] the Ohio Court of Appeals held that the owner's performance bond claim was barred by the two-year limitations period set forth in the bond. The owner sued the surety shortly after arbitration proceedings with the contractor were concluded in the owner's favor and the surety raised the two-year limitations provision as a defense. The owner argued that the surety's letter denying the claim, stating its obligations under the bond had not yet arisen

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182. No. 08-CV-01817-RPM, 2010 WL 1240354 (D. Colo. Mar. 19, 2010).
183. *Id.* at *3.
184. *Id.*
185. *Id.*
186. 228 P.3d 483 (N.M. 2010).
187. *Id.* at 484.
188. *Id.* at 485–86.
189. No. 2009-CA-000990-MR, 2010 WL 2976524 (Ky. Ct. App. July 30, 2010).
190. *Id.*
191. No. 2009-L-105, 2010 WL 3212993 (Ohio Ct. App. Aug. 13, 2010).

and advising that its principal had agreed to arbitrate the dispute, constituted a waiver of the limitations period. The court was not persuaded that such language constituted a clear, unequivocal, and decisive waiver of the contractual time limitation set forth in the bond.[192]

B. *Payment Bonds*

1. Jurisdictional Issues

In *United States ex rel. Roc Carter Co. v. Freedom Demolition, Inc.*,[193] the Middle District of Georgia granted the surety's motion to dismiss a sub-subcontractor's Miller Act claim for work, material, and labor provided in the building of military housing units at a U.S. Air Force base. The court held that the construction of the military housing project under a lease entered into by the Air Force and a developer was a private undertaking. The Air Force agreed to lease the property to the developer for the "purposes of demolition, design, construction, renovation, operation and maintenance of a rental housing development." Because the lease was not a construction contract, the Miller Act was inapplicable.[194] Additionally, the court held that the Miller Act did not apply to the design/build agreement between the developer and the general contractor because the United States was not a party to that agreement.[195]

2. Notice Requirements

In *Evco Sound & Electronics, Inc. v. Seaboard Surety Co.*,[196] the Idaho Supreme Court affirmed judgment against the surety on the issue of whether a sub-subcontractor had given timely notice of its claim and had timely filed suit. Idaho Code § 54-1927 requires a claimant that does not have a contractual relationship with the general contractor to give written notice within ninety days from the date on which the claimant last performed labor or furnished material, and further to file suit within one year of that date.[197] The project was substantially completed on January 28, 2005, but the claimant had provided training on April 15, 2005, installed part of the television system on April 26, 2005, and completed as-built drawings on June 15, 2005. The surety argued that the post-substantial completion work was not sufficient to extend the time for giving notice, and urged the court to use the project's substantial completion date as the latest possible date of work/furnishing of material. The court declined to apply the substantial completion date,

192. *Id.* at *4.
193. No. 5:09-CV-101 HL, 2009 WL 3418196 (M.D. Ga. Oct. 14, 2009).
194. *Id.* at *7.
195. *Id.* at *8.
196. 223 P.3d 740 (Idaho 2009).
197. *Id.* at 743–44.

and instead held that the determination of "last work" should be based on whether performing the labor or furnishing material was done as part of the original contract (which would qualify as the last work) or to correct defects or make repairs (which would not operate to extend the date for giving notice).[198]

In *General Insulation Co. v. Eckman Construction*,[199] the New Hampshire Supreme Court affirmed dismissal of the claimant's statutory bond claim even though the claimant had complied with the statement of claim provisions of the New Hampshire Public Works Act and filed a petition to enforce that claim within the requisite time prescribed by statute. The court concluded that the claimant's failure to provide a copy of the petition to the principal and surety within one year of filing the statement of claim as required by statute was fatal.[200]

In *Thomas v. A.G. Electrical, Inc.*,[201] employees of an electrical subcontractor filed suit against a surety's performance and payment bonds to recover underpayment of wages pursuant to the Missouri Prevailing Wage Act. The trial court granted the surety's motion for summary judgment, agreed that the workers' claims were not covered by the performance bond, and held that the workers had failed to comply with the ninety-day notice requirement set forth in the payment bond.[202] Relying on Missouri's public policy that prevailing hourly rate wages be paid to workers engaged in public works, the Missouri Court of Appeals reversed and held that the workers' claims were covered under both the performance and payment bond. The court rejected the surety's argument that the payment bond (not the performance bond) was required by statute and that the performance bond was issued only to ensure completion of the project, finding that the plain language of the Prevailing Wage Act mandated that all contractor's bonds guarantee payment of prevailing wages.[203] Although not necessary given its ruling with respect to the performance bond, the court went on to note that the trial court also erred in dismissing the workers' payment bond claims, because the surety showed no prejudice from the workers' delay in giving notice.[204] The court, relying on insurance cases, reasoned that liability should not be avoided on the payment bond because of failure to give the required notice, absent a showing of prejudice by the surety.[205]

198. *Id.* at 746.
199. 992 A.2d 613 (N.H. 2010).
200. *Id.* at 619–20.
201. 304 S.W.3d 179 (Mo. Ct. App. 2009).
202. *Id.* at 182.
203. *Id.* at 186–87.
204. *Id.* at 187.
205. *Id.* at 188.

3. Limitations

In *Comtel Technologies, Inc. v. Paul H. Schwendener, Inc.*,[206] the Northern District of Illinois granted the surety's motion for summary judgment based on the plaintiff-claimant's failure to file a timely suit to enforce its bond claim pursuant to the Illinois Public Construction Bond Act.[207] This Act provides that no action can be brought later than six months after the "acceptance by the State or political subdivision thereof of the building project or work."[208] The claimant, relying on language in the construction contract, argued that acceptance occurs when the architect finds the work acceptable and final payment is issued.[209] The court rejected the claimant's definition and pointed out that if acceptance of the project was contingent upon final payment and final completion, the filing period could be indefinite.[210] The court concluded that the project had been accepted no later than September 2002, when the projects were substantially complete, the owner had taken possession and control of the projects, was using them for their intended purposes, and had agreed to pay a completion bonus.[211]

In *Fisher Sand & Gravel Co. v. Western Surety Co.*,[212] the District of New Mexico held that the bond principal's bankruptcy and the automatic stay issued in relation to that bankruptcy did not toll the limitation period in the payment bond for filing suit; consequently, the plaintiff subcontractor's suit against the surety on the payment bond was untimely.[213] The court held that the automatic stay by its express terms only stays actions against the debtor and does not apply to entities affiliated with a debtor, like sureties, guarantors, and co-obligors.[214] The court rejected the argument that the debtor's status as an indemnitor of the surety was sufficient to automatically extend the stay to the surety and toll the limitations period.[215] The court further held that the subcontractor's allegations that the surety failed to act promptly on the claim were not sufficient to equitably toll the limitation period for filing suit.[216]

In *Mathisen Co. v. Federal Insurance Co.*,[217] the Eastern District of Michigan held that arbitration proceedings initiated, but not completed, be-

206. No. 04 C 3879, 2010 WL 1257766 (N.D. Ill. Mar. 26, 2010).
207. 30 Ill. Comp. Stat. 550/2.
208. *Comtel*, 2010 WL 1257766, at *4.
209. *Id.*
210. *Id.*
211. *Id.*
212. No. CV 09-727 WPL/RLP, 2009 WL 4099768 (D.N.M. Oct. 20, 2009).
213. *Id.* at *9.
214. *Id.* at *13.
215. *Id.* at *3–4.
216. *Id.* at *6–7.
217. No. 09-13491, 2009 WL 4350032 (E.D. Mich. Nov. 30, 2009).

tween the surety's principal and the plaintiff subcontractor did not toll the limitation period prescribed by Michigan law for suits on the public works payment bond.[218] The surety, unlike its principal, was not bound to arbitrate the underlying subcontract dispute; thus suit needed to be brought against the surety within the one-year limitation period.[219] Further, there was no evidence that the surety engaged in intentional or negligent conduct designed to induce the subcontractor from timely filing suit to support equitable tolling of the statute of limitations.[220]

At issue in *Ricky Tittle Construction Co. v. Safeco Insurance Co. of America*[221] was whether the subcontractor had timely filed suit in its Miller Act claim. The subcontractor had been terminated for default, but returned to the project a week later to remove equipment and materials and perform some general clean up. The subcontractor filed suit within one year of its post-termination activities. The Middle District of Georgia characterized the subcontractor's post-termination activities as "final wrap-up tasks," which it equated to post-project tasks such as repairs, equipment removal, and inspections.[222] The court held that such tasks did not constitute "labor" within the meaning of the Miller Act and, thus, did not extend the time period for the subcontractor to file suit.[223]

4. Lien Waivers

In *United States ex rel. Damuth Services, Inc. v. Western Surety Co.*,[224] a supplier, who was aware that the subcontractor to which it supplied materials for the project had been paid for the materials but had used the funds to satisfy other debts, agreed it would not inform the general contractor of the diversion of funds in exchange for partial payment and an agreed-upon payment schedule with the subcontractor. After receiving no payments under the payment schedule, the supplier met again with the subcontractor and renegotiated another payment schedule, again agreeing not to inform the general contractor or its surety of nonpayment. The subcontractor filed for bankruptcy and the supplier then brought a Miller Act claim against the general contractor's surety. The Eastern District of Virginia granted summary judgment to the surety on the basis of equitable estoppel and the doctrine of unclean hands. The district court found that the supplier's agreement to remain silent about the subcontractor's diversion of funds

218. *Id.* at *3.
219. *Id.*
220. *Id.*
221. No. 4:10-CV-02, 2010 WL 2690572 (M.D. Ga. July 6, 2010).
222. *Id.* at *2.
223. *Id.*
224. 368 Fed. App'x 383 (4th Cir. 2010).

was sufficient to invoke estoppel and further that the supplier had entered into an illegal bargain with the subcontractor when it agreed to keep silent about the subcontractor's conduct, which enabled the subcontractor to continue receiving payments from the general contractor.[225] The Fourth Circuit affirmed.[226]

In *United States ex rel. Pioneer Construction Co. v. Pride Enterprises, Inc.*,[227] the Middle District of Pennsylvania denied the general contractor's and surety's motions for summary judgment to enforce lien waivers executed by a subcontractor. The court held that the general contractor's course of conduct rendered the lien waivers ambiguous. The general contractor had supported and encouraged the subcontractor's delay claims to buttress its own claims for delay against the owner. The court held that general contractor's actions showed an intention not to bar future claims for delays, despite the language of the lien waivers.[228]

5. Conditional Payment

In *Crow & Sutton Associates, Inc. v. C.R. Klewin Northeast, LLC*,[229] both the bond and the subcontract at issue contained conditions precedent requiring payment to the plaintiff subcontractor only if payment had been made from the owner to the construction manager for subcontractor's work.[230] A Connecticut trial court, in enforcing the conditional payment provision, held that the surety's obligation would only be triggered if the owner paid the construction manager, who in turn failed to pay the subcontractor.[231]

In *FaulknerUSA, LP v. Alaron Supply Co.*,[232] the Texas Court of Appeals reversed the trial court's granting of summary judgment to the plaintiff subcontractor on its breach of contract and payment bond claims. The court agreed with the contractor and surety that the subcontract, which provided payment was only due the subcontractor if payment had been received by the general contractor from the owner, was an enforceable condition precedent that had not been met.[233] The provision expressly used the term "condition precedent" and further provided that the subcontract amount included compensation for the subcontractor's assumption of the risk of nonpayment by the owner.[234]

225. *Id.* at 387–89.
226. *Id.* at 390.
227. No. 3:CV-07-0994, 2009 WL 4429802 (M.D. Pa. Nov. 27, 2009).
228. *Id.* at *7.
229. No. HHDX04CV054016823S, 2010 WL 2573954 (Conn. Super. Ct. May 21, 2010).
230. *Id.* at *6.
231. *Id.*
232. No. 08–09-00119-CV, 2010 WL 2929460 (Tex. App. July 28, 2010).
233. *Id.* at *3.
234. *Id.* at *2–3.

In *United States ex rel. Aarow Equipment & Services v. Travelers Casualty & Surety Co. of America*,[235] the Eastern District of Virginia granted the surety's motion for summary judgment against the plaintiff subcontractor based on the payment provisions of the underlying subcontract. The subcontractor stopped work due to nonpayment. The general contractor claimed the subcontractor was not due any amounts because the subcontract included a pay-when-paid clause, and the government had not paid. When the subcontractor refused to perform any further work, the general contractor terminated the subcontractor for default. The court concluded that the conditional payment clause in the subcontract was valid and enforceable under Virginia law.[236] Accordingly, the court determined that the general contractor's termination of the subcontractor for default was proper. Under the default termination provision of the subcontract, plaintiff's claim for damages was purely speculative and, thus, not recoverable because the work had not yet been completed or accepted by the government.[237] The subcontractor further argued that a Miller Act surety could not withhold payment under its payment bond based on a pay-when-paid clause, citing cases from the Fourth and Ninth Circuits. While the court acknowledged that case law, it held that in this case, the surety was not relying on the conditional payment clause to defeat the subcontractors' otherwise properly payable bond claim. Instead, it was relying on the pay-when-paid provision in determining whether the general contractor's termination for default was proper.[238]

6. Licensing

A claimant's failure to be properly licensed was held to be a defense to a payment bond claim in *Stellar J. Corp. v. Smith & Loveless, Inc*.[239] The District of Oregon granted summary judgment to the general contractor and surety on the ground that the subcontractor did not have an Oregon contractor's license and, thus, could not commence an action to recover for work for which a license was required.[240]

Similarly, in *United States ex rel. Technica, LLC v. Carolina Casualty Insurance Co.*,[241] the Southern District of California granted the surety's motion for summary judgment, precluding a sub-subcontractor's Miller Act claim on the ground that the sub-subcontractor was not a licensed

235. No. 1:09-cv-00861, 2010 WL 1005161 (E.D. Va. Mar. 16, 2010).
236. *Id*. at *6.
237. *Id*. at *7.
238. *Id*. at *6.
239. No. 09-353-JE, 2010 WL 3118360 (D. Or. May 11, 2010).
240. *Id*. at *10.
241. No. 08cv1673 JAH, 2010 WL 2628715 (S.D. Cal. June 29, 2010).

California contractor. Although both the U.S. Supreme Court and the Ninth Circuit had held that a state could not require a general contractor on a federal project to obtain a license in the state of the project site, the court held the prohibition did not apply to second-tier subcontractors. Finding that California's licensing statutes were not preempted by the contractor responsibility requirements found in federal acquisition regulations, the court barred the sub-subcontractor's claims against the surety.[242]

7. Arbitration

United States ex rel. WFI Georgia, Inc. v. Gray Insurance Co.[243] involved the issue of whether an arbitration award entered by default against the principal was binding on its surety. After filing a lawsuit, the claimant filed a demand for arbitration with the principal. The claimant sent a copy of the demand to the surety and invited the surety to participate in the arbitration. Because the principal stopped defending itself, the surety filed a motion in the litigation seeking to be named the principal's attorney-in-fact, pursuant to the indemnity agreement. The court failed to rule on the surety's motion for nearly nine months. In the interim, the claimant proceeded in arbitration against the absent principal without providing further notice to the surety. Neither the principal nor the surety appeared at the arbitration, and the claimant was awarded its claimed damages in full. The claimant then moved for summary judgment against the surety. The Northern District of Georgia enforced the arbitration award against the surety,[244] holding that the surety had notice of the arbitration and the opportunity to defend by proceeding as the principal's attorney-in-fact, even though the court had not ruled on the surety's motion.[245] The court, however, held that the surety was liable only for that portion of the arbitration award that would be recoverable under the Miller Act.[246]

8. Jury Trial

The surety's right to assert a claimant's waiver of the right to a jury trial was addressed in two cases. In *Painting Co. v. Walsh/Demaria Joint Venture III*,[247] the Southern District of Ohio enforced a contractual waiver of the right to jury trial and struck the subcontractors' demand for a jury trial against the general contractor and its two sureties. The court held that because the

242. *Id.* at *5.
243. 701 F. Supp. 2d 1320 (N.D. Ga. 2010).
244. *Id.* at 1329.
245. *Id.* at 1328–29.
246. *Id.* at 1331.
247. Nos. 2:09-cv-0183, 2:09-cv-0184, 2010 WL 1027424 (S.D. Ohio Mar. 12, 2010).

surety was entitled to assert the defenses of its principal, the surety also had the right to rely on, and enforce, the jury trial waiver.[248]

In *Attard Industries, Inc. v. United States Fire Insurance Co.*,[249] the Eastern District of Virginia held that a surety did not have the right to enforce a jury waiver provision in a subcontract. While the court acknowledged that the surety had a right to assert its principal's defenses, it was persuaded that a jury waiver did not constitute a defense to liability; accordingly, the surety did not "stand in the shoes" of its principal with respect to the jury waiver.[250]

C. *Other Bonds*

1. Maintenance Bonds

In *Lower Salford Township v. International Fidelity Insurance Co.*,[251] the owner entered into an agreement with the contractor for maintenance and repairs at a development project. The maintenance bond guaranteed "against defective materials and workmanship" and contained a notice provision requiring the owner to notify the contractor and surety in writing within thirty days of the discovery of the defect.[252] When the owner found incomplete work, it wrote two letters to the contractor demanding completion. After the contractor failed to respond, the owner made a demand upon the surety. The surety denied the claim on the ground that the owner had failed to provide timely notice of its claim under the bond, which was a condition precedent to the surety's liability. The owner argued that the thirty-day period began to run only after the developer had failed to comply with the request to complete and thus, its notice was timely. The Eastern District of Pennsylvania rejected both positions, but granted the surety's motion to dismiss, holding that the bond guaranteed against defects in materials and workmanship only, and unperformed work was not a "defect" covered by the bond.[253]

2. Trustee Bonds

NOB Holdings Corp. v. Liberty Mutual Insurance Co. (*In re PSN USA, Inc.*)[254] involved the liability of a liquidating trustee, appointed to implement the debtor's Chapter 11 confirmed plan. The surety issued a trustee bond, which guaranteed "the faithful performance by [the trustee] of his official

248. *Id.* at *2.
249. No. 1:10cv121, 2010 WL 3069799 (E.D. Va. Aug. 5, 2010).
250. *Id.* at *4.
251. No. 09-cv-5081, 2010 WL 1741356 (E.D. Pa. Apr. 27, 2010).
252. *Id.* at *3.
253. *Id.*
254. 426 B.R. 916 (Bankr. S.D. Fla. 2010).

duties." The trustee had no prior experience as a liquidating trustee and, after several missteps, a creditor sought to have the trustee dismissed for misconduct. The creditor also filed an adversary proceeding against the trustee and the surety on the bond. The U.S. Bankruptcy Court for the Southern District of Florida held that the creditor did not have standing to pursue a claim against the surety because it was not an obligee on the bond and had not been requested by the court to file the complaint.[255] The court further concluded that the trustee was not personally liable to the creditor for losses to the estate and granted summary judgment against the creditor. The court stated, "[i]t is well settled that in order for a trustee to be held personally liable, the actions of the trustee must rise to the level of willful and deliberate conduct or gross negligence."[256] The court held that although trustee had made several errors in his administration of the estate, "[s]tupidity does not equal malice."[257]

In *United States ex rel. Lamesa National Bank v. Liberty Mutual Surety* (*In re Schooler*),[258] a creditor filed an adversary proceeding against the Chapter 7 bankruptcy trustee and her surety arising from the trustee's failure to pursue collection of the debtor's substantial inheritance (which had been spent) and the trustee's delay (over nine years) in administering the estate. The U.S. Bankruptcy Court for the Northern District of Texas concluded that the trustee had failed to comply with four statutory provisions in executing her duties. On cross motions for summary judgment, the creditor sought a de facto declaration that the court's finding of the trustee's "failures" was sufficient to support a holding that the trustee was in breach of the bond for failing in the "faithful performance of [her] official duties as Trustee." The court disagreed, explaining that although the bond guaranteed "faithful performance" of the trustee's duties, it was necessary to apply one consistent standard to the conduct of the trustee in determining the liability of both the trustee and the surety, because "unless a cause of action exists against the principal, it cannot exist against the surety."[259] Therefore, unless the trustee was grossly negligent, the applicable standard of care recognized by the Fifth Circuit, the surety could not be held liable under the bond.[260]

3. Subdivision Bonds

In *Westchester Fire Insurance Co. v. City of Brooksville*,[261] the contractor applied to the city for permits to build a residential subdivision. In lieu

255. *Id*. at 924.
256. *Id*. at 922.
257. *Id*
258. No. 09-05011, 2010 WL 1946268 (Bankr. N.D. Tex. May 13, 2010).
259. *Id*. at *3.
260. *Id*.
261. No. 8:09-cv-62-T-23TBM, 2010 WL 3043917 (M.D. Fla. July 30, 2010).

of fully installing water and power as a condition of subdivision plat approval, the contractor obtained phased performance bonds guaranteeing such installation. After the contractor filed for bankruptcy, the city called on the surety to pay its penal bond limit for Phase II of the project, despite the fact that construction had not started. The city and surety cross-moved for summary judgment. The Middle District of Florida held that actual construction of the residential development was an implied condition precedent to the surety's liability on the bond.[262] The purpose of the ordinance requiring the bond was to ensure that no resident purchased a home without access to the city's utility service. The court found that because no homes had been built requiring city services, the implied condition failed. Accordingly, the surety had no obligation on the bond.[263]

D. *Rights of Surety*

1. Indemnity

This year, it appeared that the favorite defense to indemnity claims was the surety's alleged failure to communicate with its indemnitors regarding claims on the bonds. Courts in North Carolina,[264] Alabama,[265] and Tennessee[266] rejected this defense and granted sureties summary judgment for indemnification.

In a more novel approach, the indemnitors in *Fidelity & Deposit Co. of Maryland v. Ralph McKnight & Son Construction, Inc.*,[267] argued that a Mississippi statute, which voided provisions requiring a party to indemnify another from that person's own negligence, barred a surety's suit for specific performance of the indemnity agreement requiring them to provide financial information and funds in the amount of the surety's reserves. The Mississippi statute applied to construction contracts but not to construction bonds or insurance contracts.[268] A Mississippi chancery court concluded that because the performance bond incorporated the construction contract

262. *Id.* at *7.

263. *Id.* at *8.

264. Fid. & Guar. Ins. Co. v. Constr. Advantage, Inc., No. 1:08-CV-460-GCM, 2010 WL 726024 (W.D.N.C. Feb. 25, 2010) (surety's alleged failure to communicate with indemnitors during settlement negotiations of the claim was insufficient to show any improper motive or bad faith by the surety).

265. Hartford Cas. Ins. Co. v. Jenkins, No. 3:06-CV-11, 2010 WL 2348619, at *6 (S.D. Ala. June 9, 2010) (rejecting the defense that the surety's failure to notify her of bond claims constituted bad faith.).

266. Hartford Fire Ins. Co. v. CMC Constr. Co., No. 3:06-CV-11, 2010 WL 3338581, at *18 (E.D. Tenn. Aug. 24, 2010) (holding that the surety had no fiduciary duty to indemnitor to keep her informed of status of bond claims).

267. 28 So. 3d 1282 (Miss. 2010).

268. Miss. Code Ann. § 31-5-41 (Rev. 2008).

by reference, the statute barred the surety's claim.[269] The Mississippi Supreme Court reversed, based on the statute's language stating that it did not apply to construction bonds.[270]

In *Pedroza v. Lomas Auto Mall, Inc.*,[271] the District of New Mexico held that a surety was entitled to indemnification for its attorney fees from one indemnitor even though the bond application containing the indemnity language was illegible, and from another indemnitor even though there was no signed indemnity agreement. In the first instance, the surety was able to provide the court with a legible copy of an unsigned bond application that the court found to be highly persuasive evidence of the terms of the signed application. The surety also provided the affidavit of its claims consultant who testified that the bond application had been signed by the indemnitor with the same terms contained in the unsigned application. This evidence, and the indemnitor's admission of the allegation in the surety's cross-claim that the application had been signed, was sufficient to support judgment in favor of the surety.[272] In the second instance, the court concluded that the surety was entitled to recover its reasonable attorney fees incurred in defending the bond claim under traditional indemnity principles, which provide that the indemnitee is entitled to be made whole by the primary wrongdoer.[273] The court found it would be "unjust or unsatisfactory" to force the surety to absorb litigation costs incurred as a result of the dealer's wrongful conduct.[274] The common law indemnification right of the surety, however, did not extend to the recovery of attorney fees incurred by the surety in pursuing its indemnification claim.[275]

2. Recovery Against Third Parties

In *American Contractors Indemnity Co. v. Sirkin*,[276] a surety successfully sued its principal's attorney for losses sustained on a court fiduciary bond resulting from the attorney's breach of her agreement to maintain a joint bank account for estate funds.[277] The agreement to place all estate funds in the joint bank account, which required both the principal and his attorney's signature on all checks, was a requirement by the surety before it was willing to issue the bond.[278]

269. *Ralph McKnight*, 28 So. 3d at 1284.
270. *Id.* at 1284–85.
271. 716 F. Supp. 2d 1031 (D.N.M. 2010).
272. *Id.* at 1045–46.
273. *Id.* 1046–47.
274. *Id.*
275. *Id.* at *18.
276. No. B202129, 2009 WL 3385670 (Cal. Ct. App. Oct. 22, 2009).
277. *Id.* at *1.
278. *Id.*

E. *Bad Faith and Extracontractual Liability*

In *Travelers Casualty & Surety Co. of America v. Crystal Towers, LLC*,[279] the obligee's performance bond claim was dismissed due to its failure to comply with the conditions precedent set forth in the bond.[280] Nevertheless, the court found that the obligee stated a cause of action against the surety for fraudulent suppression based on the obligee's claim that if it had known the true financial status of the contractor, it would have declared a default and terminated the contract. The surety took over construction of the project after its financially stressed principal provided a letter of voluntary default. The obligee had expressly asked the surety's claims handler about the financial condition of the contractor and its ability to complete the project, and was allegedly told not to worry and that the contractor had the financial strength to finish the project. The Southern District of Alabama denied the obligee's motion for summary judgment based on the existence of genuine issues of material fact, but concluded that such a claim, if proved, would have merit. The court agreed with the surety that it had no duty to share the contractor's financial status with the obligee, but concluded that once the surety chose to respond to the inquiry, it had a duty not to suppress or misrepresent information.[281]

F. *Bankruptcy*

1. Discharge

In *First National Insurance Co. of America v. Kapetanakis (In re Kapetanakis)*,[282] the surety objected to the debtor indemnitor's discharge pursuant to 11 U.S.C. § 523(a)(2)(A) for losses and expenses the surety sustained as a result of issuing bonds. The debtor admitted that he forged the signatures of the other indemnitors on the indemnity agreement and subsequently entered a consent judgment in favor of the surety, which the Bankruptcy Court for the Southern District of Texas held was nondischargeable. The court concluded that, but for the forged signatures on the indemnity agreement, the surety would not have issued the bonds.[283] Interestingly, the court noted that the surety did not seriously consider the financial wherewithal of the individual indemnitors, only sporadically required financial information, and did not carefully review the information that it received. The court, however, found this to be irrelevant given the clear evidence that without

279. No. 08-0518-KD-C, 2009 WL 5068823 (S.D. Ala. Dec. 17, 2009).
280. See discussion of cases *supra* in Section II.A.2.
281. *Id.* at *5.
282. No. 08-03237, 2010 WL 1463437 (Bankr. S.D. Tex. Apr. 12, 2010).
283. *Id.* at *10–11.

all of the individual indemnitors' signatures on the indemnity agreement, the surety would not have issued the bonds.[284]

In two cases, bankruptcy courts denied the debtors' discharge for debts to sureties arising from payment bond losses.[285] The courts concluded that the language in the indemnity agreement requiring the principal and indemnitors to hold all payments received on bonded contracts as trust funds in which the surety had an interest for the payment of obligations incurred for labor, material and services on the bonded projects created an express trust. Both courts agreed with the sureties that the debtors' debts resulted from defalcation in the course of their fiduciary capacity, which was nondischargeable under § 523(a)(4) of the Bankruptcy Code.

2. Preferences

United Rentals, Inc. v. Angell[286] involved a Chapter 7 bankruptcy trustee's preference action to avoid and recover payments made by a debtor subcontractor to an equipment supplier on several bonded projects. The supplier argued that the transfers were not preferences under § 547 of the Bankruptcy Code because the transfers represented contemporaneous exchanges for new value. The Bankruptcy Court for the Eastern District of North Carolina found in favor of the trustee. The Fourth Circuit affirmed, rejecting the supplier's argument that had the transfers not been made, the supplier would have made a payment bond claim that would have been paid and the surety would have automatically received an equitable lien by subrogation against the funds the general contractor owed to the debtor subcontractor. Relying on *O'Rourke v. Seaboard Surety Co. (In re E.R. Fegert, Inc.)*,[287] the supplier argued that the court should hold that the supplier's release of its payment bond claim constituted new value and thus the transfers could not be set aside as preferential. The Fourth Circuit declined to address the "correctness" of *Fegert*, and instead found that because the supplier had never asserted a payment bond claim, the surety never obtained an equitable lien that could be released.[288]

284. *Id.* at *11–12.

285. N. Am. Specialty Ins. Co. v. Thomas (*In re* Thomas), No. 4:09-CV-248 (CEJ), 2010 WL 716096 (E.D. Mo. Feb. 24, 2010); Cincinnati Ins. Co. v. Foy (*In re* Foy), No. 09-5090, 2010 WL 2584193 (Bankr. D. Kan. June 21, 2010).

286. 592 F.3d 525 (4th Cir. 2010).

287. 887 F.2d 955 (9th Cir. 1989).

288. *United Rentals*, 592 F.3d at 532–33.

RECENT DEVELOPMENTS IN HEALTH, LIFE, AND DISABILITY INSURANCE

William A. Chittenden III, Elizabeth G. Doolin, Joseph J. Hasman, and Julie F. Wall

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I. INTRODUCTION

Is a possible physician-assisted suicide an “accident?” Can a claimant’s failure to attend AA meetings doom his claim for disability benefits? Can insurers exclude maternity coverage for surrogate mothers? Can an ERISA plan beneficiary be a plan fiduciary? In the ERISA context, what does “downright unreasonable” mean? The answers to these and many other questions await you in this selection of the past year’s most interesting and significant decisions.

II. ACCIDENT INSURANCE

A. *Accident versus Sickness*

In an unusual twist in these types of cases, the court in *Appeldorn v. Hartford Life and Accident Insurance Co.*,[1] looked to Article 17 of the Warsaw Convention to uphold Hartford’s determination that an insured’s death was not accidental. The insured contracted bacterial meningitis on his airplane flight, which plaintiff asserted was an injury under the policy resulting from an accident and not sickness or disease. The court, on de novo review and noting the dearth of ERISA case law involving an insured’s death from meningitis after an airplane flight, cited Article 17 jurisprudence, which

1. Appeldorn v. Hartford Life & Accident Ins. Co., No. 1:09-cv-069, 2010 WL 3475915 (D.N.D. Sept. 2, 2010).

holds that if an injury is merely a reaction to normal aircraft operation it is not accidental.[2]

In a similar case, *Maher v. Mutual of Omaha Insurance Co.*,[3] Legionella bacteria fatally infected the insured, who was covered under three ERISA policies for "accidental bodily injuries" resulting "independently of sickness. . . ." The plaintiff argued the insured's exposure was an accident because the bacteria were accidentally released into the air at a chemical plant while he worked as a chemical salesman, citing four other reported cases of Legionellosis in Louisiana in the same month by the Centers for Disease Control and Prevention.[4] The court disagreed, holding such a construction of injury would render the policy's sickness limitation unnecessary. Even acknowledging such an interpretation, the court found plaintiff failed to connect the insured's Legionellosis to an event initiated during his employment on a specific date and location.[5]

B. *Heart Failure*

In *Miller v. Hartford Life & Accident Insurance Co.*,[6] the insured experienced a fatal "cardiac event" while swimming that caused him to submerge under the water for thirty to forty seconds. Autopsy findings revealed that the insured's immediate cause of death was "drowning" with "atherosclerotic coronary artery disease" listed as a contributing condition on the death certificate. His ERISA policy provided accidental death benefits for "bodily injury resulting directly and independently of all other causes from an accident. . . ."[7] In affirming the insurer's claim denial, the court found Hartford's decision was consistent with the findings of the medical examiner, EMS personnel, and a forensic investigator, all of whom noted cardiac arrest as a factor in the death.[8] To provide reasonable context to the exclusion, the court applied the Eleventh Circuit's "substantially contributed" test[9] and held that a cardiac event due to heart disease was a substantially contributing factor to the insured's death.

2. *Id.* at *2–5. Article 17 of the Warsaw Convention sets forth the "liability of international air carriers for harm to passengers." *Id.* at *4 n.1 (quoting Air France v. Saks, 470 U.S. 392, 397 (1985)).

3. Maher v. Mutual of Omaha Ins. Co., C.A. No. 09–02096, 2010 WL 3155949 (W.D. La. Aug. 9, 2010).

4. *Id.* at *1.

5. *Id.* at *4–5.

6. Miller v. Hartford Life & Accident Ins. Co., C.A. No. 1:08-CV-2014-RWS, 2010 WL 1050006 (N.D. Ga. Mar. 17, 2010).

7. *Id.* at *1–3.

8. *Id.* at *8.

9. *Id.* at *9 (citing Dixon v. Life Ins. Co. of N. Am., 389 F.3d 1179, 1184 (11th Cir. 2004)). *See also* Fisher v. AIG Life Ins. Co., No. 4:08-CV-477-Y, 2009 WL 3029756 (N.D. Tex. Sept. 23, 2009) (upholding denial of benefits under accident policy for insured who cut his

C. *Intentionally Self-Inflicted Injuries*

In this year's isolated autoerotic asphyxiation death case, *Estate of Thompson v. Sun Life Assurance Co. of Canada*,[10] the insured was found naked and hanging by his neck in his bedroom. His insurer denied an ERISA claim for benefits under his accidental death policy, explaining his "high risk activity" fell within the policy's exclusion for a loss "which is due to or results from . . . intentionally self-inflicted injuries."[11] According to the autopsy report, the insured "intended to deprive his brain of oxygen," noting he provided no means of escape and additional injuries were consistent with the act of autoerotic asphyxiation.[12] Noting the insurer's decision was unbiased, the court rejected the district court's opinion that autoerotic asphyxiation injuries are *per se* intentionally inflicted, but ruled the record supported the finding that a reasonable person could conclude the injury was intentionally self-inflicted.[13]

D. *Intoxication*

In 2008 alone, there were nearly 11,773 fatalities produced by drunk driving accidents.[14] The National Highway Traffic Safety Administration reports that someone is killed due to alcohol-impaired-driving approximately every forty-five minutes.[15] Nationwide, nearly half of all motor vehicle deaths, and even more arrests, are a product of intoxication.[16] Courts in the last year have grappled with the intersection between the public policy arguments against drunk driving, tort theory, and general principles of accident insurance law. For example, in *Kovach v. Zurich American Insurance Co.*,[17] the insured suffered the amputation of his left leg just below the knee as the result of a motorcycle collision. His blood alcohol content was .148%. Zurich determined the loss was not accidental and therefore not covered because it was reasonably foreseeable that the insured would suffer injuries by driving his motorcycle while intoxicated. The policy had no intoxication exclusion.

Although the court noted that drunk-driving "is ill-advised, dangerous and easily avoidable[]," it dismissed the statistics on drunk driving

nose in a wood chipping machine, and died days later, where numerous physicians listed the insured's underlying heart disease as a significant contributing factor in his death).

10. 354 F. App'x 183 (5th Cir. 2009).

11. *Id*. at 187.

12. *Id*. at 190.

13. *Id*.

14. NHTSA, Traffic Safety Facts, 2008 Data, *available at* http://www-nrd.nhtsa.dot.gov/Pubs/811155.PDF (accounting for fatalities involving a driver with a blood alcohol content of .08 or higher).

15. *Id*.

16. *Id*.

17. 587 F.3d 323 (6th Cir. 2009).

offered by Zurich, concluding those figures did not support the theory that injury or death was "highly likely" to occur from drunk driving.[18] The court further identified other activities that contribute to serious motor vehicle accidents, such as driving while fatigued or text messaging.[19] Rejecting Zurich's reasonable foreseeability test as tantamount to an unwritten exclusion in Kovach's policy, the court adopted, for the first time in the Sixth Circuit, the mixed objective/subjective reasonable person standard announced in *Wickman v. Northwestern National Insurance. Co.*[20] to define "accident" by reasonable expectations of the individual insured.

In a similar claim under an ERISA accident policy without an intoxication exclusion, the Tenth Circuit in *LaAsmar v. Phelps Dodge Corp. Life, Accidental Death & Dismemberment & Dependent Life Insurance Plan*,[21] considered many of the same arguments employed in *Kovach*, but opted not to adopt the standard set out in *Wickman*. Ruling in favor of the insureds, the court held the "sole cause" of death was the car crash, not their blood alcohol levels, and strongly urged insurers to include intoxication exclusions in their policies,[22] lest policyholders continue to guess regarding the coverage they purchased.[23]

An insurer was successful in applying a somewhat unusual misdemeanor exclusion in *Hansen v. Liberty Life Assurance Co. of Boston*.[24] The insured died in a single vehicle collision with a blood alcohol level of .216%. Ohio makes it a misdemeanor to operate a vehicle with "a concentration of eight-hundredths of one per cent or more by weight per unit volume of alcohol in the person's whole blood."[25] The court concluded the insured demonstrated an indifference to the risks of drinking and driving and her conduct constituted a misdemeanor under Ohio law, and upheld the insurer's denial of accident benefits.[26]

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18. *Id*. at 330, 335–36.

19. *Id*. at 335–36.

20. 908 F.2d 1077, 1088 (1st Cir. 1990) (holding the standard is "whether a reasonable person, with background and characteristics similar to the insured, would have viewed the injury as highly likely to occur as a result of the insured's intentional conduct").

21. 605 F.3d 789 (10th Cir. 2010).

22. Of course, many insurers do include such exclusions, particularly in policies issued more recently.

23. *Id*. at 814. *See also* Sanchez v. Life Ins. Co. of N. Am., 704 F. Supp. 2d 587 (W.D. Tex. 2009), *aff'd*, Sanchez v. Life Ins. Co. of N. Am., No. 09-51010, 2010 WL 3447723 (5th Cir. Sept. 1, 2010) (upholding claim denial but expressing discomfort with forseeability standard); Danouvong *ex rel*. Estate of Danouvong v. Life Ins. Co. of N. Am., 659 F. Supp. 2d 318 (D. Conn. 2009) (rejecting forseeability test for drunk driving accidents).

24. Hansen v. Liberty Life Assurance Co. of Boston, No. 3:08 CV 01835, 2010 WL 908477, at *3 (N.D. Ohio Mar. 12, 2010).

25. *Id*. at *3.

26. *Id*. at *5.

E. *Medical Error*

The question of possible physician assisted suicide surfaced in connection with a medical error in the administration of a paralytic drug. An ERISA claimant sued for accidental death benefits in *Cook v. Hartford Life and Accident Insurance Co.*,[27] after the insured was given Norcuron (vercuronium) during his treatment for end-stage liver failure. The treating physician claimed he administered Norcuron to relieve severe agonal respirations. The insured's death was immediate, but deemed due to cirrhosis by his treating physician. However, the claimant argued the death should be covered since the medical examiner identified the insured's cause of death as "respiratory arrest due to (or as a consequence of) vecuronium administration," opining the death was the result of a deliberately inappropriate use of the drug by a physician and labeling the manner of death as a homicide.[28] Finding Hartford's denial "was the result of a principled reasoning process and supported by evidence," the court upheld application of the policy's exclusion for loss resulting from medical or surgical treatment of a sickness or disease.[29] In so doing, the court concluded the insurer had thoroughly considered the conflicting causes of death, all medical records, an affidavit submitted by the insured's widow and the State Board of Medicine Consent Order supporting the treating physician's position that he did not intentionally end his patient's life.[30]

III. DISABILITY INSURANCE

A. *Dictionary of Occupational Titles*

This year the Eighth Circuit joined the Sixth Circuit and held, as a matter of first impression, that "regular occupation" means the insured's occupation as it is performed in a typical setting in the general economy,[31] in contrast to the Tenth and Third Circuits, which have held that it depends

27. Cook v. Hartford Life & Accident Ins. Co., C.A. No. 3:09-1002, 2010 WL 3259414 (S.D. W.Va. Aug. 18, 2010).

28. *Id.* at *2.

29. *Id.* at *7.

30. *Id.* at *8–9. *See also* Kendel v. Zurich Am. Ins. Co., No. 4:09CV00040 SWW, 2009 WL 3063363 (E.D. Ark. Sept. 21, 2009) (medical error during surgery by wrongfully administering paralytic drug rather than prescribed medication fell within the exclusion for a loss that was ". . . caused by, or contributed to, or resulted from: . . . 4. Illness, disease or infection," because the insured needed to have the surgery and died as a result of treatment for her medical condition).

31. *See, e.g.*, Schmidlkofer v. Directory Distrib. Ass'n, Inc., 107 F. App'x 631, 633–34 (6th Cir. 2004) (insurer reasonably interpreted "regular occupation" to mean the insured's occupation as it is performed in a typical work setting in the general economy).

on a claimant's actual job duties.[32] In *Darvell v. Life Insurance Co. of North America*,[33] the Eighth Circuit upheld the defendant's denial of long-term disability benefits to the plaintiff after finding, among other things, that the medical data did not show that he was unable to perform the material duties of his regular occupation, as defined by the Department of Labor's Dictionary of Occupational Titles (DOT). Since the policy did not define "regular occupation," the defendant interpreted this term "as referring to the duties that are commonly performed by those who hold the same occupation as defined by the DOT."[34] The Eighth Circuit held the defendant's denial of benefits was not an abuse of discretion after concluding its interpretation of "material duties of his . . . regular occupation" was not contrary to the clear language of the plan.[35]

B. *Preexisting Conditions*

This year's cases on this topic addressed whether insurers can deny long-term disability benefits for conditions that recur after a claimant's coverage lapses under their employer's ERISA plan. In *Jones v. Unum Provident Corp.*,[36] the plaintiff received long-term disability benefits after being hospitalized for major depression and inability to work. Although her treating psychiatrist cleared her to return to work full-time, plaintiff returned to work only on a part-time basis and then subsequently stopped working. Later, her employer changed group disability insurance providers to Unum. After returning to work for a short period, the plaintiff stopped working due to an infected dog scratch and filed a new long-term disability claim with Unum based on a recurrence of her major depression and other ailments. Unum denied her claim based on a preexisting condition clause in the policy.

The district court found Unum did not abuse its discretion in determining plaintiff's coverage had lapsed. On appeal, the Eighth Circuit found that "[u]nlike individual disability insurance plans, employer-provided group plans condition coverage on the insured employer's relationship with an employee."[37] The policy at issue provided that "insurance ends

32. *See, e.g.*, Bishop v. Long Term Disability Income Plan of SAP Am., Inc., 232 F. App'x 792, 794–95 (10th Cir. 2007) (insurer was required to consider claimant's actual job duties in determining the "essential duties" of his occupation).

33. 597 F.3d 929 (8th Cir. 2010).

34. *Id.* at 935.

35. *Id. See also* Cook v. Standard Ins. Co., No. 6:08-cv-759-Orl-35DAB, 2010 WL 807443 (M.D. Fla. Mar. 4, 2010) (insurer was entitled to "look at the way the occupation is generally performed in the national economy" and, therefore, can rely exclusively on DOT's classification).

36. 596 F.3d 433 (8th Cir. 2010).

37. *Id.* at 437.

when a person is no longer an active, full-time employee or stops active work, defined as working full-time."[38] Based on the terms of the policy, the Eighth Circuit affirmed the district court's decision after concluding coverage had lapsed more than six weeks prior to plaintiff's return to full time work and, therefore, "her . . . disability claim was not covered because of the preexisting condition clauses of the policy."[39]

C. *Subjective versus Objective Evidence*

This year, courts continued to struggle with subjective and objective evidence in disability insurance cases. In *Eppler v. Hartford Life and Accident Insurance Co*.,[40] the Ninth Circuit, after a de novo review, affirmed the district court's decision granting summary judgment to Hartford, which had denied disability benefits to the plaintiff because his subjective complaints were unsupported by the record. The court noted that "[p]laintiff's complaints of excessive sleepiness and cognitive difficulties" were not supported by objective evidence and were contradicted in tests showing that at least one ailment, sleep apnea, had improved with surgery.[41] Moreover, the court found the plaintiff's credibility had been "undermined" by inconsistencies exposed by surveillance video conducted by Hartford that showed the plaintiff was exaggerating "the severity of his physical limitations" related to other his other complaints.[42] In addition, the plaintiff's own physicians failed to corroborate his subjective complaints.

Similarly, the Eighth Circuit in *Manning v. American Republic Insurance Co*.,[43] evaluated whether a plan could require the use of only objective evidence in evaluating a claim. The court affirmed the district court's grant of summary judgment in favor of American Republic because plaintiff, who claimed to be suffering from migraine headaches, anxiety and high blood pressure, failed to provide any objective evidence that she suffered from a medically certified health condition, which the plan at issue required be "documented by objective disabling signs and symptoms."[44] American Republic rejected the plaintiff's use of a physician's opinion that was both

38. *Id*.

39. *Id. See also* Estate of Blanco v. Prudential Ins. Co. of Am., 606 F.3d 399 (7th Cir. 2010) (plan's preexisting condition exclusion clause precluded participant's long-term disability claim); Christy v. Sun Life Assurance Co. of Canada, No. 5:09-CV-78, 2009 WL 4785459 (W.D. Ky. Dec. 9, 2009) (plan's denial of plaintiff's claim based on preexisting condition exclusion was not arbitrary or capricious).

40. 359 F. App'x 826 (9th Cir. 2009).

41. *Id*. at 827–28.

42. *Id*. at 828. *See also* Aluisi v. Elliot Mfg. Co., 672 F. Supp. 2d 1068 (E.D. Cal. 2009) (court entered judgment on behalf of defendant where the objective findings in surveillance video contradicted Plaintiff's subjective complaints of pain and disability).

43. 604 F.3d 1030 (8th Cir. 2010).

44. *Id*. at 1036.

contradictory (opining both that the plaintiff was capable and incapable of work) and provided no objective information.[45] The court concluded "the administrator reasonably interpreted the plan to require" objective evidence.[46]

Other courts have addressed the question of whether, in regard to certain conditions, subjective evidence is the only evidence available and must therefore be given greater weight. In *Diamond v. Reliance Standard Life Insurance*,[47] the plaintiff claimed to be disabled as a result of numerous ailments, including fibromyalgia and Bechet's disease (for which the court noted there was no laboratory test to determine its existence). On administrative appeal, Reliance arranged an independent physician review of the plaintiff's medical records and upheld its decision to terminate benefits.[48] The court acknowledged that it was not necessarily an abuse of discretion for an administrator to rely more on nonexamining physicians than treating physicians, but held that when the chief symptoms of the illnesses at issue are subjective in nature "due weight should be given to the treating physician's finding since that physician has the most experience with the patient and his or her history with the symptoms of the illness."[49] In finding for the plaintiff, the court also held Reliance's failure to conduct a more current physical examination of the plaintiff rendered its denial of benefits "less credible."[50] Due to difficulties in assessing an insured's limitations due to fibromyalgia, some plans are including durations of coverage for this condition, as they have in the past for mental disorders.[51]

D. *Surrogate Coverage*

In *MercyCare Insurance Co. v. Wisconsin Commissioner of Insurance*,[52] an insured, who had agreed to act as a gestational carrier by carrying a child for other parents, was denied maternity coverage under a group disability policy that excluded "surrogate mother services," but failed to define the term. After the insured filed a complaint with the Office of the Commissioner of Insurance (OCI), the plaintiff filed its new group disability policy insurance form with the OCI for approval. The new policy defined the term "surrogate mother" as:

45. *Id.* at 1040.
46. *Id.* at 1042.
47. 672 F. Supp. 2d 530 (S.D.N.Y. 2009).
48. *Id.* at 533–34.
49. *Id.* at 537.
50. *Id.* at 538.
51. *See, e.g.*, Mobayen v. Standard Ins. Co., 358 F. App'x 893 (9th Cir. 2009) (Ninth Circuit affirmed plan's termination of long-term disability benefits under the policy which provided fibromyalgia benefits for only up to eighteen months).
52. 786 N.W.2d 785 (Wis. 2010).

> Surrogate mother means a woman who, through in vitro fertilization or any other means of fertilization, gives birth to a child which she may or may not have a genetic relationship to, or an individual who provides a uterus for the gestation of a fertilized ovum obtained from a donor when the child will be parented by someone other than the woman who gives birth.[53]

The OCI disapproved the new policy after concluding the surrogate mother exclusion violated the mandated maternity benefits of Wis. Stat. § 632.895(7) and was misleading under Wis. Stat. § 631.20 because it unfairly and discriminatorily limited coverage based on the method of conception.[54] The trial court reversed the OCI after finding § 632.895(7) clearly and unambiguously permitted plaintiff to exclude maternity care for otherwise covered persons who were serving as surrogate mothers so long as it was "applied uniformly to all covered persons."[55]

The court of appeals certified the question. The Wisconsin Supreme Court reversed and held that the OCI's statutory interpretation was reasonable, its decision was entitled to "due weight deference," and it properly disapproved the surrogacy provisions in the new policy because an insurer cannot exclude routine maternity services to surrogate mothers that are otherwise covered under the policy.[56]

E. *Treating Physician Rule*

Contradictory opinions of treating and reviewing physician continue to yield mixed results. Courts decline to invoke the treating physician rule, which requires plan administrators to give special deference to the opinions of treating physicians, but still caution that insurers are not allowed to disregard a treating physician's opinion. For example, in *Cox v. CIGNA Group Insurance*,[57] CIGNA addressed all of the medical evidence submitted by the plaintiff's treating physicians in a single sentence: "According to the medical information on file, the medical evidence submitted does not support an impairment to preclude you from working for wage or profit for the rest of your life as defined in the policy."[58] In granting the plaintiff's motion for summary judgment, the court found CIGNA acted arbitrarily and capriciously by disregarding the plaintiff's treating physicians' opinions, finding that CIGNA's denial letter "merely recounted the technical contents of [plaintiff's] various medical reports, without any meaningful analysis."[59]

53. *Id.* at 791.
54. *Id.* at 804.
55. *Id.* at 792.
56. *Id.* at 794.
57. Cox v. CIGNA Group Ins., C.A. No. 09–82-JBC, 2010 WL 724640 (E.D. Ky. Feb. 24, 2010).
58. *Id.* at *2.
59. *Id.*

The court explained that although a plan administrator is "not obligated to accord special deference to the opinions of treating physicians,"[60] a defendant cannot "arbitrarily refuse to credit [plaintiff's] reliable evidence, including the opinions of a treating physician."[61] The court further explained that the defendant "was obliged to provide some explanation" and could not merely dismiss plaintiff's claim in one conclusory sentence.[62]

Courts have also discounted the opinions of treating physicians when they are conclusory and not supported by a reasoned analysis. In *Gipson v. Administrative Committee of Delta Air Lines, Inc.*,[63] the plaintiff sought long-term disability benefits under an ERISA plan due to fibromyalgia, depression, and headaches. The plaintiff's treating physician opined she was totally disabled and should be excluded from even part-time employment. After conducting an IME, the consulting physicians opined there was nothing to preclude the plaintiff from returning to part-time sedentary work up to four hours a day provided she received time off due to headaches. In affirming the district court's decision that the denial of benefits was not arbitrary, the Eleventh Circuit held that the plan administrator was not required to give deference to the treating physician's opinion, particularly where, as here, it "was conclusory and failed to provide any basis for the decision that [plaintiff] was unable to work."[64] While the court accepted the plaintiff's medical diagnoses, it found her illnesses did not explain the limitations identified by her treating physician.[65] The appellate court further found the plan administrator could have rejected the treating physician's opinion when the consulting physicians' opinions thoroughly explained why the plaintiff was capable of some level of work and contradicted the treater's opinion.[66]

60. *Id.* at *3 (citing Black & Decker Disability Plan v. Nord, 538 U.S. 822, 825, 834 (2003)).

61. *Id.*

62. *Id. See also* MacLeod v. Reliance Standard Life Ins. Co., Civil No. 09-cv-118-JD, 2010 WL 597005 (D.N.H. Feb. 18, 2010) (plan's decision to deny long-term disability benefits was arbitrary where it gave greater weight to reviewing physician's report that was cursory and contained errors).

63. 350 F. App'x 389 (11th Cir. 2009).

64. *Id.*

65. *Id.* at 393.

66. *Id. See also* Richards v. Hewlett-Packard Corp., 592 F.3d 232 (1st Cir. 2010) (while evidence supported the diagnoses of fibromyalgia or chronic fatigue immune dysfunction, plan properly adopted the opinion of a paper consulting physician that the participant could engage in sedentary work; consulting opinion was supported by substantial evidence while that of the treating physician was based on a shaky foundation); Darvell v. Life Ins. Co. of N. Am., 597 F.3d 929 (8th Cir. 2010) (administrator did not abuse its discretion by ignoring treating physician's opinion that failed to provide reliable objective evidence of testing or other proof to support the finding of long-term disability); Cooper v. Hewlett-Packard Co., 592 F.3d 645 (5th Cir. 2009) (appellate court upheld plan's termination of disability benefits where there was conflicting evidence by plaintiff's treating physicians as to whether she was totally disabled and capable of gainful employment).

F. *Under the Care of a Physician*

In *Cox v. The Prudential Insurance Co. of America*,[67] the court looked at whether failure to attend Alcoholics Anonymous (AA) meetings violated a policy's "under a physician's care" requirement. The plaintiff, a long time Coors Brewing Company employee, suffered from seizures as a result of drinking a case of beer per day. Prudential had the case evaluated by a psychiatrist and a neurologist who concluded the plaintiff did not have any neurological impairment and that if the plaintiff was fully abstinent from alcohol, there would be "no restrictions or limitations on his employability."[68] The psychiatrist also opined that "appropriate" treatment for the plaintiff's alcoholism included intense AA 12-step program attendance and seeing a physician regularly, which plaintiff did not do.[69] Prudential determined his failure to attend AA meetings meant he was not "considered to be engaged in regular and appropriate care," in accord with the policy's requirement that a claimant be under the regular care of a physician.[70] The court held Prudential did not act arbitrarily or capriciously in terminating benefits because intensive AA attendance was appropriate medical care based on the opinion of both its psychiatrist and one of the plaintiff's chemical dependency physicians, who at one point made attendance at such meetings a condition of his return to work.[71]

IV. ERISA

A. *Attorney Fees*

In *Hardt v. Reliance Standard Life Insurance Co.*,[72] the U.S. Supreme Court examined ERISA's attorney fee provision and, resolving a split among the circuits, rejected the use of the "prevailing party" test for awarding attorney fees, noting the statute provides courts with discretion to award "a reasonable attorney's fee and costs of action to either party."[73] The Court also

67. Cox v. Prudential Ins. Co. of Am., C.A. No. 09-cv-00576-RPM, 2010 WL 194940, at *1 (D. Colo. Jan. 19, 2010).
68. *Id.*
69. *Id.*
70. *Id.* at *2.
71. *Id.* at *3. *See also* Barinova v. ING, 363 F. App'x 910 (3d Cir. 2010) (claimant not under "regular and appropriate care" which should have included more frequent intensive psychotherapy); Hoskins v. Bayer Corp. & Bus. Servs. Long Term Disability Plan, 362 F. App'x 750 (9th Cir. 2010) (plaintiff failed to provide evidence she was "under the regular care of a physician").
72. 130 S. Ct. 2149 (2010).
73. 29 U.S.C. § 1132(g)(1) provides: "In any action under this subchapter (other than an action described in paragraph (2)) by a participant, beneficiary, or fiduciary, the court in its discretion may allow a reasonable attorney's fee and costs of action to either party." 29 U.S.C. § 1132(g)(1).

acknowledged that the American Rule against fee awards absent in statute or contract is a "bedrock principle" that must be considered. "Accordingly, a fees claimant must show 'some degree of success on the merits' before a court may award attorney's fees under § 1132(g)(1)."[74] "Trivial success on the merits" or a party's "purely procedural victory" will not satisfy an entitlement to fees.[75] However, the Court specifically rejected the plan's argument that a remand of a claim decision to the plan administrator does not amount to "some success on the merits" and noted the remand ultimately led to the plan's decision to award benefits,[76] such that plaintiff "achieved far more than trivial success on the merits or a purely procedural victory."[77] The Court concluded the district court properly exercised its discretion to award the plaintiff her attorney fees and costs.[78]

While *Hardt* rejected the requirement of being a "prevailing party" in favor of showing "some degree of success on the merits," the Court did not establish any rules or guidelines for determining when a court should or should not award fees and costs. Subsequently, the Fourth Circuit in *Williams v. Metropolitan Life Insurance Co.*,[79] and the Ninth Circuit in *Simonia v. Glendale Nissan/Infiniti Disability Plan*,[80] considered this issue and concluded district courts must consider the traditional five factors when deciding whether to award fees and costs to eligible parties under ERISA: (1) the degree of the opposing parties' culpability or bad faith; (2) the ability of the opposing parties to satisfy an award of fees; (3) whether an award of fees against the opposing parties would deter others from acting under similar circumstances; (4) whether the parties requesting fees sought to benefit all plan participants and beneficiaries and/or sought to resolve a significant legal question regarding ERISA; and (5) the relative merits of the parties' positions.[81]

In *Simonia*, the plan asserted a counterclaim for overpayments based on the plaintiff's receipt of Social Security benefits. When the Social Security Administration retroactively reduced the plaintiff's benefits and thereby eliminated the existence of any overpayment to the plaintiff, the

74. *Hardt.*, 130 S. Ct. at 2158 (citing Ruckelshaus v. Sierra Club, 463 U.S. 680, 694 (1983)).
75. *Id.*
76. *Id.* at 2159.
77. *Id.*
78. *Id.*
79. 609 F.3d 622 (4th Cir. 2010).
80. 608 F.3d 1118 (9th Cir. 2010).
81. *Williams*, 609 F.3d at 635 and *Simonia*, 608 F.3d at 1121. *See also Hardt*, 130 S. Ct. at 2158 n.8 ("We do not foreclose the possibility that once a claimant has satisfied [the some-degree-of-success-on-the-merits] requirement, and thus becomes eligible for a fees award under § 1132(g)(1), a court may consider the five factors adopted by the Court of Appeals . . . in deciding whether to award attorney's fees").

plan stipulated to the dismissal of its counterclaim. Without deciding whether the plan's voluntary dismissal qualified as "some degree of success on the merits," the court declined to award fees. The court found the plan acted in good faith and noted the plan's claim was meritorious at the time it was filed. The court concluded it "did not wish to deter others from acting" with similar good faith by awarding fees against a party that voluntarily dismissed its claim once it became clear the claim was no longer viable.[82]

In contrast, the Fourth Circuit in *Williams* concluded the balance of the five factors weighed in favor of an award of attorney fees. The court noted that the plan terminated the plaintiff's long-term disability benefits based on a single piece of evidence after previously approving her claims three times. While the district court did not find that the plan acted in bad faith, it characterized the plan as having been "more than merely negligent."[83]

In *Rote v. Titan Tire Corp.*,[84] the Eighth Circuit upheld the award of attorney fees incurred by a plaintiff in connection with her lawsuit, administrative proceedings pursuant to a court-ordered remand, and the subsequent court proceedings challenging the plan's benefit determination on remand. The plan argued the original court and administrative proceedings on remand were not part of the same "action" in which the district court entered judgment in favor of the plaintiff and, therefore, the plaintiff could not recover, in the context of the action before the court, her fees in connection with the earlier proceedings.[85] The Eighth Circuit observed that a remand order is not an appealable order because it is not considered final under 28 U.S.C. § 1291.[86] Consequently, the court concluded the action in which the district court awarded fees was a continuation of the two earlier proceedings and, therefore, the district court's fee award included fees incurred in the same "action" for purposes of a fee claim under ERISA.[87]

82. *Simonia*, 608 F.3d at 1122.

83. *Williams*, 609 F.3d at 636.

84. 611 F.3d 960 (8th Cir. 2010).

85. *See e.g.*, McGahey v. Harvard Univ. Flexible Ben. Plan, 685 F. Supp. 2d 181 (D. Mass. 2010). The court in *McGahey* rejected the plaintiff's request for fees associated with her administrative appeals citing "the lead of other federal circuits who have unanimously concluded that ERISA attorney's fees are categorically unavailable for expenses incurred while exhausting administrative remedies." *Id.* at 183. The decision in *McGahey* is distinguishable from the holding in *Rote* as the administrative proceedings that generated the fees in *McGahey* were not the result of a remand order. Rather, they were part of the plaintiff's initial exhaustion of her administrative remedies.

86. *Rote*, 611 F.3d at 965; *see also* Miller v. Monumental Life Ins. Co., 376 F. App'x 871, 874–75 (10th Cir. 2010).

87. *Rote*, 611 F.3d at 965.

B. *Conflict of Interest*

Courts continue to address structural conflicts of interest and their effects on ERISA claim decisions. In *Durakovic v. Building Service 32 BJ Pension Fund*,[88] the defendants were union pension, health and benefit funds, and also trusts administered equally by employee and employer representatives, as required by the Taft-Hartley Act.[89] As a matter of first impression, the Second Circuit held that funds so organized operate under a structural conflict of interest within the meaning of *Metropolitan Life Insurance Co. v. Glenn*.[90] The court held neither the existence of the trusts nor that of an equal number of employee representatives in those trusts negated the fact that the employer representatives evaluated claims and the entities they represented ultimately pay the claims allowed. Further, the court held that the equal presence of the employee representatives should be considered regarding how heavily to weigh the conflict of interest.[91] After weighing that conflict, the court concluded that the funds' decision was arbitrary and capricious in light of the defendants' vocational report which was "seriously and obviously flawed."[92]

The weight given to a structural conflict of interest and other case-specific factors can, of course, also lead to findings that plan administrators' decisions were arbitrary and capricious because they abused their discretion in making claim decisions. In *Austin v. Life Insurance Co. of North America*,[93] the court ordered the insurer to reinstate the plan participant's long-term disability benefits, retroactively and going forward. The court cited a Ninth Circuit decision for a laundry list of case-specific factors that it could consider, and acknowledged the Ninth Circuit's statement in *Abatie v. Alta Health & Life Insurance Co*.[94] that the district court makes something like a credibility determination when reviewing an ERISA benefits denial case.[95] The court found that the insurer, which was operating under a structural conflict of interest, failed to address the participant's Social Security award at all, improperly relied upon the participant's expressed desire to work on a part-time basis, required objective evidence that was not available, and failed to consider the lack of change in the participant's heart condition.[96]

88. 609 F.3d 133 (2d Cir. 2010).
89. 29 U.S.C. § 186(c)(5).
90. 554 U.S. 105 (2008).
91. *Durakovic*, 609 F.3d at 138–39.
92. *Id*.
93. Austin v. Life Ins. Co. of N. Am., No. CV 08–8445 PA (MANx), 2010 WL 1576718 (C.D. Cal. Apr. 13, 2010).
94. 458 F.3d 955, 965 (9th Cir. 2006).
95. *Austin*, 2010 WL 1576718, at *7.
96. *Id*. at *10–13.

C. *Fiduciary Duty*

Although most ERISA litigation involves a plan participant's entitlement to benefits, courts are also concerned with the methods used by insurers to pay plan benefits to participants. For example, a plan administrator's use of total control accounts (TCAs) for distributing death benefits, with personalized checkbooks beneficiaries can use to access some or all of the TCA funds, has been held by at least one court not to violate the plan administrator's fiduciary duties. In *Faber v. Metropolitan Life Insurance Co.*,[97] a putative class action, the beneficiaries of ERISA group life insurance welfare benefit plans asserted claims for breach of fiduciary duty and for injunctive relief, alleging MetLife did not disclose that it "retain[ed] and invest[ed] [TCA] proceeds for its own account," or that it only deposited the amount of death benefits into the TCA when a beneficiary presented a check for payment.[98] Accordingly, the beneficiaries claimed that MetLife improperly earned profits based on the interest it earned by investing the money in the TCAs. The court granted MetLife's motion to dismiss, holding that, because the beneficiaries "received all of the benefits to which they were entitled under the Plans," the beneficiaries failed to state a cause of action for breach of fiduciary duty under ERISA.[99]

MetLife's use of TCAs was also reviewed by the District Court of Nevada in *Clark v. Metropolitan Life Insurance Co.*,[100] although not in the ERISA context. There, the court found MetLife's description of its TCA "inherently deceptive" because it suggested that the account was either a money market account or associated with a money market account, even though the TCA was a money market settlement option, which is not a money market account. Ultimately, however, MetLife was granted summary judgment on plaintiff's breach of contract claim because she suffered no damages as a result of this "deception," but rather earned more on the account than she would have if the funds had been placed in a money market account.[101] The court further granted summary judgment to MetLife on the plaintiff's claim for breach of a special/confidential relationship, finding that the plaintiff did not place any special confidence in MetLife, there was no special relationship between the parties, and there was no evidence that MetLife had notice that the plaintiff was placing special confidence in its actions.

97. Faber v. Metropolitan Life Ins. Co., No. 08 Civ. 10588(HB), 2009 WL 3415369 (S.D.N.Y. Oct. 23, 2009).

98. *Id.* at *1–2.

99. *Id.* at *7.

100. No. 3:08-cv-00158-LRH-VPC, 2010 WL 3636194 (D. Nev. Sept. 10, 2010).

101. *Id.* at *3.

D. *Fiduciary–Proper Party*

Courts' decisions regarding whether certain defendants are ERISA fiduciaries, and therefore proper party defendants, continue to be guided by the terms of the plan and whether the parties have been apprised of the authority given to and the roles of various plan entities. In *Miller v. Mellon Long Term Disability Plan*,[102] the district court held that because the plan participant's claim was for the recovery of long-term disability benefits,[103] the only proper defendants were the plan and plan administrator, solely in its official capacity. Noting that the Third Circuit had not yet addressed the precise issue of whether the plan is the only proper defendant in such a suit to recover benefits, the court followed the reasoning in two Third Circuit decisions, *Graden v. Conexant Systems, Inc.*,[104] and *Hahnemann University Hospital v. All Shore, Inc.*[105] Specifically, the court held that a plan administrator sued solely in its official capacity may be directed to pay benefits only from plan assets and cannot be held individually liable, with certain exceptions, including when the plan administrator agreed to be financially liable, or when it owed a fiduciary duty it breached by denying a claim without justification.[106] In addition, the court held that the ERISA plan sponsor and its predecessors-in-interest were not fiduciaries because the participant merely alleged they had authority to remove members of the plan administrator and the plan sponsor's benefits investment committee. It similarly held that the plan manager, who had no discretionary authority regarding claims, and the claims administrator, who did not have final authority regarding claims, were not fiduciaries.[107]

In *Walker v. Kimberly-Clark Corp.*,[108] the court noted that although the Fifth Circuit had not addressed the issue of whether the plan is the only proper defendant in a suit for recovery of benefits, the Fifth Circuit had endorsed the approach of allowing a cause of action to stand against an employer where the employer is also the plan administrator, and it and the plan are "closely intertwined."[109] In applying this test, the court held

102. Miller v. Mellon Long Term Disability Plan, C.A. No. 09–1166, 2010 WL 2595568 (W.D. Pa. June 25, 2010).

103. 29 U.S.C. § 1132(a)(1)(B).

104. 496 F.3d 291 (3d Cir. 2007).

105. 514 F.3d 300 (3d Cir. 2008).

106. *Miller*, 2010 WL 2595568, at *26.

107. *Id.* at *26–27; *see also* Wilkins v. Sedgwick Claims Mgmt. Servs., Inc., No. 8:09-cv-1009-T-26TGW, 2010 WL 1837812, at *3 (M.D. Fla. May 2, 2010) (based on terms of summary plan description, claims administrator had discretionary authority regarding claim decisions, and was the proper party defendant).

108. Walker v. Kimberly-Clark Corp., No. 1:08CV146-SA-JAD, 2010 WL 611007 (N.D. Miss. Feb. 17, 2010).

109. *Id.* at *7.

that the plan participant failed to provide any evidence that the employer and the plan were "so intertwined that the employer is the true party in interest."[110]

Similarly, in *Health First Health Plans, Inc. v. Glatter*,[111] the court held that a plan beneficiary, to whom a third party tortfeasor paid a settlement, was not a plan fiduciary. The insurer sued for reimbursement for certain medical benefit payments related to the beneficiary's car accident, after the beneficiary received settlement proceeds from his tort claim against the individual who caused the accident.[112] The insurer alleged a claim for equitable relief and another claim for breach of fiduciary duty and legal damages under the plan's subrogation provisions. In granting the beneficiary's motion to dismiss the breach of fiduciary duty claim, the court found that the settlement proceeds were not "plan assets" under ERISA and that the subrogation provision the insurer relied upon did not "clearly apprise Defendant of his fiduciary status."[113] For both reasons, the court rejected the insurer's claim that the plan beneficiary was also a plan fiduciary.

E. *Post-*Glenn *Discovery*

In the wake of *Glenn*,[114] courts continue to address the scope of discovery. For example, the Tenth Circuit in *Murphy v. Deloitte & Touche Group Insurance Plan*,[115] noted the lack of clarity following *Glenn* due to its conflicting instructions to district courts to assess the effect of a dual role conflict of interest while prohibiting extrarecord discovery. The court noted that without being able to consider material beyond the administrative record, it may not be able to fulfill its judicial task of allocating the proper weight to the conflict of interest.[116] Therefore, the court determined that discovery related to the scope and impact of a dual rule conflict of interest may at times be appropriate.[117] The court also noted that the party seeking discovery is not allowed to engage in an unwieldy, burdensome or speculative

110. *Id.*; *see also* Leonardo v. Health Care Serv. Corp., No. 09 C 1588, 2010 WL 317520, at *4 (N.D. Ill. Jan. 20, 2010) (noting that the Seventh Circuit recognized the same exception for plan administrators closely intertwined with plans they administer, but required a hearing on the issue, because it could not make a determination on the record before it).

111. Health First Health Plans, Inc. v. Glatter, No. 6:09-cv-1547-Orl-31GJK, 2009 WL 3367123 (M.D. Fla. Oct. 15, 2009).

112. *Id.* at *1.

113. *Id.* at *3; *see also* Kenseth v. Dean Health Plan, Inc., 610 F.3d 452, 465 (7th Cir. 2010) (ERISA plan administrator could not, on the basis of *respondeat superior* for a nonfiduciary customer service representative's representation regarding plan coverage, be held liable for breach of fiduciary duty).

114. 554 U.S. 105 (2008).

115. 619 F.3d 1151 (10th Cir. 2010).

116. *Id.* at 1158.

117. *Id.* at 1162.

fishing expedition.[118] Rather, that party has the burden of showing its propriety before discovery will be allowed.[119]

In *Kruk v. Metropolitan Life Insurance Co., Inc.*,[120] the plaintiff sought to compel the production of MetLife's internal operating guidelines that set procedures for appeals of coverage under the disability plan. The court, after reviewing ERISA's disclosure obligations,[121] held that the regulations do not require a plan or its administrator to produce an entire claims manual, but do require a plan to provide a claimant with access to all the procedures that did apply, should have applied, or could have applied.[122] In *Garvey v. Piper Rudnick LLP Long Term Disability Insurance Plan*,[123] after the employee received short-term disability benefits funded by his employer, he applied for long-term disability benefits, which the plan's insurer and administrator funded.[124] The court initially granted the employee's motion to compel discovery with respect to an alleged procedural defect in the insurer's long-term disability benefit determination based on its conflict of interest. However, when the court learned the employee's representation that the insurer also granted the employee the short-term disability benefits for which it was not the payor was incorrect, it vacated its decision to allow the discovery.[125] The court reasoned that "a prima facie showing of good cause to believe that limited discovery will reveal a procedural defect" in the insurer's decision no longer existed.[126]

As courts continue to balance the efficient resolution of ERISA claims and the need for "the discovery of relevant information," they are also allowing limited depositions, as did the court in *Baxter v. Sun Life Assurance Co. of Canada*.[127] In *Baxter*, the court tailored the deposition of a claims consultant "solely to the issue of the structural conflict of interest and its effect."[128] Similarly, while the court in *Kagan v. UNUM Provident*[129] noted that "there is no carte blanche to discover evidence outside the [administrative] record," the court still allowed the plaintiff to conduct a Rule 30(b)

118. *Id* at 1163.
119. *Id*.
120. 267 F.R.D. 435 (D. Conn. 2010).
121. 29 C.F.R. § 2560.
122. *Kruk*, 267 F.R.D. at 441.
123. Garvey v. Piper Rudnick LLP Long Term Disability Ins. Plan, No. 08 C 1093, 2009 WL 4730963 (N.D. Ill. Dec. 8, 2009).
124. *Id*. at *1.
125. *Id*. at *2–3.
126. *Id*. at *2.
127. 713 F. Supp. 2d 766, 774 (N.D. Ill. 2010).
128. *Id*. at 773.
129. Kagan v. UNUM Provident, No. 03 Civ. 8130(KMK)(GAY), 2009 WL 3486938, at *1 (S.D.N.Y. Oct. 29, 2009).

(6) deposition of the insurer,[130] and directed the plan administrator to answer the employee's interrogatories regarding the alleged conflict. In *Branch v. Life Insurance Co. of North America*,[131] the court allowed the deposition of the insurer's lead medical director, but limited the scope to the insurer's internal procedures because they were directly relevant to the conflict issue and to questions regarding the director's own review of the plaintiff's claim.[132] The court would not allow the scope to include the director's prior experience with a separate and unrelated insurance company because it believed that topic to be irrelevant to the structural conflict issue.[133] Similarly, in *Bair v. Life Insurance Co. of North America*,[134] the court noted that limited discovery has been permitted to demonstrate and probe conflicts of interest as a factor in reviewing benefit decisions and, therefore, allowed the plaintiff to depose the defendant's appeal claim manager, but restricted the scope to the conflict of interest issues.[135] In contrast, in *Pretty v. Prudential Insurance Co. of America*,[136] the court denied the participant's request to depose an insurer's representative because she failed to point to any specific evidence in the administrative record to support a conclusion that there was a reasonable chance that permitting her to take the deposition would enable her to make a good cause showing, which the court noted was a prerequisite to extrarecord discovery.[137]

F. *Preemption*

1. Discretionary Clauses

In *Hancock v. Metropolitan Life Insurance Co.*,[138] the Tenth Circuit ruled that ERISA preempted a state insurance regulation which banned reservation-of-discretion clauses, except for those in plans governed by ERISA.[139] The court found that the regulation, which authorized the use of a discretion-granting clause in an ERISA-regulated policy so long as the policy disclosed certain matters and conformed to other form requirements, was specifically directed toward entities engaged in insurance, but did not substantially affect the risk pooling arrangement between the insurer and the insured.[140]

130. Fed. R. Civ. P. 30(b)(6).
131. Branch v. Life Ins. Co. of N. Am., No. 4:09-CV-12 (CDL), 2009 WL 3781217 (M.D. Ga. Nov. 11, 2009).
132. *Id.* at *4.
133. *Id.*
134. 263 F.R.D. 219 (E.D. Pa. 2009).
135. *Id.* at 226.
136. 696 F. Supp. 2d 170 (D. Conn. 2010).
137. *Id.* at 184.
138. 590 F.3d 1141 (10th Cir. 2009).
139. *Id.* at 1148.
140. *Id.* at 1149.

In short, the court found that the state regulation related to the form, but not the substance of, an ERISA plan. As a result, the law did not "regulate insurance" and failed to satisfy the "relating to insurance" test established by the Supreme Court in *Kentucky Ass'n of Health Plans v. Miller*,[141] such that it was preempted.[142] Significantly, the court further noted: "If Rule 590-218 imposed a blanket prohibition on the use of discretion-granting clauses, we would have a different case. Two circuits have held that such a prohibition substantially affects risk pooling."[143]

2. State Law Claims–Wrongful Termination

In *Flagg v. Ali-Med, Inc.*,[144] the plaintiff asserted state statutory and common law claims, alleging he was wrongfully terminated so that his former employer could deny family medical benefits to his spouse. The defendant removed, arguing the plaintiff's claims were completely preempted by ERISA. After reviewing the plaintiff's state law claims, the court held the claims were not completely preempted because they did not "relate to" an employee benefit plan and he was not seeking to recover benefits due to him under the terms of his plan or to enforce his rights under the terms of the plan.[145] In fact, the court noted that the plaintiff's medical insurance co-terminated with his employment and, therefore, he no longer had any rights under any ERISA plan.[146]

G. *Standard of Review*

1. Conflict Between Policy and SPD–Policy Controls

Standard of review disputes often arise from the parties' conflicting conclusions regarding the legal effect of the "plan documents," which typically consist of the policy and the summary plan description (SPD). Courts continue to "follow the policy" to resolve these conflicts. For example, in *Jobe v. Medical Life Insurance Co.*,[147] the insurance policy did not grant discretionary authority to the plan administrator, but the SPD did. The district court agreed with the plan administrator and held the language of the SPD controlled, finding the SPD to be a part of the plan documents and not an amendment thereto. The Eighth Circuit disagreed, holding that a grant of discretionary authority, appearing only in an SPD, does *not* vest an

141. 538 U.S. 329 (2003).

142. *Hancock*, 590 F.3d at 1149.

143. *Id*.

144. Flagg v. Ali-Med, Inc., C.A. No. 10–10984-WGY, 2010 WL 3034217 (D. Mass. July 30, 2010).

145. *Id*. at *4.

146. *Id*.

147. 598 F.3d 478 (8th Cir. 2010).

administrator with discretion where the policy provides a mechanism for amendment and also disclaims the power of the SPD to alter the plan.[148] The court further noted that to allow an SPD to control under these facts would endorse the practice of allowing an employer to subsequently issue an SPD for the purpose of filling in missing policy terms with ones favorable to it.[149]

In *Ringwald v. Prudential Insurance Co. of America*,[150] another Eighth Circuit decision, the language granting discretionary authority also appeared only in the SPD, but not the policy. After reviewing the terms of the policy, which did not include a provision governing amendments, the court found there was no basis for concluding that the purported grant of discretion in the SPD could be a procedurally proper amendment of the policy.[151] Therefore, following its holding in *Jobe*, the court held that the policy's failure to grant discretion resulted in the default de novo standard of review.[152]

In *Lafferty v. Providence Health Plans*,[153] the policy granted discretion to the administrator, but the SPD was silent on this issue. The district court, following the precedent of the Ninth Circuit and the majority of other jurisdictions, held the policy language controlled because language contained in a policy, but not in an SPD, does not create a material conflict.[154] The court noted that equating silence in an SPD with conflict would necessarily reduce the SPD to an absurd result because the purpose of an SPD is to summarize, not to recite, the terms and conditions of the policy.[155]

2. "Downright Unreasonable"

The Seventh Circuit recently revisited the phrase "downright unreasonable," used in *Donato v. Metropolitan Life Insurance Co.*,[156] to describe the "arbitrary and capricious" standard of review. In *Holmstrom v. Metropolitan Life Insurance Co.*,[157] the court cautioned against what it viewed as a common misunderstanding of that term, stating it should represent a shorthand expression for the vast body of law applying the arbitrary and capricious standard of review and should not be interpreted as a requirement to show that "only a person who had lost complete touch with reality would have

148. *Id.* at 484.
149. *Id.* at 485.
150. 609 F.3d 946 (8th Cir. 2010).
151. *Id.* at 949.
152. *Id.*
153. 706 F. Supp. 2d 1104 (D. Or. 2010).
154. *Id.* at 1111.
155. *Id.*
156. 19 F.3d 375, 380 (7th Cir. 1994).
157. 615 F.3d 758 (7th Cir. 2010).

denied benefits."[158] At least within the Seventh Circuit, counsel for ERISA plan administrators are now on notice that the phrase "downright unreasonable" may no longer have the persuasive effect it once had.

3. Procedural Irregularities

Even when an ERISA-governed policy grants discretionary authority, some courts continue to apply a de novo standard of review if plan administrators engage in "procedural irregularities." In *LaAsmar v. Phelps Dodge Corp. Life, Accidental Death & Dismemberment & Dependent Life Insurance Plan*,[159] the plan administrator took 170 days to decide the claimant's administrative appeal, thereby failing to comply with the time limits set by the plan and ERISA. The Tenth Circuit stripped the plan administrator of its discretionary authority and reviewed the decision under the de novo standard because, in its opinion, the administrator was "not acting within the discretion provided by the Plan."[160] In *Lafferty v. Providence Health Plans*,[161] the court stripped the plan administrator of its discretion because it found the plan administrator's procedural irregularities in the claim review process, such as allowing individuals involved in the initial claim review to be involved in subsequent levels of appeal, "flagrantly" violated ERISA and amounted to acts disregarding ERISA's underlying purposes.[162] These decisions, however, are tempered by the Supreme Court's holdings in *Conkright v. Frommert*,[163] a pension benefit case wherein the Court acknowledged that plan administrators are allowed to make mistakes and held that a single, honest mistake in plan interpretation does not justify stripping deference from a plan administrator.[164] The Court expressly upheld the decisions and principles established by *Firestone* and *Glenn* which it found further promote ERISA's purposes of efficiency, predictability, and uniformity.[165] The Court further clarified that applying a deferential standard of review does not mean the plan administrator will prevail on the merits. Rather, it means only that the plan administrator's interpretation of the plan "will not be disturbed if reasonable."[166]

158. *Id.* at n.5.
159. 605 F.3d 789 (10th Cir. 2010).
160. *Id.* at 799.
161. 706 F. Supp. 2d 1104 (D. Or. 2010).
162. *Id.* at 1111–12.
163. 130 S. Ct. 1640 (2010).
164. *Id.* at 1644.
165. *Id.* at 1649; *see also* Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101 (1989); Metro. Life Ins. Co. v. Glenn, 554 U.S. 105 (2008).
166. *Conkright*, 130 S. Ct. at 1651 (quoting *Firestone*, 489 U.S. at 111).

V. HEALTH INSURANCE

A. *Actual Charges*

This year, several courts examined the meaning of the term "actual charges" in health insurance policies, with varying results. In *Ward v. Dixie National Life Insurance Co.*,[167] the Fourth Circuit examined the term both before and after the South Carolina legislature enacted a statute which defined it.[168] The case began as a class action on behalf of all South Carolina residents insured under supplemental cancer polices, wherein the insurer promised to pay the "actual charges" of cancer treatment. Initially, the insurer paid the actual charges on the full list price of the healthcare services. When the insurer began to base actual charges on the lesser payment medical providers received, the plaintiffs filed suit. The district court initially granted summary judgment in favor of the insurer, but the Fourth Circuit reversed finding the term "actual charges" ambiguous, and remanded the case back to the district court to enter judgment on the breach of contract claim in favor of the plaintiffs.

Before the district court could take action, however, the South Carolina legislature passed a statute which defined "actual charges" for all insurance policies of the type at issue in the manner advocated by the insurers. The insurer moved for summary judgment again, arguing that the new statute prohibited it from paying "actual charges" as defined by the plaintiffs. The district court held the new statute did not apply retroactively to the lawsuit and awarded the plaintiffs almost $8 million in damages. The Fourth Circuit affirmed, explaining that, under the presumption against statutory retroactivity, "courts assume that statutes operate prospectively only, to govern future conduct and claims, and do not operate retroactively, to reach conduct and claims arising before the statute's enactment."[169]

While two district courts, the courts in *Pedicini v. Life Insurance Co. of Alabama*[170] and *Smith v. Life Investors Insurance Co. of America*,[171] found that the term "actual charges" was ambiguous because it could reasonably be construed to have two different meanings, the Eleventh Circuit reached a different conclusion on this issue. In *Philadelphia American Life Insurance Co. v. Buckles*,[172] it too examined the term "actual charges incurred," but found that the term was not ambiguous. There, the plaintiff sought cover-

167. 595 F.3d 164 (4th Cir. 2010).
168. S.C. Code Ann. § 38-71-242.
169. *Ward*, 595 F.3d at 172.
170. 686 F. Supp. 2d 692, 696 (W.D. Ky. 2010).
171. Smith v. Life Investors Ins. Co. of Am., No. 2:07-cv-681, 2009 WL 3756911 (W.D. Pa. Nov. 6, 2009).
172. 350 F. App'x 376 (11th Cir. 2009).

age under a cancer and specified disease policy for the amount the hospital billed for myasthenia gravis treatments, even though plaintiff's primary insurer paid the reduced negotiated amount to the hospital, which the hospital accepted as full payment for the treatments. The Eleventh Circuit affirmed the district court's conclusion that the term "actual charges incurred" in the supplemental policy was not ambiguous and meant the "amount the provider accepts from an insurer as full satisfaction of the policyholder's liability."[173]

B. *Alternate Plan of Care*

In *Mansur v. PFL Life Insurance Co.*[174] the Tenth Circuit examined the proper construction of the "alternate plan of care" provision of a long-term care insurance policy stating that "[s]ervices under an alternate plan of care will be paid at the levels and limits specified in the plan."[175] The dispute arose when the plaintiff sought the same $80 per day rate for home care that she received for nursing home care. Although the policy did not require payment of benefits for any services provided outside a long-term care facility, the policy offered the possibility of benefits for services at home if the insured, the physician, and the insurer agreed on an alternate plan of care. The Tenth Circuit found that the alternate plan of care required agreement on payments terms, not just terms of care.

C. *Drug Benefit Provisions*

Courts continue to interpret drug benefit provisions in connection with the treatment of cancer. The Supreme Court of Alabama interpreted the prescription drug benefit provision of a cancer plus special disease policy in favor of the insurer in *Payne v. Mutual Savings Life Insurance Co.*[176] The court held that the charges for an oral chemotherapy drug, which cost $658.82 a week, fell under the "prescription drug benefit" provision of the policy, which had an annual benefit limitation of $8,000, and not under the "radiation and chemotherapy benefit" provision, which provided a benefit not to exceed $550 per day for charges for chemotherapy administered by a doctor or hospital.[177]

In *Tomlinson v. Combined Underwriters Life Insurance Co.*,[178] however, the district court found in favor of the insured. The court held that two drugs

173. *Id.* at 379.
174. 589 F.3d 1315 (10th Cir. 2009).
175. *Id.* at 1320. *See also* Kneal v. Sentry Ins., Civil No. 08–1193 (JNE/JJK), 2009 WL 3283250, at *4 (D. Minn. Oct. 9, 2009) (plain language of the "alternate care" provision required acceptance of an alternative plan of care by the insurer before services were covered).
176. Payne v. Mut. Sav. Life Ins. Co., 1090665, 2010 WL 3612134 (Ala. Sept. 17, 2010).
177. *Id.* at *2.
178. 708 F. Supp. 2d 1284 (N.D. Okla. 2010).

which supported bone marrow recovery were covered under a cancer and dread disease insurance policy, which covered the actual charges for certain treatment techniques provided they were "used for the purpose of modification or destruction of cancerous tissue."[179] Finding that this provision was ambiguous, the court applied the reasonable expectation doctrine under Oklahoma law to hold that the policy created an expectation that coverage existed because the use of the drugs was a necessary component of a technique used for the purpose of modification or destruction of cancerous tissue.[180]

D. *Exclusions*

This year the Seventh Circuit affirmed the application of the exclusion for surgery related to obesity, but vacated a grant of summary judgment in favor of the plan on the plaintiff's breach of fiduciary claim. In *Kenseth v. Dean Health Plan, Inc.*,[181] the plan (governed by ERISA) denied coverage for surgery and all associated services in connection with complications from vertical banded gastroplasty surgery, also known as stomach stapling, which the plaintiff had undergone before she became a participant in the plan. The plan excluded coverage for any surgical treatment or hospitalization for the treatment of morbid obesity. The Seventh Circuit affirmed summary judgment in favor of the plan on plaintiff's claim that the exclusion violated a Wisconsin statute[182] that precluded a group insurer from excluding coverage for a preexisting condition for a period of longer than twelve months. The court found that the exclusion for surgeries related to morbid obesity was a restriction on the nature of benefits provided rather than one based on a preexisting condition and that the statute did not prevent a group health plan from establishing limitations or restrictions on the nature of benefits or coverage.[183] However, with respect to the plaintiff's breach of fiduciary duty claim under ERISA,[184] the Seventh Circuit found that the facts supported a finding that the plan breached its fiduciary duty to the plaintiff by providing her with plan documentation that was not clear as to the coverage for her surgery; that invited plan participants to call the customer service representatives with questions about coverage, but omitted warning the participants that they could not rely on the answers given;

179. *Id.* at 1291.
180. *Id.* at 1292–93.
181. 610 F.3d 452 (7th Cir. 2010).
182. Wis. Stat. § 632.746(1)(b).
183. *Kenseth*, 610 F.3d at 463–64.
184. 29 U.S.C. § 1132(a)(3) authorizes a civil suit by a plan participant or beneficiary "(B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this subchapter or the terms of the plan[.]"; *Kenseth*, 610 F.3d at 482.

and that failed to advise how participants might obtain a definitive determination on coverage before surgery.[185] Interestingly, the court noted that the plaintiff had not pursued a denial of benefits claim, possibly because of the plan's broad discretion in construing the terms of its certificate, which would require the plaintiff to show that the decision to deny the claim was arbitrary and capricious. The court warned the plaintiff, however, that she could not obtain comparable relief under the guise of a claim for breach of fiduciary duty[186] and remanded the case to the district court to determine what equitable relief, if any, the plaintiff might be able to obtain.

In *Oldenkamp v. United American Insurance Co.*,[187] the Tenth Circuit upheld the preexisting condition limitation in a limited benefit hospital and surgical expense policy. The insurer denied coverage for surgery performed to remove a congenital cyst on an infant's eyelid, which was diagnosed before coverage under the policy began. The insured argued that the preexisting condition limitation was prohibited by a regulation[188] of the Oklahoma Insurance Department applicable to accident and health insurance, which allowed exclusions for preexisting conditions, but not for a preexisting condition involving a congenital anomaly of a covered dependent child.[189] The Tenth Circuit held that the regulation applied to accident and health insurance policies, but not to a limited benefit insurance policy, which was a separate and distinct type of policy.[190]

E. *Mandated Benefits*

In *MAMSI Life & Health Insurance Co. v. Kuei-I Wu*,[191] the district court certified to the Court of Appeals of Maryland the question whether § 19-507 of the Maryland Insurance Code[192] restricted the ability of health insurers and HMOs to provide that health benefits were secondary to person injury protection (PIP) benefits under an automobile insurance policy. The question arose when the plaintiff sought treatment with healthcare providers under the insurer's PPO plan for injuries she suffered in an automobile accident, but the defendant paid the health care provider only after the

185. *Id.* at 456.

186. *Id.* at 483. *See also* Dupre v. Employee Benefit Servs. of La., Inc., No. 09-30990, 2010 WL 3452812 (5th Cir. Sept. 2, 2010) (Fifth Circuit held that gastric bypass surgery was excluded under the plan).

187. 619 F.3d 1243 (10th Cir. 2010).

188. Okla. Admin. Code § 365:10-5-4.

189. *Oldenkamp*, 619 F.3d at 1247–48.

190. While beyond the scope of this article, it is worth noting that in its existing form the Patient Protection and Affordable Care Act prevents preexisting condition exclusions for children.

191. 983 A.2d 88 (Md. 2009).

192. Md. Code Ann., Ins. § 19-507.

PIP benefits under the plaintiff's automobile policy were exhausted. The court found that § 19-507(b)(2),[193] the coordination of benefits section, did not restrict health insurers or HMOs from contracting that their benefits could be made secondary to PIP benefits.

F. *Medically Necessary*

The Second Circuit examined the term "medically necessary" and found that the insurer's application of the term imposed a requirement that was not included in the plan. In *Durgin v. Blue Cross and Blue Shield of Vermont*,[194] the insurer denied coverage for a "standing component" for a motorized wheelchair on the grounds that the device was not "medically necessary" because there were no peer review clinically controlled studies available showing that the patient's health improved by using the standing device. The Second Circuit rejected this argument, finding that the plan did not contain such a requirement and, therefore, the administrator's decision was arbitrary and capricious.[195] The Second Circuit also found that the administrator arbitrarily refused to credit the plaintiff's reliable evidence,[196] which included ten articles from medical journals, some of which were peer-reviewed, and the treating physician's statement that the standing component resulted in a decrease in spasticity and helped to maintain bone density. The Second Circuit remanded the case to the plan administrator to determine whether the evidence offered by the plaintiff was sufficient to bring the "standing component" within the parameters of coverage, when the plan was construed in a reasonable manner.

VI. LIFE INSURANCE

Issues regarding misrepresentations in policy applications, waiver of an insurer's defenses, stranger originated life insurance (STOLI), and insurable interest continue to be heavily litigated. In a number of interesting cases decided this past year, courts provided guidance on these legal issues that will likely prove valuable to both practitioners and their clients.

A. *Misrepresentation and Estoppel*

A common counter-argument to an insurer's defense of misrepresentation is estoppel. Two recent state supreme courts made rulings that expand

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193. Md. Code Ann., Ins. § 19-507(b)(2) provides: "The named insured may: (i) elect to coordinate the policies by indicating in writing which policy is to be the primary policy; or (ii) reject the coordination of policies and non-duplication of benefits." *Kuei-I Wu*, 983 A.2d at 170–71.

194. 353 F. App'x 538 (2d Cir. 2009).

195. *Id.* at 539.

196. *Id.* at 540.

the possible use of estoppel and may serve to bolster estoppel-based arguments. In *Chism v. Protective Life Insurance Co.*,[197] the Supreme Court of Kansas considered whether an insurer is estopped from rescinding coverage when its agent made "fraudulent misrepresentations" to an applicant which then caused the "applicant to sign an application without knowing that the signature represent[ed]" that the applicant was qualified to apply for the coverage (when he was, in fact, medically ineligible).[198] The insurance company argued that the facts did not create a basis for estoppel because the agent himself did not make any misrepresentations on the application (the typical scenario) and, in any event, the applicant had a duty to read the application before he signed it.[199] The trial court, relying on Kansas precedent, agreed with the insurer. On appeal, however, the Supreme Court of Kansas reversed. Specifically, the court stated that the agent led the plaintiff and her husband to believe the application was complete, that they qualified for coverage based solely on their age, and that the agent had obtained all of the necessary information.[200] Moreover, the agent told the plaintiff and her husband "to sign on the bottom of the form without directing their attention to the disqualifying conditions."[201] The court held that if a jury accepted plaintiff's version of events, then the insurer would be estopped because "the legal effect of this action is not different from the effect of an agent not asking qualifying questions of the applicant and submitting a false answer."[202]

Estoppel was also an issue in *Harper v. Fidelity & Guarantee Life Insurance Co.*,[203] where the Supreme Court of Wyoming considered whether the doctrine of promissory estoppel required enforcement of a life insurance contract obtained through material misrepresentations on the application. After finding that there were material misrepresentations on the insured's application for insurance, and that the insurer was under no duty to investigate, but could rely on the insured's representations, the court considered whether Fidelity was entitled to summary judgment on plaintiff's estoppel theory, under which plaintiff claimed that the policy must be enforced because Fidelity issued a life insurance policy and thus the insured did not seek coverage from another company. The court notably held that "there exists a genuine issue of material fact as to whether Fidelity's issuing the policy constituted a promise that would have reasonably induced reliance."[204] The

197. 234 P.3d 780 (Kan. 2010).
198. *Id.* at 783.
199. *Id.* at 787, 790.
200. *Id.* at 789–90.
201. *Id.*
202. *Id.* at 790.
203. 234 P.3d 1211 (Wyo. 2010).
204. *Id.* at 1220.

court, however, ultimately found for the insurer, concluding there was no issue of fact regarding the reliance element because the plaintiff failed to put forward even "a scintilla of evidence" that the deceased "could have or would have obtained life insurance from another company."[205] Nonetheless, the fact that the court did not outright reject the plaintiff's theory that the mere issuance of a policy may constitute a "promise" may provide support for future estoppel arguments in rescission actions.

B. *Stranger Originated Life Insurance and Insurable Interest*

Cases regarding STOLI and insurable interest remain prevalent as courts continue to refine the precise meaning of "insurable interest" and examine new situations involving stranger originated transactions. There were a couple of interesting cases decided this past year: one involved insurable interest in the context of a benefactor-type relationship and the other analyzed STOLI issues in the annuity context.

In *Country Life Insurance Co. v. Marks*,[206] a life insurer filed a declaratory judgment action seeking, in part, a determination that the life insurance policy was void on the grounds the owners and beneficiaries had no insurable interest in the insured's life. The insured named as owners and beneficiaries the plaintiffs with whom she maintained a strong relationship and had financially supported. The insured was not, however, related to the family and had no business relationship with them. While the district court agreed with the insurer that plaintiffs had no insurable interest, the Eighth Circuit found an issue of fact.[207] The court ruled that Missouri law does not limit the "pecuniary interest" necessary to show an insurable interest to certain types of relationships.[208] Rather, the plaintiffs merely needed to show a "reasonable expectation of pecuniary benefit or advantage from the continued life of another."[209] The court, looking to case law from other jurisdictions, ruled that the plaintiffs may be able to demonstrate that the benefactor-type relationship they maintained with the insured was sufficient to demonstrate a pecuniary (and thus, insurable) interest.[210]

In *Western Reserve Life Assurance Co. of Ohio v. Conreal LLC*,[211] two life insurers filed suit alleging that the defendants engaged in stranger initiated annuity transactions (STAT) as part of a fraudulent scheme to use variable annuities as a vehicle for riskless speculation in securities. The insurers

205. *Id.*
206. 592 F.3d 896 (8th Cir. 2010).
207. *Id.* at 901–02.
208. *Id.* at 900.
209. *Id.*
210. *Id.* at 901–02.
211. 715 F. Supp. 2d 270 (D.R.I. 2010).

sought to rescind the contracts (or have them declared void) on account of fraud or the lack of an insurable interest in the annuitants. The insurers also alleged, *inter alia*, causes of action against the sponsors, brokers, agents, and some of the owners for common law and statutory fraud. The federal district court, applying Rhode Island law, held that annuities do not constitute insurance contracts, and thus the statutory insurable interest requirement did not apply to annuities sold by insurance companies.[212] On the other hand, the court held that incontestability clauses in annuity contracts nonetheless do bar insurers from seeking to rescind annuities or have them declared void because of fraud.[213] The court, however, did limit its ruling and the effect of the incontestability clause, stating: "[U]nlike Harry Potter's 'Invisibility Cloak,' which could conceal not only Harry, but anyone who wore it, the benefits of an incontestable clause can be availed of only by an insured or his or her beneficiary, and cannot be invoked by a stranger to the contract."[214]

C. *Waiver*

Like estoppel, waiver is also invoked by parties arguing that an insurer cannot avoid coverage under a policy. In two significant cases, one in the context of reinstatement and one in the context of conditional receipt, courts found that common practices by insurers will not create waiver. In *Boylan v. Jackson National Life Insurance Co., Inc.*,[215] the beneficiary argued that while the policy lapsed, the insurer nonetheless waived its right to require a formal reinstatement application because it held a late payment for approximately a month without communicating with the insured.[216] The Third Circuit agreed with the district court in holding that the "month-long retention of the [premium payment] was neither unreasonable nor indicative of a waiver."[217] The court rejected plaintiff's contention that delay alone could demonstrate waiver and further held that the delay was not unreasonable.[218] Indeed, the court noted that the insurer's procedure for handling receipt of a payment that cannot be applied to a particular policy (i.e., depositing the funds in a suspense account, holding the funds for a time certain, and researching why funds were received) was completely reasonable.[219]

212. *Id.* at 276–79.
213. *Id.* at 279–80.
214. *Id.* at 281–82.
215. 353 F. App'x 708 (3d Cir. 2009).
216. *Id.* at 711.
217. *Id.* at 713.
218. *Id.* at 713–14.
219. *Id.* at 714.

In *Kimmel v. Western Reserve Life Assurance Co. of Ohio*,[220] the plaintiff argued that a conditional receipt issued by the insurer was still in effect at the time of the applicant's death because the insurer failed to accept or deny the application or refund the initial premium in the three months between the application and the applicant's death.[221] The insurer pointed to the terms of the conditional receipt which conditioned coverage on the insurer's eventual approval of a policy and provided conditional coverage would terminate if the insurer did not approve the application within sixty days.[222] The court ruled in favor of the insurer stating that coverage expired, by its own terms, at end of the sixty-day period even though the insurer had not denied the insured's application, had not refunded his premium, and had continued investigation into the insured beyond the sixty-day period.[223] The court further held that the insurer's delay was not unreasonable or in bad faith stating: "because [the insurer] had no legal duty to act upon the Application within a given period of time, no tort liability can be imposed."[224]

VII. CONCLUSION

As is often the case, these decisions raise as many questions as they answer. Practitioners should keep in mind that decisions in one jurisdiction may contradict the case law in their own. Certain trends continue to run strong, however. Courts continue to allow limited discovery into the extent of a conflicted administrator's bias, including limited depositions. Intoxication exclusions continue to be a more reliable way to limit coverage for accidents involving drunk drivers. Mandated benefits continue to implicate coverage decisions across the board. Although a complete summary of all reported decisions in this area is beyond the scope of this article, the authors hope that it has provided some interesting answers.

220. 678 F. Supp. 2d 783 (N.D. Ind. 2010), *aff'd*, Kimmel v. W. Reserve Life Assur. Co. of Ohio, 2010 WL 4721583 (7th Cir. 2010).
221. *Id*. at 798.
222. *Id*.
223. *Id*. at 799–802.
224. *Id*. at 804.

RECENT DEVELOPMENTS IN INSURANCE COVERAGE LITIGATION

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I. INTRODUCTION

As could doubtless be said of any area of legal practice when viewed from a countrywide perspective, there have been many developments in the law governing the resolution of insurance coverage disputes in the past year, some important, others less so. In culling through these changes, we have made an effort to identify emerging case law that may be of continuing importance to insurance coverage practitioners in the future. This article addresses recent cases that, in our best judgment, fit these criteria. We discuss significant developments arising within a wide range of insurance contexts: fidelity bonds, CGL policies, D&O coverage, and first-party property policies. We also touch on recent developments in insurance coverage law of more general applicability, such as the duty to defend and bad faith. We trust that the passage of time will verify that our identification of emerging issues of continuing significance was correct, but even if not, all of the topics addressed in this article should be of inherent interest to insurance coverage litigators.

II. RECENT DEVELOPMENTS IN FIDELITY BOND LITIGATION: "DIRECT MEANS DIRECT"

A recent decision from the U.S. District Court for the Eastern District of Wisconsin has weighed in on the "direct" causation standard under the

employee dishonesty clause of a fidelity bond, to wit: "direct means direct." In *Universal Mortgage Corp. v. Wurttembergische Versigherung, AG.*,[1] the court strictly enforced the "direct" causation requirement under a mortgage bankers bond (the "fidelity bond"),[2] and held the insured had not incurred a "direct" financial loss, nor loss "directly resulting" from its employee's dishonest conduct, where the insured mortgage loan originator was required to repurchase loans from its investors as a result of improprieties in the loan applications. The *Universal Mortgage* decision is the most recent in a line of decisions interpreting the term "direct" narrowly in fidelity bonds, and is particularly timely following the historic collapse of the real estate, credit, and mortgage-backed securities markets that followed an extended period of unsound mortgage lending practices and rampant mortgage fraud in the United States.[3]

In *Universal Mortgage*, the insured was a mortgage loan originator that sold completed loans to secondary market investors. Universal Mortgage purchased the fidelity bond at issue from Wurttembergische Versigherung, AG and certain Underwriters at Lloyd's (collectively, "Underwriters").[4] The fidelity bond afforded indemnity coverage to Universal Mortgage under Insuring Clause 1 (the "employee dishonesty clause") in relevant part for "[d]irect financial loss sustained by [Universal Mortgage] . . . directly caused by: (a) dishonest acts by any Employee of" Universal Mortgage.[5]

A Universal Mortgage manager in Florida (an "Employee" under the fidelity bond) supervised mortgage application processing and verified compliance with standards established by Federal National Mortgage Association ("Fannie Mae"). Unbeknownst to Universal Mortgage, the manager conspired with representatives of an outside mortgage broker to accept

1. No. 09-CV-1142, 2010 WL 3060655, at *1 (E.D. Wis. July 30, 2010).

2. The mortgage banker bond at issue in *Universal Mortgage* covered more than employee dishonesty (i.e., fidelity), but the employee dishonesty insuring agreement was at issue and the authors use the generic term "fidelity bond" for convenience.

3. According to the Federal Bureau of Investigation: "In 2009, the continuing deterioration of the real estate market and the dramatic rise in mortgage delinquencies and foreclosures helped fuel the financial crisis and exposed fraudulent practices that were prevalent throughout the mortgage industry." Fed. Bur. of Investigation, 2009 Financial Crimes Report (2009), http://www.fbi.gov/stats-services/publications/financial-crimes-report-2009. "Weak underwriting standards and unsound risk management practices, which had allowed mortgage fraud perpetrators to exploit lending institutions and avoid detection, became evident once the housing market began declining in 2006." *Id.*

4. *Universal Mortg.*, 2010 WL 3060655, at *1–2.

5. *Id.* at *2. In its entirety, the employee dishonest clause afforded coverage for:

> Direct financial loss sustained by the Assured subsequent to the Retroactive Date and discovered by the Assured during the Bond Period by reason of and directly caused by: (a) dishonest acts by any Employee of the Assured, whether committed alone or in collusion with others, which dishonest acts were committed by the Employee with the manifest intent to obtain and resulted in the receipt of Improper Personal Financial Gain for said Employee, or for the persons acting in collusion with said Employee. . . .

and approve mortgage loan applications from prospective borrowers who required down payment assistance. Fannie Mae standards precluded borrowers from obtaining down payment assistance, so the subject loans were issued in violation of Fannie Mae standards.

While Universal Mortgage originated the loans, it sold them to secondary market investors under contracts that required Universal Mortgage to repurchase the mortgages in the event they were not compliant with Fannie Mae standards. Many of the subject loans went into default and the investors discovered that the mortgages did not meet Fannie Mae standards. Universal Mortgage was required to repurchase the mortgages from the investors, and incurred a loss for which it sought coverage under the employee dishonesty clause of the fidelity bond.[6] Specifically, Universal Mortgage asserted that its "loss" was covered by the dishonest acts of the manager in processing the noncompliant loans. Underwriters denied coverage in part on the basis that Universal Mortgage did not incur a "direct financial loss" that was "directly caused by" the employee's dishonest conduct as required for coverage under the employee dishonesty clause.[7] The court agreed, and held that no coverage was afforded for Universal Mortgage's claim.[8]

In analyzing the "direct" requirement in the employment dishonesty clause, the court acknowledged that courts have not always interpreted the "direct" causation standard consistently. Some courts have interpreted "direct" causation to mean "one proximately caused by the employee's actions, such that the acts need not be the 'sole' or 'immediate' cause of the loss."[9] The *Universal Mortgage* court expressly rejected that line of cases and sided with what the Illinois Appellate Court in *RBC Mortgage Co. v. National Union Fire Insurance Co. of Pittsburgh, Pa.* referred to as the "majority" position[10]—i.e., that "direct means direct."[11]

Applying the "direct means direct" standard, the *Universal Mortgage* court held that Universal Mortgage's losses were not "directly caused by"

6. *Id.* at *4.

7. *Id.* at *5.

8. *Id.* at *6. In dicta, the court held that coverage was also precluded by an exclusion of coverage for losses resulting from the insured "having repurchased or having been required to repurchase a Real Estate Loan from an Investor." *Id.*

9. *Id.* at *6 (citing Scirex Corp. v. Fed. Ins. Co., 313 F.3d 841, 848–50 (3d Cir. 2002)). *See also* Resolution Trust Corp. v. Fid. & Deposit Co. of Md., 205 F.3d 615 (3d Cir. 2000) (applying a "proximate cause" standard to fidelity bonds). *Universal Mortgage* specifically rejected *Scirex*, and the *RBC* court discussed and rejected both *Scirex* and *RTC*.

10. 812 N.E.2d 728, 736–37 (Ill. App. Ct. 2004).

11. *Universal Mortg.*, 2010 WL 3060655, at *2 (citing Vons Cos. v. Fed. Ins. Co., 212 F.3d 489, 492–93 (9th Cir. 2000); Tri-City Nat'l Bank v. Fed. Ins. Co., 674 N.W.2d 617, 624–25 (Wis. Ct. App. 2004)).

the employee's misconduct because (1) at the time the loans were issued, it was not inevitable that the borrowers would default, and hence the loss was contingent on a future event, and (2) Universal Mortgage incurred its loss only because it was required to repurchase the loans from investors.[12] The court similarly held that Universal Mortgage had not incurred a "direct financial loss" because its losses were "contingent upon several future events," including defaults and the repurchase obligation.[13]

Universal Mortgage continues an apparent trend among courts to find that the "direct means direct" standard for causation under a fidelity bond is not satisfied for losses incurred by mortgage companies and banks with respect to repurchase obligations, even where fraud and employee dishonesty are present in procuring the underlying mortgage.[14] Given the proliferation of mortgage fraud over the past decade, the "direct means direct" analysis—while not a new legal construct—may take on increased significance in the loan repurchase context as the fallout from the credit crisis continues to unfold. The legal trend exemplified by *Universal Mortgage* merits monitoring by practitioners as well as insurers and their insureds.

III. Recent Developments in CGL Coverage Litigation: Determining the Trigger of Coverage in Long-Latency Bodily Injury Cases

For nearly thirty years, the U.S. Court of Appeals for the District of Columbia Circuit's ruling in *Keene Corp. v. Insurance Co. of North America*[15] and its progeny have dictated application of the so-called continuous-trigger rule in identifying policies on the risk in a variety of settings where claimants allege bodily injury that only became discoverable after a long latency period. *Keene*, like many cases following its lead, was decided in the context of claims arising out of asbestos-related bodily injuries. Under *Keene*'s "continuous trigger" theory, coverage for asbestos-related bodily injury is triggered under each insurer's policies on the risk between the date of first exposure through manifestation.[16] At the heart of *Keene* and those decisions embracing its rationale is the presumption—based on expert medical

12. *Id.* at *3–4.
13. *Id.* at *4.
14. Direct Mortg. Corp v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa., 625 F. Supp. 2d 1171, 1176–78 (D. Utah 2008); *Tri-City Nat'l Bank*, 674 N.W.2d at 623–25; *RBC*, 812 N.E.2d at 736–37.
15. 667 F.2d 1034 (D.C. Cir. 1981).
16. *Id.* at 1041.

testimony at the time, or lack thereof—that "bodily injury" occurs at the microscopic level upon first inhalation of asbestos fibers and continues repeatedly at the cellular and molecular levels.[17] This long-standing medical presumption is now under attack, which can be expected to cause courts to reexamine the science that provided the "factual" basis for the continuous-trigger theory.

Our support for this assertion begins, oddly enough, with a 2010 decision by an England and Wales appellate court. The court held, in the context of an employers' liability policy, that there is no actionable injury at the time of asbestos exposure. In a consolidation of six actions, the court reversed a ruling that claimants who developed mesothelioma as a result of asbestos exposure in the workplace suffered actionable injury at the time of asbestos exposure.[18] The court based its conclusion, in large part, on its prior ruling in *Bolton Metropolitan Borough Council v. Municipal Mutual Insurance Ltd.*,[19] a case involving coverage for mesothelioma under a public liability policy. In *Bolton* the court concluded, based on evidence from five internationally recognized experts, that "actionable injury does not occur on exposure or on initial bodily changes happening at that time but only at a much later date . . . injury cannot be equated to the 'insult' received by the body when exposure first occurs."[20]

In *Butler v. Union Carbide Corp.*,[21] a Georgia trial court engaged in similar reasoning, albeit outside the context of insurance, holding that the "theory that 'any exposure' to the asbestos of Defendant's product will cause injury, also called 'the linear non-threshold'" theory, failed to meet the *Daubert* standard for admissibility of scientific evidence in the asbestos tort action.[22]

In the insurance coverage context, *Continental Casualty Co. v. Employers Insurance Co. of Wausau*[23]—known as the *Keasbey* decision after the name of the insured that brought the original action seeking coverage—

17. *See, e.g.*, Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp., 73 F.3d 1178, 1190, 1197 (2d Cir. 1995) (application of continuous trigger based on etiology evidence considered in 1992 trial); Owens-Ill., Inc. v. United Ins. Co., 650 A.2d 974, 978, 982–83 (N.J. 1994) (trigger decided prior to 1991 and in absence of discovery on or presentation of medical evidence); Ins. Co. of N. Am. v. Forty-Eight Insulations, Inc., 633 F.2d 1212, 1215 (6th Cir. 1980), *aff'g* 451 F. Supp. 1230, 1242–43 (E.D. Mich. 1978); J.H. France Refractories Co. v. Allstate Ins. Co., 626 A.2d 502, 502 (Pa. 1993) (trigger decided in 1984).

18. Employers' Liab. Ins. "Trigger" Litig., [2010] EWCA (Civ) 1096, [106]–[115] (Eng.).

19. [2006] EWCA (Civ) 50, [2006] 1 W.L.R. 1492, [18] (Eng.).

20. *Id.* at 180.

21. No. 2008CA114 (Ga. Super. Ct. June 29, 2010), *available at* http://www.dailyreportonline.com/Editorial/PDF/PDF%20Archive/0809_asbestos2.pdf.

22. *Id.*, slip op. at 8 (applying Daubert v. Merrell Dow Pharms., Inc., 509 U.S. 579, 593–94 (1993)).

23. 871 N.Y.S.2d 48 (App. Div. 2008) ("*Keasbey*").

applied New York's injury-in-fact trigger rule to reject the insured's claim that bodily injury occurs upon exposure to asbestos. The court noted not only that the underlying plaintiffs could not prove that injury occurred in the first year after initial exposure, but that current medical science demonstrates that asbestos can be safely inhaled without disease ever developing.[24] The *Keasbey* court observed that "one indisputable fact to emerge from medical evidence in the plethora of asbestos cases litigated in many different jurisdictions is that actual injury generally develops over time depending on a range of circumstances and conditions, but does not occur upon exposure by inhalation."[25] It concluded that insureds "are making an impermissible leap if they believe they can go forward and prove injury . . . simply by a conclusory assertion: claimant was exposed, claimant developed full-blown asbestos-related injury decades later, ergo, injury was sustained at time of exposure."[26] Since there was no proof of injury-in-fact at the time of exposure, the court held that the insured had not satisfied its burden of proving that coverage was triggered.[27]

This reappraisal of the medical evidence of asbestos-related bodily injury and the implications of that evidence in triggering insurance coverage illustrates the difficulties inherent in proving complex and, from a medical and scientific point of view, poorly understood causal relationship between exposure to a substance and emergence of a disease after a substantial latency period. Indeed, the continuing need to adopt assumptions—logical assumptions, but assumptions nonetheless—where verifiable facts are absent is epitomized by the *Bolton* court's substitution of a new presumption for the old one. The *Butler* court did not go so far; instead, it ruled that the only proof on causation available to a plaintiff with mesothelioma was inadmissible, thereby making it impossible for plaintiff to satisfy the burden of proof. For trigger-of-coverage purposes, the *Bolton* approach confines insurance coverage within a narrower time frame, while the *Butler* decision, if extended to the trigger-of-coverage context (as in *Keasbey*), would render the trigger-of-coverage question unanswerable, at least on the present state of medical knowledge. If the *Butler* outcome achieves more general acceptance, in the absence of a profound improvement in medical understanding, logically it would have the dual effect of eliminating both an underlying plaintiff's ability to recover damages for asbestos-related injuries and an insured defendant's ability to obtain a defense from its insurers.

24. *Id*. at 62.
25. *Id*.
26. *Id*. at 64.
27. *Id*.

IV. Recent Developments in D&O Coverage Litigation: "Bump-Up" Exclusions Effective in Limiting Coverage

This past decade has seen a marked increase in shareholder lawsuits. There also has been an increase in lawsuits alleging that shareholders did not receive enough consideration for the sale or purchase of securities by their companies. These lawsuits arise from financial transactions whereby companies merge or otherwise dispose of their securities to raise capital. Many directors and officers ("D&O") policies contain what is referred to as an "inadequate consideration" exclusion or a "bump-up" exclusion. There is very little case law interpreting "bump-up" provisions. A recent Third Circuit decision, *Delta Financial Corp v. Westchester Surplus Insurance Co.*,[28] is particularly significant given the increased prevalence of bump-up exclusions in D&O policies and the paucity of case law interpreting this type of exclusion.

Applying New York law, the Third Circuit held that a bump-up exclusion barred coverage for a lawsuit against a subprime mortgage lender, Delta Financial.[29] The underlying action arose out of a debt restructuring transaction involving Delta Financial's securities. The transaction was a two-step process. "First, Delta Financial debt holders surrendered their unsecured notes and senior secured notes to Delta LLC, an entity formed solely to facilitate the transaction. In exchange, the note holders received certain interests in Delta LLC."[30] "Second, in exchange for Delta LLC's surrender of the notes, Delta Financial transferred to Delta LLC 'excess cashflow certificates' that it valued at approximately $153 million. Delta Financial represented the value of the excess cashflow certificates and other assets transferred to Delta LLC would equal the outstanding balance of the surrendered notes."[31] Delta LLC and others filed suit in state court alleging that the excess cashflow certificates were worth only $40 million at the time the restructuring closed.[32]

Delta Financial's D&O policies excluded claims "for Loss on account of any Claim made against any Insured: . . . based upon, arising out of, or attributable to the actual or proposed payment by the Company of allegedly inadequate . . . consideration in connection with the Company's purchase of securities issued by any company."[33] The Third Circuit held that the exclusion was unambiguous, noting that "Delta Financial has neither sug-

28. 378 F. App'x 241 (3d Cir. 2010).
29. *Id.* at 244–45.
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.* at 243.

gested an alternative, narrower meaning of the exclusion, nor pointed to any relevant extrinsic evidence of the parties' actual intent with respect to the Inadequate Consideration Exclusion."[34] Delta Financial argued that underlying claims did not fall "solely and squarely" within this exclusion because the transaction could be interpreted as a discharge of debt through a strict foreclosure on collateral under the New York Uniform Commercial Code. The Third Circuit rejected this argument, however, because the underlying complaint did not include all of the elements of a "strict foreclosure" action under New York law, nor could the unsecured creditors be deemed to have foreclosed on collateral.[35]

Lastly, the Third Circuit rejected Delta Financial's argument that an underlying cause of action for breach of the management agreement was outside the "bump-up" exclusion because "[t]hat claim could have been brought, and damages recoverable, regardless of what the Cashflow Certificates and other assets were worth at the time of the exchange."[36] Delta Financial cited to the fact that "the Underlying Plaintiffs seek only $500,000 in damages under the second cause of action, whereas they seek $110 million in damages throughout the remainder of the complaint."[37] The Third Circuit held that this cause of action, like the other underlying claims, arose from an " 'actual . . . payment by the Company of allegedly inadequate . . . consideration in connection with the Company's purchase of securities issued by any company' " and was properly excluded.[38]

The *Delta Financial* decision is a timely analysis of an exclusion that is of ever-increasing importance in D&O coverage. In addition to reinforcing the general principle that courts will uphold unambiguous contractual provisions and will not entertain strained and unreasonable interpretations of insurance policies, the case also stands for the proposition that courts will enforce "bump-up" exclusions in appropriate circumstances.

V. RECENT DEVELOPMENTS IN FIRST-PARTY PROPERTY INSURANCE LITIGATION: THE MEANING OF "PHYSICAL LOSS OR DAMAGE"

The insuring clause in most property insurance policies requires that there be "physical loss or damage" to insured property.[39] This threshold require-

34. *Id*. at 244.
35. *Id*. at 245.
36. *Id*. (alteration in original).
37. *Id*.
38. *Id*. (alteration in original).
39. *See, e.g.*, ISO Standard Property Policy (CP 00 99 06 07); ISO Building and Personal Property Coverage Form (CP 00 10 06 07). *See generally* 10A Lee A. Russ & Thomas F. Segalla, Couch on Insurance § 148:46 (3d ed. 2010). "Physical" is defined to mean "of or

ment is clearly satisfied when insured property has been physically altered by perils such as fire or water. But when the structure of the property itself is unchanged, at least to the naked eye, and the insured claims the property's value, usefulness, or functionality has been destroyed or diminished, questions arise as to whether coverage is triggered under a property insurance policy.

Court interpretations of the "physical loss or damage" requirement in these types of cases have not been uniform. Some courts have found that physical loss or damage requires a physical alteration of the insured property and that mere loss of use is not physical loss or damage.[40] But other courts have found that the loss of use or functionality can, under certain circumstances, constitute physical loss or damage.[41] Recently, several courts have analyzed the "physical loss or damage" requirement, again with seemingly nonuniform results.

A. MRI Healthcare

In *MRI Healthcare Center of Glendale, Inc. v. State Farm General Insurance Co.*,[42] the Second District California Court of Appeal found that there must be some physical change or alteration in the condition of the property for

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relating to things perceived through the senses as opposed to the mind; tangible or concrete." New Oxford American Dictionary 1282 (2d ed. 2005). Courts generally agree that the word "physical" modifies both "loss" and "damage." *See, e.g.*, Meridian Textiles, Inc. v. Indem. Ins. Co., No. CV 06–4766 CAS, 2008 WL 3009889, at *3 (C.D. Cal. Mar. 20, 2008); Se. Mental Health Ctr., Inc. v. Pac. Ins. Co., 439 F. Supp. 2d 831, 837 (W.D. Tenn. 2006); AFLAC, Inc. v. Chubb & Sons, Inc., 581 S.E.2d 317, 319 (Ga. Ct. App. 2003); Ward Gen. Ins. Servs., Inc. v. Emp'rs Fire Ins. Co., 7 Cal. Rptr. 3d 844, 849 (Ct. App. 2003).

40. *See, e.g.*, Yale Univ. v. CIGNA Ins. Co., 224 F. Supp. 2d 402, 412–13 (D. Conn. 2002) ("mere presence of asbestos-and lead-containing materials" is not physical loss or damage); Great N. Ins. Co. v. Benjamin Franklin Fed. Sav. & Loan Ass'n, 793 F. Supp. 259, 263 (D. Or. 1990), *aff'd*, 953 F.2d 1387 (9th Cir. 1992) (no coverage for the cost to remove asbestos from a commercial building because presence of asbestos was an economic loss and not direct physical loss or damage); Ward Gen. Ins. Servs., Inc. v. Emp'rs Fire Ins. Co., 7 Cal. Rptr. 3d 844, 851 (Ct. App. 2003) (loss of electronically stored data was not a "direct physical loss of or damage to" covered property); Pirie v. Fed. Ins. Co., 696 N.E.2d 553, 555 (Mass. App. Ct. 1998) (no coverage for the cost to remove lead paint from a 154-year-old house because presence of lead paint was not a "physical loss"); Glens Falls Ins. Co. v. Covert, 526 S.W.2d 222, 222–23 (Tex. App. 1975) (no coverage for eighty-one safety stabilizers that fell to the floor at the insured's auto supply store where there was no evidence of any physical damage to them even though the manufacturer withdrew its warranty and the units lost their merchantability).

41. *See, e.g.*, W. Fire Ins. Co. v. First Presbyterian Church, 437 P.2d 52, 54–55 (Colo. 1968) (gasoline vapor accumulation inside church rendering it uninhabitable and dangerous "equates to a direct physical loss"); Matzner v. Seaco Ins. Co., No. 96-0498-B, 1998 WL 566658, at *3–4 (Mass. Super. Ct. Aug. 12, 1998) (carbon monoxide contamination of apartment building was direct physical loss or damage); Farmers Ins. Co. of Or. v. Trutanich, 858 P.2d 1332, 1336 (Or. Ct. App. 1993) (odor produced by methamphetamine "cooking" that infiltrated house was a direct physical loss); Murray v. State Farm Fire & Cas. Co., 509 S.E.2d 1 (W. Va. 1998) (home rendered unsafe and uninhabitable because of the danger of falling rocks and boulders suffered direct physical loss).

42. 115 Cal. Rptr. 3d 27 (Ct. App. 2010).

coverage to apply. There, and as a result of storms, MRI Healthcare's landlord had to repair the roof over the room housing MRI Healthcare's MRI machine.[43] These repairs could not be undertaken until the MRI machine was demagnetized, or "ramped down."[44] But once the machine was ramped down, it failed to ramp back up.[45] MRI Healthcare claimed that this failure constituted "damage" to the MRI machine and a resulting business income loss.[46] The State Farm policy's insuring clauses required "accidental direct physical loss" to property "caused by an insured loss."[47] MRI Healthcare claimed that the storms were covered perils and were the cause of the loss so that it was entitled to recover both the cost to repair the MRI machine and the income loss sustained while the machine was inoperable.[48] But State Farm disagreed and denied coverage.[49]

In affirming summary judgment for State Farm, the court concluded that for a loss to be covered, there must be a "distinct, demonstrable, physical alteration of the property."[50] The court, quoting from a Georgia decision, reasoned that a direct physical loss " 'contemplates an actual change in insured property then in a satisfactory state, occasioned by accident or other fortuitous event directly upon the property causing it to become unsatisfactory for future use or requiring that repairs be made to make it so.' "[51]

Here, the court found that there was no "distinct, demonstrable [or] physical alteration" of the MRI machine.[52] Rather, the court found that the failure of the MRI machine to satisfactorily "ramp up" was due to "the inherent nature of the machine itself" and not actual physical damage.[53] In other words, the fact that the machine was turned off and could not be turned back on did not "constitute a compensable 'direct physical loss' under the policy."[54] The court reiterated that for coverage to apply, "some *external force* must have acted upon the insured property to cause a *physical change* in the condition of the property."[55]

43. *Id*. at 31.
44. *Id*.
45. *Id*.
46. *Id*.
47. *Id*.
48. *Id*.
49. *Id*. at 32.
50. *Id*. at 37.
51. *Id*. (quoting AFLAC, Inc. v. Chubb & Sons, Inc., 581 S.E.2d 317, 319 (Ga. Ct. App. 2003)).
52. *Id*. at 38. Because the accidental direct physical loss requirement was part of the policy's insuring clause, the court noted that MHC bore the burden of proof. *Id*. at 36.
53. *Id*. at 38.
54. *Id*.
55. *Id*. (emphasis in original).

B. Universal Image

In *Universal Image Productions, Inc. v. Chubb Corp.*,[56] a federal district judge in Michigan also found that there must be some physical change or alteration in the condition of the property for coverage to apply. There, after a heavy rainfall, a foul odor began to permeate the building occupied by Universal, a television production firm.[57] Subsequent testing revealed bacterial contamination in the air and water inside the duct work. Universal's landlord shut down and cleaned the air-handling system and ductwork and installed temporary cooling units. Universal claimed that this work caused a major disruption of its business activities.[58] Universal's policy with Federal Insurance Co. covered "direct physical loss or damage to building or personal property caused by or resulting from a peril not otherwise excluded."[59] Universal argued that it suffered a direct physical loss in the form of a pervasive odor and mold and bacterial contamination.[60] Federal, however, denied coverage, asserting that there was no physical loss or damage.[61]

In the subsequent coverage litigation, the trial court granted summary judgment to Federal, finding that Universal did not suffer a physical loss. First, the court noted that the term "physical" is defined "as something which has a 'material existence: perceptible especially through the senses and subject to the laws of nature.' "[62] Next, the court found that Universal had not shown that it suffered "any structural or any other tangible damage to the insured property."[63] In rejecting Universal's argument that the strong odors and the presence of mold and bacteria in its building rendered the premises useless, the court concluded that even physical damage that occurs at the molecular or microscopic level must be "distinct and demonstrable."[64] Although Universal claimed its premises had been engulfed by an appalling odor, the court found that "there is

56. 703 F. Supp. 2d 705 (E.D. Mich. 2010).

57. *Id.* at 708.

58. *Id.*

59. *Id.* at 709.

60. *Id.* There is no mention of any contamination exclusion.

61. *Id.*

62. *Id.* (quoting Merriam Webster's Online Dictionary, http://www.merriam-webster.com/dictionary/physical) (last visited Mar. 26, 2010)).

63. *Id.* at 710.

64. *Id.* (quoting Columbiaknit, Inc. v. Affiliated FM Ins. Co., No. 98–434-HU, 1999 WL 619100, at *7 (D. Or. Aug. 4, 1999)). In *Columbiaknit*, rainwater entered a building occupied by a clothing manufacturer. The rainwater saturated some of the insured's garments and fabrics, and the remaining contents of the building, including other garments and fabrics, were exposed to high humidity and mold spores for a prolonged period while the building was being dried out. *Columbiaknit*, 1999 WL 619100, at *1. The court found that garments and fabrics that were water-soaked, moldy, or on which there was a "pervasive, persistent or noxious odor" sustained physical loss or damage. *Id.* at *7.

no evidence that this stench was so pervasive as to render the premises uninhabitable."[65]

C. Ward

In *TRAVCO Insurance Co. v. Ward*,[66] a federal district judge in Virginia found that physical change or alteration to property was not necessary and that a "direct physical loss" occurred where property was rendered unusable because of the presence of a noxious odor. In *Ward*, the insured sought coverage claiming that his home had been rendered uninhabitable because the walls built with "Chinese Drywall" emitted sulfide gases and other toxic chemicals through "off-gassing" that created noxious odors and caused damage and corrosion.[67] TRAVCO, whose policy provided coverage for "direct physical loss" to insured property, denied coverage, asserting that physical damage required some physical alteration or injury to the property's structure.[68]

In TRAVCO's declaratory relief action, the court found that the Ward residence had suffered a direct physical loss.[69] The court reasoned that the majority of cases on this issue appeared to support Ward's position that physical damage to the property was not necessary "where the building in question has been rendered unusable by physical forces."[70] The court found TRAVCO's cases distinguishable because they did not involve situations in which the property in question was rendered unusable.[71] The court found that, in contrast to TRAVCO's cases, Ward's home had been rendered uninhabitable by the toxic gases released by the Chinese Drywall.[72]

65. *Universal Image*, 703 F. Supp. 2d at 710.

66. 715 F. Supp. 2d 699 (E.D. Va. 2010).

67. *Id*. at 703. "Chinese Drywall" is a drywall manufactured in China that emits odors and can corrode copper piping and wiring. *See generally* Ctrs. for Disease Control & Prevention, Imported Drywall and Your Home, http://www.cdc.gov/nceh/drywall/docs/ImportedDrywallandYourHome.pdf (last visited Oct. 29, 2010).

68. *TRAVCO*, 715 F. Supp. 2d at 709.

69. *Id*. at 708.

70. *Id*. at 709 (citing Hughes v. Potomac Ins. Co., 18 Cal. Rptr. 650, 655 (Ct. App. 1962); Essex v. BloomSouth Flooring Corp., 562 F.3d 399, 406 (1st Cir. 2009); Motorists Mut. Ins. Co. v. Hardinger, 131 F. App'x 823, 825–27 (3d Cir. 2005); W. Fire Ins. Co. v. First Presbyterian Church, 437 P.2d 52, 55 (Colo. 1968); Farmers Ins. Co. v. Trutanich, 858 P.2d 1332, 1336 (Or. Ct. App. 1993); Murray v. State Farm Fire & Cas. Co., 509 S.E.2d 1, 17 (W. Va. 1998)).

71. *Id*. TRAVCO had relied on *Port Authority v. Affiliated FM Insurance Co.*, 311 F.3d 226 (3d Cir. 2002); *Whitaker v. Nationwide Mutual Fire Insurance Co.*, 115 F. Supp. 2d 612 (E.D. Va. 1999); and *Great Northern Insurance Co. v. Benjamin Franklin Federal Savings & Loan Association*, 793 F. Supp. 259 (D. Or. 1990). *TRAVCO*, 715 F. Supp. 2d 709.

72. *TRAVCO*, 715 F. Supp. 2d 709. Interestingly, the court also found that its conclusion was strengthened by the fact that "Property Damage" in the liability section of the policy was defined to include "loss of use of tangible property." *Id*. The court observed that "this definition suggests that the parties intended to define 'direct physical loss' to include total loss of use." *Id*.

But Ward's victory on the physical loss or damage issue was a hollow one because the court also found that the latent defect, faulty materials, corrosion, and pollution exclusions barred coverage for the cost of removing and replacing the Chinese Drywall and for all of the damages claimed to have been caused by the Chinese Drywall.[73]

D. *Conclusion*

As demonstrated by the *MRI Healthcare*, *Universal Image*, and *Ward* cases, disputes continue to arise between insurers and insureds as to the meaning of "physical loss or damage." In all three cases, the courts confirmed that direct physical damage was a necessary predicate to insurance coverage.

That necessary predicate was clearly absent in *MRI Healthcare*. There, the MRI equipment, after first being turned off, simply would not restart. That is not physical loss or damage. The outcomes in *Universal Image* and *Ward*, both of which involved primarily damage from odors, seemed to turn on the effect of those odors. In *Ward*, the insured's home became uninhabitable, but in *Universal Image*, there was no evidence that was the case.

Some insureds may argue that *Ward* stands for the broad proposition that any loss of use or functionality of insured property constitutes "physical loss or damage." But the case cannot be read that broadly. In *Ward*, there was physical damage (in the form of excluded corrosion) to wiring and copper components of the home. Furthermore, the noxious odor was sensory and in that sense "physical."

In sum, the interpretation of the physical loss or damage requirement can vary by jurisdiction. As such, insurers and insureds must be aware of the law on this issue in the applicable jurisdiction.

VI. Recent Developments in Bad Faith Litigation: Bad Faith May Apply to an Insurer's Failure to Settle Within an Insured's Deductible

In *Roehl Transport, Inc. v. Liberty Mutual Insurance Co.*,[74] the Wisconsin Supreme Court unanimously extended the common law tort of bad faith beyond "the three fact patterns described in the existing case law"[75] to an insurance company that failed to settle within its insured's high deductible amount, holding that an insured has a viable claim for bad faith when the insurance company "fails to act in good faith and exposes the insured to liability for sums within the deductible amount."[76] The court analogized

73. *Id.* at 712–18.
74. 784 N.W.2d 542 (Wis. 2010).
75. *Id.* at 552.
76. *Id.* at 555. The court thus determined that an excess liability judgment is not "a necessary prerequisite for an insured to bring a third-party bad faith claim under Wisconsin law." *Id.* at 551.

the circumstances in *Roehl* to a third-party case in which a claim exceeds the policy limits,[77] observing "[i]n both instances, the insurance company has control over settlement, the insured has direct financial exposure as a result of the insure[r]'s conduct, and the interests of the insurance company and the insured diverge."[78] The court opined, "an insurance company may not burden the insured with payment of the deductible through its failure to negotiate settlement or conduct its investigation of the claim in good faith."[79]

A Truckers/Auto Insurance Policy issued by Liberty Mutual insured Roehl Transport, Inc., up to $2 million in liability coverage.[80] The policy had a $500,000 deductible and included a provision giving Liberty the right and duty to defend Roehl and to investigate and settle any claim or suit as Liberty deemed appropriate.[81] Roehl paid a claim-handling fee and negotiated "Special Handling Instructions" that obligated Liberty to discuss and obtain Roehl's agreement "on all bodily injury settlements."[82]

Roehl's bad faith claim arose from a personal injury claim brought by a third party whose car had been rear-ended by a Roehl truck. When no settlement was reached, the injured third party sued Roehl and obtained a jury verdict in the amount of $830,400.[83] Roehl subsequently filed a bad faith claim against Liberty, alleging Liberty mishandled the claim by conducting an inadequate investigation, assigning inexperienced and high-turnover staff, and failed to make good faith efforts to achieve a settlement.

On cross motions for summary judgment, the Wisconsin circuit court determined Roehl had asserted a viable bad faith claim against Liberty under Wisconsin law.[84] Roehl's bad faith claim proceeded to jury trial. At trial, Roehl contended Liberty should have settled the third-party claim for $100,000 and sought damages for the difference in the $100,000 potential settlement and Roehl's $500,000 deductible ($400,000). Liberty argued there was no bad faith and thus no damages.

The jury determined Liberty had breached its duties owed to Roehl, that such breach "demonstrate[d] a significant disregard" of Roehl's interests, and that the failure to settle was in bad faith, awarding Roehl $127,000 in damages.[85] Both parties filed post-trial motions that the circuit court

77. *Id.* at 555.
78. *Id.*
79. *Id.*
80. *Id.* at 546.
81. *Id.* at 548.
82. *Id.* at 548 & n.8.
83. *Id.* at 548.
84. *Id.* at 549.
85. *Id.*

denied, which prompted the appeal and cross-appeal to the state supreme court.[86]

On appeal, Liberty argued that, despite a good faith duty, a corresponding cause of action for bad faith does not exist, even if an insurer breaches that duty, if policy limits are not exceeded.[87] The Wisconsin Supreme Court rejected this argument, opining that Roehl's interests (exposure of its substantial deductible) were within Liberty's control, which vested Roehl with a bad faith tort claim against Liberty for breach of its duty of good faith.[88]

While fact specific, the Wisconsin court's holding relies upon the well-accepted rationale that, when an insurance company's interests conflict with those of its insured, the insurer's failure to handle all aspects of a claim with the utmost good faith, including potential settlement opportunities, may give rise to a claim of bad faith.[89] The court noted that "[i]n the past, an insurance company's decision to settle within policy limits generally cost an insured little because the deductible was modest."[90] Many jurisdictions have yet to be presented with a bad faith claim when a judgment within policy limits is entered against an insured. However, such claims of bad faith against insurers who fail to settle and thereby burden their insureds with payments of high deductibles may become more prevalent, given the increasing number of policies with high deductibles.

Few courts have addressed this precise issue, and those that have are not in agreement.[91] The common law of bad faith may continue to develop as a

86. *Id.* at 550. The Wisconsin Supreme Court determined five issues on Roehl's appeal and Liberty's cross-appeal, the first of which is analyzed herein. The court also determined that the jury's finding of bad faith and award of damages were supported by the evidence; judicial public policy did not preclude Roehl's bad faith claim; Roehl was entitled to attorney fees as a matter of law upon the jury's bad faith finding; and the circuit court did not err in denying Roehl's punitive damages claim. *Id.* at 578. Thus, the court affirmed the circuit court's judgment and order awarding Roehl damages on its bad faith claim and denying punitive damages, reversed the circuit court's denial of attorney fees, and remanded the determination as to the amount of fees recoverable by Roehl. *Id.* at 578–79.

87. *Id.* at 561.

88. *Id.*

89. *Id.* at 553–54.

90. *Id.* at 546.

91. *Id.* at 563–64 & nn.41–42 (citing to the jurisdictions of New York, Texas, and Illinois). An Illinois federal district court rejected the insured's claim of bad faith under facts that had required the insured to pay a large deductible upon settlement within policy limits, opining, "[w]hile [the insured] certainly risked significant personal liability in this case because of the large deductible, that risk was exactly what it had contracted for," in *American Protection Insurance Co. v. Airborne, Inc.*, 476 F. Supp. 2d 985, 995 (N.D. Ill. 2007). *But see Roehl*, 784 N.W.2d at 555 ("An insurance company's bad faith conduct exposes an insured to a set of harms not covered by the policy."). *See also* Commerce & Indus. Ins. Co. v. N. Shore Towers Mgmt. Inc., 617 N.Y.S.2d 632, 634 (Civ. Ct. 1994) ("[c]ases involving settlements within a deductible also present a potential conflict between the insured's interest in paying as small a part of the deductible as possible"); Carlisle Ins. Co. v. Twin Cnty. Recycling Corp., 2001 WL 856472, at *1–2 (Dist. Ct. May 21, 2001) (limiting *North Shore* to its facts).

natural expansion of the concept that an insurer owes to its insured a good faith duty to handle claims against its insured in a manner that places the insured's interests, at a minimum, on par with the insurer's.[92] Equating the risk of "significant personal liability" because of a large deductible to a risk that was exactly what the insured had contracted to bear provides another perspective in evaluating this issue.[93]

Courts of other jurisdictions will likely weigh the conflict between insurers and insureds created by large deductibles and settlements within policy limits within the framework of well-established tenets that allow parties the freedom to contract and to assume known financial risks (large deductibles) in order to gain financial benefits (smaller premiums). Given the proliferation of liability policies with large deductibles, it seems unavoidable that courts will be presented with increasing numbers of bad faith claims premised upon *Roehl*'s rationale. The Wisconsin Supreme Court decision in *Roehl* portends the further extension of the common law tort of bad faith to insurance companies that fail to settle within their insureds' deductible amounts. Whether the *Roehl* holding ultimately will represent the majority view or a minority opinion remains to be seen.

VII. RECENT DEVELOPMENTS IN LITIGATION OVER THE DUTY TO DEFEND

A. *CGL Carrier's Duty to Defend No-Injury Consumer Class Action Complaints*

When does a CGL insurer have a duty to defend a so-called no-injury consumer class action complaint premised on a dangerous or defective product? The Seventh Circuit recently answered that question in *Medmarc Casualty Insurance Co. v. Avent America, Inc.*,[94] holding that no duty to defend is triggered absent allegations of actual physical harm to the plaintiffs.[95] The ruling in *Avent* is significant because it curtails an insured's ability to secure a defense for consumer class action complaints unless the relief sought in the class action complaint is for damages for actual physical harm.

The facts considered by the Seventh Circuit were not atypical for consumer class actions. Avent America, Inc. ("Avent") was named as one of several defendants in a series of class action complaints relating to the

92. *See*, *e.g.*, Rocor Int'l Inc. v. Nat'l Union Fire Ins. Co., 966 S.W.2d 559, 569 (Tex. App 1998) (affirming jury award against insurer for settling a catastrophic automobile liability claim negligently and in bad faith).
93. *Am. Prot. Ins. Co.*, 476 F. Supp. 2d at 995.
94. 612 F.3d 607 (7th Cir. 2010).
95. *Id*. at 609.

presence of Bisphenol-A ("BPA") in baby bottles and related products Avent sold.[96] The plaintiffs and putative class members were the parents of children who purchased the BPA bottles and related products unaware of the dangers BPA exposure presented to human health.[97] The various complaints, later consolidated into multidistrict litigation, asserted the same general claim: Avent manufactured products containing BPA; Avent was aware of the large body of research that showed the BPA is harmful to humans and human health, particularly to children; and Avent marketed its products as superior in safety despite its knowledge of the dangers of BPA; parents would not have purchased the products had they been aware of the dangers associated with BPA; and on hearing of the dangers, parents stopped using the products, not receiving the full economic benefit of their purchase.[98] Since the class actions were consolidated into multidistrict litigation, the court evaluated the duty to defend by examining the allegations in the representative complaint.[99] The representative complaint defined the class as all persons who purchased Avent products containing BPA. The complaint then listed, in exhaustive detail, the health risks associated with BPA exposure.[100]

The court observed that, despite a stated concern about the health risks because of exposure to BPA, there were no allegations that any child allegedly exposed to the BPA-containing products suffered any ill effects from that exposure. There were also no allegations that the children were actually exposed to BPA. The "uniform injury" as observed by the court was that the plaintiffs in all the complaints purchased "an unusable product."[101] The complaints universally sought relief under various state consumer protection statutes, alleged breach of express and implied warranty, intentional and negligent misrepresentation, and unjust enrichment.[102]

Avent tendered defense of the class actions to Medmarc Insurance Company, Pennsylvania Insurance Company, and State Farm Fire and Casualty Company, its liability insurers. Each of these insurers issued policies that agreed to "pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage'. . . ."[103] These policies defined "bodily injury" as "bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any

96. *Id*. at 609–10.
97. *Id*.
98. *Id*. at 609.
99. *Id*. at 610.
100. *Id*.
101. *Id*.
102. *Id*.
103. *Id*. at 612.

time."[104] The trial court granted the insureds' motions for summary judgment and concluded no duty to defend existed.

Avent's argument on appeal focused on the known dangers of BPA exposure.[105] Avent reasoned that, because it allegedly manufactured and distributed products known to be harmful to human health, any liability it faces in the underlying class actions is liability "*because of* bodily injury" as contemplated by the coverage grant.[106] The Seventh Circuit disagreed.

The court noted that the "problem" with Avent's argument was the absence of any allegation of actual physical harm: "Even if the underlying plaintiffs proved every factual allegation in the underlying complaints, the plaintiffs could not collect for bodily injury because the complaints do not allege any bodily injury occurred."[107]

The court also rejected Avent's contention that the decision not to allege actual harm was based on the plaintiff's whim to be able to proceed as a class action.[108] The court acknowledged the rule that insureds are generally not at the mercy of the draftsmanship skills or whims of the underlying plaintiff. But the court reasoned that the BPA class action plaintiffs' universal decision not to allege actual physical harm was no whim at all. It was instead the "strategic decision" to pursue what amounted to be a solely economic claim.[109] The court found support for this conclusion in rulings by the district court in the multidistrict litigation based on the BPA plaintiffs' admission that they sought economic damages only and not relief for physical harm.[110]

Finally, the court rejected Avent's contention that finding no duty to defend required too narrow a construction of the generally broad phrase "*because* of bodily injury" that is usually applied to the phrase "for bodily injury."[111] The court explained that even with a broadly construed "because of bodily injury" there was no allegation that tied the damages sought to physical harm caused by a BPA product.

The theory of relief in the underlying complaint is that the plaintiffs would not have purchased the products had Avent made certain information known to the consumers and therefore the plaintiffs have been economically injured. The theory of the relief is not that a bodily injury occurred and that damages flow from that bodily injury.[112]

104. *Id.*
105. *See id.* at 614.
106. *Id.*
107. *Id.*
108. *Id.* at 615.
109. *Id.*
110. *Id.*
111. *Id.* at 616.
112. *Id.* at 616.

Citing to *Healthcare Industry Liability Insurance Program v. Momence Meadows Nursing Center*,[113] the court observed that the allegations relating to the damage BPA can cause supported the economic loss claim plaintiffs asserted. It was significant that to succeed in the class action, the plaintiffs did not need to conclusively prove that BPA causes any injury.[114]

Avent was decided under Illinois substantive law. However, given that Illinois is a pro-insured duty to defend jurisdiction, *Avent* can be cited as clear authority for the proposition that insurers have no duty to defend consumer class actions asserted by disappointed purchasers seeking economic damages—even where those complaints include extensive allegations depicting the dangers to human health posed by a product. Given the reality that consumer class actions will rarely include individualized allegations of physical harm for fear of jeopardizing class certification, the *Avent* opinion represents a significant limitation on an insurer's duty to defend obligations.[115] An issue left unresolved by *Avent* is whether a claimed element of damages for medical monitoring relief constitutes damages "because of bodily injury."

In examining the lack of allegations of bodily injury in the BPA class actions, the *Avent* court noted that the BPA complaints did not allege that the plaintiffs had an increased risk of bodily injury for which they should be compensated.[116] The court also distinguished *Ace American Insurance Co. v. RC2 Corp*.[117] (in which a duty to defend was found based on exposure to lead) because that case "specifically alleged that the named plaintiffs and class members 'suffered an increased risk of serious health problems making periodic examinations reasonable and necessary.' "[118] Insureds will seize on this language to argue that, where a class action complaint includes a request for establishment of a medical monitoring fund, the complaint alleges damages "because of bodily injury" sufficient to trigger a duty to defend.[119]

113. 566 F.3d 689 (7th Cir. 2009).

114. *Avent*, 612 F.3d at 617.

115. The issue is not wholly resolved. The *Avent* court declined to follow two cases reaching the opposite conclusion finding that the analysis in those cases permitted consideration of the fact that a complaint could be amended in evaluating the duty to defend—a rule contrary to Illinois law. *Id.* at 617–18 (citing N. Ins. Co. of N.Y. v. Baltimore Bus. Comm., Inc., 68 F. App'x 414 (4th Cir. 2003); Plantronics, Inc. v. Am. Home Assur., 2008 WL 4665983 (N.D. Cal. Oct. 20 2008)). The *Northern* opinion was criticized in *Steadfast Insurance Co. v. Purdue Frederick Co.*, 2006 WL 1149202 (Conn. Super. Ct. Apr. 10, 2006).

116. *Avent*, 612 F.3d at 614.

117. 568 F. Supp. 2d 946 (N.D. Ill. 2008).

118. *Avent*, 612 F.3d at 615–16.

119. The Seventh Circuit reversed *RC2* on other grounds and did not determine whether the exposure to lead paint without manifestation of physical injury constituted damages because of bodily injury. *See* Ace Am. Ins. Co. v. RC2 Corp., Inc., 600 F.3d 763 (7th Cir. 2010); *Avent* 612 F.3d at 616 n.3.

Consistent with the *Avent* court's holding requiring actual physical harm before the duty to defend attaches, insurers will argue that a claim for a medical monitoring fund—which by its very nature concedes no physical injury has yet (or may ever) occur—does not trigger the duty to defend. Without an "occurrence" there should arguably be no coverage for a fund established to ascertain if physical harm is sustained in the future—unless that relief is sought in conjunction with damages for bodily injury allegedly sustained by some of the plaintiffs. This question was addressed by the Illinois Appellate Court in *HPF, LLC v. General Star Indemnity Co.*[120]

The insured in *HPF* was sued in connection with the sale of Phen-Fen products.[121] The class action complaint sought to establish a medical monitoring fund for persons who used Phen-Fen.[122] The insured argued that the request for medical monitoring constituted damages "because of bodily injury." The Illinois Appellate court disagreed and reasoned that, because the request was in the prayer for relief, it was not allegation of bodily injury. The court also noted that the purpose of medical monitoring is to monitor the products' effects. The court declined the invitation to presume that the products caused bodily injury.[123]

Taken together, *Avent* and *HPF* appear to strictly limit, if not eliminate, the duty to defend consumer class action complaints absent allegations of damages for physical harm sustained by members of the putative class.

B. *Carrier's Right to Reimbursement of Defense Costs After a Determination of No Coverage*

Insurers that fund their insured's defense while contesting coverage often face the question of whether they may recoup those defense costs from the insured if it is later determined that the claims against the insured are not covered. The answer to this question varies; pro-reimbursement jurisdictions usually allow reimbursement as long as the insurer's reservation of rights letter specifically states that the insurer may later seek to recoup defense costs.[124] Anti-reimbursement jurisdictions typically hold that a reservation of rights letters cannot "create" a right of reimbursement; instead,

120. 788 N.E.2d 753 (Ill. App. Ct. 2003).
121. *Id.* at 754–55.
122. *Id.* at 755.
123. *Id.* at 756–58.
124. *See, e.g.*, Buss v. Superior Court, 939 P.2d 766, 778 (Cal. 1997). *Buss* is one of the cases cited most frequently as endorsing the view that a right of reimbursement may be premised on a reservation of rights letter.

an insurer may only obtain reimbursement where the policy contains an express provision to that effect.[125] Although courts have labeled the pro-reimbursement line of cases as the "majority view,"[126] no clear consensus appears to be emerging. If anything, the split is deepening, with several recent decisions espousing the so-called minority view.[127] Here we discuss two recent decisions that exemplify the split, a Tenth Circuit Court of Appeals decision allowing an insurer to recoup defense costs and a ruling by the Pennsylvania Supreme Court rejecting an insurer's attempts at reimbursement.

1. Pro-Reimbursement View

Valley Forge Insurance v. Health Care Management Partners[128] followed the familiar fact pattern under which most cases of this type arise. Zurich and Valley Forge agreed to defend their mutual insured, Health Care Management, in a lawsuit brought by various governmental agencies alleging Medicare fraud.[129] Both insurers agreed to defend their insureds under a reservation of rights that specifically included a reservation of the right to recoup defense costs in the event a court later agreed there was no duty to defend.[130] While the underlying lawsuit was proceeding, the insurers filed a declaratory judgment action.[131] The district court ruled in favor of the insurers, finding no coverage and that the insurers were entitled to reimbursement of defense costs.[132]

On appeal the Tenth Circuit affirmed, ruling that under Colorado law, insurers are entitled to recoup defense costs if they have reserved the right to do so.[133] The court rejected the insured's argument that allowing insurers to reserve the right to obtain reimbursement absent an express provision in the policy was contrary to Colorado law and public policy.[134] In doing so, the court relied on two decisions by the Colorado Supreme Court that

125. *See, e.g.*, Gen. Agents Ins. Co. of Am. v. Midwest Sporting Goods Co., 828 N.E.2d 1092, 1104 (Ill. 2005); Terra Nova Ins. Co. v. 900 Bar, Inc., 887 F.2d 1213, 1219–20 (3d Cir. 1989).

126. *See* Am. & Foreign Ins. Co. v. Jerry's Sport Ctr., Inc., 2 A.3d 526, 532 (Pa. 2010) (discussing "majority" and "minority" views).

127. *Id.*; Zurich Am. Ins. Co. v. Pub. Storage, No. 1:09cv1394, 2010 WL 3992222 (E.D. Va. Sept. 17, 2010); Blue Cross of Idaho Health Serv., Inc. v. Atl. Mut. Ins. Co., No. 1:09-CV-246-CWD, 2010 WL 3326930 (D. Idaho Aug. 23, 2010).

128. 616 F.3d 1086 (10th Cir. 2010).

129. *Id.* at 1089–90.

130. *Id.*

131. *Id.* at 1090.

132. *Id.* at 1089.

133. *Id.* at 1094.

134. *Id.* at 1091–93.

indicated that recoupment of defense costs is appropriate if a court determines that no duty to defend exists.[135] In those decisions the Colorado Supreme Court "premise[d] the insurer's entitlement to reimbursement on its having reserved that right when it provided a defense to its insured, not on any reimbursement provision in the contract itself."[136] The Tenth Circuit reasoned that the right of recoupment need not appear in the policy, citing statements by the Colorado Supreme Court that it intended to "*create a remedy* for insurers that provided defenses to insureds when coverage ultimately did not exist."[137] The Colorado approach is a compromise that balances the interests of insurers and insureds.[138] It protects insureds by encouraging insurers to defend potentially uncovered claims, while also protecting insurers as they "won't be left holding the bag if it turns out they had no duty to provide" a defense.[139] The court concluded that "[n]othing in these rules or their underlying rationales appears to turn on whether a reservation of rights clause does or doesn't appear in a particular insurance contract."[140]

2. Anti-Reimbursement View

The Pennsylvania Supreme Court took the opposite view in *American & Foreign Insurance v. Jerry's Sport Center, Inc*.[141] The underlying coverage question arose when the NAACP filed a lawsuit against Jerry's and other members of the gun industry, arguing that defendants were liable for injury resulting from a public nuisance created by the industry's failure to sell firearms in a safe manner.[142] Jerry's insurer provided a defense to Jerry's in the NAACP lawsuit under a reservation of rights, including the right to seek reimbursement of defense costs.[143] The policy itself did not contain any language providing for reimbursement.[144] The insurer then filed a lawsuit seeking a declaration that it had no duty to defend or indemnify the NACCP action, arguing that the lawsuit did not allege "bodily injury."[145]

135. *Id*. at 1091–92 (citing Hecla Mining Co. v. N.H. Ins. Co., 811 P.2d 1083, 1089 (Colo. 1991); Cotter Corp. v. Am. Empire Surplus Lines Ins. Co., 90 P.3d 814, 828 (Colo. 2004)). The Tenth Circuit also observed that the insured did not object to the reservation of rights letters and accepted the defense, although this does not appear to have been crucial to the court's holding. *Id*. at 1090.

136. *Id*. at 1092.

137. *Id*.

138. *Id*. at 1092–93 (quoting *Cotter*, 90 P.3d at 828).

139. *Id*.

140. *Id*. at 1093.

141. 2 A.3d 526 (Pa. 2010).

142. *Id*. at 529.

143. *Id*. at 530.

144. *Id*. at 544.

145. *Id*. at 530–31.

The trial court granted summary judgment for the insurer and the ruling was affirmed on appeal.[146] The insurer then filed a motion seeking reimbursement of defense costs incurred in the underlying action from the date it filed the coverage lawsuit.[147] The trial court found that the insurer was entitled to recoup its defense costs based on the doctrine of unjust enrichment.[148] The appellate court reversed, holding that the parties' relationship was governed by the terms of the insurance policy, which could not be altered by reservation of rights letters.[149]

The Supreme Court affirmed the appellate court, holding that Jerry's had no obligation to reimburse its insurer.[150] The court reasoned that a resolution in favor of the insurer does not "retroactively eliminate the insurer's duty to defend during the period of uncertainty" in cases where coverage is in question.[151] The court held that such a result would "amount to a retroactive erosion of the broad duty to defend in Pennsylvania" by making the defense obligation essentially co-extensive with the duty to indemnify.[152] The policy in question provided that the insurer would pay, with respect to "any suit against an Insured we defend . . . [a]ll expenses we incur."[153] The court observed that this language "arguably answers the question before us" because it obligated the insurer to pay "all expenses" for those claims where it provides a defense, regardless of whether it was obligated to defend under the policy.[154] Because there was no right to reimbursement in the policy, the insurer could not reserve the "right" in letters to the insured.[155] Permitting reimbursement based only on a reservation of rights letter would be "tantamount to allowing the insurer to extract a unilateral amendment" to the policy.[156]

Finally, the court considered whether an equitable right to reimbursement existed based on an unjust enrichment theory.[157] Because an insurer defends its insured at least in part to protect itself, the court reasoned that the insured had not been unjustly enriched.[158] By exercising its right to defend, an insurer is enriched by enabling it to select defense counsel and effectively control the defense so as to mitigate any future indemnity

146. *Id.* at 531.
147. *Id.*
148. *Id.* at 531–32.
149. *Id.* at 532.
150. *Id.* at 546.
151. *Id.* at 542.
152. *Id.* at 544.
153. *Id.* at 543 n.14 (alteration in original).
154. *Id.*
155. *Id.* at 544–45.
156. *Id.* at 544.
157. *Id.* at 545–46.
158. *Id.* at 545.

obligation.[159] Additionally, by defending, the insurer protects itself from the potential for a bad faith claim.[160]

3. Conclusion

In the last year, courts continued to reach conflicting decisions concerning an insurer's ability to recoup defense costs following a determination of no coverage. The pro-reimbursement view has traditionally been described as the "majority" position and while from a numerical point of view that still may be true,[161] the anti-reimbursement position appears to be on the rise. In *Jerry's Sport Center*, the Pennsylvania Supreme Court described the anti-reimbursement view as "growing," a sentiment that was echoed in a recent opinion by the District Court for the District of Idaho.[162] Indeed, the Tenth Circuit in *Valley Forge* did not use the terms "majority" or "minority"; the court observed only that state courts are "divided on how best to handle insurers' recoupment claims."[163] Of course, this division can present claims-handling difficulties for primary insurers issuing policies in multiple jurisdictions. The safest practice for those insurers who wish to recoup defense costs is to address the issue in the policy itself rather than at the claims-handling stage.

159. *Id*.
160. *Id*. at 546.
161. *See id*. at 538–39 (citing multiple cases on either side of the discussion).
162. Blue Cross of Idaho Health Serv., Inc. v. Atl. Mut. Ins. Co., No. 1:09-CV-246-CWD, 2010 WL 3326930, at *8 n.5 (D. Idaho Aug. 23, 2010).
163. *Valley Forge Ins*. 616 F.3d at 1091.

RECENT DEVELOPMENTS IN INTELLECTUAL PROPERTY LAW

Joel W. Mohrman, R. Andrew Patty II, Randolph Stuart Sergent, and Anderson Cao

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I. INTRODUCTION

The rapid changes in technology and society, coupled with ever-increasing value of intellectual property to businesses, has caused courts to respond accordingly. In the past year, the U.S. Supreme Court and the circuit courts of appeal have continued to issue opinions attempting to keep the established body of intellectual property law applicable to modern facts.

II. PATENTS

In a continuing trend, the U.S. Supreme Court appears to be setting the stage for a high level of activity this coming year in the area of patent law, based upon the number of granted writs. In 2009–2010, the Supreme Court's most notable decision was *Bilski v. Kappos*, a case addressing the

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standard applicable in determining whether a process is patent-eligible under 35 U.S.C. § 101.[1] Bilski claimed a method for hedging risk in commodity trading due to price fluctuations, with particular application in the energy markets.[2] The patent claims were rejected as ineligible under § 101, and the U.S. Patent Office's Board of Patent Appeals and Interferences affirmed on the basis that the claims failed to employ an apparatus, merely manipulated an abstract idea, and solved a purely mathematical problem.[3] The Federal Circuit en banc affirmed the Board's decision by rejecting its prior "useful, concrete, and tangible result" test for process claim patent eligibility, and holding instead that a claimed process is patent eligible "if (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing."[4] Applying this "machine-or-transformation test" to the Bilski claims, the Federal Circuit found those claims to be ineligible for patenting.[5]

In a five-to-four decision revealing a fractured Supreme Court, Justice Kennedy wrote in the majority opinion that the prior "machine-or-transformation test" adopted by the Federal Circuit to deny patent eligibility to the Bilski process claims was not the exclusive test for patent eligibility under § 101.[6] Instead, the Court referred to that test as a nonexclusive, but useful, analytical tool in some cases.[7] The Court further held that the claimed process at issue was directed to an abstract idea.[8] As an abstract idea, the claimed process was, in accordance with precedent, ineligible for patenting under 35 U.S.C. § 101.[9]

In affirming the result below by determining that the claimed method for hedging commodities trading risks arising from price fluctuations was an abstract idea ineligible to be patented, the Court avoided pronouncement of any single test for process claim patent eligibility. It also did not set forth any particular test for holding a claimed process invention to be merely an "abstract idea," but suggested that there might be claims to processes (including business processes or methods) that do not meet the "machine-or-transformation test" but are nevertheless patent-eligible under § 101. By avoiding the harder task of defining any "abstract idea" standard, or a single standard for patent eligibility of claimed processes under 35 U.S.C. § 101, the Court left it to patent applicants and the lower courts to

1. 130 S. Ct. 3218 (2010).
2. *Id.* at 3223.
3. *Id.* at 3224.
4. *In re* Bilski, 545 F.3d 943, 954 (Fed. Cir. 2008) (en banc).
5. *Id.* at 963–66.
6. *Bilski*, 130 S. Ct. at 3226.
7. *Id.* at 3227.
8. *Id.* at 3229–30.
9. *Id.* at 3231.

determine how one might identify or claim a patent-eligible process that is devoid of the use of a machine or apparatus, and does not involve a physical transformation of matter.

The proof required to sustain a finding of inducement of patent infringement was addressed by the Federal Circuit in *SEB S.A. v. Montgomery Ward & Co*.[10] The case below involved infringement allegations regarding certain deep fryers manufactured by the defendant and allegedly covered by the patent in question.[11] The defense's motion for a judgment as a matter of law on the question of inducement of infringement was denied, even though the record showed no direct evidence that defendant had actual knowledge of the patent in suit prior to receiving notice of the suit.[12] On appeal of the district court's denial, the Federal Circuit affirmed, holding that the knowledge element, required for the alleged inducer to be liable, can be met by proof that the inducer had either actual or constructive knowledge of the patent.[13] Constructive knowledge of the patent, the court held, could be found through evidence that the inducer engaged in "deliberate indifference" with respect to whether there existed a patent that covered the product serving as a model in the development of the alleged inducer's product.[14] At the time of this writing, the Supreme Court had granted *certiorari* on the question of whether the legal standard for the state of mind element of a claim for actively inducing infringement under 35 U.S.C. § 271(b) is "deliberate indifference" to a known risk that an infringement may occur, as the Federal Circuit held, or "purposeful, culpable expression and conduct" to encourage an infringement, as the Supreme Court held in *MGM Studios, Inc. v. Grokster, Ltd*.[15] Look for more from the Supreme Court on this topic next year.

In *i4i v. Microsoft*, the Federal Circuit addressed several issues, including whether the presumption of validity with respect to an issued U.S. patent requires clear and convincing evidence to support a finding of patent invalidity, when the prior art at issue was not before the Patent Office at the time the patent was granted.[16] Plaintiff i4i sued Microsoft for infringement with respect to patents covering a method for processing and storing information about the structure of electronic documents, and the jury found for plaintiff notwithstanding Microsoft's allegations that a sale of software more than one year prior to the application for patent was invali-

10. 594 F.3d 1360 (Fed. Cir. 2010), *cert. granted*, 131 S. Ct. 458 (2010).
11. *Id*. at 1365.
12. *Id*. at 1367.
13. *Id*. at 1376–77.
14. *Id*.
15. 545 U.S. 913, 937 (2005).
16. i4i Ltd. P'ship v. Microsoft Corp., 598 F.3d 831 (Fed. Cir. 2010).

dating prior art under 35 U.S.C. § 102. The Federal Circuit affirmed the lower court holding and reaffirmed the clear and convincing standard for evidence of patent invalidity, even though the prior art reference was not before the U.S. Patent Office at the time the patent was granted.[17] On appeal to the Supreme Court, Microsoft is expected to urge that a lower evidentiary burden, e.g., a preponderance of the evidence, should be applied to determine the validity of a patent in circumstances where the asserted prior art was not considered by the U.S. Patent Office during the patent's prosecution.

The standard to be used in ascertaining inequitable conduct by an applicant or its counsel during patent prosecution again raised its head before the Federal Circuit in *Therasense, Inc. v. Becton, Dickinson & Co.*[18] The original Federal Circuit opinion was vacated, and as of this writing was pending en banc review.[19] The initial Federal Circuit opinion addressed, among other things, whether a U.S. patent in suit was invalid for inequitable conduct, arising out of failure to disclose statements made to the European Patent Office (EPO) during a revocation proceeding of the European counterpart to the patent in suit.[20] The district court found that statements made by the patent owner's predecessor-in-interest to the EPO were highly material to the prosecution of the patent in suit because they contradicted representations the predecessor made to the USPTO regarding a membraneless sensor disclosed in the patent in suit.[21] In the initial opinion, which now stands vacated, the Federal Circuit held that prior attorney arguments made in another forum (e.g., the EPO) can be material to the question of patentability when those prior statements contradict later statements made to the USPTO.[22] In the coming year, the Federal Circuit's en banc opinion may provide further guidance on whether attorney argument about prior art made in other forums can be information material to the question of patentability, such that patent applicants must relay to the USPTO all attorney prior art arguments made across the globe in counterpart patent applications to avoid possible claims of inequitable conduct.

In two different cases, the Federal Circuit shed further light on the meaning of the false patent marking statute and the scope of *qui tam* actions for civil fines thereunder.[23] First, in *Forest Group, Inc. v. Bon Tool Co.*, the court held that liability calculation under 35 U.S.C. § 292(a), for falsely marking

17. *Id.* at 847–48.
18. 593 F.3d 1289 (Fed. Cir. 2010).
19. Therasense, Inc. v. Becton, Dickinson & Co., 374 F. App'x 35 (Fed. Cir. 2010).
20. *Therasense*, 593 F.3d at 1300.
21. *Id.* at 1301.
22. *Id.* at 1305.
23. 35 U.S.C. § 292.

an article with indicia that the article is protected by a patent, is determined on a per-article basis.[24] Then, in the separate case of *Pequignot v. Solo Cup Co.*, the Federal Circuit confirmed that the false patent marking statute requires a finding that the alleged false marker had a specific intent to deceive.[25] "Because the statute requires that the false marker act 'for the purpose of deceiving the public,' a purpose of deceit, rather than simply knowledge that a statement is false, is required."[26] Thus, while a rebuttable presumption of intent to deceive was established by the fact that (a) the previously patented product was no longer patented at the time of the marking in question (because the patent had expired) and (b) the marker knew the product was no longer patented at the time of that marking, the presumption was rebutted by sufficient evidence that the marker had acted in good faith on advice of counsel.[27] In dicta, the court noted that a finding of liability in the case theoretically could have resulted, under the *Forest Group* precedence, in a penalty of $500 per article falsely marked, and with 21,757,893,672 articles falsely marked, a grand total fine of approximately $5.4 trillion.[28] Unless Congress steps into the fray with new legislation, look for further growth in the new cottage industry of *qui tam* actions for false patent marking under 35 U.S.C. § 292.

In the realm of design patent law, the Federal Circuit expanded upon its prior holding in *Egyptian Goddess*,[29] and held that the "ordinary observer test" should be the sole test for design patent invalidity over cited prior art.[30] The case *International Seaway Trading Corp. v. Walgreens Corp.* involved an owner of design patents for clogs who asserted the patents against competitor defendants, and the lower court granted summary judgment in favor of the defendants.[31] On the patent owner's appeal, the Federal Circuit held that an "ordinary observer test" similar to that adopted in *Egyptian Goddess* to design patent infringement analysis should also apply in the context foe design patent validity.[32] The "ordinary observer test," as stated in the design patent validity context, is a test that asks whether the patented design and the prior art design are substantially similar in the eyes of the ordinary observer armed with the knowledge of the prior art. The Federal Circuit held that the test should apply, affirmed in part, vacated in part, and

24. 590 F.3d 1295, 1301 (Fed. Cir. 2009).
25. 608 F.3d 1356 (Fed. Cir. 2010), *en banc rev. den*. (Fed. Cir. Sept. 15, 2010).
26. *Id*. at 1363.
27. *Id*. at 1364.
28. *Id*. at 1359, n.1.
29. Egyptian Goddess, Inc. v. Swisa, Inc., 543 F.3d 665 (Fed. Cir. 2008) (en banc).
30. Int'l Seaway Trading Corp. v. Walgreens Corp., 589 F.3d 1233, 1240 (Fed. Cir. 2009).
31. *Id*. at 1236.
32. *Id*. at 1237–40.

remanded for further proceedings so that the district court could, among other things, consider the designs' insoles under the "ordinary observer test," rather than the "point of novelty" test, to determine whether the design patents were anticipated and/or made obvious by the prior art.[33]

Finally, the Federal Circuit en banc again addressed the existence of a written description requirement under 35 U.S.C. § 112, first paragraph, in *Ariad Pharmaceuticals v. Eli Lilly*.[34] There, owners of a patent claiming methods comprising the single step of reducing Nuclear Factor Kappa B (NF-kB) activity in eukaryotic cells brought infringement action against a competitor.[35] The lower court denied a motion by the defense for a judgment as a matter of law, after the jury found the patent survived challenges based upon, inter alia, lack of an adequate written description.[36] On appeal, the Federal Circuit en banc reversed in part, holding that there is a separate written description requirement under the statute, and the patent claims asserted were invalid for failing to provide an adequate written description.[37] The court held that the patent applicant failed to provide adequate written description of the claims by hypothesizing three classes of molecules potentially capable of reducing NF-kB activity, where the patent disclosed no working or even prophetic examples of the molecules prophesized to be capable of reducing NF-kB activity.[38] For now, the written description requirement under 35 U.S.C. § 112, first paragraph, remains an additional and separate requirement from the enablement requirement under the same statute.

III. TRADEMARKS

Trademark cases from the past year continue to show that the present and future of trademark law exist on the Internet.

In *Rosetta Stone Ltd. v. Google Inc.*, a federal district court held that Google's Adwords program did not infringe Rosetta Stone's trademarks.[39] Rosetta Stone provides language learning products.[40] Google operates an Internet search engine and derives revenue from selling targeted advertising.[41] When users conduct searches on Google, search results are returned

33. *Id.* at 1244.
34. Ariad Pharm., Inc. v. Eli Lilly & Co., 598 F.3d 1336 (Fed. Cir. 2010) (en banc).
35. *Id.* at 1340.
36. *Id.*
37. *Id.*
38. *Id.* at 1355–57.
39. No. 09-00736, 2010 WL 3063152 (E.D. Va. Aug. 3, 2010).
40. *Id.* at *2.
41. *Id.*

along with sponsored links.[42] Adwords allows an advertiser to select certain search terms that will result in that advertiser's sponsored link appearing alongside related search results.[43] Some of the search terms Google sells may include trademarks.[44] Thus, an advertiser unrelated to Rosetta Stone can pay for the advertiser's sponsored links to appear in response to a search using Rosetta Stone's trademarks.[45] For example, a search for "Rosetta Stone" might yield a sponsored link to a website selling Rosetta Stone software even though the site is unaffiliated with Rosetta Stone.

Rosetta Stone claimed that by giving unrelated advertisers the right to appear as sponsored links in response to searches using Rosetta Stone's trademarks, Google infringed on Rosetta Stone's trademarks.[46]

On the issue of direct trademark infringement, the court found "no reasonable trier of fact could find that Google's practice of auctioning Rosetta Stone's trademarks as keyword triggers to third party advertisers creates a likelihood of confusion as to the source or origin of Rosetta Stone's products."[47] Google was not trying to pass off its goods or services as Rosetta Stone's:[48]

> Google's popular search engine aggregates information and provides advertising space. This is akin to a newspaper or magazine selling advertising space. . . . It does not, however, sell Google-made products on its website. . . . Any argument that Google is trying to palm off its goods as those of Rosetta Stone's is, therefore, unfounded.[49]

The court found it significant that "Rosetta Stone and Google are not direct competitors in the language-learning software market."[50] And "none of the Rosetta Stone witnesses were confused about the source of their purchase but only as to whether what they purchased was genuine or counterfeit. They were not confused by the Sponsored Links, but by the confusing nature of the websites from which they purchased."[51]

The court also found there was no contributory infringement because "no reasonable trier of fact could find that Google intentionally induces or knowingly continues to permit third party advertisers selling Rosetta Stone products to use the Rosetta Stone Marks."[52] The court took note

42. *Id*. at *3.
43. *Id*.
44. *Id*. at *3–4.
45. *Id*.
46. *Id*. at *5.
47. *Id*. at *6.
48. *Id*. at *7.
49. *Id*.
50. *Id*. at *9.
51. *Id*. at *10.
52. *Id*. at *13.

of Google's trademark task force, used to remove counterfeiters' links.[53] Similarly, because Google had no agency relationship with the advertisers, it could not be a vicarious infringer.[54]

Finally, as to trademark dilution, the court found that because Google did not sell language learning software, it could not dilute Rosetta Stone's trademarks. In fact, Google increased Rosetta Stone's brand awareness among the public.[55] Rosetta Stone's grievances were better targeted at the sellers of infringing products rather than Google as a seller of advertising space.

In *Visa International Service Association v. JSL Corp.*, the Visa credit card company sued the operator of eVisa.com for trademark infringement.[56] eVisa operated a website offering English language tutoring.[57] The name eVisa was purportedly derived from the Japanese word for English conversation, which begins with "e," and a metaphorical visa facilitating travel through the English-speaking world.[58]

While the court ultimately enjoined eVisa from using that name because appending "e" to a mark was "effectively identical" to the mark, the court's evidentiary holding was remarkable.[59] eVisa objected to Visa's market surveys and expert testimony showing dilution.[60] The court avoided the issue by holding, "a plaintiff seeking to establish a likelihood of dilution is not required to go to the expense of producing expert testimony or market surveys; it may rely entirely on the characteristics of the marks at issue."[61] The court's observation is startling because, in practice, surveys and expert testimony showing dilution or confusion are de rigueur. But here, the court holds that no such evidence is necessary, and the fact finder can simply decide by comparing the marks and nothing else. In other words, as little as a survey of one (i.e., the fact finder) is necessary as some evidence of dilution.

Mattel, Inc. v. MGA Entertainment, Inc. is the widely covered Bratz case.[62] MGA, a toymaker, hired Mattel's employee, Carter Bryant.[63] While at Mattel, Bryant conceived of a new line of dolls. Unlike Mattel's Barbie dolls, Bryant's doll concept was intended to capture a trendy attitude.[64] While at

53. *Id.* at *14.
54. *Id.* at *15.
55. *Id.* at *16.
56. 610 F.3d 1088 (9th Cir. 2010).
57. *Id.* at 1089.
58. *Id.*
59. *Id.* at 1090.
60. *Id.* at 1091.
61. *Id.*
62. 616 F.3d 904 (9th Cir. 2010).
63. *Id.* at 907.
64. *Id.*

Mattel, Bryant generated sketches of four dolls and a crude sample, which he pitched to MGA while still in Mattel's employ.[65]

MGA hired Bryant and began marketing dolls implementing Bryant's concepts. Called Bratz, these trendy dolls were a huge hit and cut into the more staid Barbie's sales.[66] Mattel was even more alarmed when it learned that its former employee was behind Bratz.[67]

While at Mattel, Bryant had an employment agreement by which he assigned to Mattel all his "right, title and interest in such *inventions*, and all [his] right, title and interest in any patents, copyrights, patent applications or copyright applications based thereon."[68] "Inventions" includes "all discoveries, improvements, processes, developments, designs, know-how, data computer programs and formulae, whether patentable or unpatentable."[69]

At trial, Mattel argued Bryant violated his employment agreement by presenting his idea to MGA instead of Mattel.[70] It also argued Mattel owned Bryant's sketches and mock-up.[71] And Mattel argued MGA wrongfully acquired the ideas for the names "Bratz" and "Jade" such that the trademarks should be transferred to Mattel.[72] The trial court agreed with Mattel on all points and enjoined MGA's activity with any Bratz product, including those based on Carter's original four designs, and extending to those created after Bryant left Mattel.[73]

On appeal, the Ninth Circuit questioned whether Bryant's ideas were covered by the employment agreement.[74] Finding room to disagree on that issue, the court held the contract ambiguous and remanded for evidence resolving the ambiguity.[75] The court also disagreed with the trial court's broad injunction against marketing all Bratz products.[76] While employed by Mattel and under his employment agreement, Bryant only conceived of the first four Bratz dolls.[77] But the court enjoined MGA from marketing *all* Bratz products, including those created after Bryant left Mattel.[78] The

65. *Id*. at 907–08.
66. *Id*. at 907.
67. *Id*.
68. *Id*. at 909 (emphasis in original).
69. *Id*.
70. *Id*. at 908.
71. *Id*.
72. *Id*.
73. *Id*.
74. *Id*. at 909–10.
75. *Id*.
76. *Id*. at 910.
77. *Id*. at 907.
78. *Id*. at 910.

court found that forcing MGA to turn over the fruits of its sweat equity, and the related trademarks, was inequitable.[79]

The court's opinion also covered copyright matters as well. Significantly, it held that the trial court did not do enough analysis in distinguishing between the nonprotectable ideas and the protectable expressions of those ideas.[80] In finding copyright infringement by substantial similarity, the trial court erred by not determining whether the substantial similarities existed in the expressions, or whether merely the ideas were substantially similar.[81]

In *Advertise.com, Inc. v. AOL Advertising, Inc.*, AOL sued Advertise.com for infringing on its advertising.com trademark.[82] AOL owned the trademark "advertising.com."[83] Finding Advertise.com confusingly similar to AOL's trademark, the trial court preliminarily enjoined Advertise.com from using the Advertise.com trade name but allowed it to use the advertise.com web address.[84]

On appeal, the issue was whether AOL's mark was generic and thus not protectable.[85] The court used its "who-are-you/what-are-you" test.[86] "A mark answers the buyer's questions 'Who are you?' 'Where do you come from?' ' Who vouches for you?' But the [generic] name of the product answers the question 'What are you?'"[87] The court found that "[w]hen any online advertising company, including AOL's competitors, is asked the question 'what are you?'" the answer could appropriately be "an advertising dot-com."[88] And the court recalled numerous cases and Trademark Trial and Appeal Board decisions holding the addition of ".com" to a mark generally does not strengthen it.[89]

IV. COPYRIGHTS

Copyright law is an area of intellectual property law that perhaps is more challenged by changes in technology and society than any other. The entire notion of what should be protected by copyright is potentially undergoing a sea change. Cases during the last year reflect these changing technological and cultural standards.

79. *Id.* at 910–11.
80. *Id.* at 916.
81. *Id.*
82. 616 F.3d 974, 976 (9th Cir. 2010).
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.* at 978.
87. *Id.*
88. *Id.*
89. *Id.* at 978–79.

In *Christen v. Iparadigms, LLC*, a graduate student brought state law claims against Iparadigms.[90] Christen was a graduate student of the University of Central Florida.[91] She had prepared papers during her studies.[92] The University of Central Florida, like many universities, used Iparadigms' Turnitin technology system to evaluate whether or not works written by students were originals or plagiarized.[93] Turnitin compares student work submitted by universities or students themselves to Internet content, student works previously submitted, and commercial databases of journal articles and periodicals.[94]

Christen's suit claimed that two of her papers were uploaded to the Turnitin system by her instructor without her consent.[95] She further asserted that this action unlawfully detained her papers and constituted a claim for replevin, conversion, and unjust enrichment.[96] Iparadigms filed a motion to dismiss based on the argument that such state court claims are completely preempted by federal copyright law, 17 U.S.C. § 301(a).[97] The court noted that preemption is subject to a two-part test that seeks to determine whether the work is within the scope of the subject matter of copyright as specified in 17 U.S.C. §§ 102 and 103 and whether the rights granted under state law are equivalent to any exclusive rights within the scope of the federal copyright statute.[98] The court recognized that the issue becomes whether or not the state court claims are "qualitatively different" from those protected by the copyright statute.[99]

The court noted that Christen was seeking damages from Iparadigms' reproduction of the work and not the actual return of the original manuscript.[100] The court stated that Christen's real claim is to intellectual property, which she claims has been misappropriated.[101] Therefore, diversion claim relief sounds in copyright.[102] The court, therefore, found that all of her state court claims, including unjust enrichment, were fully preempted and dismissed the case.[103]

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90. No. 10-620, 2010 WL 3063137 (E.D. Va. Aug. 4, 2010).
91. *Id*. at *1.
92. *Id*.
93. *Id*.
94. *Id*.
95. *Id*.
96. *Id*.
97. *Id*.
98. *Id*.
99. *Id*. at *2.
100. *Id*. at *2–3.
101. *Id*. at *3.
102. *Id*.
103. *Id*. at *4.

Another example of modern technology providing the factual backdrop for copyright lawsuits is found in *Cvent, Inc. v. Eventbrite, Inc.*[104] The plaintiff, Cvent, sued Eventbrite alleging that Eventbrite "scraped" information from Cvent's website, reformatted it, and then posted it as its own on its website.[105] Claims were made under the Computer Fraud and Abuse Act, the Virginia Computer Crimes Act, and the Lanham Act, and also included state causes of action for breach of contract, unjust enrichment, business conspiracy, and common law conspiracy.[106] Cvent also sued for copyright infringement and the Lanham Act, alleging reversed passing off.[107] Cvent sought a permanent injunction and damages.[108] Eventbrite filed a motion to dismiss all claims, except for the copyright infringement claim, alleging that the claims were either barred or preempted.[109]

The court, following analysis similar in some respects to *Iparadigms*, analyzed each of the claims against which the motion to dismiss had been lodged.[110] The court held that the unauthorized scraping of the information from the website was not hacking under the Computer Fraud and Abuse Act, since the site was not password-protected.[111] The court also held that the Virginia computer statute claim was preempted by the Copyright Act, in much the same way as in *Iparadigms*.[112] The court analyzed the remaining claims to determine whether plaintiff properly stated a claim.[113] The state claim for breach of contract was not preempted by the Copyright Act since the court found that the elements for that claim differed from the Copyright Act.[114]

But the breach of contract claim in *Cvent* was held by the court to be different from the copyright violation in that the contract claim depended upon violation of the terms of use agreement at Cvent's website.[115] The court then found that there was no contract established between Cvent and Eventbrite as a result of Eventbrite's going to the Cvent website because Eventbrite had not consented to the browsewrap agreement at the website.[116] The remaining state causes of action were dismissed for failure

104. No. 10-cv-00481, 2010 WL 3732183 (E.D. Va. Sept. 15, 2010).
105. *Id.* at *1.
106. *Id.* at *2.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.* at *3–11.
111. *Id.* at *3–4.
112. *Id.* at *5–6.
113. *Id.* at *6–11.
114. *Id.* at *7.
115. *Id.* at *7–8.
116. *Id.* at *8.

to state a claim of relief, with the exception of the unjust enrichment claim, since it presented a question of fact not properly decidable in a motion to dismiss.[117]

The U.S. Supreme Court resolved an issue that the circuit courts had taken up a number of times over the years. In *Reed Elsevier, Inc. v. Muchnick*, freelance authors brought suit against publishers in a class action that was certified in the Southern District of New York.[118] The class included authors who had registered their copyrighted works and authors who had not.[119] The complaint of the freelance authors was that publishers were reproducing their copyrighted works and, even though they were authorized to produce them in a physical format, they were also reproducing them digitally. The parties had negotiated towards a settlement for approximately three years.[120] The settlement was eventually agreed to and submitted to the court and the court certified the class and approved the settlement.[121] The plaintiffs in this case objected to the settlement and appealed.[122]

Shortly before oral argument, the Second Circuit *sua sponte* ordered the parties to brief the question of whether § 411(a) of the Copyright Act deprived the court of subject matter jurisdiction since some of the authors had not registered their works.[123] None of the parties at any time had moved to dismiss on this basis and all parties argued to the Second Circuit that the court retained jurisdiction.[124] Nonetheless, the court dismissed the lawsuit holding the lack of registration of some of the plaintiffs deprived the court of subject matter jurisdiction.[125]

No party agreed with the Second Circuit opinion, so the Supreme Court appointed *amicus curiae* to defend the court of appeal's opinion.[126] The Supreme Court looked at the history of this issue in the courts of appeal and found that the decisions rested on the distinction between jurisdictional conditions and claim processing rules.[127] The court recognized the distinction between the two can be "confusing in practice."[128]

The Court noted that when Congress does not rank a statutory limitation on coverage as jurisdictional, the Court should treat "the restriction

117. *Id.* at *9–11.
118. 130 S. Ct. 1237 (2010).
119. *Id.* at 1242.
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.*
125. *Id.* at 1243.
126. *Id.*
127. *Id.* at 1243–44.
128. *Id.* at 1243.

as non-jurisdictional in character."[129] The Court here held that, in fact, Congress had not ranked the requirement of registration as jurisdictional.[130] The Court analogized the current case to the situation under § 1331 of Title XII, where one would refrain from construing the numerosity requirement as jurisdictional. The Court stated that the registration requirement of § 411(a) imposes a precondition to filing a claim, but that it is not labeled jurisdictional, it is not located in the provision dealing with jurisdiction, and there are congressionally authorized exceptions that would allow suit to be brought without registration.

The Court stated that a number of decisions including *Bowles v. Russell*,[131] might seem to call for a different conclusion.[132] However, the court distinguished *Bowles* and found § 411(a)'s requirements to be nonjurisdictional.[133] The court, therefore, reversed the court of appeal's decision.[134]

The issue of functionality is one that often arises in copyright cases that deal with design elements. In *Universal Furniture International, Inc. v. Collezione Europa USA, Inc.*, the court was called upon to make such a determination.[135] Universal Furniture International, Inc. (UFI) was the owner of a copyright for furniture design and brought suit against its competitor, Collezione, for infringement.[136] UFI also brought suit under the Lanham Act and the North Carolina Unfair and Deceptive Trade Practices Act.[137] UFI was awarded a judgment of $11 million after a bench trial on liability and a separate hearing on damages.[138]

Collezione raised numerous defenses available to it.[139] The defendant emphasized the idea that the design element used in UFI's furniture, which Collezione copied, was not original.[140] Specifically, Collezione argued that the designs were mere reproductions of design elements in historical pieces of furniture.[141] However, UFI was able to convince the court that their designer did not simply copy earlier designs; rather, he used his own aesthetic sense to modify and combine prior decorative elements into a new whole that satisfied the Copyright Act's requirement of originality. The court

129. *Id*. at 1244 (quoting Arbaugh v. Y&H Corp., 546 U.S. 500, 515–16 (2006)).
130. *Id*. at 1245.
131. 551 U.S. 500 (2006).
132. *Reed Elsevier*, 130 S. Ct. at 1247.
133. *Id*. at 1247–48.
134. *Id*. at 1249.
135. 618 F.3d 417 (4th Cir. 2010).
136. *Id*. at 424.
137. *Id*.
138. *Id*.
139. *Id*. at 428.
140. *Id*. at 429–30.
141. *Id*. at 430.

carefully noted that its decision was based upon these decorative elements and not the underlying design of the furniture itself.[142]

Collezione also attacked UFI's claim on the basis that the decorative designs claimed were not separable from the underlying utilitarian function of the furniture. The court stated that "[c]ourts have twisted themselves in knots trying to create a test to effectively ascertain whether the artistic aspects of a useful article can be identified separately from and exist independently of the article's utilitarian function."[143]

The court reviewed a number of cases analyzing this subject and cited *Pivot Point International, Inc. v. Charlene Products*:

> Conceptual severability exists . . . when the artistic aspects of an article can be conceptualized as existing independently of their utilitarian function. This independence is necessarily informed by whether the design elements can be identified as reflecting the designer's artistic judgment exercised independently of functional influences. If the elements do reflect the independent, artistic judgment of the designer, conceptual separability exists. Conversely, when the design of a useful article is as much the result of utilitarian pressures as aesthetic choices, the useful and aesthetic choices are not conceptually separable.[144]

The court found that the designs by UFI consisted of "highly ornate collections," which contained all sorts of decorative elements and other carvings.[145] They were described by their designer as "an ornamentation explosion."[146] The court found that these decorations were unnecessary to the performance of the utilitarian function of the furniture and, therefore, were protected under copyright law and were not subject to the defense of functionality.[147]

The court also examined Collezione's argument that its designs were not similar enough to the UFI designs to infringe.[148] However, the court found that under both the extrinsic and intrinsic inquiries required by this analysis the designs were similar.[149] The court relied heavily upon the testimony of UFI's expert and said that such expert testimony is quite often the key to meeting the extrinsic inquiry portion of the test.[150] The court

142. *Id.* at 430–31.
143. *Id.* at 431 (quoting Masquerade Novelty, Inc. v. Unique Indus., Inc., 912 F.2d 663, 670 (3d Cir. 1990)).
144. *Id.* at 432–33 (quoting Pivot Point Int'l, Inc. v. Charlene Prods., 372 F.3d 913, 931 (7th Cir. 2004)).
145. *Id.* at 434.
146. *Id.*
147. *Id.*
148. *Id.* at 435.
149. *Id.* at 436–37.
150. *Id.*

concluded that Collezione's collection shared the "aesthetic harmony" of UFI's designs.[151]

The court also found that Collezione's presentation of UFI furniture pieces at a trade show where Collezione claimed those pieces as its own was a reverse passing off under the Lanham Act and also subjected Collezione to damages.[152]

Finally, the court looked at the damages claims of UFI and affirmed a judgment of $11 million.[153] Collezione had argued that the court had not allowed it offsets for various expenses and other deductions.[154] The court noted that the court could allow for such deductions, but that Collezione had wholly failed to make appropriate proof and it was its burden to do so.[155] Collezione, in fact, did not provide such evidence in discovery until right before trial and even after trial continued to provide inadequate and unverified information that the court found wholly inadequate to meet its burden in the case.[156]

Copyright issues can involve very fine judgments of aesthetics, as seen in the *Universal Furniture* case. Some of the same concepts of copyright law, however, are also used by courts to make decisions on the cutting edge of technology and the Internet. At this point, courts seem to be dealing with cases on a case-by-case basis, rather than setting out grand themes or trends in copyright law.

V. INSURANCE

Two recent decisions show that coverage may be obtained under a comprehensive general liability (CGL) policy for certain types of patent infringement, but that such circumstances remain very narrow. In *Hyundai Motor America v. National Union Fire Insurance Co. of Pittsburgh*,[157] the U.S. Court of Appeals for the Ninth Circuit found that a patent claim constituted "advertising injury" and thereby required the insurer to provide a defense to patent infringement claims under the insured's CGL policy. In doing so, the Ninth Circuit distinguished both its own and California precedent, which appeared to draw a categorical line against CGL coverage for direct or indirect patent infringement claims.

The governing California rule was set out in *Mez Industries, Inc. v. Pacific National Insurance Co.*,[158] in which a California intermediate appellate

151. *Id.* at 436 (internal quotation omitted).
152. *Id.* at 438–39.
153. *Id.* at 440–41.
154. *Id.*
155. *Id.*
156. *Id.*
157. 600 F.3d 1092 (9th Cir. 2010).
158. 90 Cal. Rptr. 2d 721 (Cal. Ct. App. 1999).

court concluded that neither direct patent infringement nor inducement to patent infringement was covered as "advertising injury" under a CGL policy.[159] The insured, Mez Industries, manufactured components used to connect joints in airflow conduction systems (such as central heating) and advertised such components for sale through wholesalers to sheet metal and mechanical contractors, who used the components to create duct systems in building projects throughout the United States.[160] According to the court, direct patent infringement "occurs when a party makes, uses or sells a product incorporating a patented invention," and the court clarified that

> [w]here the claim in the underlying action is that an insured directly infringed the patents of another by the *sale* of its products, rather than by the form of the insured's advertisements, then the patent infringing act did not occur in the course of the insured's advertising activities within the meaning of the relevant policy language.[161]

With respect to inducement, the court acknowledged that "[u]nlike direct infringement, it is possible for inducement to infringe to occur during the course of advertising activities" and that "advertising has been found to be a sufficient basis for a claim of inducement," but concluded that "liability can only be found if the inducement is 'active'; that is, a party must purposefully cause, urge or encourage another to infringe" and "[s]omething *more* is required than simply the advertising of a product for sale."[162]

The Ninth Circuit applied this reasoning in *Homedics, Inc. v. Valley Forge Insurance Co*.[163] The insured, Homedics, was accused of having "directly infringed, contributorily infringed and induced others to infringe [a] patent in a certain therapeutic magnetic device, apparently used in alternative medical procedures."[164] The patent holder claimed that the insured had "directly infringed its patent by offering to sell infringing products through advertising," under the rule that an offer to sell a patented product is itself infringement.[165] The Ninth Circuit ruled that Homedics was not entitled to a defense under the advertising injury provisions of Homedics' CGL policy because "the underlying Nikken actions at issue here do not allege violation of a method patent involving advertising ideas or a style of doing business."[166] The Ninth Circuit adopted the California court's reasoning in *Mez Industries* that "the misappropriation language [in the CGL

159. *Id*. at 727–36.
160. *Id*. at 724.
161. *Id*. at 727–28 (emphasis in original).
162. *Id*. at 728 (emphasis in original; internal quotation omitted).
163. 315 F.3d 1135 (9th Cir. 2003).
164. *Id*. at 1137.
165. *Id*. at 1137 and n.1.
166. *Id*. at 1141.

policy] could not be reasonably read by a layperson to include either *patent infringement* or the inducement thereof."[167]

The facts in *Hyundai Motor America* presented an exception to this rule, which was hinted at by the Ninth Circuit in *Homedics*. One of the two patents at issue addressed a "method of generating customized product proposals for potential customers of an automobile dealer."[168] According to the summary of the invention, the patent covered "[a]n electronic system for creating customized product proposals [that] stores a plurality of pictures and text segments to be used as building blocks in creating the proposal." The system would query a user "to determine a customer's needs and interests," and then "select[] the appropriate picture and text building blocks to fill in proposal templates."[169] Based upon the customer's answers, the patented system "links product pictures, environment pictures, and textual descriptions together in a customized proposal."[170]

Hyundai maintained a website that contained a " 'build your own vehicle ('BYO')' feature," which "allowed users to navigate through a series of questions on a menu (to select, for example, colors, engine and transmission types, and options)."[171] This BYO feature "displayed customized vehicle images and pricing information" in response to the users' responses.[172] The patent holder, Orion IP, LLC, filed an infringement suit against Hyundai and a large number of other manufacturers, and Hyundai sought indemnity and a defense from its CGL insurer, National Union.[173] Ultimately, after National Union disclaimed any duty to defend Hyundai, Hyundai brought a declaratory action against National Union, and sought a ruling that the infringement claim directed to Hyundai's BYO website constituted covered "advertising injury" under the CGL policy.[174]

Under California law, "[t]he carrier must defend a suit which potentially seeks damages within the coverage of the policy," and "[a]ny doubt as to whether the facts give rise to a duty to defend is resolved in the insured's favor."[175] To show that a claim is potentially covered as "advertising

167. *Id.* (internal quotation omitted, emphasis in original) (citing *Mez Indus.*, 76 Cal. App. 4th at 871–72).

168. Hyundai Motor Am. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 600 F.3d 1092, 1095 (9th Cir. 2010).

169. *Id.* at 1095–96.

170. *Id.* at 1096.

171. *Id.* at 1095.

172. *Id.*

173. *Id.* at 1096.

174. *Id.* at 1096–97.

175. *Id.* at 1097 (emphasis omitted) (quoting Hameid v. Nat'l Fire Ins. of Hartford, 71 P.3d 761, 764 (Cal. 2003), and Lebas Fashion Imps. of USA, Inc. v. ITT Hartford Ins. Grp., 59 Cal. Rptr. 2d 36, 40 (Cal. Ct. App.1996)).

injury," the California Supreme Court has specified three elements that must be established.[176] In order for the insured to have a "reasonable expectation of coverage" for advertising injury, the insured must show that (1) he or she "was engaged in 'advertising' during the policy period when the alleged 'advertising injury' occurred"; (2) the allegations "created a potential for liability under one of the covered offenses" in the "advertising injury" section of the policy, such as misappropriation of advertising ideas; and (3) "a causal connection existed between the alleged injury and the 'advertising.' "[177]

The Ninth Circuit first concluded that the BYO system was "advertising." "The term 'advertising' means 'widespread promotional activities usually directed to the public at large,' but it does *not* encompass 'solicitation.' "[178] The insurer contended that the BYO website was not advertising; it was effectively a form of one-on-one solicitation because it "create[d] customized proposals specific to an individual user."[179] The court rejected this argument, finding that the BYO website was described in the complaint as "marketing methods" or "marketing systems," which would "fit[] squarely within the definition of 'advertising.' "[180] In addition, while the BYO feature "has some similarities to solicitation" because it "does little, if anything, until the user inputs some personal preferences," the BYO feature could not be considered a one-on-one solicitation because it was not limited to a discrete customer or customers but was made available to the public at large.[181] In other words, because anyone with access to the website could use the feature, it was not a direct solicitation but was instead "advertising."[182]

The Ninth Circuit then determined that the patent infringement claim constituted an alleged "misappropriation of advertising ideas," which was defined as one form of "advertising injury" coverage in the CGL policy.[183] The court applied the standards articulated in *Mez Industries*,[184] in which the court concluded that the determination of whether a claim falls within a particular type of coverage must be based upon a "contextual reasonableness" analysis.[185] Thus, according to the Ninth Circuit, "[w]e must deter-

176. *See Hameid*, 71 P.3d at 764–65.
177. *Hyundai Motor Am.*, 600 F.3d at 1098 (quoting *Hameid*, 71 P.3d at 764–65).
178. *Id.* at 1098 (emphasis in original).
179. *Id.*
180. *Id.*
181. *Id.* at 1099–1100.
182. *See id.*
183. *Id.* at 1100.
184. Mez Indus., Inc. v. Pac. Nat'l Ins. Co., 90 Cal. Rptr. 2d 721, 733 (Cal. Ct. App. 1999).
185. *Hyundai Motor Am.*, 600 F.3d at 1100.

mine, in the context of the case and in light of common sense, whether a lay person reasonably would read the phrase 'misappropriation of advertising ideas' to include the patent infringement claim at issue," and "[m] ore precisely, the proper test is whether the patents at issue 'involve any process or invention which could reasonably be considered an "advertising idea."' "[186] The court found that the claims in this case *were* for "misappropriation of advertising ideas" because the patent involved "a method of displaying information to the public at large for the purpose of facilitating sales," and that the patented invention therefore could reasonably be considered an "advertising idea."[187]

Finally, the court also found a causal link between the advertisement and the alleged advertising injury. "As is the case with the previous element, courts have found no causal connection when the patents that the insured allegedly infringed concerned the underlying product for sale."[188] Here, however, the advertisement itself constituted use of the infringing invention—

> [T]he use of the BYO feature in the website is itself an infringement of the patent because it is the use of the BYO feature that violates the patent (and not the design of the car, for instance, the method of manufacturing the car, or the car's engine, or *anything* related to the car for sale).[189]

Having met each of the three elements required by California law, the Ninth Circuit found that Hyundai was entitled to a defense with respect to the patent infringement claim.[190]

Another recent case, however, shows how narrow the exception in *Hyundai Motor America* may be. In *DISH Network Corp. v. Arch Specialty Insurance Co.*,[191] the holder of an "interactive call processing" patent portfolio filed suit against DISH Network, claiming that DISH's customer service telephone system infringed a number of those patents, including one that claimed "[a] telephone interface system . . . wherein said selective operating format involves advertising a product for sale."[192] DISH sought a defense under its CGL policies, claiming that the infringement claims alleged "advertising injury" and eventually brought a declaratory action against its insurer.[193]

186. *Id.* (quoting *Mez Indus.*, 90 Cal. Rptr. 2d at 733).
187. *Id.* at 1100–01.
188. *Id.* at 1102.
189. *Id.* at 1103 (emphasis in original).
190. *Id.* at 1104.
191. No. 1:09-cv-00447-JLK-MEH, 2010 WL 3310025 (D. Colo. Aug. 19, 2010).
192. *Id.* at *1–2.
193. *Id.* at *2.

"Under four of the five CGL policies at issue, DISH [was] entitled to coverage for an 'advertising injury' only if the 'advertising injury' [was] caused by an 'occurrence,'" which was defined in the policies as "an offense committed in the course of advertising your goods, products and services that results in 'advertising injury.'"[194] An "advertising injury" was defined to include (1) publication of material that constituted slander, libel, or "disparage[ment of] a person's or organization's goods, products or services"; (2) "publication of material that violate[d] a person's right of privacy"; (3) "misappropriation of advertising ideas or style of doing business; or" (4) "infringement of copyright, title, or slogan."[195] To determine whether DISH was entitled to a defense under these terms, the Colorado court applied the same three elements required by the Ninth Circuit in *Hyundai Motor America*:

> DISH must prove three elements to establish a duty to defend for "advertising injury": (1) it was engaged in "advertising" during the policy period when the alleged "advertising injury" occurred; (2) [the complaint's] allegations created a potential for liability under one of the covered offenses (i.e., misappropriation of advertising ideas); and (3) a causal connection existed between the alleged injury and the advertising.[196]

The court concluded that the first element was met because DISH's customer service activities were "advertising."[197] The complaint alleged that the infringement arose from DISH's use of "automated telephone systems . . . that allow their customers to perform pay-per-view ordering and customer service functions over the telephone."[198] The court found that "it is unclear whether these activities constitute 'advertising,'" because "[a] telephone conversation is, with very limited exception, a two-party interaction," and "any offers to sell . . . are directed only to the caller on the other end of the line."[199] However, citing *Hyundai Motor America*, the court noted that "[o]ther courts have . . . found there to be 'advertising' in somewhat analogous situations."[200]

The court, however, found that DISH could not meet the second part of this three-part test. The second element was not met because the claims against DISH did not fall within any of the four types of "advertising injury." The court found that the claims against DISH did not constitute "misappropriation of an advertising idea" because "the patents-in-

194. *Id.* at *5.
195. *Id.*
196. *Id.*
197. *Id.* at *5–6.
198. *Id.* at *6.
199. *Id.*
200. *Id.*

suit . . . concern technologies relating to interactive call processing," and the complaint "focuses on DISH's use of these patented technologies as a means of conveying content to and tailoring its interactions with its customers" but "does not allege that the patented technologies themselves are incorporated as an element of DISH's communications."[201] The court also rejected DISH's effort to define the claims against DISH as a "misappropriation of style of doing business" because "DISH did not misappropriate the manner in which Katz conducts its business, but rather the technologies themselves."[202] Because the second element in the three-part test was not met, and there was no covered injury, the court did not need to address whether there was a causal connection between the alleged injury and the alleged advertising.[203]

These two cases together present a narrow exception to the general rule that patent infringement does not constitute "advertising injury." As a general background rule, even if the alleged infringing act is to offer a patented invention for sale, the alleged infringement is not covered. *Hyundai Motor America* identified an isolated exception that applied because the patented invention *itself* was the advertising. *DISH Network* reaffirmed the narrowness of this exception by finding that alleged infringement was not "advertising injury" even when the infringing invention was the means by which the advertising was conveyed to the consumer.

VI. CONCLUSION

In this turbulent and fascinating time for technology and society, intellectual property law is equally turbulent and fascinating. Courts continue to adapt the body of intellectual property law—some drafted decades ago—to a world where intellectual property owners, infringers, and users act at an exponentially increasing speed and scale.

201. *Id*. at *8–9.
202. *Id*. at *9.
203. *Id*. at *10.

RECENT DEVELOPMENTS IN MEDIA, PRIVACY, AND DEFAMATION LAW

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The U.S. Supreme Court dominated this survey period, with decisions affecting media interests in privacy and access to information. Meanwhile, state and lower federal courts engaged in the serious jurisprudence involving celebrity, soccer balls, Serbian financiers, subpoenas and shield laws, canine software, and solicitations by fax blasts.

I. PRIVACY

A. *Intrusion*

In *City of Ontario v. Quon*, the U.S. Supreme Court examined whether a public employee has any right of privacy when sending text messages on a government-issued mobile device.[1] Ontario, California, issued Quon a mobile device and advised him that text messages could be saved and viewed by his supervisors.[2] Quon's usage volume triggered an investigation, which found that Quon was sending numerous personal messages,

1. 130 S. Ct. 2619, 2624 (2010).
2. *Id.* at 2625.

including sexually explicit messages to his then wife and girlfriend. After Quon was disciplined, he sued the City, claiming that the City violated his Fourth Amendment rights by obtaining and reviewing his text messages.[3] The Supreme Court declined to address an employee's expectation of privacy in work-issued technology and instead held that "[e]ven if Quon had a reasonable expectation of privacy," the City's search was reasonable because it was motivated by a legitimate work-related purpose and was not excessive in scope.[4]

The New Jersey Supreme Court addressed a similar issue in the context of a nongovernmental employer in *Stengart v. Loving Care Agency, Inc.*[5] Stengart used her company-issued laptop to exchange e-mails with her lawyer through her personal, password-protected, and web-based e-mail account. When she later filed an employment discrimination suit against the employer, the company hired a computer forensic expert to recover files stored on the laptop. When Stengart's e-mails with her attorney were discovered, the employer claimed that the company had a right to review them.[6] The New Jersey Supreme Court declined to adopt categorical rules regarding a private employee's right to privacy when using an employer-issued computer, but rather used a fact-based assessment to determine whether Stengart had a reasonable expectation of privacy in the e-mails. Relying on ambiguities in the company's computer policy and Stengart's use of her personal e-mail account rather than her company e-mail address, the court held Stengart had a reasonable expectation of privacy in the e-mails,[7] and "[i]t follows that the attorney client privilege protects those e-mails."[8]

B. *Publication of Private Facts*

The "private facts" tort rests on the premise that government through the common law can prohibit publication of some information, "highly offensive" and "not of legitimate concern," even though it is true. The Restatement itself expressed uncertainty about the constitutionality of the "private facts" tort more than thirty years ago,[9] and notwithstanding its general

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3. *Id.* at 2625–26.
4. *Id.* at 2630–31.
5. 990 A.2d 650 (N.J. 2010).
6. *Id.* at 655.
7. *Id.* at 663.
8. *Id.* at 664.
9. Restatement (Second) of Torts § 652D, Special Note on Relation of § 652D to the Amendment to the Constitution (1977) ("This Section provides for tort liability involving a judgment for damages for publicity given to true statements of fact. It has not been established with certainty that liability of this nature is consistent with the free-speech and free-press provisions of the First Amendment. . . .").

recognition in many states, the "private facts" tort remains "fraught with difficulty."[10] In *United States v. Stevens*,[11] the U.S. Supreme Court provided further support for attacks on the constitutionality of any attempt to punish truthful speech through this tort. The First Amendment principles of the decision extend far beyond the specific context of dog fight videos and a federal statute directed at combating animal cruelty that brought the case before the Court. The Court held that the First Amendment's guarantee of free speech cannot be limited "simply on the basis that some speech is not worth it."[12] The Court further held that "serious value" cannot be "used as a general precondition to protecting *other* types of speech in the first place. *Most* of what we say to one another lacks 'religious, political, scientific, educational, journalistic, historical, or artistic value' (let alone serious value), but it is still sheltered from government regulation."[13]

In *Ostergren v. Cuccinelli*, the Fourth Circuit addressed the constitutionality of a Virginia statute prohibiting communication of another's social security number to the general public.[14] A different Virginia statute required counties to make land records, many of which contain unredacted SSNs, available online, and Ostergren, hoping to illustrate the government's mishandling of SSNs, posted SSNs obtained from land records on her website. When threatened with prosecution, Ostergren sued for declaratory and injunctive relief, and the district court found the statute unconstitutional as applied. The Fourth Circuit affirmed, in part. The court found that Ostergren's posting of SSNs was integral to her message that Virginia was failing to safeguard private information, and concluded that public records "by their very nature are of interest to those concerned with the administration of government."[15] A prohibition on publication of lawfully obtained truthful information about a matter of public significance

10. Robert D. Sack, Sack on Defamation: Libel, Slander & Related Problems § 12.4 at 12–33 (2009) (4th ed. 2010). *See also* Doe v. Methodist Hosp., 690 N.E.2d 681, 693 (Ind. 1997) (plurality opinion) (because the privacy tort "involving disclosure of truthful but private facts encounters a considerable obstacle in the truth-in-defense provisions of the Indiana Constitution," the court was not persuaded that it should endorse that tort); Anderson v. Fisher Broad. Cos., 712 P.2d 803, 808–09 (Or. 1986) ("What is 'private' so as to make its publication offensive likely differs among communities, between generations, and among ethnic, religious, or other social groups, as well as among individuals. Likewise, one reader's or viewer's 'news' is another's tedium or trivia. The editorial judgment of what is 'newsworthy' is not so readily submitted to the *ad hoc* review of a jury as the Court of Appeals believed. It is not properly a community standard. Even when some editors themselves vie to tailor 'news' to satisfy popular tastes, others may believe that the community should see or hear facts or ideas that the majority finds uninteresting or offensive.").

11. 130 S. Ct. 1577 (2010).

12. *Id.* at 1585.

13. *Id.* at 1591 (emphasis in original).

14. 615 F.3d 263 (4th Cir. 2010).

15. *Id.* at 272 (citation omitted).

must be "narrowly tailored to a state interest of the highest order," and the court found the statute could not possibly be "narrowly tailored" to protect privacy interests when Virginia made the same records available without redaction.[16]

In *Lorenzo v. United States*, a federal district court in California reaffirmed the notion that a police officer's conduct is of legitimate public interest.[17] Lorenzo, a Border Patrol agent, brought privacy claims against the government after other federal agents released a video showing him killing an illegal immigrant smuggler during a border altercation. The court dismissed Lorenzo's claim for public disclosure of private facts, holding that a "shooting at the border involving a law enforcement officer and an illegal alien is clearly a newsworthy event."[18]

C. *Misappropriation*

In *Hilton v. Hallmark Cards*, Paris Hilton, identified by the court as "a controversial celebrity known for her lifestyle as a flamboyant heiress" who is "famous for being famous," sued Hallmark over a birthday card with an oversized photograph of Hilton's head superimposed on a waitress.[19] Above the caption "Paris' First Day as a Waitress," the card depicted the waitress serving a customer food and saying, "Don't touch that, it's hot." The customer asks, "What's hot?" and the waitress replies, "That's hot."[20] The Ninth Circuit affirmed a denial of Hallmark's motion to strike Hilton's common law right of publicity claim. Hallmark based its motion on the affirmative defenses of "transformative use" and "public interest."[21] The court concluded that it could not find the card transformative as a matter of law because, despite differences between *The Simple Life* and Hallmark's card, "the basic setting is the same: we see Paris Hilton, born to privilege, working as a waitress."[22] The court held the public interest defense inapplicable because the card did not publish or report newsworthy information—indeed, it did not report *any* information.[23]

16. *Id*. at 276.

17. 719 F. Supp. 2d 1208 (S.D. Cal. 2010).

18. *Id*. at 1215.

19. 599 F.3d 894, 899 (9th Cir. 2010).

20. In her reality television show *The Simple Life*, Hilton uses the phrase "that's hot" whenever she finds something interesting or amusing. She has registered the phrase as a trademark. *Id*.

21. *Id*. at 908–09.

22. *Id*. at 911.

23. *Id*. at 912. On September 16, 2010, the parties reported that the case had settled. *See* Hilton v. Hallmark Cards et al., No. 2:07-CV-05818-PA-AJW (D. Cal. Sept. 16, 2010, Minute Order). Relying in part on *Hilton*, a district court for the Northern District of California held that the transformative use and public interest defenses did not bar a former college football player's misappropriation claim against the producer of the "NCAA Football" series of

D. *False Light Invasion of Privacy*

The Washington Court of Appeals reaffirmed that the state does not recognize false light invasion of privacy or a defamation claim based on the negative implication of true statements.[24] In *Yeakey v. Hearst Communications*, a crane operator unsuccessfully sued a newspaper that reported the plaintiff's drug use in a story about a crane collapse, notwithstanding his admission that the statements were true.[25]

In *Duer v. Henderson*, an Ohio appellate court held that a false light claim could not be brought on behalf of an estate against the author and publisher of a book entitled *Weird Ohio* because "torts of invasion of privacy are personal and must be brought by 'a living individual whose privacy has been invaded.' "[26]

II. DEFAMATION

A. *Strong Rulings for Fair Report Privilege in New Jersey and Illinois*

Media outlets in New Jersey breathed a sigh of relief after the state's supreme court declined to adopt an initial pleadings exception to the fair report privilege.[27] *Salzano v. North Jersey Media Group* arose after publication of news reports about a bankruptcy filing that accused the plaintiff of misappropriating $470,000. The intermediate court refused to apply the fair report privilege because the bankruptcy complaint was an initial pleading. In reversing, the supreme court identified a trend away from the initial pleadings exception and recognized the importance of press coverage in legal proceedings to society at large. It stated, "it is clear that so long as the publisher fully, fairly, and accurately reports the contents of a public proceeding, he has done what is necessary and is immune from a suit for

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video games. In *Keller v. Electronic Arts, Inc.*, No. 09-1967-CW, 2010 WL 530108 (N.D. Cal. Feb. 8, 2010), a former Arizona State and Nebraska quarterback sued video game producer Electronic Arts, Inc. ("EA"), alleging that EA used his likeness in a video game without his consent. In denying EA's motion to dismiss and special motion to strike, the court held that the depiction of Keller in "NCAA Football" was not sufficiently transformative to bar the claim as a matter of law because the video game did not "transform" Keller's character, but "represented [Keller] as what he was: the starting quarterback for Arizona State University." *Id.* at *5. The court rejected EA's "public interest" defense because the game does not report the plaintiff's statistics or abilities, but simply allows consumers to control virtual football players on a virtual field. *Id.* at *6.

24. Yeakey v. Hearst Commc'ns, 234 P.3d 332, 335 (Wash. Ct. App. 2010).

25. *Id.* at 334.

26. No. 2009 CA 15, 2009 WL 4985475, at *8–9 (Ohio App. Dist. 2 Dec. 23, 2009) (quoting Rothstein v. Montefiore Home, 689 N.E.2d 108, 110 (Ohio Ct. App. 1996)).

27. Salzano v. N. Jersey Media Grp, 993 A.2d 778 (N.J. 2010).

defamation based on false statements made, not by him, but by the participants in the proceeding."[28]

An appellate court in Illinois held that in a world of flooded inboxes, a newspaper has no obligation to review updated e-mails to successfully assert a fair report defense.[29] The case arose from an e-mail bulletin sent by a local police station to a newspaper reporter. After receiving the e-mail, the reporter submitted a one-sentence brief naming the plaintiff as the arrestee in a retail theft. After the reporter left the newsroom, the police station sent out a second e-mail that corrected the name of the arrestee. The second e-mail was not opened until after publication of the brief naming the plaintiff. The court affirmed summary judgment, finding that the publication accurately reflected the first e-mail received by the newspaper. It stated that the law "does not include a timeliness component, or an obligation to review updated information, in determining the fairness and accuracy of a published report."[30]

Meanwhile, the D.C. Circuit narrowly interpreted the fair report privilege, refusing to allow an international policy group to defeat a defamation claim even though it backed the allegedly defamatory information with a citation to a report issued by the U.S. Office of Foreign Asset Control.[31] The defendant published a report in 2003 criticizing the U.S. government for failing to aggressively investigate members of Serbia's financial world. The report listed seventeen individuals allegedly associated with the Milosevic regime, relying on a frozen asset list from the OFAC to support the allegations. Both the list in the report and the OFAC frozen asset list from 1998 included the name of a bank owned by the plaintiff. However, the court determined that nothing in the report suggested that the plaintiff supported or benefitted from the regime, contrary to the published report's allegations.[32] Therefore, the report published by the research group was not a fair and accurate report of the OFAC list, and thus was not privileged.[33]

B. *Substantial Truth: "Almost" Counts with Gangs, Not Geography*

Substantial truth related to gang affiliation resulted in the dismissal of a lawsuit filed by a Mexican American prison inmate against A&E Television.[34] The inmate claimed that A&E libeled him by broadcasting a fight between

28. *Id.* at 798.
29. Eubanks v. Nw. Herald Newspapers, 922 N.E.2d 1196 (Ill. App. 2010).
30. *Id.* at 1201; *see also* Harper v. Comcast Cable, 38 Media L. Rptr. 1235 (Colo. Dist. Ct., Denver County, 2009) (finding article based on grand jury indictment to be fair and substantially accurate and thus protected by the fair report privilege).
31. Jankovic v. Int'l Crisis Group, 593 F.3d 22 (D.C. Cir. 2010).
32. *Id.* at 27.
33. *Id.*
34. Bustos v. United States, 38 Media L. Rep. 1747, 2010 WL 2017724 (D. Colo. 2010).

the plaintiff and another inmate as part of the television series *Gangland*. The plaintiff, who was identifiable, claimed the broadcast depicted him as an Aryan Brotherhood member, directly resulting in threats of violence and death from Aryan Brotherhood, D.C. Blacks, and Mexican American gang members. However, the court determined that the asserted defamatory statement was substantially true in that its effect on the viewer would be no different than that of the plaintiff's representations that he held himself out to be a member of a gang allied with the Aryan Brotherhood.[35]

Evaluating the truth from a different angle, the Southern District of New York rejected an application by HBO to extend discovery geographically after determining that information about the plaintiffs' activities in China would not support a "substantial truth" defense for HBO's depictions of manufacturing conditions in India.[36] The case involved a segment of a television program describing inhumane conditions for child laborers making soccer balls in India. The plaintiff, Mitre, was the only soccer ball manufacturer identified by name. Mitre alleged in the lawsuit that it did not use child labor to manufacture soccer balls. HBO sought to expand discovery beyond India to include China in support of a "substantial truth" defense. Because the segment focused almost exclusively on India, the court found that even if Mitre used child labor in China, that fact would not render the statements in the HBO segment substantially true.[37]

Meanwhile, campaign mudflinging in a New Jersey state senate race led to a case of first impression there.[38] In *G.D. v. Kenny*, an organization opposed to one of the candidates posted campaign flyers stating that his aide had been convicted on drug-related charges. The aide sued on grounds that the conviction had been expunged from his record, but the court held that the defendant could assert truth as a defense. Like courts in Massachusetts and Oregon, the New Jersey court saw "no value in permitting plaintiff to use the expungement statute as a sword, rather than the shield it was intended to be."[39]

C. *West Virginia Addresses Libel by Implication*

A federal court in West Virginia heightened the standard for libel-by-implication claims in a defamation lawsuit brought by the owner of a child care facility after a mother publicly announced that her child was sexually

35. *Id.* at *1.
36. Mitre Sports Int'l Ltd. v. Home Box Office, Inc., 38 Media L. Rep. 1595, 2010 WL 1507792 (S.D.N.Y. 2010).
37. *Id.* at *2.
38. G.D. v. Kenny, 984 A.2d 921 (N.J. App. Div. 2009).
39. *Id.* at 932 (relying on Bahr v. Statesman Journal Co., 624 P.2d 664, *review denied*, 631 P.2d 341 (Or. 1981), and Rzeznik v. Chief of Police of Southampton, 373 N.E.2d 1128, 1130 (Mass. 1978)).

abused by another child while under the facility's care.[40] The mother spoke of the alleged abuse during an interview with a local television station, asserting that Kim's Kids Child Care abused her trust and her child. Although aware that the alleged sexual abuse occurred between two children, the news station failed to mention this or any other details specific to the alleged perpetrator, and the news report included a brief clip of the owner of Kim's Kids. The owner sued the television station for defamation, asserting that the broadcast falsely implied that she or another employee sexually abused the child. The plaintiff based her claims on the broadcast's failure to indicate that a child, and not another adult, was the accused perpetrator. Dismissing the plaintiff's claims entirely, the court applied a rigorous standard for libel-by-implication claims, holding that they require evidence that the defendant intended or endorsed the claimed implication.[41] In the news media context, this standard requires that broadcasters engage in conduct beyond mere selective reporting of materially true facts.

D. *Libel Tourism Bill Becomes Law*

On August 10, 2010, President Obama signed the Securing the Protection of Our Enduring and Established Constitutional Heritage (SPEECH) Act[42] to protect U.S. writers and speakers against "libel tourism." The Act forbids U.S. courts from recognizing or enforcing foreign libel judgments inconsistent with the free speech guarantees of the First Amendment or applicable state constitutions and laws. It provides a mechanism for Americans who lose a foreign libel suit to obtain an order declaring the judgment unenforceable. It was inspired by the decision in *Ehrenfeld v. bin Mahfouz*,[43] in which the Second Circuit held that it could not stop the plaintiff from enforcing a British libel verdict against the defendant, who had authored a book that accused a Saudi billionaire of terrorist financing.

III. Internet Law Developments 2011

A. *Subpoena to Unmask Anonymous Speakers*

Courts generally continued on the path of providing significant protection to anonymous online speakers over the past year. For example, several more courts adopted variations of the popular *Dendrite* test,[44] requiring a subpoenaing plaintiff to "set forth a prima facie cause of action" and make other showings before the plaintiff may obtain the identity of one

40. Tomblin v. WCHS-TV8, 2010 WL 324429 (S.D. W. Va. Jan 21, 2010).
41. *Id*. at *7.
42. Securing the Protection of Our Enduring and Established Constitutional Heritage (SPEECH) Act, Pub. L. No. 111-223, 124 Stat. 2380 (2010).
43. 518 F.3d 102 (2d Cir. 2008).
44. *See* Dendrite Int'l, Inc. v. Doe No. 3, 775 A.2d 756, 760 (N.J. Super. Ct. App. Div. 2001).

anonymously engaged in expressive speech. But a few recent developments may take this fast-developing area of law in a new direction, affording less protection to some anonymous speakers.

Some courts declined to apply the *Dendrite* formulation[45] in the cases before them, including the New Jersey court that decided *Dendrite* itself.[46] The most significant of these cases was the Ninth Circuit's decision in *In re Anonymous Online Speakers*.[47] In one of the first federal appellate decisions in this area, the Ninth Circuit reasoned that those who anonymously engage in "commercial speech" are entitled to less constitutional protection than those who anonymously engage in political speech, and therefore should not receive the benefit of the high bar to disclosure imposed under the *Dendrite* and *Cahill* tests.[48] After the panel's initial determination that the speech at issue in that case, criticism of a company's business practices, was "commercial speech" drew heavy criticism, the panel withdrew its original ruling and issued a new opinion that reached the same result (affirming the trial court's order to unmask three speakers) without determining whether their speech constituted "commercial speech." If other courts follow the panel's reasoning—that commercial speech is not entitled to the benefit of the *Cahill* and *Dendrite* tests—it may lead courts to develop a new test for (or to apply an existing lesser-burden test to) cases involving anonymous speech about commercial matters, including many matters of importance to consumers and policymakers.

Media companies continued to invoke reporter's privilege statutes in motions to quash subpoenas for anonymous posters' identities, with mixed

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45. *See*, *e.g.*, SaleHoo Groups, Ltd. v. ABC Co., 722 F. Supp. 2d 1210 (W.D. Wash. 2010) (adopting elements of *Dendrite* and quashing subpoena in action alleging defamation, trademark infringement, false designation of origin, and unfair competition); USA Techs., Inc. v. Doe, 713 F. Supp. 2d 901 (N.D. Cal. 2010) (adopting streamlined version of *Dendrite* to quash subpoena in action for securities fraud and defamation); Mortgage Specialists, Inc. v. Implode-Explode Heavy Indus., Inc., 999 A.2d 184, 193 (N.H. 2010) (adopting *Dendrite* in defamation action); Swartz v. Doe #1, No. 08C-431 (Tenn. Cir. Ct., Davidson County, Oct. 8, 2009) (applying *Dendrite* test to factual findings made by court after hearing).

46. *See* Maxon v. Ottawa Publ'g, 929 N.E.2d 666, 675–76 (Ill. App. Ct., 3d Dist., 2010) (rejecting trial court's application of *Dendrite/Cahill* standard and holding that Illinois Supreme Court Rule 224, which authorizes independent actions for the discovery of the "identity of one who may be responsible in damages," coupled with the motion to dismiss standard, provides the same level of protection given that Illinois is a fact pleading state); Too Much Media, LLC v. Hale, 993 A.2d 845, 861–62 (N.J. Super. Ct. App. Div. 2010) (rejecting named-defendant blogger's attempt to invoke *Dendrite*, in addition to shield law, in defamation action to protect identity of her sources, and more broadly asserting that the *Dendrite* standard is limited to "evaluating applications for discovery of the identity of anonymous users of Internet Service Provider (ISP) message boards" and has "never been extended beyond ISPs"); Hester v. Doe, No. 10-CVS-361 (N.C. Sup. Ct., Vance County, Jun. 28, 2010) (purporting to apply *Dendrite* in a defamation action but mistakenly asserting that the standard required only a "Rule 12(b)(6) motion to dismiss analysis").

47. 2011 WL 61635 (9th Cir. Jan. 7, 2011) (withdrawing and replacing 611 F.3d 653 (9th Cir. 1010)).

48. *Id.* at *6.

success. Colorado and North Carolina joined the growing list of jurisdictions in which courts have quashed such subpoenas under state shield laws, bringing the list to six (along with Oregon, Montana, Florida, and Illinois).[49] However, a court in Kentucky *rejected* the invocation of that state's shield law, on the ground that the statute was not meant to apply in the anonymous poster context.[50]

Another issue that is increasingly being litigated is whether website privacy policies are relevant to the decision whether to unmask anonymous posters. Several of those seeking anonymous posters' identities have argued that website owners' privacy policies, which generally ensure user privacy but provide that a user's identity may be revealed under certain circumstances, diminish anonymous speakers' expectations of privacy or even constitute a waiver of their First Amendment rights to remain anonymous altogether. Although one court in Tennessee declined to quash a subpoena on this basis,[51] two other courts found these arguments meritless. In *McVicker v. King*, a federal court in Pennsylvania held that the privacy policy at issue, although containing boilerplate language allowing for disclosures under certain circumstances, actually created an expectation of privacy in the user when taken as a whole.[52] In *Sedersten v. Taylor*, a Missouri federal court refused to find that users were contracting away their constitutional rights in the absence of any express waiver in the privacy policy.[53]

B. *Immunity Under § 230 of the Communications Decency Act*

The Ninth Circuit's 2008 holding in *Fair Housing Council v. Roommates.com, LLC*[54] continues to have fairly limited impact, as courts throughout the country have distinguished it and have continued to extend immunity to websites hosting content provided by third parties.[55] In *Nemet Chevrolet, Ltd. v. Consumeraffairs.com*,[56] the Fourth Circuit affirmed the district court's

49. People v. Bruce, No. 09M3247 (Colo. Springs Mun. Ct. Oct. 27, 2009) (applying Colo. Rev. Stat. § 13-90-119(2) to quash a subpoena issued to a newspaper website for the identity of an individual alleged to be an exculpatory witness to allegedly criminal conduct); People v. Mead, No. 10 CRS 2160 (N.C. Super. Ct., Gaston County, Aug. 16, 2010) (applying the North Carolina shield law, N.C. Gen. Stat. § 8–53.11, to grant a newspaper's motion to quash a subpoena issued by a criminal defendant).

50. Clem v. Doe, No. 08-CI-1296, at 3 (Ky. Cir. Ct., Madison County, Mar. 26, 2010).

51. *See* Swartz v. Doe #1, No. 08C-431 (Tenn. Cir. Ct., Davidson County, Oct. 8, 2009).

52. 266 F.R.D. 92 (W.D. Pa. 2010).

53. No. 09-3031-CV-S-GAF, 2009 WL 4802567 (W.D. Mo. Dec. 9, 2009).

54. 521 F.3d 1157, 1174 (9th Cir. 2008).

55. *See, e.g.*, Milo v. Martin, 311 S.W.3d 210, 216–217 (Tex. App. 2010); Shiamili v. Real Estate Grp. of New York, Inc., 68 A.D.3d 581, 583 (N.Y. App. Div. 2009); Intellect Art Multimedia, Inc. v. Milewski, 2009 WL 2915273, at *7 (N.Y. Sup. Ct. 2009); Blockowicz v. Williams, 675 F. Supp. 2d 912, 914 (N.D. Ill. 2009); Dart v. Craigslist, Inc., 665 F. Supp. 2d 961, 967 (N.D. Ill. 2009); Reit v. Yelp!, Inc., 907 N.Y.S.2d 411 (N.Y. Sup. Ct. 2010); Black v. Google, Inc., No. 10-2381, 2010 WL 3746474 (N.D. Cal. Sept. 20, 2010).

56. 591 F.3d 250 (4th Cir. 2009).

dismissal of defamation and tortious interference with business expectancy claims against a consumer complaint site. The Chevy dealer contended that Consumeraffairs.com should be liable because it " 'solicit[ed]' its customers' complaints, 'steered' them into 'specific categor[ies] designed to attract attention by consumer class action lawyers, contact[ed]' customers to ask 'questions about' their complaints and to 'help' them 'draft or revise' their complaints, and 'promis[ed]' customers would 'obtain some financial recovery by joining a class action lawsuit.' "[57] None of those activities was enough to make Consumeraffairs.com responsible for its users' postings, the Fourth Circuit held. There is nothing illegal about developing or joining a class action lawsuit, and a "website operator who does not 'encourage illegal content' or 'design' its 'website to require users to input illegal content' is 'immune' under § 230 of the CDA."[58] In *Johnson v. Arden*,[59] the Eighth Circuit upheld dismissal of defamation, trademark, and other claims brought by a couple who bred cats, also based on derogatory postings about their business on a consumer complaint site. The court held that the ISP that hosts complaintsboard.com could not be held liable for allegedly defamatory postings on that website.[60] "Because InMotion was merely an ISP host and not an information content provider, the Johnsons' claims against InMotion fail as a matter of law" under § 230.[61]

A California state court addressed the issue of whether someone who forwards an allegedly defamatory e-mail after adding their own comments can claim § 230's protection. The Fourth District Court of Appeals went beyond *Barrett v. Rosenthal*,[62] which had provided § 230 protection to a woman who posted another person's mail to Internet newsgroups without adding her own comments.[63] The appeals court held that § 230 protected a veteran of the South Vietnamese military who relayed an allegedly defamatory e-mail to fellow veterans with his own neutral comments attached.[64] The defendant had forwarded a Vietnamese-language e-mail accusing the

57. *Id.* at 256–57.

58. *Id.* at 257 (citing *Roommates.com*, 521 F.3d at 1175). Nemet's allegations also weren't enough to show Consumeraffairs.com was a content provider, since they didn't "show any alleged drafting or revision by Consumeraffairs.com was something more than a website operator performs as part of its traditional editorial function." *Id.* at 258.

59. 614 F.3d 785 (8th Cir. 2010).

60. *Id.* at 791–92. The Johnsons did not serve as the operators of complaintsboard.com.

61. *Id.* at 792.

62. 40 Cal. 4th 33, 51 Cal. Rptr. 3d 55, 146 P.3d 510 (Cal. 2006).

63. In an unpublished opinion in 2008, another California Court of Appeals panel held that § 230 barred a defamation claim based on an e-mail's embedded link to a website containing allegedly defamatory statements. McVey v. Day, No. B205465, 2008 Cal. App. Unpub. LEXIS 10462, at *45–46 (Cal. Ct. App. Dec. 23, 2008).

64. Phan v. Pham, 182 Cal. App. 4th 323 (Cal. Ct. App. 2010), *review denied*, Case No. G041666, 2010 Cal. LEXIS 4419 (Cal. May 12, 2010).

plaintiff of having been disciplined by the South Vietnamese Navy for abusive behavior,[65] and he introduced the e-mail with his introductory comment: "Everything will come out in the daylight, I invite you and our classmates to read the following comments."[66] Citing *Roommates.com*, the appellate court held that the introductory statement didn't materially contribute to the alleged defamation. "All [the defendant] said was: The truth will come out in the end. What will be will be. Whatever."[67]

Not all courts, however, have extended § 230 immunity to website operators, finding sufficient involvement in generating or developing the offensive content to treat the website operator as an "information content provider." The U.S. District Court in Connecticut refused to provide § 230 immunity for videos entered in a contest sponsored by the Quiznos sandwich chain that criticized Subway's offerings, saying Quiznos may have "actively solicited disparaging representations about Subway and thus [may have been] responsible for the creation or development of the offending contestant videos."[68] Quiznos' contest websites had encouraged video entries showing "why you think Quiznos is better" as part of an advertising campaign touting the claim that some Quiznos subs had more meat than similar Subway sandwiches. The case settled shortly after the judge's ruling.[69] A U.S. district court in Idaho ruled that plaintiffs' assertion that a moderator for a bodybuilding website had posted a disparaging statement about plaintiffs' dietary supplements was sufficient to overcome a § 230 immunity claim in a motion to dismiss.[70]

C. *Personal Jurisdiction*

This year saw a strong trend toward loosening the standards for applying personal jurisdiction in Internet-related defamation cases, with two federal appeals courts and two state supreme courts holding that statements directed at people or businesses based in the forum state are sufficient to provide personal jurisdiction.

In a case involving a dispute over software used to trace the lineage of purebred dogs, the Seventh Circuit held that defendants in Colorado, Michigan, Ohio, and Canada could be sued in Illinois for allegedly defaming the Illinois-based businessman who developed and sold the software.[71]

65. *Id.* at 324.
66. *Id.*
67. *Id.* at 328.
68. Doctor's Assocs. v. QIP Holder LLC, No. 3:06-cv-1710(VLB), 2010 U.S. Dist. LEXIS 14687, at *69–71 (D. Conn. Feb. 19, 2010).
69. *See* Doctor's Assocs. v. QIP Holders LLC, No. 3:06-cv-1710(VLB), 2010 U.S. Dist. LEXIS 62667 (D. Conn. June 23, 2010).
70. Cornelius v. Deluca, 709 F. Supp. 2d 1003, 1022–23 (D. Idaho 2010).
71. Tamburo v. Dworkin, 601 F.3d 693 (7th Cir. Ill. 2010).

The fact that defendants knew Tamburo lived in Illinois (and even included his Illinois address in some messages urging readers to harass him) was enough to establish a prima facie case of personal jurisdiction in Illinois, the court held.[72] In *Silver v. Brown*,[73] the Tenth Circuit favorably cited *Tamburo* in ruling that a New Mexico court had jurisdiction over a Florida man who created a blog criticizing a New Mexico consulting firm and its founder. The Floridian, a dissatisfied former customer of the New Mexico firm, expressly aimed his conduct at New Mexico and knew the primary effects would be felt there, the court said.[74]

The highest state courts in Ohio and Florida also ruled that personal jurisdiction may be exercised over individuals who post statements online about domiciliaries of those states. In *Kauffman Racing Equip., L.L.C. v. Roberts*,[75] the Ohio Supreme Court found jurisdiction over a disgruntled Virginia customer who complained online about an allegedly defective engine block he had purchased from an Ohio racing engine manufacturer. Jurisdiction was proper because the disgruntled customer targeted his efforts—postings on various racing and automotive websites—at Ohio, and the plaintiff company produced evidence that five Ohioans had read those postings.[76] Notably, the defendants in *Silver* and *Kauffman Racing* were both disgruntled former customers of the plaintiffs who had a contractual relationship with the plaintiff (even if the claims were not contractual ones).[77]

The Florida Supreme Court, answering a certified question from the Eleventh Circuit, ruled that the tort of defamation is completed when the allegedly defamatory online material about a Floridian is accessed in Florida (and thus is "published" there).[78] Under Florida's long-arm statute, a person commits the tort of defamation in Florida when someone in Florida reads the allegedly defamatory material.[79] The court repeatedly said, however, that it was answering only the question of when a court could exercise personal jurisdiction under Florida's long-arm statute, not whether it would be a violation of due process to do so.[80]

72. *Id.* at 697.

73. 382 F. App'x 723, 730–31 (10th Cir. 2010).

74. *Id.*

75. 930 N.E.2d 784 (Ohio 2010).

76. *Id.* at 794.

77. Similar cases involving alleged defamation in the context of soured contractual relations include *Noble Roman's, Inc. v. French Baguette, LLC*, 684 F. Supp. 2d 1065 (S.D. Ind. 2010) (franchisor suit over online gripes by former franchisee), and *Northwest Voyagers, LLC v. Libera*, No. CV09-378-C-EJL, 2009 U.S. Dist. LEXIS 96618 (D. Idaho Oct. 19, 2009) ("adventure tour" company suit over negative comments on travel websites and in e-mails by defendants, who got sick on a company-led tour to Mount Kilimanjaro).

78. Internet Solutions Corp. v. Marshall, No. SC09-272, 2010 Fla. LEXIS 943, at *38–39 (Fla. June 17, 2010).

79. *Id.*

80. *Id.* at *40–43.

In contrast to the above cases, the Eighth Circuit held that posting an allegedly defamatory or trademark-infringing comment about a Missouri business (and mentioning its location) does not subject the poster to personal jurisdiction there.[81] The court held that Missouri did not have jurisdiction over California and Colorado residents alleged to have posted defamatory complaints about the Missouri cat breeding business: "We therefore construe the *Calder* effects test narrowly, and hold that, absent additional contacts, mere effects in the forum state are insufficient to confer personal jurisdiction."[82] Similarly, the Third Circuit upheld the dismissal of a defamation action by a Pennsylvania attorney over defendants' claims, picked up by Russian-language news sites, that the lawyer had participated in a smear campaign against their businesses.[83] Absent more specific contacts, Pennsylvania does not have personal jurisdiction over those who make allegedly defamatory statements about its residents, the court held.[84]

D. *Single Publication Rule*

Courts throughout the country have continued to apply the "single publication rule" to information posted on the Internet.[85]

Adding a new wrinkle to this body of case law, a federal court in Kentucky held that providing hyperlinks to a document posted earlier was not republication.[86] The plaintiff, an attorney, claimed he was defamed by a

81. Johnson v. Arden, 614 F.3d 785, 796–97 (8th Cir. 2010).

82. *Id*. at 797.

83. Marks v. Alfa Group, 369 F. App'x 368, 370–71 (3d Cir. 2010).

84. *See also* Scott v. Lackey, No. 1:02-CV-1586, 2010 U.S. Dist. LEXIS 4350, at *34–37 (M.D. Pa. Jan. 20, 2010); Stubbs v. Collins, No. 08-cv-1567, 2010 U.S. Dist. LEXIS 17984 (W.D. Pa. Mar. 1, 2010); Nasuti v. Kimball, No. 09-cv-30183-MAP, 2010 U.S. Dist. LEXIS 65629 (D. Mass. June 29, 2010); Diagnostic Devices, Inc. v. Pharma Supply, Inc., No. 3:08-cv-149-RJC, 2009 U.S. Dist. LEXIS 101633 (W.D.N.C. Oct. 30, 2009); Martin v. Dobson, No. 3:09cv00208, 2010 U.S. Dist. LEXIS 16607 (S.D. Ohio Feb. 5, 2010); Xcentric Ventures, LLC v. Bird, 683 F. Supp. 2d 1068 (D. Ariz. 2010).

85. *E.g.*, Yeager v. Bowlin, No. Civ. 2:08-102-WBS-JFM, 2010 U.S. Dist. LEXIS 718, at *38–39 (E.D. Cal. Jan. 6, 2010) (plaintiff test pilot could not maintain privacy and publicity action against operators of website selling signed lithographic prints because repeated sales of identical products are subject to the single publication rule); Roberts v. McAfee, Inc., No. C 09-4303 PJH, 2010 U.S. Dist. LEXIS 20455, at *29–30 (N.D. Cal. Mar. 8, 2010) (dismissing defamation claim of company's former general counsel over news release announcing his firing and holding, "Under California law, website postings are subject to the single-publication rule for purposes of accrual of the statute of limitations, notwithstanding the fact that the website may operate/exist on a continuous basis."); Young v. Suffolk County, 705 F. Supp. 2d 183, 212–13 (E.D.N.Y. 2010) (plaintiff's libel claims barred by statute of limitations because under single publication rule, the fact an article remains accessible online does not constitute republication); Ladd v. Uecker, 780 N.W.2d 216, 220 (Wis. Ct. App. 2010) (adopting the single publication rule in Wisconsin for the first time and holding, "We reject the notion that each 'hit' or viewing of the information should be considered a new publication that retriggers the statute of limitations.").

86. Salyer v. S. Poverty Law Ctr., Inc., 701 F. Supp. 2d 912 (W.D. Ky. 2009).

passage in a 2006 report called "A Few Bad Men" that said he had been dishonorably discharged and barred from practicing in military courts because of his membership in a white supremacist organization. The court rejected his argument that a 2008 hyperlink to the 2006 report republished the allegedly defamatory material, explaining: "The hyperlinks, while adding a new method of access to 'A Few Bad Men,' did not restate the allegedly defamatory statements and did not alter the substance of that article in any manner."[87]

A New York state trial court also held that hyperlinks to other websites do not constitute republication of the content posted there.[88] The case is related to the libel action against producers of the movie *American Gangster* thrown out earlier by the Second Circuit.[89] The plaintiffs, a group of law enforcement officers, claimed they were defamed by accusations in a magazine article (on which the movie was based) that they stole from a convicted drug trafficker. The plaintiffs also argued that the release of a digital edition of a book with the allegedly defamatory material was a republication for statute-of-limitations purposes. The court rejected both arguments: "Although there does not appear to be any governing caselaw regarding digital 'Kindle Editions' of books, pursuant to the holding of *Firth v State of New York* [*supra*], such editions should be treated as merely 'a delayed circulation of the original edition,' rather than as a republication thereof."[90]

IV. ACCESS

A. *Developments in the U.S. Supreme Court*

This survey period is remarkable for the number of Supreme Court rulings affecting access to information. *Doe v. Reed*[91] upheld the State of Washington's public information law. *Citizens United v. FEC*,[92] best known for striking down the expenditure limits of the Federal Election Campaign Act,[93] also *upheld* the disclosure requirements of the statute. *Skilling v. U.S.*,[94] better known for dismissing Skilling's conviction under the "honest ser-

87. *Id.* at 918.
88. Haefner v. New York Media, 2009 WL 6346547, at *4–5 (N.Y. Sup. Ct. 2009) (citing Firth v State of New York, 775 N.E.2d 463 (N.Y. 2002)).
89. Diaz v. NBC Universal, Inc., 337 F. App'x 94 (2d Cir. 2009).
90. *Haefner*, 2009 WL 6346547, at *6.
91. 130 S. Ct. 2811 (2010).
92. 130 S. Ct. 876 (2010).
93. In the course of that holding, the Court noted the difficulty in drawing lines between the speech of media corporations (protected under the statute) and the speech of corporations generally. *Id.* at 884.
94. 130 S. Ct. 2896 (2010).

vices" statute, also rejected Skilling's challenge to the denial of his motion to transfer venue from Houston on grounds of the pretrial publicity there regarding the demise of Enron. *Presley v. Georgia*[95] held that the public (and by implication the press) must be allowed to attend the *voir dire* portion of a criminal trial.

In upholding the disclosure requirements of Federal Election Campaign Act, *Citizens United* emphasized the right of the recipient of information, that being the electorate, to receive information.[96] Disclosure requirements, as opposed to expenditure bans, may "burden speech" but do not prevent anyone from speaking.[97] The Court did not subject disclosure requirements to strict scrutiny, but to "exacting scrutiny," which requires a "substantial relationship" between the disclosure requirement and a "sufficiently important governmental interest."[98] The Court approvingly cited its prior opinion in *McConnell v. Federal Election Commission*[99] that these disclosure requirements would help citizens "make informed choices in the political marketplace."[100] The opinion's focus on the rights of recipients of information provides solid analytical support for open meetings and records laws that have the stated purpose of putting more information into the hands of the public.

Doe v. Reed involved a request under the State of Washington's Public Records Act (PRA) for copies of the referendum petition filed with the secretary of state to challenge a state law expanding the rights and responsibilities of state-registered domestic partners, including same-sex domestic partners.[101] The petitioners sought injunctive relief to prevent release, claiming that the PRA was unconstitutional as applied to referendum petitions in general and as applied to this particular referendum because there was a "reasonable probability" that the signatories would be subject to "threats, harassment and reprisals."[102] The district court had granted injunctive relief based solely on the facial challenge, and the Ninth Circuit reversed, finding that the plaintiffs were unlikely to succeed on their claim that the PRA was unconstitutional as applied to referendum petitions in general.[103] The Supreme Court, citing its ruling in *Citizens United* and applying its "exacting scrutiny" standard, upheld the Ninth Circuit ruling

95. 130 S. Ct. 721 (2010).
96. 130 S. Ct. at 907.
97. *Id*. at 914.
98. *Id*.
99. 540 U.S. 93 (2003). The court overruled *McConnell* on its holding on expenditure limits.
100. *Citizens United*, 130 S. Ct. at 914.
101. 130 S. Ct. 2811, 2815 (2010).
102. *Id*. at 2816–17.
103. *Id*.

on the facial challenge while noting that the "as applied" challenge was not before it.[104] Justice Roberts wrote: "[P]ertinent to our analysis is the fact that the PRA is not a prohibition on speech, but instead a *disclosure* requirement. '[D]isclosure requirements may burden the ability to speak, but they . . . do not prevent anyone from speaking.' "[105] The "exacting scrutiny" standard requires a "substantial relation" between the disclosure requirement and a "sufficiently important" governmental interest.[106] The opinion identifies these governmental interests as combating fraud and fostering governmental transparency and, more generally, extends to "promoting transparency and accountability in the electoral process."[107] Plaintiffs had argued that it was unnecessary to have the public review the petitions because the Washington secretary of state already verifies and canvasses the names on the petition. The court rejected this argument, noting that "public disclosure can help cure the inadequacies of" the secretary's process and that "disclosure also promotes transparency and accountability in the electoral process to an extent other measures cannot."[108] Only Justice Thomas dissented from Justice Roberts' opinion rejecting the plaintiffs' facial challenge to application of the PRA to referendum petitions.[109]

In *Skilling v. United States*, Skilling challenged the trial court's refusal to transfer venue on the basis of pretrial publicity and the last-minute guilty plea of a co-defendant. The Fifth Circuit had found the volume of pretrial publicity in combination with the co-defendant's plea created a "presumption of juror prejudice," but that this had been cured by "proper and thorough" *voir dire*.[110] The Supreme Court found that the facts in *Skilling* did not warrant even a presumption of juror prejudice. First, the court noted that "[a]t the time of Skilling's trial, more than 4.5 million individuals eligible for jury duty resided in the Houston area. Given this large, diverse pool of potential jurors, the suggestion that 12 impartial individuals could not be empaneled is hard to sustain."[111] Second, "although news stories about Skilling were not kind, they contained no confession or other blatantly

104. *Id*. at 2817, 2821.
105. *Id*. at 2818 (emphasis in original and quoting *Citizens United*, 130 S. Ct. at 914).
106. *Id*.
107. *Id*. at 2819.
108. *Id*. at 2820.
109. *Id*. at 2837 (Thomas, J., dissenting opinion). Relying in part on *Doe v. Reed*, the West Virginia Supreme Court of Appeals held that a petition signed by voters seeking to force a ballot referendum on a new county zoning ordinance was a public record under that state's Freedom of Information Act, finding that release of the signatures would not chill voters wishing to petition their government. Shepherdstown Observer Inc. v. Maghan, 700 S.E.2d 805, 813–15 (W. Va. 2010).
110. 130 S. Ct. 2896, 2911–12 (2010).
111. *Id*. at 2915 (internal citation omitted).

prejudicial information of the type readers or viewers could not reasonably be expected to shut from sight."[112]

In *Presley v. Georgia*, the Supreme Court reversed and remanded the conviction of a defendant holding that his Sixth Amendment right to a fair trial had been violated by excluding the public from the *voir dire*.[113] While Presley's claim was predicated on the Sixth Amendment, the Court's opinion reiterated that the public trial right extends beyond the accused and can be invoked under the First Amendment.[114] The *Presley* opinion puts the press's and public's First Amendment right to public trial and a defendant's Sixth Amendment right to a public trial on the same footing,[115] and in both instances the trial court must use the same test:

> [T]he party seeking to close the hearing must advance an overriding interest that is likely to be prejudiced, the closure must be no broader than necessary to protect that interest, the trial court must consider reasonable alternatives to closing the proceeding, and it must make findings adequate to support the closure.[116]

The trial court is obligated to examine alternatives to closure even if specific suggestions are not put forward by the defendant, or, by implication, the public or press: "Trial courts are obligated to take every reasonable measure to accommodate public attendance at criminal trials."[117]

B. *Access to Deliberations of Governmental Bodies*

As reported in last year's survey, a major contest regarding the Texas Open Meetings Act[118] (TOMA) ended in dismissal on grounds of mootness after the last of the plaintiffs, who had been charged with violation of TOMA for e-mail communications as a quorum, resigned his position as a councilmember of the City of Alpine.[119] As expected, the case was refiled with different plaintiffs and is again pending before the same judge in the Western District of Texas as *City of Alpine v. Abbott*.[120] The posture of the case has shifted considerably. The (mooted) panel ruling in the prior challenge held that the criminal provisions of TOMA were subject to a strict scrutiny standard under the First Amendment as a regulation of content-based speech.[121] The district court had ruled that the state could regulate the

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112. *Id*. at 2916.
113. 130 S. Ct. 721, 725 (2010).
114. *Id*. at 723 (citing Press-Enter. Co. v. Superior Court of Cal., Riverside Cnty., 464 U.S. 501, 104 S. Ct. 819, 78 L. Ed. 2d 629 (1984) (*Press-Enterprise I*)).
115. *Id*. at 724.
116. *Id*. (quoting Waller v. Georgia, 467 U.S. 39, 48 (1984)).
117. *Id*. at 724–25.
118. Tex. Gov't Code Ann. § 551.001 *et seq*.
119. Rangra v. Brown, 584 F.3d 206 (5th Cir. 2009).
120. No. 09-CV-00059 (W.D. Tex. filed Dec. 14, 2009).
121. Rangra v. Brown, 566 F.3d 515, 521 (5th Cir. 2009).

speech of its public officials to prohibit them from communicating via e-mail as a quorum, finding that this constituted holding an illegal closed meeting.[122] However, that ruling was based upon an extension of the holding in *Garcetti*[123] that elected officials, like public employees, enjoy no First Amendment protection of their speech made pursuant to their official duties. The panel did not sustain this extension of *Garcetti* and reversed and remanded, finding that speech of public officials did not fall into the same category as public employees and was afforded the full panoply of First Amendment rights afforded political speech.[124] Plaintiffs and defendant filed separate motions for summary judgment in *Abbott* on July 12, 2010, and there was no reference to *Garcetti* in the papers.[125] Rather, the Texas attorney general defended TOMA by citing both *Doe v. Reed*[126] and *Citizens United*,[127] arguing that TOMA's requirement of open meetings is merely a disclosure requirement and therefore subject to the "exacting scrutiny" requirement followed in those cases. That is, the government need only establish a "substantial relation" between the disclosure requirement and a "sufficiently important governmental interest."[128]

An important case this survey period found a limited First Amendment right of access to governmental proceedings of governmental bodies other than courts, specifically, hearings of New York City's Transit Adjudication Bureau (TAB).[129] The court applied the *Richmond Newspapers*' "experience" and "logic" test to find a presumptive right of access.[130] Although the "experience" of TAB hearings was a relatively brief quarter century, the court held that the experience of TAB Hearings is one of presumptive public access because its own procedures allowed access unless a respondent objected and also because the violations in question had been returnable to a criminal court where the public had always been provided a right of access. However, the crux of the court's analysis was under the "logic" prong, which asks "whether public access plays a significant positive role in the functioning of the particular process in question."[131] The court concluded

122. Rangra v. Brown, 2006 WL 3327634 (W.D. Tex. Nov. 7, 2006).
123. Garcetti v. Ceballos, 547 U.S. 410, 126 S. Ct. 1951, 164 L. Ed. 2d 689 (2006).
124. *Rangra*, 566 F.3d at 522–24.
125. City of Alpine v. Abbott, Docket Nos. 24 and 25, 09-CV-00059 (W.D. Tex. filed July 12, 2010).
126. 130 S. Ct. 2811 (2010).
127. Citizens United v. FEC, 130 S. Ct. 876 (2010).
128. *Doe v. Reed*, 130 S. Ct. at 2818; *Citizens United*, 130 S. Ct. at 914.
129. N.Y. Civil Liberties Union v. N.Y. City Transit Auth., 675 F. Supp. 2d 411 (S.D.N.Y. 2009).
130. *Id*. at 431–32 (citing Richmond Newspapers, Inc. v. Virginia, 448 U.S. 555, 589–98 (1980)).
131. *Id* at 434 (quoting Press-Enter. Co. v. Superior Court of Cal., Riverside Cnty., 478 U.S. 1, 8 (1986) (*Press-Enterprise II*)).

that a right of access to TAB hearings would serve all of the salutary functions of the First Amendment right of access.[132] The logic of the court's analysis in this case furthers expansion of the First Amendment right of access to noncourt governmental bodies.

C. *Access Under Freedom of Information Acts*

Among the prominent cases covered in last year's survey was the district court ruling in favor of Bloomberg L.P. and against the Federal Reserve Board under the federal Freedom of Information Act (FOIA) to determine the identities of the recipients of loans of the lending facilities operated out of the Federal Reserve, such as the Term Auction Facility (TAF).[133] On appeal, the Second Circuit also held for Bloomberg.[134] The court held that the information at issue, i.e., the identity of the borrowing bank, the dollar amount of the loans, the loan origination and maturity dates, and the collateral securing the loan, was not "obtained from" the borrowing banks within the meaning of FOIA Exemption 4 (trade secrets and confidential information) and the court therefore did not reach the question whether such information is "privileged or confidential" as to the borrowing banks.[135] The court also rejected the Board's request to extend the reach of Exemption 4 to encompass the so-called program-effectiveness test, adopted by the First and District of Columbia Circuits, which allows agencies to withhold information as confidential under Exemption 4 if they believe that withholding it "serves a valuable purpose and is useful for the effective execution of its statutory responsibilities."[136] The court stated that "a test that permits an agency to deny disclosure because the agency thinks it best to do so (or convinces a court to think so, by logic or deference) would undermine 'the basic policy that disclosure, not secrecy, is the dominant objective of [FOIA].' "[137]

The Kentucky Supreme Court reaffirmed the principle that under the state's open records law, settlement agreements with governmental bodies may not be sealed because "[t]here could be no viable contention that an agreement which represents the final settlement of a civil lawsuit whereby a governmental entity pays public funds to compensate for an injury it inflicted is not a public record."[138]

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132. *Id.* at 437.

133. Bloomberg L.P. v. Bd. of Governors, Fed. Reserve Sys., 649 F. Supp. 2d 262 (S.D.N.Y. 2009), *aff'd*, 601 F.3d 143 (2d Cir. 2010).

134. Bloomberg L.P. v. Bd. of Governors, Fed. Reserve Sys., 601 F.3d 143 (2d Cir. 2010).

135. *Id.* at 148–49.

136. *Id.* at 150 (citation omitted).

137. *Id.* (citation omitted).

138. Cent. Kentucky News-Journal v. George, 306 S.W.3d 41, 46 (Ky. 2010) (quoting Lexington-Fayette Urban Cnty. Gov't v. Lexington Herald-Leader, 941 S.W.2d 469, 471 (Ky. 1997)).

V. NEWSGATHERING

In this era of smart phones and wireless Internet, judges must decide whether reporters should be permitted to blog, tweet, and stream video from their courtrooms during trials. Some judges appear to embrace new technologies that expand the public's access to the courtroom, while others opt to exclude live media.

A reporter covering a criminal trial in Georgia sought the court's permission to tweet updates about the proceedings from the courtroom to his newspaper's Twitter site.[139] Analyzing the reporter's request under Federal Rule of Criminal Procedure 53, which prohibits the "broadcasting of judicial proceedings," the court concluded that electronic messages that were sent from the courtroom during the proceedings and were instantly available for public viewing fell within the term "broadcasting."[140] To the court, the expansive definition of "broadcasting" in the dictionary included tweeting, and the 2002 amendment to Rule 53 that removed the modifier "radio" preceding "broadcasting" meant that the rule was intended to account for the capabilities of modern technology.[141] Because the court determined that the term "broadcasting" included tweeting, the judge denied the reporter's request to tweet from the courtroom during the trial. The court also concluded that Rule 53 does not violate the First Amendment by unconstitutionally restricting the freedom of the press because prohibiting tweeting does not restrict an individual's legitimate right to access the proceedings.[142]

Not all federal judges have reached the same conclusion. Kansas federal District Judge J. Thomas Martin allowed a reporter to tweet updates from the courtroom during a racketeering gang trial,[143] and Judge Reggie B. Walton of the U.S. District Court for the District of Columbia gave two press credentials to the Media Bloggers Association and allowed two bloggers to sit in the press room and post blog updates during the criminal trial of Lewis "Scooter" Libby.[144]

Some state courts permitted live blogging from the courtroom. During the high-profile trial of three brothers charged with first-degree murder,[145] a reporter for *The Florida Times-Union* blogged inside the courtroom. The

139. United States v. Shelnutt, No. 4:09-CR-14, 2009 WL 3681827 (M.D. Ga. Nov. 2, 2009).

140. *Id*. at *1.

141. *Id*.

142. *Id*. at *2.

143. Michael W. Jones, *Twitter in the Courtroom*, TECH.BLORGE.COM (Mar. 7, 2009), http://tech.blorge.com/Structure:%20/2009/03/07/twitter-in-the-courtroom.

144. Thomas Pierce, *Bloggers Join Frenzy at Media-Saturated Libby Trial*, NPR.ORG (Feb. 1, 2007), http://www.npr.org/templates/story/story.php?storyID=7098188.

145. Morris Publ'g Co. v. Florida., No. 1D10–226, 2010 WL 363318 (Fla. Dist. Ct. App. Jan. 20, 2010).

interactive blog allowed the reporter to field and to respond to questions from users during the trial. Three days after the reporter began his coverage, the trial judge removed him from the courtroom because the reporter allegedly was distracting. The *Times-Union* filed an emergency petition for review. Florida's District Court of Appeal overturned the trial judge's order, holding that the reporter could use the laptop in the courtroom unless the trial court found "a specific factual basis to conclude that such use cannot be accommodated without undue distraction or disruption."[146]

While some judges have permitted tweeting and live blogging, the U.S. Supreme Court rejected a trial court's decision to broadcast a federal, nonjury civil trial involving a federal constitutional challenge to California's controversial Proposition 8, an amendment to the state constitution that limited state-sanctioned marriages to opposite-sex couples.[147] After the trial court ruled that the trial could be broadcast live via streaming audio and video to other courthouses around the country, the defendants in the underlying lawsuit sought a stay on the grounds that the district court's ruling was based on an improper, last-minute amendment to the local rules that did not comply with federal law. The Supreme Court ruled that the amendment to the trial court's local rules probably did not comply with federal law and that irreparable harm likely would result if the trial court improperly broadcast the proceedings.[148] The Court's decision does not preclude federal courts from broadcasting future trials; the Court clearly stated that its decision does not address whether court proceedings generally should be broadcast.[149] Rather, the decision purported to be based on the trial court's failure to comply with the proper procedure for amending its local rules.

A federal judge permanently enjoined an online financial news service, theflyonthewall.com, from publicizing reports about stock downgrade and upgrade recommendations issued by Barclays Capital, Morgan Stanley, and Bank of America's Merrill Lynch.[150] At great expense to themselves, the three banks create and provide their clients with equity research reports about publicly traded securities. Most of the reports are released while the domestic markets are closed; however, the information in these reports may cause the markets to move quickly once they open. The reports, which provide the banks' clients with an informational advantage over other investors, help the banks distinguish themselves from their competitors and attract and retain clients. The banks sued thefly-

146. *Id*. at *1.
147. Hollingsworth v. Perry, 130 S. Ct. 705 (2010).
148. *Id*. at 711–13.
149. *Id*. at 709.
150. Barclays Capital, Inc. v. Theflyonthewall.com, 700 F. Supp. 2d 310 (S.D.N.Y. 2010).

onthewall.com, claiming that the online service had engaged in "hot news misappropriation" by redistributing the banks' recommendations before the banks had the opportunity to share them with their own clients or before their clients had the opportunity to utilize the information.[151] Following a bench trial, the court found that theflyonthewall.com misappropriated the banks' commercially valuable, time-sensitive equity research recommendations and analyses by posting the banks' reports on its website without authorization.[152] As a remedy, the court issued a permanent injunction to restrict theflyonthewall.com's ability to disseminate information from the banks' reports so that such dissemination would not interfere with the banks' abilities to derive the full benefit of their efforts in creating the reports.[153]

VI. REPORTERS PRIVILEGE

A. *No News Is Good News at the Federal Level*

This was not a banner year for the reporter's privilege at the federal level. In Congress, the federal Free Flow Act failed to reach the Senate floor, despite being rewritten to win Judiciary Committee approval,[154] and Wikileaks' publication of leaked Afghan War reports legitimized moves to deny First Amendment protection to those who publish leaked government documents, including a plan to exclude leakers from the federal shield law.[155] In the courts, the Second Circuit not only questioned whether reporters believe they are "on some kind of pedestal" and why cross-examination of them is "so limiting,"[156] but also upheld an order requiring release of hundreds of hours of outtakes from a political documentary that normally

151. The banks also sued theflyonthewall.com for copyright infringement; theflyonthewall.com conceded that its actions constituted copyright infringement and that an injunction was appropriate on that basis.

152. *Barclays Capital*, 700 F. Supp. 2d at 316, 336.

153. *Id*. at 348.

154. The House passed the Federal Free Flow of Information Act in March 2009, but the Senate Judiciary Committee debated its scope for months before a compromise with the intelligence community and the Obama administration passed 14–5 in December 2009. *See Federal Shield Law Passes Senate Committee*, 15 Silha Bull. 40 (Fall 2009).

155. Wikileaks' publication of confidential Afghanistan war documents resulted in a proposal to amend the Act to expressly exclude websites that publish leaked government documents without editorial control. *Wikileaks Controversy Highlights Debate over Shield Law*, Wash. Post, Aug. 21, 2010; *Wikileaks' Document Dump Sparks Debate*, 15 Silha Bull. 1, 3–4 (Summer 2010); Cristina Abello, *Leaked War Documents Spark Federal Shield Law Revisions*, Reporters Comm. for Freedom of the Press (Aug. 4, 2010), http://www.rcfp.org/news items/index.php?i=11511.

156. Daniel Skallman, *Second Circuit Case Could Weaken Reporter's Rights*, Reporters Comm. for Freedom of the Press (Sept. 25, 2010), http://www.rcfp.org/newsitems/index.php?i=11570.

would have received a high degree of protection.[157] A federal district court blocked interlocutory appeal of its refusal to quash a press subpoena on grounds that a reporter seeking appellate review must first be cited for contempt.[158]

Federal law enforcement officers ignored both the privilege and the thirty-year-old Privacy Protection Act in unlawfully seizing computers and other protected materials from the newsrooms of online and student journalists,[159] forcing one student editor to choose between downloading 962 photographs to disk or having every computer in the newsroom seized, thereby shutting down operations.[160] REACT, the government-sponsored "Rapid Enforcement Allied Computer Team," seized the computers and servers from Gawker Media's Gizmodo website for publishing information about a prototype iPhone that was left in a bar by an Apple employee.[161]

On a more positive note, the Tenth Circuit permitted a former deputy district attorney to be sued individually for authorizing the search of a student journalist's home merely because his professor did not appreciate being parodied in an irreverent online newspaper called *The Howling Pig*.[162] However, even the winning cases are cause for concern given the cost to fight them, especially because they are disproportionately directed to student journalists.

B. *State Governments Protect the News and Those Who Report It*

Two additional states, Kansas and Wisconsin, enacted their first reporter's shield laws, and a third state, Maryland (which enacted the first state shield law in 1892), expanded the coverage of its statute to expressly protect online and student journalists. These new laws encapsulate the ongoing debate over the proper scope of protection for online and student publications, as well as whether the recipient of such protections should be the reporter or the business that published the article.

The Kansas law focused on the reporter, covering "information or the source [thereof]" procured by "a journalist" when "acting as a journalist,"[163]

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157. *See In re* Application of Chevron Corp., 2010 WL 2891202, at *1 (S.D.N.Y. 2010); Patrick File, *Appeals Court Narrows, Upholds Subpoena for Film Outtakes*, 15 Silha Bull. 19 (Summer 2010); Ellen Biltz, *Filmmaker Must Turn over Unused Footage: Judge Limited Chevron's Expansive Request to Three Categories*, 34 News Media & L. 14 (Summer 2010).

158. *In re* Subpoenas to Daily News, L.P., 2010 WL 2490990, at *2 (S.D.N.Y. 2010).

159. The statute, 42 U.S.C. § 2000aa, requires the use of a subpoena rather than a search warrant to obtain evidence from a newsroom, and was enacted in response to the Supreme Court's decision in *Zurcher v. Stanford Daily*, 436 U.S. 537 (1978).

160. Cristina Abello, *Newsroom Searches Occurring Despite Law*, 34 News Media & L. 16 (Summer 2010); Geoff Pipoly, *Update: Settlement Reached in Student Paper Search and Seizure*, 15 Silha Bull. 31 (Summer 2010).

161. Abello, *supra* note 161.

162. Mink v. Suthers, 482 F.3d 1244 (10th Cir. 2010).

163. Kan. Stat. Ann. § 60-481 (2010).

including those writing for an "online journal in the regular business of newsgathering and disseminating news or information to the public."[164] Wisconsin focused on the "business or organization," protecting those that, "by means of print, broadcast, photographic, mechanical, electronic, or other medium," disseminate "news or information," including "a newspaper, magazine, or other periodical; book publisher; news agency; wire service; radio or television station or network; cable or satellite network, service, or carrier; or audio or audiovisual production company,"[165] as well as those working for any such entity.[166] Maryland took the middle road, covering those acting in a "news gathering or news disseminating capacity," if they are "enrolled as a student in an institution of postsecondary education" or "employed by the news media,"[167] including those using "electronic means of disseminating news and information to the public."[168]

State court decisions considering the reporter's privilege typically focused on the precise language of the state's shield law or the applicable First Amendment balancing test. For example, the New Jersey appellate court upheld a trial court ruling, reported in last year's Annual Review, that a blogger was not engaged in gathering or disseminating news, as required by the state's shield law and the First Amendment, when she posted comments on a third party's Internet bulletin board.[169] The state Supreme Court has accepted the defendant's appeal, limited to "those issues relating to the New Jersey Shield Law and the First Amendment."[170]

In contrast, the New Hampshire Supreme Court ruled that a mortgage lender that posted comparative information about mortgage loans on its website qualified as a member of the press under New Hampshire's constitutional reporter's privilege because the website served an informative function and contributed to the flow of information to the public.[171] That court vacated the trial court's disclosure order because the trial court failed to balance the First Amendment rights of the media against the rights of the person seeking the information.[172] A District of Columbia judge quashed a subpoena to a nonparty reporter for unpublished interviews

164. *Id.* § 60-480(a).
165. Wis. Stat. Ann. § 885.14(1)(a) (2010).
166. *Id.* § 885.14(1)(b).
167. Md. Code Ann., Cts. & Jud. Proc. § 9-112(b)(1) & (2) (West 2010).
168. *Id.* § 9-112(a)(1)–(9).
169. Too Much Media v. Hale, 993 A.2d 845, 860–62 (N.J. Super. App. Div. 2010).
170. Too Much Media v. Hale, 3 A.3d 1224 (2010); Michael Booth, *N.J. High Court to Review if Web Posters Can Invoke Shield Law*, L. Tech. News, Sept. 20, 2010.
171. Mortgage Specialists, Inc. v. Implode-Explode Heavy Indus., 999 A.2d 184, 189 (N.H. 2010).
172. *Id.* at 190–91 (citing Bruno & Stillman, Inc. v. Globe Newspaper Co., 633 F.2d 583, 595–98 (1st Cir. 1980)).

because the defendants failed to satisfy the D.C. Circuit's balancing test, which is "more demanding . . . when the burden is sought to be imposed upon a third party . . . reporter."[173]

In an unusual case, a Michigan federal court denied a motion to reconsider its previous ruling that *Detroit Free Press* reporter Richard Convertino was entitled to rely on the Fifth Amendment in refusing to disclose the source of a Justice Department leak, finding that "his fear of self-incrimination is well-founded."[174]

VII. INSURANCE

A. *Lack of Carrier Control over Defense Can Prevent Insurer Liability for Failure to Settle*

Judges in recent years increasingly have shown their displeasure with the Fourth Estate's reporting of their activities by suing the press. One such suit underlay the only recent insurance coverage case arising from a media liability policy, *Mutual Insurance Co. v. Murphy*.[175] In the underlying action, Judge Ernest B. Murphy prevailed in his defamation suit against the *Boston Herald*, ultimately resulting in payment to Murphy of $3,414,687, including post-judgment interest and costs after appeal.[176] Slightly more than a month after receiving payment, Judge Murphy sent a letter to Mutual Insurance Co., the *Herald*'s insurer, demanding $6.8 million for its failure to comply with its duty to effectuate a settlement under Massachusetts statutes, by refusing to settle immediately post judgment, and appealing instead.[177] The carrier responded by filing a declaratory judgment action, to which Judge Murphy counterclaimed.[178] In considering Mutual's motion for summary judgment, the court recognized that an insurer owes a duty to settle, not only to its insured, but also to third-party claimants,[179] but found that the carrier did not have the capacity to exercise the requisite control for the statutes to apply.[180] The court focused on policy language giving the *Herald* both the right to defend and the right to settle, and the policy's lack

173. *In re* Subpoena to Goldberg, 693 F. Supp. 2d 81, 88 (D.D.C. 2010).

174. Convertino v. U.S. Dep't of Justice, 2010 WL 523042 (E.D. Mich. Feb. 9, 2010).

175. 630 F. Supp. 2d 158 (D. Mass. 2009).

176. *Id*. at 161.

177. *Id*. The $6.8 million demand was treble the amount of the jury verdict including interest. *Id*.

178. *Id*. Section 3 of Mass. Gen. Laws ch. 176D regulates unfair acts and practices in the business of insurance and explicitly forbids "unfair claim settlement practices." *Id*. at 163; Mass. Gen. Laws ch. 176D, § 3(9). Conduct by insurers prohibited under Mass. Gen. Laws. ch. 176D, § 3(9) gives rise to a cause of action under Mass. Gen. Laws 93A, § 9(1). *Id*.

179. *Murphy*, 630 F. Supp. 2d at 163 (citing Clegg v. Butler, 676 N.E.2d 1134 (Mass. 1997)).

180. *Id*. at 170.

of a "hammer clause," defined as a clause that requires an insurer to seek the insured's consent prior to settlement, and affords the carrier the ability to limit its exposure in the event the insured refuses to settle.[181] Because the *Herald* never indicated a willingness to settle, the carrier was unable to effect or otherwise force settlement per the policy terms.[182] While the court recognized that the carrier participated in the defense and recommended appellate counsel to the *Herald*, at no time did the carrier take control over either the settlement negotiations or the conduct of the case.[183]

B. *Defamation*

1. Known Falsity Exclusion

In *Chrysler Insurance Co. v. Greenspoint Dodge of Houston, Inc.*,[184] the court imputed a corporate employee's knowledge of falsity to the corporate defendant to exclude coverage for a defamation claim. Chrysler Insurance Company had issued a commercial general liability (CGL) policy to Greenspoint. The Texas Supreme Court noted that a corporation's knowledge is not limited to what the officers knew, but that such knowledge extends to other employees, and in this case, the employee at issue was a "corporate vice principal."[185] The court found that, notwithstanding the "separation of insureds" clause, the employee who uttered the defamatory statements was an "insured" under the plain policy terms, and, as such, his statements were those of his employer as a matter of law.[186] Because the employee had been found to have uttered the statements intentionally and with full knowledge of their falsity, the known-falsity exclusion applied and the carrier could not be liable for breach of the insurance agreement.[187]

The Supreme Court of Vermont came to the opposite conclusion in *Pharmacists Mutual Insurance Co. v. Myer*,[188] holding that the known-falsity exclusion did not bar coverage for a defamation claim under a homeowners' liability policy (in contrast to the *Chrysler* court's CGL policy). The underlying case involved various comments made by the insured in the aftermath of

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181. *Id.* at 166. The court also found Judge Murphy's argument unpersuasive that the right of the carrier to associate counsel demonstrated control under the policy. *Id.* (citing Outboard Marine Corp. v. Liberty Mut. Ins. Co., 536 F.2d 730, 736 (7th Cir. 1976) ("The reservation of the option to 'associate' in the defense imposes no duties when that option is not exercised.") and Employers' Liab. Assurance Corp. v. Hoechst Celanese Corp., 684 N.E.2d 600, 610 (Mass. Ct. App. 1997) (ruling that a nearly identical provision to that of the *Murphy* case "exempts the insurer from assuming charge of the defense and settlement of claims")).

182. *Id.* at 167.

183. *Id.* at 165–169.

184. 297 S.W.3d 248 (Tex. 2009).

185. *Id.* at 250.

186. *Id.* at 251–53.

187. *Id.* at 253–54.

188. 993 A.2d 413 (Vt. 2010).

a dispute over a sale of a condominium that went awry. The jury found that the insured made statements with "actual knowledge of falsity [or] reckless disregard of their probable falsity . . . or maliciously and with ill will."[189] Following judgment for the third-party plaintiff in the defamation suit, the carrier filed a declaratory judgment action, and the insured counterclaimed alleging breach of the covenant of good faith and fair dealing, and that the policy was illusory. The homeowners' policy included coverage for personal injury, but also incorporated a "known falsity" exclusion.[190] Ruling on the carrier's summary judgment motion, the trial court concluded that, based on the trial interrogatories, the carrier was not liable for either defense of the appeal of the underlying jury verdict or the damage award, but was liable for the attorney fees incurred post tender and through trial.[191]

On appeal, the Supreme Court of Vermont noted that one of the two interrogatories under which liability was found against the insured was under a negligence standard.[192] The carrier argued that, because the underlying plaintiff had only characterized the insured's actions at trial as intentional acts, the jury's verdict should be read as finding the insured acted with knowledge of the falsity of the statements made, or had reason to believe his statements were false.[193] The insured responded by arguing that applying the carriers' reasoning would essentially delete all coverage for defamation claims from the policy.[194] The court noted that a defendant may be found liable for defamation under either a negligence or intentional standard, depending on the law that applied.[195] The court ultimately ruled for the insured, finding that the trial court erred in granting summary judgment because the jury answered the question addressing negligence in the affirmative, and so it could not conclude that the offending statement was made with knowledge of its falsity.[196]

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189. *Id*. at 415.

190. The policy excluded coverage for personal injury '"caused by the publication or statement made by . . . an insured, if the insured knew or had reason to believe that the publication or statement was false."' *Id*. at 416.

191. *Id*.

192. *Id*. at 417.

193. *Id*. at 417–18.

194. *Id*. at 418.

195. *Id*. The court cited the case of *Hingham Mutual Fire Insurance Co. v. Smith*, 865 N.E.2d 1168 (Mass. App. Ct. 2007) (holding that the known-loss exclusion applied only where there was a willful intent to deceive), as support, noting that the policy language and facts in that case were nearly identical to the instant action.

196. *Pharmacists Mut. Ins*., 993 A.2d at 419. The court noted that the carrier was free to attempt to introduce evidence on remand that, notwithstanding the jury verdict, the statements were in fact made with knowledge of their falsity, but then went on to acknowledge the carrier would likely be unable to do so with regard to the indemnity obligation as it had failed to have the jury complete special interrogatories identifying those statements that were negligent and those that were intentional. *Id*. at 419–20.

2. Failure to Conform Exclusions Under CGL Policies

Two courts ruled this year that statements made in advertising ran afoul of "failure to conform" exclusions. In *Harleysville Mutual Insurance Co. v. Buzz Off Insect Shield*, the insured had been found liable for false advertising surrounding the marketing of its line of insect-proof outdoor wear.[197] The underlying plaintiff was S.C. Johnson & Son, makers of Off insect spray.[198] The insured had marketed its product as superior to Off spray in protection against insect bites, and because it was not messy, among other assertions.[199] Off argued in response that there was no empirical evidence that the insured's clothing line did anything to deter pesky insects, and, in fact, insect bites were common through the clothing.[200] The court ruled that these arguments were the crux of the claim, and that the insured's "statements about its own products were literally not true."[201] Although the false statements may have harmed the ability of S.C. Johnson to market and sell its product, the assertions at issue did not disparage S.C. Johnson's products but rather made false statements about the insured's own clothing line.[202] Thus, the court ruled that the policy's "failure to conform" exclusion applied and that the carrier was not liable for breach of the policy terms.[203]

In *Total Call International v. Peerless Insurance Co.*,[204] two competitors likewise disputed the factual basis for allegations made by an insured. Also insuring under a CGL policy, Peerless Insurance Company disclaimed coverage—stating that the underlying claims for harm to reputation and consumer fraud did not allege an advertising injury and that coverage was barred by the "failure to conform" exclusion in the policy. Total Call was a calling card company that advertised its products as providing a certain number of minutes for a certain price, which was inaccurate. The court ruled that, while the false advertisements may have reduced the plaintiff's market share, they did not pertain directly to the underlying claimant and so could not constitute defamation, a covered offense. As such, they could not fall within the policy's definition of "advertising injury."[205] The court also ruled that the policy's "failure to conform" exclusion applied to bar coverage for claims by both consumers and competitors for Total Call's

197. 692 S.E.2d 605 (N.C. 2010).
198. *Id.* at 608.
199. *Id.* at 608–09.
200. *Id.* at 621.
201. *Id.*
202. *Id.* at 622.
203. *Id.* at 623.
204. 104 Cal. Rptr. 3d 319 (2010).
205. *Id.* at 327.

alleged misrepresentations about its product because the only question at issue relating to the advertisements was whether the product performed as promised.[206]

C. *Privacy*

Courts across the nation continued to disagree on whether there is insurance coverage for "fax blasting" violations of the Telephone Consumer Protection Act (TCPA)[207] under liability policy provisions covering "oral or written publication of material that violates a person's right of privacy" typically found in personal and advertising injury coverages.

In *State Farm General Insurance Co. v. JT's Frames, Inc.*,[208] the California Court of Appeal held the policy provision defining advertising injury as "oral or written publication of material that violates a person's right of privacy" did not provide coverage for the alleged unsolicited faxes that purportedly violated the recipient's privacy right to seclusion.[209] Rather, the court found this provision would only provide coverage for faxes containing confidential information in violation of the underlying plaintiffs' right to secrecy.[210] In the underlying action, JT's Frames filed a class action suit in Illinois alleging that the Friedman Group sent 74,000 faxes to JT's fax machine and to other companies. JT's maintained that the Friedman Group violated the TCPA, committed conversion of fax ink and fax paper, and violated the Illinois Consumer Fraud and Deceptive Practices Act. On appeal in the coverage action, JT's Frames (which had been assigned the coverage rights after resolution of the underlying action) argued that the underlying action involved violations of the TCPA, which protects the right to seclusion. State Farm argued that the only right of privacy potentially covered under its policy is the right to be free from the disclosure of personal or confidential information. The court of appeal agreed with State Farm, applying the "last antecedent rule."[211] This rule provides that qualifying words, phrases, and clauses are to be applied to the words immediately preceding them and are not to be construed as extending to or including other words or meanings that are more remote.[212] Under the last antecedent rule, the court held that the phrase "that violates a person's right

206. *Id.* at 328.
207. 47 U.S.C. § 227.
208. 104 Cal. Rptr. 3d 573 (2010), *review denied* (Apr. 28, 2010).
209. *Id.* at 584–85.
210. *Id.* at 586–87.
211. *Id.* (following ACS Sys., Inc., v. St. Paul Fire & Marine Ins. Co., 147 Cal. App. 4th 137 (2007) (holding no coverage for TCPA claims under policy providing coverage for "making known to any person or organization written or spoken material that violates an individual's right of privacy")).
212. *Id.* at 586.

of privacy" must be construed to modify the word "material."[213] Thus, to come within the policy's definition of advertising injury, the content of the fax at issue must "violate a person's right to privacy," which would be the case only if the fax contained confidential information that violated a third party's right to secrecy.[214] For context, the court of appeal also looked at the other offenses contained in the policy's advertising injury definition and concluded that advertising injury coverage applies only to content-based claims, which fax-blasting claims are not.[215]

The holding in *JT's Frames* seemed consistent with a fax-blasting coverage decision by the Seventh Circuit a few months earlier. In *Auto-Owners Insurance Co. v. Websolv Computing, Inc.* ("*Websolv*"),[216] the Seventh Circuit applied Iowa law to find that the insured's sending of a single-page unsolicited fax, allegedly in violation of the TCPA and the recipient's seclusion-based right of privacy, was outside of a commercial general liability policy's advertising injury coverage for violations of a person's right of privacy through "publication" of oral or written material. The Seventh Circuit chose to follow its prior ruling in *American States Insurance Co. v. Capital Associates*,[217] in which it had attempted to construe Illinois law, even though Illinois state courts later chose to find coverage under similar policy language. The *Websolv* court based its ruling on the use of the word "publication" in the policy's advertising injury definition, which it found narrowed the scope of covered "privacy rights" to secrecy-based rights, and on the focus of other provisions of the advertising injury definition on harm arising from advertising content, rather than on harm arising from the mere receipt of an advertisement.[218]

On the day after *JT's Frames* was decided, the Florida Supreme Court construed similar policy language to reach an opposite conclusion in *Penzer v. Transportation Insurance Co*.[219] The underlying litigation involved a class

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213. *Id.*

214. *Id.* at 586–87. The court acknowledged that several courts have interpreted the language at issue here to cover fax-blasting claims (e.g., Motorists Mut. Ins. Co. v. Dandy-Jim, Inc., 182 Ohio App. 3d 311 (2009); Terra Nova Ins. Co. v. Fray-Witzer, 449 Mass. 406 (2007); Valley Forge Ins. v. Swiderski Elec., 223 Ill. 2d 352 (2006); TIG Ins. Co. v. Dallas Basketball, Ltd., 129 S.W.3d 232 (Tex. App. 2004), abrogated in part on another ground in Lamar Homes, Inc. v. Mid-Continent Cas. Co., 242 S.W.3d 1 (Tex. 2007)), while it is following the line of other courts that have found this language does not provide coverage for TCPA claims (e.g., Am. States Ins. v. Capital Assoc. Jackson Co., 392 F.3d 939 (7th Cir. 2004); Auto-Owners Ins. Co. v. Websolv Computing, Inc., 580 F.3d 543 (7th Cir. 2009); Ace Rent-A-Car, Inc. v. Empire Fire & Marine Ins., 580 F. Supp. 2d 678 (N.D. Ill. 2008); St. Paul Fire & Marine Ins. v. Brunswick Corp., 405 F. Supp. 2d 890 (N.D. Ill. 2005)).

215. *Id.* at 587–88.

216. 580 F. 3d 543.

217. 392 F.3d at 941 (applying Illinois law).

218. *Websolv*, 580 F.3d at 550–51.

219. 29 So. 3d 1000 (2010).

action for more than 24,000 allegedly unsolicited facsimile advertisements that resolved in settlement and the defendant's assignment of its rights to insurance coverage to Penzer. Penzer then brought a declaratory judgment action against Transportation Insurance in the U.S. District Court for the Southern District of Florida. The district court ruled there was no coverage. On a certified question from the Eleventh Circuit on appeal, the Supreme Court of Florida held that TCPA violations fall within the scope of covered "oral or written publication of material that violates a person's right of privacy."[220] The *Penzer* court looked to dictionary definitions of "publication," "material," and "right," in conjunction with the meaning of "right of privacy" under Florida law, to determine the plain meaning of the policy language.[221] The court concluded that the "right of privacy" included the right to be left alone, i.e., a seclusion interest.[222] It refused to apply the last antecedent rule to bar coverage.[223] Even if the phrase "that violates a person's right of privacy" only modifies the term "material," the court found that a faxed advertisement, regardless of content, may constitute "material" that is offensive and violates the individual's right of privacy under the TCPA by intruding upon the recipient's seclusion.[224] As such, the court found there was coverage for the blast-fax class action suit under the policy's "advertising injury" definition.[225]

Carriers are increasingly attempting to draft around the legal uncertainty of coverage for fax-blasting TCPA claims. Thus, although cases construing the policy language discussed above may eventually disappear, a new round of coverage litigation may arise to construe the new policy terms and exclusionary language now used by most insurers. Further, even as companies reduce or eliminate blast-fax advertising campaigns, a recent spate of text-messaging-related TCPA actions, with potentially huge exposure, foreshadow further tough issues for businesses and insurance carriers based on uncertain coverage for these privacy-related actions.[226]

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220. *Id.* at 1003.
221. *Id.* at 1005–06.
222. *Id.* at 1006.
223. *Id.* at 1007.
224. *Id.* at 1007–08.
225. *Id.* at 1008.
226. *E.g.*, Satterfield v. Simon & Schuster, Inc., 569 F.3d 946 (9th Cir. 2009) (holding text messaging is a "call" under the TCPA).

RECENT DEVELOPMENTS IN PRODUCTS, GENERAL, AND CONSUMER LIABILITY LAW

Patricia A. Sexton, Adam T. Suroff, Daniel R. Zmijewski, and LaTrice N. McDowell

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I. PRODUCTS LIABILITY

A. *Defenses*

1. Assumption of Risk

In *Sheenan v. North American Marketing Corp.*,[1] the First Circuit confirmed that certain risks are so self-evident that a person who ignores the risk and is then injured will be deemed to have assumed the risk of injury.[2] Plaintiff alleged that while attempting to dive into a shallow above-ground swimming pool she lost her balance and fell into the pool head first at a steep angle. She suffered a fraction of the C5 vertebra, and the injury left her quadriplegic.

Applying Rhode Island law, the court affirmed summary judgment and dismissed plaintiff's claim. The pool contained signs that read "NO DIVING-SHALLOW WATER."[3] Plaintiff saw the signs and knew the pool was shallow. Before entering the pool, plaintiff was standing on a flat piece commonly known as coping.[4] The coping was an aluminum ridge that encircled the pool and was about six inches wide. Its function was to connect the pieces of the pool wall.[5] Plaintiff argued that even though the coping was not intended for use as a platform, it invited users to stand on top of it. If used as a platform, the coping was narrow and unstable subjecting users to the risk of losing their balance and falling.[6] Plaintiff argued that she may have assumed the risk of diving, but not the risk of falling from the narrow coping.

The court rejected this argument. The court emphasized that plaintiff stood on the coping in order to dive and the injury she suffered was the one contemplated by the warning signs.[7] Because plaintiff assumed the risk of diving, "she assumed the risk that she might fall while diving."[8] Had she fallen simply while standing on the unstable and narrow coping, the outcome may have been different.

1. 610 F.3d 144 (1st Cir. 2010).
2. *Id.* at 145.
3. *Id.* at 146.
4. *Id.* at 147.
5. *Id.* at 146.
6. *Id.* at 148.
7. *Id.* at 155.
8. *Id.* at 154.

2. Economic Loss Rule

In *Sapp v. Ford Motor Co.*,[9] the South Carolina Supreme Court explained and applied the economic loss rule. Here, both plaintiffs purchased Ford F-150 trucks that caught fire and were badly damaged.[10] A defect in the cruise control switch allegedly caused both fires.[11]

Plaintiff alleged that Ford had prior knowledge of a design defect in the cruise control switch that created a risk of fire.[12] Each plaintiff purchased his truck used "as is".[13] Neither plaintiff suffered personal injury or property damage, other than to the trucks themselves.[14]

As the court explained, the economic loss rule provides that "there is no tort liability for a product defect if the damage suffered by the plaintiff is only to the product itself".[15] On the one hand, tort law protects society from physical harm to person or property.[16] On the other hand, contract law protects consumers from not receiving the benefit of their bargain.[17] Simply put, these plaintiffs only suffered the loss of use of their trucks that each purchased "as is" from someone other than Ford. Consequently, the economic loss rule barred their tort actions.[18] A key point from the case is that the court applied the economic loss rule despite damage to the entire truck. One could argue exceeds the mere contractual damage that replacing the damaged cruise control switches would have caused absent the fires.

3. Learned Intermediary

In a case of first impression, the Colorado Court of Appeals adopted the learned intermediary doctrine in *O'Connell v. Biomet, Inc.*[19] In this action against a medical device manufacturer and its sales representative, the court affirmed summary judgment for the defendants on plaintiff's claim of failure to warn. After plaintiff fractured his elbow, his physician decided to use an external elbow fixator, the EBI OptROM.[20] The device manufacturer "provided a package insert and surgical technique manual with the fixator describing installation techniques, risks, and potential adverse

9. 687 S.E.2d 47 (S.C. 2009).
10. *Id.* at 48.
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.* at 147.
16. *Id.*
17. *Id.*
18. *Id.* at 150. The court declined to expand the exception to the economic loss rule it created in *Kennedy v. Columbia Lumber & Manufacturing Co.*, 384 S.E.2d 730 (S.C. 1989) (creating exception to the economic loss rule for residential homebuyers).
19. No. 09CA0224, 2010 WL 963234 (Colo. Ct. App. Mar. 18, 2010).
20. *Id.* at *1.

events in the use and application of the device."[21] The physician applied the fixator to plaintiff's "humerus using bone screws, during which the drill bit or the bone screw pierced his radial nerve, wound it up, and tore a section of it out of his arm, resulting in permanent injury."[22] After the surgery, plaintiff's physician sent a letter to defendants recommending revisions to the surgical technique manual in an effort to prevent similar future occurrences.[23]

In the lower court, defendants moved for partial summary judgment on the failure to warn claim, asserting that the warnings and instructions in the package insert and surgical technique manual were adequate as a matter of law. On appeal, the court affirmed the trial court's grant of summary judgment and recognized in the context of prescription medication, "where prescription drugs are concerned, the manufacturer's duty to warn has been limited to an obligation to advise the prescribing physician of any potential dangers that may result from the drug's use."[24] Thus, the court held that the trial court correctly applied the learned intermediary doctrine in the context of the failure to warn claim as a matter of law and correctly held that the product warnings need to be given only to the physician.[25]

In *Dean v. Eli Lilly & Co.*, the Second Circuit rejected the "overpromotion" exception and affirmed a district court's dismissal of a suit by a Zyprexa user who claimed that Eli Lilly & Co.'s antipsychotic medication caused him to develop diabetes.[26] Plaintiff, a Florida resident whose case was transferred to the Eastern District of New York as part of the Zyprexa multidistrict litigation, sued Lilly for failure to warn.[27] Plaintiff, a schizophrenic, used Zyprexa almost continually from June 2002 until October 2006, when he was diagnosed with diabetes.[28] Plaintiff claimed he would not have been prescribed the drug had Lilly properly warned of its dangers.[29] In the appeal, plaintiff challenged the district court's reliance on the learned intermediary doctrine, arguing that this case was subject to the "overpromotion exception."[30]

Lilly argued that plaintiff's physician knew about Zyprexa's diabetes risk when the medication was prescribed; therefore, the learned intermediary doctrine was applicable. The court recognized that under the doctrine,

21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.* at *2.
25. *Id.* at *4.
26. No. 09–3723-CV, 2010 WL 2802614 (2d Cir. July 16, 2010).
27. *Id.* at *1, n.1.
28. *Id.* at *1.
29. *Id.*
30. *See id.* at *2.

"a manufacturer of a prescription drug discharges its duty to warn by providing an adequate warning to the prescribing physician."[31] Plaintiff's physician testified he knew the drug carried a diabetes risk when he first prescribed it for plaintiff in June 2002. He also testified that nothing he learned about Zyprexa after 2002 would have caused him to change his decision regarding the prescription because he felt any risks were outweighed by the drug's benefit.[32]

Plaintiff nevertheless argued that the learned intermediary defense should not apply in his case because, under an exception to the doctrine, Lilly's "overpromotion" of the drug negated any warnings.[33] The Second Circuit was not persuaded by the argument and explained that while the record shows Lilly launched a "vigorous sales campaign for Zyprexa aimed at [plaintiff's physician]," plaintiff offered no evidence that the company's sales staff mislead the physician about the drug's link to diabetes or caused him to prescribe it to plaintiff.[34] The evidence instead indicated that the physician's prescription of the drug to plaintiff was based on his "prior success" using the drug, "the express wishes" of plaintiff's family, and the physician's "own assessment" of plaintiff's needs.[35]

In *Dietz v. Smithkline Beecham Corp.*, the Eleventh Circuit addressed Georgia's learned intermediary doctrine.[36] Plaintiff brought a wrongful death suit that arose out of her husband's suicide while taking Paxil.[37] "Eight days after having filled and begun his Paxil prescription, *Dietz* committed suicide by throwing himself in front of a train."[38] The Eleventh Circuit acknowledged that Georgia employs the learned intermediary doctrine, which holds that the manufacturer of a prescription drug does not have a duty to warn the patient of the dangers involved with the product. Instead, the manufacturer has a duty to warn the patient's doctor, who acts as a learned intermediary between the patient and the manufacturer.[39] The court explained that in cases where

> a learned intermediary has actual knowledge of the substance of the alleged warning and would have taken the same course of action even with the

31. *Id.* at *1 (citing Zanzuri v. G.D. Searle & Co., 748 F. Supp. 1511, 1514–15 (S.D. Fla. 1990)).
32. *Dean*, 2010 WL 2802614 at *1.
33. *Id.* at *2.
34. *Id.*
35. *Id.*
36. 598 F.3d 812 (11th Cir. 2010).
37. *Id.* at 814.
38. *Id.*
39. *Id.* at 816.

> information the plaintiff contends should have been provided, courts typically conclude that . . . the causal link is broken and the plaintiff cannot recover.[40]

In this case, plaintiff's doctor provided "explicit uncontroverted testimony that, even when provided with the most current research and FDA-mandated warnings, he still would have prescribed Paxil for Dietz's depression."[41] The Eleventh Circuit affirmed, pursuant to Georgia's learned intermediary doctrine, noting such testimony eliminates any potential chain of causation through which Dietz could have sought relief, and the claims therefore failed.[42]

4. Sophisticated User

The Michigan Court of Appeals addressed the sophisticated user defense in *Heaton v. Benton Construction Co*.[43] In this case, plaintiffs entered a contract with defendant, Pristine Home Builders, operated by defendant Daniel Bonawitt, to construct their retirement home.[44] Bonawitt hired defendant Great Lake Superior Walls to design, manufacture, and install precast concrete foundation walls in the home.[45] "During the construction of the home, the foundation walls twice shifted, first in September 2005 after the retaining foundation wall was partially backfilled and again in October 2005 after shear (supporting) walls were installed on the advice of defendant and further backfilling."[46] Plaintiffs sued under theories of breach of contract, express and implied warranties, and negligence.[47]

Defendants appealed the trial court's denial of its motion for judgment as a matter of law. The trial court denied the motion because "(1) plaintiff's claim was not one of products liability but rather one for ordinary negligence, and (2) under the facts of the case, Bonawitt was not a 'sophisticated user' as contemplated by the statute."[48] First, the appellate court clarified the parties' attempt to distinguish between an action for ordinary negligence and an action for products liability. The court stated that the foundation walls were a product as defined by the products liability statutes.[49] Additionally, the court explained that "the fact that Plaintiff's theory of liability was one of negligence does not preclude its action from com-

40. *Id*. (citing Ellis v. C.R. Bard, Inc., 311 F.3d 1272, 1283 n. 8 (11th Cir. 2002)).
41. *Id*.
42. *Id*.
43. 780 N.W.2d 618 (Mich. 2009).
44. *Id*. at 621.
45. *Id*.
46. *Id*.
47. *Id*.
48. *Id*. at 623.
49. *Id*.

ing within the statutory definition of a products liability action because negligence is a 'legal . . . theory of liability brought for . . . damage to property.' "[50]

Because the court found that the claim was in the purview of a products liability action, it evaluated whether Bonawitt was a sophisticated user. Michigan law defined a sophisticated user as "a person or entity that by virtue of training, experience, a profession or legal obligations, is or is generally expected to be knowledgeable about a product's properties, including potential hazards or adverse effects."[51] However, if employees do not have "actual knowledge of the product's potential hazard or adverse effect that caused the injury," they are not sophisticated users.[52] The defendants argued that Bonawitt met this definition, and therefore, it had no duty to warn him of the need for shear walls. However, Bonawitt testified that he had only built twelve houses under his builder's license and had never before used the type of foundation walls that Great Lakes provided.[53] Thus, the appellate court affirmed the trial court's conclusion that Bonawitt was not a sophisticated user as defined by the Michigan statute.[54]

5. Statute of Repose

Statutes of repose can also serve as a bar in products liability actions sometimes even when the statute was enacted by a foreign country. In *Chang v. Baxter Healthcare Corp.*,[55] the Seventh Circuit, using California's choice of law rules, applied a Taiwanese ten-year statute of repose to a case filed in California.[56] In that case, the court explained that statutes of repose are specifically designed for products liability cases because they preclude liability after a fixed number of years, regardless of whether the plaintiff should have discovered within that period that he had a claim.[57] In *Chang*, plaintiffs claimed that defendants acquired blood from high risk donors, and then improperly processed the blood in California, where the clotting factors were manufactured.[58] Plaintiff also claimed that after discovering that the blood clotting factors were contaminated by HIV, defendant allegedly continued to distribute the product in foreign countries while withdrawing them from the distribution in the United States.[59] The court

50. *Id.*
51. *Id.* at 622.
52. *Id.*
53. *Id.* at 623.
54. *Id.*
55. 599 F.3d 728 (7th Cir. 2010).
56. *Id.* at 733.
57. *Id.*
58. *Id.* at 732.
59. *Id.*

explained that California courts would apply the Taiwanese ten-year statute of repose because plaintiffs' tort claims arose in Taiwan under Taiwanese law.[60] The court rejected plaintiffs' argument that the claims arose in California because of defendants' failure to process the clotting factors in a way that would prevent contamination by HIV occurred in California.[61] The court ruled that the action arose where the injury occurred, which was in Taiwan. Based upon Taiwan's ten-year statute of repose, the court concluded "[a] California court would reason that if Taiwan will not provide a remedy to its own citizens, there is no reason for California to do so."[62]

In *Butler v. Ford Motor Co.*,[63] the federal court in South Carolina addressed the application of the North Carolina statute of repose to a case pending in South Carolina. Plaintiffs alleged strict liability, negligent design, negligent failure to warn, breach of implied warranty of merchantability, misrepresentation, and fraud claims—all stemming from Ford's design, testing, manufacture, and sale of a E350 van that rolled over when the left rear tire detreaded.[64] Ford sought dismissal of the action based on North Carolina's six-year statute of repose for products liability actions.[65] The court explained that South Carolina's Supreme Court treated North Carolina's statute of repose as substantive law, and in applying South Carolina conflicts of law provisions, the court was required to apply the law of the state where the injury occurred.[66] The court applied North Carolina's statute of repose, which precluded plaintiffs' claims against Ford.[67] The court went on to evaluate the one exception to the general rule, i.e., foreign law will not be applied if such law is repugnant to South Carolina's public policy.[68] The court did not find that the North Carolina statute qualified as an exception.[69] Therefore, the court concluded that Ford was entitled to dismissal because plaintiffs' asserted products liability claims more than six years after the initial date of purchase of the vehicle.[70]

6. Innocent Seller

The defendant in *Zapien v. Home Depot, USA, Inc.*[71] claimed that they were shielded from plaintiff's claims under the innocent seller provision of the

60. *Id.* at 733–34.
61. *Id.*
62. *Id.*
63. 724 F. Supp. 2d 575 (D.S.C. 2010).
64. *Id.* at 579.
65. *Id.*
66. *Id.* at 580.
67. *Id.* at 581.
68. *Id.*
69. *Id.* at 583.
70. *Id.* at 581.
71. No. 09-cv-02349-REB-BNB, 2010 WL 3522570 (D. Colo. Sept. 2, 2010).

Colorado Product Liability Act.[72] The statute provides, in part, that "[n]o product liability action shall be commenced or maintained against any seller of a product unless said seller is also the manufacturer of said product or the manufacturer of the part thereof giving rise to the product liability action."[73]

Plaintiff filed suit for injuries he received from an electrical shock while using a sewer snake rented from Home Depot.[74] Plaintiff alleged claims for strict products liability, breach of warranty, breach of implied warranty of merchantability and fitness for a particular purpose, strict product liability for misrepresentation, and negligence.[75] In response to defendant's motion to dismiss, plaintiff claimed the statute did not apply because defendant had knowledge of the defect and altered or modified it in a significant manner after the product came into its possession.[76] The judge rejected plaintiff's argument after finding that plaintiff failed to provide anything other than "subjective beliefs or speculation about what may have occurred" regarding defendant's knowledge or actions.[77] Summary judgment was entered for defendant.[78]

B. *Particular Products*

1. Asbestos

The Court of Special Appeals of Maryland in *John Crane, Inc. v. Linkus*, examined the boundaries of making a submissible case for direct asbestos exposure.[79] In *Linkus*, the court held that the son of a worker who was exposed to rope and wicking products did not need expert testimony to show that the products emitted levels of asbestos fibers capable of causing pleural mesothelimoa.[80] Plaintiff, who died during the pendency of the appeal, worked at a shipyard from 1952 through the 1970s.[81] His work included removing old insulation from valves and putting new wicking or rope packing on the valves.[82] When he cut the wicking and rope, it produced "quite a bit of dust" that "would . . . get all over you."[83]

72. *Id.* at *1.
73. *Id.* at *2 (citing Colo. Rev. Stat. § 13-21-402 (2010)).
74. *Id.* at *1.
75. *Id.*
76. *Id.* at *2.
77. *Id.* at *3.
78. *Id.* at *5.
79. 988 A.2d 511 (Md. Ct. Spec. App. 2010).
80. *Id.* at 523.
81. *Id.* at 514.
82. *Id.* at 516.
83. *Id.*

After the jury entered a verdict for plaintiff, an appeal was taken. On appeal, the defendant argued that in order for a plaintiff to prevail against an asbestos manufacturer or seller, he must prove that exposure to the products was a substantial contributing factor in causing the injury. The court agreed but found that lay testimony on the amount of dust created by handling asbestos products, along with expert testimony on the lack of a safe threshold of exposure above background levels, was sufficient to create a question for the jury.[84] The court noted, "there was lay testimony that [plaintiff] worked with defendant's products regularly and frequently and the products produced considerable visible dust."[85] The court thus concluded a jury reasonably could infer that the rope and wicking emitted enough asbestos fibers to cause mesothelioma.[86]

2. *Tobacco*

Plaintiff in *Grisham v. Philip Morris, Inc.*,[87] asserted that she smoked the defendants' cigarettes, and as a result, suffered from periodontal disease and chronic obstructive pulmonary disease.[88] Plaintiff argued that the chemicals contained in cigarette smoke directly caused her injuries; defendants failed to remove or neutralize the harmful chemicals; and defendants' conduct caused plaintiff to smoke more cigarettes than she would have otherwise smoked.[89]

Plaintiff asserted that she was first diagnosed with the beginning stages of emphysema on March 28, 2001, and she was diagnosed with periodontal disease and gingivitis in April 2001.[90] She filed her complaint on March 15, 2002.[91] At the time she filed, the California statute of limitations for personal injury actions was one year.[92] Following discovery, defendants filed a motion for summary judgment relying on the one year statute of limitations. Defendants presented evidence that plaintiff first started suffering periodontal harm at least as early as 1990, not April 2001 as asserted in the complaint.[93]

The court denied defendants' motion for summary judgment and ruled that plaintiff's cause of action did not accrue until plaintiff knew of her injuries and knew, or had reason to know, that the injuries were caused by defendants' wrongful acts.[94]

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84. *Id.* at 523.
85. *Id.*
86. *Id.* at 524.
87. 670 F. Supp. 2d 1014 (C.D. Cal. 2009).
88. *Id.* at 1018.
89. *Id.*
90. *Id.* at 1019–20.
91. *Id.* at 1019.
92. *Id.*
93. *Id.* at 1020.
94. *Id.* at 1023–24.

3. Pharmaceuticals

In *Bartlett v. Mutual Pharmaceutical Co., Inc.*,[95] the federal court in New Hampshire addressed the interplay in a products liability case among failure to warn, defective design theories, and causation. On a motion for summary judgment, the court dismissed the failure to warn count for lack of causation, but allowed the defective design case to proceed to trial.[96] The facts were that after seeking medical treatment for pain in her right shoulder, plaintiff filled a prescription for Sulindac, a generic version of a nonsteroidal anti-inflammatory drug.[97] Plaintiff suffered severe side effects, including permanent blindness,[98] and sued the manufacturer for various claims, including failure to warn and design defect.[99] Plaintiff's physician, in deposition, testified that he prescribed the Sulindac without reading or relying upon the warning label. Based on this testimony, the court granted summary judgment to the manufacturer. The court concluded that a change to the warning label would not have affected whether the doctor prescribed the drug.[100]

However, the court denied summary judgment on the design defect claim. The court explained that changing the warning label would not have influenced a physician who did not read it, but changing the drug's design or taking the drug off of the market could have prevented the injury. Interestingly, although the court dismissed the failure to warn claim, the court ruled that the defendant could use the warning label to demonstrate that its product was not defectively designed.[101] Consequently, the adequacy of the warning label remained in play as a defense, but not as a theory for recovery.

In *Schilf v. Eli Lilly & Co.*,[102] the District of South Dakota dismissed three theories that are unusual in a products liability case. Here, plaintiff alleged that her daughter committed suicide because of side effects caused by the drug Cymbalta. Among plaintiff's theories were negligent failure to test, negligent overpromotion, and negligent infliction of emotional distress.[103] The court dismissed all three claims on summary judgment.[104] Addressing the claim of negligent failure to test, the court explained that South Dakota Supreme Court requires "expert testimony on causation when it is outside

95. No. 08-cv-358-JL, 2010 WL 2765358 (D.N.H. July 12, 2010).
96. *Id.* at *1.
97. *Id.*
98. *Id.*
99. *Id.*
100. *Id.* at *5, 8.
101. *Id.*
102. No. CIV 07–4015, 2010 WL 3909909 (D.S.D. Sept. 30, 2010).
103. *Id.* at *1.
104. *Id.* at *2.

the common experience and capability of a jury."[105] Because plaintiff failed to provide expert testimony demonstrating that the failure to test caused the suicide, the claim failed under South Dakota law.[106] Plaintiff's negligent overpromotion claim also failed, in part, because no South Dakota cases recognize overpromotion as a separate cause of action. Even assuming such a theory is viable, plaintiff's claim would still fail because the facts were insufficient to support the allegation.[107] Finally, in dismissing the negligent infliction of emotional distress claim, the court recognized such a claim exists in South Dakota. However, plaintiffs did not observe the suicide, and they were not in the zone of danger.[108] Consequently, that claim also failed.

Defendants attempted to dismiss the remaining claims based on preemption by the Food Drug and Cosmetic Act (FDCA).[109] The court denied the motion to dismiss, noting that in *Wyeth v. Lavine*, the U.S. Supreme Court explained state claims are not preempted by the FDCA, and there is a need for "clear evidence" that the FDA would not approve additional changes to warning labels.[110] The court found that even though the FDA e-mailed defendant and indicated Lilly should not change the label until it received final FDA approval, this is not "clear evidence" that the FDA would have rejected attempts by defendant to get the word out in other ways. As a result, defendant lacked clear evidence of preemption.[111]

In *Wimbush v. Wyeth*,[112] plaintiff, on behalf of the decedent, Mary Buchanan, pursued a strict product liability design defect claim after Buchanan ingested Redux for several months during 1996 and 1997, which allegedly caused her death in December 2003.[113] The Sixth Circuit granted summary judgment on plaintiff's strict liability claim.[114] The court affirmed the order of summary judgment confirming

> so long as adequate warning has been provided for a pharmaceutical product then the manufacturer cannot be strictly liable for design defect under Ohio law, regardless of whether there is a causal connection between the plaintiff's use of the drug and the plaintiff's injury or whether the product was unavoidably dangerous.[115]

105. *Id*. at *1.
106. *Id*.
107. *Id*.
108. *Id*. at *2.
109. *Id*. at *3.
110. *Id*. at * 4 (citing Wyeth v. Lavine, 129 S. Ct. 1187, 1194–95 (2009)).
111. *Id*.
112. 619 F.3d 632 (6th Cir. 2010).
113. *Id*. at 634–35.
114. *Id*. at 636.
115. *Id*. at 637 (citations omitted).

However, the Sixth Circuit reversed the district court's order granting summary judgment on plaintiff's common law negligence claims, stating:

> [i]f Congress thought state lawsuits posed an obstacle to its objectives, it surely would have enacted an express preemption provision at some point during the FDCA's 70-year history. But despite its 1976 enactment of an express preemption provision for medical services, *see* § 521, 90 Stat. 574 (codified at 21 U.S.C. § 360(a)), Congress has not enacted such a provision for prescription drugs. Its silence on the issue, coupled with its certain awareness of the prevalence of state tort litigation, is powerful evidence that Congress did not intend FDA oversight to be the exclusive means of ensuring drug safety and effectiveness.[116]

The court concluded that FDA approval does not automatically preempt state law tort claims for negligence and remanded the case for further proceeding.[117] The court specifically noted that

> we are aware of no federal appeals court decision since *Levine* concluding that FDA regulation preempts any aspect of state tort law, though we admit that, until today, there is also no post-*Levine* court of appeals authority for the proposition that the *Levine* rationale extends beyond the realm of failure-to-warn claims to apply to all pre-approval state law claims.[118]

4. Other Products

Can a plaintiff's misuse of a product be grounds for granting summary judgment in favor of a manufacturer under a design defect theory? In *Smith v. Yamaha Motor Corp. U.S.A.*,[119] the Superior Court of Pennsylvania reversed the ruling of the trial court and held that summary judgment is not appropriate unless it is established that the misuse solely caused the accident without the design defect contributing to the accident.[120] Plaintiff, a seasoned rider of all-terrain vehicles (ATV), was alleged to not have been using the vehicle as intended when he carefully rolled backwards down a hill to avoid colliding with other ATVs in the area.[121] In doing so, plaintiff's foot slipped and became stuck in the ATV's rear fender.[122] The fender then collapsed, causing plaintiff's foot to become trapped between the ATV's frame and rear wheel.[123] The ATV ultimately rolled backwards over plaintiff, causing severe injuries.[124]

116. *Id.* at 645.
117. *Id.* at 646.
118. *Id.* at 645.
119. 5 A.3d 314 (Pa. Super. Ct. Aug. 18, 2008).
120. *Id.* at 321.
121. *Id.* at 315.
122. *Id.*
123. *Id.*
124. *Id.* at 315–16.

Plaintiff and his wife sued the ATV manufacturer, focusing their case on the alleged defective design of the rear fender. Defendants focused their defense on plaintiff's alleged misuse of the ATV.[125] On appeal, the court reversed the grant of summary judgment by the trial court and concluded that plaintiff was using the ATV as intended at the time of the accident.[126] The court explained, "[i]n the present case, the trial court conflated the doctrine of unintended use with the concept of misuse."[127] The court elaborated that "a plaintiff's misuse of a product cannot be grounds for granting summary judgment in favor of the manufacturer under a design defect theory unless it is established that the misuse solely caused the accident while the design defect did not contribute to it."[128]

In *Beauregard v. Continental Tire North America, Inc.*, The federal court for the Middle District of Florida granted summary judgment to a tire manufacturer in a tread separation case based upon lack of evidence.[129] In this case, a seven-year-old was killed after being thrown from a Jeep Grand Wagoneer after it struck a guardrail and overturned.[130] The suit alleged that the driver lost control as a result of tread separation from the right front tire.[131] Plaintiff alleged Continental should be held strictly liable for negligently designing and manufacturing the tire.[132]

Continental moved for summary judgment based upon the assertion there was neither evidence to show that any tire failure caused the accident nor any proof that the tire was defective when it left the company's control.[133] Continental's expert demonstrated the tire was previously punctured and repaired.[134] Furthermore, the evidence showed damage to the tire as the result of its being mounted and remounted on different rims, and also showed that the tire had been improperly inflated.[135]

The court granted summary judgment in Continental's favor, reasoning that plaintiff "failed to produce more than a scintilla of evidence" that the tire belts were aged or otherwise defective when they left Continental manufacturing facility.[136] The court disagreed with the opinion of plain-

125. *Id*. at 320. Defendants alleged that plaintiff misused the vehicle because he consumed one beer and ingested his daily prescription dose of oxycontin on the day of the accident. *Id*. at 317.

126. *Id*. at 321.

127. *Id*.

128. *Id*.

129. 695 F. Supp. 2d 1344 (M.D. Fla. 2010).

130. *Id*. at 1345.

131. *Id*. at 1346.

132. *Id*.

133. *Id*. at 1347.

134. *Id*. at 1355.

135. *Id*. at 1354–55.

136. *Id*. at 1351.

tiff's expert that certain marks and stray cords he noticed in the subject tire were evidence of a defect. The court explained those pattern marks and cords were not present at the location of the tire where it failed and that tread did not separate for more than eleven years.[137]

II. PREEMPTION

In *Kurns v. A.W. Chesterton, Inc.*,[138] plaintiffs brought suit on behalf of decedent's alleged exposure to asbestos during his years of employment by a railroad company.[139] Plaintiffs allege that from 1947 to 1994, the decedent served as a welder, machinist, and supervisor for the railroad; and during that time, he was exposed to asbestos from removing insulation from locomotive boilers and installing brake shoes on locomotives.[140] After decedent's retirement, he was diagnosed with malignant mesothelioma, the one cause of which is exposure to asbestos.[141] Plaintiffs appealed from the district court's entry of summary judgment by arguing that federal law did not preempt their claims.[142]

On appeal, plaintiffs contended that the Locomotive Inspection Act (LIA) did not preempt state law design defect and failure to warn product liability claims.[143] "The plaintiffs urged that LIA preempts the regulation of locomotive equipment, but does not preempt railroad workers personal injury claims under state tort law for failure to warn about hazardous substances released during the repair of locomotives which [are] not in service."[144]

Plaintiffs further argued that the LIA only governed road injuries and was irrelevant when a locomotive was not in use.[145] The court stated that

> even if the fact that the locomotive parts and appurtenances that allegedly contained asbestos in the present case were not connected to a locomotive which was in transit at the time of exposure prevents the plaintiffs from bringing an action under the LIA, there are other federal causes of action available for such a claim.[146]

Not persuaded by this argument, the Third Circuit affirmed the judgment of the district court and held that federal law preempted the claims.[147]

137. *Id.* at 1353.
138. 620 F.3d 392 (3d Cir. 2010).
139. *Id.* at 393.
140. *Id.* at 393–94.
141. *Id.* at 394.
142. *Id.* at 395.
143. *Id.*
144. *Id.*
145. *Id.* at 397, n.5.
146. *Id.*
147. *Id.* at 399.

In *McQuiston v. Boston Scientific Corp.*,[148] the U.S. District Court for the Western District of Louisiana held that federal law preempted plaintiff's design defect claims.[149] Plaintiff filed suit after having a heart catheterization procedure.[150] The TAXUS Express Paclitaxel-Eluting Coronary Stent System, (TAXUS Stent) designed, manufactured, and sold by Boston Scientific, was implanted into his coronary artery.[151] Plaintiff alleged that the TAXUS Stent "malfunctioned and failed to deflate, causing permanent and serious injuries to him."[152] Furthermore, plaintiff contended that "the TAXUS stent was negligently designed, manufactured, marketed, sold, tested, and distributed."[153]

Congress enacted the Medical Device Amendments (MDA) to "provide for the safety and effectiveness of medical devices intended for human use."[154] The TAXUS stent is a Class III device under the MDA, which means it was subjected to the highest scrutiny under the MDA by virtue of its approval through the "rigorous" premarket approval process set forth for Class III devices.[155] Boston Scientific argued that it was entitled to summary judgment because McQuiston's state law claims conflict with federal requirements imposed by the Food and Drug Administration (FDA).[156]

The court held that federal law preempted the state claims.[157] The court also noted that "McQuiston [was] aware that Boston Scientific intended to assert preemption as a defense . . . yet . . . [he did not once seek] to amend his complaint to assert claims that Boston Scientific failed to comply with FDA requirements."[158] The motion to dismiss was granted.

III. General Liability

A. *Workers' Compensation Act Immunity*

Does a fellow employee have immunity from civil liability arising from a workplace accident? In *Robinson v. Hooker*,[159] the Missouri Court of Appeals held that no such immunity applied[160] under the Missouri Workers' Compensation Act.[161] Plaintiff, who was an employee of the City of Kansas City,

148. No. 07–1723, 2009 WL 4016120 (W.D. La. Nov. 19, 2009).
149. *Id.* at *24.
150. *Id.* at *1.
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.* at *2 (citing Medtronic, Inv. v. Lohr, 518 U.S. 470, 476 (1996)).
155. *Id.* at *4 (citing *Lohr*, 518 U.S. at 477).
156. *Id.*
157. *Id.* at *5.
158. *Id.* at *7.
159. Robinson v. Hooker, 323 S.W.3d 418 (Mo. Ct. App. 2010).
160. *Id.* at 421.
161. Mo. Rev. Stat. § 287.120 (2009).

Missouri, was injured after being struck in the face by a high-pressured hose, leaving him blinded in his right eye.[162] After receiving workers' compensation benefits, the injured employee sued his co-worker in negligence for "failing to use ordinary care while operating a high-pressure hose."[163]

The Missouri Court of Appeals reversed the trial court's dismissal of the civil action and held that employees no longer have immunity from civil actions filed by co-worker for injuries covered by the Act.[164] In reaching its decision, the court abandoned prior law providing that, "a co-employee could not be sued unless there was a showing of 'something more' than a breach of the employer's duty to provide a safe workplace."[165] The decision in *Robinson* was based on strict statutory construction of amendments to the Act passed in 2005, finding the Act contained no express provision releasing "employees" from liability to their injured co-workers.[166] The Act as written expressly released only employers from liability in exchange for providing workers compensation benefits.[167]

B. *Strict Liability for Abnormally Dangerous Activities*

The Supreme Judicial Court of Maine in *Dyer v. Maine Drilling & Blasting, Inc.*[168] adopted the Restatement (Second) of Torts approach to strict liability for abnormally dangerous activities.[169] Plaintiff in *Dyer* owned a home and was informed by defendant that it would begin blasting rock near her home in connection with the construction of a bridge.[170] The written notice assured plaintiff that defendant used "the most advanced technologies available" for blasting and further assured plaintiff blasting vibration would not "exceed the established limits that could potentially cause damage."[171]

Prior to any blasting, defendant performed a survey of plaintiff's home, and plaintiff's son documented the condition of the home by videotape.[172] Over a one-year period, defendant proceeded to conduct over 100 blasts, including one approximately 100 feet from plaintiff's home.[173] Plaintiff ultimately discovered numerous cracks in her foundation and other problems in her basement, not the least of which was the fact that the floor had dropped nearly three inches.[174]

162. *Robinson*, 323 S.W.3d at 421.
163. *Id*.
164. *Id*.
165. *Id*. at 423 (discussing Badami v. Gaertner, 630 S.W.2d 175 180 (Mo. Ct. App. 1982)).
166. *Id*.
167. *Id*.
168. 984 A.2d 210 (Me. 2009).
169. *Id*. at 219 (discussing Restatement (Second) of Torts §§ 519–20).
170. *Id*. at 213.
171. *Id*.
172. *Id*.
173. *Id*.
174. *Id*. at 214.

Plaintiff filed a lawsuit alleging strict liability and negligence. The case was dismissed by the lower court on summary judgment.[175] The court refused to adopt a strict liability standard and viewed the plaintiff's proof of damage to be insufficient to survive summary judgment.[176] On appeal, the Supreme Judicial Court, after a careful analysis of jurisdictions across the country, adopted the Second Restatement's imposition of strict liability for abnormally dangerous activities.[177] The court commented that the Second Restatement's approach "advocates considering the activity in light of surrounding circumstances on the facts of each case. This, in essence, shifts consideration from the nature of the activity to the nature and extent of the risk."[178] The court recognized that although blasting is often a beneficial activity, it can cause damage even when performed carefully. A strict liability standard places the cost on those that benefit, rather than on an innocent homeowner.[179]

IV. PRODUCTS LIABILITY CLASS ACTION DEVELOPMENTS

In *Shady Grove Orthopedic Association v. Allstate Insurance Co.*,[180] the U.S. Supreme Court addressed whether a state can prohibit a federal class action pursuant to Rule 23 of the Federal Rules of Civil Procedure. The case involved a New York statute which precludes lawsuits that seek to recover a "penalty" from proceeding to a class action.[181] Plaintiff, a group of physicians, filed a putative class action against Allstate claiming that Allstate routinely failed to pay statutory interest on overdue benefits.[182] The district court dismissed the suit for lack of jurisdiction on grounds that statutory interest is a penalty under New York law, and thus § 901(b) prohibited the proposed class action.[183] Shady Grove conceded that its individual claim was worth roughly $500 and fell far short of the statutory minimum.[184] The Second Circuit affirmed, finding that: (1) Rule 23 and § 901(b) did not conflict; and (2) § 901(b) was "substantive" and must be applied by federal courts sitting in diversity.[185]

175. *Id.* at 215.
176. *Id.*
177. *Id.* at 219.
178. *Id.*
179. *Id.* The court also reversed the lower court's ruling that plaintiffs had submitted insufficient proof of damages.
180. 130 S. Ct., 1431, 1437 (2010).
181. N.Y. Civ. Prac. Law Ann. § 901(b).
182. *Shady Grove*, 130 S.Ct. at 1437.
183. *Id.*
184. *Id.; see also* 28 U.S.C. § 1332 (a).
185. *Id.*

In a five-to-four decision, the Supreme Court reversed; Justice Scalia, who delivered the opinion of the Court with respect to Parts I and II-A, held that "§ 901(b) does not preclude a federal district court sitting in diversity from entertaining a class action under Rule 23."[186] The majority of the Court agreed that a two-step process applied to its analysis. First, the Court must determine "whether Rule 23 answers the question in dispute."[187] If it does, then Rule 23 applies "unless it exceeds statutory authorization or Congress's rulemaking power."[188]

Applying this framework, the Court first found that Rule 23 answers the question at issue, i.e., whether Shady Grove's suit could proceed as a class action.[189] The Court noted that Rule 23 "creates a categorical rule entitling a plaintiff whose suit meets the specified criteria to pursue his claim as a class action."[190] The Court found that Rule 23 and § 901(b) were in conflict because Rule 23 "provides a one-size-fits-all formula for deciding the class-action question," and § 901(b) "attempts to answer the same question—i.e., it states that Shady Grove's suit 'may not be maintained as a class action' . . . because of the relief it seeks."[191] "Rule 23 permits all class actions that meet its requirements, and a State cannot limit that permission by structuring one part of its statute to track Rule 23 and enacting another part that imposes additional requirements."[192] The Court concluded that a conflicting state class action provision could apply in a diversity suit only if "Rule 23 is ultra vires," or outside the scope of the Rules Enabling Act, 28 U.S.C. § 2071, et seq.[193]

In Part II-B of the opinion, Justice Scalia, writing on behalf of himself and three other Justices, found that a Rule of Federal Procedure is within the Rules Enabling Act as long as it regulates procedure only.[194] He noted that, if the Rule "governs only the manner and the means by which the litigants' rights are enforced, it is valid; if it alters the rules of decision by which [the] court will adjudicate [those] rights, it is not."[195] Applying this criteria, Justice Scalia concluded that Rule 23 is within the Rules Enabling Act because it is procedural in nature: it "merely enables a federal court to adjudicate claims of multiple parties at once, instead of in separate suits" and "it leaves the parties' legal rights and duties intact and

186. *Id*. at 1433.
187. *Id*. at 1437.
188. *Id*.
189. *Id*.
190. *Id*.
191. *Id*.
192. *Id*. at 1439.
193. *Id*. at 1437.
194. *Id*. at 1442.
195. *Id*.

the rules of decision unchanged."[196] Justice Scalia further noted that "the substantive nature of New York's law, or its substantive purpose, makes no difference."[197] Instead, it is the "the substantive or procedural nature of the Federal Rule" that matters.[198] Where a Federal Rule regulates procedure, it is authorized by the Rules Enabling Act, "and is valid in all jurisdictions, with respect to all claims, regardless of its incidental effect upon state-created rights."[199]

V. PREMISES LIABILITY

In *Rippy v. Home Depot U.S.A., Inc.*,[200] plaintiff alleged that he was injured while shopping when a box of tiles fell on and fractured his big toe.[201] The court dismissed his claim because he could not show that the defendant knew or should have known of an unsafe condition,[202] and further found that the condition was open and obvious.[203] The injury occurred when the plaintiff and his wife were shopping for floor tiles and cabinetry.[204] In the floor covering aisle, plaintiff took a box of vinyl tiles from the top of a stack.[205] As he reached to lift the box, another box fell on his right foot.[206] Plaintiff suffered a fractured toe.

Plaintiff asserted a premises liability claim. He alleged that the boxes of tiles that fell on his foot were stacked unsafely and that defendant failed to inspect the area at regular intervals to correct problems.[207] The parties agreed that plaintiff was an invitee and that defendant owed him a general duty to provide a safe premises.[208] Defendant, however, argued that it did not have notice, either actual or constructive, of the allegedly unsafe condition. Defendant pointed to its policy of monitoring each aisle throughout the day.[209]

The court stated, "[w]ithout establishing when the condition arose, plaintiff cannot rebut defendant's argument that it lacked notice of the 'scrambled' boxes of tile."[210] Specifically, the fact that the boxes of tiles

196. *Id.* at 1443.
197. *Id.* at 1444.
198. *Id.*
199. *Id.*
200. No. 09-CV-12043, 2010 WL 891154 (E.D. Mich. Mar. 10, 2010).
201. *Id.* at *1.
202. *Id.*
203. Id. at *4.
204. *Id.*
205. *Id.* at *2.
206. *Id.*
207. *Id.* at *3.
208. *Id.*
209. *Id.*
210. *Id.*

were "scrambled" does not alone support an inference that the condition had existed for a considerable period of time, which would have allowed the inference that defendant should have known of its presence.[211] The court also stated, "plaintiff has failed to show that the alleged condition was not open and obvious."[212] Instead, he argued that he could not be expected to notice the twisted boxes because his attention was focused elsewhere at the time.[213] Both plaintiff and his wife admitted that nothing had obstructed his vision of the tile display.[214]

In addition, plaintiff failed to demonstrate that there were special aspects of the condition that rendered it "unreasonably dangerous," e.g., that the twisted stacks of boxes caused an unavoidable danger or posed "an unreasonably high risk of severe injury."[215] The court granted defendant's motion for summary judgment.[216]

In *Melton v. Boustred*,[217] the California Court of Appeal addressed a homeowner's duty to those invited to a party. Defendant held a party at his residence at which he served alcoholic beverages and featured live music.[218] He issued an open invitation on MySpace.com.[219] Plaintiffs accepted the open invitation. Unfortunately, when they arrived they were attacked, beaten, and stabbed by a group of unknown individuals.[220] The particulars of the attack were not described by the court; although it is clear that defendant did not participate in or condone the attack.

Plaintiffs argued that defendant created an unreasonable risk of bodily harm by widely broadcasting an unlimited and unrestricted invitation to a party that included live music and alcohol.[221] Defendant provided no security and apparently made no attempt to control admission.[222]

The court rejected plaintiff's argument and sustained the trial court's dismissal of the case.[223] The court reasoned that despite issuing the unrestricted invitation, defendant had not created the peril that harmed plaintiffs.[224] The court emphasized that the violence that harmed plaintiffs was not a necessary or intended component of defendant's party.[225] In addi-

211. *Id*.
212. *Id*. at *4.
213. *Id*.
214. *Id*.
215. *Id*. at *5.
216. *Id*.
217. 183 Cal. App. 4th 521 (2010).
218. *Id*. at 527.
219. *Id*.
220. *Id*.
221. *Id*. at 528.
222. *Id*. at 527.
223. *Id*. at 544.
224. *Id*. at 535.
225. *Id*.

tion, despite plaintiffs' status as invitees to defendant's party, there was no special relationship between them that would impose upon defendant a duty to protect plaintiff from third parties and a criminal attack.[226] According to the court, the criminal attack was not reasonably foreseeable. The court stated that "(s)tripped of its bare contentions, the complaint contains no allegations that defendant was aware that his invitation would result in the criminal assault on the plaintiffs."[227] The court repeatedly came back to the point "defendant did not engage in any active conduct that increased the risk of harm to plaintiffs".[228]

VI. EVIDENTIARY CASES

A. *Other Alleged Incidents*

In *Watson v. Ford Motor Co.*,[229] the South Carolina Supreme Court explained the foundation necessary in a design defect products liability case for the admission into evidence of other similar incidents. This case arose from a single car accident involving a 1995 Ford Explorer.[230] The driver of the Explorer lost control of the vehicle which then "veered off the left side of the interstate and rolled four times."[231] The occupants of the Explorer were ejected from the vehicle.[232] The plaintiff alleged the cruise control system and seat belts were defective.[233] The theory of liability was predicated on the Explorer's cruise control system allegedly being defective as it "allowed electromagnetic interference (EMI) to affect the system."[234]

The court reversed a jury verdict and entered judgment for defendant based, in part, on the trial court's admission into evidence of other similar incidents.[235] At trial, plaintiffs were allowed to introduce

> the deposition testimony from a separate case of a former Ford employee who investigated a number of claims of unintended acceleration of Explorers driven in Britain. The former employee read from an email where he referenced '35 incidents that have been categorized as unexplainable' in which the vehicles suddenly accelerated.[236]

226. *Id.* at 535–36.
227. *Id.* at 536.
228. *Id.* at 533.
229. 699 S.E. 2d 169 (S.C. 2010).
230. *Id.* at 173.
231. *Id.*
232. *Id.*
233. *Id.*
234. *Id.*
235. *Id.*
236. *Id.* at 179.

Plaintiffs further presented three witnesses "who recalled incidents in which their Explorers suddenly accelerated and their cruise control would not disengage."[237]

On appeal, the court recognized the following factors in determining whether to admit evidence of other incidents to support a claim that the present accident was caused by the same defect: "(1) the products are similar; (2) the alleged defect is similar; (3) causation related to the defect in the other incidents; and (4) exclusion of all reasonable secondary explanations for the cause of the other incidents."[238] In reaching its decision, the court held that plaintiffs "failed to show that the incidents were substantially similar and failed to establish a special relation between the other incidents and plaintiff's accident."[239] The court elaborated that the "products were not similar because most of the other incidents involved Explorers that were made in different years from the [accident] Explorer and were completely different models with the driver's seat located on the right side of the vehicle."[240] Critical to the court's analysis was the fact that plaintiff "failed to show a similarity of causation between the malfunction and [the] case and the malfunction in the other incidents and failed to exclude reasonable explanation for the cause of the other incidents."[241] The court noted that plaintiffs presented only the testimony of other drivers.[242] They did not present any expert evidence to show that EMI was a factor in the malfunction in the other incidents.[243]

B. *Spoliation*

The U.S. District Court for the Eastern District of California in *Knight v. Deere & Co*. refused to preclude testimony about the condition of the brakes on a John Deere utility vehicle, finding no proof that plaintiff owner spoliated evidence.[244] The case arose from a fatal accident involving a John Deere utility vehicle owned by plaintiffs. In September 2006, the owners of the utility vehicle were using the vehicle to lead a pony from their residence to a nearby home.[245] Ultimately, while traveling down a gravel road, the vehicle's brakes allegedly failed.[246] The vehicle flipped over, throwing three of the passengers from the vehicle and fatally injuring another.[247]

237. *Id*.
238. *Id*.
239. *Id*.
240. *Id*.
241. *Id*.
242. *Id*.
243. *Id*.
244. No. 2:08-CV-01903, 2010 WL1948311 (E.D. Cal. May 11, 2010).
245. *Id*. at *1.
246. *Id*.
247. *Id*.

Shortly after the accident, the California Highway Patrol inspected the vehicle and concluded the brakes were not properly maintained.[248] The owner of the vehicle testified that he had replaced the braking mechanisms on the utility vehicle after the Highway Patrol's inspection. However, several weeks after the repairs, he could not locate the brake components that he allegedly removed.[249]

The manufacturer asserted that plaintiff's failure to preserve the brake components spoliated the evidence and that the court should use its inherent authority to preclude any evidence about the condition of the brakes at the time of the accident.[250] The court denied defendant's motion to exclude the brake pad evidence. The court explained that there was a factual dispute concerning which brake pads remained on the utility vehicle after the accident and which ones had been removed and lost.[251] The owner of the vehicle testified he had removed the pads from the left side of the vehicle, but the spoliation claim centered on the right side brake component. The court refused to grant the spoliation motion.[252] The court stated, "in essence defendant's motion asked the court to resolve the factual dispute concerning which brake pads Homer Fagan removed. . . . A motion in limine should not be used to resolve factual disputes or disputed evidence."[253]

C. *Experts*

In *Gunderson v. U.S. Department of Labor*,[254] plaintiff was exposed to coal dust during the course of his employment and developed chronic obstructive pulmonary disease.[255] There, plaintiff received a letter informing him that an x-ray taken as part of a monitoring program indicated that he suffered from pneumoconiosis, "a chronic dust disease of the lung and its sequelae, including respiratory and pulmonary impairments, arising out of coal mine employment."[256]

In response to this letter, Gunderson sought benefits from Blue Mountain Energy, his longtime employer, under Title IV of the Federal Coal Mine Health and Safety Act of 1969.[257] He alleged that he suffered from "clinical pneumoconiosis" and "legal pneumoconiosis."[258] The district director of

248. *Id.* at *1–2.
249. *Id.* at *2.
250. *Id.* at *3.
251. *Id.* at *5.
252. *Id.*
253. *Id.* (citing Research Corp. Techs., Inc. v. Microsoft Corp. No. CV-01–658-TUC-RCJ, 2009 WL297155, at *1 (D. Ariz. Aug. 19, 2009).
254. 601 F.3d 1013 (10th Cir. 2010).
255. *Id.* at 1015.
256. *Id.*
257. *Id.*
258. *Id.*

workers' compensation programs granted Gunderson's claim for benefits, but Blue Mountain Energy appealed that decision to an administrative law judge (ALJ).[259] The ALJ heard conflicting evidence from Gunderson's experts and Blue Mountain Energy experts and opined that Gunderson's respiratory problems were caused by chronic obstructive pulmonary disease arising from his smoking habit instead of exposure to coal.[260]

Gunderson appealed the decision. The Tenth Circuit held that the "ALJ did not offer a scientific explanation for his conclusion that the experts' testimony was evenly balanced, and should receive equal weight," and as a result, Gunderson had failed to establish that he suffered from legal pneumoconiosis.[261] The case was remanded. The decision was based on the ALJ's failure to provide a sufficient scientific explanation for his decision.[262]

In *Rhonda Hendrix v. Evenflo Co., Inc.*, the Eleventh Circuit affirmed the grant of summary judgment for Evenflo in a case in which a fifteen-day-old boy who sustained a closed head injury as a result of an allegedly defective infant safety seat. Plaintiff claimed her son was severely injured when a child-restraint system manufactured by defendant failed during a low-speed accident.[263] Plaintiff alleged her son's injuries caused him later to develop autism spectrum disorder (ASD), as well as a spinal cord cyst.[264]

Before trial, the trial court granted defendant's motion to exclude the testimony of plaintiff's expert witnesses regarding the "purported cause" of the ASD;[265] holding that the experts' conclusions were not sufficiently reliable under *Daubert*.[266] As a result of the ruling, the court granted partial summary judgment for the manufacturer on the plaintiff's ASD-related claims.[267]

The Eleventh Circuit affirmed the trial court's ruling and held that plaintiff had no reliable scientific evidence to support the assertion that brain injuries can lead to autism. The court ruled that the plaintiff's expert did not (1) create a list of all possible causes of ASB, (2) demonstrate from scientific literature that traumatic brain injury can cause brain injury, and (3) rule out all other plausible causes in this case.[268] The court concluded by stating, "[t]he courtroom is not the place for scientific guesswork, even of the inspired sort. Law lags science; it does not lead it."[269]

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259. *Id.*
260. *Id.*
261. *Id.* at 1027.
262. *Id.* at 1026.
263. 609 F. 3d 1183 (11th Cir. 2010).
264. *Id.* at 1188.
265. *Id.* at 1190.
266. *Id.*
267. *Id.*
268. *Id.* at 1198.
269. *Id.* at 1187.

RECENT DEVELOPMENTS AFFECTING PROFESSIONALS', OFFICERS', AND DIRECTORS' LIABILITY

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I. Developments in Directors' and Officers' Liability

A. *Dodd-Frank*

The Dodd-Frank Wall Street Reform and Consumer Protection Act expands the SEC's ability to bring claims for aiding and abetting securities law violations by extending the claims to include the Securities Act of 1933 (33 Act) and the Investment Company Act of 1940 (40 Act), in addition to the Securities and Exchange Act of 1934 (34 Act).[1] Dodd-Frank also lowers the standard for proof of state of mind from actual knowledge to recklessness.[2] More bases for liability and a lower scienter standard are not good news for corporate directors and officers.

Dodd-Frank resolves the question whether the SEC has authority to bring claims for control person liability under the 34 Act—it does.[3] This exposes directors and officers to potential liability for securities viola-

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010), § 929M.

2. Dodd-Frank § 929O. Previously, there was case law holding that the SEC had to plead and prove knowledge of the violation and that recklessness would not suffice. *See* SEC v. DiBella, 587 F.3d 553, 566 (2d. Cir. 2009) (requiring "knowledge"); SEC v. Fehn, 97 F.3d 1276, 1288 & n.11 (9th Cir. 1996).

3. Dodd-Frank § 929P(c). Previously, there were cases in both directions.

tions by company employees. In such circumstances, directors and officers will carry the burden to show good faith and that they did not induce the violation.[4]

Dodd-Frank expanded the SEC's power to seek monetary penalties in administrative proceedings before an SEC administrative law judge to include proceedings against public companies and their current or former officers, directors, and employees.[5]

Dodd-Frank encourages whistleblowers to provide information to the SEC.[6] The Act provides for bounties of 10 percent to 30 percent of the SEC penalties to be paid to whistleblowers who provide information to the SEC that leads to an enforcement action resulting in more than $1 million in penalties.[7] It also provides greater protections for whistleblowers against retaliation than previously available under the Sarbanes-Oxley Act of 2002.[8] The statute of limitations is much longer (up to ten years), actions may be brought in federal court directly, the remedies are greater, and the scope of the protected disclosures is much broader.[9] It is fairly safe to conclude that Dodd-Frank's whistleblower bounty and antiretaliation provisions are likely to increase whistleblower activity against corporate officers and directors.

Section 954 of Dodd-Frank imposes a mandatory claw back on public companies, obligating them to recover erroneously awarded compensation from their executives.[10] If a public company is forced to restate its financial statements, and an executive received incentive-based compensation based upon the erroneous financial statements within three years of the restatement, the company must recover that compensation.[11]

B. *SEC Antifraud Jurisdiction over Credit Default Swaps*

In a matter of first impression, the Securities and Exchange Commission persuaded the U.S. District Court for the Southern District of New

4. *See* 15 U.S.C. §§ 77o, 78t(a); *e.g.*, Laperriere v. Vesta Ins. Group, Inc., 526 F.3d 715, 721 (11th Cir. 2008) (good faith and noninducement is affirmative defense to control person liability under 34 Act).

5. Dodd-Frank § 929P(a).

6. Dodd-Frank §§ 922–24.

7. Dodd-Frank § 922(b), (c).

8. Dodd-Frank § 922(h). Section 806 of the Sarbanes-Oxley Act of 2002 already protects whistleblowers, but it offers a much shorter statute of limitations (180 days) and requires that whistleblowers file retaliation complaints with the Department of Labor. Dodd-Frank offers up to a ten-year limitation period and allows immediate action in federal court.

9. Dodd-Frank offers double back pay, where Sarbanes-Oxley provided only single back pay. Dodd-Frank § 922(h)(C). Dodd-Frank also protects whistleblowers who provide any of the information covered by Sarbanes-Oxley, as well as "any other law, rule or regulation" subject to SEC jurisdiction. Dodd-Frank § 922(h)(1)(A)(iii).

10. Dodd-Frank § 954.

11. *Id.*

York in *SEC v. Rorech* that it has antifraud jurisdiction over credit default swaps under Section 10(b) of the Securities and Exchange Act of 1934 and the Commodity Futures Modernization Act.[12] Credit default swaps are a form of derivative security in which the buyer purchases contractual protection against the credit risk of a particular company.[13] The *Rorech* court interpreted the Commodity Futures Modernization Act (CFMA) and Section 206B of the Gramm-Leach-Bliley Act to reach its conclusion.[14] This was a significant legal ruling in favor of the SEC, and because the SEC lost on the factual merits of its claims, there was no appeal.

C. *Foreign-Cubed Cases in the Supreme Court and in Dodd-Frank*

The Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*[15] addressed the power of U.S. courts in so-called foreign-cubed matters, cases initiated by foreign plaintiffs who bought a foreign company's securities on a foreign exchange. The *Morrison* plaintiffs sought to represent a class of foreign purchasers of shares of common stock in National Australia Bank Limited that were not listed on any U.S. exchange. National's American Depository Receipts (ADR), however, traded on the New York Stock Exchange. Plaintiffs alleged that National's share and ADR prices were inflated by false reporting of the results of a mortgage company subsidiary. The Court held that "it is in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which § 10(b) applies."[16]

This conclusion was good news for directors and officers of foreign companies, but any jubilation was short-lived. The *Morrison* decision was released on June 24, 2010. On July 21, 2010, Dodd-Frank extended the reach of Section 10(b), along with the 33 Act and the 40 Act in actions brought by the SEC.[17] Dodd-Frank also directed the SEC to study whether to extend the same rules to private rights of action.[18] As matters stand, Section 10(b) applies to foreign-cubed cases brought by the SEC, and there is a distinct possibility that it will eventually apply to private actions again as well.

12. 2010 WL 2595111 (S.D.N.Y. 2010).
13. *Id.* at *2.
14. CFMA, Pub. L. No. 106-554, 114 Stat. 2763 (2000); Gramm-Leach-Bliley Act § 206B, 133 Stat. 1138 (1999) (set out as a note under 15 U.S.C. § 78c).
15. 130 S. Ct. 2869 (2010).
16. *Id.* at 2884.
17. Dodd-Frank § 929P(b).
18. Dodd-Frank § 929Y.

D. *Duties of Disclosure and Shareholder Participation in Corporate Governance*

Dodd-Frank also addresses a number of issues surrounding executive compensation, including the "say-on-pay" rights of shareholders in public companies to participate in nonbinding votes regarding executive compensation.[19] Shareholders are also entitled to a nonbinding vote on golden parachutes and will have access to the company's proxy materials to include their board nominees.[20] Dodd-Frank also requires that only independent directors sit on compensation committees and that executive compensation be disclosed in proxy materials.[21] These new provisions do not expressly inflict liability for their violation, but they may nevertheless increase the exposure of corporate officers and directors for alleged failures to disclose.

E. *Securities Fraud Statute of Limitations*

The Supreme Court surprised the defense bar with its plaintiff-friendly decision in *Merck & Co., Inc. v. Reynolds*, which decided two matters of first impression. The Court held that: (1) for the purpose of the statute of limitations for a private right of action for securities fraud, plaintiffs discover facts constituting a violation when they either actually discover the facts or when a reasonably diligent plaintiff should have discovered the facts, whichever comes first; and (2) the applicable facts include scienter.[22] The Court's reasoning, however, implicitly reaffirms that securities fraud plaintiffs must plead scienter with specificity to survive a motion to dismiss.[23]

F. *Duty to Disclose Free Cash Flow Estimates*

As always, the Delaware Chancery Court had a busy year and issued a number of decisions addressing the fiduciary duties of corporate officers and directors. The court issued conflicting decisions regarding whether a company must disclose free cash flow estimates to the shareholders in connection with a merger vote. In *Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc.*, the court enjoined a merger pending disclosure of the free cash flow estimates.[24] In contrast, in a transcript ruling on a motion to expedite in *Steamfitters Local Union 447 v. Walter*, the court held

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19. Dodd-Frank § 951(a) (say-on-pay).
20. Dodd-Frank §§ 951(b) (golden parachutes), 971 (proxy access).
21. Dodd-Frank §§ 952 (independent committee), 953 (disclosure provisions); *see also* Dodd-Frank § 955 (requiring disclosure of hedging by employees and directors), 956 (requiring enhanced compensation disclosure and prohibiting some compensation arrangements by covered financial institutions), § 972 (requiring disclosure of reason for having same person act as CEO and chairman).
22. Merck & Co., Inc. v. Reynolds, 130 S. Ct. 1784, 1789–90 (2010).
23. *See id.* at 1796–97.
24. 2010 WL 1931084, at *1 (Del. Ch. 2010) (Strine, V.C.).

that the estimates were not material and distinguished the PLATO decision.[25] Recognizing the ambiguity in Delaware law on this point and that "a bright-line rule in disclosure . . . would be a good thing in some ways," the Chancellor offered to certify an interlocutory appeal, but the plaintiffs did not pursue that appeal.[26] Taken together, *Maric*, *Steamfitters*, and other related decisions may be read to mean that the obligation to disclose free cash flow estimates will be context dependent.

G. *Duties to Preferred and Common Stockholders Dilemma*

In two decisions in 2010, the Delaware Chancery Court clarified the duties of a board in dealing with a corporation's preferred shareholders. The more interesting of the two decisions is *LC Capital Master Fund, Ltd. v. James*, which surveys and harmonizes prior apparently conflicting decisions in denying a motion by preferred stockholders to enjoin a planned merger.[27] In *Fletcher International Ltd. v. ION Geophysical Corp.*, the chancery court considered a challenge by preferred stockholders to the issuance of a convertible promissory note and similarly concluded that the rights of preferred stockholders are primarily contractual, and that a claim for breach of fiduciary duty based on contractual rights would be "superfluous."[28] A board that favors the company's preferred shareholders over its common shareholders may find itself sued by the common shareholders.[29]

H. *Derivative Actions for Insider Trading*

In *Pfeiffer v. Toll*, the chancery court rejected a challenge to the Delaware doctrine that a corporation can recover from its fiduciaries for insider trading.[30] Defendants argued that Delaware should no longer offer a state law remedy for insider trading, where federal securities law polices insider trading "pervasive[ly] and comprehensive[ly]."[31] In a scholarly opinion, the court rejected the defendants' contentions. The court emphasized that the Delaware "*Brophy* claim" to remedy insider trading exists not "to recover losses by contemporaneous traders, nor to force automatic disgorgement of reciprocal insider trading gains," but to "remedy harm to

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25. Del. Ch. C.A. No. 5492-CC (June 21, 2010) (Chandler, C.), *available at* http://seclawcenter.pli.edu/wp-content/uploads/2010/08/Steamfitters-v.-Walter.pdf.
26. *Id.* at 10–11.
27. 990 A.2d 435 (Del. Ch. 2010).
28. 2010 WL 2173838, at *7 (Del. Ch. 2010).
29. *See, e.g.*, Trados, Inc. Shareholders Litig., 2009 WL 2225958, at *7 (Del. Ch. 2009) ("[I]t is *possible* that a director would breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders.") (emphasis in original).
30. 989 A.2d 683 (Del. Ch. 2010).
31. *Id.* at 701.

the corporation."[32] Accordingly, the court concluded that there is "room for *Brophy*" alongside the federal insider trading regime.

I. *Implied Covenant of Fair Dealing*

In April 2010, the Delaware Supreme Court issued a split decision on the implied covenant of fair dealing in *Nemec v. Shrader*.[33] The majority opinion rejected plaintiffs' claims, explaining that the implied covenant "involves a 'cautious enterprise,' inferring contractual terms to handle developments or contractual gaps that the asserting party pleads neither party anticipated."[34] In the dissent's view, in order for the defendant to avoid acting in bad faith, the challenged conduct must not only rely upon bargained-for contract provisions, but must also "further a legitimate interest of the party acting in reliance on the contract."[35] Because the plaintiffs adequately alleged that the redemption prejudiced the plaintiffs and served no legitimate interest of the company, the dissent would have permitted the claim to proceed.[36]

The *Nemec* decision has already been cited several times since the court issued its decision in April 2010. *Nemec* and its progeny show that the Delaware courts will honor contracts, good and bad, and will not lightly imply any additional terms or rights in those contracts. Fiduciary duty claims or unjust enrichment claims that parallel contractual rights will not survive a motion to dismiss. The *Nemec* formulation of the implied covenant has a wide application from preferred shareholder rights to LLC agreements to employee stock option plans.

J. *Special Litigation Committee Reports*

In *London v. Tyrell*, the Delaware Chancery Court found material questions of fact regarding a special litigation committee's independence and the reasonableness and good faith of its investigation, and denied its motion to dismiss a derivative action.[37] After the court denied the defendants' motion to dismiss, the company formed a special litigation committee (SLC) comprised of two directors who joined the board after the challenged plan's adoption. The SLC conducted an investigation and concluded that the suit was not in the best interests of the company and recommended it be dismissed.[38]

32. *Id*. at 699 (emphasis in original). The insider trading remedy was established in *Brophy v. Cities Service Co*., 70 A.2d 5 (Del. Ch. 1949).
33. 991 A.2d 1120 (Del. 2010).
34. *Id*. at 1125–26.
35. *Id*. at 1127.
36. *Id*. at 1131 (Jacobs, J., dissenting).
37. 2010 WL 877528, at *27 (Del. Ch. 2010) (Chandler, C.).
38. *Id*. at *10.

Applying the test set forth in *Zapata Corp. v. Maldonado*,[39] the court considered whether to dismiss the action based on the SLC's report and concluded that the SLC failed to meet the standard for dismissal.[40] The court held that there were material issues of fact concerning the independence of the SLC members, its investigation, and the conclusions it reached.[41]

The *London* decision honors the validity of the special litigation committee as a device to evaluate and, where appropriate, eliminate derivative actions. The *London* decision also, however, shows that the court will scrutinize both the committee's process and its conclusions and will not simply accept them at face value. If a special litigation committee is to be effective, it must truly be independent, and it must conduct a serious inquiry into the merits of the claims at issue.

K. *Kabuki Dancing Pilgrims*

The Delaware Chancery Court blasted plaintiffs' counsel for its conduct in the *Cox Communications* Kabuki dance of litigation for control of a minority stockholder class action in the case of *In re Revlon, Inc. Shareholders Litigation*.[42] In the three weeks that followed the April 13, 2009, announcement of a proposed merger between Revlon, Inc. and its controlling stockholder, MacAndrews & Forbes Holdings, Inc., four so-called frequent filer plaintiffs' law firms filed representative actions on behalf of small stockholders.[43]

"A brief struggle then ensued for control of the litigation."[44] Unimpressed by any of the firms' motions to serve as lead counsel, Chancellor Chandler declined to appoint lead counsel and directed the firms to work it out. Within two weeks, the firms agreed on a consolidation order establishing the leadership structure, and the court entered the agreed-upon order.[45]

"Firms who are early filers are frequently early settlers, leading some wags in the defense bar to label them 'Pilgrims.' This case would follow form."[46] After the leadership structure of the action was settled, "[r]eal litigation activity then ceased."[47] The court called this process the "opening steps of the *Cox Communications* Kabuki dance"—in the final steps of which, the "plaintiffs are brought in to bless the deal" after the corpora-

39. 430 A.2d 779, 784 (Del. 1981).
40. *London*, 2010 WL 877528, at *11–27.
41. *Id*. at *12–27.
42. 990 A.2d 940 (Del. Ch. 2010) (Laster, V.C).
43. *Id*. at 942–44 & ns.1, 2.
44. *Id*. at 944.
45. *Id*.
46. *Id*. at 945 (internal footnote omitted).
47. *Id*.

tion and controller decide on its terms.[48] The court was upset because the transaction had hallmarks of unfairness to the minority stockholders, but it found that the original plaintiffs' counsel failed to provide adequate representation and impaired their credibility with the court.[49]

In its analysis, the court stressed that when "forced to choose among competing candidates for lead counsel," it would consider the quality of the pleadings, the "willingness and ability of all contestants to litigate vigorously on behalf of an entire class of shareholders," and the "enthusiasm or vigor with which the various contestants have prosecuted the lawsuit."[50] The court downplayed, somewhat, the importance of the size of the plaintiffs' holding in the company, which it would not "use[] to generate a formalistic ranking but rather comes into play when a plaintiff owns a sufficient stake to provide an economic incentive to monitor counsel and play a meaningful role in conducting the case."[51] *Revlon* is an interesting decision for both the plaintiff and defense bars, signaling that the chancery court will independently scrutinize settlements for fairness to the shareholder class, and may not tolerate Pilgrims engaged in a Kabuki dance with the company.

L. *Poison Pills to Protect Net Operating Losses*

In *Versata Enterprises, Inc. and Trilogy, Inc. v. Selectica, Inc.*, the Delaware Supreme Court affirmed a chancery court decision approving the adoption of poison pills to protect net operating losses.[52] Net operating losses (NOLs) "are tax losses, realized and accumulated by a corporation, that can be used to shelter future (or immediate past) income from taxation."[53] The investors challenged the pills on the grounds that where Selectica had "an unbroken history of losses and doubtful prospects of annual profits," the NOLs were unusable and the poison pills unnecessary.[54] The investors also contended that the pills were impermissibly preclusive of a proxy contest for board control.[55] Applying the two-part test established in *Unocal*

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48. *Id.* at 945, 947. *See In re* Cox Comm'ns, Inc., 879 A.2d 604, 648 (Del. Ch. 2005) (Strine, V.C.) (cutting plaintiffs' counsel's fee from the $4.95 million agreed upon in a settlement to $1.275 million).

49. *Id.* at 955–57.

50. *Id.* at 955 (citations omitted).

51. *Id.*

52. Versata Enters., Inc. v. Selectica, Inc., 2010 WL 3839786 (Del. 2010); *see* Selectica, Inc. v. Versata, Inc., 2010 WL 703062 (Del. Ch. 2010); *see also In re* Cogent, Inc. Shareholder Litig., 2010 WL 3894991 (Del. Ch. 2010) (Parsons, V.C.) (approving a board's grant of top-up options to an acquirer and applying the standard from *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986)).

53. *Versata*, 2010 WL 3839786, at *2.

54. *Id.* at *1.

55. *Id.*

Corp. v. Mesa Petroleum Co.,[56] the court rejected the investors' challenges to the pills. The decision applies existing law to a unique factual situation, but reaffirms the Delaware courts' commitment to defer to good faith decisions by fully informed boards.

M. *Delaware Indemnification and Advancement Statute*

Effective August 2, 2010, Delaware amended 8 Del. C. § 145, which deals with indemnification and advancement of litigation expenses to corporate officers and directors. The amendments clarified that: (1) Section 145(d) applies to determinations of the propriety of indemnification when the potential indemnitee is an officer or director of the corporation at the time of the determination; and (2) Section 145(e) applies to advancement of expenses to current officers and directors, and that advancement may be made on any terms or conditions the corporation deems appropriate to others serving at the request of the corporation as officers, directors, employees, or agents of other enterprises.[57]

N. *California Adopts Continuing Wrong Doctrine*

In *Kruss v. Booth*, the California Court of Appeal adopted the "continuing wrong doctrine" as an exception to the contemporaneous ownership requirement for shareholder derivative claims.[58] The continuing wrong doctrine confers standing on a derivative plaintiff who does not own stock at the time of the alleged wrongdoing if the "previous misconduct and its bad effects continue over into the period after the plaintiff acquired the stock."[59] The viability of the continuing wrong doctrine varies widely in other jurisdictions.[60]

II. Developments in Accounting Malpractice

A. *Duties to Third Parties*

In *Cast Art Industries, LLC v. KPMG, LLP*, Cast Art and its principals brought fraud and professional negligence claims against KPMG for its

56. *See* 493 A.2d 946, 957 (Del. 1985) (board must show reasonable grounds to believe threat to corporate enterprise existed, and that its response was reasonable and not preclusive or coercive).

57. For an interesting decision on advancement of expenses for allegedly offensive counterclaims where the fees were inseparable from defense costs, see *Paolino v. Mace Sec. Int'l, Inc.*, 2009 WL 4652894 (Del. Ch. 2009).

58. 111 Cal. Rptr. 3d 56, 78 (Cal. Ct. App. 2010).

59. *Id.* at 78.

60. *Compare, e.g.*, Bateson v. Magna Oil Corp., 414 F.2d 128, 130 (5th Cir. 1969) ("where the complaint charged continuing wrongs, occurring at the time plaintiff owned stock, the complaint should not be dismissed on defendant's contention that the claims actually arose

audit work on behalf of Papel, a company with which Cast Art merged in 2000.[61] Papel's accounts receivable were significantly less than what was represented in Papel's financial statements, and the business folded three years after the merger.[62] KPMG received summary judgment on the fraud claims, but the jury awarded plaintiffs $31.8 million for their professional negligence claim based on the value of Cast Art at the time of merger.[63]

The primary issue on appeal was whether KPMG owed a duty to plaintiffs, who were not clients, under New Jersey's Accountant Liability Act.[64] The Appellate Division of the New Jersey Superior Court concluded that the accountants did have a duty of care to plaintiffs.[65] KPMG knew not only that Papel's audited financial statement would be presented to Cast Art but also that Cast Art would rely on the statement,[66] as its personnel participated on conference calls in which the parties discussed the need for audited financial statements, a precondition for the merger.

In *Bacon v. Stiefel Laboratories, Inc.*, participants in a laboratory employees' stock bonus plan filed suit against, among others, the accountants responsible for determining the stock's fair market value.[67] Under the terms of the stock bonus plan, the participants could not sell, trade, or redeem their shares until they left the company, at which time the company would repurchase the shares.[68] The plaintiffs claimed that, starting in 2007, some of the defendants engaged in a scheme to force employees to sell their shares back to the company at a below-market price while simultaneously planning to sell the company at a much higher price than what was offered to plaintiffs.[69] The accountant defendants were hired to determine the fair market value of the plan stock.

Moving to dismiss the claims, the accountants argued they had no duty to the plaintiffs.[70] Florida has adopted the Second Restatement's view of third-party liability that requires, at a minimum, that the accountant have knowledge that the third party will rely on the work product.[71] In *Bacon*,

prior to the time plaintiff acquired his stock"), *with In re* Bank of N.Y. Derivative Litig., 320 F.3d 291, 298 (2d Cir. 2003) ("a proper plaintiff must have acquired his or her stock in the corporation before the core of the allegedly wrongful conduct transpired").

61. 3 A.3d 562, 566–67 (N.J. App. Div. 2010).

62. *Id*. at 566.

63. *Id*. at 567. The court later reduced the award to $30 million plus $8,096,902 in prejudgment interest.

64. *Id*. at 568.

65. *Id*.

66. *Id*.

67. 677 F. Supp. 2d 1331, 1336 (S.D. Fla. 2010).

68. *Id*.

69. *Id*.

70. *Id*. at 1351.

71. *Id*. at 1351–52.

the complaint contained only conclusory allegations that the accountants knew employee plan participants would rely on their stock valuation to decide whether to sell their stock to the company. However, plaintiffs did not explain how the accountants knew plaintiffs would rely on the valuations. Their complaint against the accountants was dismissed without prejudice.[72]

California accountants were held to have no duty towards their client's employees in *Giacometti v. Aulla, LLC*.[73] The accountants were hired by a restaurant to prepare year-end documents for earnings and taxes. Employees filed professional negligence claims against the accountants, claiming that in preparing the W-2 documents, the accountants included as income to the employees tip money taken by the restaurant managers.[74] As a result, some of the employees' incomes were overreported by as much as $30,000, subjecting them to IRS investigations. The only issue on appeal, after dismissal of the complaint, was whether the accountants had a duty to accurately report the income of their client's employees. The court held the accountants owed no duty to the employees, as the accountants were in privity solely with the restaurant itself.[75] There were no allegations that the accountants knew the restaurant's calculation of employee income was incorrect when they prepared the year-end financial documents, nor were the accountants hired to calculate employee income.[76] Whatever error occurred was the result of the restaurant's furnishing of wrong information to the accountants, not the accountants' negligent work. Therefore, dismissal was proper.[77]

B. *Breach of the Standard of Care and Causation*

In *Bankruptcy Services, Inc. v. Ernst & Young, LLP (In re CBI Holding Co., Inc.)*, a Chapter 11 debtor and its investor brought audit malpractice claims against the debtor's prepetition accounting firm for failing to discover a substantial underreporting of liabilities by the debtor's management at a time when the investor could have exercised its rights to remove management and preserve the company's value.[78] The court addressed two relevant issues: (1) whether the bankruptcy judge had a sufficient factual basis for finding that Ernst & Young committed malpractice and fraud; and (2) whether there was sufficient evidence of causation.[79] To prevail

72. *Id.* at 1352.
73. 2010 WL 3328277, at * 5 (Cal. Ct. App. 2010).
74. *Id.* at *1.
75. *Id.* at *5.
76. *Id.*
77. *Id.* at *4.
78. 419 B.R. 553, 557 (S.D.N.Y. 2009).
79. *Id.* at 558.

on an auditor malpractice claim in New York, a plaintiff must establish a departure from accepted standards of practice and that the departure was a proximate cause of injury.[80]

An accountant's good faith compliance with GAAS and GAAP discharges the accountant's professional obligation to act with reasonable care.[81] However, in *Bankruptcy Services, Inc.*, the bankruptcy judge had sufficient grounds for finding a breach as well as proximate cause.[82] Ernst & Young did not properly investigate the debtor's liabilities, did not discontinue the engagement when it encountered red flags, and did not inform the debtor of its previous failure before accepting an engagement to re-audit. Moreover, the bankruptcy judge had sufficient grounds to find that Ernst & Young's actions proximately caused injury where, if it had properly accounted for liabilities, the debtor would not have suffered the loss of its value due to bankruptcy.[83]

C. *Proof of Damages*

In *Continental Casualty Co. v. PricewaterhouseCoopers, LLP*, the Court of Appeals of New York affirmed dismissal of claims against PricewaterhouseCoopers for fraud in the inducement.[84] Plaintiffs, former limited partners of an entity for which PWC served as auditor, claimed they were induced into making their initial investments in the partnership by financial statements PWC incorrectly declared accurate.[85] In an action for fraud in the inducement, a plaintiff may only recover actual pecuniary losses sustained as a direct result of the wrong, and plaintiffs could not meet this burden.[86] The only injury they established was the diminution in value of their limited partnership interests at liquidation, but this was attributable to the plaintiffs' pro rata share of partnership losses after the date of their investments.[87] They experienced these losses in common with all other limited partners. Thus, dismissal of their fraud claim was proper.[88]

D. *Audit Interference Rule*

Under the audit interference doctrine, an auditor may assert the client's negligence as an affirmative defense to a professional malpractice claim only where the client's negligence interfered with the performance of the

80. *Id.* at 563.
81. *Id.*
82. *Id.* at 565.
83. *Id.* at 569.
84. 933 N.E.2d 738 (N.Y. 2010).
85. *Id.* at 739.
86. *Id.* at 742.
87. *Id.*
88. *Id.*

audit itself. A recent Connecticut case addressed this issue in an insurer's lawsuit against its accounting firm.[89] The accounting firm argued on summary judgment that the insurer failed to follow its own internal controls.[90] The insurer, moving for summary judgment on the accounting firm's comparative negligence defense, claimed there was no evidence of interference by the insurer's employees, and thus the accounting firm was precluded from asserting a contributory negligence defense under the audit interference doctrine.[91] The court held that comparative negligence principles applied, and the audit interference rule should not be afforded any special significance.[92] It denied the insurer summary judgment on the affirmative defense because there was a genuine issue of fact as to whether its employees acted wrongfully.[93] Specifically, there was testimony that a manager knowingly made incorrect entries on the general ledger and that internal fraud controls were not followed.[94]

E. *Malpractice Experts*

In an audit malpractice case against an accounting firm, the Iowa Court of Appeals recently reversed a trial court's exclusion of testimony by the plaintiff's malpractice expert and remanded the case for a new trial.[95] Plaintiff's intended expert witness was a certified fraud examiner with twenty-eight years of experience conducting field audits of income tax returns for the IRS, including two to three hundred business audits, but he was not an accountant.[96] The witness intended to testify at trial as to the defendant's allegedly negligent audit, which he deemed inaccurate, incomplete, and misleading.[97] Defendant filed a successful motion in limine to exclude the witness's testimony regarding the standard of care applicable to certified accountants and his purportedly expert opinion as to whether defendant breached the standard.[98] On appeal, plaintiff argued that the witness's testimony was intended to guide the jury through the auditor's voluminous paperwork to highlight the red flags that should have alerted the auditor to plaintiff's financial distress.[99] Essentially, the witness would discuss in-

89. Vigilant Ins. Co. v. Deloitte & Touche, LLP, 2009 WL 3839341, at *1 (Conn. Super. Ct. 2009).
90. *Id.*
91. *Id.* at *5.
92. *Id.* at *6.
93. *Id.*
94. *Id.*
95. Quad City Bank & Trust v. Jim Kircher & Assocs., P.C., 2010 WL 2079686, at *10 (Iowa Ct. App. 2010).
96. *Id.* at *2.
97. *Id.*
98. *Id.* at *2–3.
99. *Id.* at *8.

adequacies in the audit process, not specific standards of practice. Noting that compliance with GAAS and GAAP is not the only measure of professional negligence with respect to audit activities, the appellate court held the witness was qualified to give an opinion that the auditor did not follow its checklists or perform all of the necessary interviews and inventory checks.[100] Thus, the trial court abused its discretion in not allowing the witness to testify on the issue of deficiencies in the audit.[101]

F. *Statute of Limitations*

In *Federated Industries, Inc. v. Reisin*, Illinois adopted the approach taken in a majority of other jurisdictions when it held that the statute of limitations in an accounting malpractice case involving increased tax liability begins to run when the taxpayer receives the statutory notice of deficiency or at the time the taxpayer agrees with the IRS's proposed deficiency assessments.[102]

A New York appellate court reversed the denial of summary judgment to an accountant on statute of limitations grounds in *Apple Bank for Savings v. PricewaterhouseCoopers, LLP*.[103] The court determined that the plaintiff's malpractice claim accrued in 2000 when its accountant rendered the allegedly improper tax advice. The lower court, however, erred in determining that the statute of limitations was tolled under the continuous representation doctrine during the accountant's subsequent relationship with the plaintiff.[104] Although the accountant audited the plaintiff's year-end financial statements, prepared its tax returns, and provided ad hoc tax advice to plaintiff, it never had any express mutual agreement to advise plaintiff after the original engagement.[105] Accordingly, the underlying complaint should have been dismissed.[106]

In *Abramo v. Teal, Becker & Chiaramonte, CPAs, P.C.*, the former co-owners of a corporation sued its accountants for professional negligence, fraudulent misrepresentations, aiding and abetting fraud, and other claims.[107] Plaintiffs claimed the accountants' negligence was a substantial cause of the co-owners' decision to issue bonds, which in turn led to plaintiffs' alleged damages.[108] Under New York law, a malpractice action against an accountant accrues upon the client's receipt of the accountant's work product, as

100. *Id.*
101. *Id.* at *10.
102. 927 N.E.2d 1253, 1265 (Ill. App. Ct. 2010).
103. 895 N.Y.S.2d 361, 362 (N.Y. App. Div. 2010).
104. *Id.*
105. *Id.*
106. *Id.*
107. 713 F. Supp. 2d 96 (N.D.N.Y. May 12, 2010).
108. *Id.* at 100.

this is the point that a client reasonably relies on the accountant's skill and advice, and as a consequence of that reliance, may become liable for tax deficiencies.[109] In *Abramo*, the court dismissed all the plaintiff's malpractice claims premised on work plaintiffs received from the accountants more than three years before they filed suit.[110]

G. *In Pari Delicto*

The doctrine of in pari delicto is an equitable defense based on agency principles that bars a plaintiff from recovering where the plaintiff itself is at fault. The underlying concept is that the actions of a corporation's agent are imputed to the corporation when the agent acts within the scope of his or her employment.

In a New York malpractice action analyzing the in pari delicto defense, a technology company sued its accounting firm for failing to discover fraud perpetrated by several senior managers.[111] The trial court dismissed the malpractice claims based on the in pari delicto defense, but on appeal, the court found the plaintiff's complaint was sufficient to withstand dismissal.[112] Under New York law, the "adverse interest" exception is a method by which the plaintiff can demonstrate that its agent's actions should not be imputed because the agent's fraud was entirely self-interested.[113] New York defines the exception narrowly, applying it only when the agent totally abandons his principal's interests and acts entirely for his own purposes.[114] The plaintiff set forth sufficient allegations to invoke the adverse interest exception where it alleged that senior management inflated the corporation's earnings and manipulated its earnings per share for their own personal financial benefit and to the harm of the corporation.[115]

The Supreme Court of Pennsylvania recently addressed certified questions from the Third Circuit on the availability of an in pari delicto defense in an auditor liability scenario.[116] In the underlying case, a committee of unsecured creditors sued the debtor's auditor, alleging that the auditor colluded with the debtor's officers to misstate the debtor's finances. The Pennsylvania Supreme Court determined that an auditor for a bankrupt

109. *Id.* at 103.
110. *Id.* at 105.
111. Symbol Techs., Inc. v. Deloitte & Touche, LLP, 888 N.Y.S.2d 538 (N.Y. App. Div. 2009).
112. *Id.* at 543–44.
113. *Id.* at 542.
114. *Id.* at 542–43.
115. *Id.* at 543–44.
116. Off. Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers, LLP, 989 A.2d 313 (Pa. 2010).

corporation may assert the in pari delicto defense.[117] To invoke in pari delicto, the plaintiff must be an active, voluntary participant in the wrongful conduct for which it seeks redress and bear equal or greater responsibility for the underlying illegality.[118] The imputation doctrine recognizes that principals are responsible for acts of agents committed within the scope of their authority.[119] While a main justification for imputation lies in the protection of innocents, it may extend to auditor negligence, subject to an adverse interest exception, but only so long as the auditor did not act in bad faith.[120]

III. Developments in Agent/Broker Malpractice

Over the past year, a number of decisions have been issued addressing some of the claims categories typically asserted against insurance agents and brokers—failure to procure requested coverage, failure to advise of the customer's insufficient coverage, negligent misrepresentation concerning the customer's coverage, and negligence in completing the policy application.

A. *Duty to Procure/Duty to Advise*

Generally, an insurance agent/broker has a duty to procure the coverage that has been requested or to advise the customer of the inability to do so within a reasonable time. Absent a "special relationship" or "special circumstances," there is generally no duty to provide advice about the sufficiency of coverage, the existence of additional, optional coverages, or to ensure that the customer has complete coverage for all potential risks presented. The duty to advise may be expanded where agents: (1) hold themselves out as experts or know the customer is relying on special expertise, (2) undertake special duties, (3) receive special compensation, or (4) have a special relationship with the customer.

In *Dairy America, Inc. v. New York Marine and General Insurance Co.*,[121] the insured, Dairy America, was a marketer and seller of powder milk products throughout the United States and internationally. In 2004, in addition to ocean cargo insurance (which had been in place since 2000), Dairy America approached its broker about obtaining insurance that would protect its product shipments whether the shipments were in transit or in storage. The broker offered to obtain an "ocean cargo/stock through put policy." In

117. *Id.* at 339.
118. *Id.*
119. *Id.* at 331.
120. *Id.* at 338–39.
121. 2010 U.S. Dist. LEXIS 31846 (E.D. Cal. Apr. 1, 2010).

correspondence regarding the possibility of obtaining this coverage, Dairy America's comptroller noted "[m]y initial thought is to consider coverage for all products regardless of whether it transfers title at the plant, at the border, over the rail, or at a destination."[122] Shortly after the policy's effective date, Hurricane Katrina destroyed fifty-nine loads of milk powder located in a warehouse.

Following submission of a claim for all fifty-nine loads, the insurer investigated the claim, determined that twenty-three loads had been shipped before the policy inception date, and refused to indemnify the loss arising from the destruction of those loads per the policy terms. Dairy America sued the broker for the nearly $1 million uncovered portion of the loss, asserting claims for negligent misrepresentation, professional negligence, and breach of contract. Dairy America allegedly advised the broker that it wanted coverage for all of its shipments, including shipment in transit at the time coverage incepted.

In granting summary judgment to the broker, the court noted that a broker's general duty of reasonable care does not include an "obligation to procure a policy affording the client complete liability protection."[123] Although Dairy America's comptroller apparently subjectively intended that the policy cover loads both in transit at the time of policy inception and thereafter, the court noted that there was no evidence introduced on the motion that Dairy America had specifically requested or been promised such coverage.[124] Although Dairy America also argued that, given the coverage request made, the broker had a duty to procure "proper insurance coverage,"[125] the court rejected this argument. First, the court noted that a broker "generally has no duty to volunteer that an insured should obtain different or additional coverage."[126] Second, the court noted that no evidence had been presented that coverage could actually have been obtained for goods already in transit.[127]

In *Zubres Radiology v. Providers Insurance Consultants*,[128] a radiology company had been sued for medical malpractice and later, after the death of the patient, wrongful death. While the company had medical malpractice cov-

122. *Id*. at * 4.

123. *Id*. at * 21 (quoting Jones v. Grewe, 189 Cal. App. 3d 950, 956 (1987)).

124. *Id*. at *27 ("Ms. McAbee's 'understanding' of coverage for 'product in transit at the time of the policy's inception' does not constitute Gallagher's misrepresentation of coverage for the loads").

125. *Id*. at *28.

126. *Id*. at *29.

127. *Id*. at *29–30. As to Dairy America's breach of contract claim, the court held that there could not have been a contract in place to insure the product already in storage at the Gulfport warehouse at policy inception, because Dairy America's comptroller had admitted that she didn't even know there was product being stored there at policy inception. *Id*. at *33–34.

128. 276 S.W.3d 335 (Mo. Ct. App. 2009).

erage, its insurer had been placed in receivership and liquidated. As a result, during the course of the medical malpractice case, which it ultimately won, the radiology company had to pay for the cost of defending against the claims. Later, when the patient's son instituted a wrongful death suit, the company had to defend itself against those claims as well. The radiology company then brought suit against the broker for breach of the duty of care in not notifying the company of the insurer's financial downgrade prior to its being placed into receivership, which would have afforded the radiology company the opportunity to place its coverage with another insurance carrier. In affirming dismissal of the claim, the appellate court held that after the broker had obtained and delivered the medical malpractice insurance coverage to the radiology company, the broker's duty to procure had been fulfilled, and it had no duty to continue to monitor the financial condition of the medical malpractice insurer.[129]

In *Isidore Newman School v. J. Everett Eaves, Inc.*,[130] a broker and its client, a school in Louisiana, had a sixteen-year relationship in which the broker annually procured property and casualty insurance. Each year, the broker met with the school's business managers to discuss coverages and renew the policy, and provide a written insurance proposal. As part of the property coverage, since 1999 the school had paid for "Business Income and Extra Expense" (BI & EE) coverage, which had been increased from $250,000 to $350,000.

Following Hurricane Katrina, the school suffered major damage to its physical structure, causing its closure for over two months. As a result, the school suffered a loss of tuition revenue/income of more than $3 million. The school thereupon sued the broker for failing to appropriately advise the school with regard to the BI & EE, alleging that the broker "had a duty to inform [the school] of the different coverage options that were available to it and to explain the costs and potential benefits of those coverages."[131] The school also argued that by holding itself out as an insurance professional, the broker "voluntarily assumed a duty to provide accurate and complete information about the scope of the coverage recommended."[132] In particular, the school argued that because the policy was over 400 pages in length and was quite complicated and difficult to understand (particularly with regard to whether the school understood "net profits" as something it was entitled to recover as a nonprofit institution), it was incumbent upon the broker to spell out what was covered under BI & EE.

129. *Id.* at 341.
130. 42 So. 3d 352 (La. 2010).
131. *Id.* at 354.
132. *Id.*

After a trial on the merits, the trial court found the broker had breached its duty of care, and the appellate court affirmed. However, the Louisiana Supreme Court reversed, finding no duty to advise as to the amount of insurance coverage the insured should obtain. In so holding, the court stated:

> An agent has a duty of "reasonable diligence" to advise the client, but this duty has not been expanded to include the obligation to advise whether the client has procured the correct amount or type of insurance coverage. It is the insured's responsibility to request the type of insurance coverage, and the amount of coverage needed. It is not the agent's obligation to spontaneously or affirmatively identify the scope or the amount of insurance coverage the client needs.[133]

B. *Special Relationship*

In *Williams v. Hilb, Rogal & Hobbs Insurance Services of California, Inc.*,[134] the court considered an appeal from a decision finding an insurance broker liable for the uninsured loss caused by the insured's failure to purchase workers' compensation coverage for a business engaged in installing spray-on linings onto the beds of pickup trucks. A worker was severely burned at work and obtained an $11,272,238.39 verdict, half of which was the responsibility of the insured. Workers' compensation coverage was required by law, but the broker obtained policies that were sent to the insured and made clear that workers' compensation coverage had not been obtained. Although the insured failed to read the policies, the trial court found that the insured had a right to rely on the broker to ensure that all of the necessary coverages had been put in place. On appeal, the decision was affirmed.

Critical to the court's determination at the trial level and on appeal was the fact that the broker had represented herself as an expert with a special expertise in identifying and obtaining the necessary coverages for the type of business in question and, in fact, had been handling the insurance needs of between fifty and 100 truck lining dealerships when the insured partners opened their business. Indeed, the broker had helped develop an insurance package specific to this line of business, and she indicated to the insured partners that the program "was designed specifically for Rhino Liner dealers."[135] She even filled out all of the provisions of the application for coverage, having the insured simply sign it, fill out basic information, and leave the rest to her.[136] Because the broker had held herself out as an expert with regard to the various, comprehensive insurance needs

133. *Id.* at 359.
134. 98 Cal. Rptr. 3d 910 (Cal. Ct. App. 2009).
135. *Id.* at 913.
136. *Id.*

of the insured, agreed to complete the application regarding coverages to purchase by the insured, and then failed to request or procure workers' compensation coverage despite knowing it was required as a matter of law, the appellate court upheld the trial court's conclusion that the broker had assumed a special duty of care with regard to purchasing insurance for the insured and had breached that duty.[137]

In *Myers v. Yoder*,[138] the owners of a home destroyed by a gas explosion sued their agent for failing to advise them to purchase coverage at higher limits, thereby leaving them substantially underinsured. The homeowners argued that, because they had requested "full coverage," this created a "red flag" that imposed a special duty of care on the part of the agent to make special inquiry regarding the type and amount of coverage to purchase.[139] In rejecting this argument, the court noted:

> To hold otherwise would allow a damaged insured to make a "fully covered" allegation against an insurance agency each time an insurance policy did not cover a particular type of loss. To protect against such claims, perforce this would place upon an agency the duty of intuitive foresight and an explanation of every term, condition, limitation, exclusion or restriction in coverage to an insured so that the policy might provide "full coverage" under any and all circumstances. We will not place such an impossible burden upon an insurance agency. . . .[140]

In *Axis Construction Corp. v. O'Brien Agency*,[141] in a decision recently reversed on appeal, the trial court found there was no "special relationship" creating a heightened duty of care despite a sixteen-year relationship between the agent and the insured as the insured was a sophisticated commercial entity actively involved in procuring its insurance coverages, did not compensate the agent for his insurance advice apart from payment of premiums, and did not delegate its insurance decision-making responsibility to him.

C. *Negligence in Preparing Policy Applications*

Continuing a trend of cases holding that a broker can be held liable to an insurance company for its own fraud or negligence in preparing a policy application, the court in *Liberty Surplus Insurance Corp., Inc. v. First Indemnity Insurance Services, Inc.*,[142] reversed dismissal of a legal malpractice insurer's claims against a broker seeking recovery of the $3 million it paid

137. *Id.* at 920.
138. 921 N.E.2d 880 (Ind. Ct. App. 2010).
139. *Id.* at 888–89.
140. *Id.* at 889.
141. 2009 N.Y. Misc. LEXIS 4963 (N.Y. Sup. Ct. 2009), *rev'd*, 2011 N.Y. App. Div. LEXIS 1455 (Feb. 22, 2011) (finding "issue of fact").
142. 31 So. 3d 852 (Fla. Dist. Ct. App. 2010).

out in settlement of a class action claim against its insured. The insurer alleged that the broker had either fraudulently or negligently failed to disclose several claim supplements outlining all professional liability claims, disciplinary proceedings, or suits involving the law firm's members over the past five years in an attempt to procure insurance for the firm after the policy application had been rejected by several other insurance companies, the insurer claimed that it issued its policy, and subsequently renewed the coverage, based upon incomplete information.

The trial court had granted the motion to dismiss on the ground that the insurance agent/broker is generally the agent of the insured, with no duty owed to the insurer in regards to preparation of the insurance application. However, the appellate court concluded that an agent, even of a disclosed principal, can be liable to third parties for its own tortious conduct.[143] And, quoting Section 552 of the Restatement (Second) of Torts, the court noted that

> [o]ne who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.[144]

On the other end of the spectrum, in *West Bend Mutual Insurance Co. v. 1st Choice Insurance Services*,[145] the court held that an insured had the right to sue her broker for its comparative negligence with regard to misrepresentations made in a policy application, even if the insured failed to review the application before signing. In *West Bend*, the owner of a truck stop had purchased insurance for the truck stop, but, in filling out the policy application, failed to make note of the fact that other individuals had an ownership interest in the property. When there was a fire at the location, the truck stop's property insurer refused to pay the claim, and the insured ended up having to sue both that insurer and a prior insurer it alleged had wrongfully cancelled its coverage. The trial court granted summary judgment for the broker because the truck stop owner had the opportunity to review the policy application before it was sent.

In reversing the judgment, the appellate court noted there was evidence that the broker had completed the policy application based on responses given by the insured to her questions, and the broker had never asked the owner of the truck stop about additional ownership interests in the truck

143. *Id.* at 856.
144. *Id.*
145. 918 N.E.2d 684, 691 (Ind. Ct. App. 2009).

stop or mortgages on the property.[146] Further, the owner had provided the broker with a copy of the declarations page of her prior policy before the application was submitted, and the declarations page clearly listed as additional insureds the individuals with a mortgage lien on the property.[147] This, had it been reviewed, would have alerted the broker to the existence of others with an ownership interest in the business or property.[148] Because the broker had testified that she did not review the declarations page before submitting the policy application, the court held that there was a material fact issue to be decided regarding the broker's comparative negligence in preparing and submitting the policy application.[149]

Similarly, in *Morrison v. Allen*,[150] the court affirmed a judgment against a broker for its negligence in completing a policy application for its insured, even though the insured failed to review the policy application. The court noted that "when a person relies on another, more informed person to fill out an insurance application, the proposed insured is not necessarily obligated to review the application."[151] Accordingly, the court held that

> under Tennessee law, an insured who does not read the insurance application may recover from someone with superior knowledge upon whom he relies in the completion of the application, whether that someone is the insured's agent/broker or the insurance company acting through its own agent, when that person makes a material mistake or misrepresentation in the application.[152]

And the insured's failure to read the application does not absolve the broker of his duty to the insured.[153]

D. *Proximate Cause*

If there would not have been coverage in any event, or there is a superseding or intervening cause for the plaintiff's loss, the agent or broker will not be responsible for an absence of coverage, even where a breach of duty can be shown. The application of the proximate cause defense during the past year can be found in a number of cases, across a variety of jurisdictions.

In *Anderson-Tully Co. v. Federal Insurance Co.*,[154] plaintiff was a large, privately owned lumber company (ATCO) that had retained Aon to purchase

146. *Id.* at 691–92.
147. *Id.*
148. *Id.*
149. *Id.*
150. 2009 Tenn. App. LEXIS 298 (Tenn. Ct. App. 2009).
151. *Id.* at *14 n.4.
152. *Id.*
153. *Id.*
154. 347 F. App'x. 171, 2009 U.S. App. LEXIS 21141 (6th Cir. Tenn. 2009).

directors and officers liability insurance. Prior to purchase of the D&O policy, four of ATCO's senior officers had resigned, and had thereafter complained about the performance of the new officers and directors, as well as expressed concerns about dividend distribution and the value of their stock. In April 2003, within the claims made coverage period, an attorney letter was sent to ATCO on their behalf reiterating the criticisms the former officers had made of the company's current management, demanding financial information necessary to value the stock (which was not publicly traded), and threatening litigation based on the new officers' and directors' mismanagement. ATCO sent the letter to Aon. Although Aon should have forwarded this letter on to the company's D&O insurer, it failed to do so.

Aon had clearly breached its duty of care in regards to handling of the April 2003 letter, but it nonetheless succeeded in obtaining a dismissal of ATCO's complaint on summary judgment. Aon argued that the D&O insurer had reconsidered the notice of claim defense; agreed to accept the claim as timely; and agreed to treat the original April 2003 letter as a "claim," which therefore related the November lawsuit back to a period within which the policy was still in effect. The carrier denied coverage not for lack of notice but instead because the claims were not within the insuring agreement. Accordingly, Aon argued, its negligence could not be found to have been a proximate cause of ATCO's injury. On appeal, the decision was affirmed, with the appellate court noting that

> even though Aon had breached its fiduciary duty to ATCO by failing to submit the Sullivan Letter timely, that did not cause ATCO's harm. Rather the sole cause of ATCOs harm (the absence of coverage) was [the D&O insurer's] decision to deny coverage based on its interpretation and application of the policy, specifically the I v. I Exclusion.[155]

In *Metro Allied Insurance Agency, Inc. v. Lin*,[156] plaintiff was an electrical engineer who had been awarded a government contract to perform work at a hydroelectric plant in Michigan. The contract required him to purchase a performance bond guaranteeing his performance, as well as comprehensive general liability coverages. Lin purchased the bond from a surety company and attempted to purchase the CGL policy through Metro Allied Insurance, an independent insurance agency. While Metro provided a quote for the CGL coverage and collected premiums, it failed to actually purchase the CGL policy. Subsequently, the government terminated Lin's contract and required the surety company to complete the work pursuant

155. *Id.* at *16.
156. 304 S.W.3d 830 (Tex. 2009).

to its performance bond. The surety then sued Lin to recoup the monies paid out under the bond. Lin then sued Metro for negligence and violation of the Texas Deceptive Trade Practices Act (DPTA).

Although there was no defense the broker could provide with regard to breach of its duty of care in failing to procure the promised coverage, the trial court issued a "take-nothing judgment notwithstanding verdict." On appeal, the Texas Court of Appeals reversed. On further appeal, the Texas Supreme Court reversed the apellate ruling, and the trial court was directed to reinstate its judgment notwithstanding verdict.

The Texas Supreme Court noted that while a DPTA failure to procure claim could originally be established merely by providing evidence that the insured was "adversely affected" by the failure of the insurance agent/broker to obtain the promised policy, the standard that now applied was the "producing cause" standard.[157] Because both "producing cause" and "proximate cause" contain a "cause-in-fact element," the court held that, for Lin to recover under his negligence or DPTA claims, he would have to provide evidence at trial establishing that a CGL policy would have actually covered the injury he suffered—i.e., the monies he was forced to pay to reimburse the surety for paying out under the insurance bond.[158] "Otherwise," the court explained, "Lin would have obtained an insurance policy that did not provide coverage for his surety's claims against him, and the injury would have been the same regardless of whether Metro procured the insurance or not."[159] And because,

> [a]t trial, Lin did not present any evidence of the typical terms or coverage in a CGL policy issued by an insurance company utilized by Metro, any evidence that a typical CGL policy would provide coverage for breach of an indemnity agreement under a performance bond, or any expert testimony opining on the scope of coverage for an indemnity claim under a surety bond in a typical CGL policy,

the court found that Lin had not submitted legally sufficient evidence to carry his burden of proof.[160]

In *Brown & Brown, Inc. v. Estate of Edenfield*,[161] an insurance broker appeared to have negligently created a six-week gap in a health care provider's professional liability coverage, leaving the health care provider subject to an uninsured wrongful death claim by the estate of a patient who died after sustaining injuries at the insured's nursing facility. However, the broker

157. *Id*. at 834.
158. *Id*.
159. *Id*.
160. *Id*. at 833–34, 836.
161. 36 So. 3d 889 (Fla. Dist. Ct. App. 2010).

was able to show that by operation of law, even though a gap in coverage should have been created, the prior insurer's failure to provide notice of nonrenewal before the policy was replaced caused the coverage to remain in effect until the replacement coverage became effective. Accordingly, the court reversed a trial court judgment that had been entered in favor of the estate.

Similarly, in *Watertown Tire Recyclers, LLC v. Nortman*,[162] the court affirmed the dismissal of a negligence claim against an agent who failed to obtain coverage for a tire recycling company without a broad pollution exclusion, which the insured claimed resulted in the company being left without coverage for the costs of cleanup following a stockpile tire fire. Because the agent was able to successfully argue that the policy would not have responded to the claim anyway, due to the "owned property" exclusion, the trial court granted summary judgment in favor of the agent and dismissed the action. On appeal, the judgment was affirmed because, with or without the absolute pollution exclusion, there would have been no coverage and therefore "no reasonable jury could conclude that [the agent's] actions with respect to the pollution exclusion were a substantial cause of the loss of coverage."[163]

E. *Miscellaneous*

In 2009, a New York decision addressed the privity rule. Unlike many other jurisdictions, in New York brokers generally cannot be sued by third parties relying upon the representation that they are additional insureds or loss payees in certificates of insurance because they are not in privity of contract with the broker.[164] However, a recent appellate division decision carved out an exception to this rule where it can be shown that the broker "was aware, from the moment its client contacted it about procuring coverage, that plaintiff was the intended beneficiary of the coverage, and that plaintiff participated on its own behalf in discussions with [the broker] and its clients about the coverage to be provided."[165]

And finally, a Texas appellate court considered whether the relationship between insurance agent/broker and client should be deemed to be considered fiduciary, generally, and declined to do so.[166]

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162. 2010 Wisc. App. LEXIS 459 (Wis. Ct. App. 2010).
163. *Id*. at *14.
164. *See e.g.*, Greater N.Y. Mut. Ins. Co. v. White Knight Restoration, Ltd., 776 N.Y.S.2d 257, 257 (N.Y. App. Div. 2004).
165. Dominion Fin. Corp. v. Asset Indem. Brokerage Corp., 874 N.Y.S.2d 115, 116 (N.Y. App. Div. 2009).
166. Environmental Procedures, Inc. v. Guidry, 282 S.W.3d 602, 628 (Tex. App. 2009).

IV. Developments in Legal Malpractice

Legal malpractice cases typically require an analysis of the attorney's prior representation of a client. During the past year, courts evaluating statute of limitations and res judicata defenses by defendant attorneys and continuing representation arguments by clients have considered what the client could have reasonably known or believed about the scope of the representation and any possible claims the client might have against the attorney. The recent cases described below, which principally concern the continuing representation rule and res judicata, further develop this crucial inquiry.

A. *Continuing Representation*

Under the continuing (or continuous) representation rule, the statute of limitations for a malpractice action is tolled while the attorney is representing the client in the underlying matter.[167] The rule, which has been accepted in most jurisdictions,[168] is easy to state, but the central issue in the continuing representation rule—when the representation in the underlying matter has terminated—can be difficult to apply.[169] Two recent cases suggest that in determining the scope and duration of an attorney's representation in the litigation context, courts will rely on an attorney's appearance as counsel of record, even if other circumstances indicate that the attorney's representation has come to a close or is otherwise limited.[170] A recent case involving alleged malpractice in the transactional context, however, indicates that courts will not assume continuing representation even if the attorney performs subsequent legal work that touches upon the earlier transactional work.[171]

In *Laclette v. Galindo*,[172] the California Court of Appeal found triable issues of fact as to whether the representation had continued, even though there had been a settlement in the underlying litigation and no contact between the attorney and the client for over two years after the settlement.[173]

167. *See* 3 R. Mallen & J. Smith, Legal Malpractice § 23.13, at 449–55 (2010) (describing rule).

168. *Id.* at 453–54.

169. *Id.* at 468 ("The determinative event for the 'continuous representation rule' is when the representation ended. Unfortunately, the analysis is not always straightforward. The inquiry is not whether an attorney-client relationship still exists on any matter or even generally, but when the representation on that specific subject matter concluded.").

170. Laclette v. Galindo, 109 Cal. Rptr. 3d 660 (Cal. Ct. App. 2010); Global NAPs, Inc. v. Awiszus, 930 N.E.2d 1262 (Mass. 2010).

171. Mig, Inc. v. Paul, Weiss, Rifkind, Wharton & Garrison, LLP, 701 F. Supp. 2d 518 (S.D.N.Y. 2010).

172. 109 Cal. Rptr. 3d 660 (Cal. Ct. App. 2010).

173. *Id.* at 661.

The client had been a defendant in the underlying litigation, which resulted in a structured settlement whereby the client would make monthly payments to the underlying plaintiff until the total settlement amount was paid.[174] Because of the structured settlement, the court retained jurisdiction over the matter.[175] For the two years during which the client made the monthly payments required by the settlement agreement, there had been no contact between the lawyer and the client.[176] The client filed a malpractice claim against the attorney, alleging that a conflict of interest had resulted in less favorable settlement terms.[177] The attorney moved for summary judgment on the client's malpractice action, contending that the action, which was filed two years after the settlement agreement, and two years after the last contact between the attorney and client, was barred by a one-year statute of limitations.[178]

On appeal, the California Court of Appeal remarked that an attorney's "representation ends when the client actually has or reasonably should have no expectation that the attorney will provide further legal services."[179] Whether or not the representation has terminated "should be viewed objectively from the client's perspective."[180] The court held that the "two-year hiatus" when no legal services were required did not implicitly terminate the representation.[181] In reaching that conclusion, the court noted that the client had not consented to termination and that the attorney had not shown that he had completed all of the tasks for which he had been retained.[182] The court also remarked that the lower court retained jurisdiction over the settlement, that the client had obligations to make monthly payments under the settlement agreement, and that the attorney had remained counsel of record.[183] The court concluded that the attorney had continued to represent the client because the client could have reasonably supposed that the attorney would "represent her in the event of issues arising concerning the performance of the settlement."[184]

The Massachusetts Supreme Judicial Court has also relied upon an attorney's appearance as counsel of record in determining the scope of the representation. In *Global NAPs, Inc. v. Awiszus*, the client had lost an em-

174. *Id*. at 662.
175. *Id*. at 666.
176. *Id*.
177. *Id*. at 662.
178. *Id*. at 662–63.
179. *Id*. at 665–66.
180. *Id*. at 666.
181. *Id*. at 661.
182. *Id*. at 666.
183. *Id*.
184. *Id*.

ployment case.[185] After trial counsel filed post-trial motions, the client's general counsel apprised the trial attorneys that the client had retained appellate counsel and that they should assist appellate counsel as requested.[186] After the denial of post-trial motions, appellate counsel filed a notice of appeal (and evidently affixed trial counsel's signature to the notice, with permission).[187] The notice of appeal was deemed untimely, whereupon the client filed a malpractice action against trial and appellate counsel, alleging that the failure to timely file the notice foreclosed a viable appeal.[188]

On appeal, trial counsel argued that she played "an extremely limited role" in the post-trial representation and that the client's general counsel informed her that she should perform those tasks assigned to her by appellate counsel, which did not include any work pertaining to the filing of the notice of appeal.[189] The attorney also argued that a trial would be necessary to determine the scope of her legal representation.[190] The Supreme Judicial Court of Massachusetts rejected these arguments, observing that appellate counsel was permitted to place a facsimile of trial counsel's signature on the notice of appeal and that trial counsel did not withdraw from the case until after the notice of appeal had been filed.[191] The court suggested that an attorney who has entered an appearance will be presumed to continue the representation until the appearance on the record has been withdrawn.[192]

As *Laclette* and *Global NAPs* indicate, in the litigation context, an attorney's appearance as counsel of record provides courts with a bright line to determine whether an attorney's representation in a matter has terminated, although formal withdrawal from the case may not be necessary to terminate the representation for purposes of the continuing representation doctrine if the client acknowledges that the representation has terminated[193] or if there is evidence that the specific tasks for which the attorney was retained have concluded.[194]

When the representation relates to a transactional matter, courts will often consider the representation concluded when the agreement or document at issue has been drafted, even if the attorney subsequently performs legal work referencing the document. In *Mig, Inc. v. Paul, Weiss, Rifkind, Wharton & Gar-*

185. 930 N.E.2d 1262 (Mass. 2010).
186. *Id.* at 1266.
187. *Id.* at 1273.
188. *Id.* at 1265–65.
189. *Id.* at 1273.
190. *Id.*
191. *Id.*
192. *Id.*
193. *Laclette*, 109 Cal. Rptr. 3d at 666–67.
194. Truong v. Glasser, 103 Cal. Rptr. 3d 811, 822 (Cal. Ct. App. 2009).

rison, LLP,[195] for example, a law firm drafted a certificate of designation of a corporate client's preferred stock.[196] The law firm later submitted filings to the SEC on the client's behalf that referenced the certificate of designation, acted as general outside counsel, and performed work years later relating to the certificate of designation.[197] The Southern District of New York concluded that these activities did not give rise to a continuing representation as to the certificate of designation.[198] Neither the "oblique" references to the certificate in the SEC filings nor the firm's general activities as outside counsel to the client were enough to establish a continuing representation as to the certificate.[199] Although the court appears to have determined that the firm performed some subsequent work relating to the certificate years after it was drafted, this representation was held to be "intermittent," rather than continuing, because these subsequent services did not give rise to the inference that the firm and the client "had identified a legal problem or specific legal task that required continued legal services" when the certificate was drafted.[200]

B. *Res Judicata*

Res judicata renders a final judgment on the merits conclusive as to the rights of the parties and their privies and bars all subsequent actions involving the same claim, demand, or cause of action. Res judicata bars relitigation of all claims actually resolved in the prior suit, as well as any claims that could have been, but were not, asserted. A party seeking to invoke res judicata must prove three elements: (1) a final judgment on the merits rendered by a court of competent jurisdiction; (2) an identity of parties or their privies; and (3) an identity of causes of action.

In two recent cases, courts considered whether a fee award for an attorney against his former client bars, under the doctrine of res judicata, the former client from bringing a subsequent legal malpractice claim arising out of the services forming the basis of the fee award.[201] Those cases consistently held that the fee award did not necessarily bar the former client's subsequent legal malpractice claim against the attorney.[202] Res judicata precluded a malpractice claim only if the client was aware of his claim at the time the fee award was entered.[203]

195. 701 F. Supp. 2d 518 (S.D.N.Y. 2010).
196. *Id*. at 520.
197. *Id*. at 527–28.
198. *Id*. at 526–29.
199. *Id*. at 527–28.
200. *Id*. at 528–29.
201. Kasny v. Coonen and Roth, Ltd., 924 N.E.2d 1103 (Ill. App. Ct. 2009); Breslin Realty Dev. Corp. v. Shaw, 893 N.Y.S.2d 95, 100 (N.Y. App. Div. 2010).
202. *Kasny*, 924 N.E.2d at 1105; *Breslin*, 893 N.Y.S.2d at 101.
203. *Kasny*, 924 N.E.2d at 1105; *Breslin*, 893 N.Y.S.2d at 101.

In *Kasny v. Coonen and Roth, Ltd.*, the defendant attorney sued his former client in small claims court for attorney fees in connection with the defendant attorney's representation of the former client in the dissolution of his marriage.[204] The former client failed to appear or defend the claims, and a default judgment was entered in the defendant attorney's favor.[205]

Thereafter, the former client sued the defendant attorney, alleging that he committed legal malpractice in connection with his representation.[206] The former client asserted that he was unaware of his legal malpractice claim until two months after the small claims case was resolved, when the malpractice attorney he contacted had adequately investigated his case.[207]

The Appellate Court of Illinois reversed the trial court and held that the defendant attorney failed to establish that the judgment for outstanding legal fees has res judicata effect on the former client's legal malpractice action.[208] The court held that an attorney fees claim and a client's legal malpractice claim are the same cause of action, such that a malpractice counterclaim ordinarily is mandatory when an attorney asserts a fee claim.[209] Nevertheless, the court held that res judicata does not necessarily apply to bar the former client's legal malpractice claim.[210] The court noted that the doctrine precludes only those claims that could have been raised by the exercise of due diligence.[211] Therefore, if a legal malpractice claim exists at the time of the prior proceeding, but the litigant does not discover it despite his due diligence, res judicata does not apply.[212]

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204. *Kasny*, 924 N.E.2d at 1105.
205. *Id.*
206. The former client originally asserted claims for breach of contract and legal malpractice. *Id.* at 1105. The district court dismissed with prejudice the breach of contract claim but dismissed without prejudice the legal malpractice claim. *Id.* The former client filed an amended complaint alleging that the defendant attorney committed malpractice in the following seven ways: (1) failed to appraise various marital assets and relied on inaccurate appraisals that the former client's ex-wife prepared; (2) failed to discover plaintiff's ex-wife's nonmarital assets and understand the impact that her nonmarital real property could have on a fair division of the marital property; (3) neglected to promptly and properly answer discovery; (4) allowed the dissolution case to continue for more than three years with little or no work done toward resolution; (5) violated discovery rules by failing to disclose expert witnesses who could testify about the value of various marital assets, which resulted in the former client's inability to proceed with trial; (6) failed to advise the former client that he could not proceed with a trial because of discovery violations; and (7) induced the former client to settle the case by telling him that appraisals were too expensive and would not alter the valuation of the property. *Id.* at 1105–06.
207. *Id.* at 1106.
208. *Id.* at 1106–09.
209. *Id.* at 1107.
210. *Kasny*, 924 N.E.2d at 1107.
211. *Id.*
212. *Id.*

The defendant attorney did not meet his burden of proving that the former client knew about, or through the exercise of due diligence, should have known about his legal malpractice claim and thus failed to establish the application of res judicata.[213] The court relied upon the former client's allegation that, through the exercise of due diligence, he could not have raised his malpractice claim as a counterclaim to the defendant attorney's fee claim.[214] The former client argued that he could not, and in fact did not, discover his malpractice claim until after consulting with an attorney experienced in legal malpractice matters and until that attorney had adequate time to investigate the potential claim.[215] The court determined that the entry of a default judgment in the fee claim suit was not evidence of the former client's lack of diligence in exploring his defenses.[216] The court noted that small claims proceedings are designed to be expedient and that the former client might have diligently investigated but determined that he simply had no defense to offer at that time.[217]

In contrast, in *Breslin Realty Development Corp. v. Shaw*, the Appellate Division of the New York Supreme Court held that pursuant to the res judicata doctrine, a final award of fees in a bankruptcy proceeding bars a subsequent malpractice claim based upon the services underlying the fee award where the clients were aware of their claims.[218] In *Breslin*, the defendant attorneys represented the plaintiff debtors in a Chapter 11 bankruptcy proceeding.[219] The Bankruptcy Court approved the defendant attorney fees award on December 31, 2003.[220] Thereafter, in a verified complaint dated March 18, 2005, the plaintiff debtors alleged malpractice which concerned, inter alia, a July 1999 agreement between the debtors and a third party.[221]

The defendant attorneys moved for summary judgment, arguing that the doctrine of res judicata barred the plaintiff debtors' claims because they

213. *Id*. at 1108.

214. *Id*.

215. *Id*. at 1108.

216. *Id*.

217. *Id*. The court went on to state "[t]o the extent he had any inkling of malpractice, he would not necessarily have been unreasonable for failing to rely on the prospect of small claims discovery, which he could not conduct as a matter of right, to flesh it out. While a small claims defendant cannot use the expediency of the proceeding as a shield if he has truly failed to be diligent, the small claims plaintiff cannot use it as a sword if the defendant, despite his diligence, is unable to marshal a counterclaim in time." *Id*. at 1108–09. The court did not address whether the former client's failure to appear in the fee claim precluded the application of the doctrine of res judicata because the former client did not make that argument. *Id*. at 1109.

218. 893 N.Y.S.2d at 100–01.

219. *Id*. at 97.

220. *Id*. at 99.

221. *Id*.

failed to object to the defendant attorneys' fee applications in the bankruptcy proceedings despite awareness of the alleged acts of malpractice.[222] To prove that the plaintiff debtors were aware of the alleged acts of malpractice, the defendant attorneys relied upon a letter dated January 29, 2003, written by counsel for a plaintiff debtor to his in-house counsel stating that the failure to object to a claim for professional fees in a bankruptcy proceeding barred a subsequent malpractice claim arising out of the services underlying the fee award.[223] Thus, the plaintiff debtor's counsel recommended that a detailed objection setting forth the alleged malpractice claims should be prepared.[224] The letter noted that the bankruptcy court's interpretation of the third party agreement that was the subject of the malpractice claim was not affirmed by the Second Circuit until January 23, 2003, and that the plaintiff debtors could explain their delay by claiming that their objections were premised on the Second Circuit's decision.[225] Further, the defendant attorneys pointed to a June 20, 2003, agreement, which was drafted in part by separate and independent counsel for the plaintiff debtors, whereby the plaintiff debtors agreed to pay the defendant attorneys $100,000 in final discharge of any obligation for legal fees "without prejudice to Client's or any of the Debtors' or partners of the Debtors' rights to pursue any claim against the Firm for acts of malpractice relating to" the bankruptcy proceedings.[226]

The appellate division held that the doctrines of res judicata and collateral estoppel barred the plaintiff debtors' legal malpractice claims.[227] The court relied upon state law and bankruptcy law to hold that the bankruptcy court's fee award bars the plaintiff debtors' subsequent legal malpractice claims.[228] Citing the June 2003 agreement, the appellate division found that the plaintiff debtors were aware of the factual basis of their malpractice claims at the time of the defendant attorneys' fee application and that they had ample opportunity to raise their malpractice claims as objections to the fee award.[229] The appeals court concluded that the bankruptcy court's final

222. *Id.* at 98.

223. *Id.* at 97.

224. *Id.*

225. *Id.* at 98.

226. *Breslin*, 893 N.Y.S.2d at 98.

227. *Id.* at 100. The appeals court held that the trial court erred in holding that the defendant attorneys were required to prove that the bankruptcy court had actually considered the particular acts of malpractice. *Id.* at 99.

228. *Breslin*, 893 N.Y.S.2d at 100. "Under New York State law, a determination fixing a defendant's fees in a prior action brought by the defendant against the plaintiff for fees for the same legal services which the plaintiff alleges were negligently performed, necessarily determines that there was no legal malpractice." *Id.* Further, the general rule in bankruptcy proceedings is that a finding of malpractice means that the attorneys are not entitled to compensation for those particular services found to be substandard. *Id.*

229. *Id.* at 101.

fee award was a determination on the merits that, under the doctrine of res judicata, bars the plaintiff debtors' subsequent malpractice claim based upon the services underlying the fee award.[230]

Neither decision considered whether the former client's failure to appear in the prior action leading to the fee award precluded the application of res judicata to bar the former client's subsequent legal malpractice claim. The *Kasny* court recognized that some authority suggests that res judicata does not apply where the former client fails to appear in the prior case that results in the fee award.[231] This was not mentioned at all in the *Bresny* decision, presumably because the plaintiff debtors did not make this argument. It will be interesting to see if or how the courts rule on this issue when it is properly raised.

230. *Id.*

231. 924 N.E.2d at 1109 n.1 (citing RESTATEMENT (SECOND) OF JUDGMENTS § 22, cmt. a, at 186 (1982) ("[e]ven in jurisdictions having a statute or rule making certain counterclaims compulsory, such provisions may not apply when no answer or other responsive pleading is filed") and RESTATEMENT (SECOND) OF JUDGMENTS § 22, Illustration 2, at 186 (1982) ("A, a physician brings an action against B for the price of medical services rendered to B. B fails to plead and judgment by default is given against him. B is not precluded from subsequently maintaining an action against A for malpractice relating to the services sued upon in the prior action")).

RECENT DEVELOPMENTS IN PROPERTY INSURANCE COVERAGE LITIGATION

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The survey period in property insurance law saw the emergence of a series of rulings involving coverage for damages caused by Chinese drywall. Cases involving Chinese drywall coverage, which are just beginning to work their way through the courts, will form a significant part of the property insurance landscape for the next few years. The cases raise common property insurance issues about causation, ensuing loss, and certain frequently litigated exclusions, but they raise those issues in unique and challenging ways that defy strict categorization in any of our common survey categories. The resulting complexity of these cases, along with their significance in the property insurance world, led us to highlight them at the beginning of this year's survey.

After reviewing the issues raised by Chinese drywall, we turn to developments in the more common issues that arise out of property insurance contracts. We begin our review by looking at significant developments in key areas of the risk transferred to the property insurer where disputes are frequent, namely the business interruption and collapse coverages. Then, we turn our focus to significant cases addressing what property is actually "covered" under the insurance contract, and then to notable cases dealing with the most common exclusions in the property insurance contract. Regular followers of this area of the law will observe that the survey period saw

some very interesting cases on the issue of "covered property." They will also note that those exclusions that usually rely heavily on fact-specific issues for their application, such as the exclusions for damage caused by earth movement or mold, continue to give rise to challenging cases that turn on a careful review of the facts, and that result in opinions that—while often thoughtful—defy easy categorization into clean rules of interpretation.

I. COVERAGE FOR CHINESE DRYWALL CLAIMS

In 2006 and 2007, the southeastern United States experienced an increase in new home construction and renovations. This increase was due, in large part, to the number of hurricanes that affected the region in 2004 and 2005. Homes that were totaled had to be rebuilt, and damaged homes had to be renovated. In addition, the United States was in a housing boom. Because of the unprecedented need for building materials, domestic drywall manufacturers were unable to keep up with the demand for drywall. This led suppliers, contractors, and builders to look for an alterative drywall source. Chinese drywall suppliers stepped in to meet the demand.

Shortly after installation of Chinese-produced drywall, some homeowners began to notice a "rotten egg" smell in their homes. Electronics and air-conditioning units in those homes began to fail for unknown reasons, and metal components began to blacken, pit, and corrode.

The U.S. Consumer Product Safety Commission ("CPSC") received its first report of a possible Chinese drywall incident from a consumer on December 22, 2008. As of December 16, 2010, the CPSC had received about 3,756 reports from residents in forty-one states, the District of Columbia, American Samoa, and Puerto Rico who believe their health symptoms or the corrosion of certain metal components in their homes are related to the presence of drywall produced in China.[1]

Testing of suspected Chinese drywall has confirmed that sulfur compounds can be released from the drywall and cause corrosion to metal components within homes.[2]

Many homeowners that suspected damage from Chinese drywall made claims with the insurer that wrote their homeowners' insurance. Typically, those insurers have denied coverage, relying on policy exclusions for latent defect, corrosion, faulty materials, and pollutants. A typical homeowner's policy incorporates the following exclusions:

1. *Where Has Problem Drywall Been Reported?*, U.S. Consumer Prod. Safety Comm'n, Drywall Info. Ctr., http://www.cpsc.gov/info/drywall/where.html (last visited Dec. 20, 2010).

2. *Executive Summary of April 2, 2010, Release*, U.S. Consumer Prod. Safety Comm'n, Drywall Info. Ctr., http://www.cpsc.gov/info/drywall/execsum0410.pdf.

SECTION I—PERILS INSURED AGAINST

* * *

COVERAGE A—DWELLING and COVERAGE B—OTHER STRUCTURES

We insure against risk of direct loss to property described in Coverages A and B only if that loss is a physical loss to property. We do not insure, however, for loss:

* * *

2. Caused by:
   e. Any of the following:
      (2) Inherent vice, latent defect, mechanical breakdown;
      (3) Smog, rust or other corrosion, mold, wet or dry rot;
      * * *
      (5) Discharge, dispersal, seepage, migration, release or escape of pollutants unless the discharge, dispersal, seepage, migration, release or escape is itself caused by a Peril Insured Against Under Coverage C of this policy. Pollutants means any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste. Waste includes materials to be recycled, reconditioned or reclaimed;

* * *

3. Excluded under Section I–Exclusions

   Under items 1. and 2., any ensuing loss to property described in Coverages A and B not excluded or excepted in this policy is covered.

* * *

SECTION I—EXCLUSIONS

2. We do not insure for loss to property described in Coverages A and B caused by any of the following. However, any ensuing loss to property described in Coverages A and B not excluded or excepted in this policy is covered.

* * *

   c. Faulty, inadequate or defective:
      (3) Materials used in repair, construction, renovation or remodeling;

   of part or all of any property whether on or off the "residence premises."[3]

3. Insurance Services Office Form No. HO 00 03 04 91.

Those claim denials resulted in homeowners filing suit against their carriers for breach of contract. In some cases, insurers have filed declaratory judgment actions, asking courts to determine whether coverage exists under their insurance policy. Several lawsuits filed by homeowners against their insurers are part of the multidistrict litigation ("MDL") currently pending in the U.S. District Court for the Eastern District of Louisiana.[4] In response to these lawsuits, several insurers filed motions to dismiss and for judgment on the pleadings. These motions address the application of exclusionary language similar to that cited above. In addition, two Louisiana state courts and a Virginia federal district court have ruled on Chinese drywall coverage issues under first-party homeowner's policies.

A. *Finger v. Audubon Insurance Co.*

On March 22, 2010, a trial court sitting in the Civil District Court for Orleans Parish, Louisiana, issued the first decision regarding a Chinese drywall claim under a property policy in *Finger v. Audubon Insurance Co.*[5] The decision arose in the context of the insureds' motion to strike several affirmative defenses asserted by the insurer. The court granted the insureds' motion to strike defenses based on the exclusions for pollutants, "gradual or sudden loss" (which included inherent vice, latent defect, and corrosion), and "faulty, inadequate or defective planning" (which included faulty materials). It analyzed the key exclusions applicable to a claim for Chinese drywall and concluded that those exclusions do not bar coverage for a claim for Chinese drywall.[6] The court did not address whether the Chinese drywall itself sustained direct or physical loss, although it quoted testimony of the insurer's corporate representative that the drywall itself was not damaged directly or indirectly.[7] The court also expressly stated that its decision did not address the question of whether the claim was covered as an "ensuing loss," leaving that issue for another day.[8]

B. *Ross v. C. Adams Construction & Design, LLC*

On April 14, 2010, a Louisiana trial court in neighboring Jefferson Parish reached the opposite conclusion in *Ross v. C. Adams Construction & Design, L.L.C.*[9] That court denied the insureds' motion for partial summary judgment against its homeowners' insurer, Louisiana Citizens Property

4. *In re* Chinese-Manufactured Drywall Prods. Liab. Litig., 706 F. Supp. 2d 655, 2010 WL 5288032 (E.D. La. 2010).
5. No. 2009-08071, 2010 WL 1222273 (La. Civ. Dist. Ct. Mar. 22, 2010).
6. *Id.* at *4–9.
7. *Id.* at *7.
8. *Id.* at *9.
9. No. 676-185, 2010 WL 2916525 (La. Civ. Dist. Ct. Apr. 14, 2010).

Insurance Company, and granted the insurer's cross-motion for summary judgment. Although the judgment itself does not reflect the basis of the court's ruling, the documents filed by the parties in support of their motions and the hearing transcript shed light on the arguments presented to the court.

The insureds argued that the exclusions from coverage for losses caused by pollution, faulty workmanship and defective materials, and corrosion should not apply to preclude coverage for their claim.[10] The insurer requested judgment in its favor on all claims against it, and argued that (1) the insureds' policy provided no coverage for the cost of removing and replacing the Chinese drywall because the drywall had sustained no direct physical loss, and coverage for any loss caused by the defects in the drywall was barred by the exclusions for latent defect, defective materials, corrosion, and pollutants, and (2) the insureds' policy provided no coverage for any damage caused by the drywall or by the discharge of gases from the drywall.[11] The court apparently agreed with the insurer's arguments when it entered judgment in favor of the insurer—in direct conflict with the conclusions reached by the *Finger* court in neighboring Orleans Parish.

The insureds have appealed the trial court's ruling to the Louisiana Court of Appeal. At this writing, each side has filed its respective briefs, but no ruling has been issued.[12]

C. *TRAVCO Insurance Co. v. Ward*

The third significant opinion on Chinese drywall coverage came from the U.S. District Court for the Eastern District of Virginia in *TRAVCO Insurance Co. v. Ward*.[13] In a lengthy opinion, that court granted summary judgment to an insurer that had denied a homeowner's claim. Although the court found that the insured's "residence and its components" had suffered a "direct physical loss"[14] under the policy, the policy's exclusions for latent defect, faulty materials, corrosion, and pollutants applied to preclude coverage for the claimed losses. The court rejected the insured's arguments, including its reliance on the *Finger* decision, that none of the policy exclusions applied, and noted that *Finger* was in conflict with the *Ross* decision.

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10. Plaintiffs' Mem. Supp. Mot. Partial Summ. J., Ross v. C. Adams Constr. & Design, L.L.C., No. 676-185, 2010 WL 2520773 (La. Civ. Dist. Ct. filed Jan. 15, 2010).

11. Defandants' Mem. Supp. Cross-Mot. Summ. J. & Opp. Mot. Partial Summ. J., Ross v. C. Adams Constr. & Design, L.L.C., No. 676-185, 2010 WL 2520774 (La. Civ. Dist. Ct. filed Mar. 19, 2010).

12. Original Brief of Plaintiffs-Appellants, Ross v. C. Adams Constr. & Design, L.L.C., No. 10-CA-852, 2010 WL 5015507 (La. Ct. App. filed Nov. 17, 2010); Original Brief of Defendant-Appellee, Ross v. C. Adams Constr. & Design, L.L.C., No. 10-CA-852, 2010 WL 5199349 (La. Ct. App. filed Dec. 6, 2010).

13. 715 F. Supp. 2d 699 (E.D. Va. 2010).

14. *Id.* at 701.

The court addressed individual exclusions in the policy, and assessed whether each one barred individual components of the insured's claim. Specifically, the court concluded that the policy did not cover (1) the cost of removing and/or replacing the drywall in the insured's residence; (2) the corrosion damage claimed by the insured to his air-conditioning equipment, garage door, and flat-screen televisions, and (3) any of the damages caused by the discharge of gas from the drywall, including but not limited to insured's presently claimed damages to the wiring and copper components of the home. The court found none of the claimed losses to be ensuing losses, stating "only a single claimed loss," the off-gassing of defective Chinese drywall, occurred.[15] The court also noted that even if the losses could be characterized as "ensuing losses," they would still be excluded by other provisions of the policy.[16] The court also, however, expressly stated that it would not "categorically rule out the possibility, however, that other unclaimed losses might be subject to coverage" under the ensuing loss provisions of the policy.[17]

Following the court's ruling, the insured appealed to the U.S. Court of Appeals for the Fourth Circuit. At this writing, each side has filed its respective briefs, but no ruling has been issued.[18]

D. *In re Chinese Manufactured Drywall: Products Liability Litigation*

On December 16, 2010, the MDL court issued its much-anticipated ruling on motions to dismiss filed by homeowners insurers on multiple coverage issues related to Chinese drywall.[19] Ruling for the insureds on the issue of "direct physical loss," the court found that the

> Chinese-manufactured drywall has caused a "distinct, demonstrable, physical alteration" of the Plaintiffs' homes by corroding the silver and copper elements in the homes, often to the point of causing total or partial failure in electrical wiring and devices installed in the homes, as well as by emitting odorous gases.[20]

While the mere presence of a potentially injurious material in a home might not qualify as a covered physical loss, the court found a physical

15. *Id*. at 718–19.
16. *Id*. at 719.
17. *Id*. at 707.
18. Brief of Plaintiff-Appellee, Travco Ins. Co. v. Ward, No. 10-1710, 2010 WL 3866762 (4th Cir. filed Oct. 4, 2010); Reply Brief of Appellant, Travco Ins. Co. v. Ward, No. 10-1710, 2010 WL 2010 WL 4064943 (4th Cir. filed Oct. 18, 2010).
19. *In re* Chinese Manufactured Drywall Prods. Liab. Litig., No. 09-MDL-2047, 2010 WL 5288032 (E.D. La. Dec. 16, 2010).
20. *Id*. at *6.

loss when such materials were activated, for example, by releasing gases or fibers.[21] Finally, the court found that the drywall rendered the homes useless and/or uninhabitable due to the damage to the electrical wiring, appliances, and devices, as well as the ever-present sulfur gases, thus constituting physical loss.[22]

Turning to exclusions, the court first found that the "latent defect" exclusion did not bar coverage. Under Louisiana law, the term "latent defect" was " 'a defect that is hidden or concealed from knowledge as well as from sight and which a reasonable customary inspection would not reveal.' "[23] The court rejected *Finger* because that "court commingled its analysis of the inherent vice exclusion and latent defect exclusion."[24] It declined to follow *TRAVCO* because Virginia law and Louisiana law defined "latent defect" differently.[25] The court found that the test for a latent defect focused on the cause "of the underlying defect, and not the results of the defect."[26] Under this test, the exclusion was inapplicable because "the damage caused by the drywall—the odor, the blackened wires and metals—are easily detectable through smell and sight" and because "a skilled worker such as an electrician, would immediately recognize the damage to electrical wiring, devices, and appliances."[27]

Next, relying almost exclusively on the Louisiana Supreme Court's decision in *Doerr v. Mobil Oil Corp.*,[28] the MDL court held that the exclusions for pollution or contamination did not apply.[29] The homeowners were not "polluters," as required by *Doerr*, because "Plaintiffs, who are home owners and occupants, do not constitute polluters under any sense of the word."[30]

Nevertheless, the court held that the faulty materials exclusion barred coverage. The court declined to follow *Finger* because "*Finger* failed to provide an explanation as to how it came to define faulty materials, only citing conclusions reached in the plaintiff's own memorandum and testimony, and the testimony of the insurer's corporate representative."[31] The drywall constituted "faulty materials" because "[a]lthough the drywall serves its intended purpose as a room divider, wall anchor, and insulator, the al-

21. *Id.* at *5.
22. *Id.*
23. *Id.* at *10 (quoting Nida v. State Farm Fire & Cas. Co., 454 So. 2d 328, 335 (La. Ct. App. 1984)).
24. *Id.*
25. *Id.* at *11.
26. *Id.* at *12.
27. *Id.*
28. 774 So. 2d 119, 135–36 (La. 2000).
29. *In re* Chinese-Manufactured Drywall, 2010 WL 5288032, at *12–17.
30. *Id.* at *16.
31. *Id.* at *19.

legations in the complaints provide that the drywall emits foul-smelling odors and releases gases which damage silver and copper components in the home, including electrical devices, appliances, and wiring."[32]

The exclusion for corrosion further barred coverage. The court found that "under a 'plain, ordinary and generally prevailing meaning,' corrosion is defined as 'the action, process, or effect of corroding' and 'a product of corroding.'"[33] The complaints' allegations "that the Chinese drywall in the Plaintiffs' homes emits gases which cause corrosion to metallic and electrical components in the home . . . trigger[ed] the corrosion exclusion since the corrosion is responsible for the majority of losses suffered by the Plaintiffs."[34]

Since all of the insurers, except Allstate, provided coverage for ensuing losses from faulty materials and corrosion, the court analyzed the ensuing loss provision and found that there was no ensuing loss from the faulty materials or corrosion and granted all of the insurer's motions to dismiss. The court also found that the corrosion-related losses caused by Chinese drywall did not constitute ensuing losses but "even assuming that the corrosion or corrosion-caused losses due to the Chinese drywall in Plaintiffs' homes were ensuing or resulting losses, they remain excluded losses because, as discussed above, corrosion and corrosion-related losses are specifically excluded from coverage."[35]

II. BUSINESS INTERRUPTION/CIVIL AUTHORITY

In the wake of Hurricane Katrina, several courts have addressed "experience of the business" clauses and the extent to which actual post-interruption profits should be taken into account in calculating a loss. In *Caitlin Syndicate Ltd. v. Imperial Palace of Mississippi, Inc.*,[36] the court concluded that only historical sales figures should be considered under a clause requiring that the "experience of the business before the loss and the probable experience thereafter had no loss occurred" be considered. In that case, the insured casino had increased revenues following the hurricane as other local casinos were shut down for a longer period, thus driving customers to the insured's facility. The insured unsuccessfully argued that the business income loss should be based on a hypothetical in which Katrina struck but did not damage the insured's facilities—not one in which the hurricane

32. *Id.*
33. *Id.* at *20.
34. *Id.* at *21.
35. *Id.* at *25.
36. 600 F.3d 511, 516 (5th Cir. 2010).

did not strike at all. Construing different policy language, a federal court sitting in Louisiana held that an insured could take into account favorable economic conditions after the loss where the subject policy excluded consideration of "favorable business conditions caused by the impact of the Covered Cause of Loss on customers or on other businesses" to the extent that the favorable conditions were caused by flood, which was excluded from coverage.[37]

Where the term "business income" was defined to include "net income" and "continuing normal operating expenses incurred, including payroll," a California appellate court ruled that a business income provision provided coverage for both items without the insured having to offset one against the other.[38] The court reasoned that there was nothing in the policy language to suggest that where, as under the facts presented, the insured business was not operating at a profit, the insured should not expect coverage for its continuing expenses.[39]

III. COLLAPSE

Two interesting cases during the survey period focused on whether partial damage to an insured building fell within a property policy's coverage for "collapse." First, in *Middlesex Mutual Assurance Co. v. Puerta de la Esperanza*,[40] a federal court in Massachusetts held that the collapse of one brick pier in a building that did not render any area of the building inaccessible was a covered "collapse." In granting the insured's motion for summary judgment, the court rejected the insurer's argument that the use of the word "part" in the policy's definition of "collapse" required that an area of the building, and not just one structural piece of the building like the brick pier, suffer a "collapse" in order for coverage to be triggered.[41] Additionally, the Eastern District of Missouri considered whether the failure of brick veneer on the outside of an apartment building was a "collapse" or the result of excluded wear and tear or faulty design in *Council Tower Ass'n v. Axis Specialty Insurance Co*.[42] Rejecting the policyholder's argument that the failure of the wall was a "collapse" and granting summary judgment to the insurer, that court held that the failure of the veneer did not impair

37. Berk-Cohen Assocs., LLC v. Landmark Am. Ins. Co., No. 07-9205, 2010 WL 3522959, at *4–5 (E.D. La. Sept. 1, 2010).

38. Amerigraphics, Inc. v. Mercury Cas. Co., 107 Cal. Rptr. 3d 307, 318–20 (Ct. App. 2010).

39. *Id*. at 320.

40. No. 09-30156, 2010 WL 2639859 (D. Mass. 2010).

41. *Id*. at *3.

42. No. 08-1605, 2009 WL 3806994 (E.D. Mo. Nov. 12, 2009).

the structural integrity of the building and, therefore, was not within the policy's grant of coverage.[43]

IV. COVERED PROPERTY

In *Italian Designer Import Outlet, Inc. v. New York Central Mutual Fire Insurance Co.*,[44] a New York trial court held that covered "business personal property" was not limited to items owned by the insured, but also included merchandise held for sale by the insured under a consignment agreement. The insured was a men's clothing retailer, with some of its inventory supplied under a consignment agreement, and the rest was owned by the insured outright.[45] The policy provided: "We cover your business personal property in the described buildings."[46] While the policy further excluded personal property owned by others, it also specified that business personal property included the insured's "interest in personal property of others to the extent of your labor, material and services."[47] Reasoning that the definition of business personal property was ambiguous, the court construed the term in favor of coverage.[48]

Similarly, in *Snider v. American Family Mutual Insurance Co.*,[49] a Kansas appellate court held that, because a policy's definition of "contractors' equipment" was ambiguous, air-conditioner condensers used by a heating and cooling specialist were covered property. The policy defined "contractors' equipment" as "machinery, equipment, and tools of a mobile nature that 'you' use in 'your' contracting, installation, erection, repair, or moving operations or projects."[50] The insurer argued that the condensers were not covered since they were not of a "mobile nature." In rejecting the insurer's contention, the court held that the policy language was ambiguous. The court reasoned that it was unclear whether the phrase "of a mobile nature" modified only the term "tools," or also the terms "machinery" and "equipment." Given the ambiguity, the court concluded the compressors were covered as contractors' equipment.[51]

In *Porco v. Lexington Insurance Co.*,[52] a New York federal court held that a swimming pool was covered under the more limited Coverage B for "other

43. *Id.* at *6.
44. 891 N.Y.S.2d 260, 267–68 (Sup. Ct. 2009).
45. *Id.* at 262.
46. *Id.* at 263.
47. *Id.* at 264.
48. *Id.* at 267–68.
49. No. 101,202, 2009 WL 2902588 (Kan. Ct. App. Sept. 4, 2009).
50. *Id.* at *7.
51. *Id.* at *12.
52. 679 F. Supp. 2d 432, 441, 433 (S.D.N.Y. 2009).

structures" rather than under Coverage A for the "dwelling and other structures attached thereto." The court rejected the insured's contention that the pool was attached to the dwelling via a deck, five steps, and the filtration system.[53]

In *Gieringer v. Cincinnati Insurance Cos.*,[54] a Tennessee federal court held that since a provision in a policy renewal notice reducing coverage for personal property not situated in the residence was not sufficient to notify the insureds of the reduction in coverage, the broader coverage of the original policy applied. Moreover, the court held that the original policy, which contained an exception to the $1,000 cap for personal property not in the residence, was ambiguous. Accordingly, the court declined to exclude coverage as a matter of law for personal property moved to the new residence between March 2007 and January 2008, before being destroyed by fire later in January.[55]

V. EXCLUSIONS

A. *Causation*

In *Douzart v. Balboa Insurance Co.*,[56] the policyholders' claim for the loss of their home following Hurricane Katrina was denied by the insurer based on the insurance policy's exclusions for windstorm and flood. The policyholders filed suit in Mississippi federal court, and the insurer moved for summary judgment based on those exclusions. The policyholders contended that the loss of their home fell within an exception to the policy's exclusion for an "explosion that resulted from windstorm."[57] The policyholders submitted an expert report in support of their claim that an explosion caused the destruction of their home. The district court denied the insurer's motion, finding that there were genuine issues of material fact whether all or part of the damage to the home was caused by an explosion. Further, there were genuine issues of material fact as to whether the insurer had a legitimate basis to deny the claim. The Fifth Circuit Court of Appeals affirmed, and also agreed with the district court that the bad faith claim could proceed.

In *Friedberg v. Chubb & Son, Inc.*,[58] the policyholders sued their homeowner's insurer after the insurer denied their claim for water damage

53. *Id.* at 438. *See also* Axis Surplus Ins. Co. v. Lebanon Hardboard, LLC[0], No. 07–292, 2007 WL 3171247, at *2 (D. Or. Oct. 24, 2007) (structure, which insured was dismantling and had been removed from list of covered buildings, remained a building and was therefore not instead covered as business personal property).

54. No. 08-267, 2010 WL 1050201, at *6 (E.D. Tenn. Mar. 22, 2010).

55. *Id.* at *7.

56. 367 F. App'x 563 (5th Cir. 2010).

57. *Id.* at 565.

58. No. 08-6476, 2010 WL 1286082 (D. Minn. Mar. 30, 2010).

under the policy's exclusion for rot, mold, and construction defects. The policyholders discovered water intrusion through the Dryvit cladding on the exterior of the house. The insurer's expert determined the damage was caused by the failure to properly install control joints during the original construction and had been accumulating over a period of years. The policyholders' motion for summary judgment argued that the loss was the result of covered water intrusion or, in the alternative, was a covered ensuing loss. The trial court noted that Minnesota law provides that if there are multiple causes of a loss, the policyholder may recover so long as the overriding cause is not excluded. The trial court found that there was conflicting evidence as to whether the overriding cause was poor construction, water intrusion, or both; therefore summary judgment was denied.

In *Travelers Property Casualty Co. of America v. Marion T, LLC*,[59] a fire occurred at the factory the insured had bought seven months before. The insured claimed the fire damaged a power supply used to heat and cool the facility that had been shut down, disassembled, and drained before the fire. At the time of the fire, though, the equipment could have been used if it had been reassembled.

The parties could not agree on the amount of the loss and the claim went to appraisal. During the appraisal, the insurer filed an action for declaratory judgment. The final appraisers' report provided a figure for the actual cash value of the disputed loss that consisted of the insured's claims of damage to eighty-four pieces of mechanical equipment. The insurer disputed whether any damage that might have occurred to these items was covered by the policy. The insured did not allege that fire damaged the equipment, but argued that the inability to operate the equipment following the fire's destruction of the power source had caused the equipment to sustain damage from nonuse.[60]

The insurer sought summary judgment on the ground that it owed nothing further as no direct physical loss or damage occurred to the mechanical equipment. Further, it argued that any damage that may have occurred was the result of excluded rust or corrosion. The insured claimed that the insurer was estopped from asserting the rust and corrosion exclusion and that the delay in adjusting the insurance claim damaged the equipment from nonuse.[61]

The trial court granted summary judgment to the insurer, finding that there was no evidence of direct physical loss or damage to seventy-six of the eighty-four pieces of equipment. Further, the only evidence of damage

59. No. 07-1384, 2010 WL 1936165 (S.D. Ind. May 12, 2010).
60. *Id*. at *4.
61. *Id*.

to the remaining eight pieces was evidence of rust or corrosion, both of which were unambiguously excluded from coverage.[62]

B. *Earth Movement*

In two significant cases during the survey period, state appellate courts applied the exclusion for damage caused by earth movement to bar coverage for insured homeowners' claims in unique factual circumstances. In *Walker v. Beasley*,[63] the insureds' house was built—unknown to them—on land that had not been properly filled with soil, but was instead filled with "timber and other debris."[64] After cracks appeared in the house's foundation, the insurer denied the homeowners' claim, contending that the cracks were the result of excluded "settling" or earth movement. The trial court agreed with the insurer, rejecting the insureds' argument that the settling of their house was "so excessive and extraordinary that it is more accurate to refer to it as [covered] collapse" than settling.[65] A Tennessee appellate court affirmed, relying on the insurer's own expert who had opined that the damage resulted from settling of the foundation, and holding that "certainly the settling was excessive, but it was settling nonetheless."[66] In *Liebel v. Nationwide Insurance Co. of Florida*,[67] a Florida appellate court upheld a trial court's ruling that damage to a foundation resulting from soil erosion caused by a broken water line was excluded "earth movement," but very interestingly remanded the case for a determination of whether the cost to tear out the foundation to replace the broken pipe would be covered.

C. *Vacancy*

In *Saffold v. Allstate Indemnity Co.*,[68] the policyholder sued his insurer after it failed to pay an insurance claim stemming from a fire at his rental property. The insurer had denied the claim under the policy's vacancy exclusion after an investigation determined that the fire was intentionally set and that the rental tenant had ceased residing at the property over ten months before the fire occurred. The insurer brought a motion for summary judgment, finding that the insured was not entitled to coverage under the policy's vacancy exclusion because the property had been vacant for a period of ninety days or more before the loss. The court granted the motion for summary judgment, noting that the insured's tenant had moved

62. *Id.* at *5.
63. No. W2009-00118-COA-R3-CV, 2009 WL 4801480 (Tenn. Ct. App. Dec. 15, 2009).
64. *Id.* at *1.
65. *Id.* at *3.
66. *Id.*
67. 22 So. 3d 111, 117 (Fla. Dist. Ct. App. 2009).
68. No. 08-1023, 2009 WL 3326934 (M.D. Ala. Oct. 14, 2009).

out more than ten months prior to the fire. Further, the court found that while affidavits in the record claimed that neighbors personally viewed people coming and going from the property on a regular basis, there was nothing in the record to establish whether those persons actually resided at the property.[69] The court also noted that upon seeing the property two months after the fire, the insured himself stated that the property appeared to be vacant and devoid of furnishings.[70]

In *Hollis v. Travelers Indemnity Co. of Connecticut*,[71] a commercial property insurer denied a water damage claim under the vacancy exclusion in the policy. The insurer asserted that under the terms of the vacancy exclusion, the property was vacant for more than sixty consecutive days before the loss because the insured's commercial tenants were no longer using or renting thirty-one percent or more of the total square footage of the building for customary operations, as required by the policy.[72] The insured filed suit against the insurer for breach of contract and bad faith, asserting that the policy's vacancy exclusion should be interpreted as of the time the policy is issued, that the insurer's calculation of square footage was incorrect, and that the tenant's customary operations included subleasing space in the building to others.[73] The court granted the insurer's motion for summary judgment based on the vacancy exclusion, finding that the relevant time period for determining when the building was vacant was at the time of the loss, not when the policy was issued, and that the building's tenants were using less than thirty-one percent of the building for customary operations for more than sixty days before the water leak.[74] Moreover, the court found that the fact a former tenant left valueless materials and equipment in the building after vacating it did not amount to customary operations.[75]

In *West American Insurance Co. v. Hernandez*,[76] an insurer denied coverage for a claim related to an arson fire loss pursuant to the vacancy exclusion in the policy that excluded coverage for losses caused by vandalism or malicious mischief where the property is vacant for more than sixty consecutive days prior to the loss. The insurer also filed suit, seeking a declaratory judgment that (1) it was not obligated to pay because the loss was excluded under the vacancy exclusion because the property was vacant for more than sixty days and arson is a form of vandalism or malicious

69. *Id*. at *1.
70. *Id*.
71. No. 08-2350, 2010 WL 1050991 (W.D. Tenn. Mar. 19, 2010).
72. *Id*. at *2.
73. *Id*. at *3.
74. *Id*. at *9.
75. *Id*.
76. 669 F. Supp. 2d 1211 (D. Or. 2009).

mischief excluded under the exclusion; (2) it was not obligated to pay the loss because the insureds set or conspired to set the fire; and (3) it was not obligated to pay because the insured failed to inform it of a change in ownership.[77] Both parties brought cross motions for summary judgment on the three issues, including the applicability of the vacancy exclusion. The court granted the insured's motion and held that the property was not vacant as a matter of law, but found that issues of fact existed for the two remaining issues.[78] The court found that under Oregon law, the term "vacant" meant the property "contains substantially nothing."[79] Applying the Oregon definition, the court held the property was not "vacant" because an inventory submitted by the insured with the proof of loss to the insurer showed that the property, while not fully furnished, contained furniture, appliances, and personal items.[80]

D. *Dishonest Acts*

In *Elevators Mutual Insurance Co. v. J. Patrick O'Flaherty's, Inc.*,[81] the insurer sought to introduce evidence of the insured's conviction for arson and insurance fraud as proof of the insured's dishonest and criminal acts in a civil action regarding coverage for fire damage to the insured's restaurant. The court held that because the insured's conviction was the result of a plea of no contest, evidence of both the insured's plea of no contest and the resulting conviction were inadmissible pursuant to Ohio's criminal rules and rules of evidence.[82]

A federal court in Oklahoma in *American Commerce Insurance Co. v. Harris*[83] held that an insured's fraud or misrepresentation in a portion of his claim voided all coverage under the policy. The court noted that the public policy of Oklahoma's statute on fraudulent insurance claims would be frustrated if the insured were allowed to retain the insurance benefits he previously received after a vain attempt to defraud the insurer out of additional amounts.[84]

E. *Faulty Workmanship*

In *French Cuff, Ltd. v. Markel American Insurance Co.*,[85] the Eleventh Circuit found a latent defect exception to an exclusion for design defects ambigu-

77. *Id.* at 1213–14.
78. *Id.* at 1215.
79. *Id.* at 1217.
80. *Id.* at 1219.
81. 928 N.E.2d 685, 686 (Ohio 2010).
82. *Id.* at 687–88.
83. No. 07-423, 2009 WL 3233738, at *5 (E.D. Okla. Sept. 25, 2009).
84. *Id.*
85. 322 F. App'x 669 (11th Cir. 2009).

ous as applied to materials that were inappropriately used in the design of the insured vessel. The marine insurance policy excluded loss due to manufacturing or design defects, but included an exception to the exclusion for loss due to "any latent defect in the hull or machinery." The policy defined "latent defect" as a "flaw in the material." The insured claimed that its hull cracked because it was designed and manufactured with a foam core that was too thin or friable for use as a bulkhead core. It argued that the damage was caused by a covered "flaw in the material," rather than an excluded design defect. The court agreed, ruling that the phrase "flaw in the material" could reasonably apply to a flaw created as a result of inappropriate use of a material, as well as to material that is defective regardless of use.

In *Huntingdon Ridge Townhouse Homeowners Ass'n v. QBE Insurance Corp.*,[86] a Tennessee federal district court found that faulty workmanship and latent defect exclusions applied to an insured homeowners' association's claim for collapse coverage. While there was no dispute that the "collapse" was caused by defects in the construction, installation, and design of floor trusses, there was no coverage because the policy only covered collapse caused by use of defective materials or methods in construction if the collapse occurred during the course of construction. The policy also excluded coverage for any "latent defect . . . in the property that causes it to damage or destroy itself or for any faulty [or] defective . . . construction or" materials used in construction.[87]

In a case involving "street creep" damage to the insureds' driveway due to shrinkage and expansion of an adjoining municipal street, the Eighth Circuit affirmed a Nebraska federal court's holding that the faulty workmanship exclusion barred coverage without regard to the allegation that the faulty workmanship occurred off the insured premises.[88]

F. *Mold and Water Damage*

1. No Direct Physical Loss

In *Universal Image Productions, Inc. v. Chubb Corp.*,[89] heavy rainfall caused water to enter the policyholder's HVAC system. The policyholder argued that a covered peril, water seepage, "caused it to suffer a direct physical loss in the form of pervasive odor, mold and bacterial contamination."[90] The cleansing process also caused major disruption to the policyholder's busi-

86. No. 09-71, 2009 WL 4060458 (M.D. Tenn. Nov. 20, 2009).
87. *Id.* at *5.
88. Wurtele v. Cincinnati Ins. Co., 359 F. App'x 683, 684 (8th Cir. 2010), *aff'g* No. 07-340, 2009 WL 205057, at *4 (D. Neb. Jan. 27, 2009).
89. 703 F. Supp. 2d 705 (E.D. Mich. 2010).
90. *Id.* at 709.

ness. The insurance company, on the other hand, argued that there was no physical loss because the contaminant did not alter the structural integrity of the property.[91] The court agreed and granted summary judgment to the insurance company because the mold and odors did not cause structural or tangible damage to the insured property.[92] The court also found no evidence that the entire premises were uninhabitable. Although the court noted that the finding that there was no physical loss made it unnecessary to address other exclusions, the court also granted summary judgment to the insurance company with regard to concurrent causes of loss.[93]

2. Ensuing Loss

The issue of whether water damage or faulty construction was the overriding cause of damage arose in *Friedberg v. Chubb & Son, Inc*.[94] The policyholders filed a claim for damage when water intruded through the Dryvit on the exterior of their home and caused damage to the home's wood framing and insulation as well as rot and mold. The insurance company argued that the faulty workmanship, rot, and mold exclusions barred coverage.[95] The policyholders argued that the overriding cause of the loss was water damage, a covered peril, and, even if coverage was excluded, the ensuing loss provisions provided an exception to the exclusions. The court found that there was not enough information to decide the overriding cause of the loss and denied summary judgment.[96] The court also found that a determination of the cause of the loss was necessary before it could determine if the ensuing loss provisions applied.[97]

The importance of factual findings regarding causation is also highlighted by *TMW Enterprises, Inc., v. Federal Insurance Co.*,[98] in which the Sixth Circuit reversed in part the district court's grant of summary judgment in favor of the insurance company. The court remanded for further proceedings to allow the policyholder to seek coverage for any losses not proximately caused by faulty workmanship. The court held that, "[w]hile the faulty workmanship exclusion applies to loss or damage 'caused by or resulting from' the construction defect, the 'ensuing loss' provision clarifies that the insurance company could not use the exclusion to avoid coverage for losses remotely traceable to an excluded cause."[99]

91. *Id*.
92. *Id*. at 710.
93. *Id*. at 714.
94. No. 08-6476, 2010 WL 1286082 (D. Minn. Mar. 30, 2010).
95. *Id*. at *4.
96. *Id*.
97. *Id*.
98. 619 F.3d 574 (6th Cir. 2010).
99. *Id*. at 579.

3. Anti-Concurrent Causation

Mold exclusions frequently include "anti-concurrent causation" clauses that preclude coverage. For example, in *Builders Mutual Insurance Co. v. Glascarr Properties*,[100] the mold exclusion was prefaced by language stating that "[w]e will not pay for a 'loss' *caused directly or indirectly by* any of the following. Such 'loss' is excluded *regardless of any other cause or event that contributes concurrently or in sequence to the 'loss'*."[101] When vandals broke into the house and left water taps running, the insurance company paid for the water damage but not for mold remediation.[102] The insurance company argued, among other things, that the anti-concurrent causation clause excluded losses caused by mold. The policyholder argued that, because the policy covers claims arising from vandalism, it also covers losses caused by mold, since the mold was caused by the vandalism. The court found in favor of the insurance company based on the anti-concurrent causation clause. Other interesting cases on this issue during the survey period include *Colella v. State Farm Fire & Casualty Co.*[103] and *Pisano v. Nationwide Mutual Fire Insurance Co.*,[104] each of which applied an exclusion containing an anti-concurrent causation clause.

4. Insured's Knowledge of Prior Water Damage

In *Williams v. Pekin Insurance Co.*,[105] the policy contained an endorsement for "Limited Fungi, Wet or Dry Rot, or Bacteria Coverage," which precluded coverage for loss that was

> [c]aused by constant or repeated seepage or leakage of water or the presence of condensation of humidity, moisture or vapor, over a period of weeks, months or years *unless* such seepage or leakage of water or the presence or condensation of humidity, moisture or vapor and the resulting damage is unknown to all "insureds" and is hidden within the walls or ceilings or beneath the floors or above the ceilings of a structure.[106]

The court agreed with the trial court's holding that this policy language required the homeowner to show that "(1) water seepage or leakage or the presence of humidity, moisture or vapor is unknown to the homeowner; and (2) the resulting damage is unknown and the damage is

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100. 688 S.E.2d 508 (N.C. Ct. App. 2010).
101. *Id.* at 510.
102. *Id.* at 512.
103. No. 09-2221, 2010 WL 1254318 (E.D. Pa. Mar. 30, 2010).
104. No. 08-2524, 2009 WL 3415278 (E.D. Pa. Oct. 21, 2009).
105. No. 09-0799, 2009 WL 4842468 (Iowa Ct. App. Dec. 17, 2009).
106. *Id.* at *1.

hidden within the walls, ceiling, or floors."[107] In other words, the court interpreted the "lack of knowledge" requirement to refer not only to the resulting damage but also to the water seepage itself. In this case, the policyholder did not dispute that she was aware of the flooding that occurred in her basement.[108] In fact, when she had made the earlier claim for the damage, the same insurance company had paid her the limit under the endorsement for "Water Back-up of Sewers or Drains."[109] The court held, however, that coverage for the resulting mold damage was properly denied because the policyholder knew about the source of the damage.[110]

VI. DAMAGES

A. *Hold Back*

In *Buckley Towers Condominium, Inc. v. QBE Insurance Corp.*,[111] the Eleventh Circuit refused to apply the doctrine of "prevention of performance" when it reversed the trial court's award of replacement cost value for damaged property. While it would have been costly, inconvenient, and most certainly a hardship for the insured condominium association to pay for millions of dollars in repairs without receipt of insurance proceeds, the Eleventh Circuit stated that the hardship would not excuse the contractual requirement to actually repair the property before replacement cost value damages could be awarded.[112]

B. *Overhead and Profit*

In companion class action suits filed in Arkansas, national class plaintiffs alleged that insurance companies had conspired to deprive insureds of payments reflecting contractors' overhead and profit.[113] Because the named class plaintiffs had been removed from the cases, the insurers moved to dismiss, arguing that the remaining class members had no standing. The Arkansas Supreme Court rejected the insurers' argument, finding that standing was not a prerequisite for subject matter jurisdiction under Ar-

107. *Id.* at *2.
108. *Id.* at *3.
109. *Id.* at *1.
110. *Id.* at *3.
111. No. 09-13247, 2010 WL 3551609 (11th Cir. Sept. 14, 2010).
112. *See also* Vakas v. Hartford Cas. Ins. Co., 361 F. App'x 1, 4 (10th Cir. 2010) (finding that full-replacement cost recovery was not allowed because the insured's business personal property was never replaced).
113. Chubb Lloyds Ins. Co. v. Circuit Court, No. 09-553, 2010 WL 841254 (Ark. Mar. 11, 2010); Foremost Ins. Co. v. Circuit Court, No. 09-587, 2010 WL 841248 (Ark. Mar. 11, 2010).

kansas law or its state constitution. Therefore, the cases were not dismissed for lack of subject matter jurisdiction.[114]

C. *Matching*

In *Collins v. Allstate Insurance Co.*,[115] a federal district court rejected the insurer's argument that it had no obligation, as a matter of law, to replace undamaged parts of the insured's roof so as to achieve a uniform appearance when repairing covered damage. In denying the insurer's motion for summary judgment, the court held that replacement of the entire roof, including undamaged areas, might be required under a homeowners policy covering property with replacement of property "of like kind and quality" or repair costs of "equivalent construction for similar use." Genuine issues of material fact existed as to whether there were slate tiles currently available that were sufficiently similar in color, size, and texture to those on the insured's home at the time of the loss so as to make them of "like kind and quality" or "equivalent construction" within the meaning of the policy.

In *Strasser v. Nationwide Mutual Insurance Co.*,[116] matching was not required under a business owners policy because the insurer elected to pay only the value of the damaged property under the loss payment options in the policy. Thus, the insured was not allowed to present evidence at trial concerning the cost of matching the undamaged granite tiles on the façade of its building. The court rejected the insured's argument that a Florida statute governing matching under homeowners policies mandated a reasonableness standard for resolving matching disputes. The court found that the statute had no application to commercial policies in light of legislative history showing that the Florida legislature considered but rejected making the statute applicable to commercial property.

VII. OBLIGATIONS AND RIGHTS OF THE PARTIES

Like other contracts, property insurance policies include both the substance that is the core of the parties' agreement—the risk transferred to the insurer and the exclusions from that coverage—and a set of other rights and obligations. Those other obligations, while not directly related to the

114. *Id.* Similar class action suits have been brought alleging a failure to include contractor's overhead and profit. *See, e.g.*, Dupree v. Lafayette Ins. Co., 41 So. 3d 483, 488 (La. Ct. App. 2009) (certifying class status), *rev'd*, No. 2009-C-2602, 2010 WL 4844021 (La. Nov. 30, 2010); Amended Complaint at 3, Ayotte v. USF&G Ins. Co., No. 10-81243 (S.D. Fla. filed Nov. 4, 2010) (class action alleging that the defendant insurers "failed to include in [their] upfront or pre-repair payment . . . general contractor overhead and profit"), *available at* https://ecf.flsd.uscourts.gov/doc1/05118612334.

115. No. 09-01824, 2009 WL 4729901 (E.D. Pa. Dec. 10, 2009).

116. No. 09-60314, 2010 WL 667945 (S.D. Fla. Feb. 22, 2010).

coverage itself, provide a framework of rules for the parties' working relationship around the substance of the transferred risk itself, all the way from the policyholder's duty not to make false statements on the insurance application to how the parties can resolve their disputes if they disagree on coverage for a claim. Some of these issues, like the penalties for the insurer's bad faith breach of the contract, are supplied by state law outside of the contract itself, but still derive from that framework of rules. This section reviews significant developments in the parts of this framework that most affect practitioners of property insurance law.

A. *Misrepresentation*

In an unpublished opinion in *Howard v. Farm Bureau Insurance*,[117] the Michigan Court of Appeals considered the policyholder's claims that someone else filled out his insurance application and that he had signed the application without reading the false statements in the application. The court held that, by signing the application, the insured had a duty to examine the application and know what he had signed. The court also found that by cashing the insurer's premium refund check stating that the premium was being refunded because the policy had been rescinded, the insured had unconditionally accepted the rescission.[118]

In *Grenoble House Hotel v. Hanover Insurance Co.*,[119] the insurer sought to deny coverage based upon the policyholder's statement in its application that it owned the property that was being insured, when in actuality the insured was only a tenant. Because the insured had not signed the application and no evidence had been presented that the insured had provided the information on the application, the court denied the insurer's motion for summary judgment.[120]

B. *Duties*

1. Examinations Under Oath

The Massachusetts federal court in *Miles v. Great Northern Insurance Co.*[121] held that the policyholders' refusal to fully respond to document requests and questions asked during their examinations under oath (EUO) constituted a material breach of the insurance contract that discharged the insurer's obligations. One of the policyholders, an attorney, refused to answer questions during his EUO, ordered his wife not to answer certain

117. No. 289407, 2009 WL 4985469, at *1 (Mich. Ct. App. Dec. 22, 2009).
118. *Id.* at *3.
119. No. 06-8840, 2010 WL 2985789 (E.D. La. July 26, 2010).
120. *Id.* at *2.
121. 671 F. Supp. 2d 231, 239 (D. Mass. 2009).

questions during her EUO, and withheld other information from their insurer based upon an erroneous claim of attorney/client privilege.[122] The court found that since no privilege existed, the policyholders' failure to provide the requested information was willful and unexcused.[123] The court noted that, due to the policyholders' willful failure to cooperate, they had no right to cure their breach of the duty of cooperation.[124]

In *Sweeney v. Citizens Property Insurance Corp.*,[125] the court held that under the terms of the policy, an EUO is a condition precedent to a suit and the insured's failure to comply with the EUO, even if not willful, precludes an action on the policy. On the other hand, a federal court in Florida questioned whether a policy's EUO provision requires the insured to subject itself to more than one EUO.[126]

2. Proof of Loss

In *Swaebe v. Federal Insurance Co.*,[127] the insured failed to comply with the insurance policy's "no action" provision by filing suit prior to submitting a sworn proof of loss. The court found that the submission of a sworn proof of loss was a condition precedent to coverage and that the insured's telephone statements, EUO, production of documents, and post-suit proof of loss did not cure her failure to comply with the "no action" provision.[128] Since compliance with the "no action" provision was a condition precedent to recovery, the court granted summary judgment in favor of the insurer.[129]

The Oregon Supreme Court in *Parks v. Farmers Insurance Co. of Oregon*[130] considered the meaning of the term "proof of loss" as used in Oregon's statute providing for recovery of attorney fees in actions on insurance policies. The court held that based upon its prior decisions "[a]ny event or submission that would permit an insurer to estimate its obligations (taking into account the insurer's obligation to investigate and clarify uncertain claims) qualifies as 'proof of loss' for purposes of [Oregon's attorney's fee statute]."[131] The court held that a proof of loss does not have to be in writ-

122. *Id.*
123. *Id.* at 240.
124. *Id.* at 240–41.
125. 43 So. 3d 842, 843 (Fla. Dist. Ct. App. 2010).
126. El Dorado Towers Condo. Ass'n, Inc. v. QBE Ins. Corp., 717 F. Supp. 2d 1311, 1319 (S.D. Fla. 2010).
127. 374 F. App'x 855, 857 (11th Cir. 2010).
128. *Id.* at 857–58.
129. *Id.*
130. 227 P.3d 1127, 1129 (Or. 2009).
131. *Id.* at 1130 (quoting Dockins v. State Farm Ins. Co., 985 P.2d 796, 801 (Or. 1999)).

ing and that the insured's telephone calls to the insurer's agent, during which the insured discussed the amounts he had paid and expected to pay for cleanup costs, qualified as a proof of loss.[132]

C. *Appraisal*

1. Scope of Appraisal

During the survey period, several courts considered the line between "valuation" (the task of an appraisal panel) and coverage determinations (the province of the courts). In *QBE Insurance Corp. v. Twin Homes of French Ridge Homeowners Ass'n*,[133] an insurer argued that an appraisal panel's decision constituted an impermissible coverage determination rather than a loss appraisal to the extent that it "improperly determined whether coverage existed under the [p]olicy for different types of damage."[134] The panel had concluded that hail-damaged roofs in a townhome complex could not be repaired or replaced because the shingles used were no longer marketed. The panel therefore determined the value of the loss in terms of "total roof replacement" pursuant to one of the loss formulas provided for by the policy.[135] The court concluded that the panel did not exceed its authority as the panel had merely arrived at a dollar figure representing the value of the loss and there had been no "clear showing" that the appraisers exceeded their authority.[136] In *North Carolina Farm Bureau Mutual Insurance Co. v. Sadler*,[137] an insurer contended that the insured violated the terms of his insurance policy by submitting to an appraisal that went beyond providing a valuation of the loss and included the date and cause of the damage to his home. The court rejected this position, noting that "the appraisers were clearly informed as to the cause of damage—wind—and assessed [the insured's] property for loss of value considering the type of damage that may have resulted from such a cause."[138] The court also observed that the appraisers had not engaged in any interpretation of the subject policy, thus distinguishing a Fourth Circuit case upon which the insurer relied. In a case involving the appraisal of a Hurricane Katrina loss, a federal court sitting in Louisiana concluded that appraisers must consider causation to determine the scope of a loss; however, such causation determinations are not binding and are subject to challenge.[139]

132. *Id.* at 1131–32.
133. 778 N.W.2d 393 (Minn. Ct. App. 2010).
134. *Id.* at 398 & n.1.
135. *Id.* at 398.
136. *Id.* at 399.
137. 693 S.E.2d 266, 269 (N.C. Ct. App. 2010).
138. *Id.*
139. St. Charles Parish Hosp. Serv. Dist. No. 1 v. United Fire & Cas. Co., 681 F. Supp. 2d 748, 757 (E.D. La. 2010).

2. Timeliness of Demand or Refusal to Appraise

Several recent cases applying Texas law address the question of when an insurer will be deemed to have waived its appraisal rights as a result of a delay in demanding appraisal. While the analyses in these cases were ultimately fact-specific, there was agreement that the point of reference for determining whether a demand for appraisal is timely is the date of disagreement, or "impasse" with the insured.[140] The court in *In re Slavonic Mutual Fire Insurance Ass'n* held that an insurer did not waive its appraisal rights where it demanded appraisal six days after receiving a demand letter from its insured.[141] However, in a federal case predating *In re Slavonic*, a Texas federal court held that an insurer's demand for appraisal was untimely where the insurer waited almost one year to invoke an appraisal provision from the time it received a call from the insured disputing the insurer's adjustment of a Hurricane Ike claim, during which time an unsuccessful mediation took place.[142] A subsequent Texas federal court declined to find waiver based on a three-month delay between a triggering "impasse" and the appraisal demand.[143]

In *Security Storage Properties v. Safeco Insurance Co. of America*,[144] a Kansas federal court held that an insured could not be compelled to submit its claim to appraisal where two, state-specific endorsements—one containing a "mandatory" appraisal clause (Texas) and the other a voluntary appraisal clause (Kansas)—created an ambiguity. The court concluded that "[b]ecause the policy fails to make clear that Texas rather than the Kansas endorsement was intended to apply . . . the court concludes that the Kansas endorsement must be applied to the plaintiffs' claim."[145]

3. Enforcing and Modifying Appraisal Awards

In *Florida Insurance Guaranty Ass'n v. Olympus Ass'n*,[146] a Florida appellate court held that the trial court erred in confirming an appraisal award and entering final judgment in favor of an insured without first determining the Florida Insurance Guaranty Association's ("FIGA") liability as to contested coverage claims, including claims for damage to paint or waterproofing

140. *In re* Slavonic Mut. Fire Ins. Ass'n, 308 S.W.3d 556, 562 (Tex. Ct. App. 2010); Sanchez v. Prop. & Cas. Ins. Co. of Hartford, No. 09-1736, 2010 WL 413687, at *13–14 (S.D. Tex. Jan. 27, 2010).

141. *In re Slavonic*, 308 S.W.3d at 562–63.

142. *Sanchez*, 2010 WL 413687, at *5.

143. Tran v. Am. Econ. Ins. Co., No. 10-0016, 2010 WL 2680616, at *2–3 (S.D. Tex. July 2, 2010).

144. No. 09-1036, 2010 WL 1936127 (D. Kan. May 12, 2010).

145. *Id.* at *6.

146. 34 So. 3d 791 (Fla. Dist. Ct. App. 2010).

material. The court rejected an all-or-nothing approach with respect to an insurer's ability to contest coverage, explaining that FIGA could contest part of the liability without challenging coverage as a whole: "[I]t is not reasonable to order an insurer to pay for all elements set forth by an appraiser if the insurer raises an issue of coverage as to only one element and not the whole claim."[147]

4. Appraiser Qualifications

In a case arising out of Hurricane Katrina, an insurer challenged the validity of an appraisal award in favor of an insured hospital on several grounds, including that the insured's appraiser and the umpire were not impartial.[148] Noting that the insurer bore the burden of producing evidence "that the appraiser's honesty or integrity is suspect," the court concluded that there was no lack of impartiality even though the insurer's appraiser was not present for the final deliberations with respect to the award.[149] The court observed that by that point in the process, it was clear that the insurer's appraiser would not agree to the numbers that the insured's appraiser and the umpire were leaning toward and that he had nothing else to submit for rebuttal.[150]

5. Miscellaneous Issues

In two cases decided on the same day, separate panels of Florida's Fourth District Court of Appeal ruled that the Florida Insurance Guaranty Association ("FIGA") could not compel appraisal where the insureds were not informed of their right to participate in a mediation program pursuant to Florida Statutes § 627.7015(2) (2005).[151] In *FIGA I*, the court held that FIGA was bound by the failure of the insolvent insurer whose obligations FIGA had assumed to notify the insured regarding the mediation program.[152] In *FIGA II*, the court held that the application of § 627.7015(2) was not unconstitutional as applied to FIGA even though the statutory amendment that extended the reach of the statute to cover the policy at issue was not enacted until after the subject policy went into effect.[153]

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147. *Id.* at 796.
148. St. Charles Parish Hosp. Serv. Dist. No. 1 v. United Fire & Cas. Co., 681 F. Supp. 2d 748 (E.D. La. 2010).
149. *Id.* at 754.
150. *Id.* at 755.
151. Fla. Ins. Guar. Ass'n v. Shadow Wood Condo. Ass'n, 26 So. 3d 610 (Fla. Dist. Ct. App. 2009) ("*FIGA I*"); Fla. Ins. Guar. Ass'n v. Devon Neighborhood Ass'n, 33 So. 3d 48 (Fla. Dist. Ct. App. 2009) ("*FIGA II*").
152. *FIGA I*, 26 So. 3d at 613–14.
153. *FIGA II*, 33 So. 3d at 53–54.

D. *Who Can Sue on the Policy and Collect Proceeds?*

In *Motorists Mutual Insurance Co. v. Teel's Restaurant, Inc*.[154] an Indiana federal district court held that a contract seller of a restaurant who was not a named insured on the restaurant's policy should be treated like a mortgagee for the purposes of recovering insurance proceeds. The court rejected the seller's argument that he should be considered a named insured under the policy because he was the sole officer of the restaurant.[155] The court reasoned that it would "not [be] legally possible" to allow the seller to benefit from the tax and liability protections of the corporate form, while simultaneously treating him as identical to the corporation for the purpose of recovering insurance proceeds. Accordingly, the court ruled that the restaurant owner was entitled to insurance proceeds only in the amount remaining on the purchase agreement at the time the restaurant burned.[156]

Conversely, in *Komondy v. Middlesex Mutual Assurance Co*.,[157] a Connecticut trial court held that the named insured's husband, who was not himself a named insured on a fire policy for a residence, nonetheless had standing as a third-party beneficiary to bring a breach of contract action against the insurer. The court reasoned that the policy's repeated use of the terms "you" and "your," which the policy defined as the " 'named insured' shown in the Declarations and the spouse if a resident of the same household," indicated that the parties intended the husband to be a third-party beneficiary of the policy.[158] The husband, however, did not have standing to sue the insurer for breach of the implied covenant of good faith and fair dealing, since he was not in privity of contract with the insurer.[159]

In *Parmelee v. Standard Fire Insurance Co*.,[160] a Missouri federal court ruled that a named insured who subsequently relinquished title of a home to her ex-husband was not entitled to payment for the property's actual cash value when the home was damaged in a fire. The loss-payment clause in the homeowners policy stipulated that the insured be paid "UNLESS SOME OTHER PERSON NAMED IN THE POLICY IS LEGALLY ENTITLED TO RECEIVE PAYMENT."[161] The policy also required the notice of loss to declare any changes in title or occupancy.[162] Reasoning that the terms of the policy allowed the insurer to take notice of changes in

154. No. 08-237, 2009 WL 4255550, at *3 (N.D. Ind. Nov. 20, 2009).
155. *Id*.
156. *Id*.
157. No. CV096000516, 2009 WL 3740745, at *5 (Conn. Super. Ct. Oct. 20, 2009).
158. *Id*. at *3.
159. *Id*. at *6.
160. 697 F. Supp. 2d 1069, 1079 (E.D. Mo. 2010).
161. *Id*. at 1076.
162. *Id*. at 1079.

title and ownership and reduce payments to insureds accordingly, the court held that the ex-wife was not entitled to payment for the home's actual cash value since she had relinquished all interest in the home to her co-named insured ex-husband upon divorce.[163]

In *Archer v. Cotton States Mutual Insurance Co.*,[164] a Georgia appellate court ruled that an executor of an estate forfeited his insurable interest in a property when he transferred the title of the decedent's home from the estate to himself. The home, which was destroyed in a fire, contained a death benefit clause that extended insurance benefits to the legal representative of the deceased. The executor, therefore, extinguished his right to insurance proceeds when he assumed title to the property outside his capacity as executor of the estate.[165]

In *Balboa Life & Casualty, LLC v. Home Builders Finance, Inc.*,[166] a Georgia appellate court addressed the extent of a mortgagee's right to insurance proceeds to satisfy the mortgage debt where the mortgagee foreclosed on the insured property after the loss. Employing an economic analysis test, the court held that a mortgagee was entitled to insurance proceeds equal to the difference between the mortgage debt at the time of the foreclosure and the value of the residence acquired at foreclosure, subject to policy limits.[167] Likewise, in *Peery v. Allstate Insurance Co.*, a Mississippi federal district court ruled that, where a bank's post-loss foreclosure fully satisfies the insured's mortgage debt, the bank's right to insurance proceeds under a mortgage clause are extinguished.[168] The court in *Peery* did, however, reject the insured's bad faith claim against the insurer for issuing a joint check to the bank and the insured. The court reasoned that neither the insured nor the bank had notified the insurer of the change in the property's ownership before the disbursement of the insurance proceeds.[169]

E. *Suit Limitations*

In *Pitts v. Louisiana Citizens Property Insurance Corp.*,[170] a Louisiana appellate court addressed whether an insured's participation in a class action tolls the running of a suit limitation. The insured in *Pitts* had sustained property damage during Hurricane Katrina.[171] Her insurance policy contained a one-year suit limitation, which was extended for an extra year by an act of

163. *Id.*
164. 695 S.E.2d 329, 330 (Ga. Ct. App. 2010).
165. *Id.*
166. 697 S.E.2d 240 (Ga. Ct. App. 2010).
167. *Id.* at 243.
168. No. 09-115, 2010 WL 1380377, at *3 (N.D. Miss. Mar. 31, 2010).
169. *Id.*
170. 4 So. 3d 107 (La. Ct. App. 2009).
171. *Id.* at 109.

the Louisiana Legislature. The insured participated in two class certifications against her insurer, which were filed within a year of the hurricane.[172] When the insured subsequently brought her own action against the insurer, after one class certification was denied and the other restricted, the trial court denied the claim, arguing the two-year prescription period had run.[173] The appeals court, reasoning that the class certification petitions in which the insured had participated tolled the suit limitation, held that the insured's filing of her own action was not proscribed.[174] Conversely, in *Dixey v. Allstate Insurance Co.*,[175] a Louisiana federal district court held that the Louisiana statute tolling liberative prescription periods for members of a class action could not also suspend contractual limitations periods. *Dixey*'s fact pattern was nearly identical to the fact pattern in *Pitts*. In reaching its holding, the court in *Pitts* declined to risk infringing on the Contracts Clauses of the Constitutions of the United States and Louisiana by allowing a state statute to alter the contractual obligations of private parties.[176]

In *Sheppard v. Travelers Lloyds of Texas Insurance Co.*,[177] a Texas appellate court held that an insured did not meet the suit limitation deadline of two years and one day following the accrual of a cause of action, when the insured waited more than five years from the insurer's closing of its claim file to sue. The court held that the date on which the insurer closed its claim file was the date the cause of action accrued since it established "an objectively verifiable event that unambiguously demonstrated [the insurer's] intent not to pay the claim."[178] The court rejected the insured's contention that subsequent reinvestigation of the claim, in which the insurer neither withdrew nor changed its denial nor made further payment, pushed back the accrual of the cause of action.[179]

F. *Bad Faith*

In *State Farm Florida Insurance Co. v. Seville Place Condominium Ass'n*,[180] an insured brought suit for breach of contract against its insurer arising from a claim for roof damage related to Hurricane Wilma. The insurer did not dispute coverage and paid part of the claim, but the parties disagreed on the total value of the claim and agreed to an appraisal under the policy to

172. *Id.*
173. *Id.*
174. *Id.* at 111.
175. 681 F. Supp. 2d 740, 747 (E.D. La. 2010).
176. *Id.*
177. No. 14-08-00248, 2009 WL 3294997, at *7 (Tex. App. Oct. 15, 2009).
178. *Id.* at *4 (citing Kuzinar v. State Farm Lloyds, 52 S.W.3d 759, 760 (Tex. App. 2001)).
179. *Id.* at *7.
180. No. 3D08-2538, 2009 WL 3271300 (Fla. Dist. Ct. App. Oct. 14, 2009).

determine the value of the remaining roof damage.[181] Following the filing of the final appraisal award, the trial court confirmed the award and granted an insured's motions to amend the complaint to add a claim for statutory bad faith and a demand for punitive damages.[182] The insurer appealed the ruling, arguing that before a bad faith claim may proceed the insured must obtain a final judgment on its original breach of contract claim, that it still had pending affirmative defenses, and that it must be allowed to exhaust all appellate remedies regarding that judgment.[183] A Florida appellate court denied the insurer's appeal, holding that, under Florida law, an appraisal award determining liability and extent of loss is a sufficient basis for the commencement of a bad faith claim.[184] The court also noted that the insurer had no affirmative defenses pending and that Florida law did not require all appellate remedies be exhausted before the insured's bad faith claim was ripe.[185]

In *One River Place Condominium Ass'n v. Axis Surplus Insurance Co.*,[186] the insured brought suit against its insurer for breach of contract and bad faith related to property damage related to Hurricane Katrina. After obtaining a verdict at trial, the insured moved for judgment as a matter of law or, alternatively, for a new trial.[187] The insured claimed that it was entitled to post-trial relief because no reasonable juror could have found that (1) the insurer did not violate an emergency order issued by the State of Louisiana in the wake of Hurricane Katrina; (2) the insured did not suffer more property and business interruption damages than awarded by the jury; and (3) the insurer was responsible for bad faith penalties for its improper conduct.[188] The court denied both motions, and on the bad faith claim held that the jury had sufficient evidence to disagree with the insured's position that the insurer arbitrarily and capriciously failed to pay the claim.[189] The court specifically referenced evidence the insurer submitted from the adjustment in finding that there was sufficient evidence to find against a bad faith claim, including that the insurer did not delay in paying exterior damages while inspecting the property, paid additional glass damage once it was able to confirm a prior miscount, paid withheld depreciation early, and presented evidence that the insured withheld documents required to process the claim.[190]

181. *Id.* at *2.
182. *Id.* at *3.
183. *Id.*
184. *Id.* at *4.
185. *Id.*
186. No. 07-1305, 2009 WL 2409142 (E.D. La. Aug. 4, 2009).
187. *Id.* at *1.
188. *Id.*
189. *Id.* at *2.
190. *Id.* at *2–3.

In *Quast v. State Farm Fire & Casualty Co.*[191] the insureds brought suit for breach of contract and bad faith against their insurer after the insurer denied a claim for the alleged theft of personal property due to fraud by the insureds. The insurer brought a motion for summary judgment on the bad faith count, arguing that it had a reasonable basis to believe the claim was fraudulent and deny the claim.[192] The court agreed and granted the motion, finding that after reviewing the insured's conduct, the insurer reasonably believed the claim was fraudulent.[193] The court noted that the insurer had investigated the claim according to its customary practices, and when the investigation raised concerns about fraud, the insurer had the claim analyzed by the insurer's special investigations unit and hired an outside attorney to investigate the claim and offer opinions about the claim's validity.[194] Further, the court found that there were a number of facts that led to the insurer's reasonable belief the theft was fraudulent, including (1) the theft occurred just three days before the policy lapsed and was not going to be renewed; (2) the insureds lacked supporting documentation for the stolen property; (3) old nonworking items were stolen while newer items were left behind; (4) the insureds had made seven other property theft claims since 1991; and (5) financial records showed the insureds were living beyond their means for some time.[195]

In *Philadelphia Indemnity Insurance Co. v. C.R.E.S. Management, LLC*,[196] the insured brought a bad faith claim against its insurer under the prompt payment provisions of chapter 542 of the Texas Insurance Code,[197] alleging the insurer failed to pay the undisputed portion of carpet loss and business income claims arising from Hurricane Ike within the seventy-five days permitted to pay for losses related to a weather-related catastrophe. The insured brought a summary judgment on the issue of the prompt payment provisions, to which the insurer responded that an award of statutory interest and attorney fees was inappropriate because it acted in good faith and diligently adjusted the large, complex loss that totaled nearly $8 million in damages to five separate multifamily developments, each containing several hundred units.[198] The court granted the insured's motion for summary judgment, holding that evidence of the insurer's good faith in adjusting the losses was not a defense to the prompt payment provisions of the Texas Insurance Code.[199]

191. No. 09-675, 2010 WL 4339132 (W.D. Wis. Oct. 26, 2010).
192. *Id.* at *1.
193. *Id.* at *6.
194. *Id.*
195. *Id.* at *5.
196. No. 09-1032, 2009 WL 5061805 (S.D. Tex. Dec. 15, 2009).
197. Tex. Ins. Code Ann. §§ 542.058(a), 542.059(b) (West 2009).
198. *C.R.E.S. Mgmt.*, 2009 WL 5061805, at *3.
199. *Id.* at *4.

RECENT DEVELOPMENTS IN TITLE INSURANCE LAW

Jerel J. Hill and Steven R. Parker

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I. Introduction

This article reviews significant title insurance decisions from October 1, 2009, to September 30, 2010, in which over 100 cases were reviewed. The cases cover what is insured, the duty to defend, the duty to search title, and everything in between.

II. Insured versus Insurer

A. *Terms of the Policy*

1. Who Is the Insured?

In Connecticut, a title policy procured by fraud prevented the subsequent purchaser of the mortgage loan from making a claim under the policy. In *Flagstar Bank, FSB v. Ticor Title Insurance Co.*,[1] Flagstar Bank purchased a mortgage loan believing it to be insured by the defendant, Ticor Title Insurance Co. (Ticor).[2] The loan subsequently went into default and Flagstar filed a claim on the Ticor policy. When Ticor rejected the claim, Flagstar filed suit against Ticor for breach of contract and negligence in training its agents. Ticor moved for summary judgment on Flagstar's claims, asserting that the title policy was the product of fraud.[3] The court determined that the agent's signature was forged on the closing documents. Under Connecticut law, fraud "vitiates all contracts."[4] The court explained that "even if the Title Policy otherwise appeared enforceable, the fraudulent signature would vitiate any contract thus formed."[5] Ticor also won summary judgment on the negligence claim after asserting a successful statute of limitations defense.[6]

In California, a title insurer was not held liable for negligently misstating the status of a title when one of its employees provided title information informally and orally to plaintiff. In *Soifer v. Chicago Title Co.*,[7] an investor in distressed real estate had an arrangement with an employee at Chicago Title in which he would request title information on foreclosed properties in exchange for placing business with Chicago Title upon the resale of the foreclosed property. Plaintiff required information concerning whether a foreclosing lender held the senior lien on a property, and typically needed this information within twenty-four hours. The employee would usually respond with a "yes" or "no" to the question of whether the foreclosing

1. 660 F. Supp. 2d 346 (D. Conn. 2009).
2. *Id.* at 348.
3. *Id.* at 350.
4. *Id.*
5. *Id.*
6. *Id.* at 354.
7. 187 Cal. App. 4th 365 (2010).

lender was in the senior lien position. Plaintiff used this information to determine whether to make a bid at a particular foreclosure sale. The issue giving rise to this lawsuit involved information provided by the employee to plaintiff informing him that the foreclosing loan was in a senior position, when, in fact, it was junior to a first deed of trust. Based on this information, plaintiff submitted a bid at the foreclosure sale and sustained a substantial loss in the resale of the property. Plaintiff's lawsuit alleged that he received services of an abstractor via an oral contract and that the services had been negligently performed, resulting in damage to plaintiff. Chicago Title argued that it can only be liable for negligently misstating the status of a title if it issues an abstract of title and that the informal communications between the plaintiff and its employee were not proper abstracts. The trial court reasoned that since plaintiff had neither sought nor obtained a policy of title insurance or an abstract of title, Chicago Title had no liability to plaintiff on any theory.[8] On appeal, the court found that plaintiff by his own pleading neither sought nor agreed to pay for an abstract, but instead sought only one-word answers to his very time-sensitive inquiries about specific foreclosing loans that he had already identified.[9] The court held that a plaintiff cannot recover for errors in a title company's statements regarding the condition of title to a property in the absence of a policy of title insurance or the purchase of an abstract of title.[10]

2. What Is Insured?

In *Fells v. Stewart Title Guaranty Co.*,[11] the sellers sold the buyer one of their rental properties. The property as described in the public records actually comprised two properties owned by the sellers. Consequently, the warranty deed that the sellers delivered to the buyer conveyed both properties.[12] When the parties discovered what happened, the buyer was advised by an agent of Stewart Title Guaranty Co. (Stewart Title) to file a claim. Instead of filing a claim with the insurer, the buyer sued the sellers claiming slander of title and entitlement to rents the sellers collected on

8. "Prior to the enactment of Insurance Code sections 12340.10 and 12340.11, caselaw had held that a preliminary title report is the equivalent of an abstract of title, and that a title insurer could be liable in negligence for its failure to list all recorded encumbrances in a preliminary title report." *Id.* at 371 (order modifying opinion) (quoting Southland Title Corp. v. Superior Court, 231 Cal. App. 3d 530, 535 (Ct. App. 1991)).

9. "[A] title insurer who has not undertaken to perform as an abstractor owes no duty to disclose recorded liens or other clouds on title." *Id.* at 373 (quoting Siegel v. Fid. Nat'l Title Ins. Co., 46 Cal. App. 4th 1181, 1190 (Ct. App. 1996)).

10. *Id.* at 374.

11. 2010 WL 2197693, at *1 (E.D. Ark. Apr. 23, 2010), *aff'd*, No. 10-2462 (8th Cir. Nov. 8, 2010) (per curiam) (unpublished).

12. *Id.* at *1.

the second house.[13] The buyer claimed that the seller disparaged her title by attempting to record a revised deed and by causing the tenant on the other property to refuse to pay rent to her.

The trial court granted a directed verdict against the buyer on her slander of title claim. The court entered a judgment denying the sellers' claim for reformation of the deed after the jury found that the sellers did not prove mutual mistake in the legal description by clear and convincing evidence. The buyer then sued Stewart Title in the district court for its failure to defend against the seller's reformation counterclaim, failure to prosecute the action for slander of title, and lost rents and bad faith. The trial court adopted the magistrate judge's recommendation to grant Stewart Title's motion for summary judgment. The magistrate judge held that (1) the duty to defend was not triggered because the insured buyer did not give written notice to the insurer, i.e., phone calls to the agent were not sufficient; (2) slander of title is a tort claim seeking damages, not a claim to establish title to the property, and therefore was outside of the policy coverage and, in any event, the sellers' actions were a post-policy date matter;[14] (3) the rents collected by the sellers were also a post-policy date matter; and (4) Stewart Title's conduct was not in bad faith, defined by Arkansas law as "dishonest, malicious, or oppressive" conduct.[15]

3. Insurer's Duty to Defend

The duty to defend terminates with the mortgagee policy when the insured is paid and subsequently signs a release. In *Morrison v. Wells Fargo Bank*,[16] James Eugene Morrison (Eugene Morrison) and his wife entered into a mortgage with Provident Bank, which erroneously purported to lien the property of the plaintiff, James Elder Morrison. The mortgage was subsequently transferred to Wells Fargo Bank, N.A. After the Morrisons defaulted on their loan, Wells Fargo initiated foreclosure proceedings against them and the plaintiff's property.[17] In turn, the plaintiff commenced an action to compel Wells Fargo to release its mortgage. Stewart Title accepted Wells Fargo's second claim and retained counsel to negotiate the payment of the mortgage by the Morrisons.[18] Wells Fargo subsequently released its

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13. *Id.* at *1–2.
14. *Id.* at *4–6.
15. *Id.* at *8 (citation omitted). The Arkansas Supreme Court has defined "bad faith" as "dishonest, malicious, or oppressive conduct carried out with a state of mind characterized by hatred, ill will, or a spirit of revenge." Unum Life Ins. Co. of Am. v. Edwards, 210 S.W.3d 84, 87 (Ark. 2005) (citation omitted).
16. 711 F. Supp. 2d 369 (M.D. Pa. 2010).
17. *Id.* at 374.
18. *Id.* at 375.

lien on the property.[19] Wells Fargo filed a third-party action against Stewart Title after it denied Wells Fargo's claim for continued counsel on plaintiff's action. Although Stewart Title initially appointed counsel to defend Wells Fargo in the action against it by plaintiff, it discontinued its defense on the ground that since the mortgage loan had been paid in full, Stewart Title's liability under the policy was terminated.[20] The court agreed with Stewart Title and found that it was entitled to summary judgment because once the mortgage was paid its obligation under the policy ended.[21]

Two other courts reached opposite conclusions on the question of a title insurer's duty to defend. An Ohio court held that a title insurer had no duty to defend the insured where an unrecorded instrument was excluded from coverage under the title policy. Hauck Holdings Columbia SC, LLC (Hauck) obtained a title insurance policy from First American Title Insurance Company (First American) in connection with its purchase of the Northtowne Commons Shopping Plaza.[22] This purchase made Hauck a party to an Operation and Easement Agreement (Agreement) and subsequent amendments entered into among Hauck's predecessors-in-interest, one of which was Target Corp. (Target). When Target refused Hauck's request under the Agreement for it to pay for some of the maintenance of the shopping center's common areas, Hauck made a claim under its title insurance policy. First American denied the claim on the ground that because a supplement to the Agreement concerning Target's obligations was unrecorded, it was excluded under the title policy. After settling its dispute with Target, Hauck proceeded with its declaratory judgment action against First American. First American argued that either Hauck's loss is excluded under the title policy if he had actual knowledge of the unrecorded supplemental agreement, which was unknown to First American; or if it did not have actual knowledge of the supplemental agreement, it was not a title defect insured under the title policy.[23] The issue before the court was whether the supplemental agreement could be construed as a defect or encumbrance on the title.[24] The Agreement required that in order for a modification to be effective, it must be recorded. Because the supplemental agreement was not recorded, it never became effective, was not enforceable, and therefore could not constitute a defect or encumbrance on the title. Therefore, First American had no duty to defend Hauck.

19. *Id*. at 373.
20. *Id*.
21. *Id*. at 389.
22. Hauck Holdings Columbia SC, LLC v. Target Corp., 2010 WL 1258103, at *1 (S.D. Ohio Mar. 25, 2010).
23. *Id*. at *9; *see* Emrick v. Multicon Bldrs., Inc., 566 N.E.2d 1189, 1194 (Ohio 1991) (an unrecorded land use restriction is not enforceable against a bona fide purchaser for value unless the purchaser has actual knowledge of the restriction).
24. *Hauck Holdings*, 2010 WL 1258103, at *10.

However, a Texas court held that although the insurer can reserve its rights, it has a duty to defend the entire case. In *Lawyers Title Insurance Corp. v. Graham Mortgage Corp.*,[25] a developer purchased property from a seller under a purchase money note, for which the seller attached a lien on the property. The developer obtained several development loans from Graham Mortgage Corp. (Graham), and the seller signed an agreement to subordinate her lien to each of the new loans. Graham purchased title insurance for each new loan from Lawyers Title Insurance Corp. (Lawyers Title). When the developer defaulted, the seller filed a petition alleging that her lien should have priority over Graham's liens because the subordination agreements had been procured by fraud. In response to Graham's request that it defend the claim, Lawyers Title petitioned for a declaratory judgment to determine if it owed a legal duty to defend the suit under the title policy.[26] The court noted that after an insured establishes coverage under the terms of the title policy, the burden shifts to the insurer to prove that an exclusion applies that permits it to deny coverage, in this case, whether fraud falls within a policy exclusion.[27] Lawyers Title argued that fraudulent misrepresentations allegedly made by Graham were excluded from coverage because Graham "created, suffered, assumed or agreed to" the defect under exclusion 3(a). Because Lawyers Title did not clearly allege that Graham made or knew about certain misrepresentations, the court resolved any ambiguities in the petition in finding a duty to defend.[28] Finding that an insurer "has a duty to defend against even 'groundless' suits," the magistrate judge held that Lawyers Title had a duty to defend the entire case.[29]

In California, a title insurer may be held liable for negligence in connection with a preliminary report, if the insured has a reasonable expectation that the preliminary report reflects the scope of coverage being offered. In *Lee v. Fidelity National Title Insurance Co.*,[30] the insureds purchased property that was identified by two tax assessor parcel numbers. Fidelity National Title Insurance Co. (Fidelity) issued a preliminary report that referred repeatedly to both assessor parcels, and included a legal description of only one of the parcels. The legal description, which matched the one in the insured's grant deed, was incorporated into the title insurance policy and a map depicting the two parcels was attached to the policy. When the insureds later discovered they did not, in fact, own one of the parcels, they

25. 2010 U.S. Dist. LEXIS 64125, at *1 (E.D. Tex. Apr. 16, 2010).
26. *Id.* at *2.
27. *Id.* at *5.
28. *Id.* at *9–10.
29. *Id.* at *13.
30. 188 Cal. App. 4th 583 (2010).

made a claim under the title policy. After Fidelity denied coverage, the insureds filed suit for declaratory judgment, breach of insurance contract, bad faith breach of insurance contract, and negligence.[31] In granting summary judgment to Fidelity, the trial court held that the insureds could not recover for a breach of the title policy as to land that they never purchased, owned, or insured.[32]

In holding for the insured, the court of appeals reasoned that the preliminary report could have reasonably been construed as an offer to insure both parcels, even though one was outside the land described. The report included the other parcel in the property's address, listed exclusions from coverage that were specific to the other parcel, and attached a parcel map. Although California Insurance Code § 12340.11 has established that a title insurer cannot be held liable for negligence in connection with a preliminary report, and that the recipient of the report cannot rely on it to represent the status of title to the property to be insured, title insurance coverage is still to be construed consistent with the insured's reasonable expectations.[33] An insured may also rely on a preliminary report to reflect the scope of the coverage being offered. The insureds could have reasonably expected under the circumstances that they were buying a title insurance policy on the other parcel that would conform to the preliminary report.[34] The court determined that the insureds could not know from a reading of the metes and bounds description whether the other parcel was covered. Consequently, the legal description was ambiguous.[35]

B. *Exclusions and Exceptions*

1. Exclusions

In *Washington Mutual Bank v. Commonwealth Land Title Insurance Co.*,[36] Washington Mutual Bank (WAMU) loaned money to borrowers to refinance a preexisting mortgage on their home. Commonwealth Land Title Insurance Co. (Commonwealth Land Title) issued a lender's title policy to WAMU in connection with the loan, which required in relevant part

31. *Id*. at 593.

32. *Id*.

33. *Id*. at 595 (quoting White v. Western Title Ins. Co., 40 Cal. 3d 870, 881 (1985)) ("'In determining what benefits or duties an insurer owes his insured pursuant to a contract of title insurance, the court may not look to the words of the policy alone, but must also consider the reasonable expectations of the public and the insured as to the type of service which the insurance entity holds itself out as ready to offer. Stated in another fashion, the provisions of the policy, "'must be construed so as to give the insured the protection which he reasonably had a right to expect, . . .'"'") (citations and emphasis omitted).

34. *Id*. at 597.

35. *Id*. at 598.

36. 2010 WL 135685, at *1 (Tex. App. Jan. 14, 2010).

that WAMU notify Commonwealth Land Title promptly in writing of any adverse claim to the title of the insured mortgage.[37] Subsequently, the borrowers filed for bankruptcy. Since Commonwealth Land Title recorded the deed of trust less than ninety days prior to the bankruptcy, the bankruptcy trustee instituted an adversary proceeding against WAMU, alleging that the recordation was a preferential transfer in contravention of the Bankruptcy Code.[38] WAMU and the trustee ultimately entered an agreement whereby WAMU surrendered its rights in the property, transferred all rights and benefits under the deed of trust lien from WAMU back to the borrower's estate, and left WAMU with an unsecured claim against the estate. When WAMU filed a claim with Commonwealth Land Title, it denied the claim on the ground that WAMU failed to notify it of the adversary proceeding under paragraph 3 in time for it to defend the validity of the insured deed of trust lien.[39] The court of appeals opined that compliance with a notice-of-suit provision in an insurance policy "is a condition precedent to the insurer's liability on the policy."[40] The purpose of the notice-of-suit provision in an insurance policy is to enable an insurer to investigate the circumstances of the policy-invoking incident so that the insurer has adequate time to prepare to defend any claims. The court of appeals agreed with Commonwealth Land Title that it was prejudiced as a matter of law by WAMU's failure to notify it of the adversary proceeding because it was denied the opportunity to defend against the claims of the bankruptcy trustee. Consequently, WAMU was not entitled to coverage

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37. *Id.*

38. Section 547(b) of the Bankruptcy Code provides:

> Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made—
> (A) on or within 90 days before the date of the filing of the petition; or
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
> (5) that enables such creditor to receive more than such creditor would receive if—
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C § 547(b) (2010).

39. *Washington Mut. Bank*, 2010 WL 135685, at *1.

40. *Id.* at *2 (quoting Harwell v. State Farm Mut. Auto. Ins. Co., 896 S.W.2d 170, 173 (Tex. 1995)).

and the trial court did not err in granting summary judgment to Commonwealth Land Title on the basis of the affirmative defense.[41]

On the other hand, a Washington court held a late notice issue was not proper for summary judgment even though the lender did not notify the title insurer about an action that resulted in the priority of a lien over the lender's mortgage.[42] The lender purchased insurance from Chicago Title to insure two loans lender had made to a developer. The mechanics lienors filed their notices of lien on the development and ultimately filed suit to enforce their liens.[43] The lender did not inform Chicago Title of the notices of lien or the suit, but instead hired an attorney to defend it against the lawsuit. After satisfying the liens, the lender tendered the satisfied lien claims to Chicago Title for payment and requested defense and indemnity for a foreclosure action. The insurer accepted defense of the foreclosure action.[44] The court denied the lender's partial motion for summary judgment for repayment of the amount it paid to discharge the liens, in part because genuine issues of material fact existed as to when the lender should have tendered the claims to Chicago Title and whether or not the insurer suffered prejudice as a result of the lender's late tender.[45]

An insurer had no duty to indemnify the insured where the insured assumed the risk of purchasing a home with knowledge of superior liens on the property, and thus was excluded from coverage. Norman Culbertson owned a home that was subject to the judgment liens of his creditors.[46] James Marr, plaintiff, and Culbertson engaged in a sham transaction to shield the home from Culbertson's creditors. When Marr purchased the home from Culbertson, he took out title insurance from defendant Commonwealth Title Insurance Co. (Commonwealth Title). When Culbertson defaulted on his mortgage, Marr filed a foreclosure suit to extinguish the equitable title remaining in Culbertson's name. One of Culbertson's creditors counterclaimed that his judgment lien was filed before Marr took his mortgage interest and that it held priority. Commonwealth Title defended the creditor claim for some time, then withdrew.[47] Marr settled with the creditor and then brought suit against Commonwealth Title for indemnity of the settlement proceeds and attorney fees. The court granted summary judgment for Commonwealth Title because Marr's actions excluded him

41. *Id*. at *3.
42. Columbia Cmty. Credit Union v. Chicago Title Ins. Co., No. 09-5290 RJB, 2010 WL 546923, at *1 (W.D. Wash. Feb. 12, 2010).
43. *Id*. at *1.
44. *Id*. at *2.
45. *Id*. at *4.
46. Marr v. Commonwealth Title Ins. Co., No. 3:06-CV-20-S, 2009 WL 5125624, at *1 (W.D. Ky. Dec. 21, 2009).
47. *Id*. at *4.

from coverage.[48] Commonwealth Title issued a "Commitment for Title Insurance that recited the existence of various recorded liens on the property and indicated that they would need to be paid and released before Commonwealth Title would issue the policy."[49] This statement made Marr aware of the specific liens on the property. He purchased the property and took out a title policy anyway; thus, he "assumed the risk that those liens would be superior to his."[50] Under this reasoning, Commonwealth Title was under no duty to indemnify Marr.[51]

In a case out of the Fourth Circuit, Alexandra Murnan (Murnan) created a trust, under which she was the sole beneficiary and the sole holder of the right to revoke the trust.[52] Murnan purchased a property on behalf of the trust and purchased a title insurance policy from Stewart Title shortly before closing. At the time the policy was issued there were numerous federal tax judgments pending against Murnan in her individual capacity. Murnan's attempts to sell the property a year later failed when the purchasers were unable to obtain title insurance because the tax judgments against Murnan attached to the property as tax liens. Murnan's claim with Stewart Title was denied, the lender foreclosed on the property, and Murnan brought a breach of contract claim against Stewart Title.

The Fourth Circuit affirmed the summary judgment in favor of Stewart Title.[53] The title policy excluded from coverage liens suffered by the insured claimant including taxes subsequent to the year 2002. The trial court ruled that the tax liens were excluded from coverage under the policy because Murnan "suffered" the liens on the property by accepting title on behalf of the trust. The issue was not whether Murnan caused the liens to arise in the first place but whether she permitted the liens to attach to the property.[54] Murnan was aware of the federal tax judgments when she purchased the property, those judgments became liens on all property held by her or the trust, and she knew she held expansive rights to the trust property. For these reasons Murnan suffered the liens on the property and summary judgment in favor of Stewart Title was proper.[55]

A bankruptcy trustee's allegations of a fraudulent transfer by the insured fell within the exclusions of the insured's title policy. The insured obtained a mortgagee policy from Pacific Northwest Title Insurance Company for

48. *Id.* at *6.
49. *Id.*
50. *Id.*
51. *Id.*
52. Murnan Spring Hill Trust v. Stewart Title Guar. Co., No. 09-1490, 2010 WL 1227268, at *1 (4th Cir. Mar. 31, 2010).
53. *Id.*
54. *Id.* at *2.
55. *Id.*

a $12 million loan it made against a house, in *Concept Dorssers v. Pacific Northwest Title Insurance Co*.[56] Thereafter, the bankruptcy trustee for a prior owner sued several parties, including the insured. The trustee sought to avoid all transfers of the property including the insured's lien alleging the insured failed to pay value and acquired its purported interest in the property with the intent to hinder, delay, and defraud creditors.[57] The title insurer timely issued a denial of coverage letter, which was followed by the insured's lawsuit. The court held that the trustee's allegations of a fraudulent transfer squarely fell under Exclusion 6, and therefore there was no coverage. The court further held that because the insurer's denial of coverage and failure to provide a defense were based on a reasonable interpretation of the title policy, there was no bad faith.[58]

Can an insured argue that even though he had knowledge of a title defect, he is entitled to coverage because the insurer should have done its due diligence to discover the defect? In *Nourachi v. First American Title Insurance Co*.,[59] the insured obtained a tax deed to certain unimproved real property. After acquiring a quiet title judgment, the insured posted "no trespassing" signs on his property. When a forester with the U.S. Forest Service observed the signs on land that had long been part of the Ocala National Forest, the Forest Service demanded removal of the signs. The insured was notified that the United States owned the land, pursuant to a 1937 deed that appeared in the public records. The county made a mistake in adding the property to the county tax rolls and subjecting it to the tax sale. Several months later, First American Title Insurance Co. (First American) issued a title policy to the insured insuring the property. The insured deliberately failed to disclose the existence of the United States' claim to the property and First American negligently failed to discover it.[60] A couple of years later when the county refused to accept the insured's tax payment, he notified First American of the adverse claim of ownership. First American filed a declaratory judgment and rescission action against the insured. The trial court entered judgment in favor of First American, finding that the insured should not benefit by deliberately concealing a known defect in title and then argue that the title insurer should have been more astute in performing its title search duties.[61] On appeal, the insured

56. No. C09-1692RSL, 2010 WL 1141462, at *1 (W.D. Wash. Mar. 19, 2010).

57. *Id*. at *2.

58. *Id*. at *3. The State of "Washington imposes a duty on insurers to act in good faith. To establish the tort of bad faith, an insured must show a breach of contract that was, 'unreasonable, frivolous, or unfounded.' " *Id*. (quoting Kirk v. Mt. Airy Ins. Co., 134 Wash. 2d 558, 560, 951 P.2d 1124 (1998)).

59. 44 So. 3d 602 (Fla. Dist. Ct. App. 2010).

60. *Id*. at 603.

61. *Id*.

argued that he had no duty to disclose facts that First American could, by its own diligence, have discovered. The court rejected the argument and concluded that where an insured purchases property, and subsequently learns of facts establishing that he does not have good title to the property and then seeks title insurance without disclosing the defect, he is not entitled to recover under the policy.[62]

In *De Paz v. First American Title Insurance Co.*,[63] plaintiffs purchased Lot No. 12 from a developer, which consisted of two parcels. Plaintiffs' residence was constructed on one of the parcels (Parcel 1); however, twenty-five percent of the residence was upon the other parcel (Parcel 2). When Lot No. 12 was sold to the plaintiffs, the developer only conveyed title to Parcel 1. The tax assessor's records continued to reflect that the developer owned Parcel 2. As a result, for fourteen years, the real property taxes were assessed against the developer, who did not pay them. The tax collector foreclosed on Parcel 2 and sold the property at public auction to a third party. When plaintiffs attempted to sell Lot No. 12, their title insurer discovered the tax default on Parcel 2 and the prospective buyers canceled the sales contract.[64] The parties submitted this action to arbitration where First American and the third party were named as defendants. Subsequently, pursuant to terms of settlement, the owner of Parcel 2 rescinded the tax deed and title was transferred to plaintiffs. The arbitrator issued an award in favor of First American after concluding that its offer to insure over the title defect as to any proposed buyer was equivalent to removing the cause of the claim from the coverage provisions of the policy.[65] In plaintiffs' appeal, subsequent to the trial court's denial of their petition to vacate the arbitration award, they alleged that because the title was not marketable at the time of escrow, they suffered damages when they were unable to deliver marketable title to the purchasers. The court opined that the arbitration award was predicated upon the erroneous legal theory that the offer to insure over the title defect "effectively" removed it.[66] However,

62. *Id.* The dissent subscribes to a broader rule that would entitle the insured to coverage for the defect because First American should have discovered it in its title search. "[A]n insured under a policy of title insurance . . . is under no duty to disclose to the insurer a fact which is readily ascertainable by reference to the public records. Thus, even an intentional failure to disclose a matter of public record will not result in a loss of title insurance protection. L. Smirlock Realty Corp. v. Title Guar. Co., 418 N.E.2d 650, 654 ([N.Y.] 1981); *see also* Lawyers Title Ins. Corp. v. D.S.C. of Newark Enters., Inc., 544 So. 2d 1070, 1072 (Fla. Dist. Ct. App. 1989) (general rule is that title insurer cannot avoid liability for condition discernable from public record, even if insured knew of defect and failed to disclose it to insurer)." *Id.* at 613 (Torpy, J., dissenting).

63. No. B220937, 2010 Cal. App. Unpub. LEXIS 5863, at *1 (Ct. App. July 22, 2010).

64. *Id.* at *3.

65. *Id.* at *19.

66. *Id.* at *43.

the cause of the title defect was not actually removed and the property remained unmarketable for a year from the time an offer to insure over was made.[67] Plaintiffs' loss is measured by the amount of actual loss suffered by them as a result of the defective title. By the time the title defect was removed, one year later, plaintiffs had lost substantial equity in their home due to the collapsing real estate market. The court reversed the trial court's judgment affirming the arbitration award because the arbitrator erred in concluding First American's offer to insure over the title defect as to any proposed buyer "effectively" removed the title defect.[68]

2. Exceptions

Vacating an earlier opinion to the contrary, a federal district court judge in Tennessee held that a partial release of an easement not listed on Schedule B was not an encumbrance.[69] The original easement had been listed, but not the partial release. Since the partial release increased the owner's rights, it increased instead of decreased the property value.[70]

A real estate developer filed a declaration to establish a condominium association in *Piper v. Nitschke's Northern Resort Condominium Owner's Ass'n, LLC*.[71] The declaration[72] described the condo complex as consisting of fifteen existing units as well as five units to be constructed. Subsequent amendments to the declaration increased the size of units 19 and 20 and created unit 21—all from areas designated as a common element in the original declaration. Members of the association sued the developer for misappropriation of the common elements. When the developers tendered defense to Chicago Title, the insurer intervened in the action and moved for summary judgment, claiming that the claims were not covered because the developers' policies included specific exceptions to coverage for claims arising out of amendments to the declaration.[73] The Wisconsin Court of Appeals engaged in a grammatical dissection of the exceptions semicolon by semicolon and found that the litigation was covered. "[T]itle to [units 19 and 21] depends on the amendments because the amendments partially created unit 19 and completely created unit 21. Coverage for title insurance would not pay benefits under any reasonable expected set of circum-

67. *Id.* at *41, *44.

68. *Id.* at *42.

69. GC Fin., LLC v. Old Republic Nat'l Title Ins. Co., No. 3:06-0913, 2010 WL 1408823, at *4 (M.D. Tenn. Mar. 31, 2010).

70. *Id.* at *2, *5.

71. 777 N.W.2d 677 (Wis. Ct. App. 2009).

72. A declaration is the instrument by which a property becomes subject to the condominium chapter of the Wisconsin statutes.

73. *Piper*, 777 N.W.2d at 678.

stances, when the policy fully excludes from coverage the documents on which title depends."[74]

C. *Claims Procedure*

Are claim reserves and items in the insurer's claim file subject to discovery? After the title insurer's agent embezzled $338,000 in closing funds, the lender sued the title insurer alleging failure to honor a closing protection letter, indemnification, breach of implied covenant of good faith and fair dealing, and engaging in unfair or deceptive acts or practice in the conduct of trade or commerce in violation of the Connecticut Unfair Trade Practices Act (CUTPA).[75] The title company objected to the lender's discovery requests for its claims file and information on insurance reserves on grounds of attorney/client and work product privilege, and further argued that reserves are discoverable only when there are allegations of bad faith. With respect to the title company's privilege objection, the court held that because it had not met its burden of showing that the reserve information was created by an attorney or for purposes of litigation, it would have to produce the information if the lender alleged a sustainable bad faith claim.[76] However, the court found that the lender did not allege bad faith (contrary to its assertion otherwise under its breach of implied covenant of good faith and fair dealing and CUTPA claims), and consequently the reserve information was not subject to discovery. The court required the title company to disclose all or parts of its claims file along with a privilege log for review by the court in camera.[77]

Is a title insurer's obligations under the title policy satisfied if it conveys title to the property to the insured? In *JP Morgan Chase Bank, N.A. v. First American Title Insurance Co.*,[78] First American's agent fraudulently obtained a loan on behalf of a borrower involving an 11,000-square-foot home.[79] Based on the agent's falsely stated information that the borrower had income of $250,000 per month, the lender approved the borrower's loan application in the amount of $4.5 million.[80] First American issued a title insurance policy for this amount. As a result of other fraudulent acts

74. *Id.* at 680. This is a bizarre opinion. Maybe the court was saying if there is no valid unit 21, this is a title vesting issue. The issue is different on unit 19 because the parties agreed that it existed; only the change in its dimensions was being challenged.

75. U.S. Bank N.A. v. Lawyers Title Ins. Corp., No. CV095013702, 2010 WL 1629942, at *1 (Conn. Super. Ct. Mar. 22, 2010); *see* Conn. Gen. Stat. §§ 42-110a—42-110q (2005) (Connecticut Unfair Trade Practices Act).

76. *U.S. Bank*, 2010 WL 1629942, at *1.

77. *Id.* at *7.

78. No. 09-14891, 2010 WL 2720911, at *1 (E.D. Mich. July 8, 2010).

79. *Id.* at *1.

80. *Id.*

perpetrated by the agent, the lender did not obtain an effective mortgage lien on the property. When the borrower defaulted on his loan payments, First American acquired title and possession of the property. After the insured mortgage was assigned to J.P. Morgan Chase Bank (Chase), First American sought to convey the property to Chase in order to extinguish any possible claims that could be brought under the title policy. Chase refused to accept the property, maintaining that it was entitled to monetary damages. Chase argued that First American cannot satisfy its obligations by tendering the deed to the property, as title must be established in accordance with the definition of the term in the title policy, which is defined as vesting in the borrower, with Chase possessing a mortgage lien on the property.[81] In this case, because the purchase of the property by the borrower was a sham, title never properly vested and consequently Chase did not obtain its lien interest in the property. In such a situation, the court found that tendering full title to the property to Chase established title under the title policy. The court, noting that title insurance is not a guaranty of title, but rather a contract of indemnity, found that by tendering the title to the property to Chase, First American established the title, fully performing its obligations under the title policy.[82]

In *Chicago Title Insurance Co. v. Bristol Heights Association, LLC*,[83] the issue was whether a property seller's knowledge of a tax lien on the property should be imputed to the buyer who was a limited liability company of which the seller was a member. Bristol Heights Association, LLC (Bristol Heights) purchased property from the seller in return for $800,000 and a twenty-five percent membership interest in Bristol Heights, for which Chicago Title issued an owner's title policy. As a part of the transaction, the seller warranted that the property was free from all encumbrances. As a result of the seller's failure to pay previously owed taxes on the property, the town of Bristol placed a lien on the property.[84] After Bristol Heights' purchase of the property, the town made a demand for payment of the taxes, and Bristol Heights submitted a claim to Chicago Title. Although Bristol Heights was uncooperative with Chicago Title's investigation, it accused Chicago Title of unnecessary delay in resolving the claim. Shortly after submitting the claim, Bristol Heights paid the town $200,341 in settlement of the tax liability without notice to, or the consent of, Chicago Title.

81. *Id.* at *4.
82. *Id.* For a different view, see *Citicorp Savings of Illinois v. Stewart Title Guaranty Co.*, 840 F.2d 526, 530 (7th Cir. 1988).
83. No. X02CV074020477, 2009 WL 5698103, at *1 (Conn. Super. Ct. Dec. 30, 2009).
84. *Bristol Heights Ass'n, LLC*, 2009 WL 5698103, at *1.

Chicago Title filed an action for a declaratory judgment alleging that Bristol Heights was not entitled to coverage. The court determined that Chicago Title's claims that (1) Bristol Heights had actual or imputed knowledge of the tax liability; (2) Bristol Heights suffered no loss because its debt to the seller could be reduced by the amount paid to the town to satisfy the liens; and (3) it breached its duty of good faith and fair dealing by failing to cooperate in the investigation were questions for the jury.[85] The court denied summary judgment on Chicago Title's counts alleging: (1) Bristol Heights voluntarily assumed the loss when it paid the town without the consent of Chicago Title and (2) Bristol Heights failed to cooperate in the investigation of the claim.[86] A determination of whether a settlement by an insured of a pending claim is justified if the insurer has unreasonably delayed resolution of a claim will have to wait until the case goes to trial.

D. *Damages*

Damages for partial loss on owner policies are generally measured by the difference in market value of the property with and without the defect, or the cost of removing the defect.[87] A California case seems to follow the "cost of removal" measure. In *MBK Celamonte LLC v. Lawyers Title Insurance Corp.*,[88] a notice of communities facilities district (CFD) tax was recorded. It became due when a subdivision map was recorded or a building permit issued. A certain amount was due each year on each residential unit for up to twenty-five years or it could be paid as a one-time fee.

The insured bought the property in 2006 and planned to construct 119 townhomes. The owner policy did not list the CFD notice. No taxes were due at the time of the sale because no subdivision map had been recorded or building permits issued.

When the insured started to sell units, it learned of the special tax. After holding the insurer liable for the CFD tax, the court held it had to pay the lump-sum payoff times 119 for total damages of $869,000. The opinion does not consider allowing the insurer to make the annual payments and does not question that all 119 townhomes eventually will be built.[89]

In *Rose Development Corp. v. Einhorn*,[90] however, the measure of damages was the market value of the property, notwithstanding the purchase price was far lower than that value. In the case, the third-party defendant challenged the insured's right to recover $275,000 in damages, when the

85. *Id.* at *4, *8.
86. *Id.* at *5, *8.
87. Joyce Palomar, Title Insurance Law §§ 10.5–10.8 (2007).
88. No. G041605, 2010 WL 1697703, at *1 (Cal. Ct. App. Apr. 28, 2010).
89. *Id* at *8.
90. 886 N.Y.S.2d 59, 60 (App. Div. 2009) (granting recovery in excess of purchase price).

purchase price had only been $150,000. The court rejected the challenge and held: "where there has been a total loss of title, the measure of loss will generally be the market value of the property within the limit of the policy."[91]

E. *Insurer's Liability for Agent's Acts*

Mr. and Mrs. Goodman sold their home in New Jersey and allowed their attorney to retain most of the proceeds, which were to be used when the Goodmans closed on the purchase of another home.[92] The attorney, Pizzi, stole the Goodmans' funds. A few months later when the Goodmans had entered into a contract to buy, Pizzi contacted an agent for Stewart Title. A commitment was issued that included the notice mandated by *Sears Mortgage Corp. v. Rose*[93] that the closing attorney (Pizzi) was not the insurer's agent. The notice was provided to Pizzi but was not sent directly to the Goodmans.

The resale closed and the check to the seller and lienholder bounced. The Goodmans borrowed money to cover the stolen funds and filed a claim with the New Jersey Lawyer's Fund for Client Protection (the Fund). In turn, the Fund paid the Goodmans and took an assignment of their rights. The Fund sued Stewart Title alleging the insurer was liable for Pizzi's actions because the disclosure was not sent directly to the Goodmans. The insurer maintained that the disclosure did not have to be sent directly to the parties, but, in any event, Pizzi stole the funds a few months before he contacted Stewart Title's agent. Thus, he was not Stewart Title's agent under any theory when the theft occurred.[94]

The New Jersey Supreme Court declined to decide how the *Sears* notice must be given. Nonetheless, it held that Pizzi was not Stewart Title's agent when the funds were misappropriated and the insurer was not liable to the Fund.[95]

Title agents who close transactions perform in two capacities more or less simultaneously. They are escrow for the parties and an agent for the title insurer. Two cases this year reaffirmed the principle that insurers are not necessarily liable for the agent's activities as an escrow agent. Indeed, in *Bluehaven Funding, LLC v. First American Title Insurance Co.*[96] it was an

91. *Id.* (quoting L. Smirlock Realty Corp. v. Tit. Guar. Co., 97 A.D.2d 208, 226 (N.Y. App. Div. 1983)).

92. New Jersey Lawyer's Fund for Client Prot. v. Stewart Title Guar. Corp., 1 A.3d 632, 635 (N.J. 2010).

93. 134 N.J. 326 (1993).

94. *N.J. Lawyer's Fund*, 1 A.3d at 635–36.

95. *Id.* at 639–40. For a similar case arising in North Carolina, see *Johnson v. Schultz*, 691 S.E.2d 701, 703 (N.C. 2010) (risk that closing attorney will steal funds falls on buyer).

96. 594 F.3d 1055 (8th Cir. 2010).

associate (Hartman) of the title agent (Capital Title) who used Capital Title's office space when he defrauded the plaintiff—investor.

Here the investor gave funds to Hartman to invest in properties. With one exception, no policies or commitments were issued on these transactions. The investor later discovered Hartman had diverted the funds for his own use.

Capital Title went into receivership and the investor sued the title insurer, First American Title Insurance Co., which had an express agency agreement with Capital Title. The investor claimed that Hartman and Capital Title were acting on the insurer's behalf. Moreover, the insurer had a duty to monitor and audit the agent's activities and it failed to do so.

The court reviewed the agreement between the agent and the insurer. It was explicit that the agent had no authority to act on the insurer's behalf in providing escrow services.[97] As for monitoring the agent, any right to review files granted to the insurer was for the insurer's protection, not for third parties like the plaintiff.[98] Consequently, the insurer prevailed.

Does the insurer have to audit or monitor its agents? *Bluehaven* seems to answer that no such duty exists and a Connecticut case specifically confirms that result.[99] Here a lender sued an attorney agent for failing to list a tax sale notice and a mortgage foreclosure notice in a commitment. The plaintiff also sued the Connecticut Attorneys Title Insurance Company (CATIC) for failing to properly supervise the attorney-agent in how to issue commitments.

The trial court held that CATIC had no duty to actively supervise its 3,000 agents. Such a burden would severely overextend the insurer's resources. Moreover, agents are required to carry malpractice insurance to protect third parties.[100] The opinion notes that research does not reveal any decisions from other jurisdictions imposing liability upon a title insurer for its failure to supervise its agents.[101] The title agent/escrow agent dichotomy was not mentioned in the opinion.

III. Insurer Versus Agent

First American's issuing agent misappropriated funds intended to refinance the borrower's original mortgages.[102] As a result the refinancing lender's

97. *Id.* at 1060.
98. *Id.* at 1061.
99. DeGirolomo v. Papa, No. CV095030452, 2010 WL 654388, at *1 (Conn. Super. Ct. Jan. 15, 2010).
100. *Id.* at *2.
101. *Id.* at *5.
102. First Am. Title Co. v. First Alliance Title, Inc., 718 F. Supp. 2d 669, 672 (E.D. Va. 2010).

mortgages were not placed in first and second priority on the property but were relegated to positions behind the original mortgagee. The original mortgagee's subsequent foreclosure on the home rendered the refinancing lender's interest unsecured, compelling it to tender a claim on the title insurance policy. First American paid and subsequently filed suit against the issuing agent and its surety, alleging breach of contract and seeking $100,000, the full amount of the surety bond. First American entered into a settlement agreement with the issuing agent; however, the surety refused to pay the bond arguing that (1) the settlement agreement between First American and its issuing agent extinguished its liability; (2) First American is precluded from recovering damages suffered by it as a consequence of the misconduct of its own agent; and (3) First American took other actions that prejudiced the surety's rights and therefore preclude First American from recovering.[103] The court held that (1) the consent judgment entered against the issuing agent did not extinguish its liability and did not release the surety, so consequently the surety remained bound by its obligations under the bond;[104] (2) the losses to the refinancing lender and consequently First American were wholly caused by the issuing agent's mishandling of the settlement funds;[105] and (3) no prejudicial acts by First American relieved the issuing agent of its obligation to pay First American under the terms of the bond. The court held that the issuing agent was liable for the full amount of the surety bond in the amount of $100,000.[106]

IV. Duties of Title/Escrow Agent

A. *Duty to Search Title*

This year's cases focused on the agent's duties to search title, handle escrow funds, handle documents, and disclose information about the transaction.

In *U.S. Bank, N.A. v. Integrity Land Title Corp.*,[107] an agent failed to except to a judgment against the seller in the commitment. The transaction closed and a mortgage policy issued to the lender. The judgment holder filed an action to determine priority and won.

The case would have usually ended with a claim on the mortgage policy. However, the title insurer was in receivership.[108] The lender's assignees sued the title agent in contract and tort. The Indiana Supreme Court held

103. *Id.* at 674.
104. *Id.* at 676.
105. *Id.* at 678.
106. *Id.* at 684.
107. 929 N.E.2d 742 (Ind. 2010).
108. *Id.* at 744 n.2.

that there was no privity for a contract claim, and the agent is not a party to the title issuance policy.[109]

The court determined that absent a contract, plaintiff could sue the agent for negligent misrepresentation. It is an exception to Indiana's version of the economic loss rule.[110] The opinion reviewed decisions both pro and con on the issue from other states. The case was remanded so the lender's assignees could go to trial on the tort cause of action.[111]

Does Wisconsin statutory law permit an award of attorney fees and costs to an insured for costs incurred in litigating liability and coverage issues? Two years after purchasing a residential lot, the insured was notified that a natural gas easement was on her property.[112] Chicago Title filed an action against the insured seeking a declaration that the proper covered loss due to the gas pipeline was valued at $14,000. In her answer, the insured challenged Chicago Title's appraisal of the loss and requested the court declare that the loss was $33,210. After granting judgment in favor of the insured, the court awarded the insured attorney fees of $24,412.50 and costs of $8,382 based on the equities of the case under § 806.04(8) of the Wisconsin Statutes.[113] In a case of first impression, the court analyzed case law discussing the statute and whether the recovery of attorney fees expended by the insured in establishing coverage is recoverable where there has been no breach of the duty to defend by the insurer.[114] The court determined that attorney fees are not recoverable under the statute where there has been no breach of the duty to defend.[115] The court further held

109. *Id*. at 745.

110. Indianapolis Marion County Pub. Library v. Charlier Clark & Linard, 929 N.E.2d 722, 741 (Ind. 2010).

111. *Id*. at 734. For a recent similar case, see *Hamilton v. Trans Union Settlement Solutions, Inc*., 295 S.W.3d 844, 848 (Ky. Ct. App. 2009).

112. Chicago Title Ins. Co. v. Voss, No. 2009AP1185, 2010 WL 3420234, at *1 (Wis. Ct. App. Sept. 1, 2010).

113. Section 806.04(8) of the Wisconsin Statutes provides:

> SUPPLEMENTAL RELIEF. Further relief based on a declaratory judgment or decree may be granted whenever necessary or proper. The application therefore shall be by petition to a court having jurisdiction to grant the relief. If the application be deemed sufficient, the court shall, on reasonable notice, require any adverse party whose rights have been adjudicated by the declaratory judgment or decree, to show cause why further relief should not be granted forthwith.

Wis. Stat. § 806.04(8) (2010).

114. *See* Elliot v. Donahue, 485 N.W.2d 403, 407 (Wis. 1992) (recovery of attorney fees and costs permitted where incurred because title insurer failed to follow required procedures in requesting a bifurcated trial and moving to stay any proceedings on liability until the issue of coverage was resolved); *cf*. Reid v. Benz, 629 N.W.2d 262, 273–74 (Wis. 2001) (the insured was not entitled to attorney fees expended solely to establish a duty to indemnify where the insurer did not breach its duty to defend).

115. *Voss*, 2010 WL 3420234, at *2.

that an award of costs under the statute is within the discretion of the trial court. Consequently, the court held that the trial court erred in its award of attorney fees to the insured and upheld the trial court's discretionary award of equitable and just costs under the statute.[116]

B. *Handling Documents*

An agent's failure to timely record documents had severe consequences in two cases this year. In one, the result was the avoidance of a $20 million mortgage after the borrower filed bankruptcy almost six years later.[117] In a second one, punitive damages of $672,000 were assessed against the agent who apparently lost a deed and mortgage and took no action to cure the problem before the buyer died two years later.[118]

C. *Duty to Disclose*

The title agent handling the sale of an Iowa motel was advised by the seller's real estate agent not to collect the prior year's taxes at closing.[119] Buyer apparently did not understand how taxes were assessed and collected in Iowa and signed the closing statement. When the buyer became aware the prior year's taxes were unpaid, it sued the sellers, their real estate agent, and the title agent.

The buyer alleged the title agent had a duty to advise of its error concerning Iowa taxes. The court of appeals held there was ". . . no duty to disclose information received by [the title agent] unless the agent had actual knowledge of a fraud being committed on one party."[120] The failure to point out the buyer's error on Iowa law did not rise to that standard.

In another case on disclosure obligations, Brown obtained a business loan from Dorsch and Delatoba (D&D).[121] Shortly thereafter; D&D tendered documents for a $375,000 secured loan against Brown's house to CMG Escrow. Brown's signature was forged on these documents. The loan proceeds were disbursed per the escrow instructions to a third party.

After the loan closed, Brown learned of the recorded documents and sued CMG Escrow for slander of title.[122] The appellate court held the agent

116. *Id.*

117. *In re* Bill Heard Enters., Inc., 420 B.R. 553, 567 (Bankr. N.D. Ala. 2009).

118. Chase Manhattan Mortgage Co. v. Lane, No. 3:09-cv-47, 2010 WL 2738266, at *1 (W.D.N.C. July 9, 2010).

119. Wildcat Inns v. First Am. Title Ins. Co., No. 09-1195, 2010 WL 1875730, at *1 (Iowa Ct. App. May 12, 2010).

120. *Id.* at *7.

121. Brown v. CMG Escrow Co., No. B215706, 2010 WL 93228, at *1 (Cal. Ct. App. Jan. 12, 2010).

122. *Id.*

could not be liable for slander of title because no malice had been shown. Moreover, the agent had no duty to verify escrow documents had genuine signatures. The agent had complied with the escrow instructions.[123] Of course, the lender likely made a claim on its loan policy.[124]

V. GOVERNMENTAL REGULATIONS

A. *Federal*

There were many rate reissue cases this year, and of particular interest are a couple of cases from Texas regarding whether or not RESPA liability under § 8(b) can be part of a class action claim. In *Mims v. Stewart Title Guaranty Co.*,[125] the Fifth Circuit rejected a RESPA class theory based on a HUD reasonable relationship test, which had previously been rejected in the case *O'Sullivan v. Countrywide Home Loans, Inc.*[126] because this standard of liability required too much of an individualized inquiry into the fact situation of each particular plaintiff to be handled as a class. In *Hamilton v. First American Title Insurance Co.*,[127] however, another Texas federal judge found a way around this problem by distinguishing the plaintiff's theory of RESPA § 8(b) liability from *Mims* and *O'Sullivan*. The *Hamilton* court found that plaintiff's RESPA claims rested on a question of law, specifically whether or not "title agents were barred by Texas law from accepting any compensation for services actually performed in connection with the issuance of the plaintiffs' lender's policies other than a split of the premium mandated by Rate Rule R-8."[128]

An Illinois case this year involved a challenge to the status of attorney agents who allegedly did not perform core title services. If proven, such a model would violate RESPA § 8(e) and 24 C.F.R. § 3500.14(g)(3). In *Chultem v. Ticor Title Insurance Co.*,[129] Ticor allegedly operated a system whereby attorney agents that referred business to Ticor were paid for core title agent services that they did not perform. Instead, these services for which they were paid were performed by Ticor. The court found this to be an actionable violation of RESPA and certified the class action.[130]

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123. *Id.*

124. On the limited nature of this duty, see *Victory v. Sneed Financial Services, LLC*, No. 03:07CV17970, 2010 WL 45918, at *1 (N.D. Tex. Jan. 6, 2010) (escrow agent had no duty to verify data seller provided regarding equipment or seller's business dealings).

125. 590 F.3d 298 (5th Cir. 2006).

126. 315 F.3d 732 (5th Cir. 2003).

127. 266 F.R.D. 153 (N.D. Tex. 2010).

128. Tex. Dep't of Ins., Basic Manual of Rules, Rates and Forms for the Writing of Title Insurance in the State of Texas § III, Rate Rule R-8 (2006).

129. 927 N.E.2d 289 (Ill. App. Ct. 2010).

130. *Id.* at 297; *cf.* Howland v. First Am. Title Ins. Co., No. 07 C 2628, 2009 WL 2180832, at *1 (N.D. Ill. July 21, 2009) (finding in similar fact pattern that claim was not an appropriate matter for a class action).

In *Carter v. Wells Bowen Realty*,[131] the plaintiffs allege that Chicago Title collaborated with two real estate firms to create two sham title companies, and to split the profit from those companies with the real estate firms. The court found that HUD's ten-step test for determining if a company is a sham is void for vagueness. The court was then left to determine if the companies were affiliated business arrangements (ABA). The companies indisputably performed some services, making them an ABA. To be exempt from liability, an ABA must have "(1) disclosure of the ownership arrangement; (2) no requirement for the consumer to use a particular provider; and (3) the only thing of value received by the ABA parents was their ownership interest in the provider." The court found that the companies in this case met these standards, and so had no liability under RESPA.[132]

B. *State*

In *Texas Department of Insurance v. Reconveyance Services, Inc.*, the Texas Supreme Court, in a per curiam decision, reiterated the rules of sovereign immunity and dismissed the plaintiff title insurer's claim.[133] In the case, Reconveyance Services, Inc. (RSI) provided post-closing mortgage release monitoring and verification services. Its representative contacted the Texas Department of Insurance (TDI) about offering its services in Texas. A TDI staff member responded that the services were part of the service purchased with a title insurance premium and therefore could not be charged for with an additional fee.[134]

RSI filed a declaratory judgment action against TDI but not against any of its officers or employees. It sought an order allowing it to offer its services through Texas title agents and asserted that TDI's prohibition was ultra vires its authority. The Texas Supreme Court dismissed the suit on the basis of sovereign immunity, noting that while sovereign immunity did not bar suit for ultra vires actions, such suits can only survive the bar if they are brought against the individuals claimed to be acting ultra vires.[135] A suit against TDI alone, therefore, had no jurisdictional basis.

VI. MISCELLANEOUS

A. *Bankruptcy*

A California case reaffirmed the long-standing tenet that an unscheduled bankruptcy asset remains property of the estate indefinitely. In *In re Dun-*

131. 719 F. Supp. 2d 846 (N.D. Ohio 2010).
132. *Id.* at 855.
133. 306 S.W.3d 256 (Tex. 2010) (per curiam).
134. *Id.* at 258.
135. *Id.* at 259–60 (citing City of El Paso v. Heinrich, 284 S.W.3d 366, 372 (Tex. 2009)).

ning Brothers Co., Dunning Brothers Co. ("DBC") filed a voluntary petition in bankruptcy in 1936.[136] DBC entered "NONE" on Schedule B-1 "Real Estate" and "NONE" as "Interest in Land" on Schedule B-4, "Property in Reversion, Remainder or Expectancy, Including Property Held in Trust for the Debtor or Subject to Any Power or Right to Dispose of or to Charge."[137] Neither statement was accurate. It appears that the estate was fully administered and the case was closed in August 1937. Three unscheduled (and unknown) DBC parcels comprised the fee interest under a railroad right-of-way. Seventy-three years later, the railroad owner desired to acquire the fee title to the three parcels and sought to reopen the bankruptcy.[138] The court held that the question of whether the case should be reopened would be determined under the Bankruptcy Act of 1898, rather than the Bankruptcy Code.[139] The court determined that the unscheduled real property had not been administered and it was still property of the estate, which therefore was eligible to be reopened.[140]

B. *Recording Statutes*

A properly recorded notice of assessment in California gives a buyer constructive notice of a lien, even if the notice is not recorded in the grantor-grantee index.[141] In *612 South LLC v. Laconic Limited Partnership*, the property owner financed the payment of a tax assessment by having the water district issue and sell a bond, which allowed the owner to pay off the assessment amount over time. Several years after the owner defaulted, an investor purchased the property at a public auction of the tax-defaulted property.[142] After the investor failed to pay delinquent taxes, the bondholder sought a judgment ordering the foreclosure and sale of property subject to a water district bond. The trial court concluded that the investor had actual, constructive, or inquiry notice of the assessment and that the bondholder was entitled to a foreclosure sale of the property. On appeal, the court noted that before the investor purchased the property, it obtained a preliminary title report indicating that a special tax was assessed against the property and that it would be collected with the county taxes.[143] The trial court rejected the investor's contention

136. 410 B.R. 877 (Bankr. E.D. Cal. 2009).

137. *Id*. at 879.

138. *Id*. at 880.

139. The court gives a great review of the history of jurisdiction of federal courts over bankruptcy cases from the Bankruptcy Act of 1898 to the present Bankruptcy Code. Laches was occasionally recognized as a basis for not reopening a case under the Bankruptcy Act. *Id*. at 889.

140. *Id*. at 887–88. In determining to reopen the case, the court found that "[n]o useful purpose would be served by refusing to reopen" the case. *Id*. at 889.

141. 612 South LLC v. Laconic Ltd. P'ship, 184 Cal. App. 4th 1270 (2010).

142. *Id*. at 1275.

143. *Id*. at 1276.

that failure to index the notice of assessment under the name of the property owner in the county recorder's office rendered the tax lien invalid, and found that the investor was not a bona fide purchaser for value. The court affirmed, finding that the investor had constructive notice of the bond and assessment lien because a notice of assessment had been properly recorded at the county recorder's office, and there is no statutory requirement that the notice of assessment be indexed in the grantor-grantee index.[144]

C. *LandAmerica Bankruptcy*

In *In re § 1031 Exchange Litigation*,[145] LandAmerica 1031 Exchange Services, Inc. (LES) invested its clients' exchange funds[146] in auction rate securities. That market froze in February, 2008, and LES was unable to convert the securities to cash. Until filing bankruptcy in November 2008, LES used the funds from new customers to pay on the exchanges it invested for existing customers. A group of customers, who were affected by the market freeze in February 2008 sued Sun Trust because it had arranged for the purchase of the securities by LES, and LES had its remaining exchange funds in Sun Trust accounts (the "Customers"). The Customers claimed Sun Trust (1) aided and abetted LES's breach of fiduciary duty, (2) converted the funds, (3) aided and abetted LES's conversion, and (4) engaged in a civil conspiracy.[147] As all of the allegations occurred in Richmond, Virginia, the court applied Virginia law to the Customers' claims. The court dismissed "the aiding and abetting breach of liability claim for want of actual knowledge of the primary wrong; the conversion and aiding and abetting conversion claims because the Customers did not have an immediate right to possession of the Exchange Funds; and the civil conspiracy claim because the complaint fails to adequately allege an agreement to act."[148]

D. *Unauthorized Practice of Law*

In *Ohio State Bar Association v. Dalton*,[149] the state bar association filed a complaint against the title company and its agent alleging that the de-

144. *Id*. at 1280.

145. 716 F. Supp. 2d 415 (D.S.C. 2010).

146. For a fee LES would serve as a qualified intermediary to customers who desire to effect a tax-deferred like-kind exchange under § 1031 of the Internal Revenue Code. 26 U.S.C. § 1031 (2006). Qualified intermediaries hold the proceeds of a real estate sale until the customer chooses to purchase another property. At closing, the qualified intermediary transfers the proceeds to the seller of the property. By using a qualified intermediary, a customer can avoid realizing a taxable gain on the sale of his property, as a customer avoids possession of his initial sale proceeds, effectively deferring any taxable gain until the property is sold. *See In re Section 1031 Exch. Litig*., 716 F. Supp. 2d at 419.

147. *In re Section 1031 Exch. Litig*., 716 F. Supp. 2d at 419–20.

148. *Id*. at 428.

149. 924 N.E.2d 821 (Ohio 2010).

fendants engaged in unauthorized practice of law by preparing general warranty deeds and forging an attorney's signature on one of them.[150] Before the Board on the Unauthorized Practice of Law issued its final report, the title company dissolved and the agent filed for bankruptcy. The court first determined that the automatic stay by the bankruptcy court does not stay commencement or continuation of an action or proceeding by a governmental entity to enforce its police or regulatory powers, and thus does not stay the proceedings arising from the unauthorized practice of law.[151] The court found that the defendants prepared and filed both deeds and that they forged an attorney's signature on one of them. Consequently, the defendants engaged in the unauthorized practice of law because the agent was not an attorney and the title company, as a corporation, cannot practice law.[152]

150. *Id*. at 822.
151. *Id*. at 823.
152. *Id*. at 824.

RECENT DEVELOPMENTS IN TOXIC TORTS AND ENVIRONMENTAL LAW

Beth M. Kramer, Scott L. Winkelman, Gloria Martinez Trattles, Jennifer E. Schlosser, April N. Ross, Joel D. Smith, Brandon G. Waggoner, and Brian J. Weber

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I. FEDERAL PREEMPTION

On September 15, 2010, the Ninth Circuit Court of Appeals upheld a district court ruling that guidelines enacted by a California Air Quality District to limit air pollution created by idling trains were preempted by the Interstate Commerce Commission Termination Act of 1995 (ICCTA),[1] a federal act that substantially deregulated the railroad industry.[2]

Under California law, guidelines issued by an Air Quality District within the scope of its regulatory authority have the force and effect of state law.[3] The Association of American Railroads argued that the guidelines

1. Interstate Commerce Commission Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803.

2. Ass'n of Am. R.Rs. v. S. Coast Air Quality Mgmt. Dist., No. 07-55804, 2010 WL 3565261 (9th Cir. Sept. 15, 2010).

3. Cal. Health & Safety Code § 40001.

pertaining to idling trains were preempted by ICCTA.[4] ICCTA delegates to the Surface Transportation Board jurisdiction over the regulation of rail transportation.[5] The statutory language establishes that "remedies provided" in ICCTA "with respect to regulation of rail transportation are exclusive and preempt the remedies provided under Federal and State law."[6] The Ninth Circuit previously interpreted ICCTA to preempt "a wide range of state and local regulations of rail activity."[7]

In *Association of American Railroads*, the Ninth Circuit explained that "[g]enerally speaking," ICCTA does not preempt state laws of "general applicability that do not unreasonably interfere with interstate commerce."[8] In other words, ICCTA preempts state laws that have "the effect of managing or governing rail transportation" but not those that have a "more remote or incidental effect on rail transportation."[9] In applying ICCTA preemption law to the guidelines enacted by the California Air Quality District, the court held that that the guidelines were not of general applicability.[10] Rather, the court found, the guidelines applied exclusively and directly to railroad activity, requiring specific actions by the railroads under threat of penalties.[11] Accordingly, the Ninth Circuit held that the guidelines are preempted by ICCTA.

The analysis articulated by the Ninth Circuit focuses on a conflict between state or local law and ICCTA. The analysis is different, explained the court, when the conflict is between ICCTA and federal law. There, the Ninth Circuit posited, courts must attempt to "harmonize" the two laws, and, if possible, give effect to both.[12] The California Air Quality District argued that such harmonization should occur here: it alleged that it would submit these guidelines to the California Air Resources Board, which would then submit the guidelines to the U.S. Environmental Protection Agency for inclusion in California's overall state implantation plan under the Clean Air Act.[13] Once approved by EPA, the guidelines would then have "the force and effect of federal law."[14]

While recognizing that ICCTA does not generally preempt EPA-approved state law plans, the Ninth Circuit rejected the Air Quality Dis-

4. *Ass'n of Am. R.Rs.*, 2010 WL 3565261, at *2 (citing 49 U.S.C. § 10501(b)).
5. 49 U.S.C. § 10501(b).
6. *Id.*
7. *Ass'n of Am. R.Rs.*, 2010 WL 3565261, at *2 (citing City of Auburn v. United States, 154 F.3d 1025, 1029–31 (9th Cir. 1998)).
8. *Id.*
9. *Id.* (internal citations and quotations omitted).
10. *Id.* at *3.
11. *Id.*
12. *Id.* at *2.
13. *Id.* at *3.
14. *Id.*

trict's attempt to convert the guidelines into federal law, reasoning that the guidelines do not currently have the force and effect of federal law, "even if they might in the future."[15] The court thus concluded that it lacks authority to attempt to harmonize the guidelines with ICCTA.[16]

II. Duty to Warn

California appellate courts are now split on the issue of whether a product manufacturer owes a duty to warn of dangers created by products manufactured by a third party that may be used in conjunction with the manufacturer's own product. There are five relevant California appellate decisions on this point.[17] All five were issued in asbestos cases where the defendant's product (e.g., a valve or pump) did not contain asbestos, but the product was either designed to be used with, or known to be likely used with, asbestos-containing insulation or other asbestos-containing products upon purchase and installation. Four of the five decisions—*Taylor*, *Merrill*, *Hall*, and *Walton*—are consistent with the reasoning of the Washington Supreme Court's 2008 rulings in *Braaten*[18] and *Simonetta*[19] (also asbestos cases), which rejected efforts to impose liability for a third party's product under both negligence and strict liability theories. The fifth, *O'Neil*, found that the use of the defendant's asbestos-free product in conjunction with an asbestos-containing product was a sufficient basis on which to predicate the defendant's liability.[20] In particular, the court in *O'Neil* determined that because the defendant's pumps and valves were neither fungible nor multiuse component parts, but were specifically designed to be used with asbestos insulation (albeit insulation manufactured by a third party), the defendant's pumps and valves were defective in and of themselves.[21]

15. *Id.*

16. *Id.*

17. *See* Taylor v. Elliot Turbomachinery Co., 90 Cal. Rptr. 3d 414, 426 (Ct. App. 2009), *rev. denied* (June 10, 2009) (rejecting strict products liability for manufacturers of equipment used in Navy aircraft carrier propulsion systems); Merrill v. Leslie Controls, Inc., 101 Cal. Rptr. 3d 614, 622–23 (Ct. App. 2009) (following *Taylor* with respect to valve manufacturer); O'Neil v. Crane Co., 99 Cal. Rptr. 3d 533, 542–43 (Ct. App. 2009) (refusing to follow *Taylor* with respect to manufacturer of valves and pumps); Hall v. Warren Pumps LLC, No. B208275, 2010 WL 528489, at *5 (Cal. Ct. App. Feb. 16, 2010), *review granted* (May 12, 2010) (following *Taylor* with respect to pump and valve manufacturers); Walton v. William Powell Co., 108 Cal. Rptr. 3d 412, 419 (Ct. App. 2010) (following *Taylor* with respect to valve manufacturer).

18. Braaten v. Saberhagen Holdings, 198 P.3d 493 (Wash. 2008).

19. Simonetta v. Viad Corp., 197 P.3d 127 (Wash. 2008).

20. *O'Neil*, 99 Cal. Rptr. at 542–43.

21. *Id.*

The California Supreme Court has granted review of *O'Neil*, *Merrill*, *Walton*, and *Hall*.[22] However, pursuant to Rule 8.512(d)(2) of the California Rules of Court, briefing and all further action in *Merrill*, *Walton*, and *Hall* have been deferred pending the California Supreme Court's disposition of *O'Neil*.

III. Scientific Evidence

A. *Arizona Finally in the* Daubert *Camp*

Pursuant to legislation passed in Arizona on May 10, 2010, and effective July 29, 2010, Arizona state courts must now follow the federal *Daubert* standard.[23] Previously, Arizona had adhered to the *Frye* standard, which contemplates a "pre-trial inquiry into the general acceptance of a scientific principle or discovery underlying an expert witness's proffered testimony."[24] Unlike many states that adopted the *Daubert* standard through case law, Arizona did so through legislative fiat. Legislation was necessary, in part, because of the Arizona Supreme Court's reluctance to adopt the *Daubert* standard despite repeated requests from lower courts, including the Arizona Court of Appeals.[25] Under the modified *Daubert* standard adopted by Arizona, a court must consider whether the expert's testimony or technique can be tested and has been subject to peer review; the potential rate of error of the expert opinion; and whether the opinion is generally accepted in the field.[26] With this legislation, Arizona joins the majority of states that follow some version of the *Daubert* standard for expert testimony. In January 2011, the Arizona Court of Appeals held § 12-2203 unconstitutional.[27] The Arizona Supreme Court has yet to rule on the matter.

B. *Plaintiffs Cannot Rely Solely on Governmental Classifications to Establish a Causal Link*

The Northern District of Ohio held in *Mann v. CSX Transportation, Inc.*[28] that plaintiffs seeking medical monitoring relief could not meet their burden to show that a railroad defendant proximately caused their damages by relying solely on government classifications and not independent expert assessments of the potential link between chemical exposure and disease.[29] In

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22. *O'Neil*, 104 Cal. Rptr. 3d 129 (2009); *Merrill*, 105 Cal. Rptr. 3d 181 (2010); *Walton*, 111 Cal. Rptr. 3d 18 (2010); *Hall* (review granted) (Cal. May 12, 2010).
23. Ariz. Rev. Stat. § 12-2203 (2010).
24. Lohmeier v. Hammer, 148 P.3d 101, 109 (Ariz. Ct. App. 2006) (explaining the *Frye* standard).
25. *Id.* at 115.
26. Ariz. Rev. Stat. § 12-2203(B)(1)–(4).
27. Lear v. Fields, 245 P.3d 911 (Ariz. Ct. App. 2011).
28. No. 1:07-cv-3512, 2009 WL 3766056 (N.D. Ohio Nov. 10, 2009).
29. *Id.* at *3.

Mann, plaintiffs filed a putative class action immediately following the October 10, 2007, derailment in Painesville, Ohio, of a freight train operated by CSX Transportation (CSXT).[30] Thirty-one cars, nine of which contained hazardous materials, went off the tracks.[31] The derailment and subsequent sixty-hour fire resulted in a three-day evacuation of the surrounding community by the local fire department.[32]

At issue in *Mann* was whether plaintiffs could prove both general and specific causation with respect to plaintiffs' claimed exposures and alleged need for medical monitoring. Specifically, plaintiffs were required to show "(1) [that] the dioxins released into the air by the fire are known causes of human disease; and (2) that the named [p]laintiffs were exposed to dioxins in an amount sufficient to cause a significantly increased risk of disease such that a reasonable physician would order medical monitoring."[33]

In granting CSXT summary judgment, the court held first that plaintiffs erred "because their experts rely on carcinogen classifications as their only evidence that dioxins cause the endpoint diseases for which they seek medical monitoring."[34] Absent "an independent assessment of the causal link between dioxins and disease" by plaintiffs' experts, this reliance was inappropriate.[35] Moreover, although plaintiffs also relied on the Veterans Administration's Agent Orange program "as evidence that dioxins are presumptively linked to cancer,"[36] the court found this comparison "groundless" because that VA program was designed to measure mere associations between dioxins and endpoint diseases, and *not* to determine causation.[37] As the court explained, "association does not satisfy the element of causation."[38] The court thus concluded that plaintiffs had "not demonstrated a causal link between dioxins and cancer."[39]

Second, the court held that "[e]ven if [p]laintiffs could demonstrate a causal relationship between dioxins and cancer, [p]laintiffs have failed to establish that they were exposed to dioxins in an amount warranting a reasonable physician to order medical monitoring."[40] As explained by the court, "[m]ere residence in the impact zone is insufficient evidence of contamination and increased risk because it ignores any individual variables, most notably, at

30. *Id*. at *1.
31. *Id*.
32. *Id*.
33. *Id*. at *3.
34. *Id*.
35. *Id*.
36. *Id*. at *4.
37. *Id*. (internal quotations omitted).
38. *Id*.
39. *Id*.
40. *Id*.

what level the named [p]laintiffs were actually exposed to dioxins."[41] The court went further, concluding that even if plaintiffs could offer evidence of sufficient dioxin exposure, this would not necessarily mean that a "reasonable physician would order medical monitoring based on this exposure."[42]

The court also rejected plaintiffs' reliance on EPA's soil cleanup levels "as a basis for justifying medical monitoring,"[43] finding that a conservative soil cleanup level is not a substitute for a "medically-based risk assessment or evidence of the actual dose level at which dioxin truly causes cancer."[44] In addition, the EPA's threshold soil cleanup level represents an increased risk that the general population would develop cancer of only one in one million.[45] The court observed that "courts have found risks higher than in the instant matter to be insignificant as a matter of law."[46] Accordingly, the district court held that "[p]laintiffs have not presented enough evidence for a reasonable jury to conclude that such a burdensome program is warranted."[47] Plaintiffs have appealed to the Sixth Circuit.[48]

IV. MEDICAL MONITORING

A. *Medical Monitoring Permitted in Massachusetts When, Among Other Requirements, Physiological Changes Are Present*

In a highly anticipated decision, the Supreme Judicial Court of Massachusetts held in *Donovan v. Philip Morris USA, Inc.* that Massachusetts law recognizes medical monitoring claims absent a manifest disease or illness.[49] The court in *Donovan* certified two questions from the District Court of Massachusetts and, upon granting review, held that Massachusetts recognizes medical monitoring claims where a plaintiff can demonstrate toxic exposure resulting in physiological changes that indicate a substantial risk of disease or illness.[50]

In *Donovan*, the plaintiffs sought to certify a class of Massachusetts residents over the age of fifty who smoked a pack a day of Marlboro cigarettes for over twenty years, had not been diagnosed with lung cancer, and were not being monitored for suspected lung cancer.[51] Plaintiffs, alleging that

41. *Id.*
42. *Id.* at *5.
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.*
47. *Id.* at *6.
48. Hirsch v. CSX Transp., Inc., No. 09-4548 (6th Cir. filed Dec. 21, 2009).
49. 914 N.E.2d 891 (Mass. 2009).
50. *Id.* at 902.
51. *Id.* at 895.

Philip Morris "wrongfully designed, marketed, and sold" cigarettes, asserted claims for breach of implied warranty based on design defect, negligent design and testing, and violations of the Massachusetts consumer protection statute.[52] They also asserted that the cigarettes were defectively designed and were more dangerous than other commercially acceptable cigarettes.[53]

Plaintiffs alleged that cigarette smoke injured their lung tissue and structure but did not assert that they currently suffered from a smoking-related disease. Instead, they alleged that they were at a "significantly increased risk" of developing lung cancer.[54] In lieu of damages, plaintiffs sought court-supervised medical monitoring in the form of low-dose computed tomography chest scans designed to detect lung cancer early.[55]

Massachusetts' highest court concluded that plaintiffs had stated a claim for future medical expenses.[56] The court held that medical expenses can be recovered for "diagnostic tests needed to monitor medically a person who has been substantially exposed to a toxic substance that has created physiological changes indicating a substantial increase in risk that the person will contract a serious illness or disease."[57] The *Donovan* court set forth a seven-factor test to determine when medical monitoring is appropriate and emphasized that expert testimony will usually be required.[58] The court then concluded that the "single controversy rule" would not bar a subsequent action for damages if one of the plaintiffs were eventually to contract cancer.[59]

Turning to the statute of limitations, the court held that the notice relevant to accrual of a medical monitoring claim is the "substantial increase in the risk of cancer."[60] As articulated by the court, substantial increase in risk requires a doctor's finding of subclinical changes that are not obvious to the patient.[61] Thus, the limitations period begins to run when (1) there is a "physiological change resulting in a substantial increase in the risk of cancer; and (2) that increase, under the standard of care, triggers the need for available diagnostic testing that had been accepted in the medical community as an efficacious method of lung cancer screening or surveillance."[62]

52. *Id.*
53. *Id.* at 896.
54. *Id.*
55. *Id.* at 895.
56. *Id.* at 898.
57. *Id.* at 901.
58. *Id.* at 902.
59. *Id.* at 903.
60. *Id.*
61. *Id.*
62. *Id.*

Eight months after the Supreme Judicial Court's ruling, the District of Massachusetts certified a class on the implied warranty and consumer protection claims in *Donovan* under both Rule 23(b)(2) and (3).[63] The court denied plaintiffs' motion to certify on the claim of negligence.[64]

B. *Punitive Damages Cannot Be Awarded on Medical Monitoring Claim in West Virginia*

Although West Virginia has recognized a cause of action for medical monitoring since 1999,[65] the Supreme Court of Appeals of West Virginia recently addressed a related matter of first impression in *Perrine v. E.I. du Pont de Nemours and Co.*:[66] whether punitive damages can be awarded on a claim of medical monitoring. In a lengthy opinion on a variety of legal issues, the court resolved this question in the negative.

In *Perrine*, plaintiffs brought a putative class action alleging contamination from a zinc smelter facility in West Virginia.[67] In the underlying case, defendant was found liable for $381 million to a property class and a medical monitoring class.[68] The court concluded that because medical monitoring claims in West Virginia are based on the "risk" of contracting a disease and not an "actual, present physical injury," punitive damages "may not be awarded on a cause of action for medical monitoring."[69]

V. DAMAGES

A. *Economic Losses for Damages to Marine Life Available to Fishermen Under Florida's Discharge Statute and Common Law Negligence Claims*

In *Curd v. Mosaic Fertilizer, LLC*,[70] the Supreme Court of Florida ruled that fishermen affected by an oil spill off the coast of Tampa Bay did not need to own property to recover damages. Plaintiffs in *Curd* were fishermen who brought an action against a defendant that owned or controlled a phosphogypsum storage area.[71] Pollutants contained in defendant's wastewater spilled into Tampa Bay, allegedly resulting in the "loss of underwater plant life, fish, bait fish, crabs, and other marine life."[72] The fishermen filed a

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63. Donovan v. Philip Morris USA, Inc., 268 F.R.D. 1, 30 (D. Mass. 2010).
64. *Id.*
65. Bower v. Westinghouse Elec. Corp., 522 S.E.2d 424 (W. Va. 1999).
66. 694 S.E.2d 815 (W. Va. 2010).
67. *Id.* at 828.
68. *Id.*
69. *Id.* at 880–81.
70. 39 So. 3d 1216, 1218 (Fla. 2010).
71. *Id.* at 1218.
72. *Id.*

putative class action "implicitly" seeking damages "in the nature of lost income and products" under Florida's discharge statute, Florida Statutes § 376.313 (2004), and common law claims of negligence and strict liability.[73] Plaintiffs did not claim to own the damaged property in question.[74]

The lower court held that because the fishermen did not own the relevant property, their claims were invalid.[75] Specifically, the court concluded that the fishermen's claims were for "purely economic damages unrelated to any damage to the fishermen's property" and that defendant "did not owe an independent duty of care to protect the fishermen's expectation of profits."[76] The lower court held further that Florida's discharge statute does not permit recovery for damages when the party seeking relief does not own or have a possessory interest in the property damaged by pollution.[77]

The Florida Supreme Court reversed. First, it held that Florida's discharge statute is part and parcel of a "far-reaching statutory scheme aimed at remedying, preventing, and removing the discharge of pollutants from Florida's waters and lands" and provides a private cause of action to "any person who can demonstrate damages as defined under the statute."[78] According to the court, such damages include " 'the documented extent of any destruction to or loss of any real or personal property or . . . of any destruction of the environment and natural resources, including all living things except human beings, as the direct result of the discharge of a pollutant.' "[79] Because the court determined that this statutory text allows recovery for damages to natural resources including "all living things," lack of property ownership was not a bar to the fishermen's recovery.

Second, the court held that the economic loss doctrine, which prevents recovery in tort for purely economic damages, is applicable in only two situations:

> (1) where the parties are in contractual privity and one party seeks to recover damages in tort for matters arising out of the contract, or (2) where the defendant is a manufacturer or distributor of a defective product which damages itself but does not cause personal injury or damage to any other property.[80]

The *Curd* court found that neither of these two situations applied and that plaintiffs' causes of action were controlled by traditional negligence law

73. *Id*. at 1219.
74. *Id*. at 1218–19.
75. *Id*. at 1223.
76. *Id*.
77. *Id*. at 1219.
78. *Id*. at 1222.
79. *Id*. at 1221 (citing Florida's discharge statute, Fla. Stat. § 376.031(5)).
80. *Id*. at 1223.

and strict liability principles.[81] The court added that defendant owed a duty to the fishermen that arose "out of the nature of [defendant's] business and the special interest of the commercial fisherman [sic] in the use of the public waters."[82] The court concluded that because defendant's discharge of pollutants "constituted a tortious invasion that interfered with the special interest of the commercial fishermen to use those public waters to earn their livelihood," defendant breached its duty, giving rise to a claim of negligence.[83]

B. *Punitive Damage Award Struck Down in Texas Exposure Case Where Plaintiffs Cannot Prove Gross Negligence*

In *Garner v. BP Amoco Chemical Co.*,[84] the Southern District of Texas determined that a jury's award of punitive damages in a toxic release case was unwarranted.[85] In *Garner*, over 100 plaintiffs filed suit alleging that "defendant released an unidentified toxic substance into the atmosphere at its refinery causing personal injuries to workers."[86] The jury awarded $10 million in punitive damages to each of the ten plaintiffs who litigated their claims first. Defendant challenged the award.[87]

By statute, to recover punitive damages in Texas, a plaintiff must prove gross negligence "by clear and convincing evidence."[88] The *Garner* court held that a "jury could conclude that releases, spills or leaks, on average, every third or fourth day means that the defendant knew of a possible peril that its workers were exposed to and that it was, nevertheless, willing to allow them [to] suffer the risk and inconvenience."[89] The court further held that the jury could also "conclude that a decision to repeatedly expose workers to such serious risk of harm could mean that the defendant is indifferent to the welfare and health of its workers."[90] The court, however, held these findings "insufficient to establish gross negligence."[91]

To obtain punitive damages for gross negligence, the Texas statute requires that plaintiffs offer evidence meeting both an objective and a subjective test.[92] Under the objective test, plaintiffs must show "an extreme risk

81. *Id.*
82. *Id.* at 1228.
83. *Id.*
84. No. G-07-221, 2010 WL 1049794, at *1 (S.D. Tex. Mar. 16, 2010).
85. *Id.* at *7.
86. *Id.* at *1.
87. *Id.* at *3.
88. *Id.* at *4, 7 (citing Tex. Prac. & Rem. Code § 41.001(7)).
89. *Id.* at *6.
90. *Id.*
91. *Id.*
92. *Id.* at *6 (citing Tex. Prac. & Rem. Code § 41.001(11)).

of harm," namely, "one that involves both high probability and high potential severity."[93] The court concluded that while there was a high probability of exposure to toxic odors at the refinery, it found no evidence that there were "always" injuries or that the injuries were severe.[94] Thus, the court held, the objective test for gross negligence was not met.

Moreover, the court observed, the punitive damages statute requires that there be a "specific intent" that necessitates a greater showing than that "a defendant had an awareness of the possibility of a spill or release."[95] Here, the court found no "specific intent" or evidence that defendant "ignored the obvious or known risk and took no precautions that would minimize or arrest the harm anticipated."[96] The court held that absent a showing of specific intent or evidence that defendant ignored obvious risk, the requirements of gross negligence were not satisfied.[97] Accordingly, the exemplary damages were set aside.[98]

VI. STATUTE OF LIMITATIONS

In *Krupski v. Costa Crociere S. p. A.*,[99] the U.S. Supreme Court made it clear that a tortfeasor cannot simply take advantage of a plaintiff's mistake of identity to avoid defending a suit to which it is a proper party. The Court in *Krupski* reversed an Eleventh Circuit decision regarding the "relates back" provision of Federal Rule of Civil Procedure 15(c)(1)(C)(ii), which specifies that an amendment to a complaint adding a new party relates back to the first filing date if "the party to be brought in by amendment . . . (ii) knew or should have known that the action would have been brought against it, but for a *mistake* concerning the proper party's identity."[100] The Supreme Court held that determining whether the amendment relates back does not depend on the timeliness of the amendment or whether the plaintiff "knew or should have known the identity of . . . the proper defendant."[101] The correct inquiry is whether the added defendant "knew or should have known that it would have been named as a defendant but for an error."[102]

In *Krupski*, plaintiff was injured while on a vacation cruise ship.[103] She filed suit against the sales and marketing agent for the cruise line. Just

93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.* at *7.
97. *Id.*
98. *Id.*
99. 130 S. Ct. 2485 (2010).
100. *Id.* at 2493 (citing Fed. R. Civ. P. 15(c)(1)) (quotations omitted; emphasis added).
101. *Id.*
102. *Id.*
103. *Id.* at 2490.

after the one-year statute of limitations period had expired, the cruise line informed plaintiff that the correct defendant should be the carrier, not the sales and marketing agent.[104] Plaintiff moved to amend her complaint to add the carrier.[105] The newly named carrier moved to dismiss, arguing that the amendment did not relate back and therefore was filed out of time.[106] The Southern District of Florida agreed.[107]

The Eleventh Circuit affirmed. It held that plaintiff knew or should have known the identity of the proper defendant; affirmatively chose to sue a different defendant; and did not make a mistake.[108] The Eleventh Circuit added that plaintiff delayed in moving to amend her complaint after learning the identity of the proper defendant, further evidencing the absence of mistake.[109]

The Supreme Court rejected both of the Eleventh Circuit's conclusions. First, the Court explained that the applicability of Rule 15(c)(1)(C)(ii) "depends on what the party to be added knew or should have known" and not "the amending party's knowledge or its timeliness in seeking to amend the pleading."[110] As explained by the Court, the "only question under Rule 15(c)(1)(C)(ii), then, is whether party A knew or should have known that, absent some mistake, the action would have been brought against him."[111]

Second, the Court rejected the Eleventh Circuit's conclusion that plaintiff's amended complaint did not relate back because plaintiff had "unduly delayed" her motion for leave to file.[112] The Court observed that Rule 15(c)(1)(C) "plainly sets forth an exclusive list of requirements of relation back, and the amending party's diligence is not among them."[113] Because defendant "should have known" that plaintiff's "failure to name it as a defendant in her original complaint was due to a mistake," the Court held that the amendment adding the carrier defendant related back to plaintiff's original complaint.[114]

VII. PUBLIC NUISANCE

A. *Fourth Circuit Holds Public Nuisance Cannot Displace Federal Regulation of Air Pollution*

In July 2010, the Fourth Circuit waded into the growing debate over the reach of the public nuisance doctrine, reversing the district court decision

104. *Id*. at 2491.
105. *Id*.
106. *Id*.
107. *Id*.
108. *Id*. at 2492.
109. *Id*.
110. *Id*. at 2490.
111. *Id*. at 2494.
112. *Id*. at 2496.
113. *Id*.
114. *Id*. at 2498.

in *Cooper v. Tennessee Valley Authority* and holding that public nuisance suits may not be used to regulate interstate air quality.[115] The Western District of North Carolina had held that emissions from Tennessee Valley Authority (TVA) coal plants in eastern Tennessee and Alabama constitute a public nuisance in North Carolina. The court issued an injunction requiring TVA, the nation's largest public power provider, to immediately install expensive emission control technologies at four power plants, and imposing restrictive emissions caps.[116]

Reversing the district court, the Fourth Circuit cautioned that permitting the decision to stand would "encourage courts to use vague public nuisance standards to scuttle the nation's carefully created system for accommodating the need for energy production and the need for clean air."[117] The result, said the court, "would be a balkanization of clean air regulations and a confused patchwork of standards, to the detriment of industry and the environment alike."[118] In pronouncements that may have ramifications for the success of nuisance claims in other environmental cases, including pending climate change litigation, the court expressed broad concern over the application of the public nuisance doctrine to environmental litigation: "While public nuisance law doubtless encompasses environmental concerns, it does so at such a level of generality as to provide almost no standard of application."[119]

Moreover, the court noted that public nuisance may not apply in heavily regulated industries, as "it is difficult to understand how an activity expressly permitted and extensively regulated by both federal and state government could somehow constitute a public nuisance."[120] The court, however, declined to go so far as to hold that federal law entirely preempts the field of emissions regulations and acknowledged that the savings clause of the Clean Air Act may allow for some common law nuisance suits.[121]

B. *Sixth Circuit Rejects Novel Effort to Expand Public Nuisance Doctrine*

The Sixth Circuit has likewise weighed in on public nuisance, here in the unusual setting of financial services. In *City of Cleveland v. Ameriquest Mortgage Securities, Inc.*,[122] the city pursued a novel course by seeking to ex-

115. 593 F. Supp. 2d 812 (W.D.N.C. 2009), *rev'd*, 615 F.3d 291 (4th Cir. 2010).
116. *Id.* at 832–33.
117. Cooper v. Tenn. Valley Auth., 615 F.3d 291, 296 (4th Cir. 2010).
118. *Id.*
119. *Id.* at 302.
120. *Id.* at 296.
121. *Id.* at 302–04.
122. 615 F.3d 496, 503–06 (6th Cir. 2010), *cert. denied*, 131 S. Ct. 1685 (2011).

trapolate from traditional environmental public nuisance theories to hold members of the financial services industry accountable for the recent rise in residential foreclosures and diminished property values. Asserting that twenty-one banks and financial services companies perpetrated a public nuisance when they created mortgage-backed securities, Cleveland alleged that the "spike in foreclosure activity" was a foreseeable and direct result of these lending practices and sought damages for costs associated with the foreclosed and abandoned properties plaguing Cleveland neighborhoods.[123] Cleveland further asserted that traditional tort defenses, such as bars on tort claims seeking purely economic losses, do not apply to public nuisance litigation, and that the city should not be held to traditional burdens of proving causation.[124] The Northern District of Ohio declined to extend the public nuisance doctrine to such business practices.[125] In July 2010, the Sixth Circuit affirmed.[126]

C. *States May Retain Private Contingency Fee Counsel in Public Nuisance Litigation*

In *County of Santa Clara v. Superior Court*, the California Supreme Court held that public entities are not categorically barred from engaging private counsel under contingent-fee arrangements in public nuisance cases seeking abatement as the sole remedy.[127] In that case, a group of California counties and cities brought a public nuisance claim against lead paint manufacturers seeking abatement. The public entities were represented by their own government attorneys together with several private law firms retained on a contingent-fee basis. Defendants argued that attorneys wielding the government's police power should not have a financial interest in the outcome.

The Superior Court agreed and granted defendants' motion barring public entities from compensating private counsel with contingent fees in public nuisance cases. The court reasoned that all attorneys prosecuting public nuisance actions must be "absolutely neutral."[128] The Superior Court decision thus precluded any arrangement in which private counsel

123. City of Cleveland v. Ameriquest Mortgage Secs., Inc., 621 F. Supp. 2d 513, 516 (N.D. Ohio 2009), *aff'd*, 615 F.3d 496, 503–06 (6th Cir. 2010).

124. *Id*. at 522.

125. *Id*. at 536.

126. *City of Cleveland*, 615 F.3d at 503–06. Inspired by Cleveland's lawsuit, the City of Buffalo, New York, filed a similar lawsuit against thirty-six lenders involved in fifty-seven foreclosures that led to abandoned and demolished properties. City of Buffalo v. ABN Amro Mortgage Co., No. 2008002200 (N.Y. Sup. Ct., Erie Co., filed Mar. 24, 2008).

127. 50 Cal. 4th 35 (2010), *cert. denied*, 131 S. Ct. 920 (2011).

128. *Id*. at 43 (discussing County of Santa Clara v. Atl. Richfield Co., No. 1-00-CV-788657, 2007 WL 1093706 (Cal. Super. Ct Apr. 4, 2007)).

has a financial stake in the outcome of a case brought on behalf of the public.[129]

The California Supreme Court rejected such a categorical bar on contingency arrangements in public nuisance actions. Specifically, the court found that the inherent conflict of interest generated by a contingent-fee arrangement "does not necessarily mandate disqualification in public nuisance cases when fundamental constitutional rights and the right to continue operation of an existing business are not implicated."[130] Noting that the sale of lead paint is now illegal, the court found that abatement posed no risk to an ongoing business interest of the defendants. The court held that "retention of private counsel on a contingent-fee basis is permissible in such cases if neutral, conflict-free government attorneys retain the power to control and supervise the litigation."[131]

VIII. ASBESTOS

Among the pivotal issues looming in asbestos litigation nationwide is the viability of so-called household exposure claims, also known as take-home or second-hand exposure claims, against premises owners and employers. Last year, the highest courts of two states, Iowa and Ohio, considered challenges to claims asserted against premises owners by spouses of workers allegedly exposed to asbestos during their work on the defendant's premises. Appellate courts in a third state, Illinois, split on the same issue, creating a dispute awaiting resolution by the Illinois Supreme Court in some future case.

A. *Iowa Supreme Court Rejects Independent Contractor Employee's Household Exposure Claim Against Premises Owner*

The recent decision in *Van Fossen v. Midamerican Energy Co.*[132] confirmed that under Iowa law a premises owner who hires an independent contractor owes no duty to warn the spouse of the contractor's employee of the dangers of asbestos to which that employee may be exposed. In *Van Fossen*, the contractor's employee alleged that he was exposed to asbestos from 1973 until 1981 when he worked as an iron rigger, then again from 1981 through 1997 when he was hired to perform maintenance services at defendant's power plant. The Iowa Supreme Court held that the power plant owner could not be held liable when the employee's wife developed mesothelioma, a fatal asbestos-related cancer.

129. *Id.*
130. *Id.* at 58.
131. *Id.*
132. 777 N.W.2d 689 (Iowa 2009).

Plaintiff principally grounded his claim against the premises owner on the exceptions to the general rule set forth in §§ 413 and 416 (peculiar risk) and § 427 (inherently dangerous activity) of the Restatement (Second) of Torts that the hirer of an independent contractor is not liable for the negligence of the contractor. The court, however, rejected the notion that the risk of household exposure to asbestos as a result of plaintiff's work was a peculiar risk within the meaning of Restatement (Second) §§ 413 and 416. The court concluded that

> the risk that asbestos fibers would be carried home by [the plaintiff] and cause injury to [his wife] was not a risk that inhered in the construction and maintenance work performed by [the plaintiff] as an iron worker at the [defendant's] facility. It was instead a risk that was occasioned by the failure of [the plaintiff's employers] to employ routine precautionary measures against ordinary and customary dangers that [the defendant premises owner] could reasonably assume would be undertaken by any careful contractor. These routine measures could have, for example, included workplace laundering or other safe management of clothing worn by construction workers exposed to asbestos at the [defendant's facility].[133]

The court also rejected the argument that the risks of household exposure to asbestos were "inherent" in the work plaintiff was hired to perform within the meaning of § 427, finding such dangers not inherent because they did not accompany the work "when properly done."[134] Although the court acknowledged that asbestos exposure poses "grave health risks," it held that the presence of such risks in the workplace, standing alone, is not sufficient to render the work "inherently dangerous" within the meaning of § 427.[135]

The court next rejected plaintiff's contention that the premises owner owed a "general duty" to exercise reasonable care to warn plaintiff's wife of the dangers of asbestos.[136] Significantly, the court's reasoning hinged on its rejection of foreseeability of harm as a foundation for imposing a duty. Having just adopted the framework for establishing a duty of care under the proposed Restatement (Third) of Torts in *Thompson v. Kaczinski*,[137] the *Van Fossen* court noted that the foreseeability of injury to plaintiff's wife was no longer a relevant consideration. Rather, the *Van Fossen* court explained that, under the Restatement (Third) framework, an actor owes a duty of care whenever "the actor's conduct creates a risk of physical harm."[138] However,

133. *Id.* at 695.
134. *Id.*
135. *Id.*
136. *Id.* at 696–98.
137. 774 N.W.2d 829 (Iowa 2009).
138. *Van Fossen*, 777 N.W.2d at 696 (quoting Restatement (Third) of Torts: Liab. for Physical Harm § 7(a)).

the court found that asbestos household exposure cases qualify for the "exception" to this rule occasioned where a "countervailing principle or policy warrants denying or limiting liability in a particular class of cases."[139] The court determined that reasons of policy dictate that the duties of the hirers of independent contractors should be limited to those provided under Restatement (Second) §§ 413, 416, and 427.[140] The court concluded that the contractor, rather than the hiring premises owner, is best placed to understand and protect against the risks inherent in the contractor's own work, whereas imposing a broader duty on a hiring premises owner in the household exposure context would create potentially limitless liability.[141]

B. *Ohio Supreme Court Confirms Asbestos Reform Statute Bars All Household Exposure Claims Against Premises Owners*

Ohio's legislature passed an asbestos reform statute in 2004 that included a bar to household exposure claims against premises owners. Specifically, § 2307.941 of the Ohio Revised Code provides that "a premises owner is not liable for any injury to any individual resulting from asbestos exposure unless that individual's alleged exposure occurred while the individual was at the premises owner's property."[142] In *Boley v. Goodyear Tire & Rubber Co.*,[143] plaintiffs sought to limit the scope of that bar.

In *Boley*, a Goodyear employee's wife, who washed her husband's asbestos-containing clothing, brought claims of negligence against Goodyear, seeking damages for her mesothelioma.[144] She contended that her negligence claims were not barred by § 2307.941. The Ohio Supreme Court disagreed, confirming that § 2307.941 bars all "asbestos claims stemming from exposure that does not occur at the premises owner's property," regardless of their basis.[145] Thus, negligence claims, as well as all other tort-related asbestos claims, are barred if they arise from asbestos exposure that occurred off a defendant's premises.

C. *Illinois Appellate Courts Split on Challenges to Household Exposure Claims*

As noted above, two appellate courts of Illinois have recently split on the viability of household exposure claims. In *Simpkins v. CSX Corp.*, the Fifth

139. *Id.*
140. *Id.* at 697.
141. *Id.* at 698–99.
142. Ohio Rev. Code § 2307.941(A)(1).
143. 929 N.E.2d 448 (Ohio 2010) (affirming dismissal of numerous household exposure claims against employer/premises owner).
144. *Id.* at 449.
145. *Id.* at 453.

District appellate court ruled on a facial challenge to a household exposure claim.[146] Plaintiff alleged that her mother, the wife of a former CSX employee, had been exposed to asbestos by laundering his work clothing, which had been contaminated with asbestos as a result of his work for CSX. She asserted negligence and strict liability claims against CSX based on the contention that CSX engaged in an "ultrahazardous activity" by using asbestos.[147]

The court began its analysis from the premise that in Illinois, "the existence of duty depends on whether the parties stand in such a relationship to each other that the law imposes upon the defendant an obligation to act in a reasonable manner for the benefit of the plaintiff."[148] The court found that the presence of a sufficient relationship depends on four additional factors: (1) the foreseeability of the harm, (2) the likelihood of injury, (3) the magnitude of the burden involved in guarding against the harm, and (4) the consequences of placing on defendant the duty to protect against the harm.[149] Under this framework, the court found that CSX did owe a duty to its employee's spouse. The court reasoned:

> To find that an employer whose workers are exposed to asbestos owes no duty to protect others from exposure—assuming the exposure is both foreseeable and preventable without undue burden—merely because the others do not have any particular special relationship with the employer (such as an employee or a business invitee) would defy logic and lead to grossly unfair results.[150]

The court rejected CSX's forewarning of limitless liability, a concern that is often cited by those courts that have refused to impose a duty in household exposure cases. The *Simpkins* court expressed confidence that "the scope of liability will be inherently limited by the foreseeability of the harm."[151]

The Fifth District's *Simpkins* decision is at odds with the Second District's holding a year earlier in *Nelson v. Aurora Equipment Co*.[152] In that case, the court rejected a household exposure claim brought against a premises owner/employer finding that absent a "special relationship" between defendant and the decedent, defendant owed no duty under a premises liability theory because the decedent—here, the wife of one of the defendant's employees, and the mother of a second employee—was not

146. 929 N.E.2d 1257 (Ill. App. Ct. 2010).
147. *Id*. at 1260.
148. *Id*. at 1261.
149. *Id*.
150. *Id*. at 1263.
151. *Id*. at 1265.
152. 909 N.E.2d 931, 939 (Ill. App. Ct. 2009).

exposed to asbestos while on defendant's premises.[153] In so holding, the court rejected the notion that foreseeability, standing alone, is a sufficient basis on which to predicate a duty. It should be noted, however, that the *Nelson* court analyzed the viability of the household exposure claim only under a premises liability theory—the theory advanced by plaintiffs in the amended complaint and at oral argument—and did not analyze the duty issue under any other theory of liability. Further, all parties agreed that there was no significant relationship between the decedent and the premises owner/employer, an issue that was not conceded in *Simpkins*.

The Illinois Supreme Court denied review of *Nelson*.[154] *Simpkins* has been appealed and the Illinois Supreme Court has allowed review.[155]

IX. CLASS ACTIONS

A. Daubert *Hearings Appropriate at Class Certification Stage*

The trend among the federal circuits to require the resolution of expert issues at the class certification stage continued this year as the Seventh Circuit joined the ranks of the Second, Third, Ninth, Tenth, and Eleventh Circuits.

In *American Honda Motor Co. v. Allen*,[156] the Seventh Circuit reviewed the district court's grant of class certification to purchasers of Honda Gold Wing GL 1800 motorcycles who wanted the defendant manufacturer to fix an alleged design defect that caused the steering assembly to shake excessively. Plaintiffs alleged that a design defect prevented "adequate dampening of 'wobble,' [or] side-to-side oscillation" in the steering assembly.[157] They relied heavily upon a report setting forth a wobble decay standard that their expert had devised himself.[158]

Relying on *Daubert v. Merrell Dow Pharmaceuticals*,[159] Honda moved to strike the expert report, "arguing that . . . [the] standard was unreliable because it was not supported by empirical testing, was not developed through a recognized standard-setting procedure," and "was not generally accepted."[160] The district court concluded that it was proper to determine the admissibility of the expert report before ruling on class certification.[161] While the district court acknowledged that it had reservations about the

153. *Id.*
154. Nelson v. Aurora Equip. Co., 919 N.E.2d 355 (Ill. 2009).
155. Simpkins v. CSX Corp., 942 N.E.2d 462 (Ill. 2010).
156. 600 F.3d 813 (7th Cir. 2010).
157. *Id.* at 814.
158. *Id.*
159. 509 U.S. 579 (1993).
160. *Am. Honda Motor Co.*, 600 F.3d at 814.
161. *Id.*

reliability of the standard, it then "'decline[d] to exclude the report . . . at this early stage of the proceedings.'"[162]

The Seventh Circuit held that the district court abused its discretion by not ruling conclusively on the admissibility of plaintiffs' expert's opinion.[163] The court concluded that "when an expert's report or testimony is critical to class certification," the district court "must conclusively rule on any challenge to the expert's qualifications or submissions prior to ruling on a class certification motion."[164] The court explained that this can necessitate "a full *Daubert* analysis" prior to class certification "if the situation warrants."[165] The Seventh Circuit further noted that while a trial court is given great latitude in measuring the reliability of proposed expert testimony, it must "provide more than just conclusory statements of admissibility to show that it adequately performed a *Daubert* analysis."[166] Because the district court did not determine whether plaintiffs' expert report was reliable prior to certifying the class, the Seventh Circuit vacated the certification order.

B. *Ninth Circuit Finds* Daubert *Hearing Not Required at Class Certification Stage*

The Ninth Circuit seemingly reached a rather different conclusion than the Seventh Circuit with regard to the propriety of conducting *Daubert* hearings at the class certification stage. It nevertheless clarified the standard its district courts must apply in resolving motions for class certification, confirming that courts are required to analyze underlying facts and legal issues concerning class certification questions regardless of any overlap with the merits.

In *Dukes v. Wal-Mart Stores, Inc.*,[167] a gender discrimination case, the Ninth Circuit explained that its clarification of the standards governing Rule 23 analyses was needed in part to address the debate over such standards as reflected in the parties' briefs and to correct recent district court decisions within the circuit that appeared to "drift away from" the circuit's previous case law.[168] The court observed that other circuit courts recently have attempted to clarify Rule 23 standards and found "it prudent to follow suit given evidence of confusion."[169]

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162. *Id.* at 815 (citations omitted).
163. *Id.* at 814.
164. *Id.* at 815–16.
165. *Id.* at 815.
166. *Id.* at 816 (citation and quotation omitted).
167. 603 F.3d 571 (9th Cir. 2010), *cert. granted in part*, Wal-Mart Stores, Inc. v. Dukes, No. 10-277, 79 U.S.L.W. 3128 (Dec. 6, 2010).
168. *Id.* at 580.
169. *Id.*

The Ninth Circuit confirmed that, as in most other circuits and consistent with Supreme Court precedent,

> district courts must satisfy themselves that the Rule 23 requirements have been met before certifying a class, which will sometimes, though not always, require an inquiry into and preliminary resolution of disputed factual issues, even if those same factual issues are also, independently, relevant to the ultimate merits of the case.[170]

But, the court explained, the primary purpose of a court's inquiry at the class certification stage is to focus, for example, on whether common questions of law or fact predominate over individual questions, not on the answers to those questions or the likelihood of success on the merits.[171] Thus, explained the Ninth Circuit, "[i]t is whether courts are using the facts to probe the plaintiffs' claims of compliance with Rule 23, or to hear either parties' [sic] claims directed to stand-alone merits issues, that renders a court's use of the facts proper or improper."[172]

Nevertheless, in a footnote, the Ninth Circuit seemingly indicated its disagreement with other circuits as to whether a district court's rigorous analysis of Rule 23 elements need to include an evaluation of the methodologies used by a party's expert opining on class certification topics. The court noted, "[a]s a general rule, district courts are not required to hold a *Daubert* hearing before ruling on the admissibility of scientific evidence."[173] In *Dukes*, plaintiffs presented the expert testimony of a sociologist (among others) to support the commonality prong of the Rule 23 analysis. Wal-Mart challenged one of the expert's conclusions as not meeting the *Daubert* standards for expert testimony.[174] The district court rejected Wal-Mart's contention without conducting a *Daubert* hearing, an action that the Ninth Circuit found to be proper.[175] Importantly, the court found Wal-Mart not to have challenged the expert's methodology, only the persuasiveness of his conclusions. Accordingly, the Ninth Circuit found a *Daubert* analysis not warranted because

> testing [the expert's] testimony for "Daubert reliability" would not have addressed Wal-Mart's objections. It would have simply revealed what Wal-Mart itself has admitted and courts have long accepted: that properly analyzed social science data, like that offered by [the expert], may support a plaintiff's assertions that a claim is proper for class resolution.[176]

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170. *Id*. at 583.
171. *Id*. at 590.
172. *Id*. at 582.
173. *Id*. at 603 n.22 (internal quotations omitted).
174. *Id*. at 601.
175. *Id*. at 602.
176. *Id*.

Thus, the Ninth Circuit found, because plaintiffs "clearly established foundation for [the expert's] testimony and statistics[,] [i]t was not an abuse of discretion for the district court not to exclude them, under *Daubert* or otherwise."[177] In all, the Ninth Circuit concluded that the district court amply followed the standards it clarified, including by rigorously examining and weighing the parties' evidence before certifying a class. The Supreme Court has granted, in part, Wal-Mart's petition for certiorari.[178]

Because the circumstances of Wal-Mart's challenge did not require resolution of a true *Daubert* issue—there appears to have been no dispute concerning the expert's methodologies—it is unclear at this point whether the Ninth Circuit's observations reflect a true conflict with other circuits concerning the propriety of conducting *Daubert* analyses at the class certification stage.

C. *Class Action Fairness Act*

Congress passed the Class Action Fairness Act (CAFA) in 2005 to prevent class action abuse in plaintiff-friendly state courts.[179] By relaxing the requirements for diversity jurisdiction in large class or mass actions, CAFA has rendered more cases removable to federal court. A number of recent appellate decisions have continued to explore the scope of CAFA jurisdiction.

A pair of decisions from the Seventh Circuit held that following removal to federal court under CAFA, neither denial of class certification nor amendment of the operative complaint to eliminate class allegations will divest the district court of CAFA jurisdiction. First, in *Cunningham Charter Corp. v. Learjet, Inc.*,[180] the Seventh Circuit held that federal jurisdiction under CAFA does not depend on class certification, and thus denial of a motion for class certification does not eliminate the court's subject-matter jurisdiction so as to require remand. According to the court, this holding "vindicates the general principle that jurisdiction once properly invoked is not lost by developments after a suit is filed, such as a change in the state of which a party is a citizen that destroys diversity."[181] The Seventh Circuit explained that unless the flaws in plaintiff's class allegations are "so obviously fatal as to make the plaintiff's attempt to maintain the suit as a class action frivolous," federal jurisdiction survives denial of a motion for class

177. *Id.* at 603 n.22.
178. Wal-Mart Stores, Inc. v. Dukes, No. 10-277, 79 U.S.L.W. 3128 (Dec. 6, 2010).
179. *See* 28 U.S.C. § 1332(d).
180. 592 F.3d 805 (7th Cir. 2010).
181. *Id.* at 807.

certification.[182] This decision adds to a growing split among the federal circuits on whether CAFA jurisdiction depends on class certification.[183]

In its next CAFA jurisdiction decision, the Seventh Circuit held in *In re Burlington Northern Santa Fe Railway Company*[184] that "jurisdiction under CAFA is secure even though, after removal, the plaintiffs amend their complaint to eliminate the class allegations."[185] Finding the situation "indistinguishable" from the one it addressed in *Cunningham* only months earlier, the court again based its conclusion on "[t]he well-established general rule. . . that jurisdiction is determined at the time of removal, and nothing filed after removal affects jurisdiction."[186] Moreover, the court noted, "removal cases present concerns about forum manipulation that counsel against allowing a plaintiff's post-removal amendments to affect jurisdiction" and "cases should not be shunted between court systems."[187]

A recent Eleventh Circuit decision threatened to limit federal jurisdiction under CAFA, especially in those cases originally filed in federal court. Although not a toxic tort case, the Eleventh Circuit's decision in *Cappuccitti v. DirecTV Inc.*[188] holds implications for all class actions. Under CAFA, with exceptions not relevant here, a putative class action filed in state court is removable to federal court if minimal diversity exists and the aggregate amount in controversy for the class exceeds $5 million.[189] Most CAFA-jurisdiction class actions reach federal court by this route. In *Cappuccitti*, however, the court addressed the relatively rare class action filed originally in federal court under CAFA's jurisdictional provisions. The Eleventh Circuit considered whether, in an original diversity jurisdiction action, CAFA's jurisdictional requirements supersede or alter the general diversity requirement that the district court has original jurisdiction "of all civil actions where the matter in controversy exceeds the sum or value of $75,000" and is between citizens of different states.[190] Specifically, the court addressed the question of whether an aggregate classwide amount in controversy may supersede the traditional requirement that an individual

182. *Id.*

183. *See* Vega v. T-Mobile USA, Inc., 564 F.3d 1256, 1268 n.12 (11th Cir. 2009) (CAFA jurisdiction does not depend on certification); *In re* TJX Cos. Retail Sec. Breach Litig., 564 F.3d 489, 492–93 (1st Cir. 2009) (CAFA jurisdiction depends on class certification and in the absence of certification, remand is appropriate).

184. 606 F.3d 379 (7th Cir. 2010).

185. *Id.* at 380.

186. *Id.* (citing St. Paul Mercury Indem. Co. v. Red Cab Co., 303 U.S. 283, 293 (1938); *In re* Shell Oil Co., 970 F.2d 355, 356 (7th Cir. 1992) (per curiam)).

187. *Id.* at 381.

188. 611 F.3d 1252 (11th Cir. 2010), *vacated and superseded on reh'g*, No. 09-14107, 2010 WL 4027719, at *1 (11th Cir. Oct. 15, 2010).

189. 28 U.S.C. § 1332(d)(2).

190. *Cappuccitti*, 611 F.3d at 1256; 28 U.S.C. § 1332(a).

plaintiff meet the $75,000 threshold. The Eleventh Circuit initially held that it may not, but later reversed itself.

Where a class action is initiated in federal court, rather than removed, the Eleventh Circuit held originally that plaintiff must allege that at least one putative class member has an amount in controversy exceeding $75,000, regardless of the aggregate value of the classwide controversy.[191] The *Cappuccitti* court did not address whether the individual $75,000 requirement would also apply in removed CAFA actions, and at least one federal court had recently declined to reach that very question.[192] Both plaintiff and defendant petitioned the Eleventh Circuit for rehearing, arguing that CAFA does not require any single putative class member to allege an amount in controversy over $75,000. On October 15, 2010, the Eleventh Circuit vacated its original opinion, deeming its interpretation of CAFA's jurisdictional requirements "incorrect."[193] The court issued a new opinion, holding that "[t]here is no requirement in a class action brought originally or on removal under CAFA that any individual plaintiff's claim exceed $75,000."[194]

In another recent decision with implications for class actions of all types, the Eighth Circuit in *Westerfeld v. Independent Processing, LLC*[195] held that any doubt about the "local controversy" exception to CAFA cannot be construed in favor of the party seeking remand to state court. Under the local controversy exception, a district court must decline to exercise jurisdiction over an otherwise removable class action in which (a) more than two-thirds of the class members are citizens of the state in which the action was originally filed; (b) at least one defendant "from whom significant relief is sought by members of the plaintiff class" and "whose alleged conduct forms a significant basis for the claims asserted by the proposed plaintiff class" is a citizen of the state where the class action was originally filed; (c) the principal injuries were incurred in the state where the action was filed; and (d) no other class action alleging similar facts has been filed during the preceding three years.[196] In *Westerfeld*, the Eighth Circuit held that any doubt regarding whether the local controversy exception applies must be resolved against plaintiff and in favor of removal, as the party invoking the exception bears the burden of proving its applicability.[197]

Justice Scalia also addressed the local controversy exception in September 2010. In the context of a single justice opinion staying a lower court's

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191. *Cappuccitti*, 611 F.3d at 1256.
192. *See* Kline v. Earl Stewart Holdings LLC, Civ. A. No. 10-80912, 2010 WL 3432824 (S.D. Fla. Aug. 30, 2010).
193. *Cappuccitti*, 2010 WL 4027719, at *1.
194. *Id.* at *2.
195. No. 10-2635, 2010 WL 3619819 (8th Cir. Sept. 20, 2010).
196. 28 U.S.C. § 1332(d)(4).
197. 2010 WL 3619819, at *2.

imposition of more than $250 million in damages against several tobacco companies while the companies prepared a petition for a writ of certiorari, Justice Scalia noted that the local controversy requirement leaves the federal Due Process Clause as the last line of defense for defendants in nonremovable "local controversy" class actions subject to state court abuses and procedural infirmities.[198]

X. CERCLA

On August 2, 2010, the Ninth Circuit held in *City of Colton v. American Promotional Events, Inc.* that any plaintiff asserting a claim under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) who cannot recover *past* response costs because they are inconsistent with the National Contingency Plan (NCP) also may not obtain a declaratory judgment as to liability for *future* costs.[199] In so ruling, the court addressed an issue of first impression in the Ninth Circuit and added to a growing split among the circuit courts.

City of Colton arose from the discovery of perchlorate in three drinking water supply wells serving Colton. Although the California Department of Health Services determined that the contamination levels were too low to require closure of the wells, Colton nonetheless took the wells out of service and implemented a wellhead treatment program. It then sued twenty entities, alleging that their industrial activities caused the groundwater contamination. Colton asserted a claim under CERCLA § 107(a)[200] to recover the costs of the wellhead treatment. It also sued under the Declaratory Judgment Act[201] seeking a declaration of liability for costs of a future basinwide cleanup estimated to cost between $55 and $75 million.

To establish liability for response costs under CERCLA § 107(a), a plaintiff must show, among other things, that its response costs were consistent with the NCP.[202] Response costs are consistent with the NCP if they are in substantial compliance with EPA-promulgated regulations setting forth procedures for responding to contamination.[203] Colton conceded that its wellhead treatment program was not consistent with the NCP.[204]

The Ninth Circuit affirmed summary judgment against Colton on both claims. As to Colton's cost-recovery claim for past costs, its concession

198. Philip Morris USA, Inc. v. Scott, No. 10A273, 2010 WL 3724564, at *2 (Sept. 24, 2010).
199. 614 F.3d 998, 1008 (9th Cir. 2010).
200. 42 U.S.C. § 9607(a).
201. 28 U.S.C. §§ 2201, 2202.
202. *City of Colton*, 614 F.3d at 1002–03.
203. *Id.*
204. *Id.* at 1004.

that its wellhead treatment program was not consistent with the NCP was sufficient to affirm the judgment against it.[205] The more vexing issue was whether Colton's inability to establish liability for its past costs "necessarily doomed" its request for a declaratory judgment as to liability for future costs. As the Ninth Circuit noted, the First and Tenth Circuits would permit declaratory relief under such circumstances, but the Second, Third, and Eighth Circuits would not.[206]

The Ninth Circuit began by ruling that the general remedy provided under the Declaratory Judgment Act was preempted by CERCLA's own provision for declaratory relief, § 113(g)(2).[207] It then explained that the declaratory relief available under § 113(g)(2) applies to "liability for response costs," a term that "must refer to the response costs sought in the initial cost-recovery action, given that the [provision] later refers to 'any *subsequent* action or actions to recover *further* response costs.' "[208] Hence, the court held, a CERCLA plaintiff must first establish present liability before it can establish future liability. The court concluded by noting that its reading of CERCLA would better serve the purposes of the statute, as it would "encourag[e] a plaintiff to come to court only after demonstrating its commitment to comply with the NCP and undertake a CERCLA-quality cleanup."[209] On August 23, 2010, Colton filed a petition for a writ of certiorari with the Supreme Court, seeking reversal of the Ninth Circuit's decision.The Supreme Court denied that petition on November 29, 2010.

XI. National Environmental Policy Act

In *Monsanto Co. v. Geertson Seed Farms*,[210] the Supreme Court clarified the legal standard for obtaining an injunction under the National Environmental Policy Act of 1969 (NEPA).[211] *Monsanto* arose from a decision by the Animal and Plant Health Inspection Service (APHIS) to deregulate a variety of genetically engineered alfalfa seed designed to tolerate a Monsanto herbicide. Growers of conventional alfalfa and several environmental groups challenged that decision under the Administrative Procedure Act, arguing that the agency violated NEPA by issuing its deregulation decision without first completing a detailed environmental impact statement (EIS). The district court agreed and issued an injunction prohibiting the deregulation and most planting of the seed, pending completion of the mandated

205. *Id.*
206. *Id.* at 1007.
207. 42 U.S.C. § 9613(g)(2).
208. *City of Colton*, 614 F.3d at 1007 (quoting 42 U.S.C. § 9613(g)(2)).
209. *Id.* at 1008.
210. 130 S. Ct. 2743 (2010).
211. 42 U.S.C. § 4321 *et seq.*

EIS. In so ruling, the district court rejected a proposed order that would have permitted partial deregulation of the alfalfa seed while maintaining restrictions on its planting pending completion of the EIS. On appeal, Monsanto and the government did not dispute that APHIS had failed to comply with NEPA but sought to challenge the scope of the injunction. A divided panel of the Ninth Circuit affirmed the district court's ruling.[212]

In a seven-to-one ruling,[213] the Supreme Court reversed, concluding that the district court's injunction was overly broad insofar as it enjoined APHIS from even partially deregulating the alfalfa seed pending completion of the EIS. The Court began by explaining that the mere existence of a NEPA violation does not create a presumption that injunctive relief is available or that such relief should always be granted. Writing for the majority, Justice Alito emphasized that "[i]t is not enough for a court considering a request for injunctive relief to ask whether there is a good reason why an injunction should *not* issue; rather, a court must determine that an injunction *should* issue."[214] That determination is made under the traditional four-factor test for issuance of an injunction: (1) irreparable harm, (2) inadequacy of legal remedies, (3) a balance of hardships favoring the moving party, and (4) the absence of injury to the public interest were an injunction to issue.[215]

The Court concluded that none of these factors supported the prohibition against partial deregulation pending completion of the EIS. Most importantly, the Court noted, respondents had failed to demonstrate irreparable injury from the proposed partial deregulation, and the breadth of the injunction intruded on APHIS's authority to make a decision concerning partial deregulation in the first instance.[216] For similar reasons, the district court also was deemed to have erred in entering a nationwide order against any planting of the alfalfa seed until the EIS was completed, regardless of the possibility of a partial deregulation order.[217] In closing, Justice Alito stated that "[i]f a less drastic remedy (such as partial or complete vacatur of APHIS's deregulation decision) was sufficient to redress respondents' injury, no recourse to the additional and extraordinary relief of an injunction was warranted."[218]

212. Geertson Seed Farms v. Johanns, 570 F.3d 1130, 1139 (9th Cir. 2009).
213. *Monsanto*, 130 S. Ct. 2743. Justice Stevens dissented, and Justice Breyer did not participate in the decision.
214. *Id.* at 2757.
215. *Id.* at 2756.
216. *See id.* at 2758–61.
217. *Id.* at 1261.
218. *Id.*

XII. PRICE ANDERSON ACT

The Tenth Circuit vacated a $926 million judgment against Rockwell International Corp. and Dow Chemical Co. in *Cook v. Rockwell International Corp*. based on plaintiffs' failure to show actual damage to property.[219] Property owners near the site of a former weapons plant in Colorado filed a public liability action against the facility's operators under the Price Anderson Act in 1990 on behalf of themselves and a putative class.[220] The class alleged trespass and nuisance claims arising from the release of plutonium particles onto their property.[221] After nearly two decades of litigation, the district court held a four-month jury trial, which concluded in January 2006. The jury found the two contractors liable for $726 million in compensatory damages and prejudgment interest and $200 million in punitive damages.[222]

Defendants appealed, arguing, inter alia, that to establish the threshold "injury to property" constituting a "nuclear incident" under the Price Anderson Act, plaintiffs must prove actual damage to their property, not merely contamination.[223] Plaintiffs, in contrast, argued that the mere presence of radioactive plutonium particles on their property established a "nuclear incident" under the Act and was sufficient to establish "damage to property."

The Tenth Circuit rejected the plaintiffs' position, agreeing with Rockwell and Dow that "[i]n order to prove plutonium-related 'damage to property,' Plaintiffs must necessarily establish that plutonium particles released from [the facility] caused a detectable level of actual damage to class properties."[224] The court analogized its decision to a recent Tenth Circuit case rejecting a medical monitoring claim based on risk of future injury as insufficient to establish "bodily injury" under the Price Anderson Act: "Just as an existing physical injury to one's body is necessary to establish 'bodily injury,' so too is an existing physical injury to property necessary to establish 'damage to property.' Without a demonstrable manifestation of injury, the presence of plutonium can, at best, only establish a risk of future damage to property."[225]

XIII. EMERGING TORTS: CLIMATE CHANGE

On May 28, 2010, plaintiffs in *Comer v. Murphy Oil USA*[226] faced a reversal of fortune when the Fifth Circuit vacated its prior ruling in their favor and

219. 618 F.3d 1127 (10th Cir. 2010).
220. Cook v. Rockwell Int'l Corp., 564 F. Supp. 2d 1189 (D. Colo. 2008).
221. *Cook*, 618 F.3d at 1132.
222. *Cook*, 564 F. Supp. 2d 1189.
223. *Cook*, 618 F.3d at 1139.
224. *Id*. at 1141.
225. *Id*. at 1140.
226. 607 F.3d 1049 (5th Cir. 2010).

dismissed their appeal. The Supreme Court declined to review the Fifth Circuit's vacatur and dismissal on January 10, 2011, bringing the long-running case to a conclusion.

The procedural path leading to this outcome is complicated. Mississippi Gulf Coast property owners filed a putative class action under state law against an array of energy, fossil fuel, and chemical companies, alleging that their greenhouse gas emissions contributed to global warming, which intensified Hurricane Katrina in 2005, which in turn resulted in damage to their properties. On August 30, 2007, the district court granted defendants' motions to dismiss, holding that plaintiffs lacked Article III standing and that the case raised nonjusticiable political questions.[227]

On October 16, 2009, a three-judge panel of the Fifth Circuit reversed and remanded in part, holding that that neither Article III standing nor the political question doctrine barred plaintiffs' state common law claims for nuisance, trespass, and negligence.[228] In a separate concurrence, Judge Davis stated that he would have affirmed the dismissal for failure to adequately plead proximate cause, but nonetheless joined the majority because the panel was not required to consider alternative grounds for dismissal.[229]

Defendants petitioned the Fifth Circuit for a rehearing en banc. On February 26, 2010, after seven judges were recused, the remaining nine judges granted a rehearing by a six-to-three vote.[230] Prior to the rehearing, however, new circumstances arose that prompted the disqualification and recusal of another judge, leaving only eight judges left, and a loss of a quorum necessary to proceed with the en banc rehearing. After receiving letter briefs from the parties, a majority of the remaining judges first held that, under Fifth Circuit rules, the original panel's decision in favor of plaintiffs had been automatically vacated upon the granting of a rehearing en banc.[231] The majority then concluded that once the ninth remaining judge recused herself, the court had no authority to take action on the matter—including reinstating the original panel's decision in favor of plaintiffs.[232] Thus, the Fifth Circuit found itself left no option but to dismiss the appeal.

227. Judgment on the Motion to Dismiss, Comer v. Murphy Oil USA, No. 1:05-cv-00436 (S.D. Miss. Aug. 30, 2007) (Dkt. No. 369).

228. Comer v. Murphy Oil USA, 585 F.3d 855 (5th Cir. 2009), *reh'g en banc granted*, 598 F.3d 208 (2010), *vacated by* 607 F.3d 1049 (2010). The Fifth Circuit upheld under the prudential standing doctrine the district court's dismissal of plaintiffs' unjust enrichment, misrepresentation, and conspiracy claims, which were based on alleged injuries caused by defendants' public relations efforts and pricing of petrochemicals. *Id.* at 867–69.

229. *Id.* at 880.

230. *Comer*, 598 F.3d at 210; *see also Comer*, 607 F.3d at 1055 (Davis, J., dissenting) (explaining number of votes on petition for en banc rehearing).

231. *Comer*, 607 F.3d at 1053.

232. *Id.* at 1054.

In reaching its ruling, the majority also considered and rejected a number of proposals for curing the loss of a quorum such as requesting the appointment of a judge from another circuit for the rehearing; declaring a quorum of nonrecused judges; invoking the “Rule of Necessity” to permit a recused judge to sit; “dis-enbancing” the case in order to reinstate the original opinion; and staying disposition of the appeal until a new circuit judge was appointed to fill a then existing vacant seat on the Fifth Circuit. According to the majority, none of these solutions was viable because, among other reasons, they required the court to “conduct judicial business” without a necessary quorum in the first instance.[233] Judges from the original panel dissented, arguing that the case should have been reheard on the merits and disagreeing that there was no way to cure the loss of a quorum.[234]

On August 26, 2010, plaintiffs filed a petition for a writ of mandamus asking the Supreme Court to direct the Fifth Circuit to return the case to the three-judge panel that previously decided in their favor. With the denial of that petition on January 10, 2011,[235] and the Fifth Circuit’s vacatur of its prior decision in favor of plaintiffs and dismissal of their appeal, the district court’s ruling dismissing plaintiffs’ climate change tort claims remains good law.

233. *Id.* at 1054–55.
234. *Id.* at 1055–66.
235. *In re* Comer, No. 10-294, 79 U.S.L.W. 3128 (Jan. 10, 2011).

RECENT DEVELOPMENTS IN WORKERS' COMPENSATION AND EMPLOYERS' LIABILITY LAW

Anthony J. Macauley

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I. INTRODUCTION

One of the most interesting and significant cases during the reporting period is a decision by the U.S. Circuit Court of Appeals for the Sixth Circuit that potentially exposes self-insured employers in Michigan to RICO charges in workers' compensation cases. Other cases during 2009–10 reflect concerns that surface more typically in workers' compensation and employers' liability law, such as issues relating to "arising out of and in the course and scope of employment," statutory defenses, and temporary and permanent disability. However, some interesting and surprising cases follow below, including Iowa's expansion its second injury fund (SIF) at a time when other states are dismantling their SIFs; a Kansas law that exempts employers with a payroll of less than $20,000/year, excluding family members; and Wyoming's hernia statute.

II. U.S. SUPREME COURT DENIES CERTIORARI IN RICO ACTION

The Supreme Court denied certiorari in *Brown v. Cassens Transport*[1] in an interesting intersection between workers' compensation law and the Racketeer and Corruption Influenced Organizations Act (RICO).[2] In the underlying case, the Sixth Circuit held that self-insured worker's compensation plans do not constitute insurance as defined by the McCarran-Ferguson Act,[3] and therefore the plaintiffs could proceed with their RICO suit against Cassens Transport.[4]

The plaintiffs specifically alleged that the defendants "selected and paid unqualified doctors . . . to give fraudulent medical opinions that would support the denial of worker's compensation benefits, and that defendants ignored other medical evidence in denying them benefits."[5] They further

1. 546 F.3d 347 (6th Cir. 2008), *cert. denied*, 130 S. Ct. 795 (2010).
2. 18 U.S.C. § 1961–1968.
3. 15 U.S.C. § 1012(b) ("No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, . . . unless such Act specifically relates to the business of insurance.").
4. *Cassens*, 546 F.3d at 364–65.
5. *Id.* at 351.

argued that "WDCA [Michigan Worker's Disability Compensation Act] was not enacted to regulate the business of insurance and that RICO will not 'invalidate, impair, or supersede' the WDCA."[6]

The Sixth Circuit agreed, pointing out that "at first blush worker's compensation benefits may seem to act as a form of insurance, . . . closer scrutiny reveals that this insurance-like impression is solely a matter of appearance."[7] Unlike an insurance policy, the WDCA is not a contract but rather "public regulation of the employment relationship that is a substitute for the tort system."[8] Its focus on "providing certain recovery to employees for workplace injuries . . . is underscored" by the fact that the WDCA was placed in the chapter of the Michigan statutes that addresses labor matters rather than insurance.[9] Moreover, the Michigan "Worker's Compensation Agency rather than the Office of Financial and Insurance Services administers the WDCA."[10] And finally, Cassens Transport is self-insured. Self-insurance, according to the Sixth Circuit decision, "does not relate to the 'business of insurance' under the McCarran-Ferguson Act because there is no relationship between an insurer and an insured."[11]

The Sixth Circuit's decision in *Cassens* has widespread implications for nearly 600 self-insured employers in Michigan, including General Motors, Chrysler, Ford Motor Co., AT&T, DTE Energy, as well as many county governments and public universities in the state. Self-insured employers "collectively account for nearly half of all workers' compensation paid each year."[12] "As the result of [Cassens]," according to one Michigan practitioner, "all are now subject to a lawsuit under RICO for denying a claim for workers' compensation."[13]

III. Arising Out of and in the Course and Scope of Employment

A. *Going-and-Coming Rule*

A claimant in Rhode Island was injured while driving a company van from the parking lot of his apartment when he stopped to help a stranded motorist who was blocking the exit from the lot.[14] He was on call on a 24/7 basis.

6. *Id.* at 357–58.
7. *Id.* at 359.
8. *Id.*
9. *Id.* at 360.
10. *Id.*
11. *Id.* at 361.
12. Martin L. Critchell, *Workers' Disability Compensation*, 56 Wayne L. Rev. 551, 555 (2010).
13. *Id.*
14. McGloin v. Trammellcrow Servs., Inc., 987 A.2d 881 (R.I. 2010).

He worked out of the van and always kept the van with him. Although he was not on a work call at the time of the accident, he testified he was going to a central location to await a work call. His claim was not barred by the going and coming rule, which denies workers' compensation benefits to employees who or going to or leaving work. On the contrary, the Rhode Island Supreme Court found that "[i]n light of the nature of employee's work, it is reasonable that [the employer] could have expected [his] employment activities to begin the moment he got into the cargo van—whether on the public roadways or in his own apartment parking lot."[15]

In *Fortney v. Airtran Airways, Inc.*,[16] the widow an of an Airtran pilot who was killed while flying home from his base in Atlanta appealed a decision by the Kentucky Court of Appeals, which had upheld the denial of workers' compensation benefits. Airtran argued that "Fortney's death was not work-related because he was simply commuting to work; provided no service to the employer in doing so; and benefited personally from being able to commute free or at a reduced fare. . . ."[17] The administrative law judge and the state appellate court agreed but the state supreme court ruled that the law clearly had been misapplied because the ALJ "fail[ed] to consider all factors material to concluding whether Fortney's death came within the service to the employer exception."[18]

B. *Horseplay*

In *Xenia Rural Water District v. Vegors*,[19] the Iowa Supreme Court reversed in part and affirmed in part a trial court's decision that denied workers' compensation benefits to an employee who was "struck and injured by a truck driven by a co-worker after claimant wiggled his rear end toward the co-worker."[20] The injury, according to the court, was not based on a personal as opposed to a work-related relationship. Therefore, recovery was not barred by recovery by "statutory prohibition on injuries caused by willful act . . . for reasons personal to claimant."[21]

The court further found that a determination of whether horseplay is a "substantial deviation from the course of employment" should be based on

> (1) the extent and seriousness of the deviation, (2) the completeness of the deviation (i.e., whether it was commingled with the performance of duty or involved an abandonment of duty), (3) the extent to which the practice of horseplay had become an accepted part of the employment, and (4) the extent

15. *Id.* at 886.
16. Fortney v. Airtran Airways, Inc., 319 S.W.3d 325 (Ky. 2010).
17. *Id.* at 328.
18. *Id.* at 327.
19. 86 N.W.2d 250 (Iowa 2010).
20. *Id.* at 256.
21. *Id.*

> to which the nature of the employment may be expected to include some such horseplay.[22]

C. *Post-Termination*

In a slip-and-fall case involving an employee who suffered a serious injury while cleaning out his office three days after being fired, the Louisiana Supreme Court quoted a standard commentary with approval:

> Compensation coverage is not automatically and instantaneously terminated by the firing or quitting of the employee. The employee is deemed to be within the course of employment for a reasonable period while winding up his or her affairs and leaving the premises. The difficult question is: what is a reasonable period?[23]

The injured employee definitely fell within a reasonable period, ruled the court, citing the facts that he had been fired in one location on a Friday and received permission to return to his office in another location the following Monday.[24]

D. *"Positional" Risk*

In *Cyr v. McDermott's, Inc.*,[25] the Vermont Supreme Court found that a claimant, who ingested a caustic agent that was stored in a bottle of Mountain Dew, had been in a "positional-risk" situation and "but for his employment, the instrument of his injury would never have arrived in his hands."[26] A co-worker gave the claimant the bottle by mistake. After keeping it in the employees' refrigerator for several days, the injured worker took it home and consumed it after drinking two cans of beer. His blood alcohol level was high because of the beer intake, and his workers' compensation claim had been denied because he was "intoxicated."[27] The court reversed and remanded the decision of the workers' compensation board after finding that the claimant's injury "arose out of his employment."[28]

E. *Personal Comfort Doctrine*

Without getting permission to leave her job or punching out, a woman moved her car so that she would be better able to leave work after a snow-

22. *Id.* (quoting Phillips v. John Morrell & Co., 484 N.W.2d 527, 530–31 (S.D. 1992)).
23. Ardoin v. Cleco Power, L.L.C., 38 So. 3d 264, 265 (La. 2010) (quoting LARSON'S WORKER'S COMPENSATION LAW § 26.01).
24. *Id.*
25. 996 A.2d 709 (Vt. 2010).
26. *Id.* at 715.
27. *Id.* at 713.
28. *Id.* at 715.

storm.[29] Walking back to work, she fell and was injured. This injury did not arise out of or occur in the course of employment, but the claimant argued the personal comfort doctrine provided an exception. The Idaho Supreme Court disagreed, finding that the personal comfort doctrine does not apply to acts which depart greatly from the employment or cannot be considered a part of the job.[30]

F. *Bunkhouse Rule*

A migrant worker at a remote tomato farm alleged he broke his ankle by falling on wet pavement outside housing supplied by his employer. Finding that the claimant was eligible for workers' compensation benefits, the South Carolina Supreme Court held that the so-called bunkhouse rule applies, even if the worker is not contractually required to live in the provided housing.[31] What matters are the actual circumstances of the case: "It is clear from the record that [the claimant] was required, not by contract, but by the nature of his employment, to live on-site near the packing facility as there was no reasonable alternative. . . ."[32]

Under the bunkhouse rule, "when an employee is required to live on the premises, either by his contract of employment or by the nature of his employment, . . . the entire period of his presence on the premises . . . is deemed included in the course of employment."[33] Injuries would thus be compensable.

G. *Material Deviation*

The Wyoming Supreme Court ruled against a worker who was injured while taking a more scenic route home from a mandatory training session.[34] The employee and two co-workers decided to ride their motorcycles and arrived at the program without incident. However, the three decided to take an alternative route home, during which the claimant was injured. The court ruled that "[w]hen an employee is on a work-related trip for which he is reimbursed, but takes a side trip for personal reasons, he is no longer acting within the scope of his employment."[35]

A lengthy dissent argues, among other things, that the majority opinion "ignored the unique geography of Wyoming,"[36] i.e., wide open spaces.

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29. Thompson v. Clear Spring Foods, Inc., 228 P.3d 378 (Idaho 2010).
30. *Id*. at 380.
31. Pierre v. Seaside Farms, Inc., 689 S.E.2d 615 (S.C. 2010).
32. *Id*. at 622.
33. LARSON'S WORKERS' COMPENSATION LAW § 24.01 (2009).
34. Shelest v. Wyoming Workers' Safety & Compensation Div., 222 P.3d 167, 170 (Wyo. 2010).
35. *Id* at 170.
36. *Id*. at 176 (Hite, J., dissenting).

The claimant's return trip was approximately 55 percent longer. "If this had been a case about blocks," according to the dissent, "then an alternate route which extended six blocks to nine blocks would operate to deprive a worker from worker's compensation benefits."[37]

H. *Lunch Break*

In order to be compensable under worker's compensation insurance in West Virginia, "three elements must coexist: (1) a personal injury (2) received in the course of employment and (3) resulting from that employment."[38] During her lunch break, a loan clerk ran across the street to buy something to eat, tripped and fell while returning to work, and suffered from a torn rotator cuff as a result. She claimed that she was forced to hurry because, among other reasons, the bank was understaffed. The court was not sympathetic and found that her injury satisfied only the first prong of the requirement.[39]

I. *Psyche Injuries*

In Alaska, a physical injury is a prerequisite for recovery for a psyche injury unless the stress is extraordinary and unusual. In *Kelly v. State Department of Corrections*, a prison guard was found to be "permanently and totally disabled" as the result of a series of threats by an armed prisoner who had been convicted of murder.[40] He received benefits for five years, but nine years after the threat, the workers' compensation board "filed a notice of controversion, raising for the first time the defense that the employee's claim was not compensable."[41] The board claimed that the work-related stress suffered by the guard was not unusual, given his occupation. However, the state supreme court reversed and remanded the case after finding that the "guard satisfied all of the elements required to show that he had suffered mental injury, as defined by the Workers' Compensation Act."[42]

J. *Liability of Successive Employers*

A veteran of numerous heavy duty jobs, including lumber jacking, was found to have "suffered from an occupational disease (OD)" whose major contributing cause was a lifetime of heavy lifting.[43] Turning to the ques-

37. *Id.*
38. Williby v. W. Va. Off. Ins. Comm'r, 686 S.E.2d 9 (W. Va. 2009).
39. *Id.* at 10–11.
40. Kelly v. State Dep't of Corrections, 218 P.3d 291 (Alaska 2010).
41. *Id.* at 293.
42. *Id.* at 291.
43. Liberty Nw. Ins. Corp. v. Mont. State Fund, 219 P.3d 1267, 1273–74 (Mont. 2009).

tion of which employers to hold liable in cumulative trauma or OD cases, the Montana Supreme Court reaffirmed the rule of "last injurious exposure," finding that the "OD occurs during the last employment at which the claimant was exposed to working conditions of the same type and kind which gave rise to the OD."[44]

IV. Statutory Defenses

A. *Less Than $20,000 Annual Payroll*

Not all work-related injuries are compensable, at least in Kansas. The Wonderful House Chinese Restaurant was exempt from workers' compensation requirements when it opened in December 2007 because its expected payroll, excluding family members, was less for $20,000 for the year.[45] On December 26, Alfred Slusher fell while at work and shattered his elbow. The administrative law judge (ALJ) ordered the restaurant, which had no money at the time, and ultimately the state compensation fund to pay benefits to Slusher on the assumption that the new business would have a gross payroll of more than $20,000 during 2008.[46]

The Kansas Court of Appeals found that the ALJ misread the law. Although the result was "harsh," the court ruled that Slusher was ineligible for benefits: "Even though the Kansas statute is unique, it must be enforced as written. Here, the Board correctly held Wonderful House was exempt from the Workers Compensation Act under the language set forth in K.S.A. 44-505(a)(3)."[47]

B. *Hernias*

Reversing a district court decision, the Wyoming Supreme Court found that the "phrase 'in the course of the employment' means a hernia is compensable if it is found to be causally related to the employee's original work injury."[48]

At issue in *Ball v. Wyoming* was an incident in 2007 in which James Ball fell out of bed as the result of leg pain. He ultimately was found to have a hernia, which had occurred when he tried to stand up after the accident. But the cause of the leg pain was the sudden malfuction of a spinal cord stimulator was that implanted after a 1993 compensable work-related injury.[49]

44. *Id.* at 1274.
45. Slusher v. Wonderful House Chinese Rest., Inc., 217 P.3d 11 (Kan. Ct. App. 2009).
46. *Id.* at 12.
47. *Id.* at 15.
48. Ball v. Wyo. Workers' Safety & Compensation Div., 239 P.3d 621 (Wyo. 2010).
49. *Id.* at 623.

The workers' compensation division had denied benefits based on Wyoming's so-called hernia statute, which requires that to be compensable, hernias must be: (a) "of recent origin," (b) "accompanied by pain," (c) "immediately preceded by some strain suffered in the course of employment," and (d) the pain must not have manifested before the alleged injury.[50]

The division argued that the hernia statute should trump the second injury rule which it described as common law. But the supreme court reasoned that because the second injury rule was based on the basic work injury statute, it was not a common law rule: "[T]he second compensable injury rule is a causation analysis, and not a court-created benefit or remedy."[51] Therefore, the hernia suffered thirteen years after the original work-related accident was compensable.

C. *Notice of Work-Related Incidents*

North Carolina requires work-related incidents to be reported within thirty days.[52] If the claimant files after the deadline, regardless of whether the employer was aware of the injury, the state industrial commission cannot award benefits unless it: "(1) concludes as a matter of law that the lack of timely written notice was reasonably excused and that the employer was not prejudiced and (2) supports those conclusions with appropriate findings of fact."[53] In *Gregory v. W.A. Brown & Sons*, the commission did neither before awarding benefits to a claimant who filed notice four months after her alleged injury. The late notice was partially due to miscommunication with her human relations department. After rebuking the commission for transferring the burden of notice from the employee to the employer, the the North Carolina Supreme Court reversed and remanded the case.[54]

The Iowa Supreme Court also remanded a case to determine whether the claimant had met the state's notice requirement.[55] The issue of timely notice in *IBP, Inc. v. Burress*, however, hinged on whether brucellosis, which is caused by exposure to pig blood, is an injury or an occupational disease. The court held that brucellosis in an injury despite its listing as an occupational disease in the state code.[56] If it were an occupational disease, the employer's liability would have ended one year after the claimant's last exposure.

The brucellosis did not become symptomatic for almost six years.[57] Finding that no substantial evidence suggested that the claimant was aware

50. Wyo. Stat. Ann. § 27-14-603.
51. *Id*. at 628.
52. N.C. Gen. Stat. § 97-22.
53. Gregory v. W.A. Brown & Sons, 688 S.E.2d 431 (N.C. 2010).
54. *Id*. at 439.
55. IBP, Inc. v. Burress, 779 N.W.2d 210 (Iowa 2010).
56. Iowa Code § 85.11.
57. *Burress*, 779 N.W.2d at 210

of the compensable nature of his disease, the court remanded the case to determine if he satisfied the ninety-day notice requirement.[58] The court also upheld a change in the claimant's disability from permanent partial to permanent total.[59]

V. TEMPORARY DISABILITY

Actions by the claimant were a factor in several cases involving temporary disability during the past year.

In *Schujer v. Algona*, the Iowa Supreme Court vacated a judgment in favor of an employee who had been awarded temporary disability after her treating physician noted that she had achieved maximum medical improvement (MMI).[60] The appellant had injured her lower back at work on December 2, 2002, and voluntarily left her job in early January. The employer paid temporary benefits until the end of February when her physician "released her for regular duty and directed her to continue taking her anti-inflammatory medication."[61] Despite having taken a full-time job, she saw a series of chiropractors and orthopaedic surgeons and ultimately underwent a spinal fusion.

Under the Iowa Code, the court was not required to examine the evidence de novo, but instead had to determine "whether the evidence supports the findings actually made [by the worker's compensation commissioner]."[62] Thus, the court did not evaluate the claimant's credibility but looked for evidence that the commissioner had valid reasons for "accept[ing] or reject[ing] testimony based on his assessment of witness credibility."[63] The court concluded that the "commissioner's decision on causation [was] supported by substantial evidence" and vacated the decision of the appellate court.[64]

In an Ohio case involving allegations of fraud and overpayment, a claimant received temporary total disability benefits from late 2004 through November 2006.[65] After learning that he had worked for approximately one week in mid-June 2005, the state industrial commission vacated all compensation during the period between June 2005 and November 2006 and asked for a finding of fraud.[66]

58. *Id.*
59. *Id.*
60. 80 N.W.2d 549 (Iowa 2010).
61. *Id.* at 554.
62. *Id.* at 557–58.
63. *Id.* at 558.
64. *Id.* at 562.
65. Goodwin v. Indus. Comm'n, 922 N.E.2d 196 (Ohio 2010).
66. *Id.* at 196–97.

The case was appealed to the Ohio Supreme Court after the state appellate court had overturned the commission's decision and ordered it to make the disability payments for the entire period less the one-week period in June. Like the lower court, the state supreme court discussed two prior cases of fraud[67] at some length, reaching the conclusion that the case at bar did not reach the level of fraud in the earlier cases and that "no evidence indicates that [the claimant] engaged in any activities incompatible with his medical restrictions [between June 2005 and November 2006]."[68] The court held that his misrepresentation on the state form requesting disability payments barred benefits only for the week he worked in June.

In another case, the Ohio Supreme Court held, not surprisingly, that sleeping on the job was a voluntary departure from employment that barred temporary total disability.[69] The claimant knew or should have known that napping at work was prohibited conduct and grounds for termination. She had been written up before and advised that she would be terminated if she slept on the job. The employee was found to be not eligible for temporary disability benefits.

VI. Permanent Disability

A. *Loss of Earning Capacity*

The Mississippi Supreme Court reversed a finding of a loss of earning capacity because the claimant had failed to rebut the presumption that she suffered no loss.[70] After an eighteen-year veteran of Omnova Solutions, Inc. was struck by a forklift, she returned to work in her pre-injury job at the same wage, but not before filing a "Petition to Controvert with the Mississippi Workers' Compensation Commission asserting '[t]otal loss of wage[-]earning capacity.' "[71] Five months later, she was moved to a lower paying job when an employee with more seniority took her position during a series of company layoffs. The claimant's demotion was "totally unrelated to her work injury," and she apparently had not tried to find another job.

An administrative law judge awarded compensation benefits for 450 weeks, and the decision was upheld by the state circuit court and appellate court.[72] But the supreme court found that "[no] substantial evidence was presented that her wage-earning capacity had been diminished as a

67. Ellis v. Indus. Comm'n, 751 N.E.2d 1015 (Ohio 2001); Griffith v. Indus. Comm., 849 N.E.2d 28 (Ohio 2006).

68. *Goodwin*, 922 N.E.2d at 200.

69. Galligan v. Indus. Comm'n, 921 N.E.2d 231 (Ohio 2010).

70. Omnova Solutions v. Lipa, 44 So. 3d 935 (Miss. 2010).

71. *Id*. at 936.

72. *Id*. at 936–37.

result of the work-related injury,"[73] and that the worker failed rebut the presumption by showing incapacity or the unreliability of her post-injury earnings.

B. *Res Judicata, Collateral Estoppel, and Video Tapes*

Timothy Carnahan is no longer smiling for the camera as the result of a New Hampshire Supreme Court decision issued in April 2010. The court upheld a decision by the state compensation board to reduce his rate from temporary total disability to diminished earning capacity.[74] Carnahan had been a self-employed truck driver and furniture mover when he injured his lower back in September 2000. The New Hampshire Compensation Appeals Board (CAB) reviewed his case several times at the insurance carrier's request, culminating in a May 2008 finding that Carnahan had, "at the least, a full-time, light duty work capacity" and "a significant earning capacity."[75]

Carnahan appealed the decision, and in October 2008, the CAB found that he was capable of returning to full-time work although probably not at the same earning capacity as before the accident. The CAB also found that Carnahan was "self-limiting, uncooperative, and not credible,"[76] an assessment that was supported by a video taken the day of the May hearing that showed him walking without a limp. Another concealed video in July 2008 showed Carnahan setting up a backyard pool.[77]

In his appeal to the supreme court, Carnahan argued that the doctrines of res judicata and collateral estoppel precluded the change in his benefits without evidence of a change in his work capacity. The court disagreed on several grounds. Contrary to Carnahan's argument, the CAB had determined a change in his work capacity. Although the board had relied on erroneous information from the insurance carrier in an earlier determination, it corrected the mistake in its October 2008 hearing.[78] The supreme court also dismissed Carnahan's arguments that "gainful employment" and "earning capacity" have the same meaning. Both overlap by relating to "age, education, and job training," according to the court, but the "terms are distinct."[79]

C. *Earnings versus Earning Capacity*

Sargeant Bob Straub of the Scottsbluff Police Department earned more when he was reassigned to a desk job after being struck by another vehicle

73. *Id.* at 941.
74. Appeal of Timothy Carnahan, 993 A.2d 224 (N.H. 2010).
75. *Id.* at 227.
76. *Id.*
77. *Id.* at 231.
78. *Id.* at 228.
79. *Id.* at 230.

during a routine traffic stop. But the Nebraska Supreme Court found that that he was still able to establish a 35 percent loss of earning capacity through reports from an orthopaedist and a court-appointed vocational expert.[80]

The court noted that earnings are not equivalent to earning power:

> Earning power, as used in Neb. Rev. Stat. § 48-121(2), is not synonymous with wages, but includes eligibility to procure employment generally, ability to hold a job obtained, and capacity to perform the tasks of the work, as well as the ability of the worker to earn wages in the employment in which he or she is engaged or for which he or she is fitted.[81]

The court went on to note that "[t]he fact that an employee is still employed and still paid the same or better does not, of itself, mean he or she has not experienced some loss of earning capacity."[82] A report submitted to the worker's compensation commission by a court-appointed vocational case manager predicted that Straub would be restricted to desk duty for the foreseeable future, presumably with a negative impact on his earnings.

D. *Gas Exposure Linked to Somatoform Disorder*

In *Steppi v. Conti Electric, Inc.*, the Delaware Supreme Court reinstated an award of permanent total disability due to a somatoform disorder that the claimant alleged was related to exposure to hydrogen sulfide.[83] Somatoform disorders are "characterized by physical symptoms that suggest physical illness or injury—symptoms that cannot be explained fully by a general medical condition, direct effect of a substance, or attributable to another mental disorder."[84]

While working at a petroleum refinery, James Steppi, an electrician, "became very warm and suddenly felt very woozy."[85] Neither the ambulance attendants nor the hospital where Steppi was taken mentioned a possible "chemical exposure, confusion, or similar conditions," all of which were raised during the workers' compensation hearing and subsequent appeals. Steppi went to a series of doctors because of increasingly severe breathing, heart, and liver problems, confusion, and lack of focus. At a hearing before the industrial board, expert witnesses agreed that "something" happened at work and that Conti's symptoms were "consistent with hydrogen sulfide exposure."[86] The board granted permanent total disability benefits. But the

80. Straub v. City of Scottsbluff, 784 N.W.2d 886 (Neb. 2010).
81. *Id.* at 892 (quoting Davis v. Goodyear Tire & Rubber Co., 696 N.W.2d 142, 147 (Neb. 2005)).
82. *Id.*
83. Steppi v. Conti Elec., Inc., 2010 Del. LEXIS 91 (Del. Mar. 16, 2010) (table).
84. Diagnostic and Statistical Manual, 4th ed. (DSM-IV) (Am. Psych. Ass'n 2000).
85. *Conti Elec.*, 2010 Del. LEXIS 91, at *2.
86. *Id.* at *4.

superior court overturned the board's decision after finding no evidence of a gas leak and no causal connection between the incident and the employee's disability. The supreme court reinstated the board's decision.

The supreme court's decision appears to have been based on two prongs, i.e., exposure and causation. Conflicting evidence had been presented to the board regarding the reliability of the sensors that workers carried as well as stationary monitors. No one reported any alarms around the time of the incident but Conti testified that the sensors were not reliable.[87] The board and the supreme court upheld the questionnable proposition that the absence of positive findings from any sensors was controlling. The board and the supreme court also relied heavily on the testimony of three experts, who found, respectively, that (1) Conti presented a textbook case of hydrogen sulfide exposure; (2) hydrogen sulfide exposure was more likely than not; and (3) the symptoms were consistent with hydrogen sulfide exposure.[88]

However, the determination of causation, initially by the board and upheld by the supreme court, is based almost entirely on inference. None of the expert opinions suggested a direct link between Conti's possible hydrogen sulfide exposure and the somatoform disorder. Other factors in Conti's background, including the facts that he had prior exposure to asbestos and had low back pain before the incident, were mentioned in passing and discounted.[89] Instead, the supreme court cited a 1960 case[90] for the proposition that with "other credible evidence tending to show that the injury occurred directly after the trauma and without interruption, we think such evidence would be sufficient to sustain an award."[91] Given the number of possible contributing factors to Conti's pain, citing a fifty-year old case seems to be inadequate at best.

In brief, permanent total disability has been reinstated for a questionable exposure whose only clear link to a somatoform disorder is that the disorder came after the date of the exposure because the decision of the board was supported "by the minimum quantity of evidence required."[92]

E. *Permanent Total Disability Awarded After Initial Denial Despite No Change in Physical Condition*

Seven years after the South Dakota Supreme Court upheld the state labor department's (DOL) denial of permanent disability benefits,[93] the DOL

87. *Id.* at *4–5.
88. *Id.* at *4.
89. *Id.* at *2–3,
90. Gen. Motors Corp. v. Freeman, 164 A.2d 686 (Del. 1960).
91. *Id.* at 688.
92. *Conti Elec.*, 2010 Del. LEXIS 91, at *9.
93. Wiedmann v. Merillat Indus. (*Wiedmann I*), 623 N.W.2d 43 (S.D. 2001).

granted the claimant's petition for review and ultimately determined that he was entitled to permanent total disability benefits and certain medical expenses.[94] On appeal, the circuit court reversed the determination of permanent total disability but affirmed the payment of medical expenses. Both parties appealed the decision to the supreme court.[95]

The supreme court found that the threshold issue was whether its 2001 decision could be reviewed.[96] In its initial decision, the court had upheld the DOL's denial of benefits because the claimant refused to undergo a pain management program.[97] Under South Dakota law, the DOL may review a claimant's status if there is a change in his condition.[98] Based on its 2007 review, the DOL noted that, despite the absence of any change in his condition, the claimant had met the burden of proof by completing a pain management program.

The court agreed, after noting that the DOL had correctly interpreted its earlier holding to mean "that [the claimant] had to undergo a pain management program before his claim for permanent total disability could be accepted or evaluated."[99]

F. *Total Incapacity Benefits Granted After Permanent Partial Award*

The Connecticut Supreme Court upheld an award of total incapacity benefits despite a prior voluntary agreement as to permanent partial disability.[100] The court found that the award was allowable with or without a change of condition and that the absence of the claimant's formal motion to reopen was not germane. Her application for total incapacity benefits was sufficient, and defendants had not shown prejudice.[101]

The claimant had injured her right elbow at work in 1999. After several operations, in 2002 she entered into a voluntary agreement with her employer of permanent partial disability of 41 percent.[102] A medical forensic examiner concluded that she had reached maximum medical improvement.[103] In between the first and second operations on her elbow, she tripped while going up the stairs at home and injured her right knee, resulting in two knee operations.

94. Wiedmann v. Merillat Indus. (*Weidmann II*), 776 N.W.2d 824 (S.D. 2009).
95. *Id.* at 824–25.
96. *Id.* at 825.
97. *Id.* (citing S.D. Codified Laws § 62-7-33).
98. *Id.*
99. *Id.*
100. Marandino v. Prometheus Pharm., 986 A.2d 1023 (Conn. 2010).
101. *Id.* at 1024.
102. *Id.* at 1028–29.
103. *Id.* at 1029.

After entering the voluntary agreement, she sought benefits for total incapacity. The commissioner ruled that she "had a compensable 41 percent permanent partial disability of her master right arm, that her knee injury was compensable, and that she was totally incapacitated and entitled to benefits in accordance with [Connecticut General Statutes] § 31-307."[104] The employer appealed to the workers' compensation board, which upheld the decision, and the defendants filed an appeal with the intermediate state court.

The 41 percent disability to the elbow was not in dispute and at oral argument, the employer conceded that the court could sustain the commissioner's award of total incapacity, but argued that the knee injury was not compensable.[105] The Connecticut Appellate Court affirmed the commissioner's recommendations with one exception. The knee injury was not compensable "as the medical reports relied on by the commissioner were not competent evidence."[106]

On further appeal, the state supreme court found that: (1) "[the claimant's] receipt of permanent partial disability benefits under Conn. Gen. Stat. § 31-308 did not disqualify her from total incapacity benefits," (2) the commissioner "properly" relied on expert opinion that knee injury was "casually related to her arm injury," and (3) the absence of medical facts "supporting [the expert's] conclusion was immaterial."[107]

The court reached back to the 1920s to find cases where total incapacity benefits were awarded to claimants who had already received permanent partial disability benefits.[108] It further noted that the "legislature has not amended the statute for total incapacity benefits" to preclude a claimant's seeking benefits for a second injury, despite the fact that it had seventy-five years to do so.[109] In a concurring decision, Justice Rogers would have awarded total incapacity on more narrow grounds, suggesting that the change in the claimant's condition would have justified the subsequent award.[110] The Connecticut Trial Lawyers Association filed an amicus brief in which it contested the defendants' contention that the claimant would not have been entitled to the incapacity benefits absent a changed condition. Justice Rogers pointed out, however, that they cited no case in opposition to the defendants' position.[111]

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104. *Id.*
105. *Id.*
106. *Id.* at 1024.
107. *Id.*
108. *Id.* at 1033 (citing Osterlund v. State, 66 A.2d 363 (Conn. 1949), Morgan v. Adams, 16 A.2d 576 (1940), and Costello v. Seamless Rubber Co., 99 Conn. 545, 122 A. 79 (1923)).
109. *Id.* at 1035.
110. *Id.* at 1044.
111. *Id.* at 1048.

G. *Second Injury Fund—Now Easier to Qualify in Iowa*

With three justices dissenting, the Iowa Supreme Court interpreted Iowa's second injury fund (SIF) statute[112] to allow recovery when the first injury involved more than just one of the body parts enumerated by the statute and both scheduled and unscheduled disabilities.[113] In *Gregory v. Second Injury Fund of Iowa*, the claimant underwent carpal tunnel surgery on both arms in separate operations in December 2000 and February 2001, which left her with functional impairments of 2 percent in her left hand and 6 percent in her right hand. As the result of additional surgeries during the spring and summer of 2001 to treat shoulder pain, she sustained a 10 percent impairment in both arms, "secondary to the surgical treatment of her clavicles."[114] The claimant went back to work but fractured her right foot in October 2002.[115]

In July 2004, she filed a claim for workers' compensation insurance for the foot injury and also sought benefits from the SIF fund, "alleging the 2000 injury to her left hand constituted a first qualifying injury and the 2002 injury to her right foot constituted a second qualifying injury."[116] The workers' compensation claim was settled, but the commissioner denied the SIF claim and the claimant sought judicial review.

The supreme court liberally interpreted the SIF requirements, noting that

> [the claimant's] entitlement to benefits from the Fund is dependent upon proof of the following propositions: (1) she sustained a permanent disability to a hand, arm, foot, leg, or eye (a first qualifying injury); (2) she subsequently sustained a permanent disability to another such member through a work-related injury (a second qualifying injury); and (3) the permanent disability resulting from the first and second injuries exceeds the compensable value of "the previously lost member."[117]

The court held the SIF statute applied as long as there was a permanent partial loss of at least two enumerated body parts in successive injuries. Interpreting the statute by considering its legislative intent, reasonableness, and public policy, the court "applied the statute broadly and liberally in keeping with its humanitarian objective."[118] Not surprisingly, the court reversed and remanded the district court's decision, finding that the 2000 injury to the left hand constituted the first qualifying injury.[119]

112. Iowa Code § 85.64 (2001).
113. Gregory v. Second Injury Fund of Iowa, 777 N.W.2d 395 (Iowa 2010).
114. *Id.* at 396.
115. *Id.*
116. *Id.* at 397.
117. *Id.* at 398–99.
118. *Id.* at 399.
119. *Id.* at 401.

In a vigorous dissent, Justice Cady argued that the claimant did not sustain a first qualifying injury and that the majority decision "continued the unfortunate trend" of "an overly broad interpretation of our Second Injury Fund over the years."[120] According to Justice Cady, SIFs were not "conceived to encourage employers to hire disabled workers" but to resolve a fundamental conflict between employees, for whom the ideal compensation system would compensate for the collective impact of the second injury, and employers, for whom the perfect system would limit liability to the second injury only.[121]

New York State adopted the first SIF in 1916, a scant three years after it adopted its workers' compensation statute.[122] Few states followed its lead until the early to mid-1940s when most states adopted SIFs to encourage the employment of veterans, who "were not being hired due to employers' fears of being held financially responsible for the cumulative effect of an injury suffered on the job coupled with a pre-existing war injury."[123] SIF approaches among the states were far from uniform with some requiring the employer to bear the cost of the entire disability and others compensating only for the injury that would have existed without the pre-existing injury. Iowa's SIF was adopted in 1945. Ironically, as Justice Cady points out, because the SIF did not lower the cost to employers of benefits for second injuries, it would not have encouraged Iowa employers to hire the disabled.[124]

The majority's liberal interpretation of Iowa's SIF policy comes at a time when many states are discontinuing the program.[125] As of July 2008, nineteen states had abolished SIF programs altogether, and others, such as South Carolina, enacted laws that call for the phase out of SIFs over a period of several years. A more recent example is the State of Missouri, where Attorney General Scott Koster predicted in February 2011 that the state SIF would owe more than $20 million in benefits by the end of the calendar year.[126]

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120. *Id.* at 401–02 (Cady, J., dissenting).

121. *Id.* at 402.

122. Christopher J. Boggs, *One-Eyed, One-Legged and One-Armed Men Need Not Apply—The Rise of Second Injury Funds*, MyNewMarkets.com, July 25, 2008, *available at* www.mynewmarkets.com/articles/92195/one-eyed-one-legged-and-one-armed-men-need-not-apply-the-rise-of-second-injury-funds.

123. *Id.*

124. *Gregory*, 777 N.W.2d at 402.

125. Boggs, *supra* note 120.

126. Dick Aldrich, *Attorney General Seeks Help with Second Injury Fund Crisis*, Mo. News Horizon, Feb. 8, 2011, *available at* http://monewshorizonblog.org/2011/02/attorney-general-seeks-help-with-second-injury-fund-crisis/.