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Publisher: Mary Ellen Fox

Executive Editor: Donna M. Higgins

Production Coordinator: Tricia Gorman

Managing Editor: Robert W. McSherry

Editors:
Brett Goncher, Esq.
Brett.Goncher@thomsonreuters.com
Melissa Sachs, Esq.
Melissa.Sachs@ thomsonreuters.com

Managing Desk Editor: Robert W. McSherry

Senior Desk Editor: Jennifer McCreary

Desk Editor: Sydney Pendleton

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Thomson Reuters
175 Strafford Avenue
Building 4, Suite 140
Wayne, PA 19087
877-595-0449
Fax: 800-220-1640
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How to avoid common legal pitfalls when selling or buying an insurance agency

By Alicia Mitchell Chandler and Rick Dennen,
Oak Street Funding

In the current market, opportunities to buy and sell insurance agencies are plentiful. These opportunities, however, can turn into legal nightmares for the unwary. This article will analyze some of the most common legal pitfalls when selling or buying an insurance agency and how to address them on the front end so there are no regrets and no potential lawsuits.

FOR THE SELLER

Before you put your agency on the market, there are several important aspects to consider before signing an agreement with a plethora of representations and warranties that could come back to haunt you.

The analysis should start with the ownership structure of your agency. Is it a sole proprietorship, a corporation, limited liability company or corporation with multiple owners or silent investors from whom you need consent in order to undertake the sales process?

If it is a legal entity, first ensure that it is in "good standing" with the secretary of state's office. Next, locate and review your bylaws or articles of incorporation to determine if there are any obstacles that may impede your ability to sell the agency. Consider whether you want to sell the assets of your agency or the stock, which includes all assets and liabilities, and determine what is most attractive to a potential buyer.

If you decide to sell your agency through an asset purchase agreement, you would be selling the tangible assets of your agency, such as furniture and computers, as well as the intangible assets of your agency, such as your book of business and your client list. If you decide to sell your agency through a stock purchase agreement, you would be selling your actual shares in the agency to another party; by inference, this includes all assets that are owned by the agency.

There are important distinctions and considerations when determining your sale structure, including the assumed liabilities and tax implications. Stock sales can be more complex, requiring additional negotiations over the potential liabilities that may come along with the stock. Attorneys and accountants will prove beneficial in guiding you through this decision.

An often forgotten, but simple item is to ascertain whether you or your agency has any outstanding liens or encumbrances that would impede you from selling the agency assets free and clear. It is worth obtaining a public search to determine if any liens have been filed against your or the agency, such as financing statements filed with the secretary of state where you operate, state tax liens, federal tax liens or judgments. These should be cleaned up before a sale or, at a minimum, disclosed to a buyer.

Locate and review your bylaws or articles of incorporation to determine if there are any obstacles that may impede your ability to sell the agency.

Another seemingly simple, but often ignored task is to pull and review all current carrier contracts to determine whether you individually, the agency or the carrier is listed as the owner of the expirations or book of business. Remember, ownership also varies among carriers. Some carriers grant ownership to agents/agencies, while others specifically retain ownership. Knowing these facts will help structure the asset purchase agreement and determine whether you will have to sign individually as the "seller" of the book of business.

Some carriers require express written notice from you if you anticipate selling your agency or transferring its ownership. Furthermore, some carriers require a buyer to undergo an application process to be approved by the carrier before any sale. Absent such notice, some carriers may not approve of the buyer and this will destroy your sale.

It is imperative that all of your employee producers — namely, those who sell, solicit or negotiate insurance — have signed employment agreements with

Rick Dennen (L) is the president and CEO of **Oak Street Funding**, a company he founded in June 2003. In addition, he is an instructor at the Indiana University Kelly School of Business. He can be reached at rick.dennen@oakstreetfunding.com. **Alicia Mitchell Chandler** (R) is chief counsel for Oak Street Funding and is responsible for managing legal services for the company, including negotiations, contracts, collections, litigation and direction of work with outside law firms. She can be reached at: alicia.chandler@oakstreetfunding.com.

non-solicitation and non-competition language. Additionally, make sure the agreement provisions are enforceable under your state laws. Some states are very liberal and construe these against the employer or are very sensitive about the time and radius of the restrictions.

For example, in Indiana, an appeals court dictated the following three-part test to determine whether a covenant not to compete in connection with a sale is overbroad. The court analyzed:

- Whether the covenant is broader than necessary for the protection of the buyer in some legitimate interest.
- The effect of the covenant upon the seller.
- The effect of the covenant upon the public interest.[1]

Ultimately, courts will look to whether the covenant is reasonable as to time, space and the activity restricted. Thus, it is advisable to have an attorney help you draft a sample employment agreement, which will undoubtedly be upheld in your state.

Without these protective provisions, employee producers may see this as an opportunity to try to steal your clientele and book of business or hold you or the agency ransom during the sale process. Make sure none of your employees are listed on carrier contracts such that they could assert "ownership" of the book of business. Having these agreements in place will bring value to the table and help alleviate further concerns from a buyer.

Before allowing a potential buyer to conduct due diligence, make sure the buyer signs an enforceable confidentiality agreement. Again, it is advisable to have an attorney assist you with drafting a document that can protect your book of business — your most valuable asset —in the event a sale does not materialize. The last thing you need is for a buyer to start stealing your customers and book of business during the sale process.

Confidentiality agreements offer another benefit; they can help protect you from possible HIPAA[2] violations. HIPAA, or the Health Insurance Portability and Accountability Act, imposes duties on you to keep private all of your customers' individually identifiable health information. This is a concern for your customers and is required by your carrier contracts. Violations often vary from case to case, but can involve both monetary and criminal penalties.[3]

An asset purchase agreement or stock purchase agreement protects sellers from things such as poor buyer due diligence, indemnification claims or a seller carry-back note. As a result, it is important to properly draft one. Determine whether your buyer will be paying cash for the transaction and, if so, obtain proof of funds. Alternatively, request that you carry a seller note or obtain outside financing.

Before allowing a potential buyer to conduct due diligence, make sure the buyer signs an enforceable confidentiality agreement.

For an asset sale or sale of the book of business, it is critical to correctly list all "assets" that are being sold, both tangible and intangible. These can range from the book of business to office furniture. Often, sellers forget about apportioning a value to assets such as goodwill, phone numbers, Internet site, intellectual property or company name.[4] These intangibles can have value depending on the amount of client traffic attributable to each. Other items to sell can include rights under various business contracts, prepaid expenses, permits, accounts receivable, or tax credits/refunds.

Equally important is to correctly identify a list of assets to sell and to exclude from the sale, such as personal cell phone numbers, policies for family members, corporate books and records, any information necessary for sellers to comply with federal or state regulations, and monies from commissions earned up to the date of sale.

It is advisable to review the numbers and discuss what, if any, liabilities you want a buyer to assume, such as lease obligations or obligations to pay for unpaid employee commissions due after the closing of the sale.

The discussion of the purchase price is obviously of utmost importance. In the current market, the sale price is usually a multiple of the revenue of the seller's book of business. Some buyers prefer to pay a lump-sum purchase price at closing, while other buyers prefer an extended earn-out period based upon revenue performance after the sale. The latter may carry some baggage as the parties may have to negotiate the revenue and final earn-out numbers if they disagree some six to 18 months down the road (or whatever extended timeframe you choose).

The buyer may raise concerns about non-solicitation and non-competition agreements. Typically, a buyer will want you, as the seller, to agree to a multi-year restriction. Depending upon the reasons why you are selling your agency, such restrictions may or may not pose a threat. If you are selling in order to retire, these restrictions would not appear to be of much concern. But if you are selling to obtain a good price and start a new agency or line of business, you should pay careful attention to the time and radius restrictions. Again, it is advisable to have an attorney review these provisions in order to make sure they align with your ultimate goals after the sale.

Finally, when reviewing the purchase agreement, pay careful attention to the representations and warranties sections. Make sure you can, without a doubt, affirmatively state that each representation and warranty is true, especially when it comes to the assets being sold as free and clear of all liens and encumbrances, business revenue or commission streams, and financial statements.

Most purchase agreements contain an indemnification provision that allows a buyer to come back on the seller for false or misleading representations or warranties that cause a buyer some sort of loss. Typically these indemnification provisions are limited to a relatively short timeframe, so your exposure can be limited in some respects.[5]

FOR THE BUYER

Before you purchase an insurance agency, there are numerous items that you should consider before signing on the dotted line.

One of the most important is to determine whether the party selling you the assets or book of business has the authority to sell them to you free and clear of all liens and encumbrances. The number of sales that have occurred without the buyer properly

completing due diligence is astonishing.[6]

While a buyer will parse through the carrier information and commission stream, typically that same buyer will not run a lien search or ensure the correct parties execute the purchase agreement. Whether it is the purchase of a $100,000 or a $1 million agency, this issue is important and must not be neglected. The consequences can be disastrous for you as the buyer.

Let's run through an example. The buyer desires to buy an agency from the seller. The seller has an existing loan for its agency with the bank. The bank has a lien on all the agency's assets, including all its commissions from its carriers. The bank files a financing statement with the state. The buyer fails to perform a lien search and purchases the agency's assets from the seller. The seller intentionally does not advise the bank of the sale, takes the purchase price, fails to pay off the bank and flies to the Bahamas.

The bank, upon learning of the sale, contacts the buyer and demands that the buyer pay the bank the entire purchase price (again!). Otherwise, the bank threatens it will exercise its rights and remedies under the applicable Uniform Commercial Code to foreclose on the assets and sell them. This headache could have easily been avoided by performing a public lien search for just a few dollars.

It is also important to ascertain whether the seller actually owns the assets being sold. A buyer must verify that the seller or agency is the "agent of record" with each carrier and has the right to transfer the expirations/book of business. Further, it is advisable to make sure each carrier provides written consent to the potential sale or approval of you as a buyer.

Obviously, continuity of employees is another factor to consider as a buyer. A buyer must determine what producers or staff should be retained and bring value to the business. Determine who holds the relationships — the seller or the individual producers — and whether the employees have an existing employment agreement with restrictive covenants (that is, provisions that provide that following termination of the employment relationship, the producers are restricted from soliciting current customers and/or competing in selling similar insurance products for a certain time frame). If no agreements are in place, it is best to have employees enter into agreements as part of the hiring process to work for the buyer's new agency.

In addition to restrictive covenants for employees — especially producer employees — consider the restrictive covenants necessary for all owners/principals of the seller. In order to fully make this assessment, you must determine whether the seller is exiting the business entirely (such as by retirement) or simply changing careers. Also, make sure that your time and radius restrictions are reasonable and will be upheld in your state if later challenged by the seller for any violation.

With respect to the purchase agreement, a buyer will desire the opposite of some provisions discussed for a seller. Make sure the correct party identified as the "seller" actually owns the assets being sold. Again, one of the most important items is a representation that the assets being purchased are free and clear of all liens and encumbrances or will be as a result of a payoff due to the sale. A well-worded indemnification provision is important for any buyer so he has recourse in the event any of the representations and warranties are false or incorrect. Sometimes parties include the restrictive covenants in a purchase agreement, but it can also be a separate stand-alone document.

While the items in this commentary are not an exhaustive list of issues that can arise when undergoing the buying/selling of any insurance agency, they definitely provide a solid foundation. The bottom line is to always take your time, perform your due diligence and consider having competent counsel who understands the nature of the insurance business. WJ

NOTES

[1] *Dicen v. New Sesco Inc.*, 806 N.E.2d 833 (Ind. Ct. App. 2004), *transfer granted, opinion vacated*, 822 N.E.2d 975 (Ind. 2004), *aff'd in part, vacated in part, remanded,* 839 N.E.2d 684 (Ind. 2005).

[2] Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, 110 Stat. 1936 (1996).

[3] While HIPAA does not create a private cause of action for those aggrieved (*see* 65 C.F.R. § 2566), failure to comply with HIPAA and the privacy rule can result in imposition of federal civil and criminal penalties (42 U.S.C. § 1320d-5). These fines and penalties range from as low as $100 per incident/annual maximum of $25,000 for repeat violations for negligent disclosures, to $50,000 per violation with annual maximum of $1.5 million for uncorrected willful negligent violations, along with fines of up to $250, 000 and imprisonment for up to 10 years where unauthorized identifiable health information has been intentionally used for "commercial advantage." *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

[4] *See, e.g., Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 555 (1993), *citing Boe v. Comm'r of Internal Rev.*, 307 F.2d 339, 343 (9th Cir. 1962). ("The short-hand description of goodwill [is] 'the expectancy of continued patronage.'"); *see also*, *Rice v. Angel*, 11 S.W. 338, 339 (Tex. 1889) ("Goodwill may be properly enough described to be the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.").

[5] An example of such a provision follows:

> Indemnification. The parties hereto agree that their respective representations, warranties, covenants and agreements contained in this Agreement shall survive the Effective Date for a period of one (1) year.
>
> (a) Indemnification by Seller. Seller hereby agrees to indemnify, defend and hold Buyer harmless from and will reimburse Buyer for any and all liabilities, claims, demands, losses, causes of action, taxes, penalties, and assessments to be made or levied against Buyer as follows:
>
> (i) From acts, omissions or conduct of Seller prior to Closing, including any and all liability for any claim or cause of action (referred to herein as a "claim") arising from the operation of Seller's business or any products or services sold by Seller, its employees and agents. Seller's indemnity for claims shall be contingent upon Buyer's providing Seller with written notice of such claims. Seller shall have thirty (30) days from the date of its receipt of such notice to remedy the situation and to resolve and/or satisfy fully the claim, subject to Seller's obtaining stays or extensions of the time within which Buyer must respond to the claim(s) of at least an additional thirty (30) days from the original response date so that Buyer has no obligation to respond until after the expiration of the thirty-day period within which Seller may remedy the situation and resolve and/or satisfy the claim. Regardless of whether Seller remedies the situation and resolves and/or satisfies the claim, Buyer is entitled to have full indemnification for any costs and expenses, including reasonable attorneys' fees, incurred by Buyer as a result of the claim.

(ii) From the breach of any representations, warranties or covenants of Seller contained in this Agreement.

(b) Indemnification by Buyer. Buyer hereby agrees to indemnify, defend and hold Seller harmless from and will reimburse Seller for any and all liabilities, claims, demands, losses, causes of action, taxes, penalties, and assessments to be made or levied against Seller as follows:

(i) From acts, omissions or conduct of Buyer on or after Closing, including any and all liability for any claim or cause of action (referred to herein as a "claim") arising from the operation of Buyer's business or any products or services sold by Buyer, Buyer's employees and/or Buyer's agents. Buyer's indemnity for claims shall be contingent upon Seller's providing Buyer with written notice of such claims. Buyer shall have thirty (30) days from the date of Buyer's receipt of such notice to remedy the situation and to resolve and/or satisfy fully the claim, subject to Buyer's obtaining stays or extensions of the time within which Seller must respond to the claim(s) of at least an additional thirty (30) days from the original response date so that Seller has no obligation to respond until after the expiration of the thirty-day period within which Buyer may remedy the situation and resolve and/or satisfy the claim. Regardless of whether Buyer remedies the situation and resolves and/or satisfies the claim, Seller is entitled to have full indemnification for any costs and expenses, including reasonable attorneys' fees, incurred by Seller as a result of the claim.

(ii) From the breach of any representations, warranties or covenants of Buyer contained in this Agreement.

[6] *See e.g.*, *All Bus. Corp. v. Choi*, 634 S.E.2d 400 (Ga. Ct. App. 2006).

DEFENSE COSTS

Health Net seeks rehearing over defense costs in benefits suit

A health insurer is urging a California appellate panel to reconsider a May decision limiting professional liability coverage for defense costs in a class-action suit over its alleged underpayment of claimants' medical expenses.

Health Net Inc. v. RLI Insurance Co. et al., No. B224884C, petition for reh'g filed (Cal. Ct. App., 2d Dist., Div. 3 June 4, 2012).

Health Net Inc. says the 2nd District Court of Appeal panel correctly held that the company's primary and excess policies potentially covered some charges in two underlying class-action lawsuits

The panel erred, however, when it found that Health Net's $25 million primary professional liability policy barred it from recouping defense costs for claims arising from dishonest acts, the petition for rehearing says.

The defendants were primary professional liability insurer AISLIC and excess insurers Executive Risk Specialty Insurance Co., RLI Insurance Co. and Certain Underwriters at Lloyd's London.

In a 2009 decision, Superior Court Judge Carolyn J. Kuhl found the insurers owed no coverage to Health Net.

Relying on a finding in the underlying class action that Health Net knowingly and willfully used outdated data to process claims, Judge Kuhl decided that a "dishonest acts" exclusion in AISLIC's primary policy's precluded coverage for the entire suit.

> "The court's opinion addresses the 'claim' language in [the policy's] defense provision but overlooks the 'or law suit' language," Health Net says.

The primary policy, issued by American International Specialty Lines Insurance Co., specifically indicates that AISLIC will cover all reasonable defense costs, not only those incurred defending against covered claims, Health Net argues.

Additionally, the $25 million excess policies issued by three other insurers conform to the primary policy's terms, the petition says.

Therefore, Health Net asks the appellate panel to reconsider limiting the defense costs the insurers must reimburse.

HEALTH NET'S CLAIMS

The 2003 federal court class action alleged Health Net Inc. used out-of-date databases to miscalculate insurance payments for out-of-network medical services. The insurer eventually settled the case in 2008 for $215 million.

In 2006, while the case was ongoing, California-based Health Net sued its four professional liability insurers in the Los Angeles County Superior Court, demanding they pay defense costs.

On appeal, the 2nd District in May reversed Judge Kuhl's summary judgment ruling and remanded for further findings. *Health Net v. RLI Ins. Co. et al.*, 2012 WL 1850929 (Cal. Ct. App., 2d Dist. May 22, 2012) (see *Westlaw Journal Insurance Coverage*, Vol. 22, Iss. 35).

The appellate panel found Health Net's insurers owed no coverage for many of the contractual damages requested in the underlying class action, but it ruled that the dishonest-acts exclusion applied only to specific claims and not to the entire suit.

In its petition for rehearing, Health Net says the primary policy language requires the professional liability insurers to reimburse all defense costs in the class-action suit despite the dishonest-acts exclusion.

The policy expressly requires payment of all defense costs in a suit if at least some of those costs are covered, according to Health Net.

"The professional liability insurance policy at issue here explicitly requires payment of 'all

defense costs' in the underlying 'claim or law suit' provided that at least one covered (or potentially covered) wrongful act is alleged," the petition says.

"The court's opinion addresses the 'claim' language in [the policy's] defense provision but overlooks the 'or law suit' language," it says.

Health Net is asking the panel to "modify its opinion to acknowledge that the plain language of [the policy] requires the insurers to provide a full defense" in the underlying case. WJ

Attorneys:
Plaintiff-appellant: David B. Goodwin and Michael S. Greenberg, Covington & Burling, San Francisco

Defendant-respondent (RLI): Michael R. Davisson, Susan Sullivan and Michael M. Walsh, Sedgwick, Detert, Moran & Arnold, Los Angeles

Defendant-respondent (Lloyd's): Paul K. Schrieffer and Stephen C. Bass, P.K. Schrieffer LLP, West Covina, Calif.

Defendant-intervenor (AISLIC): Andrew J. Waxler and Gretchen S. Carner, Waxler Carner Brodsky LLP, El Segundo, Calif.

Defendant-intervenor (Executive Risk): Wallace A. Christensen, Troutman Sanders LLP, Washington; Robert M. Pozin, Jennifer Mathis, Melissa J. Perez and Jacqueline S. Treu, Troutman Sanders LLP, Irvine, Calif.

Related Court Document:
Petition: 2012 WL 2057898

See Document Section B (P. 30) for the petition.

DISPARAGEMENT

Competitor's suit never alleged disparagement, California federal judge rules

A business liability insurer owed no duty to defend a food and beverage distribution company or its president against a competitor's lawsuit alleging that the policyholder misappropriated trade secrets and engaged in misleading advertising, a California federal judge has ruled.

Bullpen Distribution Inc. v. Sentinel Insurance Co., No. C 12-0894, 2012 WL 1980910 (N.D. Cal., Oakland Div. June 1, 2012).

Bullpen Distribution Inc. and its president, John Brill, argued that the underlying suit triggered the personal and advertising injury provisions in Sentinel Insurance Co.'s policy, the U.S. District Court of the Northern District of California order explains.

U.S. District Judge Claudia Wilken, however, found that the underlying suit never alleged that Bullpen or anyone acting on the company's behalf disparaged the competitor's business or products.

Rather, she said, the suit charged Bullpen with falsely advertising its own services, and Sentinel's policy did not cover those types of allegations.

Therefore, the judge granted the insurer's dismissal motion.

According to the order, Brill and Neil Adelman worked at A.Y. International Inc. before they started Bullpen, a competing operation.

AYI advertises on its website that the company serves as one of the nation's largest close-out wholesalers and liquidators, buying surplus inventory, including grocery products.

Allegedly, Bullpen sought to serve the same market, advertising on its website that "[s]ince 1996, the Bullpen team has been helping specialty foods manufacturers and distributors move excess inventory — quickly and with integrity," the judge cites in her order.

> The policyholder never referred to or disparaged the competitor or its products, directly or by implication, the judge decided.

AYI sued Brill, Adelman and Bullpen in the San Francisco County Superior Court for misappropriation of trade secrets, misleading advertising, conversion, unfair competition and conspiracy.

The suit maintained that Brill and Adelman stole AYI's customer and vendor lists and solicited its clients using this confidential information.

Bullpen also sought to benefit from AYI's reputation and business record, the company asserted.

Bullpen notified Sentinel about AYI's suit, requesting a defense and potential indemnification.

After Sentinel responded that the lawsuit was outside the scope of its policy, Bullpen filed a diversity action against the insurer in federal court. Its complaint included counts for breach of contract, declaratory relief and bad faith.

Sentinel filed a motion to dismiss the federal lawsuit, arguing that California law requires an underlying suit, here, the Superior Court case, to allege trade libel to trigger coverage for disparagement claims.

Therefore, the insurer said, "it has no duty to defend because the AYI complaint does not allege that Bullpen made any derogatory statements about AYI's products or business, or even mentioned AYI by name."

Bullpen maintained, however, that the purportedly disparaging statements need not mention AYI or its product and that the underlying state court suit alleged disparagement by implication.

The complaint alleged that Bullpen wrongfully advertised AYI's business history as its own, the company said. This constituted disparagement by implication, Bullpen asserted.

To support its argument, it cited to three recent federal cases decided under California law that found coverage for disparagement by implication: