

# Specialty Lines Advisory

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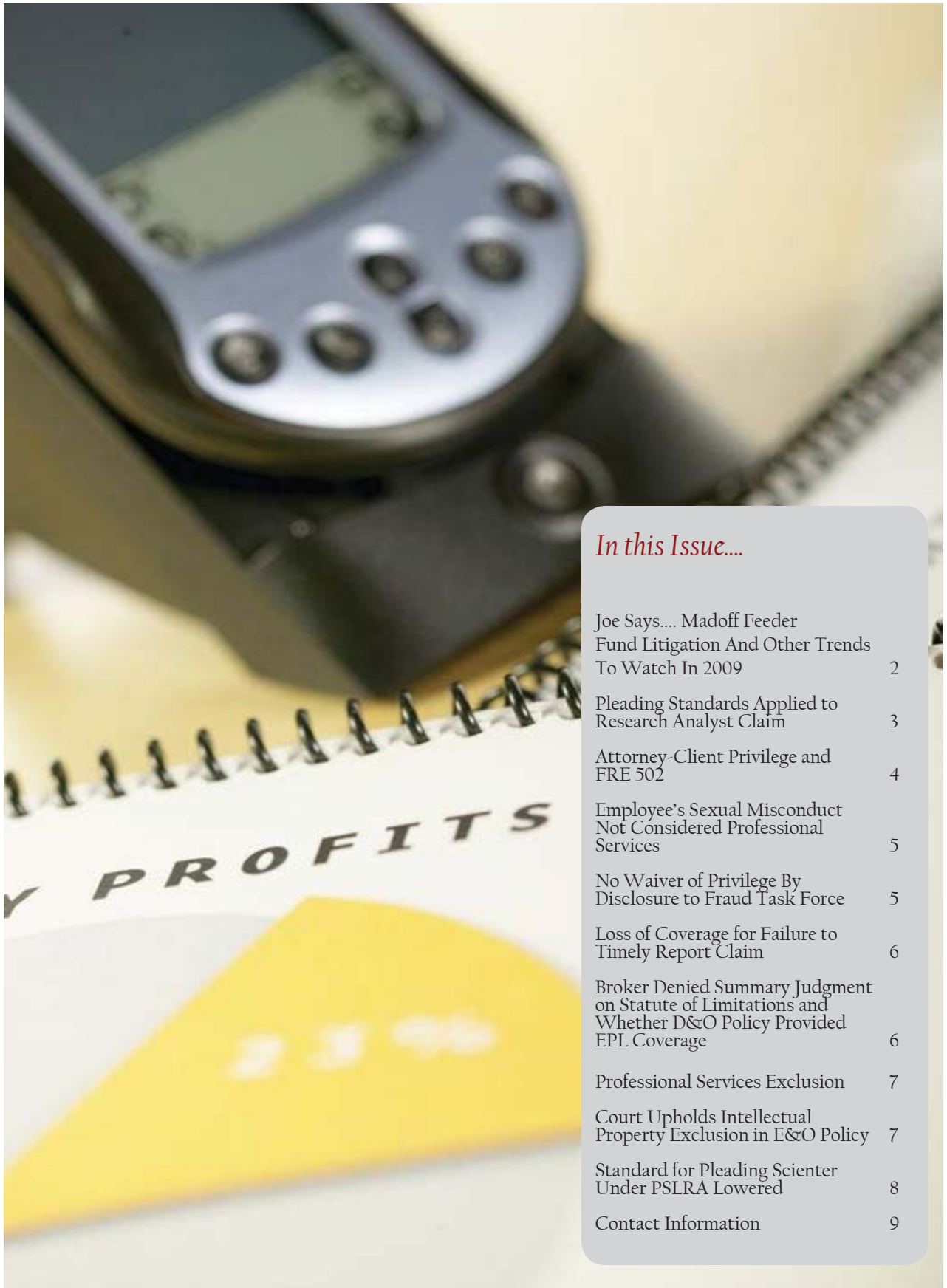
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## Joe Says ...



### **Bernie Madoff Feeder Fund Litigation And Other Trends To Watch In 2009**

I usually procrastinate as long as possible before writing one of these year-end forecasts. That's probably a good thing because, if I had done this say on Thanksgiving weekend, I could never have imagined the legitimacy of the title of this month's column!

Believe it or not, this is emerging as a viable claims trend in the financial institution arena, particularly for hedge fund D&O and E&O insurers as those funds are increasingly being called to task for placing client funds with Madoff and his various investment vehicles. To date, there have been about a half dozen suits, but that number will surely climb as the plaintiffs' bar continues to gather the aggrieved investors to serve as lead plaintiffs in class actions.

Although it is doubtful that this will be as large a genre as was subprime litigation in the latter half of 2007 and throughout 2008, it will no doubt warrant some tracking. Along those lines, one must query whether subprime continues to be an appropriate category – or at least an appropriate category *name* – to track. With the country officially in recession since December 2007 and the credit crisis showing little signs of abatement, we can expect to continue to see increased levels of litigation in the D&O and E&O arena in 2009. The underpinnings of this litigation have gone beyond subprime loan activity, but rather now are driven by tightening credit markets and its impact on economic activity. While much of the litigation in 2008 centered in the financial services sector, continuing turmoil in the domestic automobile industry and throughout the

manufacturing sectors, could lead to a more broad-based array of securities and E&O litigation.

As with any period of economic decline and recession, we can expect to see an increase in litigation activity. Unfortunately, the E&O and professional liability areas are not tracked as carefully and accurately as securities fraud class actions. Nonetheless, it should not be surprising to see the former claims track the increase in class action activity that we have seen throughout 2008.

While it is difficult to track with certainty, there also appears to be increasing frequency of coverage disputes in the specialty lines areas. As we gather decisions of interest for our commentary in this Advisory every month, it is remarkable that there is never a shortage of such decisions of interest and importance, and our most difficult task is to cull the wheat from the chaff and publish a manageable issue of significant case law developments. This is perhaps even more remarkable when one considers that many of these policies have arbitration provisions and, thus, not all coverage disputes result in decisions that become matters of public record.

We can expect to see continuing high levels of coverage litigation and arbitration despite the inexorable trend of broader coverage terms and conditions in a prolonged soft insurance market. Indeed, even where there have been some brief interludes of price hardening, the wording trends have continued to be more expansive. Although one would believe that this should lead to a decrease in coverage disputes, many of the coverage disputes we are seeing involve very fact-specific issues that seem to lend themselves to frequent and repeated litigation and arbitration.

A prime example of this would be disputes over prior acts exclusions and interrelated wrongful acts language. Many of the wordings are in a legal sense clear and unambiguous, but it is the application of the wording to the facts at hand that gives rise to the dispute and the judicial precedent only offers incomplete guidance as to resolution. Thus, each side is tempted to test whether a court or arbitration tribunal

will sustain its view of how the wording should apply to the facts.

Later in January we will be welcoming the Chinese Year of the Ox. Hopefully, yours will not be the one to be gored!

*Would you like to offer a comment? [Click here to let me know what you think.](#)*

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# HEIGHTENED PLEADING STANDARD TO ESTABLISH FRAUD ON THE MARKET APPLIED TO CLAIMS AGAINST RESEARCH ANALYST

The Second Circuit clarified whether a heightened pleading standard applies in securities fraud lawsuits against research analysts pursuant to the “fraud-on-the-market” presumption in Salomon Analyst Metromedia Litigation, 2008 U.S. App. LEXIS 20570 (2d Cir. N.Y., Sept. 30, 2008).

Plaintiffs, a class of purchasers of Metromedia Fiber Network Inc. (“Metromedia”) securities alleged that defendants (Citigroup Inc. (“Citigroup”), Citigroup Global Markets, Inc., Citicorp USA, Inc. (“Citicorp”), and Jack Grubman, a Salomon Smith Barney research analyst, participated in a scheme to defraud stock purchasers by issuing false research analyst reports. In particular, Jack Grubman, falsely portrayed projections of a \$350 million credit facility to be underwritten by Citicorp through his positive recommendations by which Metromedia intended to fund its business plan.

Acknowledging that Fed. R. Civ. P. 23(a) class action requirements had been met, the court first examined whether the class plaintiffs properly pled the Fed. R. Civ. P. 23(b)(3) predominance requirement, specifically “whether and how” the “fraud-on-the-market” presumption applies to research analysts. See Fed. R. Civ. P. 23 (2008). More precisely, did the individuals of the class sufficiently demonstrate that they were collectively harmed by the alleged misrepresentations and omissions in Mr. Grubman’s report?

The Court concluded that the price of shares is a summation of not just all public information, but any material misrepresentation. Consequently, the court stated that “an investor’s reliance on any public material misrepresentations...may be presumed for

purposes of a Rule 10b-5 action” and thus held that reliance could be established through pleading and ultimate proof of a fraud on the overall securities market.

The Court then assuaged defendants’ anticipated concerns that, absent a heightened pleading, there could be a “flood of frivolous or vexatious lawsuits” for the statements of any speaker. The Court explained that plaintiffs still must show materiality of the misstatements, and defendants may rebut such presumptions *prior* to class certification. Also, opinions regarding “uncertain future events” are not actionable.

While agreeing that non-issuers may be subject to the fraud-on-the-market presumption, the Court nonetheless disagreed with the lower court’s assessment of when a defendant may rebut the presumption.

The Court noted that defendants did not attempt to rebut plaintiffs’ allegations concerning the effect of defendants’ misrepresentations on the market price. Nonetheless, the Court gave defendants the benefit of the doubt as case law on the timing for rebuttal had not been clear until this time. As such, the Court concluded that defendants should not be deprived of the chance to rebut and granted them the opportunity to present their rebuttal argument. In permitting defendants to rebut, the Court noted that a

successful rebuttal could even defeat the classification predominance.

## TRESSLER COMMENTS

In light of everything that has taken place in the securities markets since then, the research analysts’ “scandal” and Jack Grubman in particular seem like ancient history. One would hope that many of the business practices underlying the litigation have since been corrected, and there will be little if anything in the way of future claims against investment banks as a result of their analysts’ reports. Nevertheless, this is another example of a court applying heightened pleading standards to defendants outside the realm of the securities issuer and its directors and officers.



*Prepared by Jill A. Ellman, an Associate in our New York office.*

## How to Manage Insurance Coverage in the Subprime Crisis - January 6, 2009 - 3pm (est)

Presented by DRI’s Insurance Law Committee -

Speakers: Joseph Monteleone and Thomas Hanekamp of Tressler with Kevin Gadbois of Great American Insurance



This webconference will explain the origin of the subprime crisis and the insurance industry’s reaction to the multitude of claims arising from the litigation explosion. It will teach insurance practitioners the issues and key insurance policy language that may impact the outcome of coverage disputes arising from these claims. This course also explains how these issues arise under various types of policies, including general liability policies, directors and officers liability policies and errors and omissions policies.

### Who Should Attend

- Insurance coverage practitioners who want to learn about the latest developments in insurance coverage for subprime litigation claims
- In-house counsel for companies affected by the crisis
- Commercial litigators involved in this litigation
- Insurance claims counsel and other professionals handling subprime claims

### What Will You Learn

- An overview of the subprime crisis
- Identification of common insurance coverage issues arising from subprime litigation claims
- What to tell clients about the new trends affecting this area of the law

The State Bar of California has approved this webconference for CLE credit.

Please visit [www.dri.org](http://www.dri.org) for accreditation in your state and links to all state bar associations.

**Register**

# ATTORNEY-CLIENT PRIVILEGE: FEDERAL RULE OF EVIDENCE 502 BECOMES LAW

In the past, the inadvertent production of even a single privileged document in some cases has resulted in a finding that the disclosing party waived the attorney-client privilege with respect to not only that document but to all other documents concerning the same subject matter. Consequently, discovery in recent years has become progressively time consuming, contentious and expensive.

On September 19, 2008, Federal Rule of Evidence 502 became law. Rule 502 protects litigants from subject-matter waivers, unless “fairness” requires otherwise. An inadvertent disclosure will not waive the privilege as long as the holder takes reasonable steps to prevent disclosure and acts promptly to retrieve the inadvertently disclosed documents. Rule 502 will also allow parties to seek court orders providing that the disclosure of privileged or protected information does not constitute a waiver. Further, parties in federal proceedings can enter into confidentiality agreements, which, if incorporated into a court order, will bind nonparties. Rule 502 applies to all proceedings filed after September 19, 2008 and in all pending actions “insofar as is just and practicable”. Highlights of Rule 502 and its Advisory Committee Notes are as follows:

## **RULE 502(A) - LIMITATION ON SUBJECT-MATTER WAIVER.**

- The disclosure of attorney-client privileged information or work-product during a federal proceeding or when made to a federal agency triggers a subject-matter waiver only when:
  1. The waiver is intentional;
  2. The disclosed and undisclosed information concern the same subject matter; and
  3. The disclosed and undisclosed information “ought in fairness to be considered together.”
- The Notes to Rule 502(a) indicate that subject-matter waiver should be limited to situations in which a party intentionally discloses protected information in litigation in a “selective, misleading and unfair manner” in order to gain a “tactical advantage.”

## **RULE 502 (B) - INADVERTENT DISCLOSURE OCCURRING IN A FEDERAL PROCEEDING OR MADE TO A FEDERAL AGENCY.**

- Inadvertent disclosure of privileged information or work product during a federal proceeding or to a federal agency does not constitute a waiver in a federal or state proceeding if:
  1. The disclosure is inadvertent;

2. The holder of the privilege initially took reasonable steps in an attempt to prevent the disclosure; and
3. The holder promptly took reasonable steps to rectify the error once learned.

- The Advisory Committee Notes to Rule 502(b) indicate that it does not require post-production review to determine whether protected information has been produced by mistake, but does require the producing party to act with reasonable promptness once the inadvertent disclosure has been discovered.

## **RULE 502(C) - INADVERTENT DISCLOSURE MADE IN A STATE PROCEEDING.**

- The inadvertent disclosure of privileged material made in a state proceeding does not constitute a waiver in a federal proceeding if the disclosure:
  1. Would not be a waiver under Rule 502 had it been made in a federal proceeding; or
  2. Is not a waiver under the law of the state where the disclosure occurred.
- Rule 502(c) requires a comparison of the applicable federal and state law on inadvertent waiver and applies the law which is more protective of privilege and work product.
- According to the Notes, where a state court order finds no waiver in connection with a disclosure made in a state court proceeding, that order is enforceable in a subsequent federal proceeding.

## **RULE 502(D) - IMPACT OF A FEDERAL COURT'S NON-WAIVER ORDER.**

- Rule 502(d) authorizes a federal court to enter a non-waiver order – that attorney-client privilege or work-product protection is not waived by the disclosure of protected information in connection with litigation pending before that court – in which event such a disclosure in that proceeding does not constitute a waiver in any other federal or state proceeding.
- The Notes explain that the agreement of the parties is not a prerequisite to the entry of a non-waiver order under the Rule 502 or to the enforceability of such an order.

## **RULE 502(E) - IMPACT OF PARTY AGREEMENTS ON WAIVER.**

- A non-waiver agreement entered in a

federal proceeding (e.g., clawback or a quick peek) only binds the parties to the agreement and not third parties – unless the agreement is incorporated into a court order.

## **RULE 502(F) - CONTROLLING EFFECT OF THE RULE.**

- Rule 502 applies to any type of federal proceeding including mandated arbitration proceedings.

## **TRESSLER COMMENTS**

Waiver of privilege has become a very critical litigation issue as demonstrated by the Regents of the University of California case discussed at page 5 of this *Advisory*. FRE 502 attempts to address some of these issues in federal court proceedings.



*Prepared by John M. O'Driscoll, a Partner in our Chicago office.*

# HOSPITAL EMPLOYEE'S SEXUAL MISCONDUCT DID NOT CONSTITUTE THE RENDERING OF PROFESSIONAL SERVICES

In Fairbanks Hospital v. Harrold, 2008 Ind. App. LEXIS 2501 (Ind. App. 2008), the Indiana Court of Appeals affirmed a trial court's ruling that a claim against a hospital for negligent supervision of an employee, who allegedly engaged in unwanted sexual advances toward a patient, did not constitute the rendition of health care or professional services, was not covered by the Indiana Medical Malpractice Act, and therefore was not covered by the hospital's professional liability policy.

Natilie Harrold, 18 years old, was admitted to Fairbanks Hospital for substance abuse treatment. Larry Shears, a counselor at the hospital, made a series of unwanted sexual advances toward Natilie. After she was discharged, Natilie sued the hospital. Count 1 against the hospital alleged negligent supervision of Shears. The other counts alleged that the hospital was vicariously liable for the intentional torts of Shears, including battery. The hospital sought a ruling, as a matter of law, that the claims fell within the scope of the Indiana Medical Malpractice Act and that the hospital, as a qualified health care provider, was entitled to coverage through its professional liability carrier.

The Court of Appeals noted that Indiana courts have consistently held that an "employee's sexual conduct with a patient cannot constitute a rendition of health care or professional services," and thus a claim based on sexual misconduct does not fall under the Medical Malpractice Act. In seeking to avoid that conclusion, the hospital had argued that the claims constituted medical malpractice because they focused on

whether the hospital itself had failed to use reasonable care in its supervision of Shears and thus had failed to use reasonable care in the rendering of patient care. The Court of Appeals, however, noted that in order to recover against the hospital, two elements had to be proven: (1) that Shears was guilty of sexual misconduct and (2) that Shears was in a position to commit the sexual misconduct because of the negligent supervision of the hospital. The Court ruled that in order for a claim to fall within the purview of the Medical Malpractice Act, all of the tortious conduct at issue must sound in medical malpractice, that is, all of the conduct at issue must be based on "conduct, curative or salutary in nature, by a health care provider acting in his or her professional capacity." Because Natilie had to prove that Shears was guilty of sexual misconduct in order to recover against the hospital on the negligent supervision claim, and because Shear's alleged sexual misconduct did not constitute the rendition of health care or professional services, the Court ruled that Natilie's complaint did not fall within the scope of the Medical Malpractice Act. As a result of the Court's ruling, the

hospital would not be entitled to coverage from its professional liability carrier.

## TRESSLER COMMENTS

The reasoning of the Court here is similar to that in cases where liability is sought to be imposed upon an employer for the sexual misconduct of its employee toward a subordinate or co-worker. The rationale there is that it is never within the course and scope of employment to sexually harass another employee and, thus, the employer can have no vicarious or respondeat superior liability for that conduct.



*Prepared by Michael W. Morrison, a Partner in our Chicago office.*

# PLAINTIFFS IN A SUBSEQUENT CIVIL ACTION CANNOT COMPEL THE TURNOVER OF DISCLOSURES MADE TO FEDERAL INVESTIGATORS

In Regents of the University of California v. Superior Court, 165 Cal.App.4th 672, 81 Cal.Rptr.3d 186 (2008) California plaintiffs in an anti-trust action unsuccessfully sought production of privileged documents from defendants. The court held that defendants' prior disclosure of privileged materials to a federal investigative agency did not waive privilege because the disclosure was coerced.

A group of energy suppliers disclosed attorney-client and work product privileged documents to a federal Corporate Fraud Task Force (the "Task Force"). The Task Force was investigating the group. It had a policy of considering cooperation as a factor in deciding whether to indict. The reason for the disclosure was to avoid indictment. Subsequently a group of California plaintiffs filed an anti-trust suit against the energy suppliers. Plaintiffs moved to compel production of the privileged documents arguing that disclosure to the Task Force waived any privilege.

Pursuant to California Evidence Code, §912, the attorney-client privilege is waived when privileged documents are disclosed without "coercion". The trial court held that because defendants believed that failure to disclose privileged materials to the Task Force would

result in indictment or regulatory sanction, the disclosure was "coerced".

The appellate court, on first impression, affirmed the trial court. It first reviewed cases involving inadvertent disclosure. When privileged materials are inadvertently disclosed, privilege is waived unless reasonable steps were taken to prevent disclosure and preserve confidentiality, but such steps need not be extraordinary nor heroic. Inadvertent disclosure doctrine was then likened to coercion doctrine by citing to O'Mary v. Mitsubishi Electronics America, Inc., 59 Cal.App.4th 563, 69 Cal.Rptr.2d 389 (1997) which states that discovery itself is coercive. Comparing O'Mary and other cases to the present matter, the court held that the coercion involved in a government investigation is even more powerful than the

coercion involved in a court order because the latter can be challenged without penalty.

## TRESSLER COMMENTS

Waiver of privilege is not automatic where information is provided to agencies whilst under governmental investigation. This decision is particularly timely given the recent enactment of FRE 502 as described elsewhere in this *Advisory*.



*Prepared by John M. O'Driscoll, a Partner in our Chicago office.*

# TERMITE INSPECTOR BUGGED TO LOSE COVERAGE BECAUSE OF FAILURE TO TIMELY REPORT

Alpine Home Inspections, LLC v. Underwriters at Lloyd's London, New Jersey Appellate Division, slip op. October 2008, presents an excellent illustration of the nature of claims made and reported coverage, including the perils of failure to comply with the policy's timely notice provision.

Buying a house for over \$3,000,000 and discovering it has termites takes a real bite out of a homeowner's experience. Finding out the home inspector you sued loses his errors & omissions coverage because he failed to timely report the claim leaves the homeowner feeling gnawed at the prospect of having lost access to a deep(er) pocket.

In Alpine, the court rejected the insured home inspector's arguments that he was entitled to coverage under a claims made policy despite the fact that he did not timely report the claim. While the home inspector admitted to receipt of a letter making a claim in June 2005 and providing a preliminary estimate of alleged damages, the home inspector argued that there was no need to report such claim under the Lloyd's 2004-2005 claims made policy year because the claim amount was within his deductible. In the absence of controlling policy language to the contrary, the court rejected the home inspector's argument that the value of the claim was determinative as to whether a report was necessary. The insured's effort to convince the court that

a claim for increased damages constitutes a new claim was also rejected. The court likewise rejected the insured's argument that because he obtained a policy from Lloyd's for the following year as well he had "continuous coverage".

Finding the policy language of the claims made policy clear and unambiguous, the court affirmed the award of summary judgment in favor of the insurer Lloyd's.

## TRESSLER COMMENTS

While New Jersey courts typically enforce the claims made policy language and declare that no coverage is owed when a claim is not reported in accord with the policy provisions so as not to extend the coverage beyond the exposure bargained for by the insurer, the final comments of the court in Alpine warrant comment. Particularly, in rejecting the home inspector's claim for coverage here, the court noted that the home inspector was "denied coverage not because of any misunderstanding about the nature of a claims

made policy or because he did not comply with statutory or regulatory requirements, or because of an exception within the policy, but because he simply chose not to report the claim when he received it." The lesson to be learned for insureds and their agents is to report each and every claim, regardless of amount at issue, lest one jeopardize coverage because of the policy's timely claim reporting requirement. Large insureds with multiple claims in their experience and significant deductible amounts can, however, typically negotiate policy provisions for periodic bordereau type reporting or certain reporting thresholds to prevent late notice problems.



*Prepared by Joanna L. Crosby a Partner in our Newark office.*

# BROKER DENIED SUMMARY JUDGMENT ON STATUTE OF LIMITATIONS AND WHETHER D&O POLICY PROVIDED EPL COVERAGE

As is becoming increasingly common, an insured that was denied coverage sued both its insurance broker and the insurance company arguing both were at fault for the absence of coverage for a claim made against it. Judge Mary Ann Vial Lemmon rejected the insurance broker's attempt to be dismissed from the lawsuit on the grounds that the insured filed suit too late under Louisiana's preemptive period statute because the D&O policy it obtained through Chubb did provide the type of EPL coverage the insured needed. The Court's ruling that the suit was timely filed and that there were outstanding issues of material fact as to the coverage issue, allowed plaintiff the chance to prove its claim at trial. Crescent River Port Pilot's Association v. Chubb et. al., No. 05-5491 E.D. LA. 2008 U.S. Dist. LEXIS 89221.

In April 2001, Crescent River Port Pilot's Association ("Crescent") obtained a D&O policy from Chubb through Kelly Martinez, who was with Crescent's then insurance broker, Jourdan Harrison Insurance Brokers. When Mr. Martinez joined Summit Global Partners, Inc. he brought the Crescent account with him. In 2003, Summit renewed the Chubb D&O policy for Crescent.

In 2004 Crescent was sued for age discrimination. Chubb denied the claim on the basis that Crescent did not have EPL coverage under the D&O policy. Crescent sued Chubb for denying the claim, and also sued Summit for failing to obtain the necessary EPL coverage, which it contended would have covered the age discrimination claim. As the claim against Chubb went to arbitration, the suit proceeded only against Summit. Summit moved for summary judgment arguing that Crescent filed its claim too late under Louisiana's "preemptive period" (statute of

limitations) statute (La. Rev. Statute § 9:5606.) In the alternative, Summit contended it was not liable because the D&O Policy *did* provide coverage for age discrimination claims.

Judge Lemmon quickly rejected Summit's argument that Crescent had not timely filed its suit. Although Chubb began insuring Crescent in 2001, Summit owed no responsibility to Crescent until March 2003 when it became Crescent's broker. As Crescent filed suit against Summit in November 2005, it was well within the three-year preemptive period. However, the issue of whether, as Summit claimed, the D&O Policy in fact provided EPL coverage was not as easy to determine. Focusing on deposition testimony by Mr. Martinez regarding his discussions with a Chubb underwriter and letters from Chubb explaining why there was no coverage for the claim under the policy, Judge Lemon concluded there were outstanding issues of material fact as to the coverage issue and

denied Summit's motion.

## TRESSLER COMMENTS

Insurance brokers are increasingly becoming targets of insureds when coverage is denied under a policy. As in this case, timing may be everything in terms of when the broker became responsible for procuring the policy. While the court seemed to find the broker's testimony compelling, "construing the facts in the light most favorable to the plaintiffs," she gave the insured the benefit of the doubt allowing it to proceed to trial.



*Prepared by Mary E. McPherson, a Partner in our Orange County office.*

# PATIENT'S FALL DURING X-RAY PROCEDURE FALLS WITHIN PROFESSIONAL SERVICES EXCLUSION OF GL POLICY

The Florida District Court of Appeal held that claims against a medical clinic for injuries suffered by a patient who fell while her foot was being positioned for an x-ray were subject to a "professional services" exclusion in the clinic's general liability policy. State Farm Florida Ins. Co. v. Campbell, No. 5D07-2358, 2008 WL 4820477 (Fla. Dist. Ct. App. November 7, 2008).

Appellee Sarah Campbell was a patient at the podiatric practice of Beth Pierce, DPM, P.A. and Brett Cutler, DPM, P.A. While a certified x-ray technician was positioning Campbell's foot for an x-ray, Campbell lost her balance, fell backward and sustained injuries. Campbell filed suit asserting negligence against Drs. Pierce and Cutler, who submitted the claims to their professional liability insurer. Dr. Cutler also submitted Campbell's claims to Appellant, State Farm, under his business liability policy.

State Farm subsequently sought a declaratory judgment that it was not required to defend or indemnify against Campbell's claims based on the "professional services exclusion," which precluded coverage for injuries "due to rendering or failure to render any professional services or treatments," including x-ray treatments.

The trial court interpreted "due to" to mean "caused by" and found that Campbell's injury was not caused by rendering professional services because it occurred while her foot was being positioned in preparation for the x-ray, not by an x-ray malfunction. The trial court also concluded that the language of the professional services exclusion was subject to two reasonable interpretations because the policy did not indicate that it excluded "anything

conducive to the professional service nor does it state it excludes preparation for the service." Resolving the ambiguity in favor of the insured, the trial court entered summary judgment against State Farm. The Florida District Court of Appeal reversed.

The Court began its analysis by focusing on the plain meaning of the term "due to," which Webster's defined as "owing or attributable." Thus, if Campbell's injuries were owing or attributable to the giving, providing or doing of x-ray services, it was excluded by the plain language of the policy. The Court noted further that whether an act arises from the providing of a professional service "is determined by focusing upon the particular act itself," rather than the character of the individual performing the act.

In finding that the positioning of the foot was an essential aspect of the x-ray process, rather than simply "preparation for a service," the Court noted two critical, undisputed facts. First, Campbell was injured while her foot was being positioned so that an x-ray could be taken. Second, the patient must be properly positioned to take an x-ray. Since the act of positioning Campbell's foot was causally connected to taking the x-ray, it is encompassed within the term "x-ray services," and therefore excluded from coverage. Finally,

the Court reasoned that the inclusion of the word "services" within the exclusion clearly encompassed more than just taking an x-ray and that Appellees recognized as much when they conceded that Campbell's claim would have been excluded from coverage had her injuries resulted from a misdiagnosis because her foot was not positioned properly.

## TRESSLER COMMENTS

The Court's decision in this case is a welcome one as it upholds insurers' intent not to cover professional services under a general liability policy, and applied a rather straightforward interpretation of both the plain meaning and apparent intent of the exclusionary language. Indeed, according to the Court's reasoning, the result would probably have been different if the X-ray technician had simply directed the patient to walk towards the X-ray machine and the patient slipped and fell while en route.



*Prepared by David B. Clark, an Associate in our Orange County office.*

# MASSACHUSETTS HIGH COURT UPHOLDS INTELLECTUAL PROPERTY EXCLUSION IN E&O POLICY

The Supreme Judicial Court of Massachusetts recently found that an intellectual property exclusion precludes coverage for third party actors, thereby upholding the insurer's position that it does not have a duty to defend for conduct "arising out of any misappropriation of [a] trade secret". Finn. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pennsylvania, 452 Mass. 690; 896 N.E.2d 1272 (2008) ("Uniscribe").

The insured, Uniscribe Professional Services, Inc. ("Uniscribe"), provided support services such as records management, document imaging and electronic printing for corporations and law firms. In 2002, the law firm Jones Day retained Uniscribe in connection with a project for one of its clients, DirecTV. As part of the project, three Uniscribe employees, who would work on site at the Jones Day office, signed confidentiality agreements regarding the information contained in the documents they handled. In

an attempt to meet the law firm's deadlines, one of the employees brought his nephew to help assist with the project. The employee paid his nephew in cash and recorded the nephew's hours as overtime. During that time period, the nephew sent confidential information of DirecTV's trade secrets to a web site in order to "help" the hacker community.

Jones Day informed Uniscribe of the nephew's conduct in January 2003 at which

time Uniscribe notified National Union Fire Insurance Company of Pittsburgh ("National Union") that Jones Day may request compensation from Uniscribe for the time the law firm wrote off in this matter. National Union denied coverage pursuant to the intellectual property endorsement of the error and omission's policy issued to Uniscribe. The endorsement provided:

[Coverage did not apply] to any claim arising out of any misappropriation

See *Uniscribe* on page 8

# SIXTH CIRCUIT LOWERS THE STANDARD FOR PLEADING SCIENTER UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT

In Frank, et al. v. Dana Corporation, et al., 2008 WL 4923012 (6th Cir. Nov., 19, 2008), the Sixth Circuit vacated the judgment of the district court that had dismissed a complaint for failing to satisfy the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA). The Sixth Circuit held that a complaint would survive a motion to dismiss as long as a reasonable person would deem that the inference of scienter is at least as compelling as the competing inference of nonculpability.

Howard Frank (“Frank”) represented a class comprised of investors who bought securities in Dana Corporation (“Dana”) between April 2004 and October 2005. The case was filed against Dana and two of its chief corporate officers. Dana had fallen into financial ruin and filed for bankruptcy in March 2006. Frank alleged that the officers made intentional or reckless misstatements and material omissions that were made to inflate the price of Dana’s stock during the class period.

Frank alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act. The district court dismissed the complaint finding that it failed to satisfy the heightened pleading requirements of the PSLRA. The district court ruled that the complaint failed to assert allegations that supported a strong inference that Defendants had acted with the required scienter. The court found that it was only required to accept the plaintiff’s inferences of scienter if those were the most plausible of competing inferences.

The PSLRA imposes heightened pleading requirements for scienter in a securities fraud case. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S.Ct. 2499, 2504 (2007). Under these heightened requirements a complaint must specify each statement that is alleged to have been misleading, the reasons why it is misleading and state particular facts that give rise to a strong inference that the defendant acted with the required state of mind. Thus, a

plaintiff must plead both the particular facts regarding the misstatement and the facts evidencing the defendant’s intent to deceive or defraud.

In Tellabs, the Supreme Court stated that a plaintiff cannot merely allege facts that rationally could infer scienter but instead the inference must be cogent, compelling and strong in light of other explanations. Courts are required to conduct a comparative inquiry and take into account plausible opposing inferences, including nonculpable explanations for the defendant’s conduct. Based on Tellabs, the Sixth Circuit vacated the dismissal of Frank’s class action. The Court found that the standard followed by the district court requiring the plaintiff’s inferences of scienter to be the most plausible inference, was in error. Instead the Sixth Circuit held that the proper standard is that the inferences of scienter need only be at least as compelling as any competing nonculpable inferences in order to survive a motion to dismiss.

The district court had followed the Sixth Circuit’s decision in Helwig v. Vencor, Inc., 251 F.3d 540 (6th Cir. 2001), which used a *most plausible* standard. The Court determined that after Tellabs, the standard adopted in Helwig was no longer good law. The district court’s dismissal of the class action complaint was vacated and the case was remanded to determine if Frank made allegations that support an inference of scienter that are at

least as compelling as competing nonculpable inferences.

## TRESSLER COMMENTS

After Tellabs was decided last year, many commentators opined that in some circuits this would result in a lessened pleading standard than existed before. Thus, it would not necessarily be the pro-defendant balm that other commentators hailed it to be. The Sixth Circuit has proven to be one of those jurisdictions where plaintiffs have actually benefited from Tellabs. Contrast this with the decision in Mizzaro v. Home Depot from the 11th Circuit, on which we reported in our most recent past Advisory, as well as an even more recent decision from the 4th Circuit in Cozzarelli v. Inspire Pharmaceuticals, Inc., No. 07-1851 (4th Cir., Decided December 12, 2008). Each of these decisions are representative of instances where Tellabs has been applied by the circuit courts to heighten the previously applied pleading standards under the PSLRA.



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*Uniscribe continued from page 7*

of trade secret or infringement of patent, copyright, trademark, trade dress or any other intellectual property right.

Ultimately, the potential claim matured to an actual claim that Uniscribe settled with a \$1,175,000 payment to Jones Day. Uniscribe then commenced a coverage action against National Union. The trial court found in favor of National Union and this appeal to the Supreme Judicial Court followed.

The Court weighed two different theories of the intellectual property exclusion: (1) Uniscribe’s perspective that the exclusion did not incorporate third-party conduct and (2) National Union’s view that the term “arising out of” contained within the exclusion covers all claims alleging the misappropriation of trade secrets. The Court found in favor of

National Union, specifically, that the term “arising out of” must be read expansively, incorporating a greater range of causation than that encompassed by proximate cause under tort law”.

The Court also held that Jones Day’s injury in the form of legal fees may be attributed to third party conduct in the misappropriation of trade secrets. The Court concluded that the term “arising out of” [is] analogous to ‘but for’ causation, in which examining the exclusion inquires whether there would have been personal injuries, and a basis for the plaintiff’s suit, in the absence of the objectionable underlying conduct.” Consequently, Jones Day’s loss arose out of the nephew’s misappropriation because there was no indication that the loss would have occurred ‘but for’ the nephew’s conduct.

## TRESSLER COMMENTS

This decision regarding the inclusive nature of the term “arising out of” follows suit to many recent jurisdictions’ confirmation of the broad extent of exclusionary language. In the context of such terminology, exclusions may be broader than an insured dare foresee—even seemingly distant third-party conduct may be precluded when faced with the phrase “arising out of” in a policy’s exclusion.



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