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2007 INSURANCE COVERAGE SEMINAR

TUESDAY, OCTOBER 23, 2007
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2007 Insurance Coverage Seminar

Joseph Bermudez, Esquire
Richard Bortnick, Esquire
Alicia Curran, Esquire
David Loh, Esquire
Thomas Jones, Esquire
Christopher Raleigh, Esquire

Deborah Minkoff, Esquire
William Shelley, Esquire
William Stewart, Esquire

Cozen O'Connor

October 23, 2007

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2007 Insurance Coverage Seminar

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Joseph F. Bermudez

Member
Insurance Department
Denver Office
(720) 479-3926
jbermudez@cozen.com

AREAS OF EXPERIENCE

- ADR
- Advertising Injury
- Bad Faith
- Construction Defect
- Directors & Officers Responsibilities & Liability
- Employee Practices Liability Coverage
- Environmental Coverage
- General Liability Insurance Coverage
- Claims/Litigation
- Life Science & Medical Device Litigation
- London Markets
- Long Tail/Toxic
- Primary/Excess
- Products Liability
- Professional Liability Coverage
- Property Insurance
- Reinsurance
- Toxic & Other Mass Torts

EDUCATION

- J.D., University of Michigan Law School, 1988
- B.A., Boston University, 1985

BAR ADMISSIONS

- Colorado
- New Jersey
- New York
- District of Columbia

COURT ADMISSIONS

- New York Supreme Court
- Superior Court of New Jersey
- Supreme Court of New Jersey
- U.S. Bankruptcy Court: Southern District of Georgia, Southern District of New York
- U.S. District Court: Colorado, Eastern District of Pennsylvania, Eastern District of Virginia, New Hampshire, New Jersey, Vermont, Wyoming

Joseph F. Bermudez is a Member of the firm, where he concentrates his practice on insurance coverage matters. He joined the Denver office in March 2005. Joe is Chair of the Food Contamination Coverage Practice Area.

Joe has extensive experience representing domestic and foreign insurance companies and underwriters in regard to matters involving complex insurance coverage and reinsurance issues. Since 1990, he has represented and counseled clients with respect to first party, third party and specialty coverage matters involving advertising liability, bad faith, business interruption, commercial general liability, construction defects, contamination, directors' and officers' liability, employment practices, environmental, excess and surplus lines, financial institutions, intellectual property disputes, medical devices, non-profit organizations, professional liability, product recall, products liability, property losses, punitive damages, reinsurance and toxic torts. He is a frequent lecturer on insurance and reinsurance issues.

Joe also focuses on complex commercial disputes. He has litigated matters in federal and state courts throughout the United States and represented clients in mediations and alternative dispute resolution proceedings.

Joe earned his bachelor of arts degree from Boston University in 1985, and his law degree from the University of Michigan Law School in 1988. He is admitted to practice in Colorado, New Jersey, New York, and the District of Columbia.

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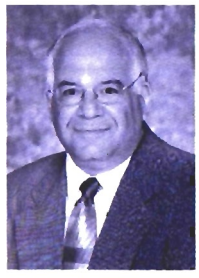

Richard J. Bortnick

Member
West Conshohocken Office
(610) 832-8357
rbortnick@cozen.com

AREAS OF EXPERIENCE

- Antitrust
- Asbestos
- Bad Faith
- Canadian Markets
- Class Action & Multidistrict Litigation
- Complex Torts & Products Liability
- Corporate Compliance Planning & Best Practices
- Corporate Disputes & Shareholder Claims
- Corporate Governance & Compliance
- Directors & Officers Responsibilities & Liability
- Employee Practices Liability Coverage
- Employment Discrimination & Wrongful Discharge
- English Law Insurance Coverage
- Environmental Coverage
- Errors and Omissions
- Financial Institutions
- Financial Risk Transfer
- General Litigation
- Insurance Coverage Claims/Litigation
- Latin American
- Subrogation & Recovery
- London Markets
- Primary/Excess
- Technology Licensing & Transfer
- Technology, Internet & E-Commerce

EDUCATION

- J.D., Villanova University School of Law, 1985
- B.S., *summa cum laude*, Boston University, 1981

BAR ADMISSIONS

- New Jersey
- Pennsylvania

Richard J. Bortnick is a Member in the firm's West Conshohocken office and practices with the Insurance Department. Richard concentrates his practice in directors' and officers' liability, securities fraud, insurance coverage, products liability, employment practices, and commercial litigation. Prior to joining Cozen O'Connor, Richard was a partner in the Commercial Litigation Department at White and Williams LLP, where he served as a member of the firm's Executive Committee.

Richard lectures at seminars across the country on topics such as:

- "What You Need to Know About Litigation Management Guidelines" – Mealey's Litigation Management Guidelines Conference, New York City, May 2007.
- "How Recent Developments in the U.S. Will Impact You," 10th Annual D&O Liability Insurance Forum, London, England, March 2007.
- "US Developments for European Insurers: Key Issue Update" - European Forum on D&O Liability Insurance, Munich, Germany, 2006.
- "D&O Exposures: Present and Future" - Annual Conference of the National Association of Mutual Insurance Companies, Tampa, Florida, 2006.
- "The Not-for-Profit Life: Life is Not So Simple for Not-for-Profits Today" - PLUS Mid-Atlantic Chapter Educational Seminar, Philadelphia, 2006.
- "21st Century Securities Fraud Litigation: Not Your Typical Insurer-Funded Settlements" - 2nd Annual Execusummit Directors & Officers Insurance Conference, New York City, 2006.
- "Insurance Markets in an Uncertain World" - European Insurance Forum 2006, Dublin, Ireland, 2006.
- "What's Happening Across The Pond? The Latest Trends and Likely Effect in Europe" - 9th Annual Forum D&O Liability Insurance Forum, London, England, 2006.
- "Good News: The World is Shrinking...Bad News: Now Everyone Can Get Sued! Transnational Issues Affecting D&O: A New Horizon" - PLUS International Conference, Boston, 2005.
- "Employment Practices Claims Against Directors and Officers:

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COURT ADMISSIONS

- Supreme Court of Pennsylvania
- Supreme Court of New Jersey
- United States Courts of Appeals for the Third Circuit and the Eleventh Circuit
- United States District Courts for the District of New Jersey, the Eastern District of Pennsylvania, and the Western District of Michigan

MEMBERSHIPS

- Philadelphia Bar Association
- Professional Liability Underwriting Society - Mid-Atlantic Chapter Steering Committee

Considerations in Determining the Best Insurance Options" - Directors' and Officers' Liability Conference, New York City, 2000.

- "Taking it to the Courts: A Direct and Cross-Examination of a Quality Assurance Director" - Product Tampering and Accidental Contamination Conference, San Francisco, CA, 2000.
- "Year 2000 - Tick...Tick...Tick" - Directors' and Officers' Liability Conference, New York City, 1999.
- "Employment Practices Liability in the United States" - CIGNA Insurance Company of Canada, Toronto, Ontario, Canada, 1999.

In addition, Richard is frequently asked to appear on television news programs to discuss major legal and political topics. Recently, he appeared on Fox's *Good Day Philadelphia* to discuss the immigration bill currently being debated in Congress, as well as the recent case of the Atlanta attorney who traveled throughout Europe after being diagnosed with a particularly drug-resistant strain of Tuberculosis.

Richard also has published and been quoted in numerous articles, including:

- Co-Author, "Supreme Court Gives Wake-Up Call to Buyers on Global Warming Risks," *National Underwriter Property and Casualty*, (with Kevin M. LaCroix), June 2007
- "International D&O: Your Global D&O Coverage May Not Be As Global As You Think," *Rough Notes*, May 2007
- "Private Buyout Deals Produce New D&O Risks," *Business Insurance*, May 2007
- "Globalization of Directors' and Officers' Coverage," *Insurance Journal*, April 2007
- Co-Author, "Class Action Opt-Outs: The New Frontier?" *PLUS Journal*, (with Kevin M. LaCroix), April 2007
- Co-Author, "European Class Actions: A Growing Movement?" *National Underwriter*, (with Kevin Mattessich), November 6, 2006
- "Hedge Funds Still Wary of Insurance," *National Underwriter Property and Casualty,* November 6, 2006
- Co-Author, "Get It In Writing," *Global Reinsurance*, June 2006
- Author, "Coming Soon to a Courthouse Near You: A Chic D&O Lawsuit and An Eight-Figure (Or Greater) Settlement," *Inside the Minds: Professional Liability Law: Leading Lawyers on Strategies for Minimizing Risk and Increasing Success in Professional Liability Suits* (ISBN: 1596221739), Aspatore Books, November 2005.
- Co-Author, "Foreign Shareholder Securities Fraud Litigation: Welcome to our Federal Courts System," *PLUS Journal*, November 2005.
- "Director and Officer Liability: Coverage and Compliance," *Philadelphia Business Journal*, October 2005.

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- Commentator, "Draft Law Proposes to Make it Easier to File Class-Action Lawsuits in the Netherlands," *Reactions*, March 2005.
- Co-Author, "When Are Settlement and Damage Payments Not 'Loss' Under a D&O Policy," *Mealey's Emerging Insurance Disputes*, March 1, 2005.
- Author, "Supplementary Payments Under U.S. General Liability Cover: Pay or Else...," *Insurance Day*, February 14, 2005.
- Co-Author, "Product Tampering and Accidental Contamination Insurance: A Practical Guide," *Andrews Insurance Coverage Litigation Report*, Vol. 10, Sept. 2000.
- Co-Author, "Employment Practices: A Liability and Insurance Coverage Primer," *Mealey's Emerging Insurance Disputes*, August 30, 2000.
- Author, "Interrelatedness Provisions in Directors' and Officers' Insurance Policies: An Enlightened View in Pennsylvania," *Risk Vue Online*, 1999.
- Co-author, "Foreign Courts Will Follow US On D&O," *International Commercial Litigation*, Vol. 30, May 1, 1998.

Richard received his bachelor of science degree, *summa cum laude*, from Boston University in 1981. In 1985, he received his law degree, *cum laude*, from the Villanova University School of Law. He is licensed to practice in Pennsylvania and New Jersey and is admitted in the United States District Courts for the Eastern District of Pennsylvania, the District of New Jersey, and the Western District of Michigan, as well as the U.S. Courts of Appeals for the Third Circuit and the Eleventh Circuit.

COZEN
O'CONNOR.

Alicia G. Curran

Member
Insurance Department
Dallas Office
(214) 462-3021
acurran@cozen.com

AREAS OF EXPERIENCE

- Bad Faith
- Insurance Coverage Claims/Litigation
- Property Insurance

EDUCATION

- J.D., Southern Methodist University Dedman School of Law, 1982
- M.B.A., Southern Methodist University, 1978
- B.B.A., Texas Tech University, 1977

BAR ADMISSIONS

- Texas

COURT ADMISSIONS

- U.S. District Court, Southern, Northern, Eastern, Western Districts of Texas
- U.S. Court of Appeals: Fifth Circuit

MEMBERSHIPS

- American Bar Association
- Dallas Bar Association - Tort and Insurance, Construction Law Sections
- Defense Research Institute

Alicia G. Curran represents and advises insurance companies in complex coverage and extra-contractual third and first party matters. She leads a highly motivated legal team specializing in representation of insurers and the defense of their insureds. Ms. Curran's emphasis on early development of factual issues, innovative case positioning, problem resolution, and timely information assists her clients in obtaining positive case results. Now concentrating her practice in the areas of bad faith insurance litigation, insurance coverage, and agent and broker malpractice, she also has prior experience with the litigation of construction defect, premises liability, and general tort matters. Joining Cozen O'Connor's Dallas office in December 2005 as a Member in the Insurance Department, she was formerly with Burt Barr & Associates, L.L.P. of Dallas.

Alicia is admitted to practice in Texas and before the U.S. District Court for the Northern, Southern, Eastern, and Western Districts of Texas, and the Fifth Circuit Court of Appeals. She is a member of the American Bar Association, the Dallas Bar Association including its Tort and Insurance and Construction Law sections, and the Defense Research Institute.

Alicia has practiced law since 1983, earning her law degree from Southern Methodist University Dedman School of Law. She also has a master of business administration from Southern Methodist University and bachelor of business administration, where she specialized in finance, from Texas Tech University.

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Thomas M. Jones

Member
Vice Chair, National Insurance Department
Seattle Office
(206) 224-1242
tjones@cozen.com

AREAS OF EXPERIENCE

- Advertising Injury
- Appellate
- Architects & Engineers Malpractice
- Arson and Fraud
- Asbestos
- Bad Faith
- Brownfields Development
- Class Action & Multidistrict Litigation
- Complex Torts & Products Liability
- Construction Defect
- Construction Law & Litigation
- Directors & Officers Responsibilities & Liability
- Electronic Discovery Disputes
- Employee Practices Liability Coverage
- Employment Discrimination & Wrongful Discharge
- Employment Practices Litigation Defense
- Environmental Coverage
- Environmental Litigation
- Environmental Subrogation & Recovery
- Errors and Omissions
- Excess and Surplus
- Fidelity
- General Liability
- Healthcare Litigation
- Insurance Coverage Claims/Litigation
- Insurance Insolvency
- Labor & Employment
- Labor & Employment Litigation
- Legal Malpractice
- Life Science & Medical Device Litigation
- Life, Health & Disability
- Long Tail/Toxic
- Primary/Excess
- Products Liability

Thomas M. Jones joined Cozen O'Connor in January 1986 and is Vice Chair of the firm's National Insurance Department. As Vice Chair, Tom manages 200 attorneys, nationally. Tom also heads the firm's e-discovery practice area. Tom's practice spans many areas of law, including, advertising liability, agent/broker liability, appellate practice, arson and fraud, bad faith litigation, business torts, class actions, multidistrict litigation and other consolidated claims, commercial general liability, construction liability, crisis management, directors' and officers' liability, labor and employment, environmental law, e-discovery, excess and surplus lines, fidelity and surety, insurance coverage in the first and third party context, medical device and drug litigation, personal lines, products liability, fair credit reporting claims, property insurance, punitive damages, reinsurance, securities, security and premises liability, technology and e-commerce, and toxic and other mass torts.

Tom has acted as lead trial insurer counsel in some of the highest profile insurance coverage cases in the country. Tom was also selected by his peers as a "Super Lawyer" in Washington from 2000-2007 and serves on the electronic discovery advisory panel for ARMA International. Tom is chairman of the Defense Research Institute's E-Discovery Marketing Committee.

Tom has authored several published articles including:

- "Food Contamination Claims," *For the Defense*, Vol. 49, No. 5, May 2007 (with Jennifer Bozeat);
- "Insurance Issues for the Insurer," (supplement) *Washington Real Property Deskbook*, Ch. 135, Washington State Bar Association, 3d Edition, 2001 (environmental issues);
- "An Introduction to Insurance Allocation Issues in Multiple Trigger Cases," *The Villanova Environmental Law Journal*, Vol. 10, Issue 1, 1999;
- "Intellectual Property Coverage," Insurance Coverage: An Analysis of the Critical Issues, Continuing Legal Education Committee of the Washington State Bar Association, 1999;

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- Professional Liability Coverage
- Property Insurance
- Reinsurance
- Technology Licensing & Transfer
- Technology, Internet & E-Commerce
- Toxic & Other Mass Torts

EDUCATION

- J.D., Oklahoma City University School of Law, 1976
- B.A., Central State University, 1973

MEMBERSHIPS

- Seattle-King Bar Association
- Washington State Bar Association
- Oklahoma Bar Association
- American Bar Association
- Defense Research Institute
- Washington Defense Trial Lawyers Association

- "Claims for Advertising Injury Coverage: A Primer," *Journal of Insurance Coverage*, Vol. 1, No. 4, Autumn 1998;
- "Washington State's Insurance Regulation for Environmental Claims: An Overview of Key Provisions and Legal Issues," *Environmental Claims Journal*, Vol. 9, No. 3, Spring 1997; and
- "Reinsurance Issues Arising from the Settlement of Complex Claims," *Insurance Litigation Reporter*, Vol. 17, #12, 590, 1995.

COZEN
O'CONNOR.

David Y. Loh

Member
Insurance Department
New York Downtown Office
(212) 908-1202
dloh@cozen.com

AREAS OF EXPERIENCE

- ADR
- General Litigation
- Insurance Coverage Claims/Litigation
- Maritime

EDUCATION

J.D., Boston College Law School, 1992
A.B., Brown University, 1985

BAR ADMISSIONS

- Massachusetts
- New York

COURT ADMISSIONS

- U.S. Courts of Appeal: First and Third Circuits
- U.S. District Courts: Southern and Eastern Districts of New York, District of Massachusetts
- U.S. Bankruptcy Courts: Southern District of New York and District of Massachusetts

MEMBERSHIPS

- Member, Maritime Law Association of the United States
- New York County Lawyers Association
- American Bar Association

David Y. Loh joined the firm's New York Downtown Office in March 2007 as a Member in the Insurance Department. Prior to joining the firm, he was a partner with Nicoletti Hornig Campise & Sweeney in New York.

David focuses his practice on international insurance matters, and has extensive experience in successfully litigating insurance coverage, aviation, maritime and other transportation matters. He is admitted to practice in Massachusetts and New York, and before the U.S. Courts of Appeal for the First and Third Circuits, the U.S. District Courts for the Southern and Eastern Districts of New York and the District of Massachusetts, and the U.S. Bankruptcy Courts for the Southern District of New York and the District of Massachusetts. He is also a member of the Maritime Law Association of the United States.

David earned his law degree from Boston College Law School, where he was the Executive Editor of the *Boston College Third World Law Journal*, and earned his undergraduate degree from Brown University. Prior to attending law school, he served on active duty in the U.S. Navy as a Surface Warfare Officer. He also served after law school as a member of the Selected Reserves and as Commanding Officer of NR Destroyer Squadron 18. He retired with the rank of Lieutenant Commander.

David is AV peer-review rated by Martindale Hubbell

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Deborah M. Minkoff

Member
Philadelphia Office
(215) 665-2170
dminkoff@cozen.com

AREAS OF EXPERIENCE

- Advertising Injury
- Appellate
- Employee Practices Liability Coverage
- Excess & Surplus
- General Liability
- Insurance Coverage Claims/Litigation
- Long Tail/Toxic
- Professional Liability Coverage
- Reinsurance

EDUCATION

- J.D., Villanova University School of Law, 1984
- A.B., Franklin & Marshall College, 1981

MEMBERSHIPS

- American Bar Association, Tort and Insurance Practice Committee
- Defense Research Institute

PUBLICATIONS

- "Multiple Insureds: Can a Good Faith Settlement Terminate a Right to a Defense?" *For the Defense*, May 2000
- "Defense Cost Sharing Agreements: A Practical Approach," *For the Defense*, June 2001

Deborah S. Minkoff is a Member of the firm and is resident in the Philadelphia office. Deborah joined the firm in 1984. Since 1989, she has been a member of the Insurance Coverage Practice Group and handles complex coverage litigation, with an emphasis on liability coverage issues.

Deborah's representative cases include disputes under claims made liability coverages; disputes over the scope of professional liability coverage; excess v. primary insurance disputes; advertising injury and personal injury coverages; claims invoking CGL policies' business risk exclusions; employment-related claims under CGL policies, and sexual harassment claims under both professional liability coverage and commercial liability coverage.

Deborah has lectured on multiple insureds under liability policies, and can a good faith settlement terminate the duty to defend; the ensuing loss exception in first-party policies; bifurcation and trifurcation in bad faith litigation; employment-related claims under CGL policies, and effective legal writing.

Deborah is a member of the American Bar Association's Tort and Insurance Practice Committee, and the Defense Research Institute (DRI). In May 2000, she published an article in DRI's *For the Defense*, "Multiple Insureds: Can a Good Faith Settlement Terminate a Right to a Defense?" In the June 2001 edition of that periodical, Deborah published an article titled, "Defense Cost Sharing Agreements: A Practical Approach."

Deborah graduated from Franklin and Marshall College in 1981, with a major in psychology and a minor in Latin. She is a 1984 graduate of Villanova Law School, where she was a member of the *Law Review* and received the Pulling Award for outstanding student authorship.

Deborah returned to Villanova Law School as a full-time visiting professor for the Fall 2004 semester, teaching statutory interpretation, case synthesis and legal writing.

COZEN
O'CONNOR.

Christopher Raleigh

Member
New York Downtown Office
212-908-1245
craleigh@cozen.com

AREAS OF EXPERIENCE

- Insurance Coverage Claims/Litigation
- Maritime
- Subrogation & Recovery
- Trucking Litigation

EDUCATION

- J.D., Fordham University Law School, 1980
- B.A., St. Michael's College, *cum laude,* 1974

MEMBERSHIPS

- Association of the Bar of the City of New York, Committee on Admiralty
- New York county Lawyers; Association, Committee on Admiralty and Maritime Law
  Maritime Law Association of the United States
- New Jersey Bar Association

Chris Raleigh is a member of the New York Downtown office of Cozen O'Connor and has an active litigation practice in the states of New York and New Jersey. Chris is certified by the Supreme Court of New Jersey as a Civil Trial Attorney, and his practice emphasizes the litigation of suits arising from transportation and insurance disputes. He has litigated hundreds of cases involving maritime casualties and inland marine losses, as well as a broad range of insurance coverage issues involving the transportation industry. In view of the significant shift in shipping activities from New York City to Port Elizabeth, he continues to maintain an active transportation practice in New Jersey and presently handles a significant amount of subrogation, inland marine and coverage work for the marine departments of insurance companies located in New York and New Jersey.

Chris graduated, *cum laude,* from St. Michael's College in 1974 and received his law degree from Fordham University in 1980. He is admitted to the bars of New Jersey and New York, and is admitted to practice before U.S. District Courts for the District of New Jersey, the Southern and Eastern Districts of New York and the U.S. Court of Appeals for the Third Circuit. He is a member of the New Jersey State Bar Association, the Maritime Law Association of the United States and is co-chair of the Admiralty & Maritime Law Committee of the New York County Lawyers Association. He regularly presents seminars to marine claims departments which focus on transportation and insurance issues.

COZEN
O'CONNOR.

William P. Shelley

Member
Chair, National Insurance Department
Philadelphia Office
(215) 665-4142
wshelley@cozen.com

AREAS OF EXPERIENCE

- Asbestos
- Bad Faith
- Bankruptcy Litigation/Adversary Actions
- Class Action & Multidistrict Litigation
- Environmental Coverage
- Errors and Omissions
- Insurance Coverage Claims/Litigation
- Life Science & Medical Device Litigation
- Long Tail/Toxic Policyholder Bankruptcies
- Technology Licensing & Transfer
- Technology, Internet & E-Commerce
- Toxic & Other Mass Torts

EDUCATION

- J.D., Rutgers University School of Law, 1979
- B.A., Rutgers University, 1976

BAR ADMISSIONS

- Pennsylvania
- New Jersey
- New York

COURT ADMISSIONS

- United States Supreme Court
- New Jersey Supreme Court
- New York Supreme Court
- United States District Court for the District of New Jersey, the Eastern District of Pennsylvania, the Southern, Eastern, Northern and Western Districts of New York

William Patrick Shelley is Chairman of the firm's National Insurance Department and currently serves on the firm's Management Committee. He is responsible for the management of the 175 attorneys and paralegals in the department, as well as assuring quality services to the firm's insurance clients. His own practice primarily focuses on complex insurance coverage issues, including general and professional liability.

Currently, Bill serves as counsel for insurers in many major asbestos coverage cases as well as pending associated bankruptcy proceedings around the country. He also serves as national coordinating counsel for a major U.S. insurer on bad faith claims. Bill has been listed in *The Best Lawyers in America* for 2006 and 2007 and has been named a Pennsylvania "Super Lawyer" by *Law & Politics*.

Bill has authored two major articles on insurance coverage for toxic tort claims that are frequently cited by courts titled, "Toxic Torts and the Absolute Pollution Exclusion Revisited," *Tort Trial & Insurance Practice Law Journal*, Vol. 30, No. 1 (Fall 2003), "Application of the Absolute Pollution Exclusion to Toxic Tort Claims: Will Courts Choose Policy Construction or Deconstruction," *Tort & Insurance Law Journal*, Vol. 33 No. 3 Spring 1998. He is also the author of "Fundamentals of Insurance Coverage Allocation," *Mealey's Litigation Report: Insurance*, Vol. 14, #9, January 5, 2000. Most recently, Bill co-authored "Unraveling The Gordian Knot Of Asymptomatic Asbestos Claimants: Statutory, Precedential And Policy Reasons Why Unimpaired Asbestos Claimants Cannot Recover In Bankruptcy," 3-10 *Mealey's Asb. Bankr. Rep.*, 22 (2004). Bill appeared in the August 2003 edition of *Metropolitan Corporate Counsel* in the article titled "Cozen O'Connor: Using All The Tools To Meet Clients' Needs." Bill serves as editor of the *Insurance Coverage Law Bulletin.*

Bill's seminar presentations include: Mealey's Wall Street Forum: Asbestos Conference (February, 2005); Mealey's Bad Faith (September, 2005); American Conference Institute: E-Commerce Coverage Claims (June, 2001); American Conference Institute – Asbestos Litigation: Co-Chair (October, 2001); Mealey's Insurance Coverage 101: Co-Chair (November, 2001); Mealey's Insurance

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- United States Court of Appeals for the 3rd, 11th and District of Columbia Circuits

MEMBERSHIPS

- American Bar Association
- New Jersey State Bar Association
- Burlington County Bar Association
- Defense Research Institute

Coverage Advanced Allocation Seminar (February, 1998).

Bill is scheduled to chair Mealey's Bad Faith Seminar in September 2007.

Bill earned his undergraduate degree from Rutgers - New Brunswick (B.A., with highest honors, 1976) and his law degree from Rutgers University School of Law - Camden (J.D., 1979). He is admitted to practice in New Jersey, Pennsylvania, New York and before all of the federal district courts in each of those states, together with the United States Supreme Court and the Second, Third and D.C. Circuit Courts of Appeal.

Recent Victory: In 2006 Bill secured a $10 mil. recovery on behalf of an insurer against that insurer's E&O insurer.

COZEN
O'CONNOR.

William F. Stewart

Member
West Conshohocken Office
(610) 832-8356
wstewart@cozen.com

AREAS OF EXPERIENCE

- Advertising Injury
- Arson & Fraud
- Asbestos
- Bad Faith
- Environmental Coverage
- Excess & Surplus Insurance Coverage Claims/Litigation
- Long Tail/Toxic Policyholder Bankruptcies
- Professional Liability Coverage
- Property Insurance
- Subrogation & Recovery
- Toxic & Other Mass Torts

EDUCATION

- J.D. Notre Dame Law School, 1990
- B.A. St. Joseph's University, 1987

BAR ADMISSIONS

- New Jersey
- Pennsylvania

MEMBERSHIPS

- Pennsylvania Bar Association
- Philadelphia Bar Association
- Camden County Bar Association
- Lecturer, Insurance Society of Philadelphia
- Contributing Author, Mealey's Bad Faith Reporter
- Fellowship of Life Management Institute
- Arbitrator, United States District Court for the Eastern District of Pennsylvania
- Arbitrator, Philadelphia Court of Common Pleas
- Supreme Court of Pennsylvania Civil Procedural Rules Committee

William F. Stewart joined Cozen O' Connor in May 1990 and practices in the Insurance Department of the West Conshohocken office. He concentrates his practice in insurance coverage, fraud defense, bad faith defense, environmental, toxic tort, and mold coverage defense. Bill has become one of the nation's foremost litigators in the fields of insurance coverage mold related litigation.

Bill is a member of the Pennsylvania State and Philadelphia, Montgomery and Camden County bar associations. He is a frequent lecturer and contributor to Business Insurance, Best's Insurance, Mealey's Bad Faith Reporter and Mealey's Mold Litigation Reporter. Bill is an arbitrator for the U.S. District Court for the Eastern District of Pennsylvania and for the Philadelphia Court of Common Pleas and the Montgomery Court of Common Pleas.

In 2005, Bill was selected by the Pennsylvania Supreme Court to serve on the State Rules Committee. Bill serves frequently as a volunteer attorney for the Montgomery County Children's Advocate Project.

Bill earned his bachelor of arts degree at St. Joseph's University in 1987 and his law degree at the University of Notre Dame in 1990, where he graduated *cum laude*. He was admitted to practice in Pennsylvania and New Jersey in 1990, and has practiced *pro hac vice* in more than 10 U.S. states and territories. In 2002 he was elected committeeman in Lower Providence Township Pennsylvania.

II

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PRACTICAL ISSUES IN ENFORCEMENT OF CLAIMS-MADE POLICIES: TIMING IS EVERYTHING

written and presented by:
Deborah Minkoff, Esquire

COZEN O'CONNOR
1900 Market Street
Philadelphia, PA 19103
215-665-2000 or 800-523-2900
www.cozen.com

Atlanta
Charlotte
Cherry Hill
Chicago
Dallas
Denver
Houston
London
Los Angeles
Miami
New York Downtown
New York Midtown
Newark
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San Diego
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Santa Fe
Seattle
Toronto
Trenton
Washington, DC
West Conshohocken
Wilmington

Practical Issues In Enforcement of Claims-Made Policies: Timing is Everything

Deborah M. Minkoff
Cozen O'Connor
1900 Market Street
Philadelphia, PA 19103
215.665.2170
dminkoff@cozen.com

Laurie R. Kleinman
Cozen O'Connor
1900 Market Street
Philadelphia, PA 19103
215.665.4607
lkleinman@cozen.com

More insurance coverage is being written on a claims-made basis than ever before. Several important distinctions exist among traditional "occurrence" coverage, "claims-made" coverage, and "claims-made and reported" coverage. Courts enforce the time parameters that characterize both "claims-made" and "clams-made and reported" policies. In order to enforce the policy language, insurers and the lawyers who represent them must understand differences between the policies.

I. OVERVIEW OF CLAIMS-MADE COVERAGE

A. Key Differences Between Claims-Made and Occurrence Based Coverage

"Claims-made" coverage differs from "occurrence" coverage in three significant ways:

1. The claim, not the injury, is the threshold event. For a claims-made policy, the threshold event is a claim against the insured during the policy period. In contrast, occurrence-based coverage looks to whether injury or damage occurred during the policy period.

2. Reporting is as element of coverage. In a claims-made policy, the reporting of the claim during the specified time period is typically an element of coverage; in occurrence policies, notice is a condition.

3. No prejudice is necessary. Because reporting is element of coverage, late notice generally precludes coverage as a matter of law, without proof of prejudice.

B. Key Differences Between Claims-Made and Claims-Made and Reported Coverage

There are two distinct types of claims-made forms. One is the "claims-made and reported" form, and the other is a pure "claims-made" form.

1. **Claims-Made Policies** require that the ***claim first be made during the policy period***. The report can be made after the policy period, but it generally must be reported to the insurer in compliance with a standard such as "immediately" or "as soon as practicable" after the claim is made. What those standards mean is a matter of state law, and may vary with each jurisdiction.

2. **Claims-Made and Reported Policies** require that a ***claim first be made during the policy period***, and also ***reported to the insurer during the policy period or designated time period***. While some policies require the payment of an additional premium to extend the discovery and/or reporting period, the courts enforce the reporting deadlines established in the policies. Unlike the claims-made policy, this form defines the acceptable timing parameters of a

report rather than leaving it to an insured to guess or a court case to determine.

3. Most courts follow the distinctions established by the policy language and do not require a showing of prejudice to deny a claim based on late reporting under a claims-made and reported policy. Some courts, however, distinguish between claims-made and claims-made and reported policies, applying a prejudice requirement to late reporting under the former, but not the latter. Other jurisdictions go so far as not requiring a showing of prejudice under a policy that is only "claims-made."

   a) **Examples of Cases Holding That No Prejudice Is Required To Be Shown To Deny a Claim Under Claims-Made and Claims-Made and Reported Policies**: Heydar v. Westport Ins. Corp., 158 Fed. Appx. 774, 776 (9th Cir. 2005); Federal Insurance Company v. CompUSA, 319 F.3d 746 (5th Cir. 2003); Andy Warhol Found. for the Visual Arts, Inc. v. Fed. Ins. Co., 189 F.3d 208, 215 (2d Cir. 1999); East Texas Medical Center Regional Healthcare System v. Lexington Ins. Co., 2007 U.S. Dist. LEXIS 50613 (E.D. Tex. 2007); Salt Lake Toyota Dealers Ass'n v. St. Paul Mercury Ins. Co., 2006 WL 1547996 (D. Utah 2006).

   b) **Examples of Cases Holding that Actual Prejudice Must Be Shown Before Coverage May Be Denied Under a Claims-Made Policy**: Westport Insurance Corp. v. Albert, 208 Fed. Appx. 222 (4th Cir. 2006); Oakland-Alameda County Coliseum, Inc. v. Nat'l Union Fire Ins. Co., 480 F. Supp. 2d 1182, 1197 (N.D. Cal. 2007); Wendy's Int'l, Inc. v. Ill. Union Ins. Co., 2007 U.S. Dist. LEXIS 15699 (S.D. Ohio 2007); Maynard v. Westport Insurance Corp., 208 F. Supp.2d 568 (D. Md. 2002).

C. Types of Coverage Often Written on Claims-Made Basis

1. Directors And Officers Liability Coverage
2. Medical Liability Coverage
3. Legal Liability Coverage
4. Employment Practices Liability Coverage
5. Brokers Errors And Omissions Coverage
6. Media Liability Coverage
7. Technology Errors And Omissions Coverage
8. Other Types Of Professional Liability Coverage
9. Certain Types Of Product Liability Coverage

D. The Benefits of Claims-Made Coverage (To Insurer and Insured)

1. The timing requirements of claims-made policies eliminate exposure for "long tail" claims, thereby allowing for better pricing. Claims based on a historical injury with recent manifestation are expensive and unpredictable. The leading example of this type of claim is asbestos injury claims where exposure may have occurred in the 1950's or 1960's. Under must jurisdictions' current law, these types of injuries trigger multiple policy periods, often multiplying the exposure faced by insurers. Because claims-made policies generally do not trigger multiple policy periods, insurers can evaluate their exposures relatively close in time to the claim, and do not have to price for "surprise" causes of action.

   - "The insurer is afforded greater certainty in computing premiums, since it does not need to be concerned with the risk of claims filed long after the policy period has ended, and as a result the insured may benefit from lower premiums." Checkrite Limited, Inc. v. Illinois National Ins. Co., 95 F. Supp. 2d 180, 192 (S.D.N.Y. 2000).

   - "An underwriter who is secure in the fact that claims will not arise under the subject policy... after its termination or expiration can underwrite a risk and compute premiums with greater certainty. The insurer can establish his reserves without having to consider the possibilities of inflation beyond the policy period, upward-spiralling jury awards, or later changes in the definition and application of negligence. . . . This theoretically results in lower premiums for an insured since there is no open-ended 'tail' after the expiration date of the policy." Gulf Ins. Co. v. Dolan, Fertig & Curtis, 433 So. 2d 512, 516 (Fla. 1983).

   - "Claims made" policies beneficially permit insurers more accurately to predict the limits of their exposure and the premium needed to accommodate the risk undertaken, resulting in lower premiums to insureds than are charged for an occurrence-based policy. Montrose Chem. Corp. v. Admiral Ins. Co., 913 P.2d 878, 904 (Cal. 1995).

2. Under professional liability, products liability and certain other types of coverage, it can be difficult to determine exactly when the "occurrence" took place for purposes of determining coverage. Claims-made policies remove the uncertainty by focusing on either the timing or the reporting, which are easily ascertainable.

- Claims-made policies provide coverage against claims made and reported during the policy period, regardless of when the events giving rise to the claims took place. Ballow v. Phico Ins. Co., 875 P.2d 1354, 1357 (Colo. 1993). In contrast, an occurrence policy is one in which coverage is provided for events that occur during the policy period, even though a claim may not be made or reported until some time after the policy period has expired. Id.

3. Claims-made policies eliminate most litigation over prejudice caused by late notice. A frequent source of litigation between policyholders and insurers is whether the policyholder timely reported a claim and, in most states, whether the insurer was prejudiced by the late notice. These suits frequently require jury trials because prejudice is usually an issue of fact for which summary judgment is inappropriate. In contrast, the time a claim was made or reported is easier to determine. While the issues may require litigation, the matters almost invariably resolve on summary judgment or on motions to dismiss. Therefore, not only is there less litigation, the litigation is more defined and, therefore, less costly to both insurer and insured.

II. WHAT IS A CLAIM?

A. Claims-Made Policies Do Not Always Define "Claim"

1. The majority of courts find that lack of a definition of "claim" does *not* render the policy ambiguous. See e.g., Oakland-Alameda County Coliseum, Inc. v. Nat'l Union Fire Ins. Co., 480 F. Supp. 2d 1182, 1194 (N.D. Cal. 2007); Safeco Title Ins. Co. v. Gannon, 774 P.2d 30 (Wash. 1989); Evanston Ins. Co. v. Security Assurance Co., 715 F. Supp. 1405 (N.D. Ill. 1989).

2. Very few courts have ruled that a policy that did not define "claim" was ambiguous. But see Andy Warhol Foundation for Visual Arts, Inc. v. Federal Ins. Co., 189 F.3d 208 (2d Cir. 1999) (claims-made policy containing no definition of "claim" ruled ambiguous for purpose of deciding when copyright infringement claim were first asserted; insured asserted "claim" made when suit was brought, and insurer argued that pre-action letter from counsel constituted "claim"); Walker v. Larson & St. Paul Fire & Marine Ins. Co., 727 P.2d 321 (Mont. 1986).

B. Courts Have Interpreted The Word "Claim" Consistently, Giving The Word Its Ordinary Meaning

1. A demand on the insured for damages resulting from the insured's alleged negligent act or omission. Gannon, supra.

2. A demand for something as of right. National Cas. Co. v. Great Southwest Ins., 833 P.2d 741 (Colo. 1992).

3. Assertion of legally cognizable damage that must be a type of demand that can be defended, settled and paid by the insurer. Evanston Ins. Co. v. GAB Business Services, 132 A.D.2d 180, 521 N.Y.S.2d 692 (1987).

4. An effort by a third party to recover money from the insured. CIPS v. American Empire Surplus Lines, 642 N.E.2d 723 (Ill. App. 1994).

5. Applying the definition in the California Insurance Code, claim means an "assertion, demand or challenge of something as a right; the assertion of a liability to the party making it to do some service or pay a sum of money." Oakland-Alameda County Coliseum, Inc. v. Nat'l Union Fire Ins. Co., 480 F. Supp. 2d 1182, 1194 (N.D. Cal. 2007).

C. In Few Cases, Courts Apply a More Restrictive Interpretation

In relatively few situations, courts apply a more restrictive interpretation of "claim," requiring a demand be made *in court*. See, e.g., Hyde v. Fidelity and Deposit Co. of Md., 23 F. Supp. 2d 630 (D. Md. 1998).

III. ENFORCEMENT OF THE REPORTING REQUIREMENT

A. Virtually All Jurisdictions Enforce Reporting Requirements

- Even when resulting in harsh consequences, "claims-made" policies, and their reporting provisions, are enforceable. Pizzini v. Am. Int'l Specialty Lines Ins. Co., 210 F. Supp. 2d 658, 668 (E.D. Pa. 2002).

- "The notice provision of a 'claims made' policy is not simply the part of the insured's duty to cooperate, it defines the limits of the insurer's obligation. . . . If the insured does not give notice within the contractually required time period, there is simply no coverage under the policy." Pantropic Power Prods. v. Fireman's Fund Ins. Co., 141 F. Supp. 2d 1366, 1370 (D. Fla. 2001)

- "The notice provision of a claims made policy is just as important to coverage as the requirement that the claim be asserted during the

policy period. If the insured does not give notice during the contractually required time period . . . there is simply no coverage under the policy." Burns v. International Ins. Co., 709 F. Supp. 187, 190 (D. Cal. 1989).

B. In Isolated Cases, Unique Facts May Require an Equitable Result

- In Root v. American Equity Specialty Ins. Co., 130 Cal. App. 4th 926, 30 Cal. Rptr. 3d 631 (June 28, 2005), the court excused the reporting requirement in a claims-made and reported policy on equitable considerations. The Root court reached this conclusion in the face of a claim made against the insured in the last days of the policy period. The insured reported the claim virtually immediately, yet after the last day of the policy period. Because the policy did not provide for an automatic or extended reporting period, coverage would have been unavailable without the court's exercise of its equitable powers. More dangerously, however, the Root court interpreted the reporting requirement as a condition, not an element of coverage, despite the fact that the requirement was contained in both the insuring agreement and the conditions section of the policy. Id. at 943-944.

IV. RECURRING LITIGATION ISSUES

A. Definition of "Claim" Issues

Litigation over the definition of "claim" have resulted in a few common rules:

1. While a demand for money is certainly a claim, the demand for relief does not have to be in the form of a lawsuit. Dalton, Brown & Long Inc. v. Executive Risk Indem., Inc., 73 Fed. Appx. 229 (9th Cir. 2003) (letter from insured's attorney to real estate agent alleging breach of fiduciary duty and demanding compensation was "claim" under California law).

2. To constitute a "claim," a demand upon the insured need not be for a specific dollar amount and, in appropriate cases, does not have to include a demand for money if specific performance is involved (i.e., some form of corrective action is demanded). Home Ins. Co. v. Spectrum Info. Techs., 930 F. Supp. 825 (E.D.N.Y. 1996) (stating that a claim is a demand for money damages or "other relief owed").

3. The circumstance that the insurer is aware of an alleged *injury* is generally not enough to constitute a claim, Richardson Electronics, Ltd. v. Federal Ins. Co., 120 F. Supp. 2d 698 (N.D. Ill. 2000) (under Illinois law, mere fact that insured reasonably concludes that claim

is inevitable is insufficient to trigger coverage under claims-made policy); Insurance Corp. of Am. v. Dillon, Hardamon & Cohen, 725 F. Supp. 1461 (N.D. Ind. 1988) ("Awareness is not a demand and the use of the word claim, unless modified by other language, requires that a demand be made").

4. A mere assertion by a third party that a wrongful act has occurred is not a "claim." California Union Ins. Co. v. American Diversified Sav. Bank, 914 F.2d 1271 (9th Cir. 1990) (assertion that wrong took place is "not the same thing as a claim for payment"); In re Ambassador Group, Inc. Litig., 830 F. Supp. 147 (E.D.N.Y. 1993) ("It is clear that a claim is something more than the threat of a lawsuit"; in addition, the insured's expectation of a lawsuit based upon his knowledge of an occurrence does not constitute a claim).

5. A demand for regulatory compliance generally does not constitute a "claim." See FDIC v. Mijalis, 15 F.3d 1314 (5th Cir. 1994) (cease and desist letter from FDIC to bank's directors and officers regarding unsafe lending practices did not constitute a claim).

6. A mere "request for information" generally does not constitute a claim. In the widely discussed case of Hoyt v. St. Paul Fire & Marine Ins. Co., 607 F.2d 864 (9th Cir. 1979), an attorney insured under a claims-made professional liability policy could not allege a "claim" for purposes of insurance coverage where the injured third party simply wrote to the insured attorney requesting information as to why he had drafted a will provision with adverse tax consequences. The court stated: "In our judgment...the letter did not constitute a claim. It was a request for information and explanation...In our view, an inquiry cannot be transformed into a claim or demand depending in each case on the reasonable expectations of the insured ..."

7. Where "claim" was defined as the commencement of a civil proceeding, courts have held that an amended complaint adding new theories of recovery does not constitute a new "claim." The claim should have been reported when the original complaint was commenced. National Union v. Willis, 296 F.3d 336 (5th Cir. 2002). See also, Community Foundation for Jewish Educ. v. Federal Ins. Co., 16 Fed. Appx. 462 (7th Cir. 2001).

B. Proper Reporting of Claims Issues (The "Who" Issue)

1. Timely Report Must Be Received by *Insurer*

In order for a report of a claim to satisfy a particular policy, the insured must report the claim within the designated period to the

insurer that issued the policy. Reporting the claim to the broker does not suffice. See e.g., Southern New Jersey Rail Group, LLC v. Lumbermens Mut. Cas. Co., 2007 U.S. Dist. LEXIS 58510 (S.D.N.Y. 2007) (Mag. opinion), adopted by 2007 U.S. Dist. LEXIS 67889 (S.D.N.Y. 2007) (court held that notice to the insurer was untimely under a claims-made and reported policy, despite insured's timely report of the claim to its broker).

2. Excess Claims-Made Policies Require *Separate* Reporting

Under virtually all occurrence-based policies, an insured's duty to provide notice to an excess carrier arises when the insured has reason to believe that the occurrence is likely to involve the excess layer. Whether an insured could reasonably conclude that an occurrence is likely to reach an excess policy is judged by an objective standard, generally presenting a question of fact.

These considerations do not apply to an excess policy that is claims-made and reported, unless otherwise written into the policy.

a) Because reporting a claim is an element of coverage, an insured seeking coverage under an excess policy must provide separate reporting to an excess carrier that issued a claims-made and reported policy. Old Republic Ins. Co. v. Ness, Motley, Loadholt, Richardson & Poole, P.A., 2006 U.S. Dist. LEXIS 900 (N.D. Ill. Jan. 11, 2006) (examining excess carrier's defense to coverage based on failure to report claim under excess claims-made policy).

b) Even if following form, reporting to the primary alone does not suffice. Lexington Ins. Co. v. Western Pa. Hosp., 423 F.3d 318 (3d Cir. 2005) (where excess policy follows form to underlying claims-made and reported primary policy, insured's failure to report claim to excess carrier within policy period defeats coverage under the excess policy).

C. Sequential Policies Do Not Create Seamless Coverage

1. No Seamless Claims-Made Coverage

Numerous courts have ruled that successive claims-made and reported policies do not create "seamless" coverage. These courts recognize that each policy stands on its own and lasts for a finite period of time, providing coverage only for those claims that are made against the insured and reported to the insurance carrier during the designated time period. The reporting provisions define the scope of coverage and are strictly construed.

See, e.g., Westport Ins. Co. v. Mirsky, 2002 U.S. Dist. LEXIS 16967, *31 (E.D. Pa. 2002) ("renewal of claims-made policies does not create a single policy for purposes of reporting"). See also, Quinones v. Jimenez & Ruiz, S.E., 261 F. Supp. 2d 87, 91 (D.P.R. 2003) (court rejected insured's argument that seamless coverage was created under a series of successive one-year "claims-made" policies issued by the same insurance company, and held that where a policy clearly stated that it terminated at the end of the policy period, a new contract with a new effective date was created each time the policy was renewed); Checkrite Limited, Inc. v. Illinois National Ins. Co., 95 F. Supp. 2d 180, 193 (S.D.N.Y. 2000) ("[N]o where in the contract does it say that renewal creates a continuing period of coverage during which the insured may report claims without regard to the policy period in which they were first made.")

For a contrary result, see Cast Steel Products, Inc. v. Admiral Ins. Co., 348 F.3d 1298 (11th Cir. 2003), in which the court refused to recognize the time parameters of each policy and, instead, interpreted the two policies as a single multi-year policy.

2. No Continuous Trigger Under Claims-Made Coverage

Because the claim is made at one identifiable point in time and, if required, reported at one identifiable point in time, a single claim cannot trigger more than one claims-made policy.

D. The Notice Condition Does Not Create Ambiguity With the Reporting Requirement

Courts consistently recognize the difference between notice provisions and reporting requirements, and hold that their incorporation into a policy does not render either provision ambiguous. See, e.g., Pension Trust Fund for Operating Engineers v. Federal Ins. Co., 307 F.3d 944 (9th Cir. 2002) (recognizing difference between reporting requirement and notice condition, and applying notice-prejudice rule to claims-made policy only because it was *not* subject to a reporting requirement); Slater v. Lawyers' Mutual Ins. Co., 227 Cal. App. 3d 1415 (Cal. App. 1991) ("we conclude that the reporting and notice provisions are not ambiguous and do not render the coverage language ambiguous.")

- In United States of American v. A.C. Strip, et al., 868 F.2d 181, 186-87 (6th Cir. 1989), the Sixth Circuit held:

  > The "as soon as practicable" language is intended to preclude an insured who has knowledge of a claim near the beginning of the policy period, from waiting many months until near the end of the policy period to

notify the insurer of the existence of the claim, when such delay would cause prejudice to the insurer. It does not excuse, modify, or render ambiguous the claim reporting requirement that is recited in paragraph I as a condition of coverage.

- In Liberty Mutual Ins. Co. v. The Black & Decker Corp., 2004 U.S. Dist. LEXIS (D. Mass. 2004), the insured argued that the reporting requirement was not a substantive limit on coverage, by virtue of the notice condition. The court rejected the insured's argument, holding:

> [N]otice provisions differ fundamentally from reporting requirements. Notice provisions, which are typically found in occurrence and claims-made policies, usually require that notice be "reasonable" or "as soon as practicable" and serves simply to help the insurer to investigate the claim while events are reliably fresh... . Reporting provisions, which are only found in claims-made-and-reported policies, require reporting within a fixed period of time, because they actually trigger the scope of coverage; the coverage-triggering event is not the occurrence or the claim, but the reporting of the claim.

V. THE RETROACTIVE DATE AND EXTENDED REPORTING PERIOD

Policies contemplate that there are certain events that lock in the available coverage. The retroactive date, automatic reporting period and extended reporting period, and awareness provision, along with the policy period, establish the policy's time parameters.

A. Automatic and Extended Reporting Periods

Some policies allow a claim to be reported within an "automatic" period of time after policy expiration, usually 30 or 60 days. Particularly if the policy is claims-made and reported, this additional period of time eliminates the concern raised by claims that are made near the end of a policy period. See Root, supra. Typically, however, this additional time is only for *reporting* claims-made within the policy period. It does not extend coverage to claims first made within the additional 30 or 60 days.

In contrast, an "Extended Reporting Period" may allow coverage for claims made after policy expiration, as well as reporting of claims. An insured changing insurers is the typical candidate for an "Extended Reporting Period," typically referred to as an "ERP." Depending on the policy language, an ERP may allow the insured to extend coverage for claims reporting during a fairly long period of time, even years. The additional

time is set forth in the policy or ERP endorsement, as is the premium charge for purchasing the coverage.

B. Retroactive Dates

Another problem that can arise when an insured is switching carriers relates to the retroactive date. Most claims-made policies provide for a "retroactive date" which provides that any occurrence which takes place before the retroactive date is not covered by the claims-made policy even if the claim is made during the policy period.

Policyholders have argued that claims-made policies which do not provide retroactive coverage are unenforceable as violative of public policy. The New Jersey Supreme Court so held in Sparks v. St. Paul Insurance Co., 100 N.J. 325, 495 A.2d 406 (1985). In Sparks, the court was faced with a legal malpractice policy where the retroactive date was the inception date of the first in a series of four policies. Relying on the reasonable expectations doctrine, the court held that because of the absence of retroactive coverage, the St. Paul policy at issue combined "the worst features of 'occurrence' and 'claims-made' policies and the best of neither. It provides neither the prospective coverage typical of an 'occurrence' policy, nor the 'retroactive' coverage typical of 'claims-made' coverage." On this reasoning, the court refused to enforce the time parameters of the claims-made coverage.

Sparks does not represent the majority rule and, even in New Jersey, is limited to its specific facts. See, e.g., President v. Jenkins, 357 N.J. Super. 28, 814 A.2d 1173 (2003) (a policy providing no retroactive coverage enforced according to its terms where insured failed to renew his existing occurrence policy, did not make sure the new claims-made policy incepted on the expiration of the existing occurrence policy, so that the resulting gap in coverage was due to his own negligence, not to any fault on the part of the carrier). See also, Yancey v. Floyd West & Company, 755 S.W. 2d 914 (Tex. App. 1988) (retroactive date provision of claim-made policy enforce in accordance with its terms; insurance contract did not violate public policy of Texas); General Insurance Company of America v. McManus, Inc., 272 Ill. App. 3d 510, 650 N.E. 2d 1080, 209 Ill. Dec. 107 (1995) (Sparks represents a minority view).

C. Awareness Provisions

Most claims-made and reported policies contain an "awareness provision" that allows the insured to report potential claims or events that the insured reasonably believes may give rise to a claim in the future. See, e.g., United States Liability Ins. Co. v. Johnson & Lindberg, P.A., 617 F. Supp. 968 (D. Minn. 1985). The "awareness clause" is a mechanism for "locking in" coverage for a claim that is actually made after the policy period ends,

where the insured reports facts and circumstances that might give rise to a claim, but no claim has yet been asserted. The awareness provision "is the notice that turns potential future claims . . . into actual claims made during the policy's term." Stewart Title Guar. Co. v. Kiefer, 1997 U.S. Dist. LEXIS 3562 (D. La. 1997).

III

COZEN
O'CONNOR®

BASICS OF D&O INSURANCE: WHAT EVERY CLAIMS REPRESENTATIVE AND CORPORATE EXECUTIVE NEEDS TO KNOW

written and presented by:
Richard Bortnick, Esquire

COZEN O'CONNOR
Four Falls Corporate Center
Suite 400
West Conshohocken, PA 19428
610-941-5400 or 800-379-0695
www.cozen.com

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The Basics of D&O Insurance: What Every Claims Representative and Corporate Executive Needs to Know

Richard J. Bortnick, Esquire
Cozen O'Connor
West Conshohocken, PA
(610) 832-8357
rbortnick@cozen.com

www.cozen.com

Introduction: The Market Today . . .

. . . Where did everybody go . . .

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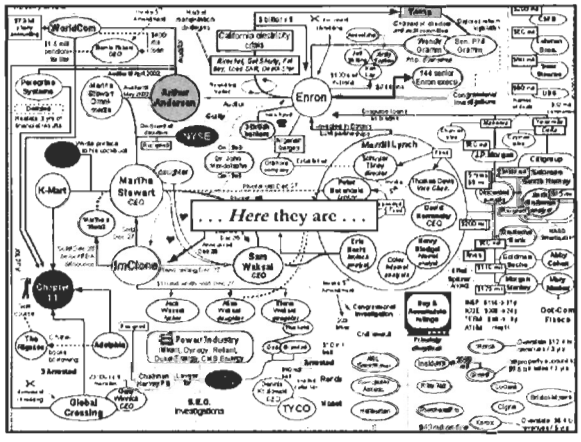

I. Background: D&O Insurance

Historical Significance and Insuring Agreements

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Background: D&O Insurance

D&O liability insurance was initially introduced in the 1930's in the United States as a response to the stock market crash.

- D&O insurance is a specialized form of professional liability coverage for directors or officers of a corporation or non-profit organization for legal expenses and liability to shareholders, bondholders, creditors or others due to a director or officer's Wrongful Act(s) or omissions.
- Companies may purchase D&O insurance to protect directors and officers if the company is financially unable to meet its indemnification obligations, if the director or officer does not meet the standard of conduct required for indemnification by the company, or if a company cannot indemnify directors and officers for certain types of judgments and settlements.
- D&O insurance covers directors and officers in respect of their performance and duties in the management of the company. E&O insurance covers the company and its employees with respect to performance, failure and negligence as regards the company's services and products provided to its clients.

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The D&O Relationship

Depending on the type of D&O policy and the circumstance, the coverage may run either through the company or directly to the directors and officers.

D&O Polices usually do not impose a "duty to defend" upon the Insurer

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D&O Liability Insurance

Coverage A	Coverage B	Entity Coverage
Coverage provided directly to D&Os who are not being indemnified by their company, because indemnification is not permitted or the company is bankrupt.	Coverage provided to the company to the extent that it pays settlements, judgments, damages and/or defense costs for its D&Os it is obligated to indemnify.	Coverage provided to the company for claims made directly against the company involving the company's securities. Not all policies include "entity" coverage.
Small or No Retention	Substantial Retention	Substantial Retention

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D&O Insuring Agreements

Coverage "A" Insuring Agreement

To pay on behalf of each and every person who was now or is or may hereafter be a Director or Officer all sums which the Insureds shall become legally obligated to pay because of Loss arising from any Claim or Claims which may be made during the Policy Period against the Insureds, jointly or severally, by reason of any Wrongful Act while acting in their capacities of Directors or Officers or by reason of their being Directors or Officers.

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D&O Insuring Agreements

Coverage "B" Insuring Agreement

This Policy shall also pay on behalf of the Company Loss arising from any Claim or Claims which are made during the Policy Period against any and every person, jointly or severally, who was or now is or may hereafter be a Director or Officers of the Company by reason of any Wrongful Act, while acting in their capacities of Directors or Officers of the Company, but only when the Directors or Officers shall be entitled to indemnification by the Company for Loss incurred in connection with the defense of any action, suit or proceeding or in connection with appeal therein to which the Directors or Officers may be parties or with which they may be threatened, pursuant to any state law, or the Charter of the Company, or the By-Laws of the Company, or any resolution of the Board of Directors of the Company or court order pursuant thereto which determines and defines such rights and indemnity.

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D&O Insuring Agreements

Coverage "C" Insuring Agreement

This Policy shall also pay on behalf of the Company Loss arising from any Open Market Securities Claim first made against the Company and reported to the Insurer during the Policy Period for any alleged Entity Wrongful Act of the Company provided that such Open Market Securities Claim is also first made against one or more Directors or Officers of the Company. Loss arising out of the first such same or related Wrongful Act shall be deemed to arise from the first such same or related Wrongful Act.

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D&O Policy Terms: Wrongful Act

"Wrongful Act" means any actual or alleged breach of duty, neglect error, misstatement, misleading statement, omission or act of any Insured, but only while acting in a covered capacity.

- The use of the word "only or "solely" in a definition of "Wrongful Act" may lead an Insurer to assert that there is no coverage where a director is sued in a dual capacity, for instance, where a director also serves as outside counsel.
- For purposes of "Claims-made" coverage, "Interrelated Wrongful Acts" usually give rise to a single "Claim," made at the time the first "Wrongful Act" is notified.
- The definition of "Wrongful Act" may have coverage implications for in-house counsel. Some policies provide that general counsel are covered only in their capacity as officers of the company, rather than as lawyers.

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D&O Policy Terms: Loss

There is no uniform definition of "Loss." One typical D&O policy defines it to mean:

. . . (T)he total amount which any Insured becomes legally obligated to pay on account of each Claim and for all Claims in each Policy Period and the Extended Reporting Period, if exercised, made against them for Wrongful Acts for which coverage applies, including, but not limited to, damages, judgments, settlements, costs and Defense Costs. Loss does not include (i) any amount not indemnified by the Insured Organization for which the Insured Person is absolved from payment by reason of any covenant, agreement or court order, (ii) any amount incurred by the Insured Organization (including its board of directors or any committee of the board of directors) in connection with the investigation or evaluation of any Claim or potential Claim by or on behalf of the Insured Organization, (iii) fines, penalties imposed by law or the multiple portion of any multiplied damage award, or (iv) matters uninsurable under the law pursuant to which this coverage section is construed.

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Are Damages Loss?

Sections 11 and 12 of the Securities Act of 1933 impose liability for false or misleading statements contained in securities offering materials equally upon the securities issuer, its directors and officers, its auditors, bank underwriters, and other parties that assisted in the preparation or dissemination of the offering documents in a given securities offering.

Recently, some courts and commentators have concluded that traditional insurance law notions preclude coverage for damages under Sections 11 and 12 because the rescissionary character of those damages rendered them uninsurable.

In Level 3 Comm., Inc. v. Federal Ins. Co., 272 F.3d 908 (7th Cir. 2001) and Conseco, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, P.A., 2002 WL 31961447 (Ind. Cir. Ct. 2002), the courts held that payments made by defendant securities issuers to resolve securities claims did not constitute insurable "Loss" because those payments represented the return of ill-gotten gains by the defendants.

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Are Damages Loss?

Courts have widely applied the principle that damages are not "Loss" where they represent the return of "ill-gotten" gains.

- Damages are not "Loss" when they represent the return of ill-gotten gains. See Reliance Grp. Holdings., Inc. v. Nat'l Union Fire Ins. Co., 594 N.Y.S.2d 20 (App. Div. 1993).
- In Safeway Stores, Inc. v. National Union Fire Ins. Co., 64 F.3d 1282 (9th Cir. 1995), the Ninth Circuit Court of Appeals agreed that Safeway's early pay-out of an $11.5 million dividend in connection with a leveraged buyout did not constitute "Loss" under the Company's D&O policy, ruling that the Company's fulfillment of its regular obligation to pay dividends in due course was not "Loss."

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Are Damages Loss?

- In Vigilant Ins. Co. v. Credit Suisse First Boston Corp., No. 600854/02 (N.Y. Supreme Ct., New York County, July 17, 2003), *aff'd* by 782 N.Y.S.2d 19 (N.Y. App. Div. 2004), the Court held that the Insured's D&O liability carriers were not obligated to cover the insured for $70 million in "disgorgement" that the Insured agreed to pay as part of a settlement with the SEC.
- In Liss v. Federal Ins. Co., et al., Docket No. MRS-L-1845-01 (N.J. Super., June 29, 2004), the New Jersey Superior Court held that a D&O insurer's defense that the insureds' payment of restitutionary damages to underlying claimants "is a salutary defense to insurance coverage pursuant to New Jersey public policy as well as prevailing insurance law." The Liss Court also held that the claim at issue, "being restitutionary in nature," also was barred from coverage because it was not within the ambit of the relevant policy's definition of "Loss," which specifically did not include "matters uninsurable under the law pursuant to which this coverage section is construed."

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Are Damages Loss?

In Level 3, the Court declined to find that a "restitutionary" settlement payment constituted "Loss" under a D&O liability policy. Instead, the Court held that an $11.8 million securities fraud settlement represented the policyholders' repayment of an "ill-gotten gain," it had obtained, or uninsurable loss. In the resulting coverage litigation, Level 3's D&O Insurer argued that the settlement payment was not "Loss" because Level 3, in essence, had stolen cash from plaintiffs and its policy did not insure a thief against the cost of disgorging stolen proceeds. The Court agreed with the Insurer's position:

> ***An insured incurs no loss within the meaning of the insurance contract by being compelled to return the property that it had stolen, even if a more polite word than "stolen" is used to characterize the claim for the property's return.***

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Are Damages Loss?

- In Conseco, an Indiana trial court likewise held that a settlement payment made in respect of an alleged violation of Section 11 does not constitute "Loss" under a D&O policy. Specifically, the Conseco Court found the Section 11 portion of a settlement [that also involved separately settled causes of action under Section 10(b) of the Securities Exchange Act of 1934] represented "restitutionary damages"corresponding to consideration the Company wrongfully took from the investing public. The Court based its holding on the principle enunciated in Level 3 that "insurance cannot be used to pay an insured for amounts an insured wrongfully acquires and is forced to return, or to pay the corporate obligations of an insured."
- In Enterasys Networks Inc., v. Gulf Ins. Co., 364 F. Supp. 2d 28 (D.N.H. Mar. 29, 2005) a New Hampshire federal court held that a company's issuance of $33 million in new stock and treasury stock in partial satisfaction of securities of a securities fraud class action settlement did not constitute "Loss" under the corporation's D&O policies. The court reasoned that coverage was not appropriate because newly issued shares and treasury shares are not corporate assets and Enterasys did not suffer a reduction of assets by virtue of giving the shares to plaintiffs. Additionally, as corporations can create stock with little or no cost, corporate insureds would receive a windfall if they were able to seek reimbursement from insurers for stock settlements.

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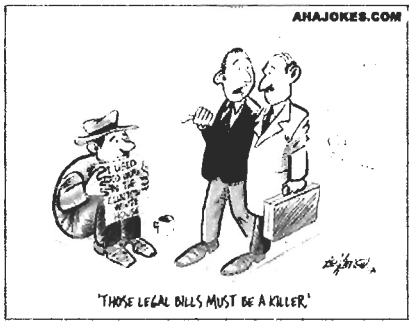
D&O Defense Costs



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D&O Defense Costs

- In the D&O context, an Insurer may be obligated to pay Defense Costs and Expenses on an "as incurred" basis.
- In virtually all cases, the Insurer will initially issue a reservation of rights to the Insured with respect to its coverage determination pending the outcome of the litigation. Where advancement of Defense Costs and Expenses is required, such advancement is often made subject to a full and continuing reservation of rights and perhaps an "Interim Funding Agreement."
- A frequent issue that arises in this situation is whether the Insurer remains obligated to advance defense costs where the Insurer has raised significant coverage issues or is seeking to rescind the policy based on material misrepresentations. Although courts are divided on this issue, a number of recent decisions have held that an Insurer must continue to advance Defense Costs until the coverage issues are resolved. Some of these cases are discussed herein.
- The requirement that an Insurer pay defense costs may attach at "dollar one" or after the Insured has satisfied a Deductible or Self-Insured Retention.
- Whether or not the Insurer is advancing payment of Defense Costs, the Insurer is entitled to "associate" in the defense of the case.

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D&O Defense Costs

- Most D&O policies include payment of "Defense Costs" as part of covered "Loss." An increasingly popular product, which insurers started offering several years ago, is an FI / D&O Policy that provides for interim advancement of such "Defense Costs," subject to certain conditions and limitations.
- Severability clauses are important in ascertaining advancement rights. Usually in the case of outside directors or innocent officers or employees, the clause will work to keep interim advancement of defense funding in place. Depending on the severability language, the insurer could still seek rescission against those Ds or Os who perpetrated a fraud, but the duty to advance defense costs usually remains in place until the reseission and coverage issues are decided—oftentimes long after the director or officer has incurred substantial defense fees in the underlying litigation.

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D&O Defense Costs

- Where an insurer is advancing a rescission action against fraudster Ds or Os, the insurer is usually required to advance defense costs to the bad-actors until its case is proven. See Associated Elec. & Gas Ins. Services, Ltd. v. Rigas, 2004 WL 540451 (E.D.Pa. 2004) (ordering advancement of $300,000 in defense costs to former Adelphia directors); Fed. Ins. Co. v. Tyco Int'l, Ltd., 784 N.Y.S 2d 920 (Sup. Ct., N.Y. County 2004), *affirmed by* Federal Ins. Co. v. Kozlowski, 792 N.Y.S 2d 397, 2005 N.Y. Slip Op. 02320 (N.Y.A.D. 1 Dept. Mar 22, 2005); and In re: WorldCom Sec. Lit., 354 F.Supp.2d 455 (S.D.N.Y. 2005).
- The Adelphia-Tyco-WorldCom line of cases suggests that the insurer has an obligation under the policy to respond to advancement requests and the contract is not rescinded or consider void *ab initio*, until the coverage litigation is resolved.
- In Tyco, the court held that the insurer must advance defense costs even though it is proceeding to rescind the D&O policy as to the party requesting the advancement. The court in WorldCom used a slightly different procedural analysis (one involving a preliminary injunction request), but came to the same result in ordering the insurer to advance defense costs. The insurer appealed, but before the appeal could be heard, the parties settled the issue privately.

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D&O Defense Costs

- In Adelphia, certain Ds and Os requested that that the bankruptcy court in New York lift the automatic bankruptcy stay to allow them to litigate advancement of their defense costs. The court denied the request, but the district court reversed. On remand, the bankruptcy court ordered the issue to proceed to litigation.
- During litigation of the issue in federal court in Pennsylvania, each D and O was awarded up to $300,000 in payment of defense costs under the D&O insurance policy. The court based its decision on the fact that the carriers' claims of rescission and fraud required further proceedings to establish the non-existence of coverage.

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D&O Allocation:

Covered and Not-Covered Claims/Parties

- In the D&O context, allocation issues often arise when a Claim is asserted against covered and non-covered parties. For example, allocation may arise where the corporation is named as a defendant in a suit where directors and officers are also sued and "entity coverage" is not implicated.
- D&O allocation issues also arise as to indemnity sought and Defense Costs incurred in connection with covered and non-covered claims. Most courts will recognize an indemnity allocation between covered and non-covered claims. However, courts often refuse to uphold a Defense Costs allocation where the Defense Costs were incurred for the benefit of both covered and non-covered portions of a Claim.
- Sometimes the policy will provide a pre-determined allocation formula or, in many cases, provide that the parties will use their "best-efforts" to arrive at a proper allocation.

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Median and Average Settlements

Source: NERA, Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?, July 2005; PricewaterhouseCoopers, 2004 Securities Litigation Study; Cornerstone Research, Post-Reform Act Securities Settlements. Figures in this chart exclude the Cendant settlement from 2000 and exclude the WorldCom and Enron settlements from 2004 and 2005.

"Monster" Settlements have driven the average settlement upward in recent years. The median settlement is also rising, in part because the heightened pleading standards in the Private Securities Litigation Reform Act of 1995 is causing courts to dismiss many low-value cases.

Year	Median ($MM)	Average ($MM)
1996-2001 Average	$4.7	$13.4
2002	$6.3	$19.5
2003	$5.6	$23.4
2004	$7.0	$27.6
2005	$7.5	$28.5

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Institutional Investors as Lead Plaintiffs

In recent years, nearly half of all securities class actions had an institutional investor as lead plaintiff. Those cases typically had significantly higher settlement amounts. The presence of an institutional investor, however, does not have a causal effect on the settlement amount, since institutions may choose to participate in only stronger and larger cases.

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Top Ten Securities Class Action Settlements

Source: Stanford Law School Securities Class Action Clearinghouse, February 2006

1.	Enron (2005)	$7,160MM
2.	WorldCom, Inc. (2004-05)	$6,156MM
3.	Cendant Corp. (2000)	$3,529 MM
4.	AOL Time Warner (2005)	$2,500 MM
5.	Nortel Networks (2005)	$2,473 MM
6.	Royal Ahold (2005)	$1,091 MM
7.	IPO Allocation Litigation (2005)	$1,000 MM
8.	McKesson HBOC (2005)	$960 MM
9.	Lucent Technologies, Inc. (2003)	$673 MM
10.	Bristol-Myers Squibb Co. (2004-05)	$574 MM

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Factors Affecting Settlement Amounts

Source: Cornerstone Research, Post Reform Act Securities Settlements, February 2006

Settlements are higher where:

- The defendant corporation's current reported assets are relatively large.
- There are a large number of entries on the lead case docket (complexity of the litigation).
- Financial statements are restated during or at the end of the class period.
- The SEC is pursuing a corresponding action against the issuer or other defendants.
- An accountant is a named co-defendant.

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Factors Affecting Settlement Amounts

Source: Cornerstone Research, Post Reform Act Securities Settlements, February 2008.

Settlements are higher where:

- An Institutional Investor is lead plaintiff.
- A corresponding derivative action has been filed.
- The settlement occurred in 2002 or later.
- The lead or co-lead plaintiff law firm is Milberg Weiss or Lerach Coughlin.
- Non-cash components, such as stock or warrants, comprise a portion of the settlement fund.

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Impact of Securities Fraud on Stock Price

Source: University of Michigan John M. Olin Center for Law and Economics, S. Ferris and A. Pritchard, Stock Price Reactions to Securities Fraud Class Actions Under the Private Securities Litigation Reform Act, 2001.

Findings

- Revelation of the bad news that is the basis for the lawsuit prompts a strong negative price reaction of approximately 25% from the market.
- News that a lawsuit has been filed produces a statistically significant negative price reaction of approximately 3%.
- News that a firm has either won or lost a motion to dismiss has no statistically significant effect on the market.

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Impact of Securities Fraud on Stock Price

Source: University of Michigan John M. Olin Center for Law and Economics, S. Ferris and A. Pritchard, Stock Price Reactions to Securities Fraud Class Actions Under the Private Securities Litigation Reform Act, 2001.

Conclusions

- The initial negative reaction is predictable in that plaintiffs' lawyers will select cases that are most likely to have strong market reactions, which in turn lead to larger damages and signal a greater likelihood of fraud.
- The much smaller reaction on the news that a suit was filed suggests that investors consider the filing of a lawsuit to be relevant. Consequently the risk of litigation is not fully incorporated into the firms' stock price upon the revelation of the initial bad news.
- The court's decision on the motion to dismiss is a non-informational event. This information is either not fully understood by the market, or is too difficult for securities analysts to obtain, given there is no disclosure requirement for this information.

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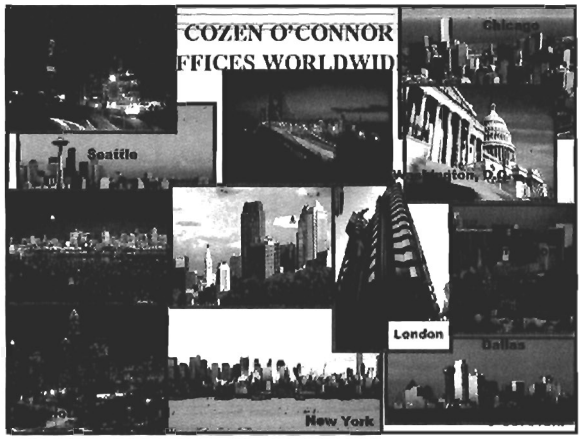
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Primer on D&O Liability Insurance

Importance of D&O Liability Insurance

In recent years, the financial world has been the subject of many lawsuits filed by disappointed investors charging corporations and their directors & officers ("D&Os") with securities fraud. Such suits seemingly are filed whenever a company's stock falls. In light of the large amounts incurred to defend and settle such suits, over 90% of U.S. companies maintain D&O liability insurance.

Brief History of D&O[1]

Initially introduced to the U.S. in the 1930's as a response to the stock market crash of 1929, corporations and their directors and officers did not begin to purchase D&O insurance as a matter of course and regular practice until the late 1960's. Even before then, however, courts imposed upon D&Os the obligation to, in good-faith, exercise the care, diligence and skill of a reasonably prudent person acting in the best interests of the corporation.

Traditionally, courts ruled that D&Os owed such fiduciary duties to their companies only. Today, however, courts have extended the beneficiaries of these duties to include other parties, such as shareholders, other directors, creditors, employees, and customers. Should a director or officer be accused of being derelict in his or her corporate duties, he or she may find him or herself named a defendant in a shareholders' derivative action or in an action seeking a monetary remedy.

As a result of these increased potential liabilities, many companies have had difficulty identifying qualified persons willing to become board members. For this reason, the mechanisms by which a company may indemnify a director or officer, whether for a judgment, settlement or even defense expenses - - for example, D&O Insurance - - has become increasingly important to companies looking to attract qualified and capable decision makers.

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[1] D&O liability insurance is often confused with Errors & Omissions liability insurance ("E&O"). E&O is concerned with performance failures and negligence with respect to a company's products and services, not the performance and duties of management.

Potential D&O Liability

D&Os are held to a variety of corporate and legal obligations as a function of their position. Among others, D&Os are required to demonstrate the following: 1) Duty of Care (common sense based on a reasonable prudent person test); 2) Duty of Prudence (cautious and deliberate action); and 3) Duty of Compliance (requires compliance with corporate acts, bylaws, federal and state law, and common law).

Typically, D&Os are responsible for their own actions as well as for the actions of their corporation. On occasion, they also are accountable for the acts and/or omissions of other directors and officers. In such circumstances, the defendants can be held jointly and severally liable to the claimant.

General Allegations Against D&Os

Most allegations made against D&Os involve acts or omissions that have reduced stock values, compromised competitive industry position, wasted corporate assets, or overlooked significant growth or investment opportunities. The causative conduct can result in financial injury to stockholders, employees, investors, and other third parties.

In the past, D&Os were somewhat protected from liability based to the "business judgment rule," particularly with regard to their duties of care. Under this rubric, D&Os were able to defend themselves to the extent they behaved in the best interests of the company, with due care, in good faith, honestly, and without a conflict of interest. Today, however, the "business judgment rule" has lost much of its effect.

According to a recent survey, there are six (6) major sources of D&Os lawsuits:

PLAINTIFFS	BASIS OF LAWSUIT
Stockholders	▪ Inadequate/inaccurate disclosure ▪ Dishonesty/fraud ▪ Financial reporting ▪ Disappointing financial performance ▪ Fiduciary Duty/Gross Negligence ▪ Stock or other public offerings ▪ Bid or threat by another company for takeover
Employees	▪ Wrongful Termination (this is the single most frequent claim)

	▪ Harassment ▪ Defamation ▪ Breach of Employment Contract ▪ ERISA
Customers/Clients	▪ Dishonesty/Fraud
Competitors	▪ Unfair Competition
Other Third Parties	▪ Environmental Public Activists
Government Agencies	▪ EPA (Environmental Protection Agency) ▪ Securities Fraud

D&O Liability Coverage

A D&O liability policy indemnifies a corporation and its D&Os for Loss resulting from Wrongful Acts that cause financial harm to a third party (such as a shareholders) and result in a Claim. D&O insurance generally has two or three coverage parts: **Coverage A**, pursuant to which an insurer indemnifies the corporation's directors and officers where the corporation does not or is unable to do so; **Coverage B**, which provides for corporate reimbursement where the corporation has indemnified its directors and officers; and, in many instances, **Coverage C**, which provides insurance for the corporate entity itself in the context of securities and sometimes EPL claims. These different coverages are generally subject to separate terms, conditions and retentions, and even may be subject to distinct policy limits or sublimits. In all cases, D&O insuring agreements specify that coverage is limited to claims first made during the policy period.

Coverage A: Directors and Officers Indemnity

Insuring Agreement A often is referred to as "A-Side Coverage." This coverage part typically provides insurance directly to the directors and officers for Loss - - including Defense Costs - - resulting from Claims made against them for their Wrongful Acts.

A-Side Coverage may apply where a corporation does not or can not indemnify its D&Os because the corporation is: (1) prohibited by law from doing so, (2) permitted by law to do so but prohibited from doing so by the company's bylaws, or (3) financially incapable of doing so due to bankruptcy, liquidation, or lack of funds. In turn, it is arguable whether this section would apply where a corporation is permitted and able to indemnify its D&Os but elects not to do so.

Insuring Agreement A, like Insuring Agreement B, also mandates that coverage is limited to those claims connected to conduct where a D&O has acted in his/her capacity as an insured director or officer of the corporation. This limiting language may appear in the insuring clause, in the definitions of Claim or Wrongful Act found elsewhere in the policy, or in all three clauses.

Coverage B: Corporate Reimbursement

Insuring Agreement B, or "B-side coverage," reimburses a corporation for its Loss where the corporation has indemnified its directors and officers for Claims first made against them during the policy period and arising from Wrongful Acts committed in the directors' and/or officers' capacity as a D&O of the corporation. Of critical import, B-side coverage does not provide coverage to the corporation for its own liability.

Coverage C: Entity Coverage

Current vintage D&O policies often offer the corporation an opportunity to purchase additional coverage to protect itself - - as a corporate entity - - for certain claims made against it. This coverage provides protection to the corporation for its own potential liability.

Coverage C - - also known as "entity coverage" - - may provide insurance for the corporation irrespective of whether its directors and officers also are named as defendants in the lawsuit. Conversely, some D&O policies provide such coverage only where the corporation is a co-defendant with its directors and officers. For obvious reasons, it is imperative that you read the language of your policy to determine whether it provides Coverage C and, if so, the scope of such coverage. Coverage C may be part of the policy form as "Insuring Agreement C" or can be added as an endorsement.

EPL Coverage

In addition to covering securities fraud claims, D&O insurance has expanded to including coverage for claims alleged Employment Practices Liability ("EPL"). Such coverage can be provided through an endorsement to the D&O policy or by way of a stand-alone policy issued to the corporation.

Typical EPL coverage protects directors, officers, employees and/or the company against EPL claims brought by employees and, in certain circumstances, specified third-parties, i.e., those asserting claims for wrongful dismissal, failures to promote, sexual harassment, wrongful failure to hire, and other violations of federal, state, or local employment and discrimination laws.

Defense Related Issues

Most D&O policies do not impose a duty to defend on the insurer. Instead, the insurer is usually required to reimbursement or indemnity the defense costs incurred and/or paid to defense counsel selected by the insureds with the insurer's consent. Most D&O policies also provide that the insurer can not unreasonably withhold its consent to the insured's choice of counsel. At the same time, however, the insurer has the right to associate in the insureds' defense and can invoke its policy right to approve defense strategies, expenditures, and settlements.

Reimbursement of Defense Costs

Although insurers do not control an insured's defense, they are required under D&O policies to reimburse only reasonable defense costs arising out of covered claims.

Advancement of Defense Costs

D&O policies often require the insurer to advance defense costs, albeit on the condition that, should the facts ultimately demonstrate a lack of coverage, the insureds and/or the corporation will reimburse to the insurer the full amount of the monies advanced. This is particularly important when many of the issues affecting coverage can be resolved only after final adjudication of the underlying lawsuit, e.g., a judgment on whether the insureds engaged in fraud.

Issues to Consider: Coverage Under a D&O Policy

1. **Claim** must be "made" against directors and/or officers of the Company (or Securities Claim against the Company where Entity Coverage is available):

2. the **Claim** must arise from **Wrongful Acts** committed by the Directors and/or Officers (or Company);

3. the Directors and/or Officers (or Company) must have suffered a **Loss**;

4. the Insured must have provided notice of the **Claim** to the Insurer within the Policy Period (or prior to the expiration of the relevant policy's Discovery Period).

5. the purported **Claim** must not be Excluded.

6. The insureds must satisfy all conditions imposed on them.

Claims Made

We emphasize that each insuring clause in a D&O policy provides coverage on a "claims-made" basis. Thus, the policy only covers claims which are made against an insured during the period the policy is effective. Additionally, the insured typically must report the claim to the insurer during the policy period or within a specified time thereafter.

Definition of Claim

D&O policies generally define Claim as any (1) civil, criminal or administrative proceeding, or (2) written demand for damages against an insured. Some D&O policies also may define Claim to include "arbitration, mediation or other alternative dispute resolution" and/or "administrative proceedings including a formal investigation."

Many policies include the "capacity" requirement in their definition of "Claim." In other words, coverage is limited to those proceedings or demands made against an insured in his or her capacity as a director and/or officer of the corporation, and not in any other capacity.

Definition of Wrongful Act

"Wrongful Act" is generally defined as "any actual or alleged act, error or omission, misstatement, misleading statement, or breach of fiduciary duty or other duty by an Insured Person in his or her capacity as an Insured Person." Again, the capacity requirement may be contained in this definition.

Definition of Loss

Loss generally includes damages, judgments, awards, settlements and Defense Costs. In turn, Loss usually excludes fines or penalties, taxes, treble (or other multiplied) damages, and matters uninsurable under law. As to punitive and exemplary damages, policies differ with respect to the availability of coverage. As such, you should study the relevant policy to evaluate this issue. Where included, coverage for punitive and exemplary damages typically is effective only where permitted by applicable law.

Exclusions

Policy exclusions may apply to one or more of the Insuring Agreements:

1. Historic Exclusions

Prior to the 'insurance crisis' of the mid-1980s, D&O policy exclusions usually focused on claims considered uninsurable for legal and public policy reasons. For the most part, the following "traditional" exclusions relating to intentional acts committed by insured directors or officers still are found in all D&O policies:

- any personal profit or advantage to which an insured person was not legally entitled;
- illegal remuneration;
- active and deliberate dishonesty on the part of the director or officer;
- willful violations of law; and
- profits obtained through violations of securities laws, particularly insider trading.

Most current-day D&O policies also include a "severability" provision stating that the acts of one director or officer giving rise to an exclusion under the policy *will not be imputed to* the other insureds.

2. More Modern Exclusions

Some of the newer vintage exclusions relate to unintentional acts on the part of an insured. These exclusions generally apply to the policy as a whole and often pertain to risks which are, or should be, covered by other policies or other types of insurance, like a CGL policy. These exclusion will eliminate coverage for:

- Claims addressed by an earlier D&O policy;
- Claims covered by another D&O policy;
- Claims arising out of a breach of fiduciary duties owed by the trustees of employee benefit plans, including pension plans;

- Claims arising out of death, bodily injury or personal injury, or damage to, or the destruction of, tangible property;
- Claims arising out of an allegation of libel or slander;
- Environmental or pollution claims, whether initiated by a government body or private citizens; and
- Claims arising out of a failure to purchase or maintain adequate insurance.

3. Newest Exclusions

The recent wave of D&O related litigation has resulted in a number of new exclusions being added to D&O policies:

- the anti-takeover exclusion excludes any claims arising from a "corporate raid;"
- the "Insured v. Insured" exclusion eliminates coverage for certain claims brought by the company against the directors and officers, or claims among or between D&Os;
- the "regulatory" exclusion excludes coverage for claims made by certain regulatory agencies;
- the exclusion for claims by major shareholders; and
- the exclusion for claims arising out of mergers, acquisitions and divestitures.

4. Other Exclusions and Endorsements

Endorsements enable D&O underwriters to tailor their policies to fit the risks and needs of a particular insured. Such endorsements may add to or subtract from the coverage provided by the standard wording of a D&O policy. In addition, other exclusions may be included, depending on the nature of the business conducted by the company or its subsidiaries.

The following are examples of other possible exclusions and/or endorsements:

- nuclear energy liability exclusion;
- corrupt practices exclusion;
- outside directorship exclusions;
- prior acts exclusions;
- prior notice exclusions;
- deletions of certain directors or officers from coverage;
- reorganization or cessation of business exclusions;
- endorsements changing applicable limits;
- endorsements providing that the insurer has no duty to defend;
- pollution exclusion endorsement;
- endorsements as to the policy applications procedure or form;
- spousal endorsements;
- Defense Cost allocation between covered and non-covered claims;
- exclusions as to discrimination claims;

- exclusions as to improper political contributions; and
- the addition of other Named Insureds.

Other D&O Related Issues

Allocation

Allocation is a key issue when the time comes to divide up responsibility for Defense Costs and settlements between those whose losses are insured and those whose losses are not. Negotiation of an "allocation" of Defense Costs and settlement amounts often is required where a policy does not provide entity coverage and a lawsuit is brought against both insured directors and officers and the insured corporation. So too, a suit may include some claims which are covered and some which are not covered. In either scenario, the policy might cover the defense and settlement expenses attributable to the directors and officers and/or the covered claims, but not those attributable to the corporation and/or to the uncovered claims.

Settlement

Under most D&O policies, an insured may not settle a claim without the prior approval of the insurer. The insurer may not, however, unreasonably withhold its consent. Where the insurer has revised its policy to provide for a "duty to defend" or the insurer has assumed the control of the defense, it is the insurer which has the right to settle, subject to the approval of the insured. If the insured refuses to settle, the insurer often retains the right to demand that the insured cover any additional costs, settlements, and/or judgment which exceed the amount the insurer could have settled for, had the insured not withheld its consent.

Bankruptcy Claims

Where a claim is brought against a corporation's directors and officers and the entity is bankrupt, it likely will be unable to indemnify them. Thus, A-Side Coverage may be available.

At the same time, the corporation's bankruptcy may have a great impact on its D&Os insurance policy. In dividing up the bankrupt estate, some courts have held that insurance policies are part of the estate, although the proceeds may not be. If the policy and its proceeds are property of the estate, the insured directors and officers may need bankruptcy court approval to obtain proceeds from the insurer.

Moreover, claims by debtors-in-possession or trustees against D&Os for the benefit of creditors may implicate the "Insured v. Insured" exclusion. The key question is whether a trustee or debtor-in-possession stands in the shoes of the corporation. The case law addressing this question is developing.

Cancellation and/or Rescission

1. At the Discretion of the Parties

In general, D&O policies allow either party to unilaterally cancel the policy upon notice to the other party. This enables the insurer to cancel in situations where the risk has increased substantially from that originally contemplated. However, this may leave the policyholders

without any insurance coverage when they might need it most, potentially resulting in coverage litigation.

2. De Facto Cancellation

Where an insurer offers to renew with a significantly higher deductible and/or premium increase, such a change could amount to a "non-renewal," entitling the insured to trigger its rights to a discovery period.

3. Misrepresentations by the Insured

An insurer may have the right to rescind a D&O policy where the insureds provide untrue, incomplete or false answer to one or more questions presented in the policy's application. Once completed, the application forms a part of the insuring agreement between the D&O insurer and insureds.

Among other information, the applicant for D&O coverage is required to provide the D&O insurer with the following facts:

- the nature of the company's business operations, as well as the size of the company;
- previous D&O insurance history, including prior claims under such a policy and breaks in coverage;
- current and historical financial information, including current audited financial statements;
- a description of any litigation involving the company or its directors and officers, particularly with respect to actions involving securities claims, class actions, and intellectual property;
- a description of any pending and publicly announced mergers or acquisitions; and
- a complete description of all pending claims and events or circumstances which may, in the future, give rise to litigation.

It is this last piece of information which most often leads to coverage litigation.

D&O policies also contain a "cognizance representation" clause. This provision requires the applicants to confirm that they are unaware of facts or circumstances which may give rise to a Claim under the terms of the proposed D&O policy. Where the insurer has reasonably relied on information contained in the application, it may be able to rescind the policy where the application contained material mis-statements or omissions.

Severability Clause: While a loss of coverage may seem harsh to innocent insureds, some courts have recognized that these insureds are in a better position than the insurer to be aware of a material fact. Because of this, some D&O policies include severability provisions designed to protect innocent insureds. These provisions state that a misrepresentation made by one insured in completing the application will not be imputed to other innocent insureds and that the policy will be treated as a separate policy with respect to each insured officer or director.

Combined Risk Policies

In the last few years, many insurers have offered multi-year, multi-line insurance policies that have combined several different types of coverages under one policy (and often subject to a single aggregate limit of liability). Insureds have used this approach to build "towers" of coverage that may often provide hundreds of millions of dollars for this combined risk. The combined policies often include D&O coverage (A-Side, B-Side and Entity Securities coverage), EPL coverage, fiduciary liability coverage, professional liability errors and omissions coverage (for financial institutions), and fidelity or crime bonds (for employee dishonesty and related losses). Combining these risks presents challenging issues for both insurers and insureds, since the risks insured are quite varied, often subject to different terms, and involve significant limits of liability and premium dollars.

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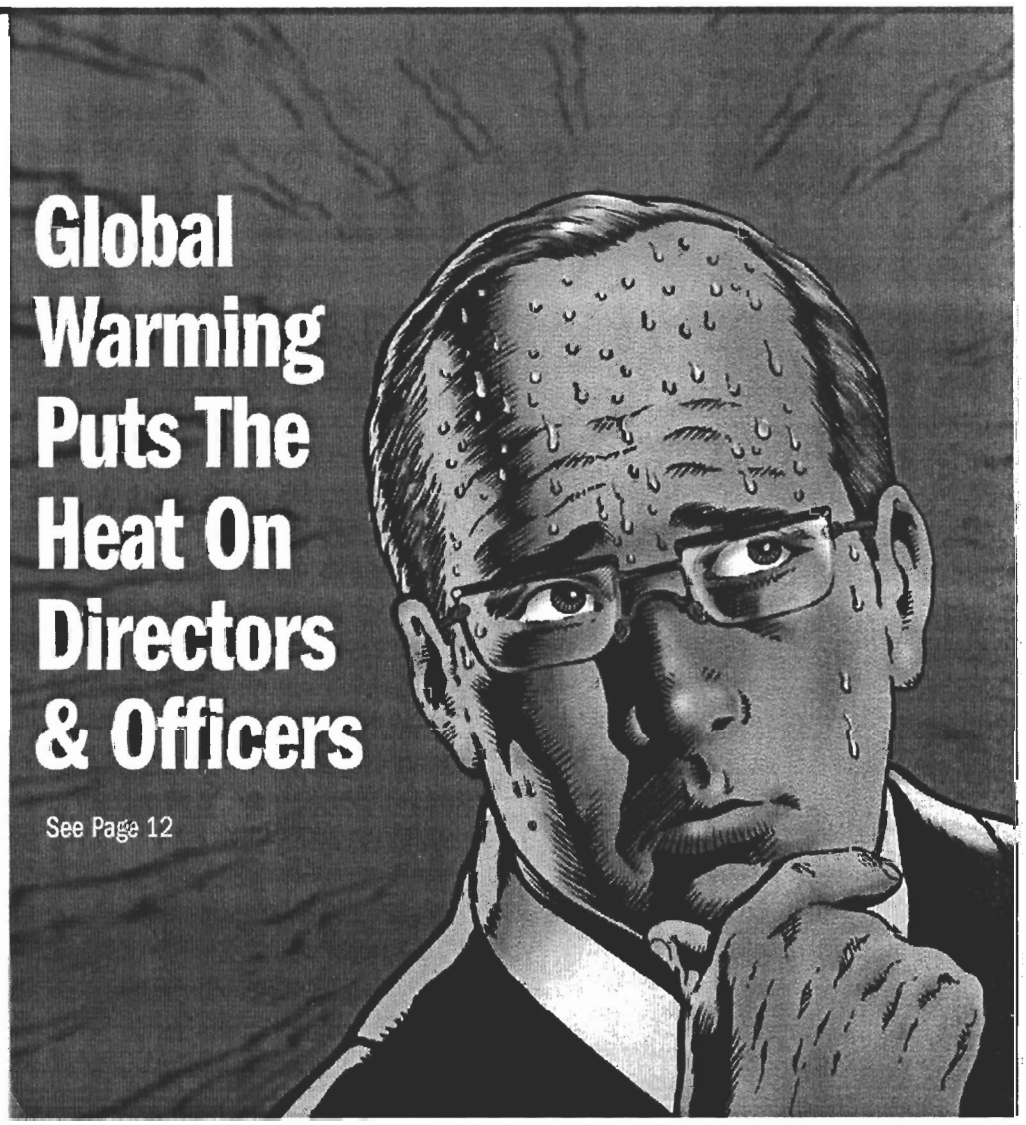


Global Warming Puts The Heat On Directors & Officers

See Page 12

■ CLIMATE IN THE BOARDROOM

Global Warming Exposures Put The Heat On Directors & Officers

BY RICHARD J. BORTNICK AND KEVIN M. LACROIX

SINCE THE ADVENT OF THE AGE OF Mega Securities Fraud Settlements (indeed, even before) class-action counsel have searched strenuously for—and corporate executives have slept fretfully worrying about—the next trend in investor claims and activism.

In the recent past, directors and officers have been challenged by, and in some cases faced down, allegations of improper stock backdating. We also have become familiar with the problems of subprime mortgages. But these issues relate primarily to considerations of personal wealth and economic interest.

The latest topic of concern has been promoted not by class-action lawyers or even capitalist entrepreneurs, and reaches far beyond mere issues of individual economic interests. Rather, the critical issues of global warming and environmental protection have been placed on the front pages and received the heightened attention of both investors and noninvestors alike because of the efforts of social activists, politicians and others.

Shareholders want disclosures on pollution-generating activities, associated risks

The import and potential impact of global warming and its implications for our environment extend well beyond the capital markets and insurance. Indeed, the issue may have potentially important repercussions for directors and officers of publicly traded companies as well as for their D&O liability insurers.

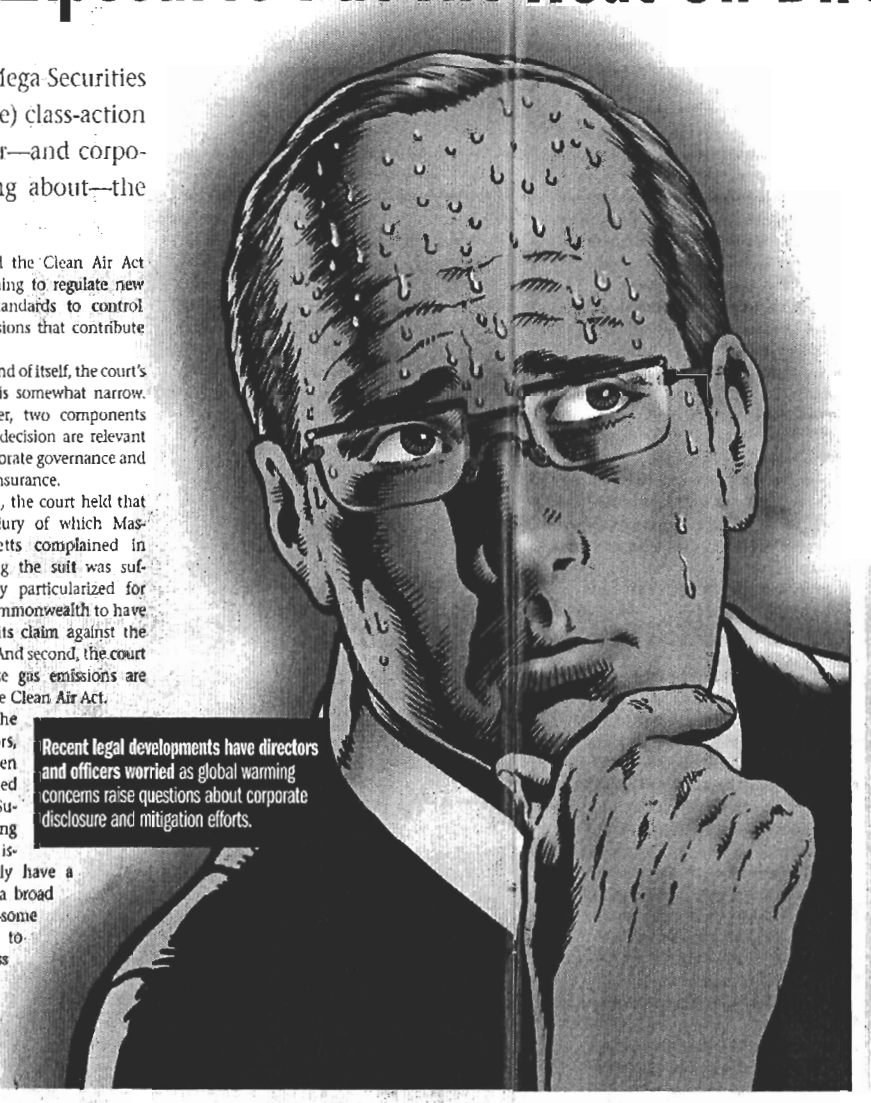
Most recently, global warming has received the attention of the U.S. government, including the executive branch.

At the same time, the U.S. Supreme Court has spoken on the subject, having held in the seminal case of *Massachusetts v. EPA* that the U.S. Environmental Protection Agency violated the Clean Air Act by improperly declining to regulate new vehicle emissions standards to control carbon dioxide emissions that contribute to global warming.

In and of itself, the court's ruling is somewhat narrow. However, two components of the decision are relevant to corporate governance and D&O insurance.

First, the court held that the injury of which Massachusetts complained in bringing the suit was sufficiently particularized for the Commonwealth to have "standing" to bring its claim against the federal government. And second, the court held that greenhouse gas emissions are "pollutants" under the Clean Air Act.

Responses of the EPA, state regulators, lower courts and even the newly constituted Congress to the Supreme Court's ruling and environmental issues could potentially have a dramatic impact on a broad range of industries—some of which will have to modify their business practices to comply with the anticipated heightened regulation and judicial scrutiny of environmental matters.



Recent legal developments have directors and officers worried as global warming concerns raise questions about corporate disclosure and mitigation efforts.

In addition, these changes could dramatically impact public companies' disclosure obligations and the way they do business—particularly in the face of Regulation S-K, Item 101 (requiring disclosure of environmental compliance) and the more generalized requirements of Item 303 (which requires disclosure of known trends or uncertainties that could affect a company's business).

In turn, public company disclosure creates a context within which it is prudent to assume that D&O claims will arise.

Beyond automotive and energy generation businesses (and supporting industries), the changing claims context could also have a significant effect on industries such as insurance, transportation, manufacturing, shipping and businesses whose operations have (or which could sustain) a substantial environmental impact, even if it is entirely localized.

In some cases, the battles already have begun, with activist shareholders asking questions, voicing concern, and demanding through corporate resolutions and other vehicles that public companies disclose:

- **The nature and extent** of their pollution generating activities.
- **The financial risks attendant** to global warming and the government's heightened scrutiny, including how they will recognize and account for the risks attendant to climate change.
- **The methodologies and plans** they are implementing or intend to implement to reduce greenhouse emissions and meet the changing regulatory, political and social environments.

To the extent claims do arise, the wording of applicable D&O policies could have an enormous impact on the availability of D&O insurance to defend and indemnify companies and their directors and officers.

▸ *continued on page 16*

■ POLICY LANGUAGE

What Do D&O Policies Say?

DOES POLLUTION EXCLUSION wording in D&O policies work to exclude the environmental consequences of greenhouse gas emissions?

While there is no standard form wording among D&O insurers, the following is illustrative of pollution exclusion wordings typically available in the D&O market today without modification:

"The Insurer shall not be liable to make any payment for Loss in connection with any Claim made against an Insured: alleging, arising out of, based upon or attributable to, directly or indirectly:

(i) the actual, alleged or threatened discharge, dispersal, release or escape of Pollutants; or

(ii) any direction or request to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize Pollutants (including but not limited to a Claim alleging damage to an Organization or its securities holders); provided, however, that this exclusion shall not apply to Non-Indemnifiable Loss, other than Non-Indemnifiable Loss constituting Cleanup Costs;

'Cleanup Costs' means expenses (including but not limited to legal and professional fees) incurred in testing for, monitoring, cleaning up, removing, containing, treating, neutralizing, detoxifying or assessing the effects of Pollutants.

'Pollutants' means, but is not limited to, any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and Waste.

'Waste' includes, but is not limited to, materials to be recycled, reconditioned or reclaimed." ■

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continued from page 13

The typical D&O policy contains a pollution exclusion. Surprisingly, however, it is not obvious that the standard forms of pollution exclusion address greenhouse gas emissions or consequences arising from such emissions. (See accompanying sidebar, "What Do D&O Policies Say?")

There may be several arguments raised to try to support the idea that the typical pollution exclusion wording has no relation to greenhouse gas emissions or their environmental consequences. Whether or not such contentions would be persuasive to a court is a matter of pure conjecture on which we do not opine.

Nevertheless, assuming the exclusion would otherwise preclude coverage for claims pertaining to greenhouse gas emissions, the pollution exclusion in most D&O policies these days carves back coverage for derivative suits and shareholder claims.

In light of the possible course of future litigation in this area, the wording of the pollution exclusion—and, in particular, the wording of the carve-back for shareholder claims and derivative lawsuits—will be absolutely critical.

The fact that policy language must anticipate cases and claims of a kind that may not have previously arisen underscores the importance of enlisting the assistance of skilled D&O insurance professionals in the D&O insurance transaction.

Some insurers are already requesting of proposed policyholders detailed information about their companies' efforts to reduce the risk of and manage environmental losses and claims. The reality is that global climate change is not some distant theoretical construct.

More to the point, the answer to the question of whether this will affect a company's risk profile is a reflection of the way the question is framed.

■ On the one hand, an underwriter can regard global climate change as a separate category of risk to be analyzed on its own merits.

■ Alternatively, the underwriter can simply view the discrete issue of climate change as imbedded within numerous other risk categories—such as commodities pricing risk, political risk and currency risk as well as what insurers call parameter risk (the risk of events different than those that have occurred in the past).

Regardless, whether viewed separately or as a part of the overall panoply of corporate risk, global climate change will be an increasingly important part of the risk landscape that companies face.

The influence of activist investors suggests that companies and their insurers disregard these risks at their peril.

DISCLOSURE

What Is Regulation S-K?

SEC Regulation S-K was enacted on March 16, 1982. The regulation:

- **Governs the content** of forms filed under the Securities Exchange Act of 1933, the Securities Exchange Act of 1934, and the Energy Policy and Conservation Act of 1975.
- **Specifically sets forth requirements** for the content of the nonfinancial statement portions of such forms.

Of particular note in the environmental context are Items 101 and 303.

▶ **ITEM 101, TITLED "DESCRIPTION OF BUSINESS,"** requires SEC registrants to disclose the material effects of complying (or failing to comply) with "federal, state and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment."

- **Under Item 101, registrants must disclose** the effect of such compliance on capital expenditures, earnings and competitive position.

▶ **ITEM 303, TITLED "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS,"** does not specifically address environmental disclosure. It does, however, require disclosure of known trends or uncertainties that could affect a company's business.

- **In particular, it requires description** of trends or uncertainties that "have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."
- **Registrants must also "identify any known trends** or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."
- **Further instruction in Item 303** says the "discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."

▶ **Kevin M. LaCroix** is a director of OakBridge Insurance Services, in Beachwood, Ohio. Kevin has been involved in directors and officers liability issues for nearly 25 years and is the author of the Internet Weblog, The D&O Diary—http://dandodiary.blogspot.com. His e-mail address is klacroix@oakbridgeins.com.

▶ **Richard J. Bortnick** is a member of Cozen O'Connor's West Conshohocken office and practices with the insurance department. He concentrates his practice in directors and officers liability, securities fraud, insurance coverage, products liability, employment practices and commercial litigation. His e-mail address is rbortnick@cozen.com

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written and presented by:
Alicia Curran, Esquire

COZEN O'CONNOR
1717 Main Street
Suite 2300
Dallas, TX 75201
214-462-3000 or 800-448-1207
www.cozen.com

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Initial Analysis of a Claim

What is usually considered

versus

What **should be** considered?

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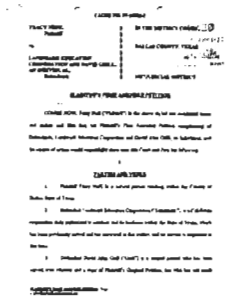

- Many times insurance carriers do not consider the policy or claims handling issues until they receive a lawsuit that alleges "bad faith."

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Suggestion:

- Your initial analysis should include extra-contractual considerations.

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Proper Underwriting Reduces Your Exposure

☑Has someone from both underwriting and claims checked the policy language?

☑Is there a consistency of legal positions and arguments within your company between states and federal districts?

☑If not, is the position defensible?

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Early Document Awareness

- Eliminates discovery problems,
- Prevents unnecessary expenses and costs, and
- Makes you a happy person.

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Who are the Keepers of Corporate Knowledge?

- Policies KEEPER
- Underwriters and Underwriting File
- Adjusters and Claim File
- Manuals and Documents
- Computer Information/Technology, including e-mails

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The Loss: Checklists

- ✓ Claimant Checklist ("Who?")
- ✓ Loss Location Checklist ("Where?")
- ✓ Loss Date Checklist ("When?")
- ✓ Sequence or facts of the Loss Checklist ("What?")
- ✓ Claims Management Checklist ("Why?")

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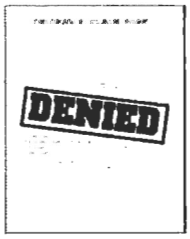
Proving Bad Faith Causes of Action



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Time Limit Demands

- The *Stowers* Doctrine is the Texas doctrine which states that a carrier has a duty to settle a case with a third party, upon receipt of a settlement demand, if:
  - (1) a claim is made against the insured within the scope of coverage
  - (2) a settlement demand is made within the policy limits; and
  - (3) the demand is reasonable under the circumstances.
    - *G.A. Stowers Furn. Co. v. American Indemn. Co.*, 15 S.W.2d 544, 547-48 (Tex. Comm'n App. 1929)

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Options when defense is tendered

- Deny the defense.
- Provide a defense under a reservation of rights.
- Provide a defense with no reservation.
- File a declaratory judgment action contesting the duty to defend.

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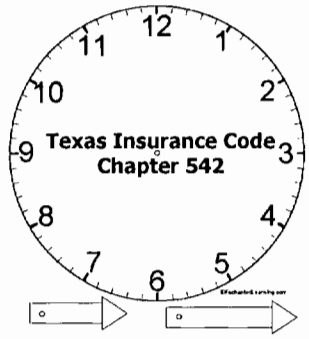

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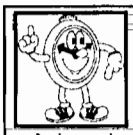

Three Timing Events

- Acknowledge receipt of claim, commence investigation, and request all items, statements, and forms that carrier reasonably believes are required **15 calendar days** from date of receipt of written notice of loss.
- Acknowledge acceptance or denial of the claim **15 business days** after receipt of all information reasonably required to secure final proof of loss.
- Pay the claim **5 business days** from the date the carrier accepts the claim.

Statute of Limitations

- The United States District Court for the Southern District of Texas held a 4-year statute of limitations applied to a 21.55 claim on the basis that 21.55 is a contract-based remedy.
- The United States District Court for the Northern District of Texas held a 2-year statute of limitations applied to a 21.55 claim on the basis that 21.55 is a tort-based remedy.

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V

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"FOOD FIGHT!" WHO PAYS WHEN GOOD FOOD GOES BAD

written and presented by:
Joseph Bermudez, Esquire

COZEN O'CONNOR
707 17th Street
Suite 3100
Denver, CO 80202
720-479-3900 or 877-467-0305
www.cozen.com

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"FOOD FIGHT!"

Who Pays When Good Food Goes Bad?

Insurance Coverage Issues Related to Food Contamination Claims

Joseph F. Bermudez
Chair, Food Contamination Coverage Practice Area
Cozen O'Connor
707 17th Street, Suite 3100
Denver, CO 80202
(720) 479-3926
(720) 479-3890
jbermudez@cozen.com

In The News

2007 Contamination Highlights

February 2007	March 2007	June 2007	August 2007	September 2007	October 2007
ConAgra: Salmonella found in jars of **PEANUT BUTTER** linked to 625 illnesses in 47 states	**Menu Foods**: 60 million cans of dog and cat **PET FOOD** recalled and linked to cat and dog deaths nationwide	**Colgate**: Counterfeit **TOOTHPASTE** from China tainted with toxic chemical used in antifreeze linked to several illnesses in US	**Metz Fresh**: Recalled 8,118 cases of **SPINACH** distributed in 48 states and Canada.	**Topps Meat**: 21.7 million pounds of **GROUND BEEF** recalled. E. coli sickens 28 in 8 states.	**ConAgra**: Salmonella found in **POT PIES**. 151 illnesses in 31 states.

Business Trends: Local Producers Obsolete

- Historically, the growth and distribution of fruits, vegetables and grains was the business of small, family-owned farming operations.

Business Trends: Critically Extended Supply Lines

GLOBALIZATION

- The U.S. is expected to import a record $70 billion in agricultural products.
- 80% of our seafood; 45% of our fresh fruit; and 17% of our vegetables are imported.
- Annually, the average American eats 260 pounds of imported foods, which is 13% of our diet.

Business Trends: Critically Extended Supply Lines

OUTSOURCING
and
OFFSHORING

As companies strive for increased profitability and larger market share, they have looked overseas for manufacturing, processing and production services.

Business Trends: Critically Extended Supply Lines

"MADE IN CHINA"

- Largest trading partner.
- Largest foreign supplier of seafood.
- Supplies additives and preservatives to our most popular kitchen staples:
  - 80% of ascorbic acid (vitamin c);
  - 50% of apple juice;
  - 40% of xanthan gum.

Business Trends: Centralized Production

CENTRALIZATION

- In the last century, food production and distribution has become increasingly centralized.
- Individual, large-scale growers provide produce which may ultimately be distributed to dozens of states across the U.S.

Other Critical Trends: Changed Appetites

PROCESSED FOODS

- Consumers' appetites have shifted toward more processed foods sold by national fast food and restaurant chains.
- A majority of Americans consider "homemade" to include bagged salad or frozen vegetables.

Other Critical Trends: Deadly Bugs

EVOLVED FOOD PATHOGENS

- E. coli O157:H7, the deadly strain, was isolated in 1982, and tracked by the CDC only as far back as 1976.
- *Salmonella typhimurium* and *Salmonella Newport* have evolved to resist most antibiotics that doctors feel comfortable giving to children.

Recent Headlines

"NO INCREASED PRECAUTIONS AFTER E. COLI OUTBREAK"

- A year later, AP investigation found gov't regulators failed to act after 2006 spinach E. coli outbreak, 5 dead, 205 sickened in 26 states.
- Since August 2006, the FDA inspected only 29 of the hundreds of California farms that grow fresh produce.
- The nation's "Salad Bowl" is largely self-regulated.
- The new, self-imposed inspection system with voluntary guidelines has recently, dramatically failed.

Recent Headlines

"DOLE STEPS UP TESTS TO PREVENT E. COLI OUTBREAKS"

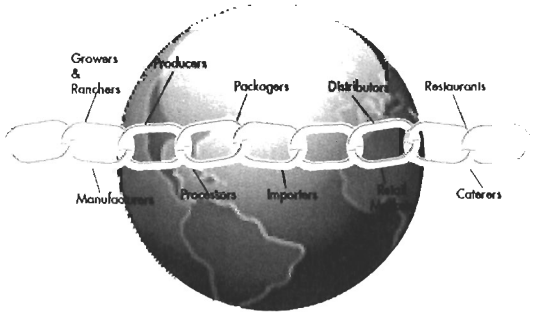
- On August 30, 2007, Dole announced new testing and tracking methods to prevent E. coli outbreaks.
- Dole "is testing samples from every acre of spinach and other vegetables that will be marketed under the Dole label. If a harmful bacterium or other problem is detected, plants from that area will not enter the processing chain." *Dole's President for Worldwide Vegetables.*

Recent Headlines

"DOLE RECALLS BAGGED SALAD FOR E. COLI"

- On September 17, 2007, Dole issued an international recall of bagged salad.
- 755 cases, containing 4,530 bags, were distributed in the U.S. and 88 cases in Canada.
- Product was sold in 9 states and Ontario, Quebec and the Maritime Provinces of Canada.
- Sample taken from a store in Canada tested positive for E. coli.

Global Supply Chain Liability: Insureds at Risk



Available Insurance Products

- **Third-party liability policies.**
- **First-party property policies.**
- **Specialized policies**:
  - Product Recall Insurance.
  - Contaminated Products Insurance.
  - Trade Disruption Insurance.
- **Crisis Management Products.**
  - Focus shifts from reaction to risk prevention.

Third-Party Coverage Issues

Monitoring Coverage Issues

"Property Damage"

Growing Trend: Product Incorporation. The incorporation of a defective product may result in "physical injury" to the product into which the defective product is incorporated.

- In *Shade Foods Inc. v. Innovative Products Sales & Marketing Inc.*, 78 Cal.App.4th 847 (2000), insured supplied nut clusters to General Mills for cereals. Wood splinters were discovered in diced almonds supplied by insured, resulting in shutdown of General Mills' production. Court held that wood splinters in the nut clusters caused "physical injury" to the cereals in which the nut clusters were incorporated.

Monitoring Coverage Issues

"Property Damage"

Growing Trend: Loss of use. Although pure economic loss is not covered property damage, some courts have found a covered "loss of use" for what would typically be considered a classic economic loss claim.

- In *Stark Liquidation Co. v. Florists' Mut. Ins. Co.*, ED 87852, 2007 WL 2317140 (Mo. App. E.D. Aug. 14, 2007) the planting of 3,500 bacterially-infected apricot trees caused grower significant losses. Grower claimed that he suffered a "diminution in economic value of his land." Court found that loss of use of the orchard was covered property damage. *See also Hendrickson v. Zurich Am. Ins. Co.*, 72 Cal.App.4th 1084 (1999).
- A recall of ice cream products caused financial loss to the insured's customer. Court held that loss of use of storage space from the customer having to store the contaminated ice cream constituted loss of use of tangible property. *United States Fire Ins. Co. v. Good Humor Corp.*, 496 N.W.2d 730 (Wis.App. 1993).

Monitoring Coverage Issues

Number of Occurrences

CAUSE v. EFFECT

- The vast majority of courts determine the number of occurrences by identifying the **cause** of the loss rather than the **effect**.

Number of Occurrences

CAUSE STANDARD = SPLIT DECISIONS

- In *Mason v. The Home Ins. Co. of Ill.*, 177 Ill.App.3d 454 (1988), multiple customers of a restaurant were infected with botulism from contaminated onions. Court held that the cause of the insured's liability was the serving of contaminated onions, not the preparation of the onions. Thus, court found **multiple occurrences** (one occurrence for each time onions were served).
- **In contrast:** *Fireman's Fund Insurance Company v. Scottsdale Insurance Co.*, 968 F.Supp. 444 (E.D. Ark. 1997). The court found a single occurrence stemming from the preparation and sale of Hepatitis A infected meat at a Taco Bell restaurant. The **single occurrence** was the negligent preparation of the meat.

Pollution Exclusion

ORGANIC v. INORGANIC

- The majority of jurisdictions have upheld the exclusion's application to exclude coverage where the contaminant met the "pollutant" definition and where there was a release or discharge as required by the policy language. *The Cincinnati Ins. Co. v. Becker Warehouse, Inc.*, 262 Neb. 746 (2001).
- At least one jurisdiction has limited the applicability of the pollution exclusion to traditional environmental claims and, as such, did not apply the pollution exclusion in the food contamination context. *Keggi v. Northbrook Prop. & Cas. Ins. Co.*, 13 P.3d 785 (Ariz.Ct.App. 2000).

Business Risk Exclusions

- Due to nature of the food industry, the Business Risk Exclusions will frequently be at issue.
- Applicability of the Exclusions is extremely fact sensitive.
- Most jurisdictions exclude coverage for costs associated merely with the repair or replacement of the insured's defective work. *Atlantic Mut. Ins. Co. v. Hillsdale Bottling Co. Inc.*, 903 A.2d. 513 (NJ App. Div. 2006); *Nu-Pak, Inc. v. Wine Specialties Int'l Ltd.*, 642 N.W.2d 848 (Wis. Ct. App. 2002);

Monitoring Coverage Issues

Business Risk Exclusions

Significant Issue: Has the insured merely provided a "service" or has it manufactured or produced a "product"?

- In *Atlantic Mut. Ins. Co. v. Hillside Bottling Co., Inc.*, 903 A.2d 513 (NJ App. Div. 2006), the insured produced soft drinks for various companies. To create a drink, the insured mixed customers' ingredients, which it stored at its plant, with other ingredients, which it provided, and cooled the drinks in a process that also added carbonation. After processing, the insured bottled the drinks for shipment, using bottles it purchased from an outside vendor. The court found that the insured did not merely provide a service, it created a product.
- In *NU-PAK, Inc. v. Wine Specialties Int'l, Ltd.*, 643 N.W.2d 848 (Wis. Ct. App. 2002), the insured contracted to "mix and package" the product, using ingredients provided by the developer. The court found that the insured "manufactured" and "handled" the product in attempting to fulfill its contract and applied the "your product" exclusion. *See also Holsum Foods Div. of Harvest States Coops. v. Home Ins. Co.*, 469 N.W.2d 918 (Wis. Ct. App. 1991).

Monitoring Coverage Issues

Impaired Property Exclusion

- Strictly construed, every element must be satisfied.
- For example: Where the insured's product can be salvaged, but not restored to use by repair or replacement of defective component, impaired property exclusion does not apply. *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal.App.4th 847 (2000).
- Impaired property exclusion does not apply to exclude coverage if the "impaired property" is physically injured.

Growing Trend: Courts have applied the "sudden and accidental physical injury" exception to defeat application of exclusion in matters involving pathogens. *See Stark Liquidation Co. v. Florists' Mut. Ins. Co.*, ED 87852, 2007 WL 2317140 (Mo. App. E.D. Aug 14, 2007) (involving bacterial canker) ; *US Fire Ins. Co. v. Good Humor Corp.*, 496 N.W. 2d. 730 (Wis. Ct. App.) (involving Listeria monocytogenes)

Monitoring Coverage Issues

Sistership Exclusion

- The sistership exclusion, also known as the product recall exclusion, generally excludes coverage for property damage claims for the withdrawal, recall or replacement of the insured's product if such product is withdrawn or recalled from the market or from use because of a suspected known or suspected defect or deficiency in the product.
- Generally precludes coverage for the full gamut of recall expenses, including expenses to prevent or mitigate further damage.

Monitoring Coverage Issues

Sistership Exclusion

Significant Issue: Which entity ordered the recall?

The vast majority of jurisdictions limit the applicability of the sistership exclusion to the **insured's recall of its own product**. These jurisdictions hold that the impaired property exclusion does not apply where a third party issues the recall of the insured's product. *U.S. Fire Ins. Co. v. Good Humor Corp.*, 496 N.W.2d 730 (Wis.Ct.App. 1993). *Olympic Steamship Co. v. Centennial Ins. Co.*, 811 P.2d 673 (Wash. 1991).

But: At least one jurisdiction has applied the exclusion to exclude coverage where a third party issued the recall of insured's product. *Hamilton Die Cast, Inc. v. U.S. Fid. & Guar. Co.*, 508 F.2d 417 (7th Cir. 1975).

Monitoring Coverage Issues

Sistership Exclusion

Significant Issue: What was the scope of the recall?

- Sistership exclusion is **limited to market-wide recalls**, not partial withdrawal of individual or partial groups of defective products. *Forest City Dillon Inc. v. Aetna Cas. & Sur. Co.*, 852 F.2d 168 (6th Cir. 1988); *Fitness Equip. Co. v. Pennsylvania Gen. Ins. Co.*, 493 So.2d 1337 (Ala. 1986); *Imperial Cas. & Indem. Co. v. High Concrete Structures, Inc.* 858 F.2d 128 (3rd Cir. 1988).

Monitoring Coverage Issues

Bodily Injury

- The majority of jurisdictions hold that emotional distress claims, absent allegations of physical injury, do **not** constitute bodily injury. *Aim Ins. Co. v. Culcasi*, 229 Cal.App.3d 209 (1991); *Allstate Ins. Co. v. Diamant*, 518 N.E.2d 1154 (Mass. 1988).
- **Exceptions**:
  - pure emotional distress claims may constitute "bodily injury" where policy defines "bodily injury" to include mental distress or mental anguish.
  - Also, a handful of jurisdictions allow coverage for emotional distress without physical manifestations.

Monitoring Coverage Issues

Bodily Injury

- **Medical monitoring/fear of injury claims**: Most jurisdictions reject coverage for medical monitoring or fear of injury claims, absent physical injury. *Aim Insurance Co. v. Culcasi*, 229 Cal.App.3d 209 (1991); *Allstate Ins. Co. v. Diamant*, 518 N.E.2d 1154 (Mass. 1988).
- **Exception**:
  - A published opinion from a Pennsylvania superior court held that a liability policy's "bodily injury" coverage is triggered as long as the insured faces bona fide liability exposure for "fear of injury" or medical monitoring claims.

First – Party Coverage Issues

Monitoring Coverage Issues

Direct Physical Loss

Significant Issue: Coverage found where a technical violation of FDA regulations does not pose a risk to human health.

- Some courts have found that products have been physically damaged where exposed to a chemical agent that is not approved for human consumption but does not pose a health threat to consumers. *Blaine Richards & Co. v. Marine Indem. Ins. Co.*, 635 F.2d 1051 (2d Cir. 1980); *General Mills v. Gold Medal Ins. Co.*, 622 N.W.2d 147 (Minn. Ct. App. 2001).

Monitoring Coverage Issues:

Direct Physical Loss

Significant Issue: Where no contamination of the insured's product has taken place, property policies do not cover economic losses caused by a product recall.

- The recent outbreak of mad cow disease in Canada in 2003 resulted in the closing of the U.S. border to the importation of beef products. The insured, a manufacturer of beef products, suffered business interruption expenses and lost profits when it could not fill orders for its beef products stuck on the Canadian side of the U.S. border. Court found that the insured was not entitled to coverage – the insured's product was not physically damaged since it was not infected with mad cow disease. *Source Food Technology, Inc. v. United States Fidelity & Guar. Co.*, 465 F.3d 834 (8th Cir. 2006).

Monitoring Coverage Issues

Direct Physical Loss

Significant issue: Is there a direct physical loss if contamination of spinach is not established for a specific bag, case, lot, etc.?

- Are mitigation or preventative measures covered if a direct physical loss is not established?
- Who has the burden of proof if the allegedly contaminated produce has been destroyed before it was tested?

Monitoring Coverage Issues

Contamination Exclusion

Significant Issue: Some courts distinguish between claims resulting from actual contamination versus suspected contamination.

- Supreme Court of Montana held that damages arising out of candy voluntarily destroyed after ***suspected*** contamination by the hepatitis virus were not excluded from coverage. As no testing was done before the inventory was destroyed, it was impossible to establish the actual contamination of the product. *Stanley Duennsing v. The Traveler's Companies*, 257 Mont. 376 (1993).

Governmental Action Exclusion

Excludes coverage for loss or damage that is caused directly or indirectly by seizure or destruction of property by order of governmental authority.

Significant Issue: A governmental agency or body must order the **actual seizure or destruction** of the property, mere compliance with a statute or regulation, voluntary action by the insured or an embargo will prevent application of this exclusion. *Townsends of Arkansas, Inc. v. Millers Mut. Ins. Co.*, 823 F.Supp. 233, 241 (D. Del. 1993); *Duensing v. Traveler's Companies*, 849 P.2d 203, 208 (Mont. 1993).

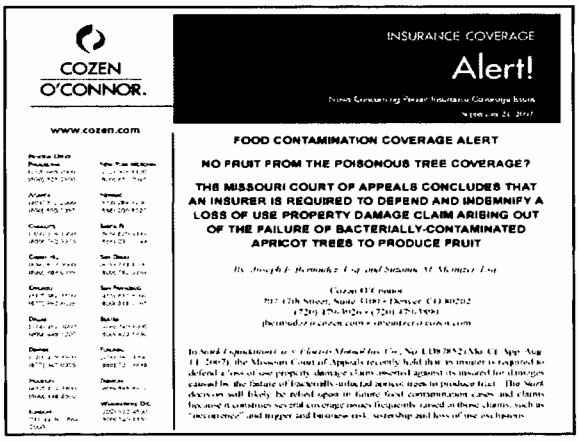
Faulty Workmanship Exclusion

Excludes coverage for losses or damages that result from error in design, faulty workmanship or faulty materials.

Significant Issue: Court refused to apply exclusion outside of construction context. *General Mills, Inc. v. Gold Medal Ins. Co.*, 622 N.W.2 147 (Minn. App. 2001).

Specialized Policies

- Although the terms of product recall policies vary widely from policy to policy, these policies generally cover the costs of inspecting, withdrawing, destroying and replacing contaminated products.
- In addition, specialty policies may provide coverage for product rehabilitation and crisis management expenses.
- Food industry specialty policies may also cover business interruption and lost profits due to the actions of food inspectors and other civil authorities. As awareness grows, the volume of specialty policies tailored to the food industry should expand.



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INSURANCE COVERAGE

Alert!

FOOD CONTAMINATION COVERAGE ALERT

NO FRUIT FROM THE POISONOUS TREE COVERAGE?

THE MISSOURI COURT OF APPEALS CONCLUDES THAT AN INSURER IS REQUIRED TO DEFEND AND INDEMNIFY A LOSS OF USE PROPERTY DAMAGE CLAIM ARISING OUT OF THE FAILURE OF BACTERIALLY-CONTAMINATED APRICOT TREES TO PRODUCE FRUIT

THANK YOU

GO ROCKIES!!!!

FOOD CONTAMINATION INSURANCE COVERAGE ISSUES: AN INSURER'S PERSPECTIVE

By:
Thomas M. Jones
Joseph F. Bermudez
Jennifer M. Bozeat
Kendall R. Kelly
Suzanne M. Meintzer

Reflecting Cases Decided as of October 1, 2007

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I. Introduction

It seems that it is difficult to turn on the television or open a newspaper without reading about another story of contaminated food. Recent multi-state, international recalls of *Escherichia coli* ("E. coli") and Salmonella contaminated produce in 2006 and 2007 highlight the countless examples of the widespread impact of food contamination claims in our modern, industrialized society. In late September 2007, over twenty-one million pounds of ground beef were recalled and linked to illnesses in several states.

While the number of foodborne pathogens identified continues to increase, the number of foodborne illnesses reported is steadily decreasing. Even though the number of foodborne-illness cases is declining, large-scale outbreaks continue to occur. It is estimated that approximately one out of every four Americans suffers from some form of foodborne illness every year. In 2003, a Hepatitis A outbreak originated from a single location of a national restaurant chain, Chi-Chi's, just outside of Pittsburgh, Pennsylvania, and led to more than 600 illnesses, including several deaths, from customers eating green onions. Given the increasing litigiousness of Americans, we can expect that even as the number of foodborne illnesses continues to decrease, the ultimate money paid out for both informal claims and litigated suits related to food contamination will continue to increase.

Historically, the growth and distribution of produce was the business of small, family-owned farming operations. With the advent of "big business" and the steady decline of "mom and pop operations," the food production and distribution process has become increasingly and overwhelmingly centralized. Individual large-scale growers provide produce that may ultimately be distributed to dozens of states across the country. Simultaneously, the Country's food supply chain has become dangerously extended through globalization, offshoring and outsourcing. The ramifications are simple and frightening. A single outbreak of contaminated produce from one grower's crop, manufactured in one state but shipped to multiple states, can potentially sicken people in every state in which that product is distributed. This reality, coupled with consumers' eating patterns toward more imported foods as well as processed foods sold by fast food and national restaurant chains is a recipe for potentially catastrophic losses stemming from foodborne illnesses.

The anticipated future loss scenarios from foodborne illnesses beg the obvious and glaring question – who is going to pay for these losses? Consumers sickened by foodborne illnesses may be entitled to monetary damages to compensate them for their injuries, which may range anywhere from stomach ache to death. Moreover, because the elderly and young children tend to be the most adversely affected by certain strains of bacterial and viral contaminations, these lawsuits will be emotionally charged, thereby increasing the risk of substantial jury awards.

Bodily injuries aside, there are enormous financial losses that result from any significant food recall. Once a recall is issued, the recalled product must be removed from shelves, transported and destroyed. Notices informing the public of the recall may have to be issued and distributed. Consumer refunds may also be issued. Additionally, costs may be incurred to rehabilitate a brand's reputation. Various entities in the distribution chain may lose anticipated profits. Depending on the recall's scope and the economic viability of the impacted businesses, a product recall can financially ruin a business. For instance, according to the U.S. Centers for Disease Control ("CDC"), medical costs and lost wages due to foodborne salmonellosis, only one of many foodborne infections, have been estimated to be more than $1 billion per year.

Given the reach of potential food contamination claims such as the recent spinach, bagged salad and ground beef outbreaks, potential targets for liability may include a broad range of businesses, beginning with growers and ranchers to fertilizer manufacturers and feed distributors and continuing through packagers, distributors and shippers and ending through points of sale, such as food processors, retail markets, restaurants and caterers.

All hope is not lost for businesses involved in the food industry. Companies can purchase insurance to defray the costs and expenses associated with product recalls. Liability policies may pay for defense costs and indemnity exposure with respect to the companies' liability to others. Companies may also purchase policies for the costs associated with losses to their own assets – property policies. Additionally, the availability of specialized policies is growing. Specialized policies, such as product recall and trade disruption policies, may supplement the coverage provided by standard liability and property policies.

II. Commercial General Liability Coverage

The Insuring Agreement in standard Commercial General Liability ("CGL") policies provides that an insurer "will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies." Standard commercial general liability policies define "property damage" as:

> (1) Physical injury to tangible property including all resulting loss of use of that property; or
>
> (2) Loss of use of tangible property that is not physically injured.

"Bodily injury" is typically defined as "bodily injury, sickness or disease."

A. Property Damage

Although bodily injury claims stemming from food contamination events are more widely publicized in the press, large-scale food contamination cases also result in enormous *economic* losses to multiple parties in the product's supply chain. Product manufacturers, growers, ranchers, feed processors, packagers, distributors and retailers can suffer heavy financial losses resulting from significant product recalls and financial losses can result in litigation between the various companies involved in the manufacture, distribution and sale of the contaminated product. Clearly, such economic loss claims do not stem from "bodily injury." However, depending on the underlying facts, these claims may fall within a third-party liability policy's "property damage" coverage. In other words, the economic loss claims may include allegations of "physical injury to tangible property" or "loss of use of tangible property that has not been physically injured."

At least one court has held in the third-party liability context that the "physical injury" requirement is met where the food product is only in technical violation of U.S. Food and Drug Administration ("FDA") regulations, but is still fit for human consumption. In *United Sugars Corp. v. St. Paul Fire & Marine Ins. Co.*, No. A06-1933, 2007 WL 1816412 (Minn. Ct. App. June 26, 2007, the Minnesota Court of Appeals applied the definition of "physical damage" previously used in a first-party property policy case, *General Mills, Inc. v. Gold Medal Ins. Co.*, 622 N.W.2d 147 (Minn. Ct. App. 2001). In *General Mills*, the Food and Drug Administration found traces of a chemical that was not harmful to consumers in cereal produced by oat stocks, but that had not been approved for use on oats. *General Mills*, 622 N.W.2d at 150. Although the insurer argued that there was no "physical damage" because the cereal could be safely consumed, the court disagreed, reasoning that "direct physical loss can exist without actual destruction of property . . . it is sufficient to show that the insured property is injured in some way." *Id.* at 152. The court concluded that the fact that the cereal could not be legally sold was sufficient to support a finding of physical damage. *Id.*

In *United Sugar*, despite the insurer's objections that *General Mills* involved a first-party property policy and not a third-party liability policy, the Minnesota Court of Appeals applied the *General Mills* definition of "physical damage" and held that "an adulterated food product can be deemed physically damaged because it is legally unsaleable." *United Sugar*, 2007 WL 1816412 at *3.

Where the policyholder's defective product has been incorporated into another product, the majority of jurisdictions have held that the *mere incorporation* does not amount to "property damage" under a CGL policy. *Diamond State Ins. Co. v. Chester-Jensen Co.*, 611 N.E.2d 1083 (Ill. App. Ct. 1993) (mere inclusion of a defective component, where no physical harm to the other parts results therefrom, did not constitute "property damage" within the meaning of an insurance policy); *New Hampshire Ins. Co. v. Vieira*, 930 F.2d 696 (9th Cir. 1991) (insurance

covering physical injury to tangible property does not cover diminution of value resulting from the installation of a defective product); *Aetna Life and Cas. Co. v. Patrick Indus. Inc.*, 645 N.E.2d 656 (Ind. Ct. App. 1995) (the concept of incorporation should not be extended so that physical injury will be deemed to occur every time a defective component is integrated into another's tangible property).

In contrast, a California appellate court has held that the incorporation of a defective product into a separate uncontaminated product may result in "physical injury" to the product into which the defective product is incorporated. *Shade Foods Inc. v. Innovative Prods. Sales & Marketing Inc.*, 93 Cal. Rptr. 2d 364 (Cal. Ct. App. 2000). In *Shade Foods*, the insured processed and supplied nut clusters to General Mills to be added to breakfast cereals. Wood splinters were discovered in the diced almonds supplied by the policyholder, resulting in the shutdown of General Mills' production and the destruction of cereal boxes at its facilities. The court rejected the insurer's argument that General Mills' claims were limited to economic loss claims, and held that the presence of wood splinters in the almonds caused "property damage" to the nut clusters and cereals into which they were incorporated. *See also Zurich American Ins. Co. v. Cutrale Citrus Juices USA, Inc.*, No. 00-CV-149, 2002 WL 1433728 at *3-4 (M.D. Fla. 2002) (holding that accidental introduction of the insured's contaminated juice products into the claimant's own juice products constituted a physical event that causes injury or damage); *National Union Fire Ins. Co. of Pittsburgh, PA v. Terra Indus., Inc.*, 216 F. Supp. 2d 899, 917-18 (N.D. Iowa 2002) (same).

A related issue is the limitation of property damage coverage to injury "because of . . . property damage" as required by CGL policies. This issue may be particularly relevant in light of the fact that pure economic loss, by itself, does not amount to covered "property damage." *McLaughlin v. National Union Fire Ins. Co.*, 23 Cal. App. 4th 1132 (Cal. Ct. App. 1994). It is widely agreed that pure economic loss claims, such as lost profits, loss of goodwill or loss of the benefit of a bargain, do not constitute "property damage." This is so because pure economic loss is not physical injury to or loss of use of tangible property. However, some courts have strained to find property damage coverage for economic loss claims in the food contamination context. For instance, in *United States Fire Ins. Co. v. Good Humor Corp.*, the insured manufacturer recalled contaminated ice cream, causing financial loss to one of the policyholder's customers. In the resulting coverage litigation, the court held that the customer's loss of use of storage space from having to store the recalled ice cream was potentially a loss of use of tangible property (the tangible property being the storage space) and not a mere economic loss. *United States Fire Ins. Co. v. Good Humor Corp.*, 496 N.W.2d 730 (Wis. Ct. App. 1993); *see also Stark Liquidation Co., v. Florists' Mut. Ins. Co.*, No. ED87852, 2007 WL 2317140 (Mo. App. E.D. Aug. 14, 2007)(coverage found for damages caused by failure of bacterially-infected apricot trees to produce fruit); *Hendrickson v. Zurich Am. Ins. Co.*, 72 Cal. App. 4th 1084 (Cal. Ct. App. 1999) (loss of strawberry production after

herbicide drifted onto grower's fields constituted a covered loss of use of the growers' land).

B. Bodily Injury

Many standard liability policies define the term "bodily injury" as "bodily injury, sickness or disease." The majority of courts have interpreted this definition as requiring that the claimant suffer actual physical injury before coverage is triggered. *Aim Ins. Co. v. Culcasi*, 280 Cal. Rptr. 2d 766 (Cal. Ct. App. 1991) ("overwhelming majority" of courts have held that emotional distress claims do not constitute bodily injury under a liability policy); *Allstate Ins. Co. v. Diamant*, 518 N.E.2d 1154 (Mass. 1988) (bodily injury is narrow term and encompasses only physical injuries to the body and the consequences thereof). In other words, the term "bodily injury" in a liability policy does not include coverage for emotional distress in the absence of physical injury. *Id.*

It should be noted, however, that the physical injury requirement is most likely inapplicable where the policy defines "bodily injury" as "injury, sickness or disease" instead of "bodily injury, sickness or disease." Moreover, the physical injury requirement is inapplicable where "bodily injury" is defined by the policy, in part, as emotional distress or mental anguish.

With respect to policies that define "bodily injury" as "bodily injury, sickness or disease," there is little dispute that the claims of consumers who have ingested contaminated food products and suffer resulting physical injury, ranging from stomach ache to death, are sufficient to trigger "bodily injury" coverage under a liability policy. However, in widespread food contamination cases in which many claimants are potentially exposed to the contaminated product, the class of claimants will frequently include individuals who have not suffered actual bodily injury, but instead allege emotional distress or fear that they will develop bodily injury in the future from exposure to the contaminated foods. Generally, "bodily injury" coverage under a liability policy requires bodily injury in the physical sense (as opposed to mental injury or distress). The majority of courts to address this issue have held that pure emotional distress claims, such as claims alleging fear of future injury, do not constitute "bodily injury" covered under a liability policy. *Aim Ins. Co. v. Culcasi*, 280 Cal. Rptr. 2d 766 , *supra*; *Allstate Ins. Co. v. Diamant*, 518 N.E.2d 1154, *supra*.

With respect to underlying food contamination liability claims, some courts have held that a company's potential liability for bodily injury extends not only to present injury claims, but to plaintiffs' concerns about the risk of future injury. *Norfolk & W.Ry.Co. v. Ayers*, 538 U.S. 135 (2003); *Redland Soccer Club v. Dep't of the Army*, 55 F.3d 827 (3rd Cir. 1995). In response to this potential liability exposure, at least one insurance coverage opinion has found "bodily injury" liability coverage for "fear of injury" or medical monitoring damages. This court reasoned that as long as the insured faces bona fide tort liability for claims for

"fear of injury" damages or medical monitoring, a liability policy's bodily injury coverage will apply. *Techalloy Co., Inc. v. Reliance Ins. Co.*, 487 A.2d 820 (Pa. Super. Ct. 1984).

C. Occurrence

1. Accident Requirement

Most standard ISO CGL forms define "occurrence" as "an accident, including repeated exposure to substantially the same general harmful conditions." An accident, according to the majority of courts that have addressed this issue, is an unanticipated event or an unknown contingency. *High Country Assoc. v. New Hampshire Ins. Co.*, 648 A.2d 474, 474 (N.H. 1994). In analyzing the existence of an "occurrence," a growing majority of courts have held that an insured's defective work and/or product, by itself, does not constitute an accident under a liability policy. *Jakobsen Shipyard Inc. v. Aetna Cas. And Sur. Co.*, 961 F.2d 387, 389 (2d Cir. 1992) (New York law) (faulty steering on tugboats was the result of faulty workmanship; no occurrence where there was no unknown or remote cause and no unexpected external force); *Hawkeye-Security Ins. Co. v. Vector Construction Co.*, 560 N.W.2d 329, 334 (Mich. Ct. App. 1990) (defective workmanship standing alone is not the result of an occurrence); *U.S. Fid. & Guar. Corp. v. Advance Roofing & Supply Co.*, 788 P.2d 1227, 1233 (Ariz. Ct. App. 1989) (insurer is not guarantor of insured's performance of contract).

One of the seminal cases reflecting the view that a faulty product or workmanship is not an accident is *Weedo v. Stone-E-Brick Inc.*, 405 A.2d 788 (N.J. 1979). In *Weedo*, the New Jersey Supreme Court addressed whether a property owner's complaint for unworkmanlike performance of a construction contract triggered coverage under a liability policy. In short, the court held that a CGL policy "does not cover an accident of faulty workmanship, but rather faulty workmanship which causes an accident." In support of its holding, the *Weedo* court reasoned that there is a moral hazard in providing liability insurance coverage for the repair or replacement of faulty workmanship or a faulty product, as the insured would have little or no incentive to perform or produce in a workmanlike manner. It appears that the court's ruling in *Weedo* represents the majority view on this issue. As such, in most jurisdictions there would be no coverage for third party contaminated food claims where the third party only alleges damages resulting from the insured's allegedly defective work and/or product.

In *Atlantic Mutual Ins. Co. v. Hillside Bottling Co.*, 903 A.2d 513 (N.J. Super. Ct. App. Div. 2006), the court relied upon *Weedo* and concluded that a bottling company's faulty work in the preparation of carbonated beverages contaminated with ammonia did not fall within the coverage provided to the bottling company. *Hillside*, 903 A.2d at 518-20. Hillside Bottling Company ("Hillside") produced and bottled soft drinks for various customers. *Id.* at 515. Hillside's customers provided Hillside with flavorings and sugar, and Hillside itself provided other

ingredients such as carbon dioxide. *Id.* During the bottling process, Hillside used an ammonia gas-refrigerated device, which cooled the beverages and added carbon dioxide to them to create carbonation. *Id.* One of Hillside's customers discovered that its soft drink product was contaminated with ammonia and three customers eventually recalled all beverage products produced at the Hillside facility. *Id.*

The customers demanded that Hillside indemnify them for all costs related to the recall, and one of the customers filed suit against Hillside. *Id.* Hillside in turn tendered the claims to Atlantic Mutual Insurance Company ("Atlantic Mutual"), which responded that its coverage obligation was limited to the amount provided in a product recall endorsement. *Id.* at 516. Atlantic Mutual paid the amount afforded under the endorsement, and then brought a declaratory action seeking a determination that it was not obligated to defend Hillside, or to cover any of Hillside's costs or losses, in excess of the endorsed amount. *Id.* Although the trial court concluded that the Atlantic Mutual policy did cover the claims asserted against Hillside, and that Atlantic Mutual was required to defend them, the appellate court disagreed, relying upon the reasoning in *Weedo*. *Id.* at 518-20. In concluding that the *Weedo* doctrine barred coverage under the policy, the appellate court reasoned that Hillside was responsible for mixing the carbon dioxide into beverages and it was during this step that the beverages became contaminated with ammonia. *Id.* at 519-20. Thus, the court concluded that Hillside's work mixing the beverages was defective, and that because Hillside was seeking coverage for its own faulty work, the claims were not covered under the policy. *Id.* at 520.

Unlike the *Hillside* court, the court in *Naumes, Inc. v. Chubb Custom Ins. Co.*, No. 05-1327-HA, 2007 U.S. Dist. LEXIS 1292 (D. Or. Jan. 5, 2007), concluded that an insured's "erroneous introduction of a premix containing substances banned in the market for which the product was intended" was an occurrence that led to the destruction, and loss of use, of tangible property. *Naumes*, 2007 U.S. Dist. LEXIS 1292 at *13-14. Naumes, Inc. ("Naumes") provided concentrated diet drink mixes to a customer that required the concentrate to conform to Japanese food and drug regulations. *Id.* at *3. The Japanese regulations required that the drinks contain neither biotin nor Vitamin E, and when Japanese authorities compelled a recall of the drinks because they contained both, the insured's customers sued the insured for delivering a non-conforming product. *Id.* at *3-4.

Naumes tendered the defense of its customer's claims to Chubb Custom Insurance Company ("Chubb"), which disclaimed any obligation to defend Naumes. *Id.* at *1. The court reasoned that the mistaken introduction of the biotin- and Vitamin E-containing mix was an unexpected consequence that led directly to the loss of the customer's product. *Id.* at *12-14. Thus, there was an "occurrence" as defined in the policy, and the court concluded that Chubb was required to defend Naumes. *Id.*

Similarly, in *Zurich American Ins. Co. v. Cutrale Citrus Juices USA, Inc.*, *supra*, the court held that adulteration of an insured's juice product constitutes an "occurrence" when the claimant uses the adulterated product in the claimant's own juice products. *Cutrale*, 2002 WL 1433728 at *3, supra; *see also Terra Indus., Inc.*, 216 F. Supp. 2d. at 918-19, *supra* (same).

2. Number of Occurrences

Liability policies generally restrict the amount of coverage available under the policy by means of a per occurrence limit (the most the insurer will pay for a single accident) and an aggregate limit (the most the insurer will pay for all accidents covered under the policy during a specific policy period.).

The determination of the number of occurrences in any given claim can have substantial monetary ramifications. Using the recent E. coli outbreak, which stemmed from fresh bagged salad as an example, the number of occurrences will eventually be a critical issue as claims are adjusted over the next several years. We assume, for the sake of this example, the grower has a single commercial general liability policy issued to it for the 2007 policy period with limits of $1 million per occurrence and $5 million aggregate. If a court determines that the "occurrence" was the cultivation process of the insured's contaminated product, the coverage available to the insured may be limited to the single limit of $1 million. If a court determines that the occurrence is the exposure of the consumers to the E. coli-contaminated spinach, then each injured claimant may trigger a separate occurrence and, as a result, the coverage available to the insured would be a maximum of $5 million – the aggregate limit. In this example, the difference between a single occurrence finding and a multiple occurrence finding is a hefty $4 million (the difference between the $5 million aggregate limit and the single $1 million per occurrence limit).

The vast majority of judicial authority determines the number of occurrences in a liability policy by examining the *cause* of the loss rather than the *effect*. Although this sounds simple enough, determining the precise cause of an insured loss is often a complicated analysis driven by the desired result – i.e., in many cases, the court's desired result may be to maximize coverage. Since a finding of multiple occurrences often results in more coverage being available to the insured for its liability, it is not unusual to see a court analyze the facts of any given claim in such a way as to find more than one occurrence. For instance, where multiple customers of a restaurant were infected with botulism from contaminated onions, the court found that the liability-causing conduct was the serving of the onions to the customers, not the preparation of the onions prior to serving. As such, the serving of the customers to each individual customer constituted a separate occurrence. *Mason v. The Home Ins. Co. of Ill.*, 532 N.E.2d 526 (Ill. App. Ct. 1988); *see also Michigan Chem. Corp. v. American Home Assurance Co.*, 728 F.2d 374 (6th Cir. 1984) (Where the insured mistakenly shipped toxin-containing flame retardant to its customers, instead of a livestock feed supplement, resulting

in the destruction of over 40,000 animals, the court held that each shipment of the flame retardant, not the number of claimants, constituted a separate occurrence).

In contrast to the *Mason* case, in *Fireman's Fund Ins. Co. v. Scottsdale Ins. Co.*, 968 F.Supp. 444 (E.D. Ark. 1997), the insured operator of a Taco Bell franchise was sued after several of its customers were infected with the Hepatitis A virus after eating contaminated meat. The court was asked to determine whether the alleged acts of food poisoning constituted a single occurrence or whether each separate case of food poisoning constituted a separate occurrence. Scottsdale, the primary insurer, argued that the accident causing the resulting injuries was the improper preparation and/or storage, handling, etc. of the food, and that this should have been regarded as having "occurred" once. Therefore, Scottsdale argued, it was irrelevant how many customers became ill upon consuming the food. A finding of a single occurrence would have limited Scottsdale's exposure to a single per occurrence limit of $1 million. The excess insurer, Fireman's Fund, argued that each sale of the contaminated meat was a separate occurrence and that the improper handling, preparation, or storage of food, by itself, was not injurious to anyone and thereby did not subject the insured to potential liability until the meat was actually served to the public. According to Fireman's Fund's argument, it was the *sale* of the meat which potentially triggered the insured's liability and, therefore, every sale resulting in injury constituted a separate occurrence. A finding of multiple occurrences would have increased the exposure of the primary insurer from $1 million to $2 million, thereby decreasing the excess insurer's exposure by $1 million. Without much discussion, the *Fireman's Fund* court held that multiple sales of contaminated meat at one restaurant was the result of a single occurrence.

It is difficult to predict how any court will interpret the number of occurrences analysis with respect to any given food contamination claim. Even where a court limits its analysis to determining the *cause* of the loss instead of the *effect*, such court may look to the cause of the underlying *injury* or, in the alternative, the cause of the insured's *liability*. Often, the cause of the underlying injury may be a single occurrence related to the growth or manufacturing process. In contrast, the cause of the insured's *liability* may frequently be related to the frequency of exposure or the number of claimants who are exposed. In such cases, multiple occurrences may be found.

D. Pollution Exclusion

Once an insured has established the applicability of a liability policy's "bodily injury" or "property damage" coverage, the coverage inquiry does not end. There are multiple policy exclusions in a liability policy that may have an impact on the ultimate coverage determination.

For example, many liability policies contain pollution exclusions that generally preclude coverage for "bodily injury" or "property damage" arising out of the actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of "pollutants." "Pollutants" are generally defined to include "any solid, liquid, gaseous or thermal irritant or contaminant, including . . . waste." There are various types of food contaminants and various sources for such contamination. Whether or not the pollution exclusion is applicable in any given coverage evaluation will depend upon the specific facts underlying the claim. One of the more notorious sources of contamination that has received significant publicity in the last decade is E. coli bacteria. In the recent spinach outbreak emanating from crops in California's Central Valley, the E. coli contamination was caused by the release of animal waste during the growth and irrigation process. In many cases, animal waste may meet a liability policy's definition of "pollutant." Furthermore, E. coli bacteria itself may constitute a "pollutant." With respect to the discharge, dispersal or release, etc. element of the pollution exclusion, the discharge may be the irrigation of the contaminated produce with contaminated water or the spreading of fertilizer.

Courts in general are divided on the applicability of the pollution exclusion outside of industrial pollution context. There are few cases addressing the pollution exclusion in the food contamination setting. However, it should be noted that at least one state court has rejected the application of the pollution exclusion in the food contamination setting. See *Keggi v. Northbrook Prop. & Cas. Ins. Co.*, 13 P.3d 785 (Ariz. Ct. App. 2000). In *Keggi*, the claimant brought suit against the insured after she drank water contaminated with fecal coliform bacteria and became very ill. The trial court had granted summary judgment in favor of the insurer on the basis of the pollution exclusion. The appellate court reversed the trial court's ruling, however, and held that the pollution exclusion was inapplicable. The liability policy at issue in *Keggi* included fairly standard pollution exclusion language which defined the term "pollutant" as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste."

With respect to whether the fecal coliform bacteria constituted an "irritant" or "contaminant," the *Keggi* court noted that the policy limited its exclusion to "irritants" or "contaminants" that are "solid, liquid, gaseous or thermal." The court further opined that ["(t])o the extent that [the fecal coliform] bacteria might be considered 'irritants' or 'contaminants', they are *living*, *organic* irritants or contaminants which defy description under the policy as 'solid,' 'liquid,' 'gaseous,' or 'thermal' pollutants." *Id.* at 789 (emphasis in original). In addition, the court noted that the pollution exclusion delineated the types of contaminants or irritants included within the definition of "pollutants" to include "smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste." These enumerated items, according to the *Keggi* court, are primarily *inorganic* in nature and, therefore, the fecal coliform bacteria, as a *living organism*, is not similar to the exclusion's enumerated list. *Id.* at 790. Based on this reasoning, the court concluded that the

"plain language of the pollution exclusion does not include . . . fecal coliform bacteria within the definition of 'pollutants.'" *Id.* Thus, the pollution exclusion did not apply to preclude coverage for the claimant's injuries.

The applicability of the pollution exclusion will vary from case to case. The first issue that should be examined is whether the food contamination at issue involves a "pollutant" (as that term is defined in the policy) that has been discharged or released as required by the pollution exclusion. If that requirement has been met, the applicability of the pollution exclusion will likely depend upon what jurisdiction(s) is involved. In those states that have narrowly construed pollution exclusions and limited their applicability to "traditional" environmental pollution claims, it is likely that the pollution exclusion will not apply. *American States Ins. Co. v. Koloms*, 687 N.E.2d 72 (Ill. 1997) (court found that accidental release of carbon monoxide due to the fact that subject furnace was broken did not constitute the type of environmental pollution contemplated by the absolute pollution exclusion in a liability policy).

In contrast, a number of jurisdictions look to the "plain meaning" of the pollution exclusion and bar coverage for pollution claims regardless of whether the claim involves traditional environmental damages. *Technical Coating v. U.S. Fid. & Guar. Co.*, 157 F.3d 843 (11th Cir. 1998) (applying Florida law) (absolute pollution exclusion unambiguously excluded coverage for bodily injuries sustained by breathing vapors emitted from insured's roofing products); *Certain Underwriters at Lloyd's v. C.A. Turner Const.*, 112 F.3d 184 (5th Cir. 1994) (applying Texas law)(pollution exclusion did not limit its application to only those discharges causing environmental harm; in contrast, it speaks broadly of "liability for *any* bodily or personal injury." "This language is not ambiguous; a plain reading of the clause dictates the conclusion that all damage caused by pollution, contamination, or seepage is excluded from coverage."); *The Cincinnati Ins. Co. v. Becker Warehouse, Inc.*, 635 N.W.2d 112 (Neb. 2001) (where claimants' food products were contaminated by xylene fumes from a concrete floor sealant, court applied the pollution exclusion to preclude coverage and rejected insured's argument that pollution exclusion only applies to "traditional environmental pollution claims").

E. Work/Product Exclusions

Most standard CGL policies exclude coverage for property damage to the insured's work as well as property damage to the insured's product. Commercial liability policies are not designed to provide insureds with coverage against claims their work is inferior or defective. The risk of replacing and repairing defective products has generally been considered a *commercial* or *business risk* that is not passed on to the liability insurer. Rather, liability coverage comes into play when the insured's defective product or work causes injury to property other than the insured's own work or products (i.e., third-party property damage).

In light of the nature of food contamination claims, the work/product exclusions are frequently at issue. The applicability of the work/product exclusions is extremely fact sensitive. Practically speaking, costs that are associated merely with the repair or replacement of the insured's defective work or product are not covered by a liability policy.

In the food distribution process, there are many individual links to the chain of distribution. Claims against insured entities that supply one ingredient to a larger contaminated product are not excluded from coverage by the product exclusion as the contaminated product (the larger product into which the supplier's smaller product was incorporated) is not the insured supplier's product. *Olympic Steamship Co. v. Centennial Ins. Co.*, 811 P.2d 673 (Wash. 1991) (product exclusion inapplicable where the insured warehouser simply affixed packer-supplied labels to cans of salmon and boxed the cans using its own casing equipment – court held that exclusion was inapplicable since the insured simply provided a service and was not the "manufacturer" of the product).

On the other hand, the costs associated with repairing or replacing a product manufactured or grown by the insured are excluded from coverage. *Nu-Pak, Inc. v. Wine Specialties Int'l Ltd.*, 642 N.W.2d 848 (Wis. Ct. App. 2002); *see also Hartog Rahal P'ship v. American Motorists Ins. Co.*, 359 F. Supp. 2d 331 (S.D.N.Y 2005) (juice concentrate adulterated with a safe, but artificial, sweetener constituted the insured's product, and was, therefore, excluded from coverage through application of the "your product" exclusion). In the *Nu-Pak* case, the claimant, Wine Specialties, had developed a freezable alcoholic beverage to be packaged and sold to consumers. Under the terms of a written contract, the insured entity, Nu-Pak, agreed to mix and package the product with ingredients provided by Wine Specialties. Nu-Pak sued Wine Specialties in response to a billing dispute. Wine Specialties brought a cross-complaint against Nu-Pak alleging that quality control problems at Nu-Pak lead to the improper formulation of the product which made it unfit for human consumption. Wine Specialties also brought a third party complaint against Nu-Pak's general liability insurer, alleging its claim against Nu-Pak was covered under Nu-Pak's CGL policy. The appellate court in *Nu-Pak* applied the "your product" exclusion and held that there was no coverage for the claim for damage to the goods and/or products manufactured by Nu-Pak. In addition, the court held that the product exclusion precluded coverage for the cost of removing the contaminated product, the value of lost future sales and profits, and the damage to the reputation of Wine Specialties. These damages, according to the court, were incidental to excluded property damage and did not constitute damage to *other* property.

Another interesting case examining the applicability of the product exclusion is the Wisconsin Court of Appeal's opinion in *Holsum Foods Division v. Home Ins. Co.*, 469 N.W.2d 918 (Wis. Ct. App. 1991). In *Holsum*, the policy barred coverage for "property damage to the named insured's products arising out of such products or any part of such products." Holsum had manufactured and

packaged barbeque sauce. The ingredients, jar, label and cap were supplied by the licensor. However, Holsum mixed the ingredients, added a sweetener it supplied, cooked the mix, and put it into jars, which were then packed into cases and stored until shipment. During the bottling process, a filler tube struck the inside of the jars, breaking glass chips into the jars; eventually, glass chips were discovered in two to three percent of the jars. The entire lot of barbeque sauce was destroyed because there was no way to determine which jars contained glass chips. The coverage issue in *Holsum* turned on whether the barbeque sauce was Holsum's product or whether Holsum had provided a service that damaged the product owned by the licensor. Because Holsum provided one ingredient and cooked and mixed all the ingredients together, the court found that the barbeque sauce was Holsum's product. As such, the product exclusion precluded coverage.

And in *Lowville Producer's Dairy Coop., Inc. v. Am. Motorists Ins. Co.*, 604 N.Y.S.2d 421 (N.Y. App .Div. 1993), a dead mouse was found in the hose leading from a milk truck to a storage silo. The court found that the cost of milk itself (the insured's product) was excluded from coverage on the basis of the product exclusion, but the cost of cleaning the silo was covered because the silo was the property of an injured third party, in that the silo was rendered unclean from the contaminated product. Similarly, in *L.D. Schreiber Cheese Co. v. Standard Milk Co., Inc.*, 457 F.2d 962 (8th Cir. 1972), the court also applied a narrow interpretation of the "your product" exclusion. *Schreiber Cheese*, 457 F.2d at 966-68. There, the claimant sought recovery of expenses it had incurred in testing 4 million pounds of cheese for enterotoxin, a poisonous bacterial by-product. *Id.* at 963. Only about three percent of the cheese was actually contaminated and the claimant sold the remainder. *Id.* at 967. The court held that the "your product" exclusion precluded coverage for the contaminated cheese, but not for the good cheese. *Id.* at 967-68. Reasoning that the entire amount of cheese should not be considered one product, the court concluded that the policy provided coverage for the claimant's costs incurred in testing the good cheese. *Id.*

The critical question is this: Is the damaged property the insured's product? If the answer is yes, the work/product exclusions apply to preclude coverage. If the answer is no, it is likely that the work/product exclusions are inapplicable.

F. Impaired Property Exclusion

Impaired property is typically defined in liability policies as tangible property, other than the insured's work or product, that cannot be used or is less useful because it incorporates the insured's work or product that is known or thought to be defective or deficient, if such property can be restored to use by the repair, replacement or removal of the insured's product. The impaired property exclusion reflects the principle that the risk of replacing or repairing a defective product is considered a commercial risk that is not passed on to a liability insurer. *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal. App. 4th 847 (Cal. Ct. App. 2000). The majority of courts strictly construe the

impaired property exclusion, requiring that an insurer show that every element of the exclusion is satisfied before a court will apply the exclusion to preclude coverage for a claim. For instance, where the insured's product can be salvaged, but not restored to use by the repair or replacement of a defective component, the impaired property exclusion does not apply. *Id.* at 867; *see also Naumes*, 2007 U.S. Dist. LEXIS 1292 at *14-15, *supra* (the impaired property exclusion is inapplicable when there was no evidence that the claimant's product could be restored to use by the repair or replacement of the insured's defective product or work). Additionally, the impaired property exclusion will not apply to exclude coverage if the "impaired product" is physically injured. *See Mullins' Whey, Inc. v. McShares, Inc.*, No. 04-C-0130, 2005 WL 1154281 at *3 (E.D. Wis. 2005) (coverage for damages to the claimant's food product, which was ruined as the result of using the insured's benzene-contaminated whey protein, was not excluded through application of the impaired property exclusion); *Cutrale*, 2002 WL 1433728 at *5, *supra* (same).

As with the other business risk exclusions, such as the work and product exclusions discussed above, the impaired property exclusion may have application to food contamination claims, but that application would only be in instances in which there was no physical injury to a third party's tangible property. Instead, a defective condition of the insured's product must have caused a loss of use of the property of a third party, but that property must still be restorable to use by the removal of the insured's work or product.

G. Sistership Exclusion

The product recall exclusion typically included in general liability policies is commonly referred to as the "sistership" exclusion. The "sistership" exclusion derives its name from an occurrence in the aircraft industry where all airplanes of a certain make and type were grounded by an order of the Civil Aeronautics Administration because of a defect and others were suspected of having a common structural defect. The damages arising out of the grounding of all "sister ships" were enormous.

Although there are various versions of the sistership exclusion in liability policies, the exclusion generally excludes coverage for property damage claims for the withdrawal, repair or replacement of the insured's work or product if such product or work is withdrawn from the market or from use because of a suspected defect or deficiency in the product.

The focus of most coverage litigation addressing the sistership exclusion is on the withdrawal element of the exclusion. A frequently contested issue is whether the sistership exclusion applies to the withdrawal and recall of defective products by the named insured only or whether the exclusion extends to the claimant's recall of the insured's work or product. The majority of courts hold that the sistership exclusion applies exclusively to claims involving recalls by the named insured.

U.S. Fire Ins. Co. v. Good Humor Corp., 496 N.W.2d 730, 738 (Wis. Ct. App. 1993) (sistership exclusion did not apply when the manufacturer of ice cream contaminated with *Listeria monocytogenes* was sued by retailer of the contaminated ice cream where the retailer, not the manufacturer, had recalled the product); *Thomas J. Lipton, Inc. v. Liberty Mutual Ins. Co.*, 357 N.Y.2d 705; 314 N.E.2d 37 (1974); *Elco Indus. Inc. v. Liberty Mut. Ins. Co.*, 414 N.E.2d 41 (Ill. App. Ct. 1980); *Olympic Steamship Co. v. Centennial Ins. Co.*, 811 P.2d 673 (Wash. 1991) (en banc) (sistership exclusion does not apply where third party withdraws the insured's product from the market); *cf. Mullins' Whey, Inc.*, 2005 WL 1154281 at *3, supra (sistership exclusion inapplicable when the claimant seeks recovery of damages for the recall of its own product, but not for the recall of the insured's product); *but see Hillside*, 903 A.2d at 521-23, *supra* (sistership exclusion applies to bar coverage where insured bottling company's customers recalled ammonia contaminated soft drinks); *Hamilton Die Cast, Inc. v. U.S. Fid. & Guar. Co.*, 508 F.2d 417, 420 (7th Cir. 1975) (court did not recognize third party exception to sistership exclusion).

In the *Thomas J. Lipton* case, *supra*, New York's highest court affirmed coverage for a manufacturer that had sold contaminated noodles to a soup-mix manufacturer for use in its dry-soup mixes. After discovering that some of the noodles were contaminated, the soup-mix manufacturer recalled and destroyed its inventory of finished soup mixes and sued the noodle manufacturer for reimbursement and other damages. The court held that the sistership exclusion did not clearly and unambiguously apply to bar coverage for damages as it was the soup-mix manufacturer, not the noodle maker, that issued the recall. *Id.* The court further stated that had the insured noodle maker conducted the recall, the sistership exclusion would have precluded coverage. *Id.* at 707-08.

Another area of dispute in the application of the sistership exclusion is the scope of the recall meant to be addressed by the exclusion. A majority of courts interpreting the sistership exclusion have held that the exclusion applies exclusively to market-wide recalls. Moreover, these courts have held that the repair and replacement of products that have actually failed in use, with no attempt to prevent future failures by the removal of other similar products, does not constitute a withdrawal under the exclusion. In other words, the sistership exclusion only applies to market-wide recalls, not to the partial withdrawal of individual or partial groups of defective products. *Forest City Dillon Inc. v. Aetna Cas. & Sur. Co.*, 852 F.2d 168 (6th Cir. 1988); *Fitness Equip. Co. v. Pennsylvania Gen. Ins. Co.*, 493 So.2d 1337 (Ala. 1986); *Imperial Cas. & Indem. Co. v. High Concrete Structures, Inc.*, 858 F.2d 128 (3d Cir. 1988).

One final limitation on the application of the sistership exclusion is the principal that it is directed toward excluding the costs of preventive measures and does not bar coverage for damages for actual injury or damage caused by the defect in the product. *Atlantic Mut. Ins. Co. v. Judd Co.*, 380 N.W.2d 122, 125 (Minn. 1986) (repair and replacement of products that actually failed in use, with no attempt to

prevent future failures of other similarly suspect products, does not constitute withdrawal); *Gulf Ins. Co. v. Parker Products, Inc.*, 498 S.W.2d 676 (Tex. 1973) (sistership exclusion did not apply to preclude coverage where the claimant did not allege a mere withdrawal, but instead alleged the loss of use of contaminated ice cream ingredients which were destroyed because of food flavoring that had been contaminated).

III. First Party Coverage

A. All Risk Versus Named Peril Policies

First-party policies typically cover either specific causes of loss ("named peril" policies) or all risks of physical loss ("all risk" policies) that result in physical property damage.

All-risk policies usually extend to risks not usually covered under other insurance. Recovery under an all-risk policy will, as a rule, be allowed for all fortuitous losses not resulting from misconduct or fraud, unless the policy contains a specific provision expressly excluding the loss from coverage.

In contrast, named-peril policies restrict coverage to claims stemming from certain enumerated risks.

Thus, the coverage provided by an all-risk policy is much broader than that provided by a named-peril policy.

B. Physical Damage Requirement

Both all-risk and named peril policies limit coverage to risks that result in physical property damage. In the contamination setting, the majority of courts have held that the contamination of food products meets the requirement for physical damage. *Blaine Richards & Co. v. Marine Indem. Ins. Co.*, 635 F.2d 1051 (2d Cir. 1980) (fumigation of beans with pesticide not approved for use in the United States resulted in physical damage covered by the policy).

The majority of jurisdictions in the United States have held that a product suffers "physical injury" where it is in violation of FDA regulations. Where a food product is contaminated and unfit for human consumption, many courts find the "physical injury" requirement is met. However, the "physical injury" analysis is murkier where a food product is only in *technical* violation of FDA regulations, but is still fit for human consumption and does not pose any risk of physical harm to the consuming public. Insurers have questioned whether a product has been physically injured where the consumption of the product does not pose a health threat. In response to this question, several courts have held that the "physical injury" requirement is met where the food product is only in technical violation of FDA regulations but is still fit for human consumption. *General Mills Inc. v.*

Gold Medal Ins. Co., 622 N.W.2d 147, 152 (Minn. 2001) (insured's oat product was treated with a pesticide which was in violation of FDA regulation; even though the oat product was fit for human consumption and did not pose a threat to public safety, court held that oat product was physically damaged since it was in violation of FDA regulations); *Marshall Produce Co. v. St. Paul Fire & Marine Ins. Co.*, 98 N.W.2d 280 (Minn. 1959).

Recognizing that the majority of courts to address the issue have found contaminated foods meet the physical damage requirement, the next logical question is whether there is coverage for food products that were not necessarily contaminated, but were destroyed as part of a product recall. In *S. Wallace Edwards & Sons, Inc. v. Cincinnati Ins. Co.*, 353 F.3d 367 (4th Cir. 2003), the insurer argued that the physical damage requirement in its policy was not met where the insured had not tested each item after a contamination outbreak, but instead had destroyed all of its product that was potentially exposed, despite the fact that most of its product that was tested did not show harmful concentrations of ammonia. In reviewing the insurer's coverage position, the *Wallace* court rejected the insurer's argument that the insured had failed to prove that its ham products had been physically damaged from accidental exposure to anhydrous ammonia gas. The court held that "even if the insured destroyed too much of the ham rather than examining it piece by piece to see which was discolored and which smelled of ammonia . . . no duty of minimizing damages would require (the insured) to so segregate the thousands of pieces of ham involved where there was a very real chance of risk to human health in selling the product for human consumption." *Id.* at 375.

Another relevant issue is whether the physical damage requirement is met where the insured's food product has been exposed to a chemical agent that is not approved for human consumption or is not approved for the particular food, but does not actually pose a human health threat. Under these circumstances, certain courts have found that the physical damage requirement has been met even where the product poses no human health threat. *Blaine Richards & Co. v. Marine Indem. Ins. Co.*, 635 F.2d 1051 (2d Cir. 1980); *General Mills v. Gold Medal Ins. Co.*, 622 N.W.2d 147 (Minn. Ct. App. 2001).

In contrast, where recalls impact products that are not contaminated, the physical damage or physical loss requirement in first-party policies has not been met and, therefore, there is no coverage for related economic losses. For instance, the recent outbreak of mad cow disease in Canada in 2003 caused U.S. officials to close the border to beef product imports. The insured manufacturer of beef products suffered business interruption expenses and lost profits because its product was located on the Canadian side of the border when it was closed. The court found that the insured was not entitled to coverage for its lost business income as its beef products, which were *not* infected with mad cow disease, did not satisfy the policy's physical damage requirement. *See Source Food Tech., Inc. v. United States Fid. & Guar. Co.*, 465 F.3d 834 (8th Cir. 2006).

C. Damages Covered Under First Party Policy

First-party policies are not uniformly drafted. As such, the scope and type of damages covered under a first-party policy will depend upon the precise language of the policy. However, it should be noted that the following types of damages which, as one could imagine, may be astronomical in a large-scale contamination outbreak, may be covered under a first-party policy issued to an insured in the food distribution chain.

1. Business Interruption Costs;
2. Replacement Costs/Product Refunds;
3. Lost Profits;
4. Costs Associated with Recall of Product (expenses for issuing warnings, checking the recalled product, etc.);
5. Costs to Destroy Contaminated Product; and
6. Expenses to Rehabilitate the Product's Brand Reputation.

Typically, these policies indemnify the insured for the actual cash value of the damaged materials, usually determined flexibly under what is known as the broad-evidence rule, which permits consideration of market price, replacement cost and other factors. *See Interstate Gourmet Coffee Roasters, Inc. v. Seaco Ins. Co.*, 794 N.E.2d 607 (Mass. App. Ct. 2003) (where employee's fingers were caught in a coffee-roasting plant's grinding machine, necessitating the destruction of the contaminated coffee and extensive clean up and sanitization measures, actual cash value was determined by intended selling price less unincurred packaging and delivery costs and not by cost of goods plus processing expense).

First-party property policies also may provide for mandatory or optional appraisal proceedings, where relevant experts in an arbitration-like setting determine the value of the loss (but not coverage questions such as the applicability of an exclusion). *See Merrimack Mut. Fire Ins. Co. v. Batts*, 59 S.W.3d 142 (Tenn. Ct. App. 2001). Where there is covered physical damage, first-party policies often separately provide coverage also for business interruption or lost-profits coverage stemming from a physical inability to continue to operate and for the cost of extra expenses to return the business to operation. Extra-expense coverage will reimburse the insured (subject to the policy's terms) for a variety of additional costs the insured incurs in setting up alternative facilities and the like. *See Am. Med. Imaging Corp. v. St. Paul Fire & Marine Ins. Co.*, 949 F.2d 690, 693 (3d Cir. 1991) (increased payroll for overtime, additional utility expense, alternative office space); *Charles Dowd Box Co. v. Fireman's Fund Ins. Co.*, 218 N.E.2d 64, 71 (Mass. 1996) (overtime, utility, and telephone costs); *Travelers Indem. Co. v. Pillar Friendly Ford Co.*, 512 S.W.2d 375, 377 (Tex. Ct. App. 1974) (overtime, rent for alternative office space, temporary property, cleanup expenses); *A. Miller & Co. v. Cincinnati Ins. Co.*, 577 N.E.2d 885, 887 (Ill. 1991) (overtime, additional storage and transportation costs, replacement of inventory and raw

materials used to reduce the overall loss); *Northwestern States Portland Cement Co. v. Hartford Fire Ins. Co.*, 360 F.2d 531, 533 (8th Cir. 1966) (replacement of inventory and raw materials to reduce the loss).

D. Contamination Exclusion

The applicability of exclusions to any given claim depends upon an application of the facts underlying the claim to the specific terms of the policy at issue. In the context of food contamination claims, the contamination exclusion is one of the most litigated exclusions in the first-party policy context.

The majority of courts to address the contamination exclusion have enforced the exclusion unless the facts supported the application of an exception to the contamination exclusion. For example, many contamination exclusions contain an exception for property damage resulting from an explosion. In other words, the policy will exclude coverage for property damage stemming from contamination except where the contamination results from an explosion. *American Produce & Vegetable Co. v. Phoenix Assurance Co. of New York*, 408 S.W.2d 954 (Tex. 1996) (contamination exclusion precluded coverage for claim where the insured's product was contaminated by the leakage of ammonia from refrigeration units); *accord American Casualty Co. of Reading, Pennsylvania v. Myrick*, 304 F.2d 179 (5th Cir. 1962). Some courts will also look to whether the contamination at issue resulted from an *actual* contamination versus a *suspected* contamination. *See Richland Valley Products, Inc. v. St. Paul Fire & Cas. Co.*, 548 N.W.2d 127 (Wis. Ct. App. 1996), *review denied*, 204 Wis. 2d 318, 555 N.W.2d 123 (1996) (although refrigeration system malfunctioned soon after mixing occurred, contamination within meaning of policy exclusion could be quick and did not need to be slow process).

At least one court has held that products voluntarily destroyed after a *suspected* contamination, where the investigation later determined that there was no *actual* contamination, are not excluded from coverage by a contamination exclusion. *Stanley Duennsing v. The Travelers Companies*, 849 P.2d 203 (Mont. 1993).

In contrast to what appears to be the majority position, certain courts have refused to enforce the contamination exclusion where the risk of third-party negligence was not expressly excluded (unlike vice, latent defect, and other risks). It should be noted that in these cases where the contamination exclusion was not applied, the relevant exclusions contained an exception for risks of loss not enumerated in the exclusion – i.e., the contamination exclusion contained a "buy back" exception which provided coverage for risks of loss not specifically set forth in the exclusion. *General Mills, Inc. v. Gold Medal Ins. Co.*, 622 N.W.2d 147 (Minn. Ct. App. 2001).

In *Allianz Ins. Co. v. RJR Nabisco Holdings Corp.*, 96 F. Supp. 2d 253 (S.D.N.Y. 2000), Nabisco began receiving numerous telephone calls on its toll-free

customer service line "concerning a chemical odor and flavor in various Nabisco products." After investigation, Nabisco determined that all the affected products had been stored in the AUL warehouse, and that they all contained trimethyl benzene ("TMB"), a chemical that, while posing no health risk, "would cause a strong displeasing odor and taste in food products." Further investigation revealed that the construction company that had built the AUL warehouse had stripped and sealed the concrete floor with chemicals containing TMB, which, according to Nabisco, the company had failed to seal and clean up properly, thus leading to the contamination of the subsequently-stored foodstuffs. Based on its investigation, Nabisco recovered and destroyed over one million cases of food that had been stored at the AUL warehouse. Nabisco then submitted a claim to Allianz and its co-insurers. In turn, Allianz sought a declaration that coverage of the loss was barred by contamination exclusion. The court ruled against Allianz, holding that contamination exclusion did not apply to contamination of food products exposed to TMB from the warehouse where they had been stored, which, though posing no health risk, resulted in a displeasing odor and taste.

In *The Pillsbury Co. v. Zurich American Ins. Co.*, No. 03-6560, 2005 WL 2778752 (D. Minn. Oct. 25, 2005), the court ruled that the contamination exclusion does not exclude coverage for losses associated with biscuit mix containing pieces of plastic, concluding that the definition of "contaminate" implies that impurities are particulate or chemical in nature and that plastic screen pieces don't constitute "contamination").

In an all-risk policy, as discussed briefly above, the policy covers all risks unless specifically excluded by the policy. Where the food contamination at issue was the result of more than one cause, one of which is excluded from coverage and one of which is not, the majority of courts will find coverage where the covered cause of loss is the primary cause of the contamination loss. *Bruce Oakley, Inc. v. Farmland Mut. Ins. Co.*, 245 F.3d 1027 (8th Cir. 2001) (court held that damage to soybeans stored in a bin that auto-oxidized from a mold were damaged by heat, a covered risk, generated from the fungus or, in the alternative, fell within an ensuing fire exception to a mold exclusion); *see also Craig B. Cooper, Olive Indus. Ltd. v. Travelers Indem. Co. of Illinois, et al.*, 2004 U.S. App. LEXIS 21324 at * 4 (9th Cir. 2004) (where contamination emanated from a sewer backup and resulting leak from the municipal manhole in the street in front of the property, and court ruled that there was no coverage for any spoilage of food pursuant to a food contamination provision in the policy requiring contamination to occur from the purchase of tainted food or transmission of a communicable disease from an employee).

E. Pollution Exclusion

Similar to third-party liability policies, some first-party policies also include pollution exclusions. Like the analysis of the pollution context in the third-party

context, the courts are split on the interpretation of the pollution exclusion with respect to first-party policies as well.

Some courts have looked to the plain language of the pollution exclusion to find that a contaminated food product is a "contaminant" for the purposes of a pollution exclusion. A typical first-party policy pollution exclusion may exclude coverage for pollutants where pollutants are defined as, "any solid, liquid, gaseous, or thermal irritant or contaminant . . . ." *See Landshire Fast Foods v. Employers Mut. Cas. Co.*, 676 N.W.2d 528 (Wis. Ct. App. 2004).

In *Landshire*, Landshire prepared sandwiches and other foods for sale to businesses and institutions. In 1999, Landshire began delivering sandwiches to the Great Lakes Naval Training Station ("Great Lakes") commissary. On May 31, 2000, Great Lakes reported it had discovered the *Listeria monocytogenes* ("Listeria") bacteria in some of Landshire's products. This form of Listeria can cause mild flu-like symptoms in healthy adults; however, in more vulnerable populations such as the elderly, this bacteria can cause a life-threatening illness with a twenty-five percent mortality rate. Great Lakes returned all of the food to Landshire and refused to accept any additional Landshire products.

Employers Mutual Casualty Company had issued a policy to Landshire that was in effect at the time of the Listeria outbreak. The policy contained a pollution exclusion where the term "pollutants" was defined as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste." The parties to the coverage litigation disagreed on the scope of the term "contaminant" in the pollution exclusion. While Landshire conceded that Listeria is a contaminant, it denied that Listeria is the kind of contaminant the Employers' policy excluded from coverage. Asserting that the Employers' policy language only excluded *inorganic* matter, Landshire argued that the pollution exclusion was inapplicable to the Listeria outbreak as Listeria does not fall within the "inorganic matter" classification. The *Landshire* court rejected the insured's argument and held that: "The presence of Listeria monocytogenes in Landshire's food products plainly rendered the food unfit for consumption, and as such meets the ordinary, unambiguous definition of 'contaminant'." *Id.* at 532.

Other courts, however, have rejected applying the pollution exclusion to "non-environmental" losses. For example, when faulty raw ingredients were used in Mountain Dew and Diet Pepsi products, the losses associated with the destroyed products were covered despite the pollution exclusion that read: "This policy does not insure against loss, damage, costs or expenses in connection with any kind or description of seepage and/or pollution and/or contamination . . . ." *Pepsico, Inc., v. Winterthur Int'l Am. Ins. Co.,* 13 A.D.3d 599, 788 N.Y.S.2d 142 (N.Y. App. Div. 2004). The court held that New York courts prefer a common-sense approach rather than a literal approach when interpreting this pollution exclusion and limited its application to environmental-type harms.

Similarly, in *Motorists Mutual Ins. Co. v. Hardinger*, 131 Fed. Appx. 823, 827 (3rd Cir. 2005), the court noted that there is no Pennsylvania case law identified by the parties that addresses whether bacteria should fall within the definition of "pollution." The court noted that in fact, courts that have addressed whether bacteria fits under similar pollution exclusions are divided. *Compare Keggi v. Northbrook Prop. and Cas. Ins. Co.,* 13 P.3d 785 (Ariz. Ct. App. 2000) (holding that bacteria does not constitute a pollutant under an identical pollution exclusion clause) *and E. Mut. Ins. Co. v. Kleinke,* Index # 2123-00, RJI # 0100062478 (N.Y. Super. Ct. Jan. 17, 2001) (holding that similar pollution exclusion is ambiguous on whether E. coli bacteria falls within the policy's definition of pollutant) *with Landshire, supra* ("bacteria, when it renders a product impaired or impure" falls within "the ordinary, unambiguous definition of 'contaminant'"). Accordingly, the court ruled that the issue of whether bacteria fall under the plain meaning of the pollution exclusion or whether the pollution exclusion is ambiguous as applied to the facts of this case should be left to the District Court in the first instance, and directed the trial court to consider whether the pollution exclusion applied to the presence of E. coli bacteria.

F. Governmental Action Exclusion

First-party policies commonly exclude coverage for loss or damage that is caused directly or indirectly by seizure or destruction of property by order of governmental authority. In food-contamination cases, government entities such as the FDA often issue orders requiring a company to halt the shipment of a product or to recall a product. When this occurs, companies often respond by not only halting the shipment but by also destroying the product.

In first-party coverage cases, the majority of courts have taken a more literal approach to the governmental action exclusion. To apply the exclusion, courts generally require that the governmental body specifically order the seizure or destruction of property. *See Stanley Duensing v. The Traveler's Companies*, 849 P.2d 203 (Mont. 1993) (where exclusion applied to loss or damage caused by seizure or destruction of property by order of governmental authority, a government-ordered embargo was not the equivalent of a seizure of property and, as such, the exclusion did not apply); *see also Townsends of Arkansas, Inc. et. al. v. Miller Mutual Ins. Co.,* 823 F. Supp. 233 (D. Del. 1993) (governmental action exclusion did not apply where insured voluntarily destroyed its product and there was no governmental body that ordered the seizure or destruction of the insured's product).

G. Faulty Workmanship Exclusion

Faulty workmanship exclusions generally exclude coverage for losses or damages that result from errors in design, faulty workmanship or faulty materials. In *General Mills Inc. v. Gold Medal Ins. Co.*, the insurer asserted that losses

resulting from contaminated oats intended for cereal products were excluded because the oats were faulty materials. The court rejected this approach and held that the exclusion refers to materials for construction of property, not raw stock for making cereals products. The court arrived at its conclusion by observing that "faulty materials," when grouped with "design" and "faulty workmanship," implies material for the construction of property. *General Mills Inc. v. Gold Medal Ins. Co.*, 622 N.W.2d 147, 152 (Minn. 2001); *see also Pillsbury Co. v. Underwriters of Lloyd's, London,* 705 F.Supp. 1396 (D. Minn. 1989) (faulty workmanship exclusion applies only to the losses related to "making good" the defect and not to losses caused by the defect); *but see Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 93 Cal. Rptr. 2d 364, 377 (Cal. Ct. App. 2000) (holding that the presence of wood splinters in the diced roasted almonds caused property damage to the nut clusters and cereal products in which the almonds were incorporated, noting that "we see no difficulty in finding property damage where a potentially injurious material in a product causes loss to other products with which it is incorporated.").

H. Virus or Bacteria Exclusion

The American Association of Insurance Services ("AAIS") is a national advisory organization that develops policy forms and rating information used by more than 600 P/C companies throughout the U.S. The AAIS has recently approved a "Virus or Bacteria" exclusion for its Agricultural Output Program ("AgOP"). This mandatory countrywide exclusion clarifies that there is no first-party property coverage under AAIS forms for loss, cost, or expense caused by, resulting from, or relating to any virus, bacterium or other microorganism that causes or is capable of causing disease, illness or physical distress. The exclusion was developed in light of the possibility of a pandemic of avian flu. However, it may have applicability to contamination claims from any disease-causing agent, including, but not limited to, SARS, rotavirus, listeria, legionella and anthrax.

The virus or bacteria endorsement is being filed with a proposed effective date of May 1, 2007 in most states under the following AAIS programs: Agricultural Output; Artisans; Businessowners; Commercial Inland Marine; Commercial Output; COP-XL; Commercial Properties; Developers Output; Farmowners; Farm Properties; and Inland Marine.

IV. Specialty Policies

A. Product Recall Coverage

The recall of a product is the most extreme action a company can take when faced with a contamination event. A company's decision to recall a product depends on a number of factors, including the nature of the problem/contamination; the potential harm to consumers from the contaminated product; the potential role of federal, state or international regulatory agencies; and the overall cost of the recall

in comparison with other less expensive alternatives. Companies tend to focus on exposure arising from the direct costs of responding to a recall. As a result, potential exposure from indirect costs, measured in terms of consumer confidence and company credibility, can often be overlooked.

Most companies are aware of the need to maintain some type of products-liability insurance coverage. What they may not be aware of are the limitations of this coverage when a product recall is required to contain an emergency, as well as the major variations in the terms of specialized product recall policies. As a general principle, insurance policies covering general product-liability risk do not usually insure the costs of implementing a product recall of an unsafe or contaminated product.

In light of the various gaps in third-party and first-party policies discussed above and in order to tailor standard coverage to the specific needs of the food industry, specialty insurance policies, like contaminated products policies, trade disruption policies or product recall policies, have been developed.

The advent of product recall insurance began in the late 1980s as a result of the well known and publicized Tylenol tampering incident. In that case, a number of Tylenol bottles were intentionally laced with cyanide. As a result, seven people died. The manufacturer ultimately paid over $100 million in remedial costs. After this incident, a few insurers began offering recall insurance for malicious or intentional tampering. Recall insurance stemming from accidental contamination began appearing in the early 1990s. And in 2004, the Insurance Services Office ("ISO") approved a standard form for product recall insurance.

The product recall policy is a specialized policy underwritten to meet the unique needs of insureds who are in the food distribution process. Although these policies are available, product recall policies are not widely issued. This is attributed to the relatively small number of insurers actually providing this coverage and the limited information and/or knowledge that insurance brokers have regarding the scope of coverage under the product recall policies.

Policies designed to cover the costs associated with a product recall, product tampering, product rehabilitation, and related expenses are available through a handful of markets. Most product recall policies are not standard ISO forms and, as such, the terms of the policies can vary widely from policy to policy. In general, however, the product recall policies cover the costs of inspecting, withdrawing, destroying, and replacing contaminated products. In addition, product recall policies may provide coverage for related expenses for product rehabilitation, crisis management and lost profits.

In the last couple of years, several insurers have announced the availability of specialized product recall policies. For example, in 2006, an international insurer announced its new primary food and drink product contamination insurance,

which includes integrated crisis management cover. This insurance not only covers costs associated with a product recall, but also places an emphasis on risk prevention and emergency response. Included in the premium is a free initial consultation with crisis managers, as well as an allocation for risk improvement work such as recall and crisis planning. For this program, the insurer has teamed up with specialist consultancies based in the U.K. and U.S. offering expertise in areas such as public relations, product security, laboratory services and regulatory advice. In the event of a contamination, the insurance gives policyholders priority access to the consultants.

A major domestic insurer in the U.S. offers a RecallResponse product which includes coverage for first-party expenses and third-party liability arising from the recall of finished or component goods. The RecallResponse policy is provided as a supplement to the insurer's product liability insurance. RecallResponse can cover product recall expenses alone or can be expanded to cover liability to third parties arising from the recall. Expenses associated with extra warehousing and extra personnel to support a recall can be insured as well.

Another major domestic insurer offers a suite of product recall coverages in one insurance form. The insurer's product recall policy includes coverage for the cost of withdrawing the defective product, communications expenses related to the recall, overtime costs and hiring of temporary employees, good faith advertising to rehabilitate the product's reputation, third-party recall expenses and an optional extension of coverage to reimburse for expenses relating to the repair, replacement or remanufacturing of the defective product.

At the present time, product recall policies are not widely distributed. However, with time, it is likely that a growing awareness of the existence of such policies (by both policyholders and brokers) coupled with the advent of widely publicized contamination scares will increase the circulation of these specialized policies.

V. Conclusion

The above decisions provide important guidance with respect to coverage issues often raised with food contamination claims. Cozen O'Connor continues to opine, litigate and monitor the many coverage issues involved with food contamination claims. Our team of food contamination coverage attorneys are prepared to provide immediate, effective assistance. Through meetings, conference calls, seminars, coverage alerts and the preparation of papers and articles, Cozen O'Connor is prepared to assist clients effectively handle the next food contamination claim.

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MARITIME INSURANCE
written and presented by:
David Loh, Esquire

COZEN O'CONNOR
45 Broadway
Suite 1600
New York, NY 10006
212-509-9400 or 800-437-7040
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COZEN O'CONNOR

MARINE INSURANCE

David Y. Loh
New York Downtown
45 Broadway Atrium,
Suite 1600
New York, New York 10006-3792
Tel: (212) 908-1202
Fax: (866) 790-1914
Email: dloh@cozen.com

www.cozen.com

GENERAL RULES OF CONSTRUCTION

- What law applies?
- Federal common law vs. applicable state law
- *See Wilburn Boat Co. v. Fireman's Fund Ins. Co.*, 348 U.S. 310 (1955).

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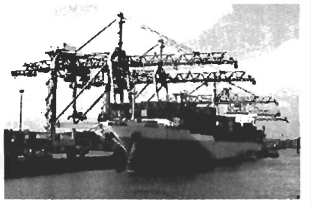
General preference for state law

- Absent controlling federal maritime law or a determination that the interests of national uniformity required that a federal maritime law be fashioned, the interpretation of a contract of marine insurance shall be governed by state law.



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Great Southern Wood v. American Home Assurance Co., et al.

- ____F.Supp.2d ____, 2007 WL 2409723 (M.D.Ala. 2007) (August 21, 2007).
- Marine open cargo policy
- Shipment of wood was destroyed in a warehouse as a result of Hurricane Katrina
- Marine insurer denied coverage as being beyond the "warehouse to warehouse" extension clause.
- Insured filed suit seeking coverage and alleging bad faith based upon Alabama state law.

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Great Southern v. American Home

- Question posed to the court was whether the goods were "in transit" or had arrived at destination. If goods were "in transit", then goods were covered. If the goods had arrived before the hurricane hit, then goods were not covered.
- In this case, the insured's bill of lading identified Gulfport, Alabama as the final destination and the insured had contracted with the local port authority to store its goods at port of Gulfport for up to 90 days.
- Federal common law found to apply because the court concluded that there was clear industry standard with respect to the interpretation of the "warehouse to warehouse" extension clause.

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Great Southern v. American Home

- Court concluded that insured exercised dominion and control of the cargo after delivery and therefore the cargo was no longer in transit.

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New Hampshire Ins. Co. v. Dagnone

- 475 F.3d 35 (1st Cir. 2007) (Fed. 2, 2007).
- Insured sought coverage for yacht damaged during a storm.
- Marine insurer denied coverage and filed a declaratory judgment action.
- Insured counterclaimed for coverage and alleged bad faith denial/claims practices.

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New Hampshire Ins. v. Dagnone

- Both sides agreed that New York law applied.
- Insured and yacht located in Rhode Island and DJ was filed in R.I.
- Would application of R.I. state law have any discernable difference?

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New Hampshire Ins. Co. v. Dagnone

- Policy required that yacht be "laid up and winterized" from October 31 to April 15, 2007.
- Yacht was brought to marina to be removed from water and placed in dry storage.
- Marina had a line of boats to be laid up, and yacht in question had to wait in line.

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New Hampshire Ins. Co. v. Dagnone

- While waiting at the marina, storm blew through and yacht was damaged during December.
- Local practice stated that final stage of winterization was to "anti-freeze" the engines and that they preferred to "anti-freeze" after yacht was out of the water.

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New Hampshire Ins. Co. v. Dagnone

- Since vessel was not fully winterized, then insured violated "lay-up" warranty and no coverage.
- Court relied upon "local practice" to interpret meaning of "winterizing" vessel and cites to *Providence Washington Ins. Co. v. Lovett*, 119 F.Supp. 371 (D.R.I. 1953).
- In retrospect, if insured had asked for an extension of coverage while the yacht waited to be winterized, underwriters probably would have given it without any additional premium.

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North Am. Foreign Trading Corp. v. Mitsui Sumitomo Ins. USA Inc.

- 2007 WL 1222640 (S.D.N.Y. 2007) (April 24, 2007).
- Insured is trading company in the business of refurbishing consumer electronics, including cordless phones, and re-selling them.
- Insured suffered mysterious disappearance from 2 different warehouses in China.

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North Am. Trading v. Mitsui

- Policy had a requirement that insured had to file suit within one year of reporting claim. Insurer and insured entered into Standstill agreement to allow the parties to further investigate. Standstill agreement expired on May 19, 2005.

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North Am. Trading v. Mitsui

- Cidmate warehouse claim was $1.2 million. Insured filed suit on May 18, 2005 (one day before expiration).
- Lionda warehouse claim was $7.2 million. Insured filed suit on June 23, 2005 (almost one month after expiration).
- Parties agreed that New York law applied.

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North Am. Trading v. Mitsui

- Court ultimately found that Mitsui acted in bad faith and estopped Mitsui from denying coverage, including on the basis of time bar.
- Insured represented by counsel at all times.

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North Am. Trading v. Mitsui

- Mitsui found to have violated duty of good faith and fair dealing, so equitably estopped from denying coverage.
- No "mysterious disappearance" exclusion in Mitsui policy.
- Declination letter indicated that warehouse extension clause did not cover loss, but did not explain that insured could not prove that the goods had in fact arrived at the warehouse.

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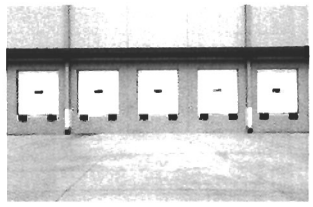
North Am. Trading v. Mitsui

- Insured had spreadsheets of goods being held by warehouse, but no warehouse receipts.
- Declination letter should have been more specific.
- Insurer hired forensic accountants to investigate, but insurer never shared forensic accountant reports with insured until after suit was filed.



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North Am. Trading v. Mitsui

- Insurer was not fully forthcoming in acknowledging receipt of forensic accountant's report.
- Although Court found Mitsui to be in bad faith, Court did not award punitive damages or prejudgment interest?
- Mitsui has appealed to Second Circuit, and insured has cross-appealed for punitives and interest.

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written and presented by:
Christopher Raleigh, Esquire

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212-509-9400 or 800-437-7040
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Christopher Raleigh
Cozen O'Connor
45 Broadway, Ste. 1600
New York, NY 10006
craleigh@cozen.com
212-908-1245

www.cozen.com

TYPES OF POLICIES ENCOUNTERED:

- OPEN CARGO POLICY
- CONTINGENT CARGO POLICY
- MOTOR TRUCK CARGO POLICY

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EXCLUSIONS AND ISSUES UNDER OPEN CARGO POLICIES

- **Goods must be "in transit" for coverage to attach:**
- "We cover property "in transit" within:

  (a) the forty-eight contiguous United States of America;"

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Definition of "in transit."

- "Covered property shipped via a 'carrier' shall be considered 'in transit' from the time the goods are in the exclusive custody and control of the "carrier" and continuously until the transporting vehicle arrives at the destination premises and are transferred to the exclusive custody and control of the consignee, warehouseman, or receiver."
- *Kessler Export Corp. v. Reliance Insurance Company*, 207 F. Supp. 355, *aff'd* 310, F.2d 936 (Second Cir. 1962) – Shipment stolen from warehouse after trucker issues bill of lading but before commencement of transit not covered.
- *Dengre Plastics Co., Inc. v. Travelers Indemnity Co.*, 107, N.J. Super. 535 (Law Div. 1969) – "To be in transit, cargo must be in the process of movement towards its destination; the act of delivery must have begun."
- *N.B.* The term "in transit" must be defined in the policy or the lack of clarity will be construed against the insurer – *Hartford Casualty Insurance Co. v. Banker's Note, Inc.*, 817 F. Supp. 1567 (N.D. Ga. 1993).

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Late Notice of Claim:

- "Notice of loss. The insured will, as soon as practicable, report in writing to the company every loss occurrence which may give rise to a claim under the policy."
- *Members Insurance Co. v. Branscum*, 803 S.W. 2d 462 (Tex. Ct. App. 1991) – Insured's failure to notify results in prejudice to the insurer.

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Analyze potential prejudice on subrogation potential by reference to:

- Failure to give timely notice of claim;
- Expiration of short statute of limitations available to common carrier.

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F. C. & S. Warranty:

- "Capture, seizure, arrest, restraint, detainment, confiscation, preemption, requisition, or nationalization and the consequences thereof, or any attempt thereat, whether in time, peace, or war and whether lawful or otherwise."
- *Northern Feather International, Inc. v. Certain London Underwriters*, 714 F. Supp. 1352 (D.N.J. 1989) – Shipment of cloth destroyed while detained by U.S. Customs pending resolution of cargo classification dispute.
- *Blaine Richards & Co. v. Marine Indemnity Insurance Co.*, 635 F. 2d 1051 (2d Cir. 1980) – Detention by FDA resulting in cancellation of sales.
- *Commodities Reserve v. St. Paul Fire & Marine Insurance*, 879 F. 2d 640 (9th Cir. 1989) – Detention of vessel by Greek authorities, resulting in delay of a cargo shipment.

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INHERENT VICE

- Definition: "The term inherent vice refers commonly to the deterioration of a shipment during transit as a result of their natural behavior without the intervention of any fortuitous external accident or casualty. Examples of deterioration due to inherent vice include decay, spontaneous combustion, disease or fermentation." Marine Insurance and the New Institute Cargo Clauses, p. 31.
- *Perzy v. Intercargo Corporation*, 827 F. Supp. 1365 (N.D.Ill. 1993) – Shipment of snowball paperweights which froze during transit resulted from the exertion of fortuitous circumstances rather than the inevitable decay which occurs through the passage of time.

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COMMON ISSUES UNDER CONTINGENT CARGO POLICIES

- **Purpose of contingent cargo coverage:**
- "To reduce the cost of insuring goods in transit, policies are available to indemnify an insured shipper for loss only when the shipper has been unable, after reasonable effort, to recover its damages from the carrier of the goods…the contingency may be provided by an endorsement to an inland marine policy or to a carrier liability policy for losses caused by other carriers." Sorkin, Goods in Transit, Section 43.03 (2).
- "Goods are insured while in the due course of transportation as arranged by the insured from the premises of the point of origin to the premises at the point of destination while in the custody of any public or private truckman, railroad, air carrier, freight forwarder, or any combination thereof."

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Circumstantial Evidence Not Sufficient

- *Dunlop Tire & Rubber Corp. v. Fidelity and Deposit Co. of Maryland –*
- Circumstantial proof may not be sufficient: "There are no confessions, actual or implied, from employees who had been stealing goods. (Insured) has not shown suspicious circumstances that employees were pilfering goods."

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Nature of Property Carried:

- Insurance applications typically inquire as to the nature of the cargo carried, specifically, tobacco products, explosives, furs, jewelry, electronic devices, liquor, beef and seafood.

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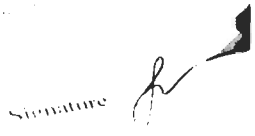
Review Insured's Application to Confirm:

- Type of cargo covered;
- Material misrepresentation of fact has not been made by the insured.



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MANAGING DISCOVERY OF ELECTRONIC INFORMATION: A POCKET GUIDE FOR JUDGES

presented by:

Thomas Jones, Esquire

COZEN O'CONNOR
1201 Third Avenue
Suite 5200, Washington Mutual Tower
Seattle, WA 98101
206-340-1000 or 800-423-1950
www.cozen.com

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Managing Discovery of Electronic Information: A Pocket Guide for Judges

Barbara J. Rothstein, Ronald J. Hedges, and
Elizabeth C. Wiggins

Federal Judicial Center
2007

Contents

Preface

This pocket guide is designed to help federal judges manage the discovery of electronically stored information (ESI). It encourages judges to actively manage those cases involving ESI, raising points for consideration by the parties rather than awaiting the parties' identification and argument of the matters. The guide covers issues unique to the discovery of ESI, including its scope, the allocation of costs, the form of production, the waiver of privilege and work-product protection, and the preservation of data and spoliation. As you are reading, you may encounter some unfamiliar terms. Many of these terms are defined in a glossary at the end of the guide. A note of appreciation goes to Judge Lee H. Rosenthal (S.D. Tex.), Ken Withers (the Sedona Conference), and John Rabiej (Administrative Office of the U.S. Courts) for their suggestions, which improved this publication. I hope you find the guide useful in meeting the challenges presented by the discovery of ESI.

Barbara Jacobs Rothstein
Director, Federal Judicial Center

Introduction

It is a fact of modern life that an enormous volume of information is created, exchanged, and stored electronically. Conventional documents originate as computer files, e-mail is taking the place of both telephone calls and postal letters, and many, if not most, commercial activities are transacted using computer-based business processes. Electronically stored information (ESI) is commonplace in our personal lives and in the operation of businesses, public entities, and private organizations.

In the past decade, discovery involving word-processed documents, spreadsheets, e-mail, and other electronically stored information has become more routine: Once seen only in large cases involving sophisticated entities, it is now seen in routine civil cases and in many criminal cases. In some cases, ESI does not raise any issue, or it is converted to paper and is exchanged in the traditional manner. In other cases, disputes arise as to the scope of discovery, the form in which ESI is produced, whether inadvertent production of ESI will lead to waiver of attorney–client privilege or work-product protection, the shifting of costs from producing to requesting parties, and the preservation of ESI and related spoliation allegations. For example, in some cases a dispute may surface when one party finds that digital files have been delivered in a format that is not readily usable. In other cases, technology issues may remain submerged until later in the pretrial process when one side accuses the other of spoliation because routine digital file management practices remained in place after the complaint was filed, resulting in the deletion of computer files.

The court may minimize such disputes by encouraging lawyers and parties to identify, in the earliest stages of litigation, potential problems in the discovery of ESI and possible resolutions to those problems, and by intervening before misunderstandings and disputes lead to significant delay and costs. Case law addressing conventional discovery and ESI-related discovery, the Federal Rules of Civil Procedure, local rules,[1] the *Manual for Complex Litigation*,

1. *See, e.g.*, U.S. Dist. Ct. Rules E.D. & W.D. Ark., L. R. 26.1; U.S. Dist. Ct. Rules D.N.J., L. Civ. R. 26.1; U.S. Dist. Ct. Rules M.D. Pa., L. Civ. R. 26.1; and U.S. Dist. Ct. Rules D. Wyo., L. Civ. R. 26.1, App. D. *See also* Ad Hoc Committee for Electronic Discovery of the United States District Court for the District of Delaware, *Default Standard for Discovery of Electronic Documents* (http://www.ded.uscourts.gov/OrdersMain.htm); U.S. District Court for the District of Kansas, *Guidelines for*

Fourth, and various legal publications offer management tools for the judge's use.[2] Amendments to the Federal Rules of Civil Procedure that specifically address the discovery of ESI went into effect December 1, 2006.[3]

Discovery involving ESI may require more intensive judicial involvement than required by conventional discovery. The purpose of this guide is to identify problems that recur during the course of electronic discovery and to present management tools for responding to them.

What Is Electronically Stored Information and How Does It Differ from Conventional Information?

Among others things, ESI includes e-mails, webpages, word processing files, and databases stored in the memory of computers, magnetic disks (such as computer hard drives and floppy disks), optical disks (such as DVDs and CDs), and flash memory (such as "thumb" or "flash" drives). Federal Rules of Civil Procedure 26 and 34, which went into effect December 1, 2006, use the term "electronically stored information" rather than the term "data compilation" and identify it as a distinctive category of information subject to discovery obligations on par with "documents" and "things."

ESI differs from conventional, paper information in several ways. The volume of ESI is almost always exponentially greater than paper information, and it may be located in multiple places. For example, draft and final versions of a single paper memorandum may be stored electronically in multiple places (e.g., on the computer hard drives of the document's creator, reviewers, and recipients; on the company server; on laptops and home computers;

the Discovery of Electronically Stored Information (http://www.ksd.uscourts.gov/guidelines/electronicdiscoveryguidelines.pdf).

2. *See also* American Bar Association, Civil Discovery Standards 57–76 (2004) (Standards 29–33) (at http://www.abanet.org/litigation/discoverystandards/); The Sedona Principles: Best Practices, Recommendations & Principles for Addressing Electronic Document Discovery (Sedona Conference Working Group Series Jan. 2004) [hereinafter *The Sedona Principles*] (updated version available at http://www.thesedonaconference.org/content/miscFiles/publications_html).

3. These rules can be found at http://www.uscourts.gov/rules/index.html.

and on backup tapes). Market research tells us that the average employee sends or receives about 50 messages per working day,[4] which translates into more than 1,200,000 messages a year for an organization of 100 employees.

Also, although the possibility that paper documents may be damaged, altered, or destroyed has always been a concern, the dynamic, mutable nature of ESI presents new challenges. For example, computer systems automatically recycle and reuse memory space, altering potentially relevant information without any specific direction or even knowledge of the operator. Merely opening a digital file changes information about that file.

Some aspects of ESI have no counterpart in print media, metadata being the most obvious. Metadata, which most computer users never see, provide information about an electronic file, such as the date it was created, its author, when and by whom it was edited, what edits were made, and, in the case of e-mail, the history of its transmission. Also, some computer-based transactions do not result in a conventional document, but instead are represented in integrated databases. Even less-complex ESI may be incomprehensible and unusable when separated from the system that created it. For example, a spreadsheet produced in portable document format (PDF) may be useless because embedded information, such as computational formulas, cannot be seen or discerned. Finally, deleting an electronic document does not get rid of it, as shredding a paper document would. An electronic document may be recovered from the hard drive, to the extent it has not been overwritten, and may be available on the computers of other people and on archival media or backup tapes used for disaster recovery rather than archival purposes.

How ESI differs from paper information:

- Volume
- Variety of sources
- Dynamic quality
- Hidden information: metadata and embedded data
- Dependent on system that created it
- Deleting doesn't delete it

These differences between ESI and conventional information have important implications for discovery. For example, the dynamic nature of ESI makes it vital that a data producer institute "lit-

4. Microsoft, *Survey Finds Workers Average Only Three Productive Days Per Week* (Mar. 15, 2005) <http://www.microsoft.com/presspass/press/2005/mar05/03-15ThreeProductiveDaysPr.mspx> (visited Jan. 3, 2007) (U.S. workers reported they receive an average of 56 e-mail messages per day).

igation holds" to preserve information that may be discoverable, often even before the lawsuit is filed. Moreover, the volume and multiple sources of ESI may lead to disputes about the scope of discovery and may make review to identify and segregate privileged information more difficult, increasing the likelihood of its inadvertent production even when the producing party has taken steps to avoid it. In addition, because deleted or backup information may be available, parties may request its production, even though restoring, retrieving, and producing it may require expensive and burdensome computer forensic work that is out of proportion to the reasonable discovery needs of the requesting party.

Early Consideration of ESI—Rules 26(f) and 16

Exchanging information in electronic form has significant benefits—it can substantially reduce copying, transport, and storage costs; enable the requesting party to more easily review, organize, and manage information; facilitate the use of computerized litigation support systems; and set the stage for the use of digital evidence presentation systems during pretrial and trial proceedings. To ensure that these benefits are achieved and any problems associated with ESI are minimized, attorneys and parties should address ESI in the earliest stages of litigation, and judges should encourage them to do so.

All too often, attorneys view their obligation to "meet and confer" under Federal Rule of Civil Procedure 26(f) as a perfunctory exercise. When ESI is involved, judges should insist that a meaningful Rule 26(f) conference take place and that a meaningful discovery plan be submitted. Amended Rule 26(f) directs parties to discuss any issues relating to disclosure or discovery of ESI, including the form or forms in which it should be produced. More specifically, the parties should inquire into whether there will be discovery of ESI at all; what information each party has in electronic form and where that information resides; whether the information to be discovered has been deleted or is available only on backup tapes or legacy systems; the anticipated schedule for production and the format and media of that production; the difficulty and cost of producing

the information and reallocation of costs, if appropriate; and the responsibilities of each party to preserve ESI.[5]

Amended Rule 26(f) also directs parties to discuss issues related to claims of privilege or protection as trial-preparation material. If the parties agree on a procedure to assert such claims after production, they should discuss whether to ask the court to include their agreement in an order. (See related discussion, *infra* page 14.)

Discussion topics for a Rule 26(f) conference:

- What ESI is available and where it resides
- Ease/difficulty and cost of producing information
- Schedule and format of production
- Preservation of information
- Agreements about privilege or work-product protection

For the "meet and confer" process to be effective, attorneys must be familiar with how their clients use computers on a daily basis and understand what information is available, how routine computer operations may change it, and what is entailed in producing it. Attorneys need to identify those persons who are most knowledgeable about the client's computer system and meet with them well in advance of the Rule 26 conference; it may also be advisable to have those persons present at the conference.

The Rule 16 conference and order afford the court the opportunity, early in the case, to discuss and memorialize the agreements or shared understandings that parties reach in their "meet and confer" session, and to resolve disputes that may have arisen. Amended Rule 16(b) provides that scheduling orders may include provisions for disclosure or discovery of ESI and any agreements the parties reach for asserting claims of privilege or of protection as trial-preparation material after production.

ESI and Rule 26(a)(1) Disclosures

Rule 26(a)(1) requires disclosure of the identities of individuals likely to have discoverable information, as well as "a copy of, or a description by category and location of, all documents, data compilations, and tangible things" that the disclosing party may use

5. Specific topics for discussion related to the preservation of information are listed in the *Manual for Complex Litigation, Fourth* § 40.25(2) (Federal Judicial Center 2004) [hereinafter *MCL 4th*].

to support its claims or defenses, unless solely for impeachment. Effective December 1, 2006, the term "data compilations" was changed to "electronically stored information," clarifying a party's duty to include ESI in its disclosures. Automatic disclosures must be made "at or within 14 days after the Rule 26(f) conference unless a different time is set by stipulation or court order."

The *Manual for Complex Litigation, Fourth* emphasizes that the parties have a duty to conduct a reasonable investigation pursuant to disclosure, particularly when a party possesses extensive computerized data, which may be subject to disclosure or later identification.[6] This task may be daunting for a party with voluminous ESI to identify, especially if that information is not readily accessible. With respect to less-accessible ESI, *Moore's Federal Practice* suggests that the following disclosures and investigation should satisfy the basic requirements of Rule 26(a)(1):

> The disclosing party should identify the nature of its computer system—including back-up system, network system, and e-mail system—as well as any software applications used to operate those systems. However, the disclosing party should not be required to attempt to search back-up systems or to retrieve deleted files in an exhaustive effort to locate all potentially relevant evidence as part of this initial disclosure obligation. Further, a party should not be held liable for sanctions or other penalties for failing to disclose this evidence as part of its initial disclosure obligation, even when that evidence is subsequently used in the litigation. The difficulty in retrieving this information provides "substantial justification" to excuse such an exhaustive search effort.[7]

ESI and Scope of Discovery Under Rules 26(b)(1) and 26(b)(2)

The central issue in almost all discovery management is the determination of scope. Under Rule 26(b)(1), parties may obtain discovery relevant to the "claim or defense of any party" that is not privi-

6. *MCL 4th, supra* note 5, § 11.13.

7. J.M. Moore, Moore's Federal Practice § 37A.21[1] (3d ed. 2005) (footnote omitted).

leged or protected as trial preparation material. In addition, the court may order discovery of information relevant to the "subject matter involved in the action" for "good cause." Under either standard, the principles of proportionality set out in Rule 26(b)(2)(C) apply.[8] Rule 26(b)(2)(C) provides:

> The frequency or extent of use of the discovery methods otherwise permitted under these rules and by any local rule shall be limited by the court if it determines that: (i) the discovery sought is unreasonably cumulative or duplicative, or is obtainable from some other source that is more convenient, less burdensome, or less expensive; (ii) the party seeking discovery has had ample opportunity by discovery in the action to obtain the information sought; or (iii) the burden or expense of the proposed discovery outweighs its likely benefit, taking into account the needs of the case, the amount in controversy, the parties' resources, the importance of the issues at stake in the litigation, and the importance of the proposed discovery in resolving the issues. The court may act upon its own initiative after reasonable notice or pursuant to a motion under Rule 26(c).

In the context of ESI, whether the proportionality analysis of Rule 26(b)(2)(C) is satisfied often turns on the type of computer data being sought. Assuming the requested information is relevant to the claims or defenses or the subject matter of the dispute and is not subject to a claim of privilege or protection, the production of active data, available to the responding party in the ordinary course of business, is most likely to satisfy the proportionality test. Active electronic records are generally those currently being created, received, or processed, or that need to be accessed frequently and quickly. Systems data, which include such things as when people logged on and off a computer or network, the applications and passwords they used, and what websites they visited, may be more remote and more costly to produce. Other types of data are even more removed from what is available in the ordinary course of business and may involve substantial costs and time and active intervention of computer specialists. These types of data include offline archival media, backup tapes designed for restoring computer systems in the event of disaster, deleted files, and legacy

8. Prior to December 1, 2006, Rule 26(b)(2)(C) was Rule 26(b)(2).

data, which were created on now-obsolete computer systems with obsolete operating and computer software.[9] Even active data may involve substantial burdens to produce—for example, when vast amounts are requested or when data are requested in a form that requires the reprogramming of databases. When hard-to-access information is of potential interest, the court should encourage lawyers to negotiate a two-tiered approach in which they first sort through the information that can be provided from easily accessed sources and then determine whether it is necessary to search the less-accessible sources.

Rule 26(b)(2)(B) and the accompanying Committee Note embrace this two-tiered approach. The rule establishes the following procedure for the discovery of not reasonably accessible ESI:

> (B) A party need not provide discovery of electronically stored information from sources that the party identifies as not reasonably accessible because of undue burden or cost. On motion to compel discovery or for a protective order, the party from whom discovery is sought must show that the information is not reasonably accessible because of undue burden or cost. If that showing is made, the court may nonetheless order discovery from such sources if the requesting party shows good cause, considering the limitations of Rule 26(b)(2)(C). The court may specify conditions for the discovery.

The requesting party may need discovery to test the assertion that the information is not reasonably accessible. Such discovery may involve taking depositions of those knowledgeable about the responding party's information systems; some form of inspection of the data sources; and requiring the responding party to conduct a sampling of information contained on the sources identified as not reasonably accessible. Sampling of the less-accessible source can help refine the search parameters and determine the benefits and burdens associated with a fuller search.[10]

9. *See also* Zubulake v. UBS Warburg LLC, 217 F.R.D. 309, 318–19 (S.D.N.Y. 2003) (describing the media on which ESI is maintained, and distinguishing online, active data, nearline data, offline storage/archives, and backup tapes).

10. *See* McPeek v. Ashcroft, 202 F.R.D. 31 (D.D.C. 2001); McPeek v. Ashcroft, 212 F.R.D. 33 (D.D.C. 2003); Hagemeyer N. Am., Inc. v. Gateway Data Sciences Corp., 222 F.R.D. 594 (E.D. Wis. 2004) (all supporting the use of sampling to tailor the scope of further discovery).

Even if it is determined that a source of ESI is not reasonably accessible, the requesting party may obtain discovery by showing good cause subject to the limitations of Rule 26(b)(2)(C). The Committee Note suggests that, in determining whether to allow the discovery, the judge consider the following:

> (1) the specificity of the discovery request; (2) the quantity of information available from other and more easily accessed sources; (3) the failure to produce relevant information that seems likely to have existed but is no longer available on more easily accessed sources; (4) the likelihood of finding relevant, responsive information that cannot be obtained from other, more easily accessed sources; (5) predictions as to the importance and usefulness of the further information; (6) the importance of the issues at stake in the litigation; and (7) the parties' resources.

In making this determination, the court has a variety of available tools, including

- ordering the parties to examine the information that is available from reasonably accessible sources before requiring discovery into sources that are identified as not reasonably accessible;
- ensuring that the requesting party makes a specific and tailored discovery request;
- ordering sampling of the sources identified as not reasonably accessible to assess the costs and burdens of production and the likelihood of finding responsive information and its usefulness to the litigation;
- ordering limited discovery into the costs and burdens of accessing the information from the sources identified as not reasonably accessible and into the basis for believing that they do, or do not, contain information likely to be important to the case and not available from other, accessible sources, such as depositions of the responding party's computer system personnel; and
- ordering the requesting party to pay all or part of the reasonable costs of producing the information from sources identified as not reasonably accessible. (See the discussion in the next section.)

Allocation of Costs

In cases involving vast amounts of ESI, or ESI that is not available from reasonably accessible sources, the cost to the producing party in locating the information, reviewing it for privilege, and otherwise preparing it for production may be much greater than in conventional discovery. At the same time, the cost of copying and transporting the information is practically eliminated and the cost to the requesting party of searching the information may be reduced because it can be done electronically.

In such cases, it may be appropriate to shift at least some of the production costs from the producing party to the requesting party. Two major cases—*Rowe Entertainment, Inc. v. William Morris Agency, Inc.*[11] and *Zubulake v. UBS Warburg LLC*[12]—have introduced multifactor tests to determine when cost shifting is appropriate.

In *Rowe*, a racial discrimination case, the defendants objected to the production of e-mail information from backup media on the grounds that such discovery was unlikely to provide relevant information and would invade the privacy of nonparties, and they requested that the plaintiffs bear the costs if production was nevertheless required. The court concluded that the e-mail information sought by the plaintiffs was relevant and that a blanket order precluding its discovery was unjustified. However, balancing eight factors derived from case law, the court required the plaintiffs to pay for the recovery and production of the e-mail backups, except for the cost of screening for relevance and privilege. The eight *Rowe* factors were (1) the specificity of the discovery requests; (2) the likelihood of discovering critical information; (3) the availability of such information from other sources; (4) the purposes for which the responding party maintains the requested data; (5) the relative benefit to the parties of obtaining the information; (6) the total cost associated with production; (7) the relative ability of each party to control costs and its incentive to do so; and (8) the resources available to each party.[13]

Zubulake, a gender discrimination case, also involved the production of e-mails that existed only on backup tapes and other archived media. After concluding that the plaintiff's request was rel-

11. 205 F.R.D. 421 (S.D.N.Y.), *aff'd*, 53 Fed. R. Serv. 3d 296 (S.D.N.Y. 2002).
12. 217 F.R.D. 309 (S.D.N.Y. 2003).
13. *Rowe*, 205 F.R.D. at 428–29.

evant to her claims, the court held that the usual rules of discovery generally apply when the data are in accessible format, but that cost shifting could be considered when data were relatively inaccessible, such as on backup tapes, and substituted seven factors for the *Rowe* factors. The *Zubulake* factors, in order of importance, were (1) the extent to which the request is specifically tailored to discover relevant information; (2) the availability of such information from other sources; (3) the total cost of production, compared to the amount in controversy; (4) the total cost of production, compared to the resources available to each party; (5) the relative ability of each party to control costs and its incentive to do so; (6) the importance of the issues at stake in the litigation; and (7) the relative benefits to the parties of obtaining the information. The court emphasized that the factors should not be applied mechanistically and should be weighted according to their importance.

Other courts have adopted or modified the *Rowe* and *Zubulake* formulations.[14] Moreover, the Committee Note to Rule 26(b)(2)(B) makes explicit the authority to shift costs when information that is not reasonably accessible is being produced.

Zubulake also set forth a sensible approach for assessing costs when a large number of backup tapes are involved. Following the order in the above case, the defendants restored and reviewed 5 of the 77 backup tapes of interest; they found approximately 600 messages deemed to be responsive at a cost of about $19,000. Based on this work, the defendants were able to estimate the cost of restoring and reviewing the entire 77-tape collection. Considering the seven factors, the court determined that the balance tipped

14. *See* Wiginton v. CB Richard Ellis, Inc., 2004 U.S. Dist. LEXIS 15722, *13 (N.D. Ill. Aug. 10, 2004) (adds the importance of the requested discovery in resolving the issues of the litigation to the *Zubulake* factors); Multitechnology Servs., L.P. v. Verizon Southwest, 2004 WL 1553480 (N.D. Tex. July 12, 2004) (analyzes application to shift costs for "relevant and discoverable" electronic information under Rule 26(c) and apparently rejects *Zubulake*'s applicability and concludes that "requiring the parties to evenly shoulder the expense is the most effective resolution because it balances the benefit of the discovery . . . and provides . . . [an] incentive to manage costs it incurs"; also held that "it is appropriate to classify the expense as court costs that can be recovered by the prevailing party"); Hagemeyer N. Am., Inc. v. Gateway Data Sciences Corp., 222 F.R.D. 594, 599–603 (E.D. Wis. 2004) (analyzes cost-shifting tests and concludes that "*Zubulake* brought the cost-shifting analysis closest to the Rule 26(b)(2) proportionality test" and adopts it).

slightly against cost shifting and required the defendants to bear 75% of the restoration costs.[15]

Discovery from Nonparties

Discovery from nonparties is likely to be more frequent when the parties are seeking ESI than when they are seeking conventional paper documents. Many businesses and individuals depend on telecommunications companies, Internet service providers, and computer network owners for computer services, and these nonparties may be the source for relevant and discoverable ESI, especially e-mail messages. Even larger companies routinely outsource their computer-management and data-storage functions to contractors and consultants. Rule 45, effective December 1, 2006, conforms the provisions for subpoenas to other changes in the rules related to the discovery of ESI. Parallel to amended Rule 26(b)(2), Rule 45 introduces the concept of sources that are not reasonably accessible. It also addresses the form for the production of ESI, adds a procedure for asserting claims of privilege or of protection as trial-preparation materials, and allows for the testing or sampling of ESI. Although Rule 45 has no equivalent to the Rule 26(f) "meet and confer" process, parties seeking discovery under Rule 45 should be encouraged to meet informally with respondents and discuss the scope of the subpoena, the desired form of response, protection for privileged and protected information, and the allocation of discovery costs.

15. This case is commonly referred to as *Zubulake III*, 216 F.R.D. 280 (S.D.N.Y 2003). *Zubulake II*, 230 F.R.D. 290 (S.D.N.Y. 2003), addressed the plaintiff's request to release a sealed transcript. *Zubulake IV*, 220 F.R.D. 212 (S.D.N.Y. 2003), addressed the plaintiff's request for sanctions (including an adverse inference instruction) arising out of the failure to preserve backup tapes and deletion of isolated e-mails. In ruling on the request, the court considered the obligation of a party to preserve digital information. In *Zubulake V*, 229 F.R.D. 422 (S.D.N.Y. 2004), the court imposed sanctions for deleting relevant e-mail. In *Zubulake VI*, 231 F.R.D. 159 (S.D.N.Y. 2005), the court denied a defense motion (brought by new counsel) to assert an affirmative defense. In *Zubulake VII*, 382 F. Supp. 2d 536 (S.D.N.Y. 2005), the court addressed in limine motions. On April 6, 2005, a jury awarded the plaintiff $9.1 million in compensatory damages and $20.1 million in punitive damages.

Form of Production

Electronically stored information can be produced in a variety of forms or formats, each with distinctive advantages and disadvantages. The form may have important implications for how easily, if at all, the information can be electronically searched, whether relevant information is obscured or sensitive information is revealed, and how the information can be used in later stages of the litigation. For example, ESI may be produced as a TIFF or PDF file, which is essentially a photograph of an electronic document. Alternatively, ESI may be produced in "native format," that is, the form in which the information was created and is used in the normal course of operations. Part Two of *Effective Use of Courtroom Technology*[16] reviews in depth the various digital formats in which documents, photographs, videos, and other materials can be produced and the related issues of cost and usability.[17] Recent decisions, including *Hagenbuch v. Sistemi Elettronici Industriali S.R.L.*[18] and *Williams v. Sprint/United Management Co.*,[19] have addressed the form of production.

Rule 34 was amended to provide a procedure for addressing the form of ESI because this issue simply did not arise with respect to paper discovery. The rule permits the requesting party to designate the form or forms in which it wants ESI produced, and it requires the responding party to identify the form in which it intends to produce the information if the requesting party does not specify a form or if the responding party objects to a form that the requesting party specifies. It also requires the parties to meet and confer if there is a dispute about form of production and provides that in the absence of a party agreement or court order, the responding party must produce electronically stored information either in a form or

16. Effective Use of Courtroom Technology: A Judge's Guide to Pretrial and Trial (Federal Judicial Center 2001).

17. Also see the term *file format* in the glossary.

18. 2006 WL 665005 (N.D. Ill. Mar. 8, 2006) (holding that production of ESI as TIFF images was insufficient and ordering production of ESI in its original format).

19. 230 F.R.D. 640 (D. Kan. 2005) (holding that the production of spreadsheets in static format was insufficient because the mathematical formulas, text exceeding cell size, and metadata were eliminated, and that the defendant should have preserved and produced the spreadsheets in native format or taken other measures to preserve and produce the nonapparent information).

forms in which it is ordinarily maintained or in a form or forms that are reasonably usable.

In resolving disputes over the form of production, considerations for the court include the following:

- What alternatives are available? What are their benefits and drawbacks for the requesting and responding parties?
- If the responding party is not producing information in the form in which it is ordinarily maintained, is the party producing it in a form that is reasonably usable to the requesting party?
- If the requesting party disputes that the proposed form of production is reasonably usable, what limits its use? Has the responding party stripped features, such as searchability, or metadata or embedded data that may be important? If so, what is the justification?

Waiver of Privilege or Work-Product Protection

The volume of ESI searched and produced in response to a discovery request can be enormous, and characteristics of certain types of ESI (e.g., embedded data, metadata, threads of e-mail communications and e-mail attachments) make it difficult to review for privilege and work-product protection. Thus, the inadvertent disclosure of privileged or protected material during production is a substantial risk that persists even if expensive and time-consuming steps are taken to identify and segregate it. To facilitate discovery, parties have entered into agreements that help minimize the risk of waiver. Under what is commonly called a "quick peek" agreement, the responding party provides requested material without a thorough review for privilege or protection, but with the explicit understanding that its production does not waive any privilege or protection. The requesting party then designates via Rule 34 the specific documents it would like produced. The responding party then has the opportunity to review the documents that have been specifically requested and withhold those that are privileged or protected. Alternatively, under "claw back" agreements, the parties typically review the material for privilege or protection before

it is produced but agree to a procedure for the return of privileged or protected information that is inadvertently produced within a reasonable time of its discovery.

Amended Rule 26(f) encourages parties to discuss whether they can agree on these or similar arrangements, recognizing the increased likelihood of inadvertent production of privileged or protected information and the commensurately increased cost and delay required for effective preproduction review.[20] Amended Rule 16(b) provides that if the parties are able to agree, the court may include their agreement in the case-management order. The rule, however, does not authorize the court to require the parties to enter into such an arrangement, absent their agreement. Because substantive privilege (and waiver) rules are beyond the scope of the Federal Rules of Civil Procedure, the rules recognize that although such an agreement is binding among the parties, it may or may not bind third parties.[21] Including the parties' agreements in a court order clarifies the effect of inadvertent production on the waiver of privilege or protection between the parties and bolsters the argument that no waiver has occurred as to third parties in other litigation.

In addition, amended Rule 26(b)(5) establishes procedures for asserting privilege or work-product protection claims after production. Under these procedures, the party claiming that already-produced information is subject to a claim of privilege or protection may notify any party that received the information of the claim and the basis for it. The receiving party must then promptly return,

20. Some early decisions have refused to enforce such agreements (*MCL 4th*, *supra* note 5, § 11.431). Other opinions and commentary have raised concerns or limitations about the use of such agreements. *See* R.J. Hedges, "A Critical Appraisal of Proposed Amendment to Federal Rule of Civil Procedure 26(b)(5)(B)," vol. 5, no. 2, Digital Discovery & e-Evidence 4 (Mar. 2005) (will production of privileged materials under an agreement be deemed a waiver vis-à-vis a third party?); Maldonado v. New Jersey, 225 F.R.D. 120, 141 (D.N.J. 2004) (such agreements may lead to the disqualification of attorneys if, even after a privileged document is returned, the attorneys' temporary possession of the document "creates a substantial taint on any future proceedings"). Also see *The Sedona Principles*, *supra* note 2, Comment 10.d, regarding concerns raised by claw back or quick peek agreements.

21. *See* Hopson v. Mayor and City Council of Baltimore, 232 F.R.D. 228 (D. Md. 2005) (reviewing the conflicting case law about whether an inadvertent disclosure of privileged or protected information constitutes a waiver and whether a confidentiality order binds third parties in parallel or future litigation, and describing the benefits of embodying any waiver agreement in a court order).

sequester, or destroy the information and any copies it has and may not use or disclose the information until the claim is resolved; if the party has disclosed the information before being notified, it must take reasonable steps to retrieve it. The receiving party may promptly present the information to the court under seal for a determination of the claim.

The accompanying Committee Note to Rule 26(b)(5) emphatically states that these procedures do not address the substantive questions of whether privilege or work-product protection has been waived or forfeited; courts should rely on developed principles to determine whether, and under what circumstances, waiver results from inadvertent production.[22] For example, unreasonable delay in seeking the return of privileged information may give rise to a waiver. The note also emphasizes that agreed-on procedures under Rules 26(f) and 16(b) would take precedence over the rule-based ones.

Any assertion of privilege raises the question of how that assertion is to be tested. The accepted practice is, of course, in camera inspection of the material by the court. In cases involving ESI, however, the judge may have to grapple with whether the sheer volume of information requires new methods of review, such as sampling or, in the most difficult cases, the use of a special master.

Preservation of ESI

As noted above, amended Rule 26(f) and the accompanying Committee Note direct parties to discuss issues regarding the preserva-

22. A proposed new Federal Rule of Evidence 502 was published for comment in August 2006. It (1) provides that inadvertent disclosure of privileged or protected information in connection with a federal proceeding constitutes a waiver only if the party did not take reasonable precautions to prevent disclosure and did not make reasonable and prompt efforts to rectify the error; (2) provides that when a confidentiality order governing disclosure is entered in a federal proceeding, according to terms agreed to by the parties, the order's terms are enforceable against nonparties in any other federal or state proceedings; and (3) codifies the proposition that parties can enter an agreement to limit the effect of waiver by disclosure between or among themselves, and makes clear that if the parties want protection from a finding of waiver by disclosure in separate litigation, the agreement must be made part of a court order. The proposed rule also limits the circumstances in which a subject-matter waiver should be found and includes a provision on selective waiver.

tion of discoverable information, particularly with respect to ESI because of its dynamic, mutable nature. In doing so, parties should attempt to balance the need to preserve relevant information and the need to continue routine computer operations critical to a party's activities.

The court may help ensure that parties meet their responsibilities for preserving information and avoid allegations of spoliation by reviewing with them steps for establishing and implementing an effective data-preservation policy. These include (1) allowing the party's "discovery liaison" to readily describe information systems, storage, and retention policies to the opposing party and the court; (2) interviewing key employees to determine sources of information; (3) affirmatively and repeatedly communicating litigation holds to all affected parties and monitoring compliance on an ongoing basis; (4) integrating discovery responsibilities with routine retention policies; (5) actively managing and monitoring document collections; (6) thoroughly documenting and demonstrating the efficacy of the preservation process; and (7) preparing to take responsibility for ensuring that information is preserved, collected, and produced.[23]

In some cases, a preservation order that clearly defines the obligations of the producing party may minimize the risk that relevant evidence will be deliberately or inadvertently destroyed, may help ensure information is retrieved when it is most accessible (i.e., before it has been deleted or removed from active online data), and may protect the producing party from sanctions.[24]

The *Manual for Complex Litigation, Fourth* provides guidance about what type of preservation order is most useful, and under what circumstances an order should be entered.[25] Because a blanket preservation order may unduly interfere in a party's day-to-day operations, may be prohibitively expensive, and may actually compound the information to be searched and produced, any order should be narrowly drawn to preserve relevant matter without imposing undue burdens.[26] Early in the case, the court should

23. This list is based on the discussion in *Zubulake V*, 229 F.R.D. 422 (S.D.N.Y. 2004).

24. Treppel v. Biovail Corp., 2006 WL 278170, *5 (S.D.N.Y. Feb. 6, 2006) (describing the benefits of preservation orders).

25. *MCL 4th*, *supra* note 5, § 11.442.

26. For an example of a broad data-preservation order, see *Pueblo of Laguna v. United States*, 60 Fed. Cl. 133, 141–43 (Ct. Cl. 2004).

discuss with the parties whether an order is needed and, if so, the scope, duration, method of data preservation, and other terms that will preserve relevant matter without imposing undue burdens.[27] In crafting the order, it is important to know from the responding party what data-management systems are routinely used, the volume of data affected, and the costs and technical feasibility of implementing the order. Preservation orders should ordinarily include provisions permitting the destruction of information under specified circumstances. Preservation orders may, for example, exclude from preservation specified categories of documents or data whose cost of preservation substantially outweighs their relevance in the litigation, particularly if the information can be obtained from other sources. Moreover, as issues in the case are narrowed, the court should reduce the scope of the order.

A closing note about preservation orders: Courts are divided as to the standard for issuance of preservation orders. One line of cases holds that preservation orders are, in effect, case-management orders and are governed by Rule 16(b).[28] A few cases have handled preservation orders as injunctions.[29]

Spoliation and Sanctions

The flip side of data preservation is, of course, spoliation. Spoliation is "the destruction or material alteration of evidence or the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation."[30] The authority to impose sanctions for spoliation arises under the Federal Rules of Civil Procedure and the court's inherent powers.[31] Determining whether

27. A court may be asked to issue an ex parte preservation order, but such orders should rarely be entered. The court is unlikely to have sufficient information about the responding party's computer system to be able to strike the correct balance between preservation and continued operation.

28. *See, e.g.*, *Treppel*, 2006 WL 278170, *7; Capricorn Power Co. v. Siemens Westinghouse Power Corp., 220 F.R.D. 429, 433–34 (W.D. Pa. 2004); *Pueblo of Laguna*, 60 Fed. Cl. at 138 n.8.

29. *See In re* African-American Slave Descendants' Litig., 2003 U.S. Dist. LEXIS 12016, *7–8 (N.D. Ill. July 15, 2003).

30. Silvestri v. General Motors Corp., 271 F.3d 583, 590 (4th Cir. 2001).

31. Zubulake v. UBS Warburg, Inc. (*Zubulake IV*), 220 F.R.D. 212, 216 (S.D.N.Y. 2003).

sanctions are warranted for spoliation of ESI is challenging because it is easier to intentionally or inadvertently delete or modify ESI and it is more difficult for parties to craft preservation policies that ensure that the appropriate data are preserved.

The degree of scienter necessary to impose sanctions for spoliation is unsettled among the courts. For example, the Eighth Circuit Court of Appeals has held that an adverse inference instruction for destruction of evidence is available only when the destruction was intentional.[32] A New Jersey district court, in contrast, has affirmed the imposition of sanctions against the defendants, including an adverse inference instruction, without any finding of bad faith.[33] Similarly, the Second Circuit Court of Appeals has stated in dicta that ordinary negligence, as the result of which a party breaches a preservation obligation, is sanctionable.[34] In general, however, case law supports the notion that extreme sanctions are available only in extreme circumstances. Once a finding of spoliation has been made, courts will address whether the specific act of spoliation in question justifies an extreme sanction, such as an adverse inference jury instruction, issue preclusion, or judgment/dismissal, rather than a less severe sanction, such as additional discovery with shifting of costs and a monetary sanction.[35]

Considering spoliation of ESI and sanctions:
- Degree of scienter
- Extent of prejudice
- Relationship to records-management policy
- Rule 37(f)

An issue that is likely to arise is whether spoliation sanctions should be imposed when evidence is destroyed in compliance with an established records-management policy. This, in turn, may lead to collateral discovery about whether such sanctions are warranted. One common function of computer systems is to delete certain information on an ongoing, prescheduled basis to prevent overloading the system (e.g., overwriting deleted digital informa-

32. Stevenson v. Union Pac. R.R. Co., 354 F.3d 739 (8th Cir. 2004); Morris v. Union Pac. R.R., 373 F.3d 896 (8th Cir. 2004).

33. Mosaid Techs. Inc. v. Samsung Electronics Co., 348 F. Supp. 2d 332 (D.N.J. 2004).

34. Residential Funding Corp. v. DeGeorge Fin. Corp., 306 F.3d 99, 108 (2d Cir. 2002).

35. See the Advisory Committee Note to the 1970 amendment to Rule 37 as it then existed (discussing *Societe Internationale v. Rogers*, 357 U.S. 197 (1958), and concluding that under Rule 37 "willfulness was relevant only to the selection of sanctions, if any, to be imposed").

tion, recycling backup tapes, and purging e-mails). Rule 37(f), effective December 1, 2006, acknowledges such record-management policies, stating that "*absent exceptional circumstances*, a court may not impose sanctions under these rules on a party for failing to provide electronically stored information lost as a result of the routine, *good-faith* operation of an electronic information system" (emphasis added). Good faith may require, among other things, a party to modify or suspend certain features of the electronic information system to prevent the loss of information subject to preservation, and it may preclude a party from exploiting the routine operation of the system to thwart the party's discovery obligations. The lead-in phrase of the rule, "absent exceptional circumstances," provides the court with additional flexibility for dealing with rare, complex situations by allowing for sanctions in extraordinary circumstances even if evidence was destroyed as a result of routine, good-faith operation of the system.

Conclusion

Discovery of ESI presents unique issues regarding the scope of discovery, the allocation of costs, the form of production, the waiver of privilege and work-product protection, and the preservation of data and spoliation. To effectively manage these issues, judges must understand the relevant technology at a level that allows effective communication with attorneys, parties, and experts. The information in this guide is a start, and additional resources can be found on the Center's intranet site.

More specifically, judges must require attorneys to take seriously their obligation to meet and confer under Rule 26(f) and to submit a meaningful discovery plan that addresses ESI issues, and judges must ensure that adequate disclosures are made pursuant to Rule 26(a)(1). Judges must also encourage parties to narrowly target requests for ESI and to make these as early as possible in the litigation. Judges must evaluate whether the costs of complying with the requests are proportional to their benefit. To this end, judges may need to encourage or order tiered discovery and sampling to determine the relevance, need, and cost of more expansive discovery, and may shift costs from the producing party to the requesting party, particularly when information that is not rea-

sonably accessible must be produced. Judges need to help ensure that ESI is produced in a usable form, and, to facilitate efficient and cost-effective discovery, judges may need to clarify the procedures to be followed if privileged or protected information is inadvertently disclosed. They should help parties establish effective data-preservation policies, balancing the need to preserve relevant evidence and the need to continue routine computer operations critical to a party's activities, and enter preservation orders as appropriate.

In complex cases, these responsibilities are not easy undertakings. Thus, it may be appropriate for the judge to require parties to provide the judge with expert briefings on the relevant technological issues, and in some instances to seek the assistance of a special master or neutral expert. For example, the court may appoint a neutral expert to help develop a discovery plan and supervise technical aspects of discovery, review documents claimed to be privileged or protected, or participate in an on-site inspection.[36]

In the end, judges must actively manage electronic discovery—raising points for consideration by the parties—rather than awaiting the parties' identification and argument of the matters. Such active management can help ensure the expeditious and fair conduct of discovery involving ESI.

36. *See MCL 4th*, *supra* note 5, § 11.446, and *The Sedona Principles*, *supra* note 2, Comment 10.c.

Glossary

Note: Most entries in this glossary were derived, with permission, from a glossary prepared by the Sedona Conference. That extensive glossary, often with fuller definitions than presented here, is updated periodically and is available for download at www.thesedonaconference.org.

active data (active records): Information located in a computer system's memory or in storage media attached to the system (e.g., disk drives) that is readily available to the user, to the operating system, and to application software. (See *storage medium.*)

archival data: Information that is intentionally maintained in long-term storage for business, legal, regulatory, or similar purposes, but not immediately accessible to a computer system's user. May be stored on removable media, such as CDs, tapes, or removable disk drives, or may be maintained on system disk drives. Typically stored in an organized way to help identify, access, or retrieve individual records or files.

backup data (disaster recovery data): An exact copy of data that serves as a source for recovery in the event of a system problem or disaster. Generally stored separately from active data on, for example, tapes or removable disk drives, and often without indexes or other information and, as a result, in a form that makes it difficult to identify, access, or retrieve individual records or files.

backup tape recycling: A process in which backup data tapes are overwritten with new backup data, usually on a fixed schedule determined jointly by records-management, legal, and information technology (IT) sources.

computer forensics: The scientific examination and analysis of computerized data primarily for use as evidence. May include the secure collection of computer data; the examination of suspect data to determine details, such as origin and content; and the presentation of computer-based information to courts. May involve re-creating deleted, damaged, or missing files from disk drives; validating dates and authors/editors of documents; and certifying key elements of electronically stored information.

data (electronic): Information stored on a computer, including numbers, text, and images. Computer programs (e.g., word processing software, spreadsheet software, presentation software) are used to process, edit, or present data.

de-duplication: A process that searches for and deletes duplicate information. (See the glossary maintained by the Sedona Conference for a description of different types of de-duplication: www.thesedonaconference.org.)

deleted data: Data that once existed on a computer as active data, but have been marked as deleted by computer programs or user activity. Deleted data may remain on the storage media in whole or in part until they are overwritten or "wiped." Even after the data have been wiped, directory entries, pointers, or other information relating to the deleted data may remain on the computer.

deletion: A process in which data are marked as deleted by computer programs or user activity and made inaccessible except through the use of special data-recovery tools. Deletion makes data inaccessible with normal application programs, but commonly leaves the data itself on the storage medium. There are different degrees of deletion. "Soft deletions" are data marked as deleted in the computer operating system (and not generally available to the end-user after such marking), but not yet physically removed from or overwritten on the storage medium. Soft-deleted data can often be restored in their entirety. This can be contrasted with "wiping," a process that overwrites the deleted data with random digital characters, rendering it extremely difficult to recover, and "degaussing," which rearranges the magnetic patterns on the medium, rendering it impossible to recover with all but the most sophisticated computer forensics tools.

electronic discovery: The process of collecting, preparing, reviewing, and producing electronic documents in a variety of criminal and civil actions and proceedings.

embedded data: Data that include commands that control or manipulate data, such as computational formulas in spreadsheets or formatting commands in a word processing document. Not visible when a document is printed or saved as an image format. (See *metadata*.)

ESI: Electronically stored information.

file format: The internal organization, characteristics, and structure of a file that determine the software programs with which it can optimally be used, viewed, or manipulated. The simplest file format is ASCII (American Standard Code for Information Interchange; pronounced "ASK-ee"), a nonproprietary text format. Documents in ASCII consist of only text with no formatting or graphics and can be read by most computer systems using nonproprietary applications. Specific applications may define

unique (and proprietary) formats for their data (e.g., WordPerfect document file format). Files with unique formats may only be viewed or printed by using their originating application or an application designed to work with compatible formats. These formats are also called the "native" format. Computer systems commonly identify files by a naming convention that denotes the native format (and therefore the probable originating application). For example, a WordPerfect document could be named document.wpd, where .wpd denotes a WordPerfect file format. Other common formats are .xls for Microsoft Excel spreadsheet files, .txt for ASCII text files, .ppt for Microsoft PowerPoint files, .jpg for photographs or other images, and .pdf for Adobe Acrobat documents.

form of production: The manner in which requested documents are produced. Used to refer to both file format and the media on which the documents are produced (paper vs. electronic).

hash value: A unique numerical identifier that can be assigned to a file, a group of files, or a portion of a file, based on a standard mathematical algorithm applied to the characteristics of the data set. The most commonly used algorithms, known as MD5 and SHA, will generate numerical values so distinctive that the chance that any two data sets will have the same hash value, no matter how similar they appear, is less than one in one billion. "Hashing" is used to guarantee the authenticity of an original data set and can be used as a digital equivalent of the Bates stamp used in paper document production.

image (verb): To image a hard drive is to make an identical copy of the hard drive at the lowest level of data storage. The image will include deleted data, residual data, and data found in hidden portions of the hard drive. Also known as creating a "bitstream image" or "mirror image," or "mirroring" the drive. It is different than the process of making a "logical copy" or "ghosting" a hard drive, which normally copies only the active data found on the hard drive, and not the deleted data, residual data, and data found in hidden portions of the hard drive.

legacy data: Information in which an organization may have invested significant resources to develop and which retains importance, but which was created and is stored with software and/or hardware that has become obsolete or replaced ("legacy systems"). May be costly to restore or reconstruct.

metadata: Information about a particular data set or document which describes how, when, and by whom the data set or document was collected,

created, accessed, or modified; its size; and how it is formatted. Some metadata, such as file dates and sizes, can easily be seen by users; other metadata can be hidden from users but are still available to the operating system or the program used to process the data set or document. (See *embedded data* and *systems data*.)

nearline data storage: Storage in a system that is not physically part of the computer system or local network in daily use, but can be accessed through the network. Nearline data may be stored in a library of CDs, which can be automatically located and mounted for reading, or stored at a remote location accessible through an Internet connection. There is usually a small time lag between the request for data stored in nearline media and the data's availability to an application or end-user. Making nearline data available is an automated process (as opposed to "offline" data, which can only be made available by a person physically retrieving the data).

offline storage: The storage of electronic records, often for long-term archival purposes, on removable media (e.g., CDs, removable disk drives) or magnetic tape that is not connected to a computer or network. Accessibility to off-line media usually requires manual intervention and is much slower than online or nearline storage, depending on how and where the media are stored.

PDF (portable document format): A file format developed by Adobe Systems Incorporated. Documents, once converted to this format, are readable outside of the application that created them. A PDF file captures document formatting information (e.g., margins, spacing, fonts) from the original application (e.g., WordPerfect) in such a way that the document can be viewed and printed as intended in the original application by the Adobe Reader program, which is available for most computer operating systems. Other programs (notably Adobe Acrobat) are required to edit or otherwise manipulate a PDF file.

records management: The activities involved in handling information, generally for organizations that are large data producers. Records management includes maintaining, organizing, preserving, and destroying information, regardless of its form or the medium on which it is stored.

residual data (ambient data): Data that are not active on a computer system and that are not visible without use of "undelete" or other special data-recovery techniques. May contain copies of deleted files, Internet files, and file fragments.

restore: To transfer data from a backup or archival storage system (e.g., tapes) to an online system. Restoration of archival data may require not only data restoration but also replication of the original hardware and software operating environment.

sampling: A process of selecting and searching a small part of a larger data source to test for the existence or frequency of relevant information, to assess whether the source contains privileged or protected information, and to assess the costs and burdens of identifying and producing requested information.

search engine: A program that enables a search for keywords or phrases, such as on webpages throughout the World Wide Web. (See the glossary maintained by the Sedona Conference for a description of different types of searches: www.thesedonaconference.org.)

storage medium: The physical device containing ESI, including computer memory, disk drives (including removable disk drives), magneto-optical media, CDs, DVDs, memory sticks, and tapes.

systems data: Information about a computer system that includes, for example, when people logged on and off a computer or network, the applications and passwords they used, and what websites they visited.

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The Federal Judicial Center is the research and education agency of the federal judicial system. It was established by Congress in 1967 (28 U.S.C. §§ 620–629), on the recommendation of the Judicial Conference of the United States.

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COZEN O'CONNOR

DIRECTORY OF OFFICES

PRINCIPAL OFFICE: PHILADELPHIA
1900 Market Street
Philadelphia, PA 19103-3508
Tel: 215.665.2000 or 800.523.2900
Fax: 215.665.2013
For general information please contact:
Joseph A. Gerber, Esq.

ATLANTA
Suite 2200, SunTrust Plaza
303 Peachtree Street, NE
Atlanta, GA 30308-3264
Tel: 404.572.2000 or 800.890.1393
Fax: 404.572.2199
Contact: Kenan G. Loomis

CHARLOTTE
Suite 2100, 301 South College Street
One Wachovia Center
Charlotte, NC 28202-6037
Tel: 704.376.3400 or 800.762.3575
Fax: 704.334.3351
Contact: T. David Higgins, Jr., Esq.

CHERRY HILL
Suite 300, LibertyView
457 Haddonfield Road, P.O. Box 5459
Cherry Hill, NJ 08002-2220
Tel: 856.910.5000 or 800.989.0499
Fax: 856.910.5075
Contact: Thomas McKay, III, Esq.

CHICAGO
Suite 1500, 222 South Riverside Plaza
Chicago, IL 60606-6000
Tel: 312.382.3100 or 877.992.6036
Fax: 312.382.8910
Contact: James I. Tarman, Esq.

DALLAS
1717 Main Street, Suite 2300
Dallas, TX 75201-7335
Tel: 214.462.3000 or 800.448.1207
Fax: 214.462.3299
Contact: Lawrence T. Bowman, Esq.

DENVER
707 17th Street, Suite 3100
Denver, CO 80202-3400
Tel: 720.479.3900 or 877.467.0305
Fax: 720.479.3890
Contact: Brad W. Breslau, Esq.

HOUSTON
One Houston Center
1221 McKinney, Suite 2900
Houston, TX 77010-2009
Tel.: 832.214.3900 or 800.448.8502
Fax: 832.214.3905
Contact: Joseph A. Ziemianski, Esq.

LOS ANGELES
Suite 2850
777 South Figueroa Street
Los Angeles, CA 90017-5800
Tel: 213.892.7900 or 800.563.1027
Fax: 213.892.7999
Contact: Mark S. Roth, Esq.

LONDON
9th Floor, Fountain House
130 Fenchurch Street
London, UK
EC3M 5DJ
Tel: 011.44.20.7864.2000
Fax: 011.44.20.7864.2013
Contact: Richard F. Allen, Esq.

MIAMI
Wachovia Financial Center
200 South Biscayne Boulevard,
Suite 4410, Miami, FL 33131
Tel: 305.704.5940 or 800.215.2137
Contact: Richard M. Dunn, Esq.

NEW YORK
45 Broadway Atrium, Suite 1600
New York, NY 10006-3792
Tel: 212.509.9400 or 800.437.7040
Fax: 212.509.9492
Contact: Michael J. Sommi, Esq.

909 Third Avenue
New York, NY 10022
Tel: 212.509.9400 or 800.437.7040
Fax: 212.207.4938
Contact: Michael J. Sommi, Esq.

NEWARK
Suite 1900
One Newark Center
1085 Raymond Boulevard
Newark, NJ 07102-5211
Tel: 973.286.1200 or 888.200.9521
Fax: 973.242.2121
Contact: Kevin M. Haas, Esq.

SAN DIEGO
Suite 1610, 501 West Broadway
San Diego, CA 92101-3536
Tel: 619.234.1700 or 800.782.3366
Fax: 619.234.7831
Contact: Joann Selleck, Esq.

SAN FRANCISCO
Suite 2400, 425 California Street
San Francisco, CA 94104-2215
Tel: 415.617.6100 or 800.818.0165
Fax: 415.617.6101
Contact: Joann Selleck, Esq.

SANTA FE
125 Lincoln Avenue, Suite 400
Santa Fe, NM 87501-2055
Tel: 505.820.3346 or 866.231.0144
Fax: 505.820.3347
Contact: Harvey Fruman, Esq.

SEATTLE
Suite 5200, Washington Mutual Tower
1201 Third Avenue
Seattle, WA 98101-3071
Tel: 206.340.1000 or 800.423.1950
Fax: 206.621.8783
Contact: Jodi McDougall, Esq.

TRENTON
144-B West State Street
Trenton, NJ 08608
Tel: 609.989.8620
Contact: Jeffrey L. Nash, Esq.

TORONTO
One Queen Street East, Suite 1920
Toronto, Ontario M5C 2W5
Tel: 416.361.3200 or 888.727.9948
Fax: 416.361.1405
Contact: Christopher Reain, Esq.

WASHINGTON, DC
The Army and Navy Building
Suite 1100, 1627 I Street, NW
Washington, DC 20006-4007
Tel: 202.912.4800 or 800.540.1355
Fax: 202.912.4830
Contact: Barry Boss, Esq.

WEST CONSHOHOCKEN
Suite 400, 200 Four Falls Corporate Center
P.O. Box 800
West Conshohocken, PA 19428-0800
Tel: 610.941.5400 or 800.379.0695
Fax: 610.941.0711
Contact: Ross Weiss, Esq.

WILMINGTON
Suite 1400, Chase Manhattan Centre
1201 North Market Street
Wilmington, DE 19801-1147
Tel: 302.295.2000 or 888.207.2440
Fax: 302.295.2013
Contact: Mark E. Felger, Esq.

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