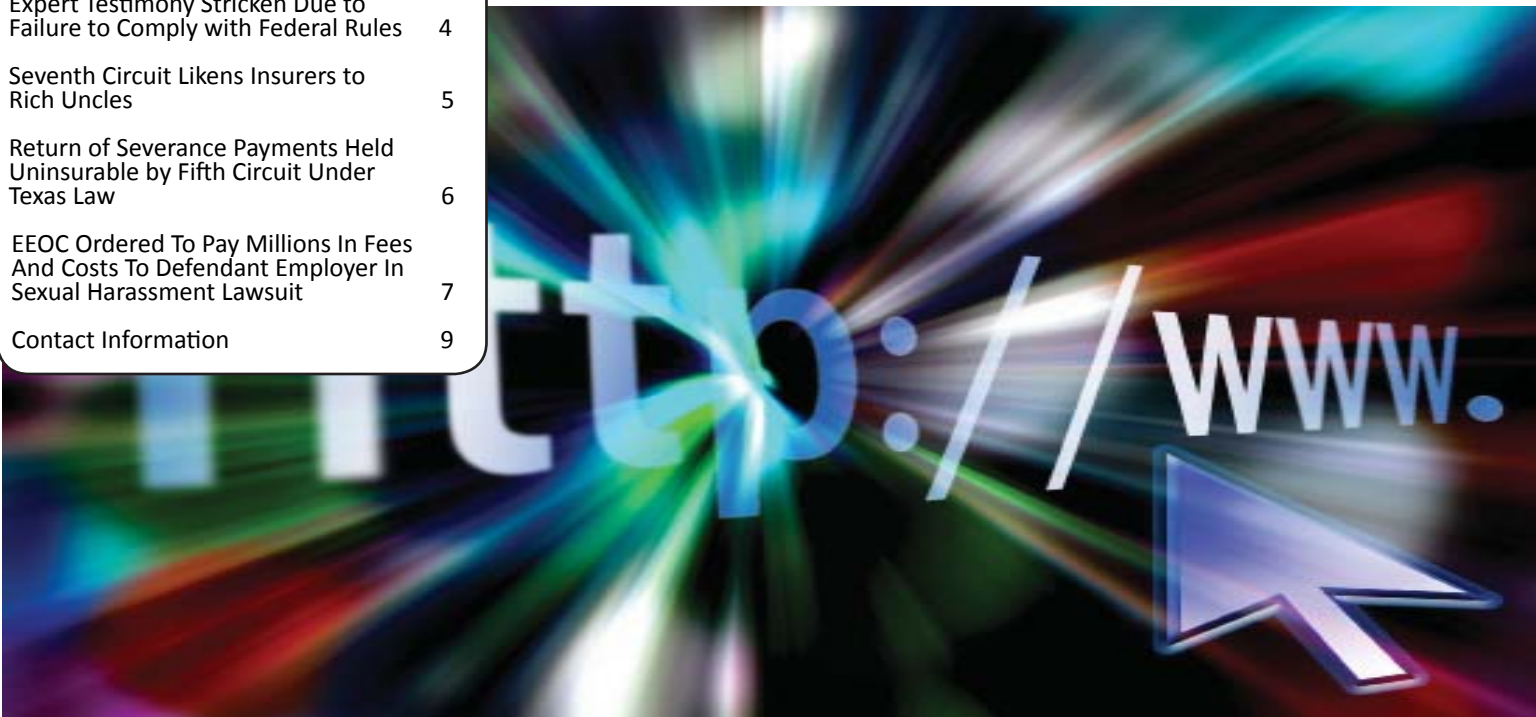


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Specialty Lines Advisory



DANA SAYS...

Dana would like to thank Joe Monteleone for the opportunity to provide commentary in the space usually filled by Joe's regular column. Joe has kindly agreed to share the "Says" spotlight over the next several issues with other guest commentators - but rest assured, fans of Joe, he will be back!

Oh, What a Tangled Internet Web We Weave...

On February 24, 2010, an Italian court convicted three Google executives, including Google's global privacy counsel, on criminal invasion of privacy. Each executive received a suspended six-month jail sentence. The criminal case arose out of a September 2006 posting on Google Video, which was a three minute video clip posted under the title, "Bullying: Disabled Boy Abused in School." The video depicted four Italian students teasing an autistic classmate, beating him and throwing tissues at him. The video was shot on the cell phone of a fifth student, who posted the footage to Google Video. The video was available online for about two months before it was taken down by Google at the request of an advocacy group and the Italian police.

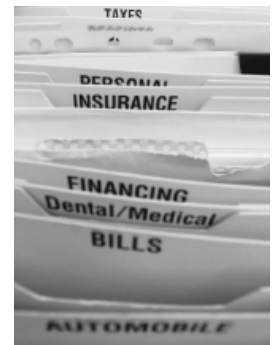
The Italian Court's criminal conviction of the Google executives has sparked an intense debate about the nature of the flow of information on the internet and the legal responsibility of any companies doing business

on the world wide web to act in accord with privacy statutes and regulations and to monitor the type and content of information disseminated on the internet via sites they own/operate. Google's position is generally that only the person who films and uploads the video to a hosting site should take the steps necessary to protect the privacy interests of those depicted in the video. However, the Judge ruled that Google has a duty to make sure the video did not violate Italy's privacy laws and that Italian law allowed individual employees of Google to be held accountable for the actions taken by the employer entity (even if they had nothing to do with what happened, which was the case here as none of the convicted executives had any knowledge of the video or part in the decision to remove it).

While companies like Google and Facebook have historically received "safe harbors" from prosecution over user-generated content in the US and Europe, such was not the case in Italy. Generally, various laws in the US and Europe protect web content providers and platforms from content posted by others, subject to certain conditions such as removing illegal content when notified. Legal experts are generally of the view that the Italian verdict is not going to trigger legal precedent elsewhere, or even withstand appeal in Italy, and that over time this verdict will not stand to strike fear in the hearts of web content providers such that the business of hosting content on the internet somehow comes to a paralyzed, or even overly, restricted halt. But it is certainly troubling in that the implication here seems to be that hosting sites/providers will need to morph into the police of the internet, constantly monitoring their sites and the content posted to them, ensuring compliance with regulations that vary the world

See Dana Says on page 3 for conclusion

ESTOPPEL DOCTRINE TRUMPS INSURERS' LATE NOTICE DEFENSE: AN ILLINOIS APPELLATE COURT FINDS INSURERS OWE A DUTY TO DEFEND



In Uhlich Children's Advantage Network and Darlene Sowell v. National Union Fire Company of Pittsburgh, PA, and AIG Domestic Claims, Inc., 2010 Ill. App. LEXIS 61, an Illinois Appellate court rejected insurers' late notice defense finding that the insurers were estopped from raising such a defense.

Uhlich Children's Advantage Network ("UCAN") brought a lawsuit against National Union Fire Company of Pittsburgh, PA and AIG Domestic Claims, Inc. (collectively, "AIG") alleging that the insurer defendants had a duty to defend the insureds under an employment practices liability insurance policy in a lawsuit filed against the agency and its executive vice president. Defendants filed a motion to dismiss arguing that the underlying claim was untimely noticed according to the provisions in the insureds' "claims made and reported" policies. The trial court granted defendants' motion to dismiss the complaint.

UCAN purchased two "claims first made and reported" insurance policies from AIG for policy periods July 1, 2004 to July 1, 2005 and July 1, 2005 to July 1, 2006. One of UCAN's former employees, Andrew Leonard, filed a charge with the Equal Employment Opportunity Commission (the "EEOC") on January 21, 2005. The charge, alleging UCAN's violations of the Americans With Disabilities Act of 1990 ("ADA"), was later amended on July 13, 2005. The plaintiff received his right to sue letter from the EEOC in August 2005 and filed a lawsuit on September 29, 2005 against UCAN and its executive vice president at the time, Darlene Sowell. The complaint included allegations against UCAN for violation of the ADA and against both UCAN and Sowell for retaliating against him for pursuing his rights under the Family Medical Leave Act. UCAN notified AIG of the claim upon its receipt of the complaint on November 3, 2005, during the second policy period. AIG declined to cover the underlying claim stating that the claim was first made on the date of the first filing of the EEOC charge on January 31, 2005 during the first policy period. UCAN and Sowell filed a complaint against the insurers on February 4, 2008.

Plaintiff argued that defendant insurers owed a duty to defend because the Leonard claim triggered coverage under the issued policies. Moreover, plaintiffs argued that the estoppel doctrine prevented defendants from upholding their late notice defense.

In analyzing whether the insurers had a duty to defend, the court applied the "rule of estoppel" as discussed in Employers Insurance of Wausau v. Ehlco Liquidating Trust, 186 Ill. 2d 127, 150, 708 N.E. 2d 1122, 237 Ill.

Dec. 82 (1999). Specifically, the Ehlco court held that an insurer may not refuse coverage to its insured under a policy that includes a duty to defend. The insurer has the option of either defending the claim under a reservation of rights, or seeking declaratory judgment asserting there is no coverage. If the insurer does not follow either of these avenues, then the insurer is estopped from raising coverage defenses provided in the policy.

Defendants contended that Sowell was put on notice that she was likely to be sued when the amended EEOC charge, which mentioned the human resources vice president, was filed in July 2005. The court noted that the amended EEOC charge was made and reported within the second policy period, and further, a claim was not "first made" against Sowell until she was named in the lawsuit filed in September 2005. The court rejected the notion that the EEOC charge was a claim against Sowell because the ADA violation in the EEOC charge could not have been brought against her as such claims are brought against the company, not its officers.

Defendants relied on American Center for International Labor Solidarity v. Federal Insurance Co., 518 F. Supp. 2d 163 (D.D.C. 2007) in reaching the conclusion that UCAN's failure to report the EEOC charge in the first policy period barred coverage for the claim against Sowell. Similar to Uhlich, the American Center case examined a situation where a former employee filed an EEOC charge against the employer and an executive director; the executive director was not named as a party until the complaint was filed a year later. In American Center, the District Court of Columbia found that the insurer was not obligated to cover the insured executive director based on that policy's definition of "Interrelated Wrongful Acts," which provided that "Interrelated Wrongful Acts of any Insured shall be deemed one Loss, and such Loss shall be deemed to have originated in the earliest Policy Year in which a Claim is first made against any Insured." Uhlich at 15; citing American Center, 518 F. Supp. 2d at 174. There, the District Court of Columbia concluded that since the lawsuit "arose out of the same casually connected facts" as the EEOC charge, there was only one single loss under the policy and the executive director did

not have a separate claim. Id.

In contrast to American Center, the Uhlich court found that the insureds' policy did not expressly set forth that all "suits or proceedings" are a single claim or constitute a single loss. The Uhlich policy language provided as follows:

"Related wrongful acts" are "wrongful acts" that are the "same, related or continuous" or that "arise from a common nucleus of facts. Claims can allege Related Wrongful Acts regardless of whether such Claims involve the same or different claimants, insureds or legal causes of action."... a single retention amount or deductible "shall apply to Loss arising from all Claims alleging the same Wrongful Act or Related Wrongful Acts."

Absent the precise wording associating "related wrongful acts" to a single claim or single loss in the policy, defendants could not preclude coverage for Sowell on this presumption.

The court found that with respect to UCAN, insurers were estopped from raising any policy coverage defenses. The court refuted defendants' argument based on Graman v. Continental Casualty Co., 87 Ill. App. 3d 896, 899, 409 N.E. 2d 387, 42 Ill. Dec. 772 (1980) which concluded that an insured in a "claims made and reported" policy must provide notice to the insurer "within the time constraints" of the policy, otherwise no coverage is afforded.

Instead, the court relied on Ehlco to conclude that there is no exception to the estoppel doctrine for late notice defenses. The court found that the estoppel doctrine referenced in Ehlco included not only occurrence based policies, but also "claims first made and reported" policies.

While the court did agree that certain circumstances warrant an insurer's declination of its duty to defend, the defendant insurers in this case did not meet the criteria.

Interestingly, the court agreed with defendants that UCAN did not provide timely notice—the

Estoppel Doctrine continued on page 8

over and then acting fast enough to block content before it draws any complaint. If the trend to police sites takes hold, it could put web companies on the defensive, forcing them to spend time defending privacy violation cases and restrict content as a proactive (and paranoid), not just a reactive, measure.

So the privacy spider continues its slow and complicated progress across the web. And the issue of privacy protection morphs and evolves from one of underlying regulation and protection under various state, federal and other country laws to whether any such violation becomes a covered risk under insurance issued to the internet insured charged with and liable for the violation. In today's insurance market, various carriers are issuing E&O policies that cover loss or damages stemming from personal privacy violations. Or, there are certain forms of E&O coverage that provide reimbursement for an insured's cost of complying with federal or state regulation to notify those persons who have had their privacy rights impacted/invaded. The web tangles when addressing coverage considerations concerning privacy risk. For example, what do you do if personal data was disseminated illegally and the persons whose data was breached are located all over the US and the data itself was sent all over the US?

What state or federal laws would apply in such a context to ensure notification to the persons whose data was breached? And if you are the carrier covering the cost of notification, does your burden become disproportionate to the premium calculated if what ultimately is required is layered and complicated notification in compliance with multiple applicable laws? Or, how about covering the cost of monitoring web content under cyber policies? For those carriers who cover expense or damages affiliated with privacy notification or violations, could it also be argued that the coverage should be expanded to reach monitoring costs or to reach those claims where ultimately the insured was liable because it simply did not act fast enough to take content off its site?

Using the above Google example – If an insurance policy covers fees and costs associated with defending employees or companies on charges of violation of another's privacy and such coverage stems only from defined cyber or internet activities, should it matter that the employees themselves had absolutely nothing to do with the posting of, regulation of, or removal of the particular video at issue in the criminal action? I present these questions not with any immediate answers in the limited space provided by this column; but merely ask you to consider the above as food for coverage

thought. As in every case, the answers will depend on the policy language at issue. Thus, in the end, how cyber policy language is drafted, read and interpreted is perhaps the only way to address and untangle the web of underlying and coverage considerations presented by cyber risk and privacy claims.



Prepared by Dana Hentges Sheridan, a partner in our Los Angeles office.

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Would you like to offer a comment? Click here to let me know what you think.

CGL Dispatch

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MISSOURI DISTRICT COURT GRANTS MOTION TO STRIKE INSUREDS' EXPERT TESTIMONY BECAUSE IT FAILED TO COMPLY WITH THE FEDERAL RULES

In [Tactical Stop-Loss LLC v. Travelers Casualty & Surety Co. of America](#), 2010 U.S. Dist. LEXIS 8304 (W.D. Mo. Feb. 2, 2010), the United States District Court for the Western District of Missouri granted an insurer's motion to strike the expert testimony of the former director of the Missouri Department of Insurance on the grounds that the expert's testimony failed to satisfy the requirements set forth under the Federal Rules of Evidence and Civil Procedure.



In this case, Plaintiffs Tactical Stop-Loss LLC, ("Tactical") TSL Holdings Inc. and American Trust Administrators ("ATA") (collectively, the "Plaintiffs") alleged that the former president of Tactical and ATA diverted large amounts of money into personal bank accounts and other improper accounts. Plaintiffs also alleged that their vice president and chief operating officer acted in collusion with the former president to illegally divert Plaintiffs' funds. Plaintiffs sought coverage for their losses under a crime insurance policy purchased from Defendant Travelers Casualty and Surety Company of America ("Travelers") which purportedly provided coverage for employee theft and ERISA fidelity theft. However, Travelers denied coverage and Plaintiffs subsequently filed suit against Travelers.

This decision principally concerned the expert testimony of Scott Lakin, the former director of the Missouri Department of Insurance. Travelers filed a motion to strike the expert's testimony on the grounds that, among other things, the report failed to comply with Federal Rule of Civil Procedure 26(a)(2)(B)(iv) because it did not contain "a list of all publications authored in the previous 10 years." In response, Plaintiffs argued that Mr. Lakin did provide a general description of his publications that were published during his tenure as director of the Missouri Department of Insurance and that the report did in fact comply "with Rule 26 because it put defendant on notice that Mr. Lakin has published 'op-ed' articles on insurance issues during his time as director, and the absence of specificity is substantially justified and harmless to defendant."

The court, however, disagreed with Plaintiffs and concluded that Plaintiffs' expert report must be stricken because it failed to meet the requirements set forth under Rule 26(a)(2)(B). Specifically, the court held that "[P]laintiffs provide no case law or other authority supporting the position that just because someone has published often, it

is impossible to prepare a list of published works. . . ." The court further reasoned that once notified of the defect, Plaintiffs failed to cure the problem with the expert report and as such, Travelers' motion to strike Mr. Lakin's testimony was granted.

Travelers alternatively argued that Mr. Lakin lacked the requisite knowledge, skill, experience, training, or education to offer his opinions pursuant to Rule 702 of the Federal Rules of Evidence. The court noted that "[t]he proponent of expert evidence must show by a preponderance of the evidence that the expert is qualified to render his opinion and the methodology underlying his conclusions is valid. [Citing Marmo v. Tyson Fresh Meats, Inc.](#), 457 F.3d 748, 757-58 (8th Cir. 2006). Plaintiffs argued that as director of the Missouri Department of Insurance, "Mr. Lakin developed an expertise in critiquing insurance claims handling and identifying wrongful denials." Travelers argued, however, that Plaintiffs failed to refute the fact that neither the expert report nor Mr. Lakin's curriculum vitae revealed any experience in handling insurance claims generally, or in handling fidelity claims. As a result, the court concluded that Mr. Lakin's expert report should be stricken because Plaintiffs failed to demonstrate that Mr. Lakin had the knowledge, skill, experience, training, or education to render his opinions, both as to claims handling and as to coverage under the policy.

Finally, Travelers argued that Mr. Lakin's opinion as to whether there was any coverage for the underlying claim did not comply with Federal Rule of Evidence 702 because it was not based on sufficient facts or data, was not the product of reliable principles and methods, and there was no way to know whether Mr. Lakin applied the principles and methods to the facts of the case. The court agreed. Specifically, the court held that Mr. Lakin "made a bald conclusion on an ultimate issue in this case, without performing any intervening analysis to why this claim ought to have been paid." The court explained that a proper expert opinion would have cited to sections of the policy that would apply to the Plaintiffs' claims and then would have applied those pertinent policy provisions to the facts of the case. Mr. Lakin,

however, without citing to any specific policy provisions, simply testified that he believed "that the Missouri Department of Insurance would have strongly encouraged Travelers to pay the claim based on the fact that [the vice president] did not have an ownership interest in the company. . . ." The court found this "bald conclusion" to be insufficient under the Federal Rules and thus, granted Traveler's motion to strike on this alternative basis as well.

TRESSLER COMMENTS

This case was a clear win for Travelers as the insureds' expert testimony was stricken because the expert lacked the requisite knowledge, experience and training necessary to offer his opinion as to coverage for the claim and because he failed to provide any basis for his opinion. This case also serves as a warning to both carriers and insureds that experts in coverage disputes will be expected to include citations to pertinent policy provisions and then apply those policy provisions to the facts of the case. It is also interesting that, according to the court, it was not enough that the expert served as the director of Missouri's Department of Insurance; rather, the court required experience and knowledge in both claims handling and the type of policy at issue.

This decision is further heartening to insurers because the Court did not merely leave it to the ultimate finder of fact to weigh the credibility of the expert's testimony, but instead struck his testimony entirely.



Prepared by Monica C. Mendes, an associate in our Los Angeles office.

SEVENTH CIRCUIT LIKENS INSURERS TO RICH UNCLES

While some politicians are demonizing insurance companies, Judge Richard Posner, writing for a unanimous panel of the U.S. Court of Appeals for the Seventh Circuit in United States v. Thouvenot, Wade & Moerchen (#09-2421 2-18-2010), compares them to a beloved and generous member of the family.

The three cases, consolidated on appeal, were brought under the Equal Access to Justice Act (“EAJA”), which allows the recovery of attorney’s and expert witness fees provided that the applicant submits a timely application “which shows that the party is a prevailing party and is eligible to receive an award under this section” [meaning that the party is of limited financial means as defined by the statute]. The applicant “shall also allege that the position of the agency was not substantially justified.” 5 U.S.C. 504(a)(2). The three defendants prevailed at trial and the questions on appeal were whether the government’s conduct was “substantially justified” and, in one case, whether a party meets the financial parameters of the statute when his defense expenses are being paid by an insurance company.

Judge Posner recounted the history of the EAJA, which an earlier decision had called an “anti-bully” law. The statute had been enacted to deter the federal government from using its vast resources against persons and organizations of “limited financial means,” which is defined as a net worth not in excess of \$2 million if an individual and \$7 million if an organization.

On the question of whether the government’s conduct was “substantially justified,” the Seventh Circuit decision criticized the trial judge in the case involving the defendant construction engineering company Thouvenot, Wade & Moerchen (“TWM”). At one point, the lower court judge found that the evidence was sufficient to show that the company was culpable for the design and construction of an apartment complex that wasn’t accessible to disabled persons. Later, however, the same judge said that the evidence showed that TWM had no role in designing the complex. The bottom line, according to Seventh Circuit Judge Posner, is that the government will be deemed to have met the “substantially justified” standard if the court denies a defendant’s motions for summary judgment and for judgment as a matter of law at the close of the government’s case and for

judgment as a matter of law at the close of all the evidence and allows the case to go to the jury.



The case also raised the question of whether the EAJA allows the granting of fees to parties whose defense costs are covered by insurance. The Seventh Circuit did not have to reach the question since the decision held that the defendant was not entitled to fees on the ground that the government’s conduct was “substantially justified.” However, since the issue was a recurring one and had already been briefed

and the circuit courts had disagreed on it, Judge Posner thought it was worth entering the fray.

The decision posits a hypothetical situation of a defendant borrowing money from a “rich uncle” who has a net worth of more than \$2 million. If the nephew won an award, it would belong to the party and “what he does with the money—buy a Rolls Royce or repay his uncle—is his business.” Judge Posner then goes on to observe that “[I]nsurance is the same; it is a contingent loan. The insured pays premiums and in exchange is promised that the insurance company will bear the cost of the insured’s defense (subject to a deductible) if he is sued on a claim that the policy covers.” In his view, even if the cost of the defense is borne by the insurance company, the insured basically paid for it in the form of insurance premiums. Finally, the danger of a “stand-in litigant” is not present here since it is not a rich real-party-in-interest finding a poorer stand-in to litigate. Rather, the insurance company “has no quarrel with the government.”

In concluding that the EAJA does not prevent reimbursement of legal fees to an insurance company, the Seventh Circuit disagreed with the reasoning of the Fourth and Eighth Circuits, which held that an award under the Act cannot include expenses for which a litigant has been indemnified by his employer. See United States v. Paisley, 957 F.2d 1161, 1163-64 (4th Cir. 1992), and SEC v. Comserv Corp., 908 F.2d 1407, 1413-

16 (8th Cir. 1990).

The other two consolidated cases dealt with persons who prevailed in litigation with the Social Security Administration over their claims for social security disability benefits. In one case involving a person with bipolar disorder, the appeals court found that the district court’s denial of fees was inconsistent with an earlier Seventh Circuit decision that reversed the District Court’s finding in favor of the government. Basically, what the appellate court found was that the government was not “substantially justified” and neither was the trial court in ruling in the government’s favor. Thus, the denial of fees was reversed. In the other case, the Seventh Circuit affirmed the denial of fees.

TRESSLER COMMENTS

Judge Posner’s opinion will benefit insurance companies, who pay defense fees in EAJA cases where the government’s conduct is not substantially justified. As to whether this was Congress’ intention is a debatable question, albeit not one in which the answer should necessarily be influenced by the present Congress’ apparent antipathy to health care insurers. In any event, the apparent split in the circuits on the insurance and indemnification issue will probably be resolved by the U.S. Supreme Court, a rare instance of the high court having to address an insurance issue.

As to the language of the opinion comparing an insurance company to a generous uncle, that is simply one more example of Judge Posner’s well-documented view that everything boils down to economics. Along with his opinion in the Level 3 case a few years back, this should further ensure Judge Posner’s place in the pantheon of admired jurists by the insurance industry.



Prepared by Barry T. Bassis, of counsel in our New York office.



RETURN OF SEVERANCE PAYMENTS HELD UNINSURABLE BY FIFTH CIRCUIT UNDER TEXAS LAW

In *In the matter of: TransTexas Gas Corp., et al.*, Case Nos. 08-41128/08-20401, 2010 U.S. App. LEXIS 2762 (5th Cir. Feb 10, 2010) the United States Court of Appeals for the Fifth Circuit ruled in favor of the insurer, National Union, holding that the return of severance payments, deemed “fraudulent transfers”, did not constitute insurable “Loss”. The 5th Circuit held that the return of these payments to the insured’s liquidating trustee was restitutionary in nature and thus uninsurable under Texas law.

In April 2002, TransTexas Gas Corporation (“TransTexas”) purchased an executive and organization liability policy (the “Policy”) from National Union. John Stanley, Sr. (“Stanley”), the chief executive officer and a director of TransTexas, was an insured for covered claims made during the policy period.

TransTexas was engaged in the exploration, production and transmission of oil and natural gas. In April 1999, TransTexas filed for Chapter 11 bankruptcy protection. TransTexas’s reorganization included a three-year employment agreement with Stanley. The agreement, effective March 17, 2000, provided that Stanley could be terminated two years after the agreement’s execution and that Stanley would be entitled to severance pay of \$3,000,000 if he was dismissed without cause, \$500,000 if he was dismissed with cause or no severance if he voluntarily resigned.

Throughout 2001, TransTexas struggled financially, having to use funds from reserve accounts to fund current operations. In January 2002, in the midst of financial deterioration, TransTexas’s Board of Directors (“the Board”) agreed that the “severance option” under Stanley’s employment agreement should be invoked and considered it “acceptable” to divert money from the company’s drilling program to fund the severance payment. In March 2002, Stanley and TransTexas agreed that Stanley would resign and the Board executed a separation agreement that explicitly superseded the employment agreement and provided that Stanley would be paid \$3,000,000 in severance. Stanley received \$2,270,794.90 before the payments ceased.

In November 2002, as a result of its financial deterioration, TransTexas filed a second Chapter 11 proceeding in the bankruptcy court for the Southern District of Texas (the “Bankruptcy Court”), which confirmed the creditors’ plan for reorganization in August 2003. Under the plan, a liquidating trust was established with U.S. Bank as the liquidating trustee.

U.S. Bank thereafter filed an adversary proceeding against Stanley in the Bankruptcy Court, seeking to avoid the severance

payments. The Bankruptcy Court agreed with U.S. Bank, finding that the severance payments constituted both unlawful preferences and fraudulent transfers under 11 U.S.C. §§ 547(b) and 548 of the Bankruptcy Code. Stanley was ordered to repay the \$2,270,794.90 severance he received, plus attorneys’ fees and costs. On appeal, the United States District Court for the Southern District of Texas (the “District Court”), held that the severance payments were avoidable as fraudulent transfers pursuant to Section 548 and the Texas Uniform Fraudulent Transfer Act, but not as preferential transfers under Section 547(b). Stanley and U.S. Bank both appealed to the 5th Circuit.

Prior to the District Court’s ruling, National Union filed for a declaratory judgment action in the same court against U.S. Bank and Stanley. National Union sought to have the court declare that it was not liable under the Policy for the \$2,270,794.90 judgment against Stanley, on the basis that the judgment did constitute a “Loss” under the Policy. The District Court granted summary judgment to National Union holding that the Bankruptcy Court judgment was not insurable “Loss” under the Policy as it was restitutionary in nature. U.S. Bank sought reversal on appeal to the 5th Circuit.

The 5th Circuit issued an opinion addressing the District Court’s opinions in both the underlying adversary proceeding and the insurance coverage litigation. The 5th Circuit first addressed whether the District Court erred in concluding that the severance payments were fraudulent transfers under Section 548 of the Bankruptcy Code. This provision protects creditors of insolvent debtors from unlawful pre-filing transfers to company insiders. The 5th Circuit held that the severance payments met the requirements of an avoidable fraudulent transfer under the Bankruptcy Code. Specifically, the 5th Circuit concluded that: (1) the severance payments were obligations; (2) incurred by TransTexas, for the benefit of Stanley, a company insider; (3) made within two years of the bankruptcy petition date; and (4) TransTexas received less than reasonably equivalent value in exchange for such obligation while TransTexas was insolvent. With regard to the “reasonably

equivalent value” prong, the 5th Circuit concluded that TransTexas did not receive reasonably equivalent value for providing Stanley greater compensation than required by the terms of the employment agreement.

Next, the 5th Circuit addressed whether the District Court erred granting National Union’s motion for summary judgment based on the holding that the bankruptcy judgment against Stanley did not constitute “Loss” under the Policy. In addressing this issue, the parties agreed that Texas substantive law applied.

The Policy defined “Loss” as:

damages, settlements, judgments (including pre/post-judgment interest on a covered judgment), Defense Cost and Crisis Loss; however, “Loss” (other than Defense Costs) shall not include. . . (6) matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed[.]

The 5th Circuit found this language to be unambiguous and would be enforced as written. Applying Texas law, the 5th Circuit agreed with the District Court, holding that the bankruptcy order is not insurable “Loss” because it is a “disgorgement of ill-gotten gains and a restitutionary payment.”

In making this decision, the 5th Circuit relied on two cases cited in the District Court’s opinion. In *Nortex Oil & Gas Corp. v. Harbor Ins. Co.*, 456 S.W.2d 489, 490 (Tex. App.–Dallas, 1970, no writ), the court held that the payment of the plaintiff’s “net loss” as a result of defendant’s acquisition of oil under the plaintiff’s land, through the use of slanted drills, was not a covered loss because the payment was a disgorgement of profits to which the defendant was not entitled.

The 5th Circuit also relied on *Level 3 Comm’n’s Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. Ill. 2001). In *Level 3*, the 7th Circuit addressed whether coverage was afforded under a directors’ and officers’ liability policy for a \$12,000,000 settlement of an underlying lawsuit. In the underlying matter, the plaintiffs

TransTexas continued on page 8

TABLES TURNED: EEOC ORDERED TO PAY MILLIONS IN FEES AND COSTS TO DEFENDANT EMPLOYER IN SEXUAL HARASSMENT LAWSUIT

A federal district court in Iowa ordered the Equal Employment Opportunity Commission to pay \$4.56 million in attorney fees and expenses to CRST Van Expedited, a Cedar Rapids trucking business, after dismissing the agency's sexual harassment lawsuit.

In *EEOC v. CRST Van Expedited, Inc.*, 2010 U.S. Dist. LEXIS 11125 (N.D. Iowa Feb. 9, 2010), the Equal Employment Opportunity Commission ("EEOC") filed suit under Title VII on behalf of approximately 270 female drivers alleging that CRST's drivers had subjected these female drivers to sexual harassment and a sexually hostile work environment and that the company had failed to correct and protect them.

In rulings on a series of summary judgment motions, the court found that the EEOC had not established that CRST engaged in a pattern or practice of tolerating sexual harassment in its workplace. The court specifically held that CRST could not be held liable for the allegations of the majority of these women and barred the EEOC from seeking relief on their behalf at trial. The court's disposition of these summary judgment motions left 67 allegedly aggrieved persons remaining in the EEOC's action.

Afterward, the court entered an order on a Motion to Show Cause in which it dismissed

the EEOC's Complaint because "the EEOC wholly abandoned its statutory duties as to the remaining 67 allegedly aggrieved persons in this case." Specifically, the court found that "the EEOC did not conduct any investigation of the specific allegations of the allegedly aggrieved persons for whom it seeks relief at trial before filing the Complaint—let alone issue a reasonable cause determination as to those allegations or conciliate them." The court concluded that "[t]he EEOC's failure to investigate the claims of the 67 allegedly aggrieved persons deprived CRST of a meaningful opportunity to engage in conciliation and foreclosed any possibility that the parties might settle all or some of this dispute without the expense of a federal lawsuit." Accordingly, the court barred the EEOC from seeking relief on behalf of the 67 allegedly aggrieved persons. In the order, the court noted that CRST was a "prevailing party" and stated that "CRST may file an application for attorneys' fees from the EEOC. CRST sought \$ 7,624,546.47 in attorneys' fees and \$816,864.95 in costs and expenses. In response to the fee

petition, the court awarded \$4,004,371.65 in fees and \$463,071.25 in expenses, for a total award of \$4,467,442.90.

TRESSLER COMMENTS

Although the EEOC is charged with the task of ferreting out discrimination and harassment in the workplace, the EEOC's strategy, in at least this particular case, of "sue first and ask questions later" backfired. The court sent a strong message that all plaintiffs must do their due diligence in pursuing an action, regardless of whether or not the plaintiff is a government entity pursuing altruistic goals.



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insured received notice of the EEOC charge during the first policy period but did not provide notice until the second policy period. In the insurers' case here, "but for Ehlco, defendants would not have had a duty to defend UCAN." Uhlrich at 23. As per Ehlco, the court interpreted the estoppel doctrine to have "broad implications" in barring the insurer from raising coverage defenses even if such defenses were deemed to have merit.

The court also did not support defendants' assertion that a duty to defend is not triggered unless the insured tendered the defense in writing. Specifically, the policy in Uhlrich provided:

[T]he Insureds shall have the right to tender the defense of any Claim to the Insurer, which right shall be exercised in writing ... This right shall terminate if not exercised within 30 days of the date the Claim is first made against an Insured ... Provided the Insureds have complied with the foregoing, the Insurer shall be obligated to assume the defense of the Claim[.]

This argument was rejected by the court

which found that the notice of a claim to the insurers on October 10, 2005 triggered the insurers' duty to defend.

Of note, the court also set the grounds for seeking declaratory relief under the estoppel doctrine, "the insurer must take some action to adjudicate the issue of coverage or undertake to defend the insured under a reservation of rights, and it must take that action within a reasonable time of a demand by the insured." Ulrich at 26; citing, Korte Construction Co. v. American States Insurance, 322 Ill. App. 3d 451, 458, 750 N.E. 2d 764, 255 Ill. Dec. 847 (2001). The fact that defendants in this case "took action" after plaintiffs filed a declaratory relief, two years after defendants denied coverage, did not satisfy the standard for "a reasonable time" as set forth in Korte.

TRESSLER COMMENTS

The Uhlrich court leaves insurers with two sole options under Illinois law when faced with denying coverage for late notice: (1) file immediate declaratory judgment or (2) defend the insured with a reservation of rights. The court's unyielding support of the estoppel doctrine will undoubtedly be difficult for insurers relying on a late notice defense to deny claims. For "claims made

and reported" policies, the Uhlrich decision builds in more cushion for insureds tendering claims to insurers if coverage would not be excluded but for the estoppel doctrine. However, the decision simultaneously poses a disadvantage to insurers, and appears to defeat the purpose of a "claims made policy," if insurers are obligated to factor in unexpected risks after the expiration of a policy period.

Nonetheless, the Uhlrich court's decision is grounded in estoppel and not upon the merits of the notice defense when, under a policy with both claims made and claims reporting triggers, claim is made in one policy and not reported until a subsequent policy is in effect. The watchword here is simply to tread more cautiously in Illinois than in other jurisdictions not having such strict estoppel rules.



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alleged that they sold their shares based on Level 3's fraudulent misrepresentations and sought the difference in value between the shares on the date of trial and the price at which they sold the shares to Level 3. Even though the plaintiffs did not seek a return of the shares, the 7th Circuit characterized the remedy as restitutionary in nature because the plaintiffs were seeking to deprive Level 3 of the net benefit of its unlawful act. The 7th Circuit held that the settlement was not "Loss" because "Loss" does not include the restoration of "ill-gotten gain."

The 5th Circuit in TransTexas rejected U.S. Bank's argument that the bankruptcy judgment was insurable "Loss" because unlike the insureds in Nortex and Level 3, Stanley did not "steal" the severance payments but had a clear contractual right to them pursuant to the separation agreement. The 5th Circuit rejected this argument, holding that "payments fraudulent as to creditors that must be repaid due to bankruptcy court order is a disgorgement of ill-gotten gains and a restitutionary payment." Accordingly, the 5th Circuit affirmed the District Court's judgment in favor of National Union.

TRESSLER COMMENTS

Given the current economic climate and

related increase in corporate bankruptcy filings, D&O insurers will find the TransTexas decision to be both instructive and useful in addressing the insurability of the return of compensation paid to corporate executives, where the payment of that compensation is determined to be unlawful.

TransTexas is also significant because it furthers the current trend among courts to follow and rely upon the 7th Circuit's holding in Level 3, specifically that disgorgement does not give rise to insurable loss. Courts have been willing to apply Level 3 to varied circumstances and requests for coverage. See, e.g., CNL Hotels & Resorts, Inc. v. Twin City Fire Ins. Co., 2008 U.S. App. LEXIS 17686 (11th Cir. Fla. 2008) (Section 11 settlement payment to the purchaser class was not a loss covered by the policy because the payment was restitutionary in nature); Genzyme Corp. v. Fed. Ins. Co., 657 F. Supp. 2d 282 (D. Mass. 2009) (the corporation's settlement payment was not an insurable loss under the policy because the corporation could not demand indemnification for the redistribution of the benefits of equity ownership among its shareholders); St. Paul Fire & Marine Ins. Co. v. City of Cairo, 2008 U.S. Dist. LEXIS 52954 (S.D. Ill. 2008) (insurer is not responsible for the costs associated with the return of city employee's improperly obtained

compensation); and Pereira v. Cogan, 2006 U.S. Dist. LEXIS 49263 (S.D.N.Y. 2006) (trustee could not seek coverage for the portions of the judgment representing the return of monies wrongfully obtained by officers and directors).

Finally, TransTexas and other cases that follow Level 3 demonstrate that the disgorgement itself will generally give rise to the finding of uninsurability regardless of any specific policy terms and conditions, and courts will tend to reject the insureds' arguments that the repayment was not "ill-gotten" or otherwise unlawful.

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