

Social Networking: Blunders and Breaches, Benefits and Best Practices continued

- 23 See, e.g., R. Hedges, K. Rashbaum & A. Losey, *Electronic Service of Process at Home and Abroad: Allowing Domestic Electronic Service of Process in the Federal Courts*, 4 THE FEDERAL COURTS LAW REVIEW 1 (2009), <http://www.fclr.org/fclr/articles/html/2009/hedges.pdf>.
- 24 Doug Mandell, Presentation at *Advocating Conference*, January 21, 2010.
- 25 Socialnomics09, *supra* note 6.

INSURANCE FOR BAD FOOD – CHALLENGES AND OPPORTUNITIES

by David Brenner, Riddell Williams PS¹

When we go out to eat, I inevitably like what my wife ordered more than my own selection. Smart risk management would suggest that I always follow her lead when we dine out. But this article concerns risk management for legally bad food, not bad menu selections.

Food recalls have become a fact of daily life. In March 2010 alone, the Food & Drug Administration's Food Recall website identified nearly 40 different recalls, including, ironically, one for a product line called "Foods You Can Feel Good About."² Washington's own Bill Marler, of Marler Clark, maintains on Marler Clark's website a running list of over 25 different food contaminants and the online resources related to them.³ Some, like E. coli and salmonella, are household names, but many, like shigella, are not.

Insurance coverage is determined by the nature of the risk. Risks arising out of food recalls fall into two distinct categories – liability claims for bodily injury to persons allegedly harmed by the food, and economic losses to the businesses affected by the recall.⁴ Such businesses may include food growers, processors, packagers, product manufacturers, distributors, grocery stores and other retail outlets, restaurants and other purveyors.

Whether a business faces liability or property loss claims, it will be very helpful to have insurance when a claim emerges. Unless the business has purchased specific recall insurance, it can expect to run a gauntlet of insurer defenses to coverage. This does not mean coverage will prove unavailable but the claim will call for persistence and thoughtful application of the facts of the claim to the insurance policy language.

Insurance for Liability Risks under Ordinary CGL Insurance

When a business is sued for liability arising out of alleged bodily injury or property damage, the business will most likely look to its commercial general liability (CGL) insurance policy for coverage. Bodily injury is usually defined to include "sickness or disease," so actual illness caused by food-borne pathogens should qualify. Claims by persons for emotional distress from exposure to contaminated foods who do not actually become sick may qualify for coverage depending on the wording of the definition of "bodily injury," for example whether it is limited to "physical harm."⁵

While bodily injury claims provide the headline news, other parties in the chain of food product manufacture will have potential claims for damage to their property. *Olympic Steamship Co. v. Centennial Ins. Co.*⁶ shows how this may arise. Olympic operated a warehouse for salmon packers. It received unlabeled cans of salmon from packers during the fishing season and stored the canned salmon until the packers entered into purchase contracts with their customers. Olympic would then label, case and ship the cans to the packers' customers per the packers' instructions. In 1985, the warehouse discovered that its casing equipment had been crimping some cans and breaking their seals for the past five months, creating a threat of botulism. After testing, the Food and Drug Administration ordered a product recall, requiring either the destruction or return and inspection of cans already shipped. The packers and their customers jointly opted to inspect the cans in the field, salvaged the cans that they could, and then demanded that Olympic reimburse their costs. Olympic paid them and then sought the costs from its insurer.⁷

Substantially similar issues are likely to arise between insured and insurer whether the liability claim is for bodily injury or property damage. For example, it may be important whether the bodily injury occurred as a result of an "accident." The "trigger" clause which states the basic coverage in most CGL policies typically applies to "accidents or continuous or repeated exposure to conditions" Insurers may contend that intentional processes that produce defects in food product are not in themselves "accidents,"⁸ while policyholders can argue in most cases that events leading to food contamination are classic "accidents" because the consequences are unintended by the company. Recent Washington decisions incorporating the concept of "deliberate" acts into the definition of "accident" should favor the insured where Washington law applies.⁹ These cases stand for the common sense proposition that an intentional act can still be an accident if the act was done without awareness of the implications or consequences.¹⁰

A similar issue likely to arise is whether the contamination was "unexpected or unintended" by the insured. The burden is on the policyholder to prove that it did not expect or intend the contamination.¹¹ Proving lack of intent should

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seldom be a problem; what participant in the food chain normally intends to poison its customer? However, proving that contamination is “unexpected” may be harder, especially in situations where a company has a history of sanitary citations and violations. In Washington, the test is the actual subjective expectation of the policyholder rather than the objective expectation of a reasonable person.¹² However, circumstantial and indirect evidence can be considered by the trier of fact in determining the insured’s subjective expectation.¹³ In the food contamination context, this could include knowledge of past inspection failures, contamination problems, and a failure to correct them. Although the test is subjective, a jury is not likely to credit an unreasonable belief, no matter how earnestly expressed.

Another issue is whether exclusions for “your product,” “your work,” and “impaired product” will apply. These exclusions are in the CGL policy to prevent it from becoming a warranty for poor workmanship for the insured’s own product. However, the exclusions for “your product” and “your work” apply only to damage to the product or work itself. If the insured’s product or work is incorporated into or causes damage to a larger product, the damage to the larger product should be covered.¹⁴ The “impaired product” exclusion aims to eliminate coverage if the insured’s product has a defective or dangerous condition that is incorporated into a larger good but only causes loss of use rather than physically injuring it. This exclusion typically applies only if the larger good can be restored to use by the repair, replacement or removal of the insured’s contributing product.¹⁵ The blending and incorporation of ingredients from a wide range of sources into a food product makes modern food production a difficult health challenge. But it also works to avoid the effect of these policy exclusions by damaging the entire product or making it impossible to segregate and remove the contaminated ingredient.

Finally, the policy is likely to have a product recall exclusion. These exclusions are sometimes called “sistership” clauses, after the practice in the aircraft industry of grounding other aircraft when one of the same model had problems. In general, the purpose of such clauses is to eliminate coverage for the insured’s cost of recalling products that have not yet failed.¹⁶ The exclusion may also be limited to recalls of the policyholder’s own product, but not liability for claims by others arising out of the recall.¹⁷ *Olympic Steamship* concerned such an exclusion. The Supreme Court held that Olympic was entitled to coverage because the clause applied only when the insured withdrew its *own* product from the market.¹⁸ The cans of salmon recalled in that case were the packers’ product which Olympic only labeled and warehoused. Some more recent policies have language broader than that at issue in *Olympic Steamship* so it is important to review the specific language of the exclusion in the policy at issue before relying on the *Olympic Steamship* ruling.

Even if these issues are raised on a claim and there is a substantial possibility that they apply, there is still much for a policyholder to consider from its CGL policy. An insured business facing liability claims for bodily injury wants two things from its CGL policy: (1) insurance for its defense costs, and (2) insurance for the cost of settlements or judgments. Defense costs are critical, especially if the insured is facing multiple victims at the same time it is incurring substantial business costs in recalling the contaminated goods.

The right to defense costs is easier to prove than the right to payment of a settlement or judgment. The new decision of the Washington Supreme Court in *Am. Best Food, Inc. v. Alea London, Ltd.*,¹⁹ illustrates how broad the duty to defend is in Washington. Defense costs are determined by the allegations in the complaint. The insurer has a duty to defend “if the insurance policy *conceivably* covers allegations in the complaint” or “if there is any reasonable interpretation of the facts and the law that could result in coverage.”²⁰ Moreover, if this standard is met, the insured must continue to defend until it is clear that the claim is not covered.²¹

By contrast, payment of a settlement or judgment turns on whether the actual facts that occurred in the dispute underlying the liability claim match up with the insurance coverage, i.e., whether the policy *actually* covers the insured’s liability.²² Even if the underlying liability case is settled, the insurer who denies indemnity may attempt to litigate what the policyholder knew about the potential for existence of contamination, whether the damage was to the insured’s own product only, and other potential grounds to avoid covering the settlement or judgment.

First-Party Property Insurance for Food Recalls

Liability insurance applies to claims for injury by third parties. Prompt action by the manufacturer or seller may confine such claims to a bare minimum, but will often lead to a wide range of other expenses and harm. These costs include:

- expenses in investigating the cause and identifying the necessary remedy;
- the cost of implementing a recall, including publicizing it, and recalling, inspecting, storing, destroying, or re-distributing the potentially contaminated products;
- reputational harm including the cost of product and brand rehabilitation; and
- costs of hiring specialized help including crisis consultants and attorneys to deal with transactional and contractual issues.

For such remedial action, an insured will look to its first-party property insurance.

As a starting point, it is important to determine if the property policy covers losses caused by “all risks” or, more narrowly, specifically identified “named perils.” Even if the insurance is broader “all risk” coverage, there are still

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many other parts of the policy that can narrow the insurance, especially the exclusions and the definition of covered damages.

It is important to consider how the loss covered by “all risk” and “named peril” policies is defined. Many policies insure only against “direct” or “physical” loss or damage to the insured property.²³ Insurers will try to interpret this requirement narrowly. Food contamination poses a number of issues concerning the presence of “physical” loss, for example, whether the introduction of impurities that do not render the product unfit for human consumption constitutes physical damage. Courts have recognized that technical violations of FDA regulations or aesthetic problems that are not actual health or safety problems can nevertheless be sufficient to constitute physical damage.²⁴ Another issue is how many food items are physically damaged where only some may be contaminated but it is not economically feasible to determine which items are damaged and which are not.²⁵ If food inventories lose value because of physical damage to other insured property, that can be a basis for recovery.²⁶

Property policies are less uniform than CGL policies. Those property policies sold in the food industry may have narrower or more defined exclusions than ordinary property policies. Here are some exclusions that have generated coverage disputes:

- *Exclusions for “contamination.”* A key to interpreting such exclusions is the specific language,²⁷ especially whether types or causes of contamination are specifically listed or excepted. Even where “contamination” is excluded broadly, it may be possible to restore coverage by showing that some of the causes in a chain of causation are covered (for example, contamination that follows a covered fire or water pipe break).
- *Food contaminated by “pollutants,” essentially a specialized form of contamination.* There is a large body of case law interpreting the meaning and breadth of pollution exclusions. Unfortunately for Washington policyholders, this is one issue on which Washington courts have narrowed coverage by broadly defining the pollution exclusion in policies after 1986 to extend beyond classic “environmental” pollution.²⁸
- *Faulty workmanship exclusions.* These are similar to the “your product” and “your work” exclusion in the liability context, in that the insurer is attempting to avoid supplying an open-ended product warranty of fitness regardless of the cause of the contamination.
- *Governmental action exclusions.* These seek to exclude losses arising out of the exercise of governmental authority²⁹, such as seizure or orders to destroy food by government agencies such as the FDA or Department of Agriculture. Here policyholders can try to

avoid the exclusion by narrowly defining the scope and requirements of government decisions.³⁰

Finally, assuming coverage applies, any business in the food industry will want to carefully consider the types of loss covered by the policy. Conventional insurers are likely to vigorously contest expenses for investigation, recall implementation, restoration of reputation, and consulting expenses.

There are a number of specialized food-industry policies and endorsements on the market that are intended to address some or all of the particular risks to which companies in the food industry are exposed. For example, Liberty Mutual offers its RM Custom Select policy for food processors which includes recall expenses, testing costs, coverage for food stored at third-party locations, utility service interruption for off-site cold storage, spoilage in transit, and business interruption coverage for lost profits.³¹ A broker can walk food-industry policyholders through specific benefits. These policies are not standardized in any way so are not easily addressed in the context of this article. Rather, the point of the discussion here is to demonstrate the issues under traditional insurance, recognizing that some of the challenges with such insurance may be avoided by acquiring specialized food-industry insurance.

Conclusion

The food industry continues to deal with the challenges of an ever widening supply chain. Food contamination is increasingly on the consumer’s radar screen, and the plaintiffs’ bar is well organized to keep it there. Insurance is a potentially effective frontline risk-management tool for potential food contamination losses. Traditional CGL policies may provide a defense to food-injury liability claims, but coverage for settlements and judgments is likely to be more challenging. Traditional first-party coverage may provide insurance for some aspects of a food contamination problem but likely will not cover all economic losses. Businesses in the food industry should give careful thought to the full range of risks to which they are exposed and insure accordingly.

- 1 David Brenner has headed the insurance coverage practice at Riddell Williams, PS, in Seattle since 1990. In that interval, he and his colleagues have recovered hundreds of millions of dollars in insurance claims for policyholders.
- 2 <http://www.fda.gov/Safety/Recalls/default.htm> (last checked 4/8/10).
- 3 <http://www.marlerclark.com/> (last checked 4/8/10).
- 4 Not all recalls on the FDA site are based on actual food contamination. They may occur due to technical violations such as mislabeling and misidentification of ingredients. <http://www.fda.gov/Safety/Recalls/default.htm>.
- 5 See in a non-food context, *Northwest Farm Bureau Ins. Co. v. Roberts*, 52 Wn. App. 888, 891, 765 P.2d 328 (1988); *E-Z Loader Boat Trailers, Inc. v. Travelers Indem. Co.*, 106 Wn.2d 901, 908, 726 P.2d 439 (1986).
- 6 117 Wash.2d 37, 811 P.2d 673 (1991).
- 7 *Id.* at 39-40.

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- 8 See, e.g., *Food Contamination Insurance Coverage Issues: An Insurer's Perspective*, at 6, Cozen & O'Connor website, at http://www.cozen.com/admin/files/publications/Food_Contamination_Coverage_White_Paper_Current.pdf (hereinafter "Cozen White Paper").
- 9 E.g., *State Farm Fire & Cas. Co. v. Ham & Rye, LLC*, 142 Wn. App. 6, 174 P.3d 1175 (2007); *Nationwide Mut. Ins. Co. v. Hayles, Inc.*, 136 Wn. App. 531, 537, 1560 P.3d 589 (2007).
- 10 *Id.*, 136 Wn. App. at 537.
- 11 *Queen City Farms, Inc. v. Central Nat. Ins. Co.*, 126 Wn.2d 50, 71, 881 P.2d 718 (1995).
- 12 *Id.* at 66-67.
- 13 Thomas V. Harris, *Washington Insurance Law* § 22.1 at 22-4 (2006).
- 14 E.g., *S.L. Rowland Constr. Co. v. St. Paul Fire & Marine Ins. Co.*, 72 Wash. 2d 682, 434 P.2d 725 (1967).
- 15 International Risk Management Institute, Inc., *I Commercial Liability Insurance*, at V.D. 213 (Aug. 2009 ed). *Shade Foods, Inc. v. Innovative Prods. Sales & Mktg., Inc.*, 78 Cal. App. 4th 847 (Ct. App. 2000) (presence of wood splinters in almonds caused "property damage" within meaning of commercial general liability policy when contaminated almonds were incorporated into nut clusters and cereal products).
- 16 E.g., *International Env't Corp. v. National Union Fire Ins. Co.*, 843 F. Supp. 1218, 1229 (N.D. Ill. 1993).
- 17 *Washington Insurance Law*, *supra*, at 24-10.
- 18 117 Wash.2d at 44.
- 19 168 Wn. 2d 398 (2010).
- 20 *Id.* at 404, 405 (emphasis added), citing *Woo v. Fireman's Fund Ins. Co.*, 161 Wn.2d 43, 53, 164 P.3d 454 (2007) and *Truck Ins. Exch. v. VanPort Homes*, 147 Wn.2d 751, 58 P.3d 276 (2002).
- 21 *Id.* at 405.
- 22 *Id.* at 404.
- 23 P. Kalis, T. Reiter, J. Segerdahl, *Policyholder's Guide to the Law of Insurance Coverage*, § 13.04 (1997).
- 24 *General Mills Inc. v. Gold Medal Ins. Co.*, 622 N.W.2d 147, 152 (Minn. 2001) (oat product treated with pesticide that violated FDA regulation was physically damaged even though it remained fit for human consumption and did not pose a threat to public safety); *Allianz Ins. Co. v. RJR Nabisco Holdings Corp.*, 96 F. Supp. 2d 253 (S.D.N.Y. 2000) (holding that contamination exclusion did not apply to contamination of food products exposed to trimethyl benzene at the warehouse where they had been stored, which, though posing no health risk, resulted in a displeasing odor and taste); *Zurich Am. Ins. Co. v. Centrale Citrus Juices USA, Inc.*, 2002 WL 1433728, at *3 (M.D. Fla. Feb. 11, 2002) (in CGL case holding "the adulteration of juice sold to Tropicana, was 'property damage' to the extent that, the adulterated juice was blended with other juice products, even though juice was not unfit for human consumption.") .
- 25 See, e.g., *S. Wallace Edwards & Sons, Inc. v. Cincinnati Ins. Co.*, 353 F.3d 367 (4th Cir. 2003) (no duty to minimize damages by trying to sort through thousands of pieces of ham for contamination where selling any of the product posed a risk to human health).
- 26 E.g., *Hampton Foods, Inc. v. Aetna Cas. and Sur. Co.*, 787 F.2d 349 (8th Cir. 1986) (under "all risks" policy, forced sale of food inventory as salvage that had to be removed from a building due to imminent collapse was covered).
- 27 *Stanley Duensing v. The Traveler's Companies*, 257 Mont. 376, 849 P.2d 203 (1993), illustrates the value of careful parsing. In that case, coverage was found for the value of products voluntarily destroyed because of suspected contamination that was later found not to be present, because the exclusion was interpreted to apply only to cases of *actual* contamination.
- 28 E.g., *Quadrant Corp. v. Am. States Ins. Co.*, 154 Wn.2d 165, 110 P.3d 733 (2005); *Cook v. Evanson*, 3 Wn App. 149, 920 P.2d 1223 (1996), *rev. denied*, 131 Wn.2d 1016 (1997).
- 29 E.g., International Risk Management Institute, Inc, *I Commercial Property Insurance* at V.T.12 (Nov. 2009 ed).
- 30 See *Stanley Duensing v. The Traveler's Companies*, *supra*, n.25 at 384-85 (exclusion did not apply because health department embargo did not order government to take possession and destroy goods).
- 31 http://www.libertymutualgroup.com/omapps/ContentServer?c=cms_document&pagename=LMG_Business%2Fcms_document%2FShowDoc&cid=113835700564 6 Internet cite (site last checked May 15, 2010).

TO DEMAND OR NOT TO DEMAND, THAT IS THE QUESTION: IN RE F5 NETWORKS, INC. DERIVATIVE LITIGATION

by Keith J. Seo[†]

I. Introduction

Perhaps it is no longer surprising to hear about millions of dollars of bonuses paid out to the directors and officers of the few companies that, as we hear on the news, could not have stayed afloat without government bailouts. But while the propriety of this type of compensation is subject to debate, another type of compensation is not only improper, but illegal, and has been a subject of controversy and litigation for several years: backdating of stock options.

While the directors and officers of a corporation manage the business and affairs of the corporation, they also have fiduciary duties to the corporation and its shareholders not to cause harm to the corporation. When the directors and officers breach their fiduciary duties by, say, granting backdated stock options, shareholders have standing to bring a corporate cause of action, often called a derivative action, against the directors and officers to redress the harm.

And a recent Washington case involved a derivative action against the directors and officers of a corporation alleged to have backdated stock options to grant in-the-money stock options to themselves and others. In *In re F5 Networks, Inc., Derivative Litigation*, aside from the controversy surrounding the backdating of stock options, one of the key issues involved whether the shareholders were allowed to bring a derivative action in court without first making a pre-suit demand to the board of directors.¹

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