

***OBTAINING REIMBURSEMENT FOR DEFENSE FEES IN ANTITRUST/
UNFAIR COMPETITION COUNTERCLAIMS CAN FUND AFFIRMATIVE
PROSECUTION OF INTELLECTUAL PROPERTY LAWSUITS***

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I. INTRODUCTION

A number of courts have challenged insurer assumptions that attorneys' fees incurred for pursuit of affirmative relief are never compensable. Commercial liability policies, they readily point out; provide a "duty to defend," not an obligation to fund all aspects of litigation in which an insured is embroiled. An insurer is not a "guardian angel." Its obligations are circumscribed by contract.

While this is true, it does not address the question of what happens when a defendant or counterdefendant is seeking affirmative relief, either by its own counterclaims or its initial complaint that requires the same legal efforts as the defense of the claims against it. Are such fees and costs recoverable, or does the circumstance that they were incurred in aid of the insured's affirmative relief deprive the insured of reimbursement? The answer will vary somewhat depending on which state's law governs, but in general the answer is that defensive expenses are recoverable no matter in what part of the case they are expended.

II. CLAIMANT HP WAS RECENTLY AWARDED \$51.6 MILLION FOR FEES INCURRED IN ITS PURSUIT OF INTELLECTUAL PROPERTY RELIEF WHERE SUCH FEES WERE ALSO "CONDUCTED AGAINST LIABILITY"

- A. In *HP v. ACE*, U.S.D.C., N.D. Cal., San Jose Div., Case No. C-99-20207 JW the U.S. District Court for the Northern District of California entered judgment August 22, 2007 for Hewlett-Packard Company, and against ACE Property & Casualty Insurance Company (*HP v. ACE*, U.S.D.C., N.D. Cal., San Jose Div., Case No. C-99-20207 JW)

The judgment is for the principal amount of \$28,418,671.72 plus prejudgment interest and costs and followed the approval of a Special Master's finding that ACE had breached its duty to pay defense expenses in that amount. The court approved all of the post-tender fees sought. After approval of the amount of interest and costs, the **total judgment** is more than **\$51.6 million**.¹

The insurance coverage action by HP sought expenses incurred in defending a counterclaim for antitrust violations and patent invalidity (*HP v. Nu-kote Int'l, Inc.*, U.S.D.C., N.D. Cal., Civil Case No. 94-20647 JW). In 1999 the federal court found that ACE had a duty to defend HP in the Nu-kote Action (*HP v. Cigna*, 1999 U.S. Dist. LEXIS 20655, 53 U.S.P.Q.2d

1846 (1999)) but ACE refused to do so. HP successfully defended the Nu-kote claims after a sixteen-week jury trial. But ACE continued its refusal to reimburse the defense expenses, challenging whether the substantial defense expenses were objectively reasonable and necessary in defending the Nu-kote counterclaim.

The Nu-kote Action had been initiated by HP against Nu-kote for patent infringement, federal and state trademark infringement, trade dress infringement, and related causes of action arising out of Nu-kote's sale of printer cartridges, use of deceptive packaging mimicking HP's trade dress, and falsely advertising that its inkjet cartridge refill products were approved by HP. The action took a dramatic turn when Nu-kote launched a massive counterattack alleging antitrust claims against HP and seeking to invalidate all of HP's patents which represented over a decade of HP's development of inkjet printers. Nu-kote continued to pursue its claims seeking potentially billions of dollars in damages, even after filing bankruptcy and obtaining permission from the bankruptcy court to press the suit against HP.

HP successfully argued that the costs incurred in **prosecuting** the patent infringement and related claims were "reasonable and necessary" as "**defense costs**," even though HP sought affirmative relief. HP's defense strategy and proof of its affirmative claims of patent and trademark infringement were found by the Special Master and the District Court to be objectively reasonable and necessary to defend against Nu-kote's counterclaims for antitrust violations and patent invalidity. HP's strategy was vindicated when the jury found that Nu-kote infringed HP patents and trademarks and also found that HP had not violated antitrust laws.

HP successfully showed that the expenses for prosecuting affirmative claims could not and should not be separated out from defense expenditures. The bad faith claim against ACE is still pending.

B. Legal Work that Serves Dual Purposes, Advancing the Defense As Well As Claims for Affirmative Relief, Is Recoverable

In evaluating whether to investigate expenses in a claim for recovery of fees incurred in an environmental clean up dispute, the California Supreme Court emphasized that to be

recoverable, the site investigation must amount to a reasonable and necessary effort to avoid or at least minimize liability.² This required application of an objective standard because “motive, however, is ‘hard ... to discern.’” “That is true ... [as to] an individual: a person’s mind and heart typically reveal themselves and conceal themselves at one and the same time. It is truer still ... [as to] a group of individuals: many minds and hearts are then involved, and they cannot simply be added up. And, of course, it is truest ... [as to] a corporation or similar entity” – like the typical commercial or governmental insured: “the ‘mind’ and ‘heart’ of such a one is purely fictive.” *Id.* at 62-63. The court concluded “[w]hat matters here is whether the site investigation expenses would be incurred against liability by a reasonable insured under the same circumstances.” *Id.* at 63.

The burden of proof was on the insured to show the reasonableness and necessity of defense costs by a preponderance of evidence. Where an insurer breached its duty to defend the expenses incurred by the insured, after being shown to be of a particular amount, would be “presumed to be reasonable and necessary as a defense cost with the insurer required “to carry the burden of proof that they are in fact unreasonable or unnecessary.” *Id.* at 64.

C. Intellectual Property Case Law Extends Obligation to Pay for Prosecution Expenses Which Dovetail with Fees Incurred in Defense of a Distinct Lawsuit Where the Fees Are “Conducted Against Liability”

Transferring these observations to an intellectual property dispute setting in *KLA-Tencor Corp. v. Travelers Indem. Co. of Illinois*, 2004 WL 1737297(N.D. Cal. 2004), the court ruled that Travelers had a duty to defend disparagement allegations made by Therma-Wave and Therma-Wave II. *KLA* at *3. *KLA* moved for consolidation of Therma-Wave I and Therma Wave II arguing “that if *KLA* prevailed against Therma-Wave in Therma-Wave I, then statements that Therma-Wave was enjoined from shipping its Opti-Probe products would be true. Thus, resolution of the '055 patent may provide *KLA-Tencor* with a further defense to the disparagement counterclaim in Therma-Wave II.”

The court noted “*KLA* asserts, essentially, that the best defense to the disparagement counterclaims was showing that the '055 patent was valid, and further that Therma-Wave's Opti-

Probe products infringed that patent. Considering KLA's potential for liability based on its internal investigation, this was not an unreasonable strategy.” *KLA* at *4. The court stated that the general rule that “reasonable and necessary costs of defending a lawsuit are recoverable if the insurer breaches its duty to defend,” and summarized the relevant burdens of proof for recovery of such costs when an insurer breaches its duty defend set forth in *State v. Pacific Indem. Co.*, 63 Cal. App. 4th 1535, 1548 (1198); *Aerojet-General Corp. v. Transport Indem. Co.*, and *Barratt American, Inc. v. Transcontinental Ins. Co.*, 102 Cal. App. 4th 848 (2002).

In affirming the special master’s report in HP on December 4, 2006, Judge Ware agreed that all fees incurred in prosecution of claims for pursuit of patent, trademark and false advertising claims against the counterclaimant whose defense was compelled given the character of the fact allegations included therewith, were defenses to that counterclaim. One of the first allegations of which included declaratory relief action that there were no valid patents nor infringement by the defendant counterclaimant.

D. Defense of a Declaratory Relief Action May Include Fees Incurred in Prosecuting a Compulsory Counterclaim re Patent Infringement and Invalidity

Where a patent infringement claim is pursued as compulsory counterclaim to a infringed declaratory relief action asserting noninfringement of that patent, there can be no question that pursuit of a counterclaim is compulsory and that its assertion is “conducted against liability.” *Polymer Industrial Products Co. v. Bridgestone/Firestone, Inc.*, 347 F.3d 935 (Fed. Cir. 2003).

III. DEVELOPING CASE LAW HAS SOUGHT TO DEFINE WHAT CONDUCT IS “DEFENSIVE” IN CHARACTER

Four representative cases offer distinct approaches to this issue.

- *Ultra Coachbuilders, Inc. v. General Security Ins. Co.*, 229 F. Supp. 2d 284, 289 (S.D.N.Y. 2002) (The prosecution of “counterclaims, alleging unfair competition and interference with competitive advantage, were used to argue (albeit unsuccessfully) that the injunction application was barred by the doctrine of unclean hands, see *Ford Motor Co. v. Ultra Coachbuilders, Inc.*, 57 U.S.P.Q.2d

1356, 2000 WL 33256536, at *10 (C.D.Cal.2000), and were thus ‘inextricably intertwined with the defense of [defendant’s] claims and necessary to the defense of the litigation as a strategic matter.’ *Safeguard Scientifics, Inc. v. Liberty Mut. Ins. Co.*, 766 F.Supp. 324 (E.D.Pa.1991).” Thus, there was no reason to diminish the full amount of defense fees owed because of the asserted counterclaims.).

- *Barratt American, Inc. v. Transcontinental Ins. Co.*, 102 Cal. App. 4th 848, 862 (2002) (The case did not address the standard counterclaim scenario. Rather, the insured sued in a construction defect case sought to charge its insurer with the remediation expenses in fixing the homes of parties who had not yet sued it to gain knowledge of what caused the defects as well as the cost of fixing them. This activity was too far afield from the direct defense of the claims against the insured to make it compensable. The court clarified that fees incurred for potentially covered counterclaims conjoined with pursuit of affirmative relief must assess “what expenses would be conducted against liability by a reasonable insured under the same circumstances.”).
- *Great West Cas. Co. v. Marathon Oil Co.*, 315 F. Supp. 2d 879, 882 (N.D. Ill. (E. Div.) 2003) (“ ‘Defense’ is about avoiding liability. Claims and actions seeking third-party contribution and indemnification are a means of avoiding liability just as clearly as is contesting the claims alleged to give rise to liability.”).
- *Hebela v. Healthcare Ins. Co.*, 370 N.J. Super. 260, 277, 280 (N.J. 2004) (“[P]laintiff was . . . entitled to the benefits of that defense in any way it would overlap those services which plaintiff’s counsel would or did render on plaintiff’s behalf in the prosecution of complaint. . . . [T]he burden of persuading the trial judge, by a preponderance of the evidence . . . should fall upon the insurer . . .”).

IV. THE REASONABLE INSURED TEST UNDER *AEROJET* AND *BARRATT* SETS OBJECTIVE LIMITS ON “DEFENSE” ACTIVITY

A. The Reasonable Insured Test

The courts in *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 60, 66 (1997) and *Barratt American, Inc. v. Transcontinental Ins. Co.*, 102 Cal. App. 4th 848 (2002) devised and applied the reasonable insured test to determine whether, under appropriate circumstances, a litigation strategy was reasonable and necessary to a party’s defense when the insurer failed to defend its insured. The test puts a reasonable limit even on a breaching insurer’s defense obligations, but it does not limit defense reimbursement obligations to only those that are obviously and unequivocally defensive. Rather, the cases hold that a broad range of conduct – even non-litigation activities outside the lawsuit itself – may be reasonably and necessarily defensive and reimbursable by the insurer.

B. The Tests

1. The *Aerojet* Test

The reasonable insured test was first articulated by the Court in *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 70 Cal. Rptr. 2d 118, 948 P.2d 909 (1997). It was evaluating whether a defendant in an environmental cleanup action could seek reimbursement from its insurer as defense expenses for site investigation costs. In *Aerojet*, the insured spent over \$26 million for a soil pollution site investigation as a first step to remediate the pollution pursuant to a consent decree. The *Aerojet* Court held that whether the costs were incurred pursuant to government order or for remediation was not the relevant question but that for the costs of the site investigation to be reimbursed, “the site investigation must amount to a reasonable and necessary effort to avoid or at least minimize liability.” *Aerojet*, 17 Cal. 4th at 61.

The Supreme Court held that “[w]hat matters here is whether the site investigation would be conducted against liability by a reasonable insured under the same circumstances.” *Id.* at 62 (emphasis added). The *Aerojet* Court called for an objective test to determine the reasonableness and necessity of defense expenses. It said that the insured’s motive

is irrelevant. *Id.* at 62. *Aerojet* makes clear that reimbursement is not limited to merely defend against “elements” of a claim.

2. The *Barratt* Test

In *Barratt*, the court considered whether a defendant’s repairs to non-plaintiff homes in a construction defect suit could be defense expenses for which the non-defending insurer was responsible. The answer: they might be defense expenses. What a reasonable insured would do to defend “necessarily involves consideration of whether the benefits of the strategy are worth the costs.” *Barratt*, 102 Cal. App. 4th at 862. *Barratt* illustrates the broad scope of activity that may be necessary defense strategy. The case was remanded to determine whether the expense of house repairs would have been conducted by a reasonable insured against liability – **whether** the benefit of the **strategy outweighed** the **costs**.

[A] developer seeking reimbursement for repair costs to homes not the subject of a lawsuit must present **evidence that a reasonable insured would have engaged in a similar defense strategy**, which necessarily involves a consideration of **whether the benefits of the strategy are worth the cost**. . . . “What matters here is **whether the ... investigation would be conducted against liability by a reasonable insured under the same circumstances**.” (*Aerojet-General, supra*, 17 Cal.4th at p. 62.) [*Id.* (emphasis added).]

Under the *Aerojet/Barratt* reasonable insured test, the “prosecution” expenses to which an insurer objects “must amount to a reasonable and necessary effort to avoid or at least minimize liability. [The prosecution] expenses must be reasonable and necessary for that purpose.” *Aerojet*, 17 Cal. 4th at 61. Reasonableness and necessity are determined by whether the costs of the strategy as a whole are worth the benefits.

Notably, the *Aerojet* and *Barratt* courts applied this analysis in the context of evaluating conduct that, on the face of it, would not obviously come within the usual scope of litigation expense, and certainly not to “overlapping claims.” The test is devised to determine whether, in spite of being outside the scope of obvious defense activities, non-obvious conduct may be fairly conducted as a reasonable defense strategy. The *Barratt* court did not suggest a “systematic cost-benefit analysis” for specific expenditures. The test in *Barratt* focuses on **strategies, not**

particular expenditures, that is, whether repairing numerous non-plaintiff houses was a reasonable strategy.

Aerojet and *Barratt* devised a test to determine whether activities remote from conventional defense conduct can nonetheless serve to “avoid or minimize liability and as such would be adopted by a reasonable insured.” To identify conduct a “reasonable insured” would adopt, *Aerojet* discusses conduct “avoiding or *minimizing* liability” and *Barratt* proposes a cost-benefit analysis to objectively determine the reasonableness of defense conduct.

Both cases agree that remote, unconventional and expensive actions may be reasonable defense activity. The activities in question could at most be considered as discovery or research that might or might not reveal an approach to defending against the claims. The cases considered conduct that on its face was unconnected from any direct litigation activity against the opposing parties. The point of applying a “reasonable insured” standard was to objectively analyze unconventional activities.

So, for instance, as *Barratt* makes clear, a cost-benefit analysis is a useful means of determining whether an insured’s conduct is objectively reasonable precisely because there is a question as to the worth of the strategy of repairing houses for non-plaintiffs as a defense strategy. In a case where proof of an affirmative claim serves to directly disprove a counterclaim, no question of the value of the proof to the defense would arise. Such a proof would always be worth the cost and a cost-benefit analysis would be entirely superfluous.

C. Limitations on the Insurer’s Ability to Curtail the Scope of “Defensive” Activity

Insurers’ claims that a strategy is only defensive when it serves as a complete defense misstate the *Aerojet/Barratt* test. In place of a test devised to assess the defensive value of a litigation strategy, insurers submit a narrow, technical mis-interpretation of “conducted against liability.” This “evidence” is irrelevant under the *Aerojet/Barratt* reasonable insured test. Because they narrow the reasonable insured test to the circumstance where affirmative claims and counterclaims overlap, the evidence that insurers would present to satisfy the invented test is

not relevant and insurers, as a matter of law, cannot meet their burden of proof, overcoming the presumption that all litigation conduct was reasonable and necessary.

V. TWO CASES TAKE DIFFERENT VIEWS OF WHAT FEES ARE INEXTRICABLY INTERVENED

In *Bennett v. St. Paul Fire & Marine Ins Co.*, ME Civil No. 04-CV-212-GNZ, NH Civil No. 04-DS-401-PB, 2006 WL 1313059 (D. Me. May 12, 2006), Judge Barbadoro, purporting to apply Maine law, narrowly defined the circumstances when a counterclaimant third-party complaint would be deemed defensive of liability to circumstances where it was “inextricably intertwined” with the defense of the suit against the insured.

Although initially articulating the standard to determine whether prosecution of counterclaims and third-party claims were an insurer’s obligation because “defensive in nature,” looking to the specific language of the professional liability policy, and not relying on a case cited that specifically extended the duty to defend to affirmative claims other than “reasonable and necessary to limit or defeat liability,” it deemed the facts before it as insufficient to meet that standard, stating:

Although Bennett’s counterclaim may put pressure on Liberty to abandon or settle his case, the counterclaim primarily seeks affirmative relief based on allegations that are only tangentially related to Liberty’s complaint.

The court did not define what was tangentially related or advise whether that conduct might be strategically defensive and yet still sufficient to entitle the insured to a defense. Relying on a string of cases that found that there is no obligation to pursue a counterclaim or cross-claim within the meaning of defense, the court then distinguished a number of decisions wherein “inextricably intertwined” fact patterns were analyzed, finding them inapplicable.

Notably, the court did not discuss, much less distinguish, the *Barratt*, *Aerojet*, and *Hebela* cases, which preceded its decision. The court’s incomplete analysis and failure to follow what is

the clear majority trend among cases to date and inappropriately characterizing them as in the minority position does not appear worthy of emulation.

In *Adobe Systems, Inc. v. St. Paul Fire & Marine Ins. Co.*, No. C 07-00385 JSW, 2007 WL 3256492 (N.D. Cal. Nov. 5, 2007), the court stated:

[I]n this matter, Adobe contends that it initiated the London and California actions as a necessary legal strategy to defend itself against an impending claim from Agfa/ITC. The Court finds persuasive the reasoning in *IBP, Inc. v. National Union Fire Ins. Co. of Pittsburgh, PA*, which held that even though an insured initiates a lawsuit, that fact does not automatically preclude coverage for defense-type legal fees and expenses where the insured is resisting a contention of liability for damages. 299 F.Supp.2d 1024, 1031 (D.S.D.2003) (citing *Simon v. Maryland Cas. Co.*, 353 F.2d 608, 613 (5th Cir.1965) (holding that subcontractor insured was entitled to recover legal fees and expenses from insurer for bringing a declaratory judgment action asserting it was not negligent and was entitled to be paid funds withheld by the general contractor, despite a “defense” clause in policy); *Potomac Elec. Power Co. v. California Union Ins. Co.*, 777 F.Supp. 980, 984-85 (D.D.C.1991) . . .

Some lesser connection than “inextricably intertwined” defense activity i.e. evidence at defense fees were “conducted against liability” would suffice to make prosecution fees recoverable.

VI. CONCLUSION

In the classic counterclaim scenario, most affirmative proof will echo the relief sought in the affirmative defenses. Where this is the case, there may be no practical distinction between affirmative and defensive legal activity. In other situations, where the insured goes far afield in its quest for strategically defensive activity that is reimbursable, courts will draw sensible lines. The issue, however, in such line drawing is not whether the activity is also beneficial to the insured but what role it played in limiting liability or damages in the suit pending against the insured. By this standard, not only counterclaims by third-party actions and quests for indemnity would be subject to reimbursement.

¹David Gauntlett and Jim Lowe of Gauntlett & Associates were counsel for the plaintiffs in the HP action.
²*Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 70 Cal. Rptr. 2d 118, 948 P.2d 909 (1997)