Trade Secret Insurance

By Drew E. Pomerance

Suppose your client hires a rising star away from a competitor in its industry to improve the company's manufacturing process, design a superior product, improve distribution methods, or revamp the marketing approach. Shortly after the whiz kid begins working for your client, the previous employer files a lawsuit against him or her, and your client, for a whole host of wrongful conduct, including the primary allegation of misappropriation of trade secrets pertaining to its client list, production process, marketing techniques, and the like.

Naturally, you review the client's comprehensive general liability (CGL) policy to see if it has coverage for this lawsuit, and you are relieved to come across the portion of the insurance policy that provides coverage for "advertising injury." You read that there apparently is coverage for "the misappropriation of advertising ideas or style of doing business." Because neither *advertising ideas* nor *style of doing business* are defined anywhere in the policy, you conclude that the claims probably fall within the policy's language, and therefore the carrier will likely defend the lawsuit.

Unfortunately, that good feeling may be short-lived because a defense for a misappropriation of trade secret cause of action, not to mention coverage (or indemnity) for the claim, is anything but certain. But if you learn a few things about the policy's language and the controlling case law, you can increase your chances of convincing the liability carrier to defend your client in that nasty lawsuit.

Exactly What Is Covered?

It is a serious mistake to take a couple of words or phrases out of context and assume that coverage is in order, so you must examine the language of the policy carefully. A typical CGL policy provides for "personal and advertising injury" coverage. *Advertising injury* is then defined in the policy as an injury other than bodily injury or property damage arising out of one or more of the following offenses committed in the course of advertising activities: (1) slander, libel, or disparagement; (2) violation of a person's right of privacy; (3) misappropriation of advertising ideas or style of doing business; or (4) infringement of copyright, title, or slogan.

In the context of a misappropriation of trade secret claim, item 3 would appear to trigger coverage. Because neither *advertising ideas* nor *style of doing business* is defined within the typical CGL policy, courts should, and probably will, give a fairly broad meaning to those terms. See, e.g., *Lebas Fashion Imports v ITT Hartford Ins. Group* (1996) 50 CA4th 548, 557-567 (trademark infringement case).

However, you cannot end the analysis here. There is an important qualifier in the policy, that the enumerated offense must occur "in the course of advertising activities." That phrase is specifically defined by the policy to mean "the widespread distribution of material promoting your goods, products, or services."

So having read the policy, what conduct is really covered? The plain language of the policy suggests that the insured should be covered for any liability for economic damages caused by the misappropriation of the plaintiff's advertising ideas or its style of doing business during or as part of the insured's advertising or marketing of its products or services.

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Ninth Circuit Cases

The courts have wrestled a bit with how this language works in the real world. However, two recent decisions from the Ninth Circuit Court of Appeals, which reach opposite results, have shed some light on the nature and extent of the coverage provided by the advertising injury clause for misappropriation of trade secret claims.

In *Simply Fresh Fruit, Inc. v Continental Ins. Co.* (9th Cir 1996) 94 F3d 1219, the insured was sued for misappropriation of trade secrets and tendered defense of this suit to its liability carrier under the advertising injury coverage. The court held that there was no coverage (and therefore no defense) available because there was no nexus between the alleged misappropriation and any advertising activities of the insured. The alleged misappropriation involved a mechanical method for processing fruit and could not have occurred as part of the insured's advertising activities. "The advertising activity must cause the injury, not merely expose it." *Simply Fresh Fruit,* 94 F3d at 1223.

In *Sentex Systems, Inc. v Hartford Accident & Indem. Co.* (9th Cir 1996) 93 F3d 578, a company called Electronic Security Systems, Inc. (ESSI) brought an action against Sentex Systems and one of its employees, Paul Columbo, who had previously been a key employee of ESSI, alleging that Sentex induced Columbo to breach his noncompetition agreement with ESSI and work for Sentex. ESSI further alleged that Sentex, through Columbo, had misappropriated ESSI's trade secrets, including its marketing techniques. Sentex tendered defense of the ESSI lawsuit to Hartford under the advertising injury provision of its CGL policy. Hartford refused the defense, so Sentex had to defend itself and ultimately settled with ESSI. It thereafter brought suit against Hartford for breach of a duty to defend.

Like most standard CGL policies, the advertising injury provision in Sentex's policy with Hartford required that the misappropriation occur in the course of advertising Sentex's goods, products, or services. Hartford argued that *misappropriation of advertising ideas* must be narrowly drawn to encompass only wrongdoing that would involve the theft of the text, words, or form of an actual advertisement.

The Ninth Circuit rejected this narrow construction, saying that this particular policy language was broader than just the misappropriation of actual advertising text because it used the word *ideas.* 93 F3d at 580. The court also held that for purposes of obtaining a defense, Sentex need not show that it used ESSI's advertising ideas directly in its written sales materials. "In this day and age, advertising cannot be limited to written sales materials, and the concept of marketing includes a wide variety of direct and indirect advertising strategies." 93 F3d at 580. The allegations of ESSI's complaint revealed the possibility that Sentex had misappropriated ESSI's advertising ideas, and the court of appeals agreed that Hartford breached its duty to defend.

Simply Fresh Fruit is distinguishable from *Sentex* (and thus both cases were correctly decided) because the misappropriation in *Simply Fresh Fruit* pertained only to the method of processing the product. There were no allegations that any marketing information was misappropriated, and, therefore, no potential existed for an advertising injury committed in the course of the plaintiff's advertising activities. In *Sentex,* it was "significant that ESSI's claims for misappropriation of trade secrets relate to marketing and sales and not to secrets relating to the manufacture and production of security systems." 93 F3d at 580.

One court expressly assumed that, at least for purposes of review of a grant of summary judgment, there was a sufficient nexus between alleged trademark infringement and the act of advertising the products. *Lebas,* 50 CA4th at 557. However, *Lebas* was pointedly distinguished in a subsequent misappropriation case. *Monarch E & S Ins. Servs. Inc. v State Farm Fire & Cas. Co.* (CD Cal 1999) 38 F Supp 2d 841, 845.

Bank of the West

Insurers often seize on the California Supreme Court's decision in *Bank of the West v Superior Court* (1992) 2 C4th 1254, as justification for refusing a defense. In that case the court held that there was no coverage because the

insured had failed to demonstrate a causal connection between the harm from the alleged unfair competition and the advertising activities, as required by the policy.

Insured policyholders should be aware, however, that although the carrier's analysis may be appropriate in assessing whether there is ultimately coverage for the offense, it is not correct when determining whether, in the first instance, the insurer owes its insured a defense for the misappropriation claim.

A closer reading of *Bank of the West* reveals that the court was careful to limit its holding to whether there was coverage for the enumerated defense and not whether the insurance carrier owed a duty to defend. 2 C4th at 1258; accord, *Pacific Group v First State Ins. Co.* (ND Cal 1993) 841 F Supp 922, 934. To emphasize the limited nature of its ruling, the Supreme Court distinguished the case of *John Deere Ins. Co. v Shamrock Indus., Inc.* (D Minn 1988) 696 F Supp 434, because the *John Deere* case decided a duty to defend issue and not, directly, a coverage issue. 2 C4th at 1276. With respect to evaluating an insurance carrier's duty to defend, *Bank of the West* arguably does not control.

There is a big difference between being covered for a claim and being entitled to a defense.

Is There a Duty to Defend?

There is a qualitative difference between having insurance coverage for a claim and being entitled to a defense attorney at the insurer's expense. An insurance carrier's duty to defend is separate from and much broader than its duty to provide coverage (i.e., indemnity) for the loss. The insurer owes a duty to defend its insured against claims that create a mere potential for indemnity. Thus, the duty to defend will exist even if it is later determined that the underlying claim was not covered. "The carrier must defend a suit which potentially seeks damages within the coverage of the policy. Implicit in this rule is the principle that the duty to defend is broader than the duty to indemnify; an insured may owe a duty to defend its insured in an action in which no damages ultimately are awarded.... Hence the duty may exist even where coverage is in doubt and ultimately does not develop." *Montrose Chemical Corp. v Superior Court* (1993) 6 C4th 287, 295 (cites omitted).

Therefore, for an insurance carrier to avoid providing a defense, it must affirmatively negate any possibility of coverage. You need not prove that coverage exists; rather, the burden is on the carrier to prove that coverage *does not* and *cannot* exist. "To prevail, the insured must prove the existence of a potential for coverage, while the insurer must establish the absence of any such potential. In other words, the insured need only show that the underlying claim may fall within the policy coverage; the insurer must prove it cannot." *Montrose,* 6 C4th at 300. In practice, the shifting of this burden should make it much more difficult for a carrier to avoid providing a defense. The carrier cannot escape its duty by simply opining that coverage is doubtful or even highly unlikely.

In order to defeat a duty to defend, the insurer "must establish as a matter of law that there was no potential coverage for third party claims." *A-H Plating Inc. v American Nat'l Fire Ins. Co.* (1997) 57 CA4th 427, 443. This means that the insurance carrier must prove that the underlying complaint against its insured "can by no conceivable theory raise a single issue which could bring it within the policy coverage." *Charles E. Thomas Co. v Transamerica Ins. Group* (1998) 62 CA4th 379, 380.

Prisoner of the Complaint?

Even if it appears that the carrier can make such a showing, you are not necessarily out of luck. A defense may still be warranted. Insurers often try to hide behind the four corners of a plaintiff's complaint as the justification for refusing a defense. Essentially, if the plaintiff does not precisely allege a misappropriation

of advertising ideas occurring in the course of your client's advertising activities, the carrier will argue that there is no conceivable basis for coverage under the complaint as pleaded.

Fortunately, California law does not make the insured a prisoner of the words used by the plaintiff in its complaint. If the carrier learns of facts from any source that might reveal the potential for coverage, a defense is required. Thus, the duty to defend "is not measured by the technical legal cause of action pleaded in the underlying third party complaint, but rather by the potential for liability under the policy's coverage as revealed by the facts alleged in the complaint or otherwise known to the insurer." *CNA Casualty v Seaboard Surety Co.* (1996) 176 CA3d 598, 606. Rather, "the duty to defend should be fixed by the facts which the insurer learns from the complaint, the insured, or other sources. An insurer, therefore, bears a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability under the policy." 176 CA3d at 607, quoting *Gray v Zurich Ins. Co.* (1966) 65 C2d 263, 276-277. Thus, although the complaint filed in the underlying action is certainly the initial source of information, the insurer must consider additional information it obtains from other sources.

The insurer's duty to defend may exist even if it is later determined that there is no coverage.

In general, failure to make an adequate investigation before denying a claim will bar the carrier from denying coverage. *Stalberg v Western Title Ins. Co.* (1991) 230 CA3d 1223, 1233.

Even if there is no coverage for the acts as alleged within the complaint, the existence of additional facts will trigger a duty to defend when, because of those facts, the complaint could reasonably be amended to give rise to a liability that would be covered. *Montrose,* 6 C4th at 299.

Uses of Discovery

Presumably the extrinsic facts can be developed through discovery or can be furnished by the insured outside the formal discovery process. For example, assume that the whiz-kid employee is alleged to have misappropriated the competitor's client list and its method for mass-producing its product. These allegations, of themselves, probably do not give rise to a duty to defend, since there is no allegation that any of the competitor's advertising ideas or its style of doing business was misappropriated in the course of your client's advertising activities. *Sentex,* 93 F3d at 581. Suppose, however, that prior to litigation the competitor wrote your client several cease and desist letters in which it complained about your client's distribution of brochures to customers, promoting a supposedly new product that allegedly bore a striking resemblance to some of the competitor's marketing material. Notwithstanding the precise allegations of the complaint, this extrinsic evidence will likely trigger the carrier's duty to defend. You should alert the carrier to such facts that give rise to the potential that the client may have misappropriated its competitor's style of doing business in the course of the widespread distribution of promotional material.

Conclusion

Coverage provided by the advertising injury provision of a CGL policy is not a panacea for every allegation that could be brought against a business for misappropriation of trade secrets. As demonstrated above, carriers often put the insured through the task of proving that coverage exists, or they will blind themselves to any relevant facts that are not specifically alleged in the complaint. However, if you are familiar with the laws that interpret advertising injury coverage, as well as those cases that discuss, in general terms, a carrier's duty to defend, you will be in a much better position to argue to the carrier that the insured is entitled to a defense. ❑