FDCC QUARTERLY

THE CONNECTION BETWEEN PHYSICAL DAMAGE AND BUSINESS INTERRUPTION COVERAGE
Andrew B. Downs and Linda M. Bolduan

NON-COMPETITION AGREEMENTS
Linda S. Woolf

PUNITIVE DAMAGES: CALIFORNIA MODEL APPLYING *GORE* AND *STATE FARM*
Patrick J. Hagan and Anne Marie Bridges

DIRECTORS' & OFFICERS' LIABILITY INSURANCE: THE ISSUE OF "NON-INDEMNIFIABLE LOSS"
Donna Ferrara

REINSURANCE ARBITRATORS: TOTALLY NEUTRAL OR NOT

- PITFALLS IN MOVING TO ALL-NEUTRAL REINSURANCE ARBITRATION PANELS
  Kathryn P. Broderick
- IMPARTIAL, INDEPENDENT, NEUTRAL ARBITRATORS V. NON-NEUTRAL PARTY APPOINTED ADVOCATES
  Anthony M. Lanzone

FDCC QUARTERLY VOLUME 54 INDEX

VOL. 54, NO. 4 — SUMMER, 2004

FEDERATION OF DEFENSE AND CORPORATE COUNSEL

PRESIDENT

JEAN M. LAWLER
Chase Plaza, 9th Floor
801 South Grand Avenue
Los Angeles, CA 90017
(213) 630-1019
E-mail: jlawler@murchison-cumming.com

PRESIDENT-ELECT

LEWIS F. COLLINS, JR.
Bayport Plaza, Suite 1100
6200 Courtney Campbell Causeway
Tampa, FL 33607-5946
(813) 281-1900
E-mail: lcollins@butlerpappas.com

SECRETARY-TREASURER

DAN D. KOHANE
1300 Liberty Building
Buffalo, NY 14202
(716) 849-8900
E-mail: ddk@hurwitzfine.com

BOARD CHAIR

JACK T. RILEY, JR.
55 East Monroe Street,
Suite 4100
Chicago, IL 60603-5896
(312) 984-0269
E-mail: rileyj@jbltd.com

BOARD OF DIRECTORS

2003-2005

JANET L. BROWN
P.O. Box 2593
101 Southhall Lane, Suite 375
Orlando, FL 32802

RICHARD E. HALL
702 W. Idaho Street, Suite 700
Boise, ID 83702

LORI E. IWAN
29 N. Wacker Drive, Suite 500
Chicago, IL 60606

WAYNE B. MASON
1717 Main Street, Suite 5400
Dallas, TX 75201

2004-2006

ALAN S. BROWN
201 North Illinois Street, Suite 1000
P.O. Box 44961
Indianapolis, IN 46244

COLIN V. CROLY
Beaufort House
15 St. Botolph Street
London, England EC3A 7NJ

THOMAS A. DILLON
155 E. Broad Street, 12th Floor
Columbus, OH 43215

MICHAEL T. LUCEY
275 Battery Street, Suite 2000
San Francisco, CA 94111-3305

VICE PRESIDENTS

F. THOMAS CORDELL
201 North 4th Street
P.O. Box 533
Chickasha, OK 73023

STEPHEN E. GOLDMAN
280 Trumbull Street
Hartford, CT 06103-3597

EDWARD M. KAPLAN
9 Capitol Street
P.O. Box 1256
Concord, NH 03302-1256

DAVID O. NARIGON
717 Mulberry Street
Des Moines, IA 50309

MICHAEL I. NEIL
1010 2nd Avenue, Suite 2500
San Diego, CA 92101-4906

TIMOTHY A. PRATT
1200 Main Street
One Kansas City Place
Kansas City, MO 64105-2118

SARAH J. TIMBERLAKE
105 N. Hudson, 10th Floor
P.O. Box 1937
Oklahoma City, OK 73102-5405

JAMES A. VARNER
Fourth and Main Streets
P.O. Drawer 2040
Clarksburg, WV 26301

EXECUTIVE DIRECTOR
MARTHA J. (MARTY) STREEPER
11812-A North 56th Street
Tampa, FL 33617
(813) 983-0022
(813) 988-5837 Fax
E-mail: mstreeper@thefederation.org

PUBLICATIONS COMMITTEE CHAIR
SUSAN M. POPIK
650 California Street, 19th Floor
San Francisco, CA 94108
(415) 352-3000
E-mail: spopik@chapop.com

EDITOR-FLYER
JOHN S. REA
2639 Wooster Road
Cleveland, OH 44116
(440) 331-3853

EDITOR-BROCHURE
MARY K. GOGOEL
515 King Street, Suite 340
Alexandria, VA 22314
(703) 739-3300
E-mail: mgogoel@hudginslawfirm.com

CLE COORDINATOR
FRANCIE BERG
3714 22nd Avenue South
Minneapolis, MN 55407
(612) 339-5863
(612) 339-1529 Fax

EDITOR-WEB SITE
DAN D. KOHANE
1300 Liberty Building
Buffalo, NY 14202-3670
(716) 849-8900
E-mail: ddk@hurwitzfine.com

EDITOR-ROSTER
LESLIE C. O'TOOLE
P.O. Box 33550
Raleigh, NC 27636
(919) 865-7009
E-mail: leslie_o'toole@elliswinters.com

FDCC QUARTERLY EDITORIAL OFFICE
Marquette University Law School
P.O. Box 1881
Milwaukee, WI 53201-1881
(414) 288-7095
(414) 288-5914 Fax
E-mail: john.kircher@marquette.edu

Editor-in-Chief
John J. Kircher
Professor of Law
Marquette University Law School

Associate Editor
Prof. Christine M. Wiseman
Vice President for Academic Affairs
Creighton University

Student Editors
Kristofor L. Hanson
Jeffrey C. Marty
Jeremy J. Westlake

LIAISON-QUARTERLY
BRUCE D. CELEBREZZE
One Embarcadero Center, 16th Floor
San Francisco, CA 94111-3765
(415) 781-7900
E-mail: bruce.celebrezze@sdma.com

FDCC QUARTERLY

SUMMER, 2004 VOLUME 54, NUMBER 4

CONTENTS

THE CONNECTION BETWEEN PHYSICAL DAMAGE AND BUSINESS INTERRUPTION COVERAGE
Andrew B. Downs and Linda M. Bolduan 307

NON-COMPETITION AGREEMENTS
Linda S. Woolf 333

PUNITIVE DAMAGES: CALIFORNIA MODEL APPLYING *GORE* AND *STATE FARM*
Patrick J. Hagan and Anne Marie Bridges 343

DIRECTORS' & OFFICERS' LIABILITY INSURANCE: THE ISSUE OF "NON-INDEMNIFIABLE LOSS"
Donna Ferrara 359

REINSURANCE ARBITRATORS: TOTALLY NEUTRAL OR NOT

- PITFALLS IN MOVING TO ALL-NEUTRAL REINSURANCE ARBITRATION PANELS
  Kathryn P. Broderick 373

- IMPARTIAL, INDEPENDENT, NEUTRAL ARBITRATORS V. NON-NEUTRAL PARTY APPOINTED ADVOCATES
  Anthony M. Lanzone 381

FDCC QUARTERLY VOLUME 54 INDEX 393

Cite as: 54 FED'N DEF. & CORP. COUNS.Q. ___ (2004).

The Federation of Defense & Corporate Counsel Quarterly (USPS 189-180) (ISBN 0887-0942) is published quarterly for $60.00 per year by the Federation of Defense & Corporate Counsel, Inc., 11812-A North 56th Street, Tampa, FL 33617. Periodicals postage paid at Tampa, Florida and additional mailing offices. POSTMASTER: Send address changes to the Executive Director, 11812-A North 56th Street, Tampa, FL 33617.

No article may be reproduced without the express written permission of both FDDC and the author.

Copyright, 2004, by the Federation of Defense & Corporate Counsel, Inc.

FDCC 2005

Winter Meeting

Sunday,

February 27

to

Sunday,

March 6

Marco Island

Marriott Resort,

Golf Club and Spa

Marco Island, Florida

The Connection Between Physical Damage and Business Interruption Coverage†

Andrew B. Downs
Linda M. Bolduan

I.
Introduction

Hurricanes, earthquakes, and floods. Urban riots and other civil disturbances. Terrorist threats and terrorist activity. Such events may require limited access to business or may require businesses to close altogether – either independently or by order of civil authority. Insureds facing loss from such events may seek coverage under business interruption insurance policies or under the "Civil Authority" provisions generally found in such policies. Those provisions typically cover losses resulting from prohibited access to covered property due to other property damage. Insureds, however, have become more assertive in presenting access claims arising out of events much more distant and remote than those traditionally envisioned in underwriting business interruption exposures. Given that trend, this article explores the connection required between covered physical damage and coverage for business interruption or denial of access caused by the action of civil authorities.

II.
Business Interruption Insurance

> *"The nature of business interruption insurance is to indemnify the insured for any loss sustained because of the insured's inability to continue to use specified premises as a result of the destruction of the premises or parts thereof."*[1]

---

† Submitted by the authors on behalf of the FDCC Property Insurance Section.

[1] Linnton Plywood Ass'n v. Protection Mut. Ins. Co., 760 F. Supp. 170, 172 (D.Or. 1991) (citation omitted; emphasis added).

Andrew B. Downs is a shareholder in the firm of Bullivant Houser Bailey, PC, residing primarily in its San Francisco, California and Las Vegas, Nevada, offices. Mr. Downs is admitted to practice in California and Nevada and specializes in the representation of first-party property, inland marine and ocean marine insurers in connection with coverage and extra-contractual claims throughout California and Nevada. He was formerly Chair of the Property Insurance Law Committee of TIPS, and is currently a Vice Chair of the Property Insurance Section of the Federation of Defense & Corporate Counsel. Mr. Downs is a member of the Editorial Board of West's Insurance Litigation Reporter *and authored the chapter on concurrent causation in the West/TIPS multi-volume treatise,* Law and Practice of Insurance Coverage Litigation. *He is a frequent speaker and author on property insurance and extra-contractual liability issues and is a regular panelist at the Property Loss Research Bureau's Claims Conference.*

In its most basic form, commercial property insurance covers loss or damage to the real and personal property of a business. However, loss or damage to business property often leads to consequential economic losses, such as loss of income or increased expenses. To cover those consequential losses, businesses may obtain "business interruption" insurance.

"Business interruption" insurance "is designed to do for the business what the business would have done for itself had no loss occurred."[2] Such insurance typically covers business interruptions resulting from physical loss or damage to covered property caused by a covered cause of loss.[3]

A. *Contract Language*

There is a wide variety of business interruption clauses in use — many of them manuscript forms. The ISO Business Income and Extra Expense Coverage Form, for example, provides as follows:

> We will pay for the actual loss of Business Income you sustain due to the necessary "suspension" of your "operations" during the "period of restoration." The "sus-

[2] A & S Corp. v. Centennial Ins. Co., 242 F. Supp. 584, 589 (N.D.Ill. 1965).

[3] *See* Protection Mut. Ins. Co. v. Mitsubishi Silicon Am. Corp., 992 P.2d 479, 481 (Or. Ct. App. 1999), *rev. denied*, 6 P.3d 1100 (Or. 2000).

Linda M. Bolduan is an associate with Bullivant Houser Bailey, PC. She is a member of the American Bar Association and is admitted to practice in the Oregon state and federal courts. Ms. Bolduan's practice focuses on insurance coverage.

> pension" must be caused by direct physical loss of or damage to property at premises which are described in the Declarations and for which a Business Income Limit of Insurance is shown in the Declarations.[4]

B. *Physical Damage to Covered Property*

Many business interruption policies contain language similar to that of the current ISO form, quoted above. Most notably, this language ties a duty to pay under business interruption coverage to the occurrence of covered physical damage to covered property. Most courts will enforce that language. For example, in *Harry's Cadillac-Pontiac-GMC Truck Co. v. Motors Insurance Corp.*,[5] a snowstorm damaged the insured's automobile dealership. That snowstorm also made the dealership inaccessible for a week. The North Carolina appellate court rejected the insured's attempt to recover under its business interruption coverage for the week the business was inaccessible. The court held:

> Plaintiff neither alleged nor offered proof that its lost business income was due to damage to or the destruction of the property, rather all the evidence shows that the loss was proximately caused by plaintiff's inability to access the dealership due to the snowstorm. There was no suspension of business due to the roof damage or the repairs thereto. We hold that, under the language of the business interruption clause of the policy, coverage is provided only when loss results from suspension of operations due to damage to, or destruction of, the business property by reason of a peril insured against.[6]

---

4 CP 00 30 (4-02 ed.).

5 486 S.E.2d 249 (N.C. Ct. App. 1997).

6 *Id.* at 251-52.

Similarly, in *Roundabout Theatre Co. v. Continental Casualty Co.*,[7] scaffolding on a building under construction partially collapsed into the street and onto adjacent buildings. Separated from the building and partially-collapsed scaffolding by another building, the insured theatre suffered only minor damage, which was repaired within one day. However, after the collapse, the City of New York closed the street for almost a month because of substantial damage to the area and the danger presented by the partially-collapsed scaffolding. As a consequence of the street closure, the theatre became inaccessible to the public and was forced to cancel thirty-five performances. The insured sought coverage under its business interruption insurance, which provided in part that the insurer would pay for loss incurred as a result of a "'postponement or cancellation of an insured Production as a direct and sole result of loss of, damage to or destruction of property or facilities . . . .'"[8] The court held that the insured had not met its burden of showing a covered loss, concluding that "the language in the instant policy clearly and unambiguously provides coverage only where the insured's property suffers direct physical damage."[9]

C. *How Far Can You Go without Losing Coverage?*

Business interruption insurance generally covers losses resulting from suspension of the insured's business operations due to direct physical loss of, or damage to, property at the insured's premises. Relevant to such coverage is the question whether the location of the physical damage and the location of the insured's business operations must be the same, and if not, what degree of separation is permissible.

1. Close Enough to Home: Damage to a Common Structure

Damage to the structure occupied by the insured, but not to the particular portion occupied by the insured, may support a business interruption claim when it results in a suspension of operations. The leading case is *Datatab, Inc. v. St. Paul Fire & Marine Insurance Co.*[10] There, the insured (Datatab) occupied the fifth and sixth floors of a commercial building. After a water main broke in the basement of the building, damaging the building's air conditioning system, the insured had to shut down its data processing and computer equipment. The insured's business interruption policy covered, in part, "'actual loss as covered hereunder when as a direct result of a peril insured against the premises in which the property is located is so damaged as to prevent access to such property.'"[11]

---

[7] 751 N.Y.S.2d 4 (App. Div. 2002).

[8] *Id.* at 3 (quoting policy language; emphasis omitted).

[9] *Id.* at 8.

[10] 347 F. Supp. 36 (S.D.N.Y. 1972).

[11] *Id.* at 37 (quoting policy language).

The insurer argued that, because there was no direct physical damage to the insured's premises on the fifth and sixth floors, and because physical access to the equipment was not impaired after the water main broke, the above provision did not apply. The insured contended, however, that the term "premises" within its policy applied to the entire building, not just to the fifth and sixth floors. Datatab also argued and that the term "access" referred to the insured's ability "to utilize the equipment normally in the operation of its business."[12]

The court found both the terms "access" and "premises" ambiguous, construing the ambiguities in favor of the insured as required under New York law. Finding as well that the insurer's construction of the terms was "bizarre" and "strained,"[13] the court concluded:

> Obviously, what was relevant and important to Datatab when it bought the St. Paul policy was the ability to utilize the computers in its business on a normal basis. Datatab could not have been less interested in whether, following a peril insured against, it had the ability to physically touch a non-functioning mass of metal.[14]

2. So Near, Yet So Far: Things the Insured Failed to Insure

Sometimes insureds buy both physical loss coverage and business interruption coverage for only some of their property. As illustrated by the following cases, the general rule that governs these situations provides that if the source of the business interruption at the insured location is damage to an uninsured (for business interruption) location, business interruption losses at the undamaged location for which that coverage was purchased are not covered.

For example, in *Swedish Crucible Steel Co. v. Travelers Indemnity Co.*,[15] the insured operated a plastics and foundry manufacturing facility. The facility consisted of eight buildings. For reasons not explained in the opinion, the insured purchased a business interruption policy for the foundry building (Building 1), which was separate from the business interruption policy it had purchased to cover the other seven buildings. A fire in Building 2 damaged various molds, dyes, and patterns used in the operation of the foundry (Building 1). The insured sought to recover its business interruption losses for Building 1 under the policy insuring that building.

The court held that business interruption coverage under the policy for Building 1 applied only to interruptions caused by covered physical damage to Building 1, and not to interruptions caused by physical damage to Building 2. In reaching that conclusion, the court expressed the fear that finding coverage would encourage insureds to obtain cover-

---

[12] *Id.*

[13] *Id.* at 38.

[14] *Id.*

[15] 387 F. Supp. 231 (E.D. Mich. 1974).

age only for their most important property, expecting that business interruption coverage on that property would provide them with some protection, regardless of which property was damaged. The court found it "clear" that the policy at issue "was intended to insure against business losses occasioned by the destruction of the described premises, and no more."[16]

Similarly, in *Gregory v. Continental Insurance Co.*,[17] the court declined to extend business interruption coverage beyond the premises specified. In that case, the insured operated a golf course. The insured purchased a property policy covering the golf course office, pro shop, and restaurant building (listed on the policy as Building 1), which included business interruption coverage for that structure. (Other structures were also insured, apparently without business interruption coverage.)

A hurricane later seriously damaged the building in question (housing the office, pro shop and restaurant). More importantly to the insured's business, the hurricane blew trees and other debris onto the golf course. The course was closed for about two weeks while the debris was cleared. The insured then sought to recover business interruption losses not only for the pro shop and restaurant, but also for the course as a whole. The Mississippi Supreme Court held that the business interruption coverage on the office/pro shop/restaurant did not extend to losses caused by the closure of the entire golf course.[18]

3. Mutually Beneficial Relationship or Mutual Dependency?

In recent years, a 1931 decision of the New Hampshire Supreme Court in *Studley Box & Lumber Co. v. National Fire Insurance Co.*,[19] has inspired more insureds' attorneys than courts. In that case, Studley Box and Lumber Company ("Studley Box") occupied a series of more or less adjacent buildings as part of its box factory and mill. Portions of the facility were operated by horses. The stable and some of the horses were destroyed in a fire. The insured sought to recover for the additional expense of hiring horses to operate the mill until it could replace those horses that it had lost. The insured's business interruption policy described the principal structures at the facility in general terms, but did not identify various secondary structures, including the stable. The court held that the policy's description of the insured property was general only and extended to the entirety of the insured's facili-

[16] *Id.* at 235.

[17] 575 So. 2d 534 (Miss. 1990).

[18] *Id.* at 540. *See also* St. Marys Foundry, Inc. v. Employers Ins. of Wausau, 332 F.3d 989, 993-94 (6th Cir. 2003) (applying Ohio law), in which a fire burned patterns owned by the insured's customers, but necessary to its business. Although the building in which they were stored was a covered location, the patterns themselves were not insured property. The Sixth Circuit held that, because the patterns were uninsured, their loss was not a covered loss entitling the insured to payment for its business interruption loss.

[19] 154 A. 337 (N.H. 1931).

ties. More importantly, the court also held that the various structures were mutually dependent so that business interruption losses at all of them could be recovered when damage occurred to a single insured structure.[20]

Modern courts have distinguished *Studley*. The leading case is *Ramada Inn Ramogreen, Inc. v. Travelers Indemnity Co.*[21] There, the Court of Appeals for the Eleventh Circuit applied Florida law and determined that a hotel owner could not recover under its business interruption coverage for reductions in its hotel room occupancy caused by the destruction of the on-premises restaurant. The hotel and restaurant had been insured by a single policy, but different limits applied for each.

The court rejected the insured's argument that the mutual dependency doctrine of *Studley* should control. The court examined the structure of the policy, observing that the restaurant was insured with a separate limit of liability. It also noted that the insured had failed to rebuild the restaurant after the fire, which constituted evidence that there was no mutual dependency between the restaurant and the hotel. In reaching its decision, the court observed:

> The concept of mutual dependency is more appropriately applied to the four hotel buildings, which together comprise a single unit. If any one of them were [sic] sufficiently damaged, a portion of the hotel operation would be suspended. The insurance policy clearly provides for this situation by allotting an aggregate sum which encompasses damage to any one of the four buildings.[22]

In deciding *Ramogreen*, the Eleventh Circuit relied heavily on *Hotel Properties, Ltd. v. Heritage Insurance Co.*[23] As in *Ramogreen*, *Hotel Properties* involved damage to a hotel restaurant, but the case did not address the mutual dependency issue. Instead, a tenant of the insured operated the restaurant. The insured then claimed a business interruption loss

---

[20] The court noted:

> The business as a whole is protected. It is plainly impossible to assign to each unit of the group which makes up the plant the amount of business loss which its destruction or damage would occasion. The business being conducted as a whole, a fire loss on any of the units of the plant affects the business in its entirety and not merely the particular part of it carried on in such unit. The units are mutually dependent, and, if one fails, the others ordinarily suffer."

See Studley, 154 A. at 338.

[21] 835 F.2d 812 (11th Cir. 1988) (applying Florida law).

[22] *Id.* at 814.

[23] 456 So. 2d 1249 (Fla. Dist. Ct. App. 1984), *petition for review denied*, 464 So. 2d 555 (Fla. 1985).

based on the *reduction* in hotel occupancy following closure of the restaurant. The Court of Appeal of Florida held that the business interruption policy did not cover a "diminution" in volume of the insured's hotel business.[24]

The insured fared even more poorly in *Royal Indemnity Insurance Co. v. Mikob Properties, Inc.*[25] The insured property in that case was a three-building waterfront apartment complex near Houston, Texas. When the building closest to the water burned, asbestos was discovered in the debris, and access to the waterfront amenities disappeared for an extended period of time. Not surprisingly, the complex in its post-loss condition was less attractive to tenants, and occupancy rates in the two undamaged buildings dropped significantly in the months following the fire.

The insured sought to recover for the diminution of business in the two undamaged buildings. The Texas federal district court held that there was no mutual dependency and no covered loss because operations in the undamaged buildings were not suspended. Citing *Ramogreen* in part, the court determined that "the amenities which attract customers may be affected by a covered loss, but if the insured premises are still operating, the business interruption clause does not cover a decrease in income."[26]

4. For the Want of a Nail: Damage to Suppliers

Whether damage to an insured's suppliers is covered under the insured's business interruption insurance depends upon the language of the policy. Some policies cover losses resulting from damage to supplier facilities while others do not. Even where damage to supplier facilities is covered, the existence of coverage depends on the relationship between the insured and the entity claimed to be a supplier. In that regard, physical distance is less important than the actual policy language.

Archer-Daniels-Midland Co. v. Phoenix Assurance Co.[27] is the best-known of the modern cases addressing this issue. *Archer-Daniels-Midland* ("ADM") involved the "unprecedented flooding"[28] of the Mississippi River in 1993. The floods disrupted ADM's supply chain. A

---

[24] *Id.* at 1250. *See Ramogreen*, 835 F.2d at 813 (explaining that, under *Hotel Properties*, "a decrease in hotel occupancy due to loss of a restaurant is not a loss covered under the hotel business interruption policy").

[25] 940 F. Supp. 155 (S.D. Tex. 1996).

[26] *Id.* at 160 (footnote omitted).

[27] 936 F. Supp. 534 (S.D. Ill. 1996). This opinion is but one of many associated with Archer-Daniel-Midland Company's lengthy efforts to find someone to pay for losses resulting from the 1993 flood of the Mississippi River. *See also* 975 F. Supp. 1124 (S.D. Ill. 1997); 975 F. Supp. 1129 (S.D. Ill. 1997); 975 F. Supp. 1137 (S.D. Ill. 1997); Archer Daniels Midland Co. v. Hartford Fire Ins. Co., 243 F.3d 369 (7th Cir. 2001); Archer Daniels Midland Co. v. Aon Risk Servs., 2002 WL 31185884 (D. Minn. 2002).

[28] *Archer-Daniels-Midland*, 936 F. Supp. at 536.

"substantial part" of ADM's raw materials traveled by barge on the Mississippi River and its tributaries, but as a result of the flood, barge traffic was halted. This forced ADM to arrange alternate and more expensive rail transport. ADM also incurred increased costs for raw materials.

In part, ADM sought coverage for its increased costs under the "Contingent Business Interruption and Extra Expense Coverage" in its policies. The applicable language provided as follows:

> This policy covers against loss of earnings and necessary extra expense resulting from necessary interruption of business of the insured caused by damage to or destruction of real or personal property, by the perils insured against under this policy, *of any supplier of goods or services which results in the inability of such supplier to supply an insured locations* [sic].[29]

In particular, ADM contended that the Army Corps of Engineers ("Corps"), which operates and maintains the Mississippi River system, and the U.S. Coast Guard, which provides aids to marine navigation (*e.g.*, visual, audible, and electronic signals), were "suppliers of goods or services" under the policy. The court agreed with ADM, holding that both the Corps and the Coast Guard were "suppliers" to ADM within the meaning of its policies. The court reasoned that the Corps' and the Coast Guard's "funding [of] the construction and maintenance of the physical infrastructure of the Mississippi River system through fuel taxes imposed on the users of that system easily [brought] the Corps and the Coast Guard within the plain meaning of the term 'any supplier of goods and services.'"[30]

ADM also argued that Midwest farmers were "suppliers" under the subject policy provisions. The court agreed with ADM on that issue as well, rejecting the defendant's argument that the farmers were not "suppliers" because ADM did not contract directly with individual farmers to purchase their grain. Rather, ADM purchased its grain from licensed grain dealers. Finding that the policy language did not limit coverage to those suppliers "in direct contractual privity" with ADM, the court ruled that the farmers were "suppliers" under the policies, notwithstanding that they were "indirect" suppliers to ADM.[31] In reaching its decision, the court commented that, "[h]ad either of the parties wanted to limit the coverage to 'direct' suppliers, they easily could have added language to that effect."[32]

---

[29] *Id.* at 540 (quoting policy language; emphasis added).

[30] *Id.* at 542.

[31] *Id.* at 544.

[32] *Id.*

By contrast, the court in *Pentair Inc. v. American Guarantee & Liability Insurance Co.*,[33] found that the insured could not recover under policy language similar to that at issue in *ADM* because the relationships involved were too remote. In the *Pentair* case, an earthquake in Taiwan damaged an electric substation, which in turn caused a power failure at the insured's "sole and exclusive suppliers" of one of its products.[34] As a result of the power failure, the supplier could not manufacture the subject product for two weeks. Because the insured's retailers were stocking the product for Christmas, the insured shipped the product from Taiwan to the United States by air, rather than by ship, to ensure that the product would arrive in time.

Since the insured incurred significant additional expenses for shipping by air, it sought to recover those expenses under policy language limiting coverage to the risk of "'direct physical loss or damage'" to the "'property of a supplier of goods and/or services to the Insured.'"[35] The court denied coverage, however, concluding that the insured's loss did not fall within the meaning of that language. The court determined that the insured's loss resulted from physical loss or damage occurring at the electrical substations that provided electricity to the insured's suppliers; therefore, the electrical substations were not "suppliers" within the meaning of the policy. The court noted that,

> [h]ad the direct physical loss or damage occurred to [the insured's suppliers], the Policy clearly would have provided coverage, because [the insured's suppliers] "supplie[d] goods and/or services to the Insured." However, under the plain language of the Policy, the physical damage that occurred to the electrical substations that, in turn, supplied electricity to [the insured's] suppliers is too far removed to entitle [the insured] to coverage.[36]

The court distinguished *ADM*, *supra*, on the basis that the policy language at issue in the instant case was more limiting. As noted, that policy provided coverage for losses resulting from "direct physical loss or damage" to the "property of a supplier of goods and/or services to the Insured." Furthermore, there was no coverage because no direct physical loss occurred to the insured's suppliers.[37] In contrast, the policy in *ADM* applied to "*any* supplier of goods or services," and the court there agreed that the use of the term "any" did not limit coverage to particular suppliers, such as principal suppliers or suppliers with whom ADM had a written contract.[38]

---

[33] 2003 WL 21804874, No. Civ. 02-3696 (D. Minn. July 31, 2003).

[34] *Id.* at *1.

[35] *Id.* at *4 (quoting policy language; emphasis omitted).

[36] *Id.* (footnote omitted).

[37] *Id.*

[38] *See* Archer-Daniel-Midland Co. v. Phoenix Assur. Co., 936 F. Supp. 534, 543 (S.D. Ill. 1996).

III.
CIVIL AUTHORITY PROVISIONS

As noted earlier, business interruption insurance proper ties a duty to pay to the occurrence of covered physical damage to covered property. Similarly, the extension of business interruption coverage to losses resulting from the action of civil authorities generally requires the occurrence of direct physical damage, but it requires damage to property other than the insured property.

A. *Evolution of Civil Authority Provisions*

Questions of coverage related to the actions of civil authorities have a long history stretching back more than 100 years. Several of the earliest cases arose in what were then the Hawai'i Territories, but they involved insurance policy *exclusions* for losses caused by orders of civil authority.

For example, in *Hawaii Land Co. v. Lion Fire Insurance Co.*,[39] the Board of Health ordered certain buildings burned to control an outbreak of bubonic plague. The fire spread to and destroyed the insured's building. The fire policy at issue excluded "loss caused directly or indirectly . . . by order of any civil authority."[40] The court held that the insured's loss was caused by the order of the Board of Health and therefore was not covered under the policy.[41]

Although early policies often contained civil authority *exclusions*, coverage was available for losses caused by the order of civil authority. In *Princess Garment Co. v. Fireman's Fund Insurance Co.*,[42] the insured held a fire policy that excluded coverage for "loss caused directly or indirectly . . . by order of any civil authority."[43] Subsequent to the issuance of the policy, the insured added a rider to cover "loss or damage by fire caused by order of military or civil authority exercised to prevent the spread of fire."[44]

In January 1937, the Ohio River overflowed its banks and entered the insured's buildings. As the flood waters rose, the insured's employees began moving the buildings' contents to higher floors. During the same interval, a gasoline tank was torn from its moorings and exploded, causing a fire to edge toward the insured's building. Members of the Police and Fire Departments ordered all the employees in the buildings to leave, fearing that the

---

[39] 1900 WL 2526 (Hawai'i Terr. Oct. 30, 1900).

[40] *Id*. at *1.

[41] *See also* Key Kan v. Manchester Fire Assur. Co., 1904 WL 1310 (Hawai'i Terr. June 4, 1904) (holding that civil authority exclusion would bar coverage for fire loss to insured building resulting from Board of Health's order to burn plague-contaminated buildings). *See* Bankers Fire & Marine Ins. Co. v. Bukacek, 123 So. 2d 157, 160-63 (Ala. 1960) (citing cases discussing civil authority exclusions).

[42] 115 F.2d 380 (6th Cir. 1940).

[43] *Id*. at 38 (quoting policy language).

[44] *Id*.

buildings were in imminent danger of catching on fire. Pursuant to a police cordon, no one could enter the buildings. Although the fire eventually was checked and never reached the insured premises, the flood waters continued to rise and damaged the buildings' contents. The trial court responded to the insured's claim of coverage by ruling that the loss was an uncovered flood loss; not a covered fire loss.

The Sixth Circuit reversed and remanded, finding a question of fact as to whether the proximate cause of the insured's loss was not the flood, but the fire, which prompted the civil authority to act. The court commented that the phrase "civil authority" as used in the policy "should be construed to carry out its purpose. It is to the interest of insurers to enlarge the good faith efforts of public agencies to prevent the spread of fires."[45]

Thus, at least initially, it was the "common intent" of civil authority coverage to extend business interruption coverage to situations where the insured's own property had not itself been damaged (or was not sufficiently damaged to cause as severe a business income loss as would be caused by a total inability to occupy) but to which access had been officially restricted. Because of damage to nearby property, the police or fire fighters would cordon off the area and prohibit access, perhaps even to premises that had not been directly involved in the loss. The prohibition might extend beyond the time of the actual fire if, for instance, there was danger to adjacent buildings from collapse of the damaged property. In the case of extensive wind damage, an entire disaster area might be cordoned off for an extended period after the actual loss in order to prevent looting or possible danger to onlookers, until the damage could be assessed and order restored.[46]

Civil rights unrest during the 1960's led many cities to impose curfews or to order that certain types of businesses cease operation. Affected business owners thereafter made claims under their civil authority coverage, contending that the orders of civil authorities to close their businesses resulted directly from the riots, a peril against which they were insured. However, this was "an interpretation of the civil authority clause that was probably never envisioned by its original drafters" and "not contemplated in the rating structure."[47]

As a consequence, the civil authority provision was modified in 1969, adding language which required that "the order of civil authority result from damage to or destruction of property adjacent to the insured premises."[48] In 1986, however, the coverage for civil au-

---

[45] *Id.* at 382.

[46] FC&S Bulletins, Business Interruption Ca-1 (May 1987). *See generally* Paula B. Tarr, *Where Have All the Customers Gone? Business Interruption Coverage for Off-Premises Events*, 30-WTR BRIEF 20, 21-22 (Winter 2001) (citing FC&S Bulletins, Business Interruption Ca-1 (May 1987)); Seth B. Schafler & Marjorie Han, *Civil Authority Coverage and Related Coverages*, 674 PLI/Lit 59 (Practising Law Institute April 2002).

[47] FC&S Bulletins, Business Interruption Ca-1 (May 1987).

[48] Tarr, *supra* note 46.

thority losses was enlarged by deleting the adjacent-property language and requiring only that the order of civil authority prohibit access to the covered property due to property damage "other than at the described premises."[49]

1. No Express Requirement for Damage to Property

As noted above, early civil authority provisions covered loss of business income where an order of civil authority prohibited access to the insured premises. Those provisions did not include any express requirement for physical damage to adjacent property or to the insured premises. Notwithstanding the absence of a damage requirement, courts disagreed as to whether property damage was necessary to trigger the coverage.

a. *Property Damage Required*

Generally, those courts that have required damage to the insured premises or to adjacent property have looked to other policy provisions in addition to the particular civil authority provision at issue. For example, in *Cleland Simpson Co. v. Firemen's Insurance Co.*,[50] Hurricane Diane wreaked havoc in northeastern Pennsylvania. The hurricane caused severe flooding, which interrupted the water supply to the city of Scranton, Pennsylvania. Without water, and concerned about the danger of fire, the mayor declared a state of emergency, ordering all stores in the city to close. As a result of the prohibition the insured could not access its business premises for three business days. The insured thus sought coverage under its business interruption policy for the losses incurred.

The policy was a standard form, insuring against "all direct loss" by fire or lightning and excluding coverage for any indirect or consequential damage caused by those perils.[51] The policy also contained a business interruption form, which provided coverage for "loss directly resulting from necessary interruption of business caused by destruction or damage by the perils insured against."[52] In addition, the business interruption form provided:

> Interruption by civil authority: Liability under this policy is extended to include actual loss as covered hereunder sustained during the period of time, not exceeding two weeks, when as a direct result of a peril insured against access to the premises described is prohibited by order of civil authority.[53]

---

[49] ISO Business Income Coverage Form (And Extra Expense), CP 00 30 (4-02 ed.).

[50] 140 A.2d 41 (Pa. 1958) (adopting opinion of the trial court).

[51] *Id.* (quoting policy).

[52] *Id.* (quoting policy).

[53] *Id.* (quoting policy).

Examining the policy as a whole, the court concluded that the civil authority provision covered only those additional losses incurred after the insured property was damaged by an insured peril and a subsequent order of civil authority barred access. In reaching its decision, the court analyzed "the buildup of the [insurance] contract."[54] First, the policy specified the perils against which the holder was insured (fire and lightning) and limited the coverage to "direct" loss from those perils. Second, the policy included a business interruption coverage form, which substituted business interruption coverage for coverage of direct loss from fire or lightning, but limited coverage to loss caused by "destruction or damage by the perils insured against."[55] Finally the policy extended the coverage to include "a time limited loss" due to prohibited access by order of civil authority, "but again as a *direct result* of a peril insured against."[56]

Based upon its analysis of the policy structure, the court concluded that "the clear language of the policy restricts the loss to that following a direct invasion of the property by fire or another specified peril and the subsequent prohibition by civil authority of access to the properties."[57] The court reasoned:

> Here the specified peril is fire; the risk insured against is loss of profit through business interruption caused directly by fire and extended for a period of time to continued interruption caused by the action of civil authorities in preventing access to the business premises as a direct result of fire.
>
> By no process of logic can we read into the policy that the risk includes prohibition of access because of apprehension of either the possibility or probability of a fire which never occurred. We have no doubt that a policy could be written to cover such a contingency, but this policy was not so written.[58]

---

[54] *Id.*

[55] *Id*. (quoting policy).

[56] *Id.* at 43-44.

[57] *Id.* at 44.

[58] *Id. See also* Simpson Real Estate Corp. v. Firemen's Ins. Co., 140 A.2d 47 (Pa. 1958) (same, companion case to *Cleland*, 140 A.2d 41).

In a lengthy dissent, Justice Musmanno rejected the majority's reading of the policy, emphasizing that the civil authority provision at issue "says nothing about a 'direct invasion of the property by fire.'" *Cleland*, 140 A.2d at 71 (Musmanno, J. dissenting). Rather, the provision states that the insured can recover where a civil authority order prevents the insured's access to its property as a direct result of "a peril insured against." *Id*. (Musmanno, J. dissenting). The Justice observed:

> What is the peril insured against? Obviously, fire. What was the peril which the good Mayor of Scranton was seeking to prevent? Obviously, fire.
>
> In order to arrive at the conclusion reached by the Majority of this Court, the insurance provision would have had to read that liability is extended to included actual loss "as a direct result of *destruction* caused by fire.

Id. at 45 (Musmanno, J., dissenting).

Similarly, in *Two Caesars Corp. v. Jefferson Insurance Co.*,[59] the District of Columbia Court of Appeals held that an "access" civil authority provision did not provide coverage absent damage to the insured premises. In that case, which arose out of civil disturbances following the death of Dr. Martin Luther King, Jr., the Commissioner of the District of Columbia issued an emergency proclamation that imposed a curfew on the District and prohibited "[t]he sale or dispensing of alcoholic beverages, including beer and wine."[60] The insured restaurant, which served both food and alcoholic beverages, allegedly sustained business losses during the curfew due to the curfew restrictions on the use of public places and the prohibited sale of alcoholic beverages. The insured sought coverage, in part, under the civil authority provision in its policy, which provided:

> Interruption by Civil Authority. This policy is extended to include the actual loss as covered hereunder, during the period of time, not exceeding 2 consecutive weeks, when as a direct result of the peril(s) insured against, access to the premises described is prohibited by order of civil authority.[61]

In reaching its decision that the civil authority provision did not apply to provide coverage, the court relied upon its earlier decision in *Brothers, Inc. v. Liberty Mutual Fire Insurance Co.*,[62] in which it had determined that there was no coverage under a civil authority provision absent damage to or destruction of adjacent property. Like the situation in *Two Caesars*, *Brothers* arose out of the 1968 riots following the assassination of Dr. King. The restaurant in *Brothers* similarly claimed that the curfew and the restrictions on the sale of alcoholic beverages resulted in a covered loss under the civil authority provision in its policy.

The policy at issue in *Brothers* provided coverage for a business interruption loss "when, *as a direct result of damage to or destruction of property adjacent to the premises herein described* by the peril(s) insured against, access to such described premises is specifically prohibited by order of civil authority."[63] The plaintiff did not allege physical damage to its premises or to adjacent property. Rather, it based its claim upon the loss of business due "solely" to the curfew and accompanying municipal regulations.[64] The court therefore concluded that, although the alleged loss resulted from the curfew and municipal regulations, "these did not prohibit access to the premises because of damage to or destruction of adjacent property" as required under the civil authority provision at issue in the case.[65]

---

[59] 280 A.2d 305 (D.C. Ct. App. 1971).

[60] *Id.* at 305.

[61] *Id.* at 306 n.2 (quoting policy language).

[62] 268 A.2d 611 (D.C. Ct. App. 1970).

[63] *Id.* at 613 (emphasis added).

[64] *Id.* at 612.

[65] *Id.* at 614.

Returning to the analysis in *Two Caesars*, the plaintiff there had argued that the civil authority provision in its case and that at issue in *Brothers*, *supra*, were distinguishable. The civil authority provision in *Two Caesars* did not contain the language providing coverage only where a civil authority order prohibited access to the insured's property because of damage or destruction to adjacent property. The *Two Caesars* court, however, rejected plaintiff's distinction.

The basic policy at issue in *Two Caesars* provided coverage "to the extent of the actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property;" it did not insure against loss caused by "order of any civil authority except acts of destruction at the time of and for the purpose of preventing the spread of fire."[66] The court found that this policy language supported its conclusion that an order of civil authority prohibiting access did not provide coverage in the instant case:

> It is true, of course, that one of the perils insured against was interruption of business by Order of Civil Authority and that the loss claimed by [the insured] resulted from the interruption of its business during the effective periods of the curfew. The inescapable fact is, however, that, by the clear provisions of the policy, the loss is compensable only when the Order of Civil Authority, which prohibits access, is predicated upon damage to or destruction of the business property.[67]

Construing the same civil authority provision as that in *Two Caesars*, the Wisconsin Supreme Court in *Adelman Laundry & Cleaners, Inc. v. Factory Insurance Ass'n*[68] followed the *Two Caesars* court. It therefore required physical damage to the insured property even though the civil authority provision in *Adelman*, as in *Two Caesars*, did not expressly require such damage. In reaching its decision, the *Adelman* court noted that the basic policy at issue covered business interruption losses "due to damage to or destruction of described property caused directly by riot, . . . civil commotion, [etc.] . . . ."[69] The policy limited recovery of such losses to that "length of time as would be required with the exercise of due diligence and dispatch to rebuild, repair or replace such described property as had been damaged or destroyed . . . ."[70]

---

[66] *Id.* at 307 (quoting policy language).

[67] *Id.* at 307-08.

[68] 207 N.W.2d 646 (Wis. 1973).

[69] *Id*. at 646-47 (quoting policy language).

[70] *Id*. at 647 (quoting policy language).

Finding that the civil authority provision had to be considered in light of the "length of time . . . to rebuild" language, the court concluded that the civil authority language was "not an extension of coverage to delete the requirement of damage or destruction."[71] Instead, it was "an extension of the time within which an otherwise compensable loss may be sustained."[72]

b. *Property Damage Not Required*

Cases like *Cleland* and *Two Caesars*, discussed above, have required property damage to trigger civil authority provisions not expressly containing such a requirement. In contrast, the Michigan Court of Appeals, construing a similar provision, has concluded otherwise.

In *Sloan v. Phoenix of Hartford Insurance Co.*,[73] the insureds operated movie theaters in Detroit, Michigan. The theaters were open for matinees and from 7:30 p.m. until midnight as well. During the summer of 1967, riots occurred in and around Detroit. However, none of the plaintiffs' theaters was physically damaged. Because of the riots, the Governor of Michigan issued an executive order that established a 9:00 p.m. to 5:30 a.m. curfew and closed all places of amusement in Detroit for eight days. Pursuant to the curfew, the insureds closed their theatres and sustained a loss of business income.

The insureds sought coverage for their losses under their business interruption insurance. Under paragraphs 1 and 2 of the policy, losses "resulting directly from necessary interruption of business caused by damage to or destruction of real or person property by peril[s] insured against" were covered, but "for only such length of time as would be required . . . to rebuild, repair or replace such part of the property . . . damaged or destroyed."[74] In the ensuing paragraph 7, the policy contained the following civil authority coverage:

> Interruption by Civil Authority. This policy is extended to include the actual loss as covered hereunder, during the period of time, not exceeding 2 consecutive weeks, when as a direct result of the peril(s) insured against, access to the premises described is prohibited by order of civil authority.[75]

---

[71] *Id.*

[72] *Id. See also* Mac's Pipe & Drum, Inc. v. Northern Ins. Co., 280 A.2d 308, 308 (D.C. Ct. App. 1971) (construing same language as that in *Two Caesars* and requiring damage to or destruction of the insured property); Allen Park Theatre Co. v. Mich. Millers Mut. Ins. Co., 210 N.W.2d 402, 406-07 (Mich. Ct. App. 1973) (same).

[73] 207 N.W.2d 434 (Mich. Ct. App. 1973).

[74] *Id.* (quoting policy language).

[75] *Id.*

The insurer had argued that there was no coverage because there was no direct physical loss to the insureds' property. On the other hand, the insureds contended that the risk against which they were insured was the prohibition of access to their premises by order of a civil authority resulting from a covered peril (here, riot and civil commotion), and that physical damage to the insured property was not required.

The court agreed with the insureds, concluding that the plain language of the civil authority provision did not require physical damage to the insured property as a condition of payment under the policy. The court observed that paragraphs 1 and 2 of the policy specifically addressed business interruption losses " '[c]aused by damage to or destruction of' the insured property."[76] In contrast, paragraph 7 addressed business interruption losses resulting from denial of access by order of civil authority. Furthermore, the paragraph made "no mention . . . of the necessity for physical damage to the premises before paragraph 7 can become operative."[77] The court noted that it was "too late" to rewrite the policy to add that condition.[78] The court also found "no rational relationship" between the two-week maximum benefit period under paragraph 7 and coverage for losses based upon the "length of time as would be required with the exercise of due diligence and dispatch" to make repairs under paragraph 2.[79]

2. Express Requirement for Damage to "Adjacent" Property

As noted earlier, more recent civil authority provisions prohibit access to the described premises due to direct physical loss of or damage to property other than, or adjacent to, the insured property caused by a covered cause of loss.[80] In *Syufy Enterprises v. Home Insurance Co.*,[81] the court narrowly construed such a provision, barring coverage where damage to other property was more than two blocks away from the insured property. In *Syufy*, the insured owned and operated movie theaters throughout the West Coast. Following the riots and looting after the Rodney King verdict, civil authorities in various cities imposed a dawn-to-dusk curfew for several days. As a result, the insured closed its theaters during the curfew period.

---

[76] *Id.*

[77] *Id.*

[78] *Id.*

[79] *Id. See also* Southlanes Bowl, Inc. v. Lumbermen's Mut. Ins. Co., 208 N.W.2d 569, 570 (Mich. Ct. App. 1973) (court noted it had previously held that, "where the insured businesses were closed by order of a civil authority, physical damage to the insured premises was not a prerequisite to the insurer's obligation to reimburse the insured for the net losses resulting therefrom") (citing *Sloan*, 207 N.W.2d 434).

[80] *See, e.g.*, ISO Business Income Coverage Form (and Extra Expense), CP 00 30 10 91, at 2 (*cited in* SUSAN J. MILLER & PHILIP LEFEBVRE, MILLER'S STANDARD INSURANCE POLICIES ANNOTATED 482.104 (2002 Supp.)).

[81] 1995 WL 129229 (N.D. Cal. March 21, 1995).

Subsequently, the insured submitted a claim under its business interruption policy, which provided coverage for actual loss of business income for up to two weeks when, as a direct result of damage to or destruction of property "adjacent" to the insured premises caused by a covered peril, an order of civil authority "specifically prohibit[s]" access to that insured premises.[82] Based on the following facts, the insurance company denied coverage:

(1) no civil authority ever specifically prohibited access to a Syufy theater as a result of the Rodney King riots;

(2) no Syufy theater nor any property next door to or across the street from a Syufy theater was physically damaged as a direct result of the riots; and

(3) no property located within two blocks of any Syufy theater was physically damaged as a direct result of the riots.[83]

The court agreed with the insurance company that, under the facts of the case, there was no coverage. The insured had argued that the term "adjacent" was ambiguous and should be construed in favor of the insured to mean that property damage occurring *anywhere* in the curfew zones would be "sufficiently 'adjacent'" to the insured's theaters for purposes of triggering coverage.[84] The court rejected the insured's argument, however, noting that the " 'ordinary and popular' reading of the term 'adjacent' denotes a sense of physical proximity" and that "[d]amage occurring in an unspecified area at least two blocks from a Syufy theater is clearly and plainly not 'adjacent' to the theater."[85]

The court also emphasized that the insured had not met any of the other conditions for coverage. That is, no civil authority "specifically" denied access to the insured's theaters.[86] Moreover, there was no causal link between damage to adjacent property and denial of access. As the court noted, the insured closed its theaters as a direct result of the curfews and not, as required by the policy, as a direct result of adjacent property damage. The court did provide an example illustrating circumstances under which coverage would be "clearly" available, however:

---

[82] *Id.*

[83] *Id.*

[84] *Id.* at *2.

[85] *See id.*

[86] *Id.*

> A building next door to a Syufy theater is damaged by fire; for safety reasons, the civil authorities issue an order closing the Syufy theater during repairs to the adjacent building. Any business loss suffered by Syufy for up to two weeks would be covered under the business interruption provision.[87]

3. Express Requirement for Damage to Property "Other Than at the Described Premises"

The most recent civil authority provisions typically delete the adjacent-property language and require instead that the order of civil authority respond to damage to property "other than at the described premises."[88] For example, ISO Form CP 0030 provides:

> Civil Authority. We will pay for the actual loss of Business Income you sustain and necessary Extra Expense caused by action of civil authority that prohibits access to the described premises due to direct physical loss of or damage to property, other than at the described premises, caused by or resulting from any Covered Cause of Loss.
>
> This coverage for Business Income will begin immediately after the time of that action and will end:
>
> (1) 3 consecutive weeks after the time of that action; or
>
> (2) When your Business Income coverage ends;
>
> which ever is later.[89]

By its terms, the civil authority provision quoted above extends business income and extra expense coverage to loss caused by any action of civil authority "that prohibits access to the described premises due to direct physical loss of or damage to property, other than at the described premises, caused by or resulting from any Covered Cause of Loss." The coverage becomes effective seventy-two hours after the action of the civil authority has

---

[87] *Id.* at *2 n.1. *Cf.* Travelers Indem. Co. v. Pollard Friendly Ford Co., 512 S.W.2d 375, 382 (Tex. Ct. Civ. App. 1974) (Civil authority provision provided coverage for "actual loss" caused by order of civil authority where order was direct result of loss by insured peril "in the vicinity of said premises." Court held that provision did not apply where access to insured's business was prohibited by civil authority, but insured's buildings suffered physical damage; civil authority provision "extends liability [to pay extra expenses] to the situation where insured's buildings do not suffer a direct loss, but the area is blocked off by civil authorities thereby denying access to the insured's business by its customers").

[88] FC&S Bulletins, Business Income A.2-4 (Aug. 2001) (quoting ISO Business Income (and Extra Expense) Coverage Form CP 00 30).

[89] *Id.*

commenced – not after any physical loss to the property – and continues for up to three weeks after that action or whenever the insured's business income coverage ends, "which ever is later."

As discussed previously, courts construing older policy language disagreed as to whether property damage was required to trigger a civil authority provision that did not expressly contain such a requirement. However, the current language is clear in requiring "direct physical loss or damage to property," thereby resolving that issue. The current language also clarifies which property must be damaged – delineating property "other than at the described premises."

In addition, the current language is much broader in scope than previous language, which typically limited coverage to loss involving "adjacent" property. The current language provides coverage not only for loss involving adjacent property, but for loss involving *any* property other than the insured property. That is,

> [w]ith the current language, the property damage producing the action of civil authority need not be in the insured's immediate vicinity. Loss from a fire or explosion in a chemical plant several miles upwind of the insured's premises, for example, forcing evacuation of a large area downwind from the plant, is covered by the new language but not the old.[90]

Thus, the current version of the civil authority provision is triggered only where —

1) an insured peril
2) causes direct physical loss or damage
3) to property other than the insured property,

and

4) that property damage causes civil authorities to issue an order,
5) prohibiting access to the insured property,
6) which causes an interruption of the insured's business,
7) which, in turn, causes a loss of business income or causes extra expense as defined by the policy at issue.

The denial of access by civil authorities may extend beyond the time of the insured's actual loss if, for example, there is a danger to adjacent buildings from collapse of the damaged property. Alternatively, in the case of extensive wind damage, an entire disaster

[90] FC&S Bulletins, Business Income A.2-6 (Aug. 2001).

area may be cordoned off for an extended period after the loss to prevent looting or possible danger to onlookers until the damage can be assessed and order restored. "*As long as the interruption is caused by damage due to an insured peril to any property other than that noted on the insured's declaration page, this clause applies.*"[91]

Assurance Co. of America v. BBB Service Co.[92] illustrates the application of the property-damage requirement in a "Civil Authority" provision. In that case, Brevard County, Florida, issued an evacuation order due to Hurricane Floyd. As a result of the evacuation order, the insured restaurant owner closed its restaurants in Brevard County and evacuated the area for two and a half days. The insured sought coverage under a "Civil Authority" provision for the income it lost during the time it could not operate its businesses. The provision at issue stated:

> We will pay for the actual loss of "business income" you sustain and necessary "extra expense" caused by action of civil authority that prohibits access to your premises due to direct physical loss or damage to property, other than at the "covered premises," caused by or resulting from any Covered Cause of Loss.[93]

The insurer rejected the claim, asserting that the evacuation order was issued due to the "threat" of property damage to other property, rather than the actual property damage required under the policy. The insured then brought suit, in part, for breach of contract. The trial court found in favor of the insurer on that claim. The Georgia Court of Appeals reversed, finding issues of fact regarding whether there was damage to other property, even though the evacuation order was based on the threat of damage from the hurricane.[94] On remand, the trial court found in favor of the insured, and the insurer appealed.

The same appellate court then affirmed the trial court's decision, finding that the evidence supported the existence of the requisite property damage. At trial, the parties had stipulated that the evacuation order was in effect for two and a half days; that the insured's restaurants were closed because of the evacuation order and that the insured lost business income during that time; and that property damage occurred during the term of the evacuation order when the hurricane came on land. The insured introduced photographs of the hurricane's landfall in the Bahamas and presented testimony that " 'there was a lot of damage being done to the south of us [Brevard County] at the various islands that it crossed.' "[95] The insured also presented testimony that the evacuation was based on "the fact that the

---

[91] FC&S Bulletins, Business Income A.2-6 (Aug. 2001) (emphasis added).

[92] 593 S.E.2d 7 (Ga. Ct. App. 2003).

[93] *See* Assurance Co. of Am. v. BBB Service Co., 576 S.E.2d 38, 39 (Ga. Ct. App. 2002) (quoting policy language).

[94] *Id*.

[95] *BBB Service Co.*, 593 S.E.2d at 8 (quoting testimony of a member of the Brevard County "Policy Group," which made emergency decisions about weather-related problems).

storm had been causing damage in its path, the forecast that the storm was headed to Brevard County, and the anticipated impact of the storm if it reached Brevard County."[96]

The appeals court concluded that the trial court's ruling in favor of the insured was an "implicit[ ] finding that a basis for the evacuation order was actual damage to property other than the insured premises."[97] Noting that the trial judge's findings were not "clearly erroneous," the appellate court affirmed the trial court's ruling.[98]

By contrast, in *Santa Monica Amusements, LLC v. Royal Indemnity Co.*,[99] the court found that a "Civil Authority" provision did not apply because there was no damage "to property other than insured premises."[100] In that case, one of the suspects barricaded himself with hostages in an arcade on the Santa Monica Pier during a shootout with police. Consequently, the police prohibited public access to the Pier for some eighteen hours.

The insured lost income during the Pier closure and during the thirty days following the closure because of a decline in attendance. The insured then sought coverage under the "Civil Authority" provision in its policy. The insurer paid for the loss of earnings incurred by the insured during the actual closure of the Pier, but not for the alleged loss of earnings incurred after the Pier reopened. The insured brought suit, contending that the "Civil Authority" provision was unambiguous and did not limit coverage only to income lost during the closure and consequent denial of access.

The court disagreed with the insured, concluding that the "Civil Authority" provision was not triggered because the Pier had not closed due to property damage, as required. (Note that the insurer paid for the insured's lost income during the closure even though the "Civil Authority" provision was never triggered.) In holding that the insured was not entitled to coverage, the court observed:

> The undisputed evidence indicates that the police prohibited public access to the pier for 18 hours to apprehend a suspect who had barricaded himself with hostages in an arcade on the pier. Although a shootout resulted in bullet holes in property other than the insured property, there is no evidence in the record to indicate that the pier was closed due to bullet holes or any other property damage.[101]

---

[96] *Id.*

[97] *Id.*

[98] *Id. See also* Narricot Indus., Inc. v. Fireman's Fund Ins Co., 2002 WL 31247972, at *4 (E.D.Pa. Sept. 30, 2002) (in aftermath of Hurricane Floyd, finding coverage under "Civil Authority" provision where actions of police officers prohibiting access to insured's property "stemmed directly from 'damage to property, other than at the described premises,' such as electrical lines, waste water treatment plant, and raw water pump station," and damage to the other property resulted from flood and hurricane, which were 'covered cause[s] of loss' under the insurance policy").

[99] 2002 WL 31429795 (Cal. Ct. App. Oct. 31, 2002).

[100] *Id.* at *1.

[101] *Id.* at *2.

B. *Physical Damage and "Denial of Access"*

In the wake of September 11, one case of special interest has addressed the scope of civil authority provisions and ruled in favor of the insurance company. In *730 Bienville Partners Ltd. v. Assurance Co. of America*,[102] the owner of two hotels in New Orleans, Louisiana, sought coverage under the "Civil Authority Extension" of its commercial property policy for loss of business income allegedly incurred because of the post-9/11 Federal Aviation Administration's ("FAA") order closing all the airports in the United States. The insurance company denied coverage, and the insured brought suit.[103] The "Civil Authority" provision at issue stated:

> We will pay for the actual loss of 'business income' you sustain and necessary 'extra expense' caused by action of civil authority that prohibits access to your premises due to direct physical loss of or damage to property, other than at the 'covered premises,' caused by or resulting from any Covered Cause of Loss. This coverage will apply for a period of up to 4 consecutive weeks from the date of that action.[104]

The insured had argued that the FAA's closure of the nation's airports after September 11, and the subsequent cancellation of numerous flights, kept many guests from getting to its hotels. Although the insured argued that the civil authority provision in its policy covered the loss of business income and necessary expenses, the court disagreed.

As noted in the quotation above, the loss of business income and necessary expenses were covered only if "caused by the action of civil authority that *prohibits* access to your premises." In granting the insurance company's motion for summary judgment, the court looked to the ordinary meaning of the policy text. It then concluded: "While the FAA's

---

[102] 2002 WL 31996014 (E.D. La. Sept. 30, 2002), *aff'd without opinion*, ____F.3d____, 2003 WL 21145725 (5th Cir. April 29, 2003).

[103] The insured sued in Louisiana state court. The insurance company removed the action to Louisiana federal court based upon a federal question and diversity jurisdiction. The insurer then moved to transfer venue to the United States District Court for the Southern District of New York pursuant to the Air Transportation Safety and System Stabilization Act, which gives the New York court original and exclusive jurisdiction over "all action[s] . . . resulting from or relating to the terrorist-related aircraft crashes of September 11, 2001." Pub. L. 107-42(2001), §408(b)(3). The Louisiana federal district court denied the motion: "While the September 11, 2001 attacks are implicated, plaintiff's claim is primarily a breach of contract claim against an insurer for wrongful denial of coverage. Thus, the Act does not intend for such claims to be filed exclusively in Southern District of New York." 730 Bienville Partners Ltd. v. Assurance Co. of Am. Int'l, 2002 WL 985809, at *2 (E.D. La. April 16, 2002).

[104] *730 Bienville Partners*, 2002 WL 31996014, at *2 (quoting policy language).

closure of the airports and cancellation of flights may have prevented many guests from getting to New Orleans and ultimately to plaintiff's hotels, the FAA hardly 'prohibited' access to the hotels."[105]

The court noted that Webster's Third New International Dictionary defined the word "prohibit" as meaning "to forbid by authority or command."[106] The court offered that "[t]he FAA did not forbid travelers from staying at the hotels if other than air transportation was available. Any other interpretation of the policy would pervert the ordinary meaning of words and stretch the notion of causation beyond any doctrine."[107]

Thus, in reaching its decision to deny coverage, the *Bienville* court strictly construed the term "prohibit" as used in the civil authority provision at issue. By doing so, *Bienville* indicates that civil authoritative action resulting in something less than actual prohibition of access — such as impairment of access — will be insufficient to support civil authority coverage. Moreover, *Bienville* demonstrates that courts may be unwilling to stretch the causal relationship between a civil authority order and the loss of access to encompass an insured's remote, but undamaged property.

Similarly, in *54th Street Limited Partners v. Fidelity & Guaranty Insurance Co.*,[108] the city denied access to the insured restaurant on December 7 and 8. Thereafter, both vehicular and pedestrian traffic was diverted, but access to the restaurant was not denied. The insured sought coverage, in part, under the "civil authority" provision of its business interruption policy. Although the court did not repeat the language of that provision in its decision, the court held that the provision applied only to the income lost while access to the restaurant was denied by the act of civil authority – i.e., December 7 and 8. However, the provision did not cover the loss of income allegedly due to the subsequent diversion of vehicular and pedestrian traffic because "the restaurant was accessible to the public, plaintiff's employees and its vendors."[109]

---

[105] *Id.* (footnote omitted).

[106] *Id.* at *2 n.3.

[107] *Id.*

[108] 763 N.Y.S.2d 243 (App. Div. 2003).

[109] *Id.* at 244 (citations omitted). *See also* St. Paul Mercury Ins. Co. v. Magnolia Lady, Inc., 1999 WL 33537191 (N.D.Miss. Nov. 4, 1999), in which Arkansas authorities closed a bridge over the Mississippi River after a barge collided with the bridge, causing major structural damage to the bridge. The bridge was located near the insured's casino-hotel located in Lula, Mississippi, and the insured claimed that it lost 80% of its business during the time the bridge was closed for repairs. The insured sought coverage, in part, under a "Civil Authority" provision, which provided coverage for actual loss of earnings and necessary extra expenses " 'when a Civil Authority . . . denies access to the described location.' " 1999 WL 33537191, at *1 (quoting policy language). The court found there was no coverage because the insured's business was accessible during the bridge closure, and the insured continued to operate its business and to accept customers. The court rejected the insured's assertion that customers from Arkansas were "denied access" within the meaning of the policy, noting that those customers could have gained access to the insured's business from the Mississippi side of the bridge. *Id.* at *3.

IV.
CONCLUSION

Circumstances arise in which losses that might not be covered under most commercial property policies are covered as a consequence of unusual policy language. In addition, there are instances in which result-oriented jurisprudence prevails over contractual language and majority precedent. As a general proposition, however, the "physical damage" requirement is still alive and well, though it may be tested in pending cases arising out of September 11, 2001 or recent natural disasters, such as the California fires.

As the world becomes increasingly globalized and interdependent, events occurring thousands of miles away to perfect strangers can affect businesses to some significant degree. Although a causal relationship may exist between these distant events and business slowdowns or closures, insureds cannot hope to substitute the often infinite results of causation analysis for finite contractual conditions precedent. Commercial property insurance cannot be used as financial guarantee insurance.

Non-Competition Agreements†

Linda S. Woolf

I.
Introduction

Non-competition agreements (or restrictive covenants) have become increasingly important tools in preventing former employees from utilizing or disclosing proprietary and confidential information once the employment relationship ends. A non-compete provision is an agreement between an employee and his or her employer whereby the employee contracts not to compete with the employer following termination of the employment relationship. These agreements generally prevent the employee from engaging in the same business/profession, soliciting the company's customers and revealing the company's confidential information for the benefit of the former employee or the benefit of a new employer. Although most (but not all) jurisdictions recognize reasonable covenants not to compete, a multitude of statutory and common laws provide various restraints on their validity and enforcement. As such, it is critical to consult applicable state statutes and decisions, since the agreements may be prohibited (e.g., California non-compete provisions are generally unenforceable) and/or limited by statutory and/or case law (e.g., Alabama non-compete agreements are void unless they fall within a statutory exception). Subject to that caveat, this article discusses the general requirements for non-compete agreements and the enforceability of such agreements.

II.
Enforceability of Non-Compete Agreements

Most jurisdictions recognize and enforce *reasonable* covenants not to compete. A covenant is *reasonable* if the following criteria are met: (a) the agreement protects a legitimate business interest of the employer; (b) the agreement is reasonably limited in duration and geography so as to not impose undue hardship upon the former employee; and (c) the agreement does not violate public policy. Several jurisdictions also require the agreement to be supported by additional consideration in the form of a benefit to the employee.

---

† Submitted by the author on behalf of the FDCC Employment Litigation and Civil Rights Section.

Linda Woolf is a partner and founding member of the Baltimore firm of Goodell, DeVries, Leech & Dann, LLP, and head of its commercial litigation department. She is a magna cum laude graduate of the University of Baltimore Law School and was the Managing Editor of its Law Review. Ms. Woolf is a member of the Executive Board of the Maryland Association of Defense Counsel, co-chair of its Appellate Committee and past editor of its quarterly publication, THE DEFENSE LINE. Ms. Woolf's practice focuses on commercial litigation, business torts, employment and insurance coverage disputes. She is a frequent lecturer and faculty member for continuing legal education programs sponsored by the Maryland Institute for the Continuing Professional Education of Lawyers (MICPEL), including its nine-day Intensive Trial Advocacy Program. In addition, she is a member of the FDCC Business Tort and Commercial Litigation, Employment Litigation and Civil Rights and Insurance Coverage Sections, the Defense Research Institute, and past chair of the Network of Trial Law Firms, Inc.

A. *Legitimate Business Interests*

A restrictive covenant is reasonable and enforceable when it protects some legitimate interest of the employer beyond the mere interest in protecting the employer from competition. Those extended legitimate interests generally assume some version of the criteria noted below.

1. Trade Secrets and Confidential Information

An employer has a legitimate business interest in keeping former employees from using its trade or business secrets or other confidential information in competition against it. Even in the absence of a demonstrable trade secret, the employee may be enjoined from using confidential information obtained during his employment under certain circumstances.[1]

[1] PADCO Advisory, Inc. v. Omdahl, 179 F. Supp. 2d 600 (D. Md. 2002).

2. Customer Relationships and Specialized Training

An employer is entitled to protect its customer relationships or the knowledge that its employees gained solely by reason of their employment with the company.[2] Furthermore, although an employer does not have a protectable interest in the *general* knowledge and skill of an employee, some courts will enforce non-compete agreements if the employer's services are unique.[3]

B. *Scope, Geography and Duration*

A non-compete agreement should be limited by type of activity, geographical area and duration. The extent to which the agreement is limited is crucial in determining the reasonableness of the agreement. If (1) the agreement proscribes activities more extensive than necessary; (2) the agreement covers a geographical area more extensive than necessary to protect the interests of the business; or (3) the agreement lasts longer than is required to

---

[2] Smith v. HBT, Inc., 445 S.E.2d 315 (Ga. Ct. App. 1994) (employer has an interest in the customer relationships its former employee established and/or nurtured while employed); Cohoon v. Financial Plans & Strategies, Inc., 760 N.E.2d 190 (Ind. Ct. App. 2001) (employer had a legitimate, protectable interest in good will of its clients and "past" clients with whom employee had direct contact during last twelve months of his employment); Rogers v. Runfola & Assocs. Inc., 565 N.E.2d 540 (Ohio 1991) (legitimate business interest exists to keep employees from disclosing internal information and client relationships developed at employer's expense); Farr Assocs., Inc. v. Baskin, 530 S.E.2d 878 (N.C. Ct. App. 2000) (protection of customer relationships against misappropriation by a departing employee is a legitimate interest of an employer); *but see* Prof'l Bus. Servs. Co. v. Rosno, 589 N.W.2d 826 (Neb. 1999) (agreement can only restrict former employee from soliciting customers or clients with whom former employee did business and had actual contact); Ken J. Pezrow Corp. v. Seifert, 602 N.Y.S.2d 468 (App. Div. 1993) (customer lists readily available from outside sources are not protected).

[3] Willis of New York, Inc. v. DeFelice, 750 N.Y.S.2d 39 (App. Div. 2002) (insurance brokerage firm was entitled to enforce restrictive covenants against its former high-level employee to prevent the employee from soliciting firm's clients after employee joined firm's competitor because employee's services were unique); Vantage Tech., L.L.C. v. Cross, 17 S.W.3d 637 (Tenn. Ct. App. 1999) (an employer may have a protected interest in the unique knowledge and skill that an employee receives through special training by his employer, at least when such training is present along with other factors tending to show a protected interest).

protect those interests, the agreement will be deemed unreasonable and unenforceable. Thus, employers can protect their interests, but they must narrowly tailor restrictive covenants as to scope,[4] geography and duration.[5]

C. *Public Policy*

Courts generally will not enforce restrictive covenants that contravene public policy.[6] Restrictive covenants affecting attorneys, for example, are generally unenforceable as a violation of professional conduct codes.[7] In addition, non-compete agreements with health care professionals are sometimes rigorously scrutinized out of concern that the public will be deprived of a qualified practitioner if such an agreement is enforced.[8] Courts have even found that where an agreement is ambiguous, subjecting the employee to uncertainty offends public policy.[9]

D. *Consideration*

Several jurisdictions also require that any non-compete agreement be supported by *additional* consideration in the form of a benefit to the employee. The type of consideration can be important and varies with each state. In most states, signing a non-compete agree-

---

[4] *See, e.g.*, Howard Johnson & Co. v. Feinstein, 609 N.E.2d 930 (Ill. App. Ct. 1993) (agreement's activity restraint was carefully tailored and narrowly drawn to meet parties' interests); *cf.* Modern Environments, Inc. v. Stinnett, 561 S.E. 2d 694 (Va. 2002) (non-compete clause prohibiting employee from working in any capacity for competitor was overbroad and unenforceable); Marshall v. Gore, 506 So. 2d 91 (Fla. Dist. Ct. App. 1987) (computer programmer could not be prohibited from working in *any* computer business, but only firm competing with employer in software relating to dairy feeding and management); Moore v. Eggers Consulting Co., 562 N.W.2d 534 (Neb. 1997) (agreement precluding employee from entering into business with anyone of whom he had knowledge because of his employment rather than clients with whom he had done business was unenforceable).

[5] *See, e.g.*, Cardiovascular Surgical Specialists v. Mammana, 61 P.3d 210 (Okla. 2002) (non-compete clause precluding surgeon from practicing cardiovascular and thoracic surgery within twenty-mile radius of former practice was overbroad and unenforceable where closest hospital outside twenty-mile radius was 100 miles away from location of former practice); Hopper v. All Pet Animal Clinic, Inc., 861 P.2d 531 (Wyo. 1993) (enforcement of one-year term appropriate); Sheffield v. Stoudenmire, 553 So. 2d 125 (Ala. 1989) (five-year restriction and fifty-mile radius restraint was not reasonably related to agency's interest); Pinnacle Performance, Inc. v. Hessing, 17 P.3d 308 (Idaho Ct. App. 2001) (agreement was unreasonable where employee was hired for a four-month period on single project and prohibited from performing any services for any past or present clients in any geographical area for two years).

[6] *See* Dowd & Dowd, Ltd. v. Gleason, 693 N.E.2d 358 (Ill. 1998).

[7] *See, e.g.*, *id.*; Jacob v. Norris, McLaughlin & Marcus, 607 A.2d 142 (N.J. 1992).

[8] Valley Medical Specialists v. Farber, 982 P.2d 1277 (Ariz. 1999); *but cf.* Cardiovascular Surgical Specialists v. Mammana, 61 P.3d 210 (Okla. 2002) (upholding non-compete clause precluding surgeon from soliciting patients of former practice for one year, except where patient affirmatively requested surgeon to continue providing his or her medical services).

[9] Power Dist. Inc. v. Emergency Power Eng'g, 569 F. Supp. 54 (E.D. Va. 1983).

ment at the inception of one's employment is valuable consideration sufficient to support a covenant not to compete.[10] After the employment relationship begins, an employer can provide consideration for signing a non-compete agreement by providing new responsibilities, a cash payment or other benefit.[11] While continued employment is sufficient consideration in some courts,[12] it is insufficient consideration in others.[13]

III.
NON-COMPETITION AGREEMENTS IN CONNECTION WITH THE SALE OF A BUSINESS

While covenants not to compete in employment contracts are generally not favored by the law, a lesser degree of scrutiny is applied to covenants that are ancillary to the sale of a business.[14] The rationale behind this distinction when analyzing covenants not to compete focuses on the different nature of each contract. A contract of employment inherently involves parties of unequal bargaining power, whereas a contract for the sale of a business is far more likely to be entered by parties of equal footing.[15] As a result, a covenant entered into as part of the sale of a business generally can be drafted more broadly than one entered into as part of an employment contract.[16]

A. *Enforcement*

Whether the terms of the non-compete agreement are reasonable typically turns on the specific facts of each transaction.[17] Indiana courts apply a three-pronged test to determine whether covenants not to compete ancillary to the sale of a business are overbroad. The elements of this test consist of the following:

---

[10] *See, e.g.*, Farr Assocs., Inc. v. Baskin, 530 S.E.2d 878 (N.C. Ct. App. 2000).

[11] *See, e.g.*, Davis & Warde, Inc. v. Tripodi, 616 A.2d 1384 (Pa. Super. Ct. 1992).

[12] Coastal Unilube, Inc. v. Smith, 598 So. 2d 200 (Fla. Dist. Ct. App. 1992); Leatherman v. Mgmt. Advisors, Inc., 448 N.E.2d 1048 (Ind. 1983).

[13] Lyle R. Jager Agency v. Steward, 625 N.E.2d 397 (Ill. App. Ct. 1997); Milner Airco, Inc. v. Morris, 433 S.E.2d 811 (N.C. App. 1993).

[14] Habif, Arogeti & Wynne, P.C. v. Baggett, 498 S.E.2d 346 (Ga. Ct. App. 1998).

[15] Watson v. Waffle House, 324 S.E.2d 175 (Ga. 1985).

[16] Gale Indus. v. O'Hearn, 570 S.E.2d 661 (Ga. Ct. App. 2002); Rent-A-Center v. Canyon Television & Appliance Rental, 944 F.2d 597 (9th Cir. 1991); H&R Block v. Lovelace, 493 P.2d 205, 210 (Kan. 1972).

[17] Rent-A-Center v. Canyon Television & Appliance Rental, 944 F.2d 597 (9th Cir. 1991).

1. whether the covenant is broader than necessary for the protection of the covenantee in some legitimate interest;
2. the effect of the covenant upon the covenantor; and
3. the effect of the covenant upon the public interest.[18]

Of primary importance are the questions whether the covenant not to compete is reasonable to the covenantee and whether it is reasonable as to time, space and activity.[19]

Four factors are considered in determining whether the protection afforded a covenantee in a territorial restraint covenant ancillary to the sale of a business is reasonable under the circumstances. These factors can be listed as follows:

1. the type of business sold;
2. the effect of including territory into which the transferring business did not extend,
3. the extent of the purchaser's original business, and
4. the period of restraint.[20]

The most important of these factors is the type or nature of the business purchased. For this purpose, businesses are categorized in three ways: businesses involving (1) services, (2) distribution of goods, and (3) the production, manufacturing, or processing of goods.[21] In regard to duration, courts typically will examine the amount of the purchase price to determine reasonableness.[22]

---

[18] Fogle v. Shah, 539 N.E.2d 500 (Ind. Ct. App. 1989).

[19] *Id*. (citing 46 A.L.R.2d 114, 147-151 (1951)).

[20] *Id*. (citing 46 A.L.R.2d 114, 228-260 (1951)).

[21] *Id*.

[22] Bowen v. Carlsbad Ins. & Real Estate, 724 P.2d 223, 225 (N.M. 1986) (citing Bonneau v. Meaney, 178 N.E.2d 577, 579 (Mass. 1961)); *see also* Valley Mortuary v. Fairbanks, 225 P.2d 739, 743 (Utah 1950) (twenty-five year covenant ancillary to sale of business was valid and enforceable); DBA Enter. v. Findlay, 923 P.2d 298, 301 (Colo. Ct. App. 1996) (five years plus term of covenant was reasonable); Bicycle Transit Auth., Inc. v. Bell, 333 S.E.2d 299, 304 (N.C.1985) (seven-year covenant was reasonable).

B. *Assignability of Non-Competition Clauses*

Divested businesses frequently are parties to pre-existing employment contracts containing non-compete provisions. Jurisdictions are split, however, on whether employment contracts containing covenants not to compete are assignable to the new owner in the event of a sale of the business.[23] The majority of these states have concluded that the restrictive covenants are not assignable.[24] Some of these jurisdictions have based their decisions on a finding that the employment contracts are personal to the parties and may not be assigned.[25] Other jurisdictions have concluded that employment contracts involve personal services and are not assignable without the parties' consent.[26]

Several other jurisdictions have taken a less restrictive view; these generally allow non-competition agreements to be assigned absent specific language in the agreement prohibiting such assignment.[27] The decision in *AutoMed Techs., Inc. v. Eller* reasoned that the identity of the party enforcing a restrictive covenant should make "very little" difference to the employee.[28] Furthermore, because courts only enforce covenants to the extent that they are reasonable and necessary to protect an employer's legitimate interests, an employee will not be prejudiced by having the contract assigned to a successor business.[29]

In situations where an employee consents to assignment, an issue may arise regarding whether the purchase and sale of the business goodwill should be interpreted to include the purchase and sale of an employment agreement with a non-compete clause when that employment agreement is not explicitly included in the list of purchased assets. In *Campbell v. Millennium Ventures, LLC,*[30] the court noted this issue of first impression, and determined that when a purchaser buys the "goodwill" of the seller, "logic suggests" that the goodwill

---

[23] Hess v. Gebhard & Co., 808 A.2d 912 (Pa. 2002).

[24] *Id*.

[25] *Id*. (citing Sisco v. Empiregas, Inc., 237 So. 2d 463 (Ala. 1970) (stating that covenants not to compete are personal to the performance of the company and the employee and are not assignable, particularly as they involve a relationship of personal confidence between the two parties); Smith, Bell & Hauck, Inc. v. Cullins, 183 A.2d 528 (Vt. 1962)).

[26] *Id*. at 919 (citing Trinity Transp. v. Ryan, 1986 WL 11111 (Del. Ch.1986) (contract is for personal services and not assignable); SDL Enters. v. DeReamer, 683 N.E.2d 1347 (Ind. Ct. App. 1997)); *see also* Phillips v. Corporate Express Office Prods., 800 So. 2d 618 (Fla. Dist. Ct. App. 2001) (holding that non-compete agreements were personal services contracts and not assignable without the parties' consent); Clark Substations, L.L.C. v. Ware, 838 So. 2d 360 (Ala. 2002) (same).

[27] Artomick Int'l., Inc. v. Koch, 759 N.E.2d 385 (Ohio Ct. App. 2001); *see also* AutoMed Techs., Inc. v. Eller, 160 F. Supp. 2d 915, 924 (N.D. Ill. 2001) ("without any Illinois precedent holding that restrictive covenants may never be assigned without consent, we are unwilling to anticipate new public policy restrictions on contract rights.").

[28] AutoMed Techs., Inc. v. Eller, 160 F. Supp. 2d 915, 924 (N.D. Ill. 2001).

[29] *Id*.

[30] 55 P.3d 429 (N.M. Ct. App. 2002).

sold includes the employment agreement.[31] Furthermore, the court was persuaded that the purchase agreement included assignment of the employment agreement since the employment agreement was not listed in the purchase agreement as an excluded asset. That factor operated in conjunction with other circumstances surrounding the purchase agreement (e.g., the employee's consent to the assignment).

IV.
ENFORCING THE AGREEMENT

A. *Burden of Proof*

The party seeking to enforce the non-compete agreement bears the burden of proving its reasonableness by clear and convincing evidence.[32]

B. *Judicial Enforcement*

Courts take one of three positions when approaching covenants not to compete: (1) an agreement that is overly broad and unreasonable in scope, duration and/or geography will not be enforced;[33] (2) an overly broad agreement can be "blue-penciled" by deleting the offending provisions and enforcing the remaining contract;[34] or (3) an overly broad agreement can be redrafted or revised to provide reasonable protection to an employer's legitimate business interest.[35]

C. *Remedies*

Upon a breach of the agreement, the non-breaching party is entitled to money damages and/or injunctive relief. Generally, courts prescribe relief under one or more of the theories noted below.

1. Injunctive Relief

An employer may seek injunctive relief to enforce the terms of the restrictive covenant. For example, an employer may seek to prevent the former employee's solicitation of customers or key employees, or to prevent disclosure of trade secrets or other confidential information. Ordinarily, injunctive relief may be granted only upon a showing that: (1) the plaintiff's remedies at law are inadequate, causing irreparable harm pending resolution of

---

[31] *Id*. at 436.

[32] Raimonde v. Van Vlerah, 325 N.E.2d 544 (Ohio 1975); AEE-EMF, Inc. v. Passmore, 906 S.W.2d 714 (Mo. Ct. App. 1995); Clark v. Mt. Carmel Health, 706 N.E.2d 336 (Ohio Ct. App. 1997).

[33] Presto-X-Co. v. Beller, 568 N.W.2d 235 (Neb. 1997).

[34] Commercial Bankers Life Ins. Co. of Am. v. Smith, 516 N.E.2d 110 (Ind. Ct. App. 1987).

[35] Raimonde v. Van Vlerah, 325 N.E.2d 544 (Ohio 1975).

the substantive action; (2) the plaintiff has a reasonable likelihood of success at trial; (3) the plaintiff's threatened injury outweighs the potential harm to the defendant resulting from the injunction sought, and (4) the injunction will serve the public interest.[36] An employer may be entitled to preliminary injunctive relief where it can demonstrate that it is likely to suffer irreparable harm if such relief is not granted before a decision on the merits can be rendered.[37] Injunctive relief may be denied, on the other hand, where the former employer fails to demonstrate that such relief is necessary to protect its legitimate business interest.[38]

2. Actual Damages

Although it may be impossible to ascertain an exact amount of lost profits resulting from the breach of a non-compete covenant, an award of damages is not precluded. Rather, the plaintiff must provide evidence that establishes damages with a fair degree of probability.[39]

3. Liquidated Damages

A liquidated damages clause in an employment contract is governed by the same rules that prevail under other contracts.[40] In order to recover liquidated damages under a contract, "(1) injury caused by the breach must be difficult or impossible of estimation in fact and not merely contended by the contract; (2) the parties must intend to provide for damages; (3) and the sum stipulated must be a reasonable pre-estimate of the probable loss."[41]

4. Other Theories of Relief upon Breach

Beyond injunctive relief and damages, there are other theories of relief that may be sought upon breach. These include:

---

[36] *See, e.g.*, Washel v. Bryant, 770 N.E.2d 902 (Ind. Ct. App. 2002); John T. Callahan & Sons, Inc. v. City of Malden, 713 N.E.2d 955 (Mass. 1999); City of Cleveland v. Cleveland Elec. Illum. Co., 684 N.E.2d 343 (Ohio Ct. App. 1996).

[37] Shred-It, USA, Inc. v Mobile Data Shred, Inc., 202 F. Supp. 2d 228 (S.D.N.Y. 2000).

[38] *See* PADCO Advisory, Inc. v. Omdahl, 179 F. Supp. 2d 600 (D. Md. 2002) (denying permanent injunction enjoining former employee from misappropriating confidential customer database where evidence showed that former employee did not physically take tangible records, customer list was constantly changed, and employee's memory of list contents two years after he left would not qualify as trade secret).

[39] Prairie Eye Center, Ltd. v. Butler, 768 N.E.2d 414 (Ill. App. Ct. 2002); Scobell Inc. v. Schade, 688 A.2d 715 (Pa. Super. Ct. 1997).

[40] *See* Habif, Arogeti & Wynne, P.C. v. Baggett, 498 S.E.2d 346 (Ga. Ct. App. 1998).

[41] Capricorn Sys., Inc. v. Pednekar, 546 S.E.2d 554 (Ga. Ct. App. 2001).

(a) Uniform Trade Secret Act (USTA);

(b) Unfair Competition and Deceptive Trade Practice State Statutes;

(c) Breach of Fiduciary Duty;

(d) Intentional Interference with Contractual Relations, or

(e) Conspiracy.

D. *Possible Defenses to Enforcement*

An employer's material breach of the employee's employment contract may provide a defense to enforcement.[42] Failure to provide sufficient consideration also may provide a defense to enforcement of a restrictive covenant.[43] In addition, enforcement may be challenged if the agreement is unreasonable in light of its scope, geography or duration, as previously discussed. Standard contract defenses such as fraud or promissory estoppel also may apply.

V.
CONCLUSION

Employers must take proactive measures to protect company information. Careful attention to statutory and common law is required when drafting non-compete agreements. Although such agreements may not provide full protection from disclosure of company information, non-compete agreements can be extremely effective in protecting the proprietary and confidential information of a business when drafted properly.

[42] Ward v. Am. Mut. Liab. Ins. Co., 443 N.E.2d 1342 (Mass. Ct. App. 1983).

[43] McCandless v. Carpenter, 848 P.2d 444 (Idaho Ct. App. 1993).

Punitive Damages: California Model Applying *Gore* and *State Farm*†

Patrick J. Hagan
Anne Marie Bridges

I.
Introduction

This article contextualizes the role of punitive damages in an award model based essentially upon California law. First, it discusses the United States Supreme Court decision in *BMW of North America, Inc. v. Gore*.[1] An overview of the Ninth Circuit's interpretation of *Gore*, as articulated by *In re the Exxon Valdez*,[2] follows that analysis. Finally, the article explores California's interpretation of *Gore* based on relevant California appellate decisions.

II.
The Origin and Nature of Punitive Damages

The practice of assessing punitive damages to punish particularly blameworthy conduct is centuries old. The punitive and deterrent purposes of such damages, highlighted in the early common law, established a foundation for the use of punitive damages in the modern common law system.

Introduced into the United States in the late eighteenth century, punitive damages were firmly accepted as a noncompensatory award. Depending on the particular jurisdiction, however, courts have varied in their approach to determining the appropriate size of such an award. California is fairly typical of the majority, identifying three factors by which to

---

† Submitted by the authors on behalf of the FDCC Toxic Tort and Environmental Law Section.

1 517 U.S. 559 (1996).

2 270 F.3d 1215 (9th Cir. 2001).

Patrick J. Hagan is a partner and supervising attorney for the Environmental/Product Liability Team at Dillingham & Murphy, LLP, in San Francisco. He is a graduate of St. Joseph's University in Philadelphia, PA (B.S. 1965) and the University of California, Hasting College of the Law (J.D. 1975). Mr. Hagan is a member of the California, San Francisco County and the American Bar Associations. He is also a member of the Federation of Defense & Corporate Counsel (former chair of the Toxic Tort and Environmental Section), the Defense Research Institute and the Association of Defense Counsel for Northern California. He is widely published in his areas of expertise.

gauge the propriety of a punitive award: (1) the reprehensibility of the defendant's conduct; (2) the amount of compensatory damages awarded; and (3) the wealth of the defendant. Nevertheless, questions continue to surface regarding the permissible scope and size of any punitive damage award.

III.
GORE: SETTING A PRECEDENT FOR PUNITIVE DAMAGES

A. *Criteria before Gore*

Before establishing punitive damage guideposts in *Gore*, the Supreme Court had addressed the issue of punitive damages in *Honda Motor Co. v. Oberg*.[3] The decision in *Honda* focused the Court's prior attempts to deal with punitive damages in *TXO Production Corp. v. Alliance Resource Corp.*[4] and *Pacific Mutual Life Insurance Co. v. Haslip*.[5] Reasoning from those decisions, the Court noted that lower courts must follow a rational process when assessing punitive damages:

> The opinions in both *Haslip* and *TXO* strongly emphasized the importance of the procedural component of the Due Process Clause. In *Haslip*, the Court held that the common-law method of assessing punitive damages did not violate procedural

[3] 512 U.S. 415 (1994).

[4] 509 U.S. 443 (1993).

[5] 499 U.S. 1 (1991).

Anne Marie Bridges is an associate attorney in the San Francisco office of Tucker Ellis & West, LLP. She is a graduate of St. Mary's College of California (B.A., cum laude) and the University of San Francisco School of Law (J.D.). During law school Ms. Bridges completed the Intensive Advocacy Program and taught juvenile delinquents through the national Street Law program. She has experience in director and officer liability, products liability, environmental law, general business and commercial liability, and in defending class actions and complex litigation.

> due process. In so holding, the Court stressed the availability of both "meaningful and adequate review by the trial court" and subsequent appellate review. Similarly, in *TXO*, the plurality opinion found that the fact that the "award was reviewed and upheld by the trial judge" and unanimously affirmed on appeal gave rise "to a strong presumption of validity." 509 U.S., at 457, 113 S.Ct., at 2720. Concurring in the judgment, Justice Scalia (joined by Justice Thomas) considered it sufficient that traditional common-law procedures were followed. In particular, he noted that "'procedural due process' requires judicial review of punitive damages awards for reasonableness."[6]

Thus, the decisions in *Haslip* and *TXO* were catalysts for *Honda*, but it was *Honda* that bridged the road to the *Gore* guideposts.

B. *Facts and Procedural History of Gore*

In *Gore*, an automobile purchaser brought an action against a foreign automobile manufacturer and dealer based on a distributor's failure to disclose that the automobile had been repainted after being damaged prior to delivery.[7] The Alabama Circuit Court entered judgment on the jury verdict awarding the plaintiff (Gore) compensatory damages of $4,000 and punitive damages of $4 million. Both the automobile distributor and automobile manu-

---

[6] Honda Motor Co., Ltd. v. Oberg, 512 U.S. 415, 420-21 (1994) (citing TXO Production Corp. v. Alliance Resource Corp., 509 U.S. 443, 457, 471 (1993) and Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1, 20 (1991)).

[7] *Gore*, 517 U.S. 559.

facturer appealed. After determining that the court lacked jurisdiction over the manufacturer, the Alabama Supreme Court reduced the award to $2 million and conditionally affirmed the punitive damage award. Certiorari was granted, and the United States Supreme Court eventually held that: (1) lawful conduct by the automobile distributor outside the state of Alabama could not be considered by the Alabama court in making the award of punitive damages; and (2) the punitive damage award of $2 million was grossly excessive.[8]

IV.
SUPREME COURT "GUIDEPOSTS" IN CALCULATING PUNITIVE DAMAGES

In determining that the Alabama Supreme Court's award of punitive damages was excessive, the United States Supreme Court adopted three "guideposts." The Court examined "the degree of reprehensibility of the nondisclosure; the disparity between the harm or potential harm suffered by Dr. Gore and his punitive damages award; and the difference between this remedy and the civil penalties authorized or imposed in comparable cases."[9]

A. *Applying the Gore Guideposts*

The Supreme Court in *Gore* cited these three guideposts to calculate punitive damages. The California courts, both federal and state, have adopted the principles articulated in *Gore*, but award less credence to the Supreme Court's analysis and conclusions when applying those guideposts. Using the Supreme Court's language piecemeal, California instead articulates a different analysis and offers independent conclusions when relating these guideposts to the relevant facts.

1. Guidepost No. 1: Degree of Reprehensibility

a. *The Supreme Court*

The first guidepost analyzed by the Supreme Court in *Gore* was the degree of reprehensibility involved in the nondisclosure ("degree of reprehensibility"). The Court initiated its analysis with the following statement: "Perhaps the most important indicium of the reasonableness of a punitive damages award is the degree of reprehensibility of the defendant's conduct."[10] The Court continued: "In *TXO*, both the West Virginia Supreme

---

[8] *Id*.

[9] *Id*. at 575.

[10] *Id*.

Court and the Justices of this Court placed special emphasis on the principle that punitive damages may not be 'grossly out of proportion to the severity of the offense.' "[11] In making its decision, the Court reasoned that "none of the aggravating factors associated with particularly reprehensible conduct" was present.[12] The Court observed in particular that "BMW's conduct evinced no indifference to or reckless disregard for the health and safety of others."[13] Further, the Court noted that "[t]here is no evidence that BMW acted in bad faith when it sought to establish the appropriate line between presumptively minor damages and damage requiring disclosure to purchasers."[14] When summarizing its analysis of this guidepost, as applied to the facts, the Court stated, "Finally, the record in this case discloses no deliberate false statements, acts of affirmative misconduct, or concealment of evidence of improper motive. . . ."[15] The Court concluded: "That conduct is sufficiently reprehensible to give rise to tort liability, and even a modest award of exemplary damages does not establish the high degree of culpability that warrants a substantial punitive damages award."[16]

b. *Post-Gore Modifications*

In *State Farm Mutual Automobile Insurance Co. v. Campbell*,[17] the Supreme Court later observed:

> We have instructed courts to determine the reprehensibility of a defendant by considering whether: the harm caused was physical as opposed to economic; the tortious conduct evinced an indifference to or a reckless disregard of the health and safety of others; the target of the conduct had financial vulnerability; the conduct involved repeated actions or was an isolated incident; and the harm was the result of intentional malice, trickery, or deceit, or mere accident. The existence of any one of these factors weighing in favor of a plaintiff may not be sufficient to sustain a punitive damages award; and the absence of all of them renders any award suspect.[18]

---

[11] *Id*. at 576 (citing *TXO*, 509 U.S. at 453, quoting *Haslip*, 499 U.S. 1 at 22).

[12] *Id.*

[13] *Id*.

[14] *Id.* at 579.

[15] *Id*.

[16] *Id*. at 580.

[17] 123 S.Ct. 1513 (2003).

[18] *Id*. at 1521 (citing *Gore*, 517 U.S. at 576-77).

The Court continued, clarifying its concept of reprehensibility and the sanction available for such reprehensible conduct. In that regard, the Court observed that the conduct must be "so reprehensible" in order to warrant punitive damages.[19] Furthermore, a "defendant should be punished for the conduct that harmed the plaintiff, not for being an unsavory individual or business."[20] Finally, the "reprehensibility guidepost does not permit courts to expand the scope of the case so that a defendant may be punished for *any malfeasance*. . . ."[21]

The opinion in *State Farm* reinforced *Gore* by underscoring the need to limit punitive damages and to award them with cautious discrimination. "It should be presumed a plaintiff has been made whole for his injuries by compensatory damages, so punitive damages should only be awarded if the defendant's culpability, after having paid compensatory damages, is so reprehensible as to warrant the imposition of further sanctions to achieve punishment or deterrence."[22] In addition to protecting defendants against excessive damage claims, the Court attempted to ensure that punitive damages do not become criminal penalties imposed in a civil court: "Although these awards serve the same purposes as criminal penalties, defendants subjected to punitive damages in civil cases have not been accorded the protections applicable in a criminal proceeding. This increases our concerns over the imprecise manner in which punitive damages systems are administered."[23] The Court affirmed its *Gore* guidelines, instructing lower courts to maintain a low ratio of punitive to compensatory damages: "Single-digit multipliers are more likely to comport with due process, while still achieving the State's goals of deterrence and retribution, than awards with ratios in the range of 500 to 1. . . ."[24] It added that "few awards exceeding a single-digit ratio between punitive and compensatory damages . . . will satisfy due process."[25]

---

[19] *Id*. (citing *Gore*, 517 U.S. at 575).

[20] *Id*. at 1523.

[21] *Id*. (emphasis added).

[22] *Id*. at 1521 (citing *Gore*, 517 U.S. at 575).

[23] *Id*. at 1520.

[24] *Id*. at 1524 (citing *Gore*, 517 U.S. at 582).

[25] *Id*.

c. *The Ninth Circuit*

In its analysis of Exxon's appeal in *In re the Exxon Valdez*, the Ninth Circuit cited as a key issue "whether punitive damages should have been barred as a matter of law and whether the award was excessive."[26] The court went on to examine the guideposts articulated in *Gore*.

Turning initially to Exxon's "degree of reprehensibility," the court acknowledged plaintiffs' argument that "Exxon's conduct was reprehensible because it knew of the risk of an oil spill in the transportation of huge quantities of oil through the icy waters of Prince William Sound. And it knew Hazelwood was an alcoholic who was drinking."[27] However, the court remarked that such an argument "goes more to justify punitive damages than to justify punitive damages at so high a level."[28] Comparing the *Exxon* facts to other cases demonstrating a much higher degree of reprehensibility, the Ninth Circuit discounted Exxon's reprehensible conduct:

---

[26] *In re* the Exxon Valdez, 270 F.3d 1215, 1221 (9th Cir. 2001). The Exxon Valdez departed from the Trans-Alaska Pipeline terminal March 23, 1989. William Murphy, an expert ship's pilot hired to maneuver the 986-foot vessel through the Valdez Narrows, was in control of the wheelhouse. At his side was the captain of the vessel, Joe Hazelwood. The ship ran aground on Bligh Reef in Prince William Sound, Alaska, on March 24, 1989. The vessel spilled 261,905 barrels of oil when it ran ashore. Captain Hazelwood was seen in a local bar before the accident and admitted to having some alcoholic drinks. A blood test showed alcohol in his blood even several hours after the accident. Captain Hazelwood was found guilty of a misdemeanor and was fined. Due to the complexity of the case, the district court divided the case into four phases:

> In the first phase, the jury found that Hazelwood and Exxon had been reckless, in order to determine liability for punitive damages. The second phase assessed the amount of compensatory damages attributable to the spill to commercial fishermen and Alaska Natives. The third phase established the amount of punitive damages. A fourth phase, which settled before trial, was to determine the compensatory damages of plaintiffs whose damages were not determined in Phase II, including landowners and participants in other commercial fisheries.

Id. at 1225.

Using this analysis:

> The jury awarded $287 million in compensatory damages, from which the court deducted released claims, settlements, and payments by the Trans-Alaska Pipeline Liability Fund to find net compensatory damages of $19,590,257. The jury also awarded, in what was then the largest punitive damages award in American history, $5 billion in punitive damages against Exxon, as well as $5,000 in punitive damages against Hazelwood.

Id.

[27] *Id*. at 1242.

[28] *Id*.

> Exxon spent millions of dollars to compensate many people after the oil spill, thereby mitigating the harm to them and the reprehensibility of its conduct. Reprehensibility should be discounted if defendants act promptly and comprehensively to ameliorate any harm they cause in order to encourage such socially beneficial behavior. Also, as bad as the oil spill was, Exxon did not spill the oil on purpose, and did not kill anyone. By contrast, in *Protectus Alpha*, a man was foreseeably killed by a deliberate act.[29]

d. *The California Court of Appeal*

The California Court of Appeal likewise summarized the *Gore* guideposts in *Sierra Club Foundation v. Graham*.[30] The court noted that the first guidepost is an "exact [match] in California's scheme which requires [the court] to look at the defendant's conduct and the amount of compensatory damages."[31]

In another decision of some note, the California Court of Appeal held in favor of the plaintiffs, stating that the defendants had failed to meet the *Gore* guidepost requirements for reducing punitive damages. In *Notrica v. State Compensation Insurance Fund*,[32] an employer commenced an action against State Compensation Insurance Fund (SCIF), the employer's workers' compensation insurer, alleging tortious breach of the implied covenant of good faith and fair dealing, and unfair, unlawful, or fraudulent business practices relating to SCIF's case reserve and claims handling policies and practices. The Los Angeles County Superior Court entered a judgment awarding the employer $478,606 in compensatory damages and $20 million in punitive damages. It also enjoined SCIF from various business practices and awarded $333,319.65 in attorneys' fees.

---

[29] *Id*. at 1242-43 (citing Protectus Alpha Navigation Co. v. N. Pac. Grain Growers, Inc., 767 F.2d 1379, 1381-82 (9th Cir. 1985)).

[30] 85 Cal. Rptr. 2d 726 (Ct. App. 1999).

[31] *Id*. at 743 (citing *Gore*, 517 U.S. at 581-83 and *TXO*, 509 U.S. at 460). In *Sierra Club*, a charitable environmental foundation brought an action against a donor for malicious prosecution based on the donor's fruitless federal suit against the foundation for fraud, breach of contract, and other causes. The Superior Court, San Francisco County, entered judgment in favor of the foundation for $672,638.07 in compensatory damages and $2,017,914.21 in punitive damages. On review, the court of appeal held that: (1) a grant of summary judgment to the foundation in the donor's federal action was a favorable termination; (2) substantial evidence supported a finding that the donor did not have probable cause to initiate or maintain the federal action; (3) a finding that the donor acted with malice in commencing and maintaining a federal action was supported by substantial evidence; (4) the donor's claim that jury instructions on separate malice elements for the tort of malicious prosecution and punitive damages confused jurors was speculative; (5) the punitive damage award was not excessive; and (6) the trial court lacked authority to award sanctions to the foundation in connection with the donor's third motion for summary judgment. Judgment was affirmed and the sanctions order reversed.

[32] 83 Cal. Rptr. 2d 89 (Ct. App. 1999).

After hearing SCIF's appeal, the appellate court held that: (1) SCIF breached the covenant of good faith and fair dealing requiring it to defend and resolve workers' compensation claims with due regard to the impact of outstanding claims and reserves on the premiums an insured would be assessed and on policy dividends it could receive; (2) SCIF's claims handling protocol supported a bad faith judgment; (3) the insured was entitled to introduce evidence of SCIF's financial condition to support the liability claim; (4) a lower court finding that SCIF engaged in unfair business practices was supported by substantial evidence; (5) the injunction was not overreaching, unnecessary, or unworkable; (6) the evidence supported awards to the insured for both compensatory and punitive damages; and (7) as a matter of law, the punitive damage award of $20 million was excessive, but a $5 million award was not. The court therefore reduced the plaintiff's award of $20 million in punitive damages to $5 million, implementing a 10 to 1 ratio of punitive damages to compensatory damages. The decision was otherwise affirmed.

Relying on *Gore*, defendants argued that the jury's punitive damage award, though supported by findings of covenant breach and fraud, nevertheless violated its right to due process since it did not receive fair notice either that such conduct would subject it to punishment or that the penalty could be so severe. The court disagreed, however, noting that:

> [t]here was substantial evidence that senior management personnel at SCIF, the insurer of last resort, knew it was over-reserving and intentionally misled prospective insureds regarding how the reserve policy would be implemented. In addition, SCIF's claims handling and control of file access served to obfuscate the impact of the new "maximum probable potential cost" reserve guideline. SCIF management and sales personnel understood that the increase in case reserves would lead to increased future premiums for the affected employers, a factor potential insureds would want to consider before purchasing a policy. Notrica's premiums did increase substantially as a result of the implementation of the new guideline. This conscious disregard of Notrica's rights was fair notice that SCIF's conduct could subject it to punitive damages.[33]

It is apparent that the California Court of Appeal heavily weighs a defendant's conscious disregard of rules or regulations. Here, the court determined that such disregard provided fair notice to defendants that punitive damages were an appropriate remedy for plaintiffs.

[33] *Id*. at 114-15 (citing J.R. Norton Co. v. Gen. Teamsters, Warehousemen & Helpers Union, 256 Cal. Rptr. 246 (Ct. App. 1989)).

2. Guidepost No. 2: The Ratio Requirement

a. *The Supreme Court*

The second guidepost analyzed by the Supreme Court in *Gore* was the disparity between the harm or potential harm suffered by Dr. Gore and his punitive damage award ("ratio requirement"). The Court began its analysis as follows: "The second and perhaps most commonly cited indicium of an unreasonable or excessive punitive damages award is its ratio to the actual harm inflicted on the plaintiff."[34] The Court continued: "*TXO*, following dicta in *Haslip*, refined this analysis by confirming that the proper inquiry is 'whether there is a reasonable relationship between the punitive damages award and *the harm likely to result* from the defendant's conduct as well as the harm that actually has occurred.'"[35] In determining that the ratio of disparity between the harm or potential harm suffered by Dr. Gore and his punitive damage award was excessive, the Court noted that "low awards of compensatory damages may properly support a higher ratio than high compensatory awards, if, for example, a particularly egregious act has resulted in only a small amount of economic damages."[36]

The Court upheld its ratio requirements in *State Farm*, while allowing for some flexibility. Although it again declined to establish rigid ratio requirements, the Court nevertheless cautioned that its "jurisprudence and the principles it has now established demonstrate . . . that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."[37]

b. *The Ninth Circuit*

In *Exxon*, the Ninth Circuit continued with its analysis of the guideposts from *Gore* and examined the "ratio requirement." The court analyzed the disparity between the harm or potential harm suffered by plaintiffs and the amount of punitive damages awarded. The court stated:

> Although it is difficult to determine the value of the harm from the oil spill in the case at bar, the jury awarded $287 million in compensatory damages, and the ratio of $5 billion punitive damages to $287 million in compensatory damages is 17.42 to 1. The district court determined that 'total harm could range from $288.7 mil-

[34] *Gore*, 517 U.S. at 580 (citing *TXO*, 509 U.S. at 459 and *Haslip*, 499 U.S. at 23).

[35] *Id*. at 581 (citing *TXO*, 509 U.S. at 460 (emphasis in original), quoting *Haslip*, 499 U.S. 1).

[36] *Id*. at 582.

[37] *State Farm*, 123 S.Ct. at 1524.

> lion to $418.7 million' which produces a ratio between 12 to 1 and 17 to 1. This ratio greatly exceeds the 4 to 1 ratio that the Supreme Court called 'close to the line' in *Pacific Mutual Life Ins. Co. v. Haslip*.[38]

Calculating the ratio requirement, the Ninth Circuit also considered Exxon's post-oil spill actions. Specifically, the court examined the costs and fines Exxon paid to remedy the oil spill. In doing so, the court remarked that, "[t]he cleanup expenses Exxon paid should be considered as part of the deterrent already imposed."[39] The court analogized the situation to someone who ruined a $10,000 rug by spilling a bottle of ink on it. The person who spilled the ink "would be exceedingly careful never to spill ink on the rug again, even if it cost him 'only' $10,005 and he was not otherwise punished."[40] In its calculation of Exxon's already-paid expenses, the court included the costs of clean up, the fine and restitution, settlement with government entities, settlements with private parties, and the net compensatory damages. The court finally concluded that "[b]ecause the costs and settlements in this case are so large, a lesser amount is necessary to deter future acts."[41]

c. *The California Court of Appeal*

When summarizing the *Gore* guideposts in *Sierra Club* as noted above, the court observed that the second guidepost is also an "exact [match] in California's scheme which requires [the court] to look at the defendant's conduct and the amount of compensatory damages."[42] Specifically, the court remarked:

> The high court in *TXO* and *BMW* has refined the disparity analysis to take into account the *potential* loss to plaintiffs, as where a scheme worthy of punitive damages does not fully succeed. In such cases, the proper ratio would be the ratio of punitive damages to the potential harm to plaintiff. This twist helps the plaintiff, not the defendant, and thus does not raise the constitutional ante.[43]

However, the court cautioned that "[t]he *BMW* guidelines are just that — they are guidelines which, if not exactly replicated in a state scheme, do not spell constitutional doom."[44]

---

[38] *Exxon Valdez*, 270 F.3d at 1243 (citing *Haslip*, 499 U.S. at 23).

[39] *Id*. at 1244.

[40] *Id*.

[41] *Exxon Valdez*, 270 F.3d at 1244.

[42] *Sierra Club*, 85 Cal. Rptr. 2d at 743 (citing *Gore*, 517 U.S. at 581-83 and *TXO*, 509 U.S. at 460).

[43] *Id*. (citations omitted).

[44] *Id*.

3. Guidepost No. 3: Comparable Other Penalties

a. *The Supreme Court*

The Supreme Court in *Gore* outlined the final guidepost as follows: "Comparing the punitive damages award and the civil or criminal penalties that could be imposed for comparable misconduct provides a third indicium of excessiveness." In its analysis, the Court prescribed that "[a] reviewing court engaged in determining whether an award of punitive damages is excessive should 'accord "substantial deference" to legislative judgments concerning appropriate sanctions for the conduct at issue.' "[45] Concluding its point, the Court observed that, "In the absence of a history of noncompliance with known statutory requirements, there is no basis for assuming that a more modest sanction would not have been sufficient to motivate full compliance with the disclosure requirements imposed by the Alabama Supreme Court in this case."[46] Beyond these comments, the Court did not "dwell long" on this same guidepost in *State Farm* due to the lack of relevant civil sanctions.[47]

b. *The Ninth Circuit*

Concluding its analysis of the *Gore* guideposts, the Ninth Circuit likewise turned to the "comparable penalties" rubric in *Exxon*. The Ninth Circuit noted that the underlying purpose of the third guidepost was to "accord 'substantial deference' to legislative judgments concerning appropriate sanctions for the conduct at issue."[48] When analyzing comparable penalties, the court examined Exxon's casualty losses for the vessel and cargo, the costs of clean-up, the fine and restitution, settlement with government entities, settlements with private parties, and net compensatory damages.[49] Exxon was to pay over $3.4 billion in penalties, compensatory payments, and other voluntary expenditures. The court remarked that it was "hard to imagine a more adequate deterrence for negligence, [sic] but uninten-

---

[45] *Gore*, 517 U.S. at 583 (citing Browning-Ferris Indus. v. Kelco Disposal, Inc., 492 U.S. 257, 301 (1989)).

[46] *Id*. at 584-85. In concluding that the Alabama Supreme Court's award of punitive damages was excessive, the Court reasoned: "The fact that BMW is a large corporation rather than an impecunious individual does not diminish its entitlement to fair notice of the demands that the several States impose on the conduct of its business." *Id*. at 585. Finally, the Court concluded that it was not "prepared to draw a bright line marking the limits of a constitutionally acceptable punitive damages award." *Id*. The Court reversed the judgment of the Alabama Supreme Court and remanded the case for further proceedings not inconsistent with its opinion.

[47] *State Farm*, 123 S. Ct. at 1526.

[48] *Exxon Valdez*, 270 F.3d at 1245 (citing *Gore*, 517 U.S. at 582).

[49] The court noted that criminal fines are "particularly informative because punitive damages are quasi-criminal." *Id*.

tional conduct."[50] The Ninth Circuit also observed that the district judge had denied plaintiffs' prayer for $150 million and denied the motion for a new trial on punitive damages because Exxon had paid certain criminal penalties before the harm to the plaintiffs was quantified. Although the criminal fine would not serve to limit punitive damages, it nevertheless offered a significant datum. Under the circumstances, a $5 billion punitive damage award was excessive under *Gore*. Thus, the court vacated the award and remanded the matter to the district court to set a lower amount.

c. *The California Court of Appeal*

Offering an interpretation of the third guidepost, the California Court of Appeal stated, "[t]he third factor can assist a reviewing court in figuring out whether the punitive damages award approaches the point of equilibrium that satisfies but does not exceed the amount necessary to properly punish and deter."[51] It continued:

> In a proper case, our inquiry into whether there is equilibrium between the penalty and its deterrent and punitive effects would take into account the comparative sanctions question. As our Supreme Court has stated, this inquiry is to be made in light of the relevant facts. There is, of course, nothing in California's procedures which would preclude a defendant from developing facts on comparative sanctions which, in turn, would inform appellate review.[52]

---

[50] *Id*. at 1246.

[51] *Sierra Club*, 85 Cal. Rptr. 2d at 743.

[52] *Id*. In this case the defendant did not allude to any comparable civil or criminal penalties for deterring malicious prosecution of a civil lawsuit. While court sanctions are available in many jurisdictions against frivolous claims and delaying tactics (*e.g*., CAL. CIV. PROC. CODE § 128.7), such sanctions are meted out on a pleading-by-pleading and motion-by-motion basis. By their nature they do not address the grander scale of harm inflicted from a lawsuit seen to judgment. Also, in this case, using the *Gore* guideposts, the court stated:

> Under either *BMW* or *Neal*, the award was not excessive. The reprehensibility of [defendant's] conduct can be seen in his own disbelief in the underlying charges; his media strategy to extract settlement on his terms while bringing negative attention to the Foundation during its centennial fund-raising campaign; and his vendetta over the Oxbow incident. Proportionality is not a problem—the punitive damages award was three times the compensatory award, not a penny more. (*See Haslip, 499 U.S. at 23-24* upholding award with greater than four-to-one ratio.) We are not aware of any comparable civil or criminal penalties that could be levied to deter malicious prosecution. Finally the award was more than 2 percent of Graham's net worth, far less than the 10 percent cap generally recognized by our courts. (*See Weeks v. Baker & McKenzie, 74 Cal. Rptr. 2d 510 (Ct. App. 1998))*.

Id. at 743-44.

The decision by the California Court of Appeal in *Rich v. Schwab*[53] provides a third interpretation of the *Gore* guideposts, analyzing comparable penalties in detail.[54] The facts of the *Rich* case involved a retaliatory rent increase. In response to a thirteen percent rent increase, and a subsequent $80 increase after tenants sought relief for the thirteen percent rent increase, tenants at Rancho Carlsbad sued Western, Schwab and Dawes to recover the excessive rent. Trial was conducted in two phases commencing in 1991. In the initial phase, a jury determined that the March 1981 rent increase was, in fact, imposed in retaliation for the tenants' opposition to the earlier rent increase. In the second phase of the trial, conducted in 1996 after an intervening bankruptcy proceeding initiated by Dawes, a second jury determined that 423 tenants had left Rancho Carlsbad as a result of Schwab's and Dawes's conduct, suffering $1.7 million in compensatory damages. The jury also imposed $1,000 in punitive damages against Schwab for each of the 653 tenants who had suffered the $80 rent increase. Following the jury's verdict, however, the trial court refused to award any punitive damages to the 230 tenants who had stayed at Rancho Carlsbad despite the rent increase. The trial court also refused to award the tenants any of their attorneys' fees.

After judgment against Schwab and Dawes was entered accordingly, Schwab, Dawes and the tenants each appealed from the judgment.[55] Ruling on their issues, the court stated as follows:

> Under [Civil Code] section 3294, "the judge or jury, as the case may be, has the authority to decide whether and what amount of punitive damages should be awarded. In contrast, statutory damages[56] are set by a legislative body; while the fact finder must still determine *whether* such damages are to be awarded, if they are granted the amount is fixed by statute. Statutory damages may either take the form of penalties, which impose damages in an arbitrary sum, regardless of actual damages suffered or, as in the instant case, may provide for the doubling or trebling of the actual damages as determined by the judge or jury. Thus, while both exemplary damages and statutory damages serve to motivate compliance with the law and punish wrongdoers, they are distinct legal concepts, one of which is entrusted to the fact finder, the other to the Legislature."[57]

---

[53] 75 Cal. Rptr. 2d 170 (Ct. App. 1998).

[54] *Id*.

[55] *Id*.

[56] It is plausible that, when referencing "statutory damages," the court intended to include CAL. BUS. & PROF. CODE § 17200 among others. However, the opinion is void of any specific reference to such a statute. The vague reference to "statutory damages" is the only potential reference to such a statute.

[57] *Id*. at 816.

Citing *Gore*, the *Rich* court continued:

> Where, as here, the Legislature has set the level of punishment which may be imposed for a particular act, the doctrine of separation of powers limits the nature of our review when such a penalty has in fact been imposed. We are required to "'accord "substantial deference" to legislative judgments concerning appropriate sanctions for the conduct at issue.'" As with any other statute, we may interfere with the Legislature's determination of what is required by the public interest only when there is no rationale [sic] basis for the decision reached by the Legislature.[58]

The court concluded that though it might interfere with the legislature's determination of what is required by the public interest, it must still give some consideration to the cumulative impact upon the defendant.[59]

---

[58] *Id*. (citing *Gore*, 517 U.S. at 583; Horeczko v. State Bd. of Registration, 284 Cal. Rptr. 149 (Ct. App. 1991)). On this point, the court stated:

> Here, the maximum potential penalty for each violation, $1,000, is in no sense disproportionate to the annual rent collected on typical commercial, residential or agricultural leaseholds covered by the terms of section 1942.5 or disproportionate to the public interest in deterring retaliatory conduct by landlords. Given the relatively low limit imposed and the well-established public interest in regulating real property leases, we are in no position to add any general requirement that a tenant also show the financial condition of his landlord before the penalties authorized by section 1942.5, subdivision (f), may be imposed. Presumably, the Legislature considered the potential impact on landlords in setting the very specific monetary parameters which exist in the statute.

Id. at 816-17.

[59] *Rich*, 75 Cal. Rptr. 2d 170. The court further stated:

> We hasten to add that where, as here, the penalties imposed amount to several hundred thousand dollars, some consideration of their cumulative impact on a landlord might be warranted. However, in the context of a statutory penalty, the issue of defendant's financial condition will at most be a matter for the defendant to raise in mitigation. (*See e.g.* State of Cal. v. City & County of San Francisco, 156 Cal. Rptr. 542 ___ (Ct. App. 1979), holding that once evidence of statutory violation is presented, defendant bears the burden of establishing that the court should impose less than statutory maximum.) Here, no such mitigating evidence was offered on Schwab's behalf.

Id. at 176-77.

V.
CONCLUSION

The Supreme Court articulated a test for analyzing punitive damages in *Gore*. This test frequently becomes a tool for reducing punitive damage awards. The three components of the test include the reprehensibility of defendant's conduct, the ratio of compensatory damages to punitive damages, and a comparison of relevant civil or criminal penalties. In the case of *In re the Exxon Valdez,* the Ninth Circuit limited a punitive damage award based on the third component of the test, finding that Exxon already had paid a great deal of money to clean up the oil it spilled prior to litigation.

Likewise, in *Sierra Club*, *Notrica*, and *Rich*, the California appellate court also used the three *Gore* guideposts to analyze punitive damage awards. However, none of these state cases reduced a punitive damage award to the respective plaintiff.

Directors' & Officers' Liability Insurance: The Issue of "Non-Indemnifiable Loss"†

Donna Ferrara

I. Introduction

For anyone who has been living on a desert island, there is a crisis in Directors' & Officers' Liability Insurance ("D&O").[1] It was a long time coming. One carrier's website reports dismally that in 2001, rates had dropped to half of their level in 1996, while D&O exposure had grown by one thousand percent.[2] After ten years of increasing claims frequency and severity, resulting in dismal profitability, D&O insurers decided to raise prices and narrow coverage.

In an effort to return sagging lines of coverage to profitability, carriers have raised premium levels considerably, a fact that no insurance professional has missed. In addition, insurers are limiting coverage. Certain policy amendments, such as the elimination of entity coverage and the imposition of co-insurance are obvious. Others, such as the use of "Non-Indemnifiable Loss" in conjunction with presumptive indemnification, are less so.

II. What Exactly is A "Non-Indemnifiable Loss"?

A number of policy forms use the term non-indemnifiable loss, either to set a trigger of coverage or to define its scope. The term is most often defined as any loss that is not

---

† Submitted by the author on behalf of the FDCC Management, Economics and Technology of Practice Section. The views expressed herein represent my own opinion and not necessarily that of Arthur J. Gallagher Risk Management Services or my colleagues there.

1 *It Still Costs Big to Insure Against Boardroom Scandal*, Wall St. J., July 31, 2003, at C1.

2 NIB/National Union: Issues, *available at* http://www.aig.com/directorsandofficers/html/nu_issues_box.html#poor_economics (as of June 20, 2004). There is no explanation of either "rate" or "exposure," but the sentiment is clear.

Donna Ferrara holds the position of Senior-Vice President and Managing Director of Gallagher Strategic Risk Solutions, the professional liability division of Arthur J. Gallagher, Inc., an international insurance brokerage and risk management services firm. In addition, Ms. Ferrara has spoken and written on numerous subjects, including D & O Liability, International Insurance Issues, Internet Liability, Securities Litigation Reform and Employment Practices Issues. During over 20 years of insurance experience, Ms. Ferrara has represented clients in a wide array of insurance matters, in both corporate and litigation arenas. Her articles on insurance, law and technology have been published in the legal and trade press. Admitted to the New York, New Jersey and federal bars, Ms. Ferrara holds a B.A. from Roger Williams College, a J.D. from New York Law School and an L.L.M. from the New York University School of Law.

indemnifiable. "Indemnifiable" is defined as "[l]oss for which an Organization has indemnified or is permitted or required to indemnify an Insured Person pursuant to law or contract or the charter, bylaws, operating agreement or similar documents of an Organization."[3]

To this point, the language is similar to that found in D&O policies for years. The section continues as follows:

> For the purposes of determining whether Loss constitutes Indemnifiable Loss, the Organizations shall be *conclusively deemed* to have indemnified the Insured Persons to the to the maximum extent that an Organization is permitted or required to provide such indemnification pursuant to law, common or statutory, or contract or by the charter, bylaws, operating agreement or similar documents of an Organization, which are hereby deemed to incorporate, for the purposes of this policy, *the broadest provisions of the law* which determines or defines such rights of indemnity.

[3] The quoted provision itself is derived from a number of policies, including, but not limited to AIG IDL Premier 80808 (3/03), American International Group's ExecSecure 81776 (3/03), American International Group's D&O First 80894 (3/03), Chubb Executive Risk Not For Profit C22207 (9/96 ed.), Executive Liability Underwriters General Partners & Limited Partnership Reimbursement GP 71 00 05 00, Onebeacon Management Liability Form No. G16229 03 02 (12/02 ed.), Travelers DPR-1001 (7/98), Travelers Private Company Director and Officer Liability PLUS DPR-1001 (7-98), United States Fire Platinum Management Protection (Private Companies FM) 124.0.0, and XL Management Liability and Corporate Reimbursement from, DO 71 00 09 99. In addition, they can be found in securities claims and other endorsements added to D&O forms.

> The Organization hereby agrees to indemnify the Insured Persons to the fullest extent permitted by law, *including the making in good faith of any required application for court approval*.[4]

III.
ISSUES

First, the term "non-indemnifiable" is not a statutory term. It has been used by some courts, though not in the same context as insurers have defined it. Whenever a term has a meaning in one arena that does not comport with its definition in another, there is potential for grave misunderstanding.[5]

Second, while the concept of insuring loss that has not been indemnified by the corporation is not new to D&O, the foregoing wording provides that regardless of whether a director[6] actually has been indemnified, the insurer will *presume* that he or she has been.[7]

The third leg on the stool is the use of differential retentions: Claims that are "non-indemnifiable" — and therefore will be paid by individuals rather than corporations — will often be subject to a lower retention than others, on the theory that an individual will be less able to absorb a larger share of the risk.

Over the past two or three years, retention levels of more than a million dollars have become common. For a director facing years of protracted litigation, this presents a grim picture.

In sum, to trigger coverage, the loss in question must fall under one of the following exceptions:

- It must not be indemnified already, so there is no chance of double payment; or,
- It must be something that the corporation cannot indemnify, even if the corporation has asked a court's permission to do so.

This returns us to the first question: What exactly is a loss that the corporation cannot indemnify?

---

[4] *Id*.

[5] As most insurers know, ambiguity in policy wording can be an unhappy event, even in D&O. *See, e.g.*, Qwest Communications Int'l, Inc. v. Nat'l Union Fire Ins. Co., 821 A.2d 323 (Del. Ch. 2003) (a sophisticated insured is entitled to have a court construe ambiguities against the insurer); *In re* Molten Metal Tech., Inc., 271 B.R. 711 (D. Mass. 2003) (insured versus insured provision does not include a trustee in bankruptcy where language is ambiguous).

[6] Unless otherwise noted, use of the term "director" also includes "officer."

[7] Presumptive indemnification was proposed in the last D&O crisis, but did not gain wide acceptance for long. Some carriers kept the provision in their forms, but would remove it for little or no additional premium.

If one asks a number of D&O underwriters to give an example of a "non-indemnifiable loss," as I did, the answers were remarkably consistent: derivative actions and bankruptcy claims are two examples of non-indemnifiable loss. The answers were, in fact, so consistent that it appeared "non-indemnifiable" had become insurance shorthand for "derivative and bankruptcy." These are consistent answers, but wrong.

The simple issue first. The federal Bankruptcy Code governs bankruptcies. Only in instances in which the Code does not specifically address a subject will the court apply other state or federal law.[8]

The Code does not forbid indemnification of officers and directors, although such claims may have a low priority. State law does not forbid the indemnification of claims in bankruptcy.

Of course, there are many reasons a bankrupt corporation does not indemnify its officers and directors. Most can be reduced to the simple fact that the corporation does not have enough money. That situation can make claims in bankruptcy *unindemnified*, but not "non-indemnifiable." Using the policy definition, however, because the corporation *could* have indemnified the director, it will be *presumed* to have indemnified the director, even if it had not.[9]

What about the second consistent answer: derivative claims. Are claims brought on behalf of the corporation non-indemnifiable? This is a more complicated answer, requiring analysis of laws governing corporations. As with many subjects, corporate governance is a matter of state law and every state has placed it own gloss on the subject. For ease of reference, I'll refer primarily to Delaware law.

Like many states, Delaware's main indemnification statute, whether addressing claims brought by third parties or those brought on behalf of the corporation, is "permissive" for

---

[8] *See, e.g.*, Chicago Title & Trust Co. v. Forty-One Thirty-Six Wilcox Bldg. Corp., 302 U.S. 120, 126 (1937) (quoting Stellwagen v. Clum, 245 U.S. 605, 613 (1918)); *see also* Morton v. Nat'l Bank of N.Y. (In re Morton), 866 F.2d 561, 563 (2d Cir. 1989) (quoting same); Missouri *ex rel*. Darr v. A.B. Collins & Co., 34 F. Supp. 550, 554 (W.D. Mo. 1940) ("[I]f a bankruptcy law conflicts with some state procedure, of course the state procedure must give way . . . .").

[9] I am avoiding the issue of whether the proceeds of a D&O policy belong to the corporation or the individuals. That issue is rightly the subject of its own article.

the most part.[10] The law *permits* the corporation wide latitude in indemnification matters, but *requires* indemnification in only one instance.[11] Further, the statute is not exclusive,

---

[10] Title 8, section 145 of the Delaware Code reads, in pertinent part:

(a) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that the person's conduct was unlawful.

(b) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit *by or in the right of the corporation* to procure a judgment in its favor by reason of the fact that the person is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by the person in connection with the defense or settlement of such action or suit if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper. (Emphasis added.)

[11] Section 145(c) provides:

To the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.

meaning that methods of indemnification other than corporate by-laws or charters, including contractual provisions, are permitted. [12]

Section 145(b) of the Delaware Code specifically addresses derivative actions, permitting indemnification of the *expenses* of defending a derivative action if the person requesting indemnification "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation."[13]

For purposes of determining the scope of "indemnifiable," therefore, indemnification of expenses is explicitly permitted, even if the person has been found liable, as long as the requirements of good faith and loyalty are met, except:

> [N]o indemnification shall be made in respect of any claim, issue or matter as to which such person *shall have been adjudged to be liable to the corporation* unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine. . . .[14]

In other words, if a court allows it a person who loses a derivative action may still be indemnified, if a court allows.[15] This appears to be the type of provision that insurers had in mind when drafting the presumptive indemnification language.

If our inquiry ended here, the presumptive indemnification language would be harsh enough. The insured could have purchased coverage in reliance upon the underwriters' statement that "bankruptcy and derivative claims" will trigger coverage, yet after slogging through the statute, find the issue at best ambiguous.

Reading the presumptive indemnification provision literally, it will do an individual no good to petition a court for indemnification. Unless the insured *organization* applies to the court and is refused, the presumptive indemnification is not rebutted. It is highly unlikely that a corporation not voluntarily indemnifying a director will apply to a court for permission to do so.

---

[12] Section 145(f) provides:

> The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official capacity and as to action in another capacity while holding such office.

[13] *Id*. § 145(b).

[14] *Id*. (emphasis added).

[15] Section 145(a) allows the indemnification of third party claims (with the same requirement of good faith and loyalty), even when the person seeking indemnification has been found liable.

Additionally, a Delaware statute allows a corporation to protect directors from financial liability arising from breach of care in service to the corporation.[16] This protection is broader in scope than section 145, though available only to directors, rather than any "director, officer, employee or agent."

Delaware courts have held that an exculpatory provision adopted in accordance with section 102(b)(7) can operate to bar claims for money damages against the board members caused by the alleged breach of their duty of care.[17]

In theory then, a director *may* be protected from any liability arising from a breach of the duty of care by the corporate charter, the by-laws, and an employment contract, as long

---

[16] Title 8, section 102(b) of the current Delaware Code provides:

> In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters
>
> . . . .
>
> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [deals with a director's liability for unlawful payment of dividends or unlawful stock purchase or redemption]; or (iv) for any transaction from which the director derived an improper personal benefit . . .

See also In Re Baxter Int'l, Inc. Shareholders Litig., 654 A.2d 1268, 1270 (Del. Ch. 1995) (dismissing a derivative action, in part because of a provision drawn form section 102(b)(7)).

[17] *See* Malpiede v. Townson, 780 A.2d 1075 (Del. 2001). *See generally* Thomas C..Lee, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. PA. L. REV. 239 (1987) (arguing that section 102(b)(7) does not adequately preserve a director's duty of care to shareholders).

as those vehicles comport with the statutes. The primary statutory restriction on indemnification is that the director's actions must have been undertaken in good faith and in a manner reasonably believed to be in the best interests of the corporation.[18]

Specifically turning to derivative claims, a director can be indemnified by the corporation for the expenses of defending such an action, even if found liable, as long as the requirements of good faith and loyalty are met.

Further, while it appears that the settlement of a derivative action may not be indemnifiable under section 145(c), Delaware courts have not explicitly ruled on the subject,[19] nor have they carved out derivative claims from the exculpatory provisions of section 102(b)(7).

Recently, the opportunity for such a decision arose – and the court declined. In the case of *In re Walt Disney Co. Derivative Litigation*,[20] the court did not hold derivative claims were unindemnifiable. It merely found that section 102(b)(7) did not mandate dismissal of such claims when there was an issue of fact as to whether the directors acted in good faith and with a reasonable belief that their actions were in the best interest of the corporation.

While our discussion has focused on Delaware law, other states, including New York and California, specifically allow indemnification of settlements when the person seeking

---

[18] In at least one case, Manley v. Ambase, Corp., 337 F.3d 237 (2d Cir. 2003), a corporation agreed to much broader contractual indemnification than the statutory framework would appear to support. In that case, the indemnification provision (governed by Delaware law) read:

> If [the director] has been or is made a party . . . to any action, suit or proceeding . . . by reason of the fact that he was a director or officer of AmBase . . . or by reason of the fact that he was serving at the request of AmBase as a director, officer, member, employee or agent of another corporation or of a partnership, joint venture, trust or other enterprise, . . . he shall be indemnified and held harmless by AmBase . . . against all expense, liability and loss (including, without limitation, attorneys' fees, judgments, fines, ERISA excise taxes or penalties and amounts paid or to be paid in settlement) reasonably incurred or suffered… in connection therewith . . . .

Id. at 242. The corporation honored this provision for the settlement of at least eighteen third party and derivative lawsuits. It drew the line, however, when Manley demanded that Ambase pay his share of the settlement in the bankruptcy of his outside law firm. The Second Circuit held the indemnification did not stretch that far, not because of statutory restrictions but because the grant had been to Manley, the individual, while Manley, the Professional Corporation, had been the partner in the law firm.

[19] One federal court in New York opined in an unpublished opinion that to allow section 145 to permit the indemnification of settlements of derivative actions would be "circular." TLC Beatrice Int'l Holdings, Inc. v. Cigna, 1999 WL 33454 (S.D.N.Y. 1999). In thisat case, the carrier attempted to avoid coverage under a policy that excluded indemnifiable claims, asserting that the bankrupt estate should indemnify the officers. The judge noted that no Delaware court had decided the same issue. The case is instructive, but not precedent. Further, the "circularity" reasoning noted by the court is not universally accepted. *See, generally*, Mae Kuykendall, *A Neglected Policy Option: Indemnification of Directors For Amounts Paid to Settle Derivative Suits - Looking Past "Circularity" to Context and Reform*, 32 SAN DIEGO L. REV. 1063 (1995).

[20] 825 A.2d 275 (Del. Ch. 2003).

indemnification can show "success" (including advantageous settlement) in the matter.[21] This is not to say that a corporation or a court would necessarily find indemnification of a derivative action to be appropriate, even when the law specifically permits. It is, nevertheless, an example of how a crucial term can have one meaning during the sales process and quite another when a claim arises.

It would appear, then, that the blanket statement positing all derivative actions are non-indemnifiable is unsupported.[22] Apply the converse to the policy language: when a bankruptcy action or derivative claim meets the good faith and loyalty requirements, it is at least potentially indemnifiable.

The policy, however, *presumes* that the director has been indemnified, even when he or she has not. In fact, the policy *presumes* that the corporation has gone to court for permission to do so – a situation only necessary after an individual has been found liable in a derivative action.

Taking the argument further, the policy presumes indemnification when *any* vehicle – law, corporate documents, or contract – allows it. As noted above, the statutory framework in Delaware and many other states is *permissive*. A corporation could offer, through an employment contract for example, indemnification that is far broader than the permissive standards.[23]

---

[21] N.Y. BUS. CORP. LAW § 724 (McKinney 2003); CAL CORP CODE § 317 (2004). Delaware recognizes the concept of "success" as a prerequisite to mandatory indemnification. As with other states, the definition of success is not always simple. In Merrit-Chapman & Scott v. Staub, 321 A.2d 138 (Del. Super. Ct. 1974), the court permitted indemnification of defense costs for criminal charges that were later dropped, though the indemnitee was convicted on others. The court in that case reasoned as follows:

> The statute does not require complete success. It provides for indemnification to the extent of success "in defense of any claim, issue or matter" in an action. Claimants are therefore entitled to partial indemnification if successful on a count of an indictment, which is an independent criminal charge, even if unsuccessful on another, related count.

Id. at 141.

[22] Perhaps in recognition of the complexity of the corporate law, Delaware, like all other states, allows a corporation to insure risk whether or not it could have indemnified it. DEL. CODE ANN. tit. 8, § 145(g) (2004).

[23] For example, a particular officer of an investment company may be asked to serve on outside boards either formally or as an adviser. The investment company may offer that particular officer broad indemnification for potential liability arising from that service, even if the officer is not "duly elected or appointed" by the outside companies.

If the corporation offers such contractual indemnification to one director or a group of directors such as an audit committee, will it be presumed to have offered it for all? If it is offered to directors of a subsidiary corporation, will it be imputed to the directors of the parent company, or vice versa?

IV.
WHOSE JOB IS IT, ANYWAY?

A fair question from the insurer's point of view would be, "if permissible under the law, why didn't the corporation indemnify the individual?"

There are many answers to that question. A corporation may fail to indemnify individuals for any of the following reasons:

- It has adopted a more restrictive indemnification scheme in its corporate by-laws;
- It doesn't have the money;
- The person seeking indemnification is unable to persuade management to grant it; or,
- The corporation purchased insurance to fulfill its indemnification obligation.

What is the result? A director may face a loss that is neither insured nor indemnified, despite the fact that the actions were in good faith and were not contrary to the best interests of the corporation.

There are, of course, claims that a corporation simply may not indemnify. Most fall within the ambit of breach of the duty of loyalty. For example, corporate law in most, if not all, states forbids a director from usurping (taking personal advantage of) an opportunity that belongs more appropriately to the corporation. Further, a loss may not be indemnified because the individual was not acting in a capacity in which indemnification was available.

Many truly non-indemnifiable claims will not be covered because of other policy exclusions. Usurping a corporate opportunity, a classic breach of the duty of loyalty, will almost certainly be excluded by the "personal gain" exclusion, except possibly for defense costs. Likewise, if an act is not indemnifiable because it was performed in a capacity other than as a director or officer of a particular corporation, it will fall outside the coverage of that corporation's D&O policy.

V.
THE GOOD NEWS

While this is a complicated issue, it is not an insoluble one. Several carriers have addressed the issue of the potential gap in coverage by either offering alternative coverage with more favorable terms or rejecting the concept of presumptive indemnification completely.

The first round of policy forms styled as "Side-A Coverage" or "Individual Director Protection" have been supplanted, or at least supplemented, by policy forms that offer better coverage, although no insurance policy is a complete risk management solution. Unfortunately, the cost of this improved coverage is high.

Some insureds, aware of the shortcomings in their D&O, have opted for alternative risk transfer methods. There may even be instances in which an insured is willing to accept a policy whose coverage is limited to non-indemnifiable loss, despite the issues raised.

Whatever the outcome, it is essential that insureds and their advisors be proactive in dealing with the subject and that the individual insureds be appraised of potential issues.

VI.
CONCLUSION

This analysis is not intended to point an accusatory finger at D&O insurers, but rather to demonstrate the difficulties that can ensue when industry jargon is assumed to have a common and consistent meaning that does not conform to statutes, case law, or even dictionary definitions.

Unfortunately, relationships among insurers, insureds, and other insurance professionals have grown strained over the years. The result is an erosion of trust. The fact that many insureds are actively seeking alternatives to the conventional insurance market highlights this fact. In their customers' eyes, insurers tout partnership, safety, and reliability, while at the same time drafting policy forms that offer less coverage for more money. In addition, a number of carriers and brokers have chosen to advertise new coverage forms by implying that traditional D&O policies can easily be rescinded.[24] Worse, the prevailing culture encourages insurers to keep payments secret, engendering a belief that carriers refuse to pay legitimate claims, or at best, honor contracts only after litigation. The highly public rash of rescission actions by carriers exacerbates the situation. Faced with the potential of paying billions, the mantra of D&O insurers is that the insured must have "more skin in the game."

According to the 2001 Tillinghast Survey, the average D&O limit for companies of all sizes was $20.14 million.[25] By 2002, the average limit of total coverage had actually dropped

---

[24] American International Group, Advertisement, *D&O Insurance: 2003-2004 Briefing Paper*, (2003) (using the words "rescind" or "rescission" at least twenty-nine times in its effort to sell the company's Side-A coverage), *available at* http://www.briefbase.com/pnews/news_553.pdf (as of June 20, 2004); *see also*, Dan A. Bailey, *Directors and Officers*, THE ACE REP., *available at* http://www.acelimited.com/MediaCenter/DAndOReport/html/daor_30.html (as of June 20, 2004); Laurie B. Smilan, *Directors' and Officers Liability Insurance: The Economics of Fraud*, AIG, *at* http://www.aig.com/directorsandofficers/pdfs/lw.pdf (as of June 20, 2004); Julianna K. Burke, *Rescission of Directors' and Officers' Liability Insurance Policies*, MORRIS, MANNING & MARTIN, LLP. REVIEW, Fall 2002, at 3, *available at* http://www.mmmlaw.com/industry/insurance/Fall_2002_Newsletter.pdf (as of June 20, 2004).

[25] Tillinghast-Towers Perrin, 2001 DIRECTORS AND OFFICERS LIABILITY SURVEY, Table 11c.

to $18.87 million.[26] In the same period, the average class-action lawsuit settlement increased by sixty-five percent, from $14.7 million to $24.3 million.[27] Of all claims against directors and officers (not just securities), sixty-six percent were fully indemnified by the corporation, but only twenty-three percent were reported as "fully covered" by insurance, and only nine percent as partially covered.[28]

While insurers have been beset by their own losses, they might not have noticed that their insureds have substantially increased their "skin in the game."

There is more bad news to come: Federal securities class action litigation suits increased by 31 percent between 2001 and 2002, rising from 171 to 224 filings.[29] In light of such predictions, it is hardly reassuring for clients to hear that insurers do not believe they have suffered enough. While it is true that insureds have committed fraudulent acts in some cases, those instances are relatively few.

One assumes that the major players in the D&O market wish to remain viable forces. In a market where a dozen companies control eighty-five percent of the business, one or two companies can affect real change. Short-sighted, short-term fixes, however, are no substitute for systemic improvement.

---

[26] Tillinghast-Towers Perrin, 2002 DIRECTORS AND OFFICERS LIABILITY SURVEY, Table 11c.

[27] CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS 2002: A YEAR IN REVIEW 2 (2003), *available at* http://securities.cornerstone.com/pdfs/LES%20YIR.pdf (as of June 20, 2004); *see also* LAURA E. SIMMONS & ELLEN M. RYAN, POST -REFORM ACT SECURITIES CASE SETTLEMENTS CASES REPORTED THROUGH DECEMBER 2002 (Cornerstone Research 2003), *available at* http://www.cornerstone.com/fram_res.html (as of June 20, 2004).

[28] Tillinghast-Towers Perrin, 2002 DIRECTORS AND OFFICERS LIABILITY SURVEY, Tables 71, 72.

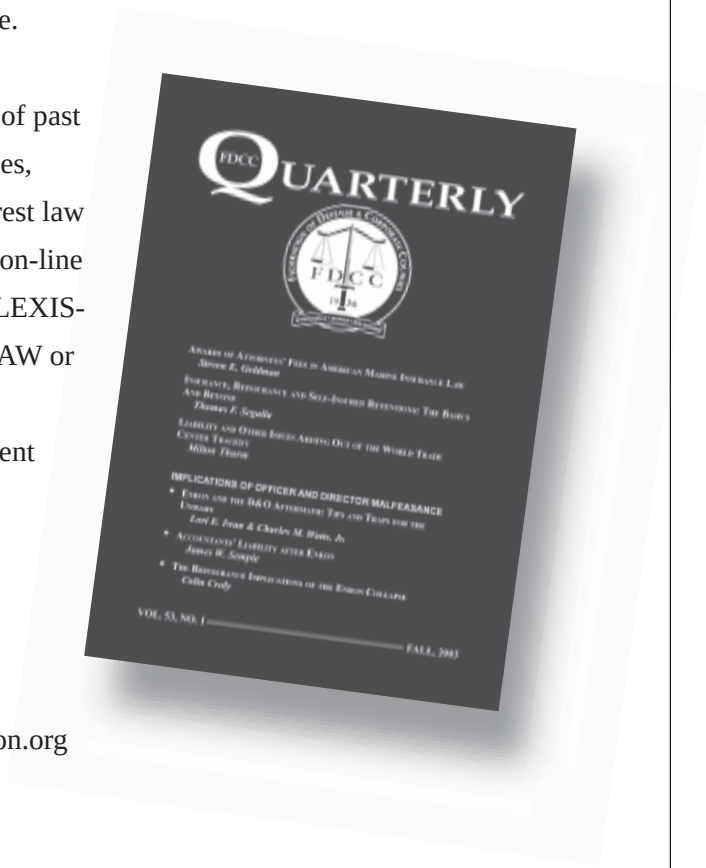
[29] The Stanford Law School Securities Class Action Clearinghouse, *available at*: http://securities.stanford.edu/.

Back Issues of the QUARTERLY

The Federation maintains a limited stock of back issues of the **QUARTERLY**. For more information contact the Executive Director, Martha J. Streeper, whose address, phone number, etc. may be found on the inside front cover of this issue.

To secure copies of past **QUARTERLY** articles, contact your nearest law school library or on-line services such as LEXIS-NEXIS, WESTLAW or ProQuest Direct. Articles from recent years are also available at the Federation's web site:

www.thefederation.org



REINSURANCE ARBITRATORS: TOTALLY NEUTRAL OR NOT

Arbitration of insurance disputes is certainly nothing new. For years it has been commonplace to arbitrate insured/insurer disagreements in areas such as property insurance and uninsured motorist coverages. The same is certainly true for conflicts between reinsurers and reinsureds. As the following articles attest, prevailing issues do not so much concern the use of arbitration to resolve reinsurance disputes as the manner for selecting such arbitrators. Not too long ago, the insurance industry was committed almost entirely to the use of American Arbitration Association (AAA) arbitrators for uninsured motorist coverage disputes. That trend subsided as insurers came to realize that AAA arbitrators too often favored the claimant. Their pivotal issue concerned how much the UM insurer would pay and not whether coverage actually existed. The practice now requires each party to select an arbitrator and for those selected to designate a third, who is ostensibly neutral. The two articles that follow examine the pros and cons of that system for reinsurance arbitration. The authors have done an excellent job analyzing the issues and we commend their work to your attention.

Ed.

Pitfalls in Moving to All-Neutral Reinsurance Arbitration Panels†

Kathryn P. Broderick

I.
Introduction

This article considers whether it would be desirable, as a general proposition, to use all-neutral panels in reinsurance disputes that are submitted to arbitration. I suggest that moving to all-neutral panels may in some important respects work to the detriment of the parties to reinsurance arbitrations.

It is not my intent in this article to suggest that there are no conceivable benefits to the all-neutral model. Anthony Lanzone's article in this same issue sets forth many of the concerns that have led some observers to conclude that an all-neutral panel is preferable to the tripartite model typically used in reinsurance arbitration in the United States.[1] For an opposing view see an article written by fellow FDCC member Vincent Vitkowsky.[2] Attorneys counseling clients who are interested in the possibility of agreeing to an all-neutral panel will certainly want to review with those clients the points in favor of all-neutral panels contained in the Lanzone article. At the same time, however, attorneys will want to ensure that the potential pitfalls of all-neutral panels are understood and carefully considered before a final decision is made.

---

† Submitted by the author on behalf of the FDCC Alternative Dispute Resolution Section.

1 *See* Anthony M. Lanzone, *Impartial, Independent, Neutral Arbitrators v. Non-Neutral Party Appointed Advocates*, 54 Fed'n Def, & Corp. Couns. Q. 381 (2004).

2 *See* Vincent Vitkowski, *The Value of Party-Appointed "Non-Neutral" Arbitrators*, ARIAS-U.S. Quarterly, Vol. 1, No. 3/4, 4th Quarter 1995.

Kathryn P. Broderick is a founding partner in the law firm of Broderick, Stirn & Regan in Washington, D.C. She is a member of the District of Columbia and Virginia Bars, the U.S. Supreme Court Bar, and the Bars of several federal appellate and district courts. Ms. Broderick is also a member of the American Bar Association (Litigation and Tort & Insurance Practice Sections); ARIAS-U.S.; the Defense Research Institute; and the Federation of Defense & Corporate Counsel (past Reinsurance Section Chair and current ADR Section Vice Chair). She obtained her undergraduate degree summa cum laude from Trinity College at Duke University, and graduated with highest honors from the National Law Center at George Washington University. Ms. Broderick was a member of Phi Beta Kappa and the Order of the Coif, and served as a member and then as Notes Editor of THE GEORGE WASHINGTON LAW REVIEW.

II.
BACKGROUND: THE PRESENT SYSTEM

While there is no universal practice, it is usual for reinsurance contracts specifying arbitration as the mechanism for dispute resolution to provide for so-called tripartite arbitration panels.[3] Each party appoints an arbitrator, and those two arbitrators then select an umpire. In some instances, the umpire is appointed by a court, an institution such as the American Arbitration Association or ARIAS-U.S., or an individual holding a specified office or position such as, for example, the Commissioner of Insurance for a specified jurisdiction.

It has long been accepted in United States arbitration jurisprudence that "party-designated arbitrators are not and cannot be 'neutral', [sic] at least in the sense that the third arbitrator or a judge is."[4] The Code of Ethics thus permits party-appointed arbitrators to be

---

[3] *See generally ARIAS-U.S., Practical Guide to Reinsurance Arbitration Procedure ("ARIAS Practical Guide"),* Chapter II, *available at* http://www.arias-us.org/index.cfm?a=39.

[4] Astoria Med. Group v. Health Ins. Plan of Greater N.Y., 182 N.E.2d 85, 87 (N.Y. 1962). The *Code of Ethics for Arbitrators in Commercial Disputes* ("*ABA-AAA Code of Ethics*"), *available at* http://www.adr.org, which has been approved and recommended by special committees of the American Arbitration Association and the American Bar Association, respectively, adopts the presumption that party-appointed arbitrators in a tripartite arrangement are non-neutral.

disposed to the party appointing them. The Code also permits party-appointed arbitrators to consult with the appointing party about the acceptability of persons being considered for the neutral third arbitrator role and to consult about any other aspect of the case provided disclosure of the intent to have such communication is first made to the other arbitrators and the parties. As a practical matter, the parties to reinsurance arbitrations typically agree that ex parte communication can occur with party-appointed arbitrators, without disclosure, up to a specified stage in the proceedings.[5] The *ARIAS Practical Guide* suggests cutting off ex parte communications at (a) the Organizational Meeting; (b) the end of discovery; (c) the filing of pre-hearing briefs; or (d) commencement of the hearing. In the author's experience, it is customary to adopt the end of discovery or the filing of pre-hearing briefs as the cutoff point. It is relatively unusual to adopt either the organizational meeting or the commencement of the hearing.

Legislation governing the arbitration process generally reflects the lack of a neutrality requirement for all arbitrators. Section 12(a)(2) of the Uniform Arbitration Act ("UAA"), as adopted by the Conference of Commissioners on Uniform State Laws in 1955 and subsequently enacted by most states, provides that arbitration awards can be vacated for "evident partiality" on the part of a neutral arbitrator only.[6]

The Revised Uniform Arbitration Act ("RUAA"), adopted by the Conference of Commissioners in 2000, preserves the distinction between neutral and non-neutral arbitrators. Section 11(b) provides, "An individual who has a known, direct, and material interest in the outcome of the arbitration proceeding or a known, existing, and substantial relationship with a party may not serve as an arbitrator required by an agreement to be neutral."[7] This leaves such an individual free to serve as a non-neutral arbitrator. Section 23(a)(2)(A) provides for vacatur of awards for evident partiality on the part of an arbitrator appointed as a neutral arbitrator only.[8]

In contrast, the Federal Arbitration Act ("FAA"),[9] does not distinguish explicitly between neutral and non-neutral arbitrators.[10] Nonetheless, courts applying the FAA have adopted very different standards for the conduct of party-appointed, non-neutral arbitrators as contrasted with neutral arbitrators. In *Sphere Drake Insurance Ltd. v. All-American Life Insurance Co.*,[11] the Court of Appeals for the Seventh Circuit observed of the decision under review that "[a]s far as we can see, this is the first time since the Federal Arbitration

---

5 *See supra* note 3, Chapter III, § 3.9.

6 UAA *available at* http://www.law.upenn.edu/bll/ulc/fnact99/1920_69/uaa55.htm.

7 RUAA § 11(b), *available at* www.law.upenn.edu/bll/ulc/uanba/arbitrat1213.htm.

8 *Id*. at § 23(a)(2)(A). Additional information is available from http://www.nccusl.org.

9 9 U.S.C. § 1-16 (2004).

10 *See id*. § 10(a)(2) (award subject to vacatur "where there was evident partiality or corruption in the arbitrators, or either of them").

11 307 F.3d 617 (7th Cir. 2002)

Act was enacted in 1925 that a federal court has set aside an award because a party-appointed arbitrator on a tripartite panel, as opposed to a neutral, displayed 'evident partiality.'"[12] Having made that observation, the court proceeded to reverse the decision below, removing the one exception it had found to the general rule.

It may be seen even from this relatively brief summary that a movement to all-neutral panels in United States reinsurance arbitration would entail a dramatic change from the status quo. I am not persuaded that the present system would be improved by such a change. In addition, an all-neutral system contains some disadvantages compared with the present procedure. Three major pitfalls are addressed below.

A. *Pitfall #1: Loss of Access to the Arbitrator's Expertise*

Reinsurance arbitration clauses typically require that the arbitrators be active in or retired from the insurance or reinsurance business. Even when no such qualification requirement is imposed, it is rare in practice for parties to reinsurance disputes to appoint as arbitrators or nominate as neutral arbitrators or umpires individuals with no background in insurance or reinsurance whatever.

It is evident from the background summary above that party-appointed arbitrators in a tripartite system such as that customarily employed for reinsurance disputes typically interact extensively with the parties appointing them throughout much of the arbitration. Replacing the present tripartite system with a system of all-neutral panels would almost certainly eliminate such communication. This is problematic because one of the primary reasons for resolving disputes through arbitration is to ensure that the decision makers are familiar with the industry in which the dispute arises and are thus able to apply their accumulated knowledge and expertise to the resolution of that dispute. As the *Sphere Drake* court explained:

> The more experience the panel has, and the smaller the number of repeat players, the more likely it is that the panel will contain some actual or potential friends, counselors, or business rivals of the parties. Yet all participants may think the expertise-impartiality tradeoff worthwhile; the Arbitration Act does not fasten on every industry the model of the disinterested generalist judge.[13]

Advocates of the all-neutral system may respond that arbitrators may bring their expertise to bear on the dispute presented with or without ex parte contacts with their appointing parties. Yes, but it is not quite that simple. In formulating its case in practice, the appointing party often benefits considerably from the ability to consult directly with its appointed

---

[12] *Id*. at 620.

[13] *Id*.

arbitrator. At the outset, such consultations may even have the effect of preventing arbitrations from taking place that are doomed from the start. If a prospective arbitrator advises a party that he or she cannot comfortably or effectively advocate that party's position in panel deliberations, the party may rethink its position and be more open to settlement of the dispute. After all, if a prospective arbitrator who is respected by the would-be appointing party finds that party's position unpersuasive, it is likely that at least one other member of the tripartite panel will be similarly unpersuaded.

Even if generally disposed favorably toward the appointing party's position, an arbitrator can provide invaluable advice on what types of documentary and other evidence will be most persuasive to a panel of experts whose decision is expected to be informed by their knowledge of custom and practice in reinsurance. This input can be very useful to counsel in deciding what specific arguments to put forth and which alternative approaches to emphasize in presenting the client's case. While the value of such consultations is most obvious when a party's counsel is relatively inexperienced in reinsurance matters, seasoned counsel also benefit from this kind of discussion and are better able to serve the client as a result.

The appointed arbitrator, as well as the appointing party and its counsel, can also benefit from these consultations. The ability to confer candidly and confidentially about the merits of the dispute better equips the appointed arbitrator to perform effectively the role of advocate on the panel.[14]

B. *Pitfall #2: Loss of an Advocate on the Panel*

As noted in the *Sphere Drake* decision, "party-appointed arbitrators are *supposed* to be advocates."[15] The same decision goes on, however, to state that once the case is taken under advisement, party-appointed arbitrators are supposed to be "impartial adjudicators."[16] In practice, this means that the party-appointed arbitrator is expected to take responsibility for ensuring that the appointing party's position is fully understood and considered by the panel as a whole, but at the end of the day is expected to vote his or her conscience.

The presence of an advocate on the panel — at least to the extent of ensuring meaningful consideration of the appointing party's position — is very important in guaranteeing a fair process. As a practical matter, arbitration awards cannot generally be vacated under United States law for mistakes of fact or errors in judgment.[17]

---

[14] *See infra* II.B.

[15] *Sphere Drake*, 307 F.3d at 620.

[16] *Id.*

[17] *See, e.g.*, Michigan Mut. Ins. Co. v. Unigard Sec. Ins. Co., 44 F.3d 826, 832-33 (9th Cir. 1995) (declining to vacate award relieving reinsurers of future contractual obligations which was more favorable than rescission they had requested due to lack of any requirement to return premium); Employers Ins. of Wausau v. Certain Underwriters at Lloyd's London, 552 N.W.2d 420, 425-26 (Wis. Ct. App. 1996) (award of amount in excess of contract limits absent explanation not subject to vacatur).

Thus, in the vast majority of cases, the only "shot" a party to a reinsurance arbitration has is before the arbitration panel. In contrast to litigation, there is no meaningful ability to have even serious errors in the decisionmaking process reviewed and corrected. Are parties truly well served by retaining the arbitration process, with its extremely limited scope for judicial review, while relinquishing the ability to have an advocate doing his or her best to ensure that their positions are given a fair shake in the panel's deliberative process?

C. *Pitfall #3: Loss of Access to Information on the Reasons for the Panel's Decision*

In United States reinsurance arbitrations, it is rare for the panel to issue a so-called "reasoned decision" setting forth the rationale for the award made by the panel. The *ARIAS Practical Guide* goes so far as to state that "the United States custom and practice is that arbitration Panels, unless requested otherwise, do not issue written explanations of the basis of their award."[18] While the *Guide* encourages panels to provide reasoned awards if both parties request them, many ARIAS-certified arbitrators make no secret of their disinclination to issue such awards, and some have even stated that they will refuse to serve on a panel if a request for such an award is made.

Most parties are interested in having at least some idea of the reasons for the panel's decision, so that they can be guided by those reasons in future disputes or transactions. Absent such guidance in the award itself, a party's appointed arbitrator is likely to be the only available source of information. Communications regarding the bases for the award are, however, more limited than other types of ex parte communication. Specifically, there is broad agreement that even in a tripartite system the panel's deliberations should not be disclosed by the appointed arbitrators to their appointing parties.[19]

In practice, however, many arbitrators find it possible to convey to their appointing parties the general reasons for the ultimate award without breaching the confidentiality expected by the other panel members as to the specifics of the deliberative process. In fact, the *ARIAS Code* directs arbitrators to consider whether it is appropriate for the parties to be given some informal explanation of the reasons for the award. While the *ARIAS Code* notes the possibility that this informal explanation can come from either the appointed arbitrators or the umpire, the appointed arbitrator, with his or her greater understanding of the appointing party's case, is likely in the best position to provide a meaningful understanding of why

---

[18] *See supra* note 3, ARIAS *Practical Guide*, Chapter V, § 5.4, comment A.

[19] *See ARIAS-U.S., Code of Conduct* ("*ARIAS Code*"), Canon VI, Comment 3 (improper to "inform anyone concerning the contents of the deliberations of the arbitrators"); *see supra* note 3, *ARIAS Practical Guide*, Chapter III, § 3.9, comment C ("Unless the Panel specifically decides otherwise, Panel members should not disclose panel discussions to the parties"). *See also supra* note 4, *ABA-AAA Code of Ethics* Canon VI (C).

that case did or did not prevail. If nothing else, the appointed arbitrator should be able to share with the appointing party what aspects of that party's case the individual arbitrator found persuasive or otherwise.

III.
Conclusion

It is suggested that the old saw, "If it ain't broke, don't fix it" may be applicable to the debate over moving to all-neutral panels. Inherent in that saying are two possibilities: (1) the present situation may not be seriously in need of repair; or (2) the repair under consideration may make the situation worse, not better. While few would suggest the present system is perfect, it is not as clear as the proponents of all-neutral panels would have it that the problems with that system stem from use of the tripartite as opposed to the all-neutral model. And, as suggested in this article, the proposed cure may bring pitfalls that outweigh any benefits.

FUTURE MEETINGS

2005

WINTER 2005

Sunday, February 27 – Sunday, March 6

Marco Island Marriott Resort
Marco Island, Florida

ANNUAL 2005

Sunday, July 17 – Sunday, July 24

La Costa Resort and Spa
Carlsbad, California

Impartial, Independent, Neutral Arbitrators v. Non-Neutral Party Appointed Advocates†

Anthony M. Lanzone

I.
Issue

In reinsurance arbitrations should the panel be impartial, independent and neutral or, except for the umpire, should the other panelists be party-appointed advocates?

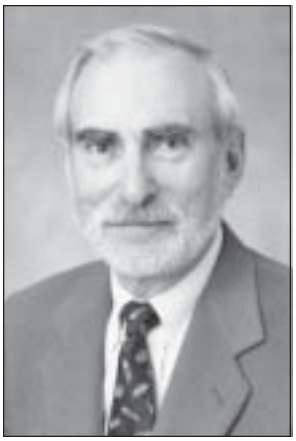
II.
Historical Background

Reinsurance occurs when an insurance company insures or transfers all or a part of the original risk business it has written to another insurer, referred to as the reinsurer. The insurer making the transfer is referred to as the reinsured or cedent. This reinsuring transaction results in their sharing of the risk of any losses arising out of the original coverage afforded to the insured.

The concept in some respects is similar to a bookmaker seeking to reduce its risk exposure by transferring some of the bets it has accepted and placing all or a part of them with another bookmaker. We leave to your imagination how any dispute between unlicensed bookmakers might be resolved.

Generally, any dispute between a cedent and its reinsurer is resolved by going to arbitration. Reinsurance arbitrations are customarily the final frontier in the resolution of the proliferating number of disputes between cedents and reinsurers; however, in recent years the courts have become increasingly more involved.

† Submitted by the author on behalf of the FDCC Alternative Dispute Resolution Section.



Anthony M. Lanzone is a 1953 graduate of St. John's University School of Law. He became a member of the New York Bar that same year. He is admitted to practice before the United States Supreme Court and various Federal Appellate and District Courts. Mr. Lanzone is know for his legal activities in both domestic and international insurance and reinsurance matters in respect of which he served as trial counsel in litigation, arbitration and mediation cases. He now acts solely as a neutral arbitrator and mediator. Over the years he has authored articles and given lectures on a number of insurance, reinsurance and arbitration issues. Mr. Lanzone has been active as a member of the Federation of Defense & Corporate Counsel and has been a speaker at many of its conventions. He is also a member of the American Bar Association and its Section on Alternate Dispute Resolution; the New York State Bar Association; the Association of the Bar of the City of New York; the Defense Research Institute; the International Bar Association; ARIAS U.K., and is a certified arbitrator by ARIAS U.S. The Reinsurance Association of America also lists Mr. Lanzone as a neutral.

My personal introduction to reinsurance and its related disputes occurred more than forty years ago. At that time my law firm was asked to represent certain London reinsurance underwriters. Though the underwriters wished to consult with counsel there existed a desire on their part, along with those of the other parties involved, to resolve any dispute in a more congenial and less confrontational manner than the attitude that exists today in the insurance and reinsurance industry!

At that time lawyers in America handled few cases concerning reinsurance disputes. There was little American case law so that when necessary we searched for precedents in United Kingdom court decisions.

As a young lawyer my reinsurance learning curve began under the tutelage of both underwriters and brokers. Unlike today, there were few reinsurance texts available for us to study and we relied for our education upon the knowledge and experience of the people working daily in both the insurance and reinsurance market.

All the parties participating in the negotiations for reinsurance (the cedent, its broker and the reinsurer) were presumed to be acting with "utmost good faith," and the reinsurance contract was acknowledged to be an "honorable undertaking"! An atmosphere of cordiality existed that encouraged any disagreements arising out of reinsurance transactions be resolved during informal discussions, often while sitting at a coffee table in the old

Captains Room at Lloyds or during a visit to the conference room of the Lloyds broker who had placed the reinsurance. The efforts made at these meetings usually resulted in a satisfactory business solution to the problem.

Should these informal attempts by the parties fail then sometimes in a further effort to resolve matters they would request a respected neutral and independent market underwriter to informally review the matter and express a confidential opinion on the issues. The opinions expressed by the underwriter sometimes formed the basis for resolution of the disputes. Failing these efforts the parties would then take their disagreement to arbitration using a panel comprised of neutral and independent market persons who were aware of the customs and practice within the reinsurance underwriting market.

It was rewarding to engage in extensive discussions with many experienced underwriters, claims persons, and brokers. A number of these individuals worked in the market during and prior to World War Two and their familiarity with the origins of "contract wording" aided our understanding the origin and meaning of various terms and conditions, and why a word or clause was selected for use in different reinsurance contracts.

Over many years London market reinsurance underwriting and claims operations developed numerous customs and practices that impact upon most underwriting transactions. These include terms and conditions that while not specifically mentioned in the Placing Slips or Cover Notes, are implied to have been incorporated into the transaction and would later appear in the written reinsurance contract.

As noted above it was a basic premise early on in the London market that should their informal efforts to find a business solution to a reinsurance dispute fail, it would be preferable to have the matter decided by arbitration before an independent, neutral and impartial panel of individuals familiar with the operations of their specialized market.

As evidence of this intention, arbitration clauses were introduced into most reinsurance contracts. Many such clauses directed that the arbitrators appointed by the parties be active or retired underwriters, or executives of insurance, reinsurance, or brokerage companies. The London market arbitration clauses anticipated that since laws of the United Kingdom and elsewhere required arbitrators be independent, neutral and impartial, such would be the controlling premise in reinsurance arbitration.

Over time and subject to few exceptions, whether a reinsurance contract was prepared in the London, European, American or another reinsurance market it would contain an arbitration clause. Eventually the clauses expanded the pool of candidates for arbitrator to include an active or retired claims person who was an executive officer or a lawyer having at least ten years of experience in reinsurance.

Historically, it has always been observed that, pursuant to their contract, it is the parties arbitration clause and their intentions as expressed therein that determine the procedures controlling the arbitration process. While most of these arbitrations were of an "ad hoc" nature without specific guidelines in place, it was generally recognized that the London market and other international arbitration clauses contemplated that even though the parties appointed the arbitrator, he or she would be an individual who was independent, neutral and impartial.

In the absence of the parties mutual agreement to the contrary, the established institutional arbitrational organizations provided, particularly in international arbitrations, for the independence, neutrality and impartiality of presiding arbitrators in their procedural rules.[1] Provisions such as these have been adopted for use by the 1975 Inter-American Convention on International Commercial Arbitration, the UNCITRAL Arbitration Rules – Rules of the United Nations Commission on International Trade Law, the Court of Arbitration of the International Chamber of Commerce ("ICC") and the London Court of International Arbitration ("LCIA").[2]

Both initially and during the arbitration process, an arbitrator's independence and neutrality must be maintained. According to the Rules of the LCIA, "[a] party-nominated arbitrator is not, however, the representative of the party which nominates him or her. He or she must confirm and maintain his or her independence and impartiality."[3]

The position uniquely preferred by some American lawyers of choosing when possible the use of party-appointed, non-neutral advocates reflects a less desirable concept to foreign insurers. In their own nations or when engaged in international arbitrations under various international treaties, such as the UNCITRAL Treaty, they expect and adhere to the requirements of independence and neutrality of the panel. The United States is a signatory to the UNCITRAL Treaty and, absent mutual party intervention, its provisions remain controlling where applicable.

The International Centre for Dispute Resolution is the international division of the American Arbitration Association ("AAA") and, where adopted, its Rules under Article 7 require that "[a]arbitrators acting under these rules shall be impartial and independent."[4]

Recognizing the need for uniformity in the conduct of reinsurance arbitration, as well as due to concern expressed about perceived arbitration abuses, these institutions formulated rules that may be adopted at the option of the parties and used as guidelines in the conduct of reinsurance arbitration proceedings.

Some old reinsurance contracts stated that the parties should follow the Rules of the American Arbitration Association; however, it was not unusual for the lawyers to agree that the language did not mandate that the arbitration be conducted under the auspices of the AAA. Accordingly, they would progress with an ad hoc proceeding, and if a procedural issue arose during the arbitration, it was understood that they would look to these rules for guidance in resolving the issue.

---

[1] See The Rules of Procedure of the Inter-American Commercial Arbitration Commission IACAC.

[2] These Rules may be found at www.law.fsu.edu or www.adrworld.com.

[3] London Court of International Arbitration Rules, *available at* http://www.lcia-arbitration.com/lcia/#2 (as of June 20, 2004).

[4] American Arbitration Association: International Arbitration Rules, art. 7, § 1 (2003), *available at* http://www.adr.orgindex2.1.jsp?Spssid=15747&JSPsrc+upload\LIVESITE\Rules_Procedures\National_International\..\..\facusArea\international\AAA175current.htm#Impartiality (as of June 20, 2004).

Despite the presence or absence in the contract wording of any requirement as to the neutrality or independence of the party-appointed arbitrator, some parties and their lawyers here in America preferred an agreement to appoint a non-neutral arbitrator, with only the umpire or third arbitrator being neutral and independent.

Even when a treaty requires that an international arbitration panel be composed entirely of neutrals, some lawyers are willing to waive the requirement. These lawyers are accustomed to working with a party-appointed, non-neutral arbitrator whose very non-neutrality enables them to confer ex parte during the proceedings. These communications are something that would be prohibited if that person was acting in the capacity of a neutral. There are further comments on this issue later in this article, but it is appropriate to note that in an international arbitration such ex parte communications are forbidden:

> No party or anyone on its behalf shall have any ex parte communication relating to the case with any arbitrator, or with any candidate for appointment as party-appointed arbitrator except to advise the candidate of the general nature of the controversy and of the anticipated proceedings and to discuss the candidate's qualifications, availability or independence in relation to the parties, or to discuss the suitability of candidates for selection as a third arbitrator where the parties or party designated arbitrators are to participate in that selection. No party or anyone acting on its behalf shall have any ex parte communication relating to the case with any candidate for presiding arbitrator.[5]

III.
INCREASE IN THE NUMBER OF ARBITRATIONS

During the 1980s, for a variety of reasons, there developed a significant increase in the number of reinsurance disputes. Cumulatively, billions of dollars are involved in these disputes. These events have resulted in a large number of arbitrations and litigations. There now exists in America a considerable body of case law regarding reinsurance.

Judges who had never heard the term reinsurance, much less of reinsurance customs and practice, are being asked for interpretations of reinsurance wording. They are required, along with jurors, to choose between the proffered testimony of several alleged experts in insurance and reinsurance. There are many viewpoints within the insurance industry concerning whether the courts are correct in their interpretations. What is clear is that experienced underwriters, claims personnel, brokers or attorneys knowledgeable in reinsurance matters are not deciding many reinsurance disputes.

While reliance on the arbitration process is preferable in the resolution of reinsurance disputes, many insurance spokespersons, while not happy with the extent of the courts' involvement, do seriously question the use of non-neutral arbitrators.

---

[5] *Id*. at § 2.

The twenty-first century promises an even more dramatic increase in the number of reinsurance disputes and arbitrations. The existence of large shortfalls in recoveries will trigger disputes between ceding companies and under-reserved reinsurers. Existing tensions between insurers and reinsurers are escalating as they concern themselves with bad reinsurance debts and some reinsurers' failure to track their reserves for asbestos and other liabilities with those of the cedent.[6]

IV.
DISPUTE OVER NEUTRAL ARBITRATORS

As noted, many reinsurance contracts contain mandatory arbitration clauses.

Industry representatives who question the continued effectiveness of using arbitration to resolve reinsurance disputes cite as a concern the appointment of a non-neutral arbitrator with whom the parties and their lawyers continue to communicate until either the hearing commences, or in some instances, until the arbitrators retire to decide the issues.[7]

In Kathryn P. Broderick's article appearing in this issue, she describes three major pitfalls of neutral panels in reinsurance arbitrations and states "that a movement to all-neutral panels in United States reinsurance arbitration would entail a dramatic change from the status quo."[8]

In addition to the earlier observations concerning international attitudes on neutrality it is worth taking notice of the Code of Ethics for Arbitrators in Commercial Disputes 2003 Revision. The Code was jointly promulgated by the American Bar Association and the American Arbitration Association and became effective March 1, 2004. The revised Code sets the ethical standards for not only lawyers, but for all other persons who undertake to act as commercial arbitrators. It is the controlling definitive statement of the obligations, duties, and conduct expected from arbitrators during the entire arbitration process.[9] In order to appreciate the scope and impact of the Code, it is recommended that it be read in its entirety.

This article will reference certain portions of the Code to indicate the general support and intentions that favor the neutrality of the arbitration panel. While recognizing that Canon X of the Code contains an exemption from certain of the ethical provisions con-

---

[6] BUS. INS., Feb. 9, 2004 quoting a Standard & Poor's Corp. report.

[7] See Linda Dakin-Grimm & M. Benjamin Valeric, *A Case Against Reinsurance Arbitration?*, CONSULTING LITIGATION & EXPERT WITNESS SECTION QUARTERLY CPCU SOCIETY Vol. 9 No. 4, Dec. 2002; Anthony M. Lanzone, *Abuses In Reinsurance Arbitrations – Do they Really Exist?*, INS ADVOCATE Vol. 115 No. 5 Feb. 2, 2004.

[8] *See* Kathryn P. Broderick, *Pitfalls In Moving To All-Neutral Reinsurance Arbitration Panels*, 54 FED'N DEF. & CORP. COUNS. Q. 373 (2004)

[9] It may be read online at http.www.abanet.org/leadership/2004/dj/107.pdf.

tained therein, I believe it does so in recognition of the existence under American law of the parties' right to agree to the use of a non-neutral arbitrator. This is a concept that this article does not support for the variety of reasons that are being elaborated upon herein.

A. *The Code of Ethics for Arbitrators in Commercial Disputes — Selective Excerpts*

Preamble

. . .

. . . Persons who act as arbitrators . . . undertake serious responsibilities to the public as well as to the parties. Those responsibilities include important ethical obligations.

. . . [T]his code sets forth generally accepted standards of ethical conduct for the guidance of arbitrators and parties in commercial disputes . . .

. . . .

Note on Neutrality

. . . The sponsors of this Code believe that it is preferable for all arbitrators – including any party-appointed arbitrators to be neutral, that is, independent and impartial, and to comply with the same ethical standards. This expectation generally is essential in arbitrations where the parties, the nature of the dispute, or the enforcement of any resulting award may have international aspects. However, parties in certain domestic arbitrations in the United States may prefer that party-appointed arbitrators be non-neutral and governed by special ethical considerations. These special ethical considerations appear in Canon X of this Code.

This Code establishes a presumption of neutrality for all arbitrators, including party-arbitrators, which applies unless the parties agreement, the arbitration rules agreed to by the parties or applicable laws provide otherwise. This Code requires all party-appointed arbitrators, whether neutral or not, to make pre-appointment disclosures of any facts which might affect their neutrality, independence, or impartiality. This Code also requires all party-appointed arbitrators to ascertain and disclose as soon as practicable whether the parties intended for them to serve as a neutral or not. If any doubt or uncertainty exists, the party-appointed arbitrators should serve as neutrals unless and until such doubt or uncertainty is resolved in accordance with Canon IX. This Code expects all arbitrators, including those serving under Canon X to preserve the integrity and fairness of the process.[10]

It is submitted that the drafters of this Code of Ethics, while acknowledging that in some American arbitrations the parties might agree to the appointment of non-neutral arbi-

[10] *Id.*

trators, clearly favor, as do I, the appointment of a neutral, independent, and impartial arbitrator.

In her "Pitfall No.1," Ms. Broderick makes the following assertion:

> [P]arty-appointed arbitrators in a tripartite system such as that customarily employed for reinsurance disputes typically interact extensively with the parties appointing them throughout much of the arbitration. Replacing the present tripartite system with a system of all-neutral panels would almost certainly eliminate such communication.[11]

Why is there a problem in eliminating this unlimited access between counsel or a party with their appointed arbitrator? How is the fairness in the hearing enhanced by allowing any continuing ex parte dialogue between counsel and the arbitrator? Would it not be an abuse of the arbitration process to permit lawyers to confer at will with their arbitrator during this dispute resolution process?

Such communications are nothing more than an effort to obtain a running account of how effectively the lawyers are presenting their case, and asking the arbitrator: "How am I doing?" They want to know the impact that their evidence is having on both the neutral umpire and the other arbitrator. This need for access by some lawyers to their appointed non-neutral arbitrator serves as a "security blanket" that may afford the attorney some assurance that he or she is trying the case to the best advantage.

Having such ex parte access to their arbitrator/advocate inhibits the ability of the other panel members to candidly discuss the evidence and case developments among themselves. How forthcoming would an umpire be in discussing his or her reactions to the evidence if it is known that later that evening the party-appointed, non-neutral arbitrator will be dissecting and analyzing the umpires every comment with the lawyer?

A non-neutral arbitrator is exposed to extensive discussions about the case with both counsel and the party representative during the selection process. On these occasions information and documents are either made available or discussed with the candidate for non-neutral party advocate. It would not be unusual for some degree of bonding to occur with the party concerning his or her position on the issues.

An issue exists as to whether such an appointee may feel obliged to try, if the communication sessions during the hearing fail to produce a winning strategy, to then obtain some type of "split the baby" decision. Additionally, during these periods of ex parte communications both the lawyer and party representative may seek to aid or perhaps guide their arbitrator in deciding the future areas of inquiry following the resumption of the hearing.

---

[11] Broderick, *supra* note 8, at 375.

During the selection process the party and its counsel are seeking a candidate for arbitrator who is sympathetic to their position. A negative reaction from such a person is usually followed by a further search until they have a person appointed whom they are satisfied is willing to advocate their position on the issues.

There is presently no lack of candidates waiting to be called for an interview and who wish to have the opportunity to serve as a non-neutral.

The argument is raised that if limited to appointing only neutrals, then appointing counsel will lose the opportunity to consult in detail with the candidate about his or her opinions concerning the issues in the case and to be educated by the candidate. If counsel feels a need for an expert consultation or to be educated on some aspect of reinsurance practice he or she can always consult with an expert.

B. *Pitfall No. 2: "Loss of An Advocate on The Panel."*[12]

Why is there any need to seek out a candidate who will then be perceived as a non-neutral hired gun whose purpose is to again argue and repeat the same position that the lawyer and his witnesses have been espousing throughout the arbitration hearing?

Is it reasonable to expect a party-appointed, non-neutral who is acting as an advocate to be able, at the end of the hearing, "to vote his or her conscience" when he or she has been communicating, consulting, planning, discussing, reviewing, and analyzing all of the events and evidence both before and during the hearing with counsel. Can such a person suddenly, after taking the case under advisement, become an "impartial adjudicator" who at the end of the day will then be capable to vote his or her conscience?

Instead of the non-neutral acting as "[t]he presence of an advocate on the panel guaranteeing a fair process,"[13] why not just trust an appointed independent, neutral and impartial arbitrator? If we are talking about a "fair process," I suggest that an independent observer watching a party-appointed non-neutral doing what is expected of him or her before, during and after each day's session consulting with counsel would have to wonder where the fair hearing was being held.

Those lawyers who worry about not being able to communicate with their non-neutral, party-appointed advocate are like the character in the Verizon Wireless commercial who walks around asking, "Do you hear me now?" In expressing his or her need to communicate throughout the arbitration process with the non-neutral arbitrator/advocate the lawyer is repeatedly asking, "How am I doing?" One would expect that a lawyer with this concern must be very upset with a judicial code that would not permit him or her during a trial to daily have lunch with a juror in order to ask the burning question, "How am I doing?"

---

[12] *Id*. at 375.

[13] *Id*. at 375.

C. *Pitfall #3: "Loss of Access to Information on the Reasons for the Panels Decision."*[14]

This concern can be addressed in the reinsurance contract. The parties prior to the commencement of the arbitration can also address it by agreeing that the arbitration panel shall render "findings of fact and a reasoned decision." The rationale for the award will then be clear to the parties.

The argument is made that many "arbitrators make no secret of their disinclination to issue such awards, and some have even stated that they will refuse to serve on a panel if a request for such an award is made."[15] Any candidate who refuses to serve on a panel if required to provide a reasoned award should be excused. There is no acceptable reason why an arbitration panel should not provide a "reasoned decision."

A "reasoned decision" ensures the parties that the panel understood the issues in dispute and also aids in deciding if the panel participants were indeed qualified to hear and determine the dispute. If the arbitrator's lack of competency is made evident by the decision, then the party can avoid selecting that individual in future cases. The parties may request the panel to make any specific findings in addition to requiring their issuance of a reasoned decision.

V.
CONCLUSION

It is submitted that a reinsurance arbitration using party-appointed, non-neutral arbitrator/advocates, that allows ex parte communications, and, in the absence of a concern for the preservation of trade secrets, is unwilling to issue a reasoned decision will not result in a fair hearing. The international rule favoring the use of neutral panels to ensure fair hearings should be adopted as a due process rule in America.

There have been many voices raised in the insurance and reinsurance industry questioning the continued use of the arbitration process to resolve reinsurance disputes. Many insurance industry officials have expressed their lack of trust in the current process, and they contend that some arbitrations are merely contrived "dog and pony shows" directed by lawyers who often have a stable of "actors" frequently playing different roles in their arbitrations.

---

[14] *Id*. at 375.

[15] *Id*. at 375.

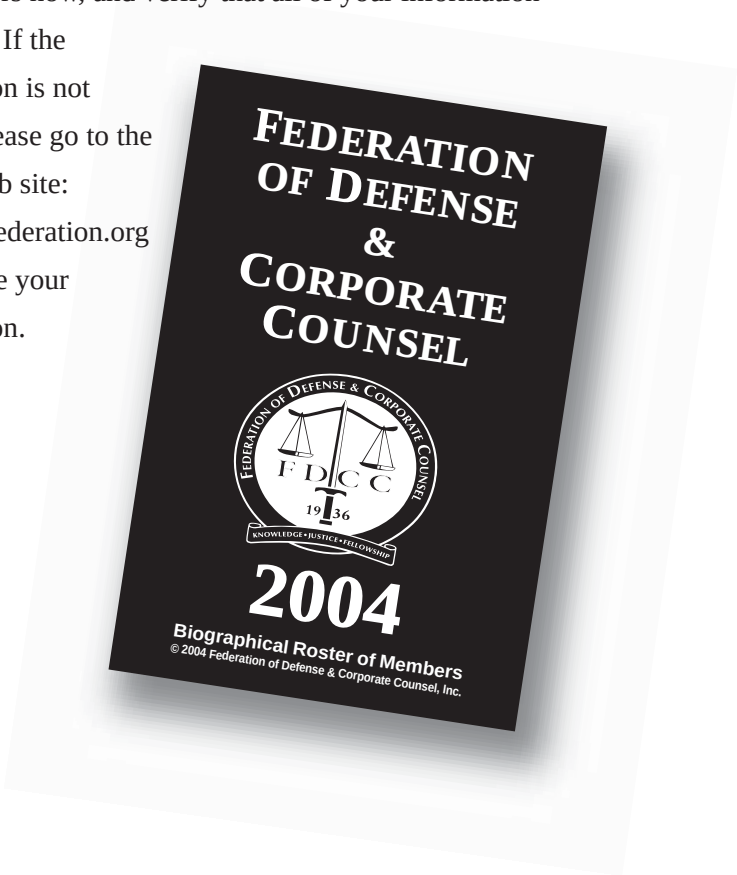
Those objecting to the use of a non-neutral appointee have questioned the law firm's repeated use of the same individual as an arbitrator, as a consultant and as an expert witness. Likewise they question the efforts made by the firm to have such individuals' names submitted for the role of umpire. Is there room for doubt as to whether the party or its lawyer will suggest that the party-advocate propose an umpire not thought to be more disposed to the client's position in the arbitration?

There is a solution to this lawyer and party created dilemma – independency, neutrality and impartiality of the panel. The panelist may be appointed by the parties or by an independent institutional organization. Fairness would be assured. It works in international arbitration and when used it also works here in America.

Independent, neutral and impartial — the terms sound right. And adhering to the Code of Ethics for Arbitrators in Commercial Disputes, 2003 Revision, will ensure that regardless of the outcome of the arbitration the parties will at least know that they have been afforded a fair hearing.

FDCC 2004 Roster

Please check your listing in the 2004 Biographical Roster of Members now, and verify that all of your information is correct. If the information is not correct please go to the FDCC web site: www.thefederation.org and update your information.



FEDERATION OF DEFENSE & CORPORATE COUNSEL QUARTERLY / VOLUME 54

Subject Index

ALTERNATIVE DISPUTE RESOLUTION

All-Neutral Reinsurance Arbitration Panels: Another View, Anthony M. Lanzone, Vol. 54 No. 4, Summer 2004, page 381.

Pitfalls in Moving to All-Neutral Reinsurance Arbitration Panels, Kathryn P. Broderick, Vol. 54 No. 4, Summer 2004, page 373.

CYBERLAW

Impact of Electronic Data upon an Attorney's Client, **The,** Terry L. Hill & Jennifer Johnson, Vol. 54 No. 2, Winter 2004, page 95.

DAMAGES

Generally

Anticipatory Wrongful Death Damages: A Visit to Alice in Wonderland, Gregory P. Forney, Vol. 54 No. 2, Winter 2004, page 163.

Blueprint for General Causation Analysis in Toxic Tort Litigation, William O. Dillingham, Patrick J. Hagan & Rodrigo E. Salas, Vol. 54 No. 1, Fall 2003, page 21.

Connection Between Physical Damage and Business Interruption Coverage, The, Andrew B. Downs & Linda M. Bolduan, Vol. 54 No. 4, Summer 2004, page 307.

Directors' & Officers' Liability Insurance: The Issue of "Non-Indemnifiable Loss," Donna Ferrara, Vol. 54 No. 4, Summer 2004, page 359.

Punitive

Evidentiary Implications of *State Farm v. Campbell*, The, James L. Crandall, Vol. 54 No. 1, Fall 2003, page 79.

Jury Selection Landmines – Sexual Harassment Allegations, Corporate Judgments and Punitive Damages, Kimberly D. Baker, Vol. 54 No. 2, Winter 2004, page 133.

Observations on Possible Appellate Challenges to Punitive Damage Awards, Forrest S. Latta, Vol. 54 No. 1, Fall 2003, page 69.

Punitive Damages: California Model Applying *Gore* and *State Farm*, Patrick J. Hagan & Anne Marie Bridges, Vol. 54 No. 4, Summer 2004, page 343.

***State Farm v. Campbell*: Anticipated Effects for Punitive Damages in Bad Faith Litigation**, David M. Bell, Vol. 54 No. 1, Fall 2003, page, 53.

DISCOVERY

Doctrine of Inevitable Disclosure, The, Edward M. Kaplan & Melissa M. Hanlon, Vol. 54 No. 3, Spring 2004, page 259.

Impact of Electronic Data upon an Attorney's Client, **The,** Terry L. Hill & Jennifer Johnson, Vol. 54 No. 2, Winter 2004, page 95.

Loss of Privilege: The New Discoverability of Reinsurance Information, Mitchell A. Orpett, Vol. 54 No. 2, Winter 2004, page 153.

ETHICS (Professional Responsibility)

Advice of Counsel in Bad Faith Litigation: Preserving Privileges and Ethical Considerations, H. Michael Bagley, Vol. 54 No. 3, Spring 2004, page 283.

★ **Professionalism in Depositions: The Sound of Silence**, E. Phelps Gay, Vol. 54 No. 3, Spring 2004, page 213.

EVIDENCE

Advice of Counsel in Bad Faith Litigation: Preserving Privileges and Ethical Considerations, H. Michael Bagley, Vol. 54 No. 3, Spring 2004, page 283.

★ **Hecker Award Winner**

Blueprint for General Causation Analysis in Toxic Tort Litigation, William O. Dillingham, Patrick J. Hagan & Rodrigo E. Salas, Vol. 54 No. 1, Fall 2003, page 21.

Doctrine of Inevitable Disclosure, The, Edward M. Kaplan & Melissa M. Hanlon, Vol. 54 No. 3, Spring 2004, page 259.

Impact of Electronic Data upon an Attorney's Client, **The,** Terry L. Hill & Jennifer Johnson, Vol. 54 No. 2, Winter 2004, page 95.

Loss of Privilege: The New Discoverability of Reinsurance Information, Mitchell A. Orpett, Vol. 54 No. 2, Winter 2004, page 153.

Missing Insured and the Life Insurance Death Claim, The, C. Edgar Sentell, Vol. 54 No. 2, Winter 2004, page 197.

Non-Competition Agreements, Linda S. Woolf, Vol. 54 No. 4, Summer 2004, page 333.

Storming the Barricade: The Attack on the Attorney-Client Privilege in First-Party Insurance Cases, Marvin L. Karp, Vol. 54 No. 1, Fall 2003, page 3.

EXTRACONTRACTUAL LIABILITY

Advice of Counsel in Bad Faith Litigation: Preserving Privileges and Ethical Considerations, H. Michael Bagley, Vol. 54 No. 3, Spring 2004, page 283.

Insurance Carrier as Fiduciary, The: Inappropriate Judicial Lawmaking by Activist Judges in the Context of Regulated Contracts, Peter A. von Mehren, Michael R. Nelson & Mark Rosenberg, Vol. 54 No. 1, Fall 2003, page 37.

Other People's Money: Insurer Liability for Failing to Settle Within Policy Limits, Michael F. Aylward, Vol. 54 No. 3, Spring 2004, page 267.

Punitive Damages: California Model Applying *Gore* and *State Farm*, Patrick J. Hagan & Anne Marie Bridges, Vol. 54 No. 4, Summer 2004, page 343.

***State Farm v. Campbell*: Anticipated Effects for Punitive Damages in Bad Faith Litigation**, David M. Bell, Vol. 54 No. 1, Fall 2003, page, 53.

Storming the Barricade: The Attack on the Attorney-Client Privilege in First-Party Insurance Cases, Marvin L. Karp, Vol. 54 No. 1, Fall 2003, page 3.

FEDERAL RULES

EVIDENCE

Blueprint for General Causation Analysis in Toxic Tort Litigation, William O. Dillingham, Patrick J. Hagan & Rodrigo E. Salas, Vol. 54 No. 1, Fall 2003, page 21.

Doctrine of Inevitable Disclosure, The, Edward M. Kaplan & Melissa M. Hanlon, Vol. 54 No. 3, Spring 2004, page 259.

Impact of Electronic Data upon an Attorney's Client, **The,** Terry L. Hill & Jennifer Johnson, Vol. 54 No. 2, Winter 2004, page 95.

Loss of Privilege: The New Discoverability of Reinsurance Information, Mitchell A. Orpett, Vol. 54 No. 2, Winter 2004, page 153.

Missing Insured and the Life Insurance Death Claim, The, C. Edgar Sentell, Vol. 54 No. 2, Winter 2004, page 197.

Non-Competition Agreements, Linda S. Woolf, Vol. 54 No. 4, Summer 2004, page 333.

Storming the Barricade: The Attack on the Attorney-Client Privilege in First-Party Insurance Cases, Marvin L. Karp, Vol. 54 No. 1, Fall 2003, page 3.

PROCEDURE

Evidentiary Implications of *State Farm v. Campbell,* The, James L. Crandall, Vol. 54 No. 1, Fall 2003, page 79.

Observations on Possible Appellate Challenges to Punitive Damage Awards, Forrest S. Latta, Vol. 54 No. 1, Fall 2003, page 69.

★ **Professionalism in Depositions: The Sound of Silence**, E. Phelps Gay, Vol. 54 No. 3, Spring 2004, page 213.

***State Farm v. Campbell*: Anticipated Effects for Punitive Damages in Bad Faith Litigation**, David M. Bell, Vol. 54 No. 1, Fall 2003, page, 53.

★ **Hecker Award Winner**

INSURANCE

FIRST PARTY GENERALLY

Advice of Counsel in Bad Faith Litigation: Preserving Privileges and Ethical Considerations, H. Michael Bagley, Vol. 54 No. 3, Spring 2004, page 283.

Connection Between Physical Damage and Business Interruption Coverage, The, Andrew B. Downs & Linda M. Bolduan, Vol. 54 No. 4, Summer 2004, page 307.

Insurance Carrier as Fiduciary, The: Inappropriate Judicial Lawmaking by Activist Judges in the Context of Regulated Contracts, Peter A. von Mehren, Michael R. Nelson & Mark Rosenberg, Vol. 54 No. 1, Fall 2003, page 37.

Missing Insured and the Life Insurance Death Claim, The, C. Edgar Sentell, Vol. 54 No. 2, Winter 2004, page 197.

Punitive Damages: California Model Applying *Gore* and *State Farm*, Patrick J. Hagan & Anne Marie Bridges, Vol. 54 No. 4, Summer 2004, page 343.

***State Farm v. Campbell*: Anticipated Effects for Punitive Damages in Bad Faith Litigation**, David M. Bell, Vol. 54 No. 1, Fall 2003, page, 53.

Storming the Barricade: The Attack on the Attorney-Client Privilege in First-Party Insurance Cases, Marvin L. Karp, Vol. 54 No. 1, Fall 2003, page 3.

DIRECTORS & OFFICERS

Directors' & Officers' Liability Insurance: The Issue of "Non-Indemnifiable Loss," Donna Ferrara, Vol. 54 No. 4, Summer 2004, page 359.

GENERALLY

All-Neutral Reinsurance Arbitration Panels: Another View, Anthony M. Lanzone, Vol. 54 No. 4, Summer 2004, page 381.

Connection Between Physical Damage and Business Interruption Coverage, The, Andrew B. Downs & Linda M. Bolduan, Vol. 54 No. 4, Summer 2004, page 307.

Do State OSHA Regulations Apply to Homeowners?, Michael J. Brady & Elisa R. Nadeau, Vol. 54 No. 2, Winter 2004, page 183.

Directors' & Officers' Liability Insurance: The Issue of "Non-Indemnifiable Loss," Donna Ferrara, Vol. 54 No. 4, Summer 2004, page 359.

Insurance Carrier as Fiduciary, The: Inappropriate Judicial Lawmaking by Activist Judges in the Context of Regulated Contracts, Peter A. von Mehren, Michael R. Nelson & Mark Rosenberg, Vol. 54 No. 1, Fall 2003, page 37.

Pitfalls in Moving to All-Neutral Reinsurance Arbitration Panels, Kathryn P. Broderick, Vol. 54 No. 4, Summer 2004, page 373.

Punitive Damages: California Model Applying *Gore* and *State Farm*, Patrick J. Hagan & Anne Marie Bridges, Vol. 54 No. 4, Summer 2004, page 343.

***State Farm v. Campbell*: Anticipated Effects for Punitive Damages in Bad Faith Litigation**, David M. Bell, Vol. 54 No. 1, Fall 2003, page, 53.

Storming the Barricade: The Attack on the Attorney-Client Privilege in First-Party Insurance Cases, Marvin L. Karp, Vol. 54 No. 1, Fall 2003, page 3.

LIFE

Missing Insured and the Life Insurance Death Claim, The, C. Edgar Sentell, Vol. 54 No. 2, Winter 2004, page 197.

THIRD PARTY GENERALLY

Advice of Counsel in Bad Faith Litigation: Preserving Privileges and Ethical Considerations, H. Michael Bagley, Vol. 54 No. 3, Spring 2004, page 283.

Directors' & Officers' Liability Insurance: The Issue of "Non-Indemnifiable Loss," Donna Ferrara, Vol. 54 No. 4, Summer 2004, page 359.

Do State OSHA Regulations Apply to Homeowners?, Michael J. Brady & Elisa R. Nadeau, Vol. 54 No. 2, Winter 2004, page 183.

Insurance Carrier as Fiduciary, The: Inappropriate Judicial Lawmaking by Activist Judges in the Context of Regulated Contracts, Peter A. von Mehren, Michael R. Nelson & Mark Rosenberg, Vol. 54 No. 1, Fall 2003, page 37.

Other People's Money: Insurer Liability for Failing to Settle Within Policy Limits, Michael F. Aylward, Vol. 54 No. 3, Spring 2004, page 267.

PROPERTY

Connection Between Physical Damage and Business Interruption Coverage, The, Andrew B. Downs & Linda M. Bolduan, Vol. 54 No. 4, Summer 2004, page 307.

Do State OSHA Regulations Apply to Homeowners?, Michael J. Brady & Elisa R. Nadeau, Vol. 54 No. 2, Winter 2004, page 183.

REINSURANCE

All-Neutral Reinsurance Arbitration Panels: Another View, Anthony M. Lanzone, Vol. 54 No. 4, Summer 2004, page 381.

Loss of Privilege: The New Discoverability of Reinsurance Information, Mitchell A. Orpett, Vol. 54 No. 2, Winter 2004, page 153.

Pitfalls in Moving to All-Neutral Reinsurance Arbitration Panels, Kathryn P. Broderick, Vol. 54 No. 4, Summer 2004, page 373.

Recent Developments in English Reinsurance Law, David Kendall, Vol. 54 No. 3, Spring 2004, page 239.

INTELLECTUAL PROPERTY

Non-Competition Agreements, Linda S. Woolf, Vol. 54 No. 4, Summer 2004, page 333.

MEDICAL/LEGAL

Blueprint for General Causation Analysis in Toxic Tort Litigation, William O. Dillingham, Patrick J. Hagan & Rodrigo E. Salas, Vol. 54 No. 1, Fall 2003, page 21.

NEGLIGENCE

Workers' Compensation Defense in Tort Cases, The, John F. Ledwith, Vol. 54 No. 3, Spring 2004, page 253.

PRACTICE & PROCEDURE

Advice of Counsel in Bad Faith Litigation: Preserving Privileges and Ethical Considerations, H. Michael Bagley, Vol. 54 No. 3, Spring 2004, page 283.

Anticipatory Wrongful Death Damages: A Visit to Alice in Wonderland, Gregory P. Forney, Vol. 54 No. 2, Winter 2004, page 163.

Blueprint for General Causation Analysis in Toxic Tort Litigation, William O. Dillingham, Patrick J. Hagan & Rodrigo E. Salas, Vol. 54 No. 1, Fall 2003, page 21.

Doctrine of Inevitable Disclosure, The, Edward M. Kaplan & Melissa M. Hanlon, Vol. 54 No. 3, Spring 2004, page 259.

Evidentiary Implications of *State Farm v. Campbell,* The, James L. Crandall, Vol. 54 No. 1, Fall 2003, page 79.

Impact of Electronic Data upon an Attorney's Client, **The,** Terry L. Hill & Jennifer Johnson, Vol. 54 No. 2, Winter 2004, page 95.

Jury Selection Landmines – Sexual Harassment Allegations, Corporate Judgments and Punitive Damages, Kimberly D. Baker, Vol. 54 No. 2, Winter 2004, page 133.

Loss of Privilege: The New Discoverability of Reinsurance Information, Mitchell A. Orpett, Vol. 54 No. 2, Winter 2004, page 153.

Missing Insured and the Life Insurance Death Claim, The, C. Edgar Sentell, Vol. 54 No. 2, Winter 2004, page 197.

Observations on Possible Appellate Challenges to Punitive Damage Awards, Forrest S. Latta, Vol. 54 No. 1, Fall 2003, page 69.

★ **Professionalism in Depositions: The Sound of Silence**, E. Phelps Gay, Vol. 54 No. 3, Spring 2004, page 213.

Punitive Damages: California Model Applying *Gore* and *State Farm*, Patrick J. Hagan & Anne Marie Bridges, Vol. 54 No. 4, Summer 2004, page 343.

***State Farm v. Campbell*: Anticipated Effects for Punitive Damages in Bad Faith Litigation**, David M. Bell, Vol. 54 No. 1, Fall 2003, page, 53.

★ **Hecker Award Winner**

REMEDIES

Anticipatory Wrongful Death Damages: A Visit to Alice in Wonderland, Gregory P. Forney, Vol. 54 No. 2, Winter 2004, page 163.

Directors' & Officers' Liability Insurance: The Issue of "Non-Indemnifiable Loss," Donna Ferrara, Vol. 54 No. 4, Summer 2004, page 359.

Insurance Carrier as Fiduciary, The: Inappropriate Judicial Lawmaking by Activist Judges in the Context of Regulated Contracts, Peter A. von Mehren, Michael R. Nelson & Mark Rosenberg, Vol. 54 No. 1, Fall 2003, page 37.

Non-Competition Agreements, Linda S. Woolf, Vol. 54 No. 4, Summer 2004, page 333.

Other People's Money: Insurer Liability for Failing to Settle Within Policy Limits, Michael F. Aylward, Vol. 54 No. 3, Spring 2004, page 267.

Punitive Damages: California Model Applying *Gore* and *State Farm*, Patrick J. Hagan & Anne Marie Bridges, Vol. 54 No. 4, Summer 2004, page 343.

TRIAL TACTICS

Advice of Counsel in Bad Faith Litigation: Preserving Privileges and Ethical Considerations, H. Michael Bagley, Vol. 54 No. 3, Spring 2004, page 283.

Blueprint for General Causation Analysis in Toxic Tort Litigation, William O. Dillingham, Patrick J. Hagan & Rodrigo E. Salas, Vol. 54 No. 1, Fall 2003, page 21.

Doctrine of Inevitable Disclosure, The, Edward M. Kaplan & Melissa M. Hanlon, Vol. 54 No. 3, Spring 2004, page 259.

Evidentiary Implications of *State Farm v. Campbell*, The, James L. Crandall, Vol. 54 No. 1, Fall 2003, page 79.

Impact of Electronic Data upon an Attorney's Client, The, Terry L. Hill & Jennifer Johnson, Vol. 54 No. 2, Winter 2004, page 95.

Jury Selection Landmines – Sexual Harassment Allegations, Corporate Judgments and Punitive Damages, Kimberly D. Baker, Vol. 54 No. 2, Winter 2004, page 133.

Loss of Privilege: The New Discoverability of Reinsurance Information, Mitchell A. Orpett, Vol. 54 No. 2, Winter 2004, page 153.

Missing Insured and the Life Insurance Death Claim, The, C. Edgar Sentell, Vol. 54 No. 2, Winter 2004, page 197.

Observations on Possible Appellate Challenges to Punitive Damage Awards, Forrest S. Latta, Vol. 54 No. 1, Fall 2003, page 69.

Other People's Money: Insurer Liability for Failing to Settle Within Policy Limits, Michael F. Aylward, Vol. 54 No. 3, Spring 2004, page 267.

★ **Professionalism in Depositions: The Sound of Silence**, E. Phelps Gay, Vol. 54 No. 3, Spring 2004, page 213.

Punitive Damages: California Model Applying *Gore* and *State Farm*, Patrick J. Hagan & Anne Marie Bridges, Vol. 54 No. 4, Summer 2004, page 343.

***State Farm v. Campbell*: Anticipated Effects for Punitive Damages in Bad Faith Litigation**, David M. Bell, Vol. 54 No. 1, Fall 2003, page, 53.

Storming the Barricade: The Attack on the Attorney-Client Privilege in First-Party Insurance Cases, Marvin L. Karp, Vol. 54 No. 1, Fall 2003, page 3.

VICARIOUS LIABILITY

Workers' Compensation Defense in Tort Cases, The, John F. Ledwith, Vol. 54 No. 3, Spring 2004, page 253.

WORKERS' COMPENSATION

Workers' Compensation Defense in Tort Cases, The, John F. Ledwith, Vol. 54 No. 3, Spring 2004, page 253.

★ **Hecker Award Winner**

FEDERATION OF DEFENSE & CORPORATE COUNSEL QUARTERLY / VOLUME 54

Author Index

A

Aylward, Michael F., Other People's Money: Insurer Liability for Failing to Settle Within Policy Limits, Vol. 54 No. 3, Spring 2004, page 267.

B

Bagley, H. Michael, Advice of Counsel in Bad Faith Litigation: Preserving Privileges and Ethical Considerations, Vol. 54 No. 3, Spring 2004, page 283.

Baker, Kimberly D., Jury Selection Landmines – Sexual Harassment Allegations, Corporate Judgments and Punitive Damages, Vol. 54 No. 2, Winter 2004, page 133.

Bell, David M., *State Farm v. Campbell*: Anticipated Effects for Punitive Damages in Bad Faith Litigation, Vol. 54 No. 1, Fall 2003, page, 53.

Bolduan, Linda M. (with Andrew B. Downs), The Connection Between Physical Damage and Business Interruption Coverage, Vol. 54 No. 4, Summer 2004, page 307.

Bridges, Anne Marie (with Patrick J. Hagan), Punitive Damages: California Model Applying *Gore* and *State Farm*, Vol. 54 No. 4, Summer 2004, page 343.

Brady, Michael J. (with Elisa R. Nadeau), Do State OSHA Regulations Apply to Homeowners?, Vol. 54 No. 2, Winter 2004, page 183.

Broderick, Kathryn P., Pitfalls in Moving to All-Neutral Reinsurance Arbitration Panels, Vol. 54 No. 4, Summer 2004, page 373.

C

Crandall, James L., The Evidentiary Implications of *State Farm v. Campbell*, Vol. 54 No. 1, Fall 2003, page 79.

D

Dillingham, William O. (with Patrick J. Hagan & Rodrigo E. Salas), Blueprint for General Causation Analysis in Toxic Tort Litigation, Vol. 54 No. 1, Fall 2003, page 21.

Downs, Andrew B. (with Linda M. Bolduan), The Connection Between Physical Damage and Business Interruption Coverage, Vol. 54 No. 4, Summer 2004, page 307.

F

Ferrara, Donna, Directors' & Officers' Liability Insurance: The Issue of "Non-Indemnifiable Loss," Vol. 54 No. 4, Summer 2004, page 359.

Forney, Gregory P., Anticipatory Wrongful Death Damages: A Visit to Alice in Wonderland, Vol. 54 No. 2, Winter 2004, page 163.

G

★ **Gay, E. Phelps**, Professionalism in Depositions: The Sound of Silence, Vol. 54 No. 3, Spring 2004, page 213.

H

Hagan, Patrick J. (with Anne Marie Bridges), Punitive Damages: California Model Applying *Gore* and *State Farm*, Vol. 54 No. 4, Summer 2004, page 343.

Hagan, Patrick J. (with William O. Dillingham, & Rodrigo E. Salas), Blueprint for General Causation Analysis in Toxic Tort Litigation, Vol. 54 No. 1, Fall 2003, page 21.

Hanlon, Melissa M. (with Edward M. Kaplan), The Doctrine of Inevitable Disclosure, Vol. 54 No. 3, Spring 2004, page 259.

Hill, Terry L. (with Jennifer Johnson), The Impact of Electronic Data upon an Attorney's Client, Vol. 54 No. 2, Winter 2004, page 95.

★ **Hecker Award Winner**

J

Johnson, Jennifer (with Terry L. Hill), The Impact of Electronic Data upon an Attorney's Client, Vol. 54 No. 2, Winter 2004, page 95.

K

Kaplan, Edward M. (with Melissa M. Hanlon), The Doctrine of Inevitable Disclosure, Vol. 54 No. 3, Spring 2004, page 259.

Karp, Marvin L., Storming the Barricade: The Attack on the Attorney-Client Privilege in First-Party Insurance Cases, Vol. 54 No. 1, Fall 2003, page 3.

Kendall, David, Recent Developments in English Reinsurance Law, Vol. 54 No. 3, Spring 2004, page 239.

L

Latta, Forrest S., Observations on Possible Appellate Challenges to Punitive Damage Awards, Vol. 54 No. 1, Fall 2003, page 69.

Lanzone, Anthony M., All-Neutral Reinsurance Arbitration Panels: Another View, Vol. 54 No. 4, Summer 2004, page 381.

Ledwith, John F., The Workers' Compensation Defense in Tort Cases, Vol. 54 No. 3, Spring 2004, page 253.

N

Nadeau, Elisa R. (with Michael J. Brady), Do State OSHA Regulations Apply to Homeowners?, Vol. 54 No. 2, Winter 2004, page 183.

Nelson, Michael R. (with Peter A. von Mehren & Mark Rosenberg), The Insurance Carrier as Fiduciary: Inappropriate Judicial Lawmaking by Activist Judges in the Context of Regulated Contracts, Peter A. von Mehren, Michael R. Nelson & Mark Rosenberg, Vol. 54 No. 1, Fall 2003, page 37.

O

Orpett, Mitchell A., Loss of Privilege: The New Discoverability of Reinsurance Information, Vol. 54 No. 2, Winter 2004, page 153.

R

Rosenberg, Mark (with Peter A. von Mehren & Michael R. Nelson), The Insurance Carrier as Fiduciary: Inappropriate Judicial Lawmaking by Activist Judges in the Context of Regulated Contracts, Vol. 54 No. 1, Fall 2003, page 37.

S

Salas, Rodrigo E. (with William O. Dillingham & Patrick J. Hagan), Blueprint for General Causation Analysis in Toxic Tort Litigation, , Vol. 54 No. 1, Fall 2003, page 21.

Sentell, C. Edgar, The Missing Insured and the Life Insurance Death Claim, Vol. 54 No. 2, Winter 2004, page 197.

V

von Mehren, Peter A. (with Michael R. Nelson & Mark Rosenberg), The Insurance Carrier as Fiduciary: Inappropriate Judicial Lawmaking by Activist Judges in the Context of Regulated Contracts, Vol. 54 No. 1, Fall 2003, page 37.

W

Woolf, Linda S., Non-Competition Agreements, Vol. 54 No. 4, Summer 2004, page 333.

The Federation of Insurance Counsel was organized in 1936 for the purpose of bringing together insurance attorneys and company representatives in order to assist in establishing a standard efficiency and competency in rendering legal service to insurance companies, and to disseminate information on insurance legal topics to its membership. In 1985, the name was changed to Federation of Insurance and Corporate Counsel, thereby reflecting the changing character of the law practice of its members and the increased role of corporate counsel in the defense of claims. In 2001, the name was again changed to Federation of Defense and Corporate Counsel to further reflect changes in the character of the law practice of its members.

The FEDERATION OF DEFENSE & CORPORATE COUNSEL QUARTERLY, published quarterly through the office of publication by the Federation of Defense & Corporate Counsel, Inc., 11812-A North 56th Street, Tampa, FL 33617.

All inquiries as to subscriptions or back issues should be addressed to the Executive Director - FDCC, 11812-A North 56th Street, Tampa, FL 33617.

Subscription Rates: Non members $60.00 per year or $15.00 per copy. (International - $70.00) College/University/Law School Libraries $50.00 per year or $12.50 per single issue (International - $60.00)

Entered as Periodicals matter at Tampa, Florida and additional mailing offices.

Manuscripts and correspondence relating to the submission of articles for possible publication should be sent to the Editor, Professor John J. Kircher, Marquette University Law School, 1103 West Wisconsin Avenue, P.O. Box 1881, Milwaukee, WI 53201-1881. All other correspondence should be directed to the Executive Director.

Views expressed by authors are solely their own and do not necessarily reflect the position of the Federation, its Officers, or the Editor.

The FDCC is pleased to provide electronic access to Quarterly articles from 1997 to present at its Internet website, www.thefederation.org.