

FIDELITY & SURETY REVIEW

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First and Ninth Circuits Rule on Significant Fidelity and Surety Issues

Ninth Circuit finds Trade Secrets are not “Tangible Property” that has “Intrinsic Value” and, therefore, not “Covered Property” under Crime Policy

By: Samuel J. Arena, Jr.
Andrew W. Boczkowski

Employee dishonesty coverage provisions in standard commercial crime policies generally provide coverage for loss of, and loss from damage to, “covered property” resulting directly from “employee dishonesty.” “Covered property” often is defined as “‘money,’ ‘securities,’ and ‘property other than money and securities.’” “Property other than money and securities” is, in turn, defined as “any tangible property other than ‘money’ and ‘securities’ that has intrinsic value” In *Avery Dennison Corp. v. Allendale Mutual Ins. Co.*, 310 F.3d 1114 (9th Cir. 2002), the United States Court of Appeals for the Ninth Circuit determined in a case of first impression under California law that trade secrets did not constitute “tangible property with intrinsic value” under a commercial

crime policy and, therefore, found no coverage for losses allegedly sustained by the insured when one of its employees sold trade secrets to a competitor.

Avery Dennison Corporation (“Avery”) purchased an insurance policy from Allendale Mutual Insurance Company (“Allendale”) which included what the Ninth Circuit described as “special provisions covering crime, including coverage of loss or damage to ‘Covered Property’ caused by employee dishonesty.” 310 F.3d at 1116. The Allendale policy defined “Covered Property” as “money,” “securities” and “property other than money or securities.” *Id.* The policy further provided:

“Property other than Money or Securities” means any tangible property other than “money” and “securities” that has intrinsic value but does not include any property listed in any Coverage Form as Property Not Covered.

Id. Avery made a claim against Allendale when one of Avery’s employees sold trade secrets to a competitor. Allendale denied the claim on the ground that the policy did not cover intangible property, such as Avery’s

(Continued on page 2)

Ninth Circuit *(Continued from page 1)*

trade secrets.¹ The district court granted Allendale's motion for summary judgment and dismissed Avery's Complaint.

On appeal, the Ninth Circuit agreed with the district court that under the plain terms of the policy and the principles established by analogous California cases, "trade secrets are not tangible property with intrinsic value, and therefore do not qualify as covered property under Allendale's policy." *Id.* Citing Black's Law Dictionary, the Circuit Court found that the plain meaning associated with "tangible property" is "[t]hat which may be felt or touched, and is necessarily corporeal." *Id.* (citing, Black's Law Dictionary 1306 (5th ed. 1979)). Having been directed to no California cases addressing trade secrets in this context, the Ninth Circuit looked to California Supreme Court cases which described the meaning of "tangible property" in general liability insurance contracts. The Ninth Circuit found that the focus of coverage for tangible property is the property itself, and does not include intangible economic losses, violation of anti-trust laws or nonperformance of contractual obligations. *Id.* (citing, *Waller v. Truck Ins. Exch., Inc.*, 11 Cal. 4th 1, 17, 44 Cal.Rptr.2d 370, 900 P.2d 619 (1995)). The Ninth Circuit also cited the California Supreme Court for the proposition that "tangible property" is not ambiguous and that "[c]onsistent with the insurer's reasonable expectations, tangible property refers to things that can be touched, seen or smelled." *Id.* quoting, *Kazi v. State Farm Fire & Cas. Co.*, 24 Cal. 4th 871, 880, 103 Cal.Rptr.2d 1, 15 P.3d 223 (2001).

The Ninth Circuit then applied this California precedent and concluded that the trade secrets for which Avery sought to be compensated could not be "touched, seen or smelled." The Circuit Court rejected Avery's contention that some of the secrets were embodied in tangible property, concluding that Avery did not "seek to be compensated for the intrinsic value of some sheets of paper." *Id.* at 1116-17. Instead, the Court found that Avery sought to be compensated for the value of its trade secrets, which it found by no means intrinsic in the pieces of paper by which some of them may have been trans-

mitted. Avery was not deprived of possession of its trade secrets; its trade secrets were merely "shared with a competitor." *Id.* at 1117. The lost value to Avery was in the exclusivity of the knowledge represented by the trade secrets, which the Court found not to be a loss of "tangible property."

The Ninth Circuit also rejected the insured's argument that it should read the policy according to what Avery purported to be its "reasonable expectation of coverage." The Ninth Circuit found "tangible property" not to be an ambiguous term and that its meaning was sufficiently clear that an expectation that it would cover trade secrets was not reasonable. The Court made note of the fact that Allendale produced evidence that no insurer wrote crime policies that covered theft or dishonest disclosure of trade secrets; that Avery's purchase of insurance had not been motivated by the desire to protect trade secrets; and that Avery was informed by its broker that Allendale's policy "excluded" coverage for trade secrets. *Id.*

The Ninth Circuit accordingly concluded that the district court did not err in rejecting Avery's "reasonable expectations" argument and affirmed the district court's decision.² ■

¹ Allendale also relied on exclusions of "indirect" loss, loss resulting directly from "inability to realize income that you would have realized had there been no loss of . . . covered property," and loss "the proof of which as to its existence or amount is dependent upon: . . . a profit and loss computation." Given the court's conclusion that trade secrets are not covered property, it did not address the effect of these other exclusions.

² The Ninth Circuit also concluded that the district court properly granted summary judgment against Avery on its claim of breach of an implied covenant of good faith and fair dealing and found that the district court did not abuse its discretion in denying Allendale's quest for sanctions against Avery for Avery's allegedly false or misleading responses to requests for admissions relating to Avery's expectations concerning the coverage for trade secrets.

First Circuit Rules That Indemnitors Are Required to Allege and Prove Fraud or Collusion to Avoid Repayment Under Indemnity Agreement

By: *Samuel J. Arena, Jr.*
Andrew W. Boczkowski

In keeping with precedent in other jurisdictions, the United States Court of Appeals for the First Circuit recently held under Rhode Island law that the broad discretion provided to the surety by the general agreement of indemnity requires that indemnitors allege and prove fraud or collusion in order to avoid their repayment obligation to the surety. The First Circuit also ruled that the indemnitors could not rely on an absence of good faith on the part of the surety in settling claims unless fraud on the part of the surety or collusion between it and the bond claimants was shown. In reaching its decision, the First Circuit found that the common law rule that all contracts contain an implied covenant of good faith and fair dealing was inapplicable given the stringent language of the indemnity agreement. Fireman's Insurance Co. of Newark, New Jersey v. Todesca Equipment Co., Inc., 310 F.3d 32 (1st Cir. 2002).

In Todesca, the appellants, as principals and indemnitors, entered into a continuing indemnity agreement with Fireman's Insurance Company of Newark, New Jersey ("Fireman's"), as surety, in 1991. Pursuant to the indemnity agreement, Fireman's issued various payment and performance bonds in connection with construction projects involving companies with which appellants were allied or in which they were

beneficially interested. In exchange, appellants agreed to indemnify and hold Fireman's harmless for all losses and expenses Fireman's incurred under the bonds and provided Fireman's with broad discretion to determine whether a claim should be paid, settled or challenged. The indemnity agreement provided:

In the event of any payment by SURETY, SURETY shall be entitled in any accounting with PRINCIPAL or INDEMNITOR(S) to reimburse it for any and all disbursements made by it in good faith in and about the matters contemplated by this Agreement under the belief that it is or was liable for the sums and amounts so disbursed, or that it was necessary or expedient to make such disbursements, *whether or not such liability, necessity or expediency existed.*

310 F.3d at 36. Further, the indemnity agreement placed complete and exclusive authority in Fireman's to determine if claims should be paid:

SURETY shall have the exclusive right in its name or in the name of PRINCIPAL to adjust, settle or compromise any claim, counterclaim, demand, suit or judgment involving any BOND or to take whatever other action it may deem necessary, expedient or appropriate. SURETY'S determination as to whether any such claim, counter-

claim, demand, suit or judgment should be settled or defended shall be binding and conclusive upon PRINCIPAL and INDEMNITORS.

Id. Finally, the agreement also required that its terms be "liberally construed so as to protect, exonerate, and indemnify SURETY." Id.

In 1993, a lawsuit was filed by Coken Company ("Coken") against Fireman's seeking \$44,371.35 and against another surety company for \$139,326.38 for subcontracting work that Coken had performed for companies named in appellant's indemnity agreement. Fireman's did not file an answer to that complaint and no action occurred in the lawsuit until March 1997 when Coken filed for summary judgment. Fireman's did not respond to Coken's summary judgment motion. A motion and judgment was entered against Fireman's for \$139,326.34 plus interest and costs, in June 1997. An execution incorporating costs and interest was subsequently obtained by Coken in the amount of \$153,696.98 against Fireman's. Although there apparently was some confusion over whether Coken correctly pleaded the original amounts against Fireman's and their other surety (a footnote indicates that the amounts were reversed), the First Circuit concluded that the parties appeared to have agreed that Fireman's eventually paid plaintiff \$207,855.55 and incurred attorneys'

(Continued on page 4)

First Circuit Rules

(Continued from page 3)

fees of \$17, 285.79 in defense of the matter.

In August 2000, Fireman's filed suit against appellants in federal district court seeking recovery of more than \$315,000 that it had paid out to various claimants under its bonds. The Coken payment constituted the largest payout for which Fireman's sought repayment. In July 2001, Fireman's moved for summary judgment and appellants objected, based solely upon the amount of the payment to Coken. The motion was granted by the district court and this appeal was taken.

On appeal, appellants argued that the district court erred when it ignored the common law rule that every contract contains an implied covenant of good faith and fair dealing and applied prior case law enforcing the terms of the language of the indemnity agreement. In affirming the decision of the district court, the First Circuit looked to and applied Rhode Island precedent as set forth in Massachusetts Bonding & Insurance Co. v. Gautiere, 69 R.I. 70, 30 A.2d 848 (1943) and also cited a number of decisions from other jurisdictions with similar holdings.

In Massachusetts Bonding, the Rhode Island Supreme Court held that the expansive character of the language in the indemnity agreement indicated that the parties had "lodged in the indemnitee a discretion limited only by the bounds of fraud." Given the language in the

agreement, indemnitors were required to prove that the surety committed fraud or engaged in collusion in order to avoid repaying the surety. The First Circuit rejected the appellants' argument that Massachusetts Bonding could be distinguished on the ground that Massachusetts Bonding involved a situation where it was argued that the surety should pay nothing on a claim, whereas appellants did not deny that they owed something but argued that the surety paid too much on a claim. The First Circuit also rejected appellants' argument that common law covenants of good faith and fair dealing implied in every contract should override the language of the indemnity agreement. Following Massachusetts Bonding, and citing to cases from other jurisdictions, the First Circuit rejected appellants' argument finding that "appellants must live by the terms of their agreement, which entitle Fireman's to repayment for all claims paid by it in the absence of fraud or collusion." *Id.* at 37.

Although the First Circuit's opinion in Todesca, decided under Rhode Island law, may have limited precedential effect for the great majority of surety claim practitioners, it is a well-written opinion which cites to a number of cases from other jurisdictions in support of its holdings. It is definitely worth remembering the next time a principal or indemnitor challenges the surety's payment of bond claims. ■

In The News

Stradley Ronon is pleased to announce that its partner and chair of its Fidelity and Surety Practice Group, Samuel J. Arena, Jr., was appointed chair elect of the Fidelity and Surety Committee of the Tort and Insurance Section of the American Bar Association. Arena, who served as a vice chair of this committee, also serves as a vice chair of the International Association of Defense Counsel, Fidelity and Surety Committee. He will serve as chair elect beginning in August 2003 and will take over as chair in August 2004. ■



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