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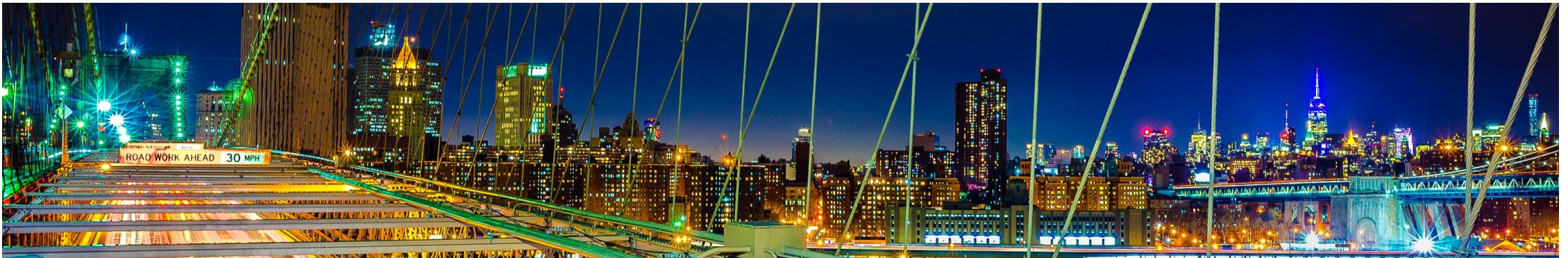
# TRANSACTIONAL LIABILITY INSURANCE ROUNDTABLE

THURSDAY, MARCH 7, 2024



# TODAY'S TOPICS

- **Panel I:** Representation & Warranty Insurance Underwriting – Insights from the Trenches on Key Process and Substantive Issues
- **Panel II:** Key Issues in Underwriting Contingent Risk
- **Panel III:** Artificial Intelligence Risks and M&A
- **Panel IV:** Claims Handling – Perspectives from Outside Counsel



PANEL I

# Representation & Warranty Insurance Underwriting – Insights from the Trenches on Key Process and Substantive Issues





# PANEL I

## REPRESENTATION & WARRANTY INSURANCE UNDERWRITING – INSIGHTS FROM THE TRENCHES ON KEY PROCESS AND SUBSTANTIVE ISSUES



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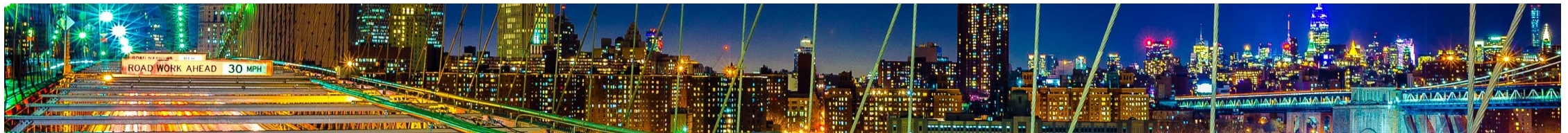
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# ON TOUR WITH BILL, JOE AND MIKE: A DEEP DIVE INTO TOPICS IMPACTING COVERAGE AND UNDERWRITING PROCESSES

- “Don’t Blame Me” – When can the Insurer can step in and make a claim against the Seller for fraud?
- “This Is Why We Can’t Have Nice Things”– Evolving ESG regulations and anti-ESG backlash in some US States
- “Treacherous” – What the Corporate Transparency Act may mean for insurers



# ON TOUR WITH BILL, JOE AND MIKE: A DEEP DIVE INTO TOPICS IMPACTING COVERAGE AND UNDERWRITING PROCESSES

- “Shake It Off” – Heightened Concerns in NBILs
- “Enchanted” – AI tools in our practices
- “Mastermind” – Insights on RWI from M&A counsel and their clients



# ON TOUR WITH BILL, JOE AND MIKE: A DEEP DIVE INTO TOPICS IMPACTING COVERAGE AND UNDERWRITING PROCESSES

- "Getaway Car" – Race to the Bottom
- "Labyrinth" – Emerging trends in state and local taxes
- "It's Nice To Have A Friend" – How best to use your counsel in the underwriting process





PANEL II

# Key Issues in Underwriting Contingent Risk





# PANEL II

## KEY ISSUES IN UNDERWRITING CONTINGENT RISK



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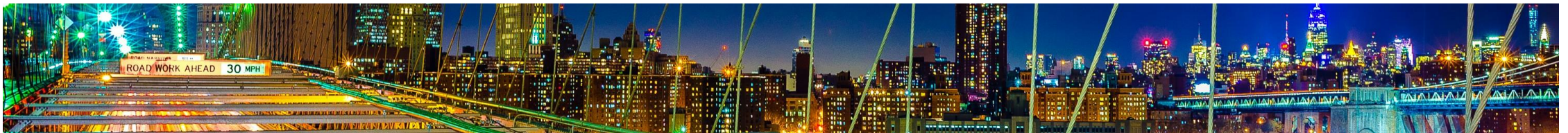
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# OVERVIEW – IMPORTANCE OF IP AS COLLATERAL

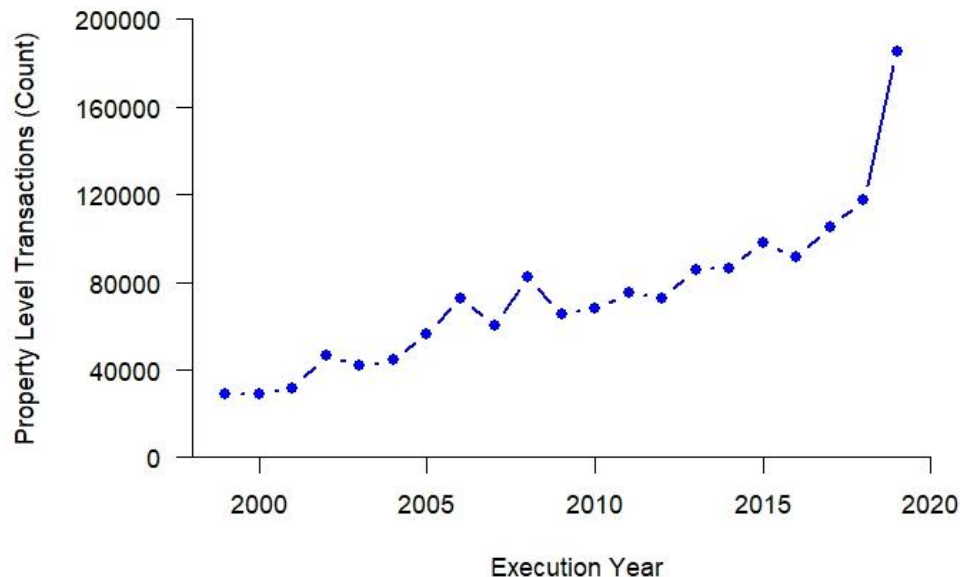
- IP assets continue to become more popular as collateral
  - Intangible assets are estimated to account for 90% of the total assets held by companies in the S&P 500
- For example, in the summer of 2020 during the COVID-induced travel slump, United Airlines pledged its MileagePlus frequent flyer program, including important IP assets such as brands and member data, to secure a \$5 billion loan.
- Market predicted to grow substantially over the next 5-6 years.





# OVERVIEW – IMPORTANCE OF IP AS COLLATERAL

- IP assets provide a competitive advantage
- IP should always be considered when assessing collateral packages
- Popularity is reflected in the data (USPTO Assignment Database)



Based on data from **2021** and **2022**,  
filing rates moderated from 2020  
peak but remain high

# PERFECTING A SECURITY INTEREST IN IP

- How do the federal preemption rules apply to intellectual property?
- UCC Section 9-311(a)(1) – filing a UCC financing statement is not effective to perfect property subject to certain US statutes, regulations or treaties. However, courts have not always found preemption of UCC filing requirements in regard to IP.

	Federal Law Preempts U.C.C. Article 9?	Financing Statement (UCC-1)	USPTO/Copyright Office Recordation
Patents	No	Must File	Recommended
Trademarks	No	Must File	Recommended
Copyrights (Registered)	Yes	Recommended	Must File
Copyrights (Unregistered)	No	Must File	N/A
Trade Secrets	No	Must File	N/A

- **Best practice:** (1) file a financing statement with the Secretary of State office where debtor is located; **and** (2) record with the USPTO or Copyright Office.



# CONTINGENT RISK INSURANCE – INSURING LENDERS’ RISKS

Important protections and considerations when insuring a Lender under a Credit Agreement when the collateral is IP.

- The Insurer should have the right to approve any amendments or modifications to the Credit Agreement—at a minimum, those that relate to the IP.
- The Insurer should be included as a secured party or a beneficiary of the secured party’s lien.
- No IP Collateral should be released without consent of the Insurer. The concept of “payment in full” must take into account any amounts owed to the Insurer.
- The Borrower should acknowledge the right of the Insurer to be subrogated to and exercise the Lender’s rights under the Loan Documents in lieu of the Lender—the Insurer should be a third party beneficiary of the Borrower’s obligations.
- The Insurer should have the right to audit the collateral.
- The Insurer should carefully review the Credit Agreement to confirm it imposes obligations on the Borrower to maintain the value of and otherwise protect the IP.
- The Insurer should diligence the IP prior to undertaking any risk.

# DUE DILIGENCE CONSIDERATIONS FOR IP COLLATERAL

- In conducting due diligence, the lender is looking for whether the IP assets have value, are robust, are marketable, and can be monetized.
- Risks associated with using IP as security:
  - IP rights can be lost, *e.g.*, patent could be held invalid
  - Borrower still needs to be able to use the IP
  - Borrower could, wittingly or unwittingly, abandon the IP by failing to prosecute or failing to maintain in certain or all jurisdictions
  - Borrower could otherwise harm the IP's value by publishing secrets, licensing or assigning without consent, etc.
  - Fraud on the USPTO could result in lost IP rights
  - The borrower could transfer IP – the so-called “J. Crew” transaction or variations thereof



# SPECIFIC IP DILIGENCE STEPS

- Conduct domestic and international owner-based searches to determine how much registered IP is available.
  - Searches should be inclusive of all databases: USPTO (patents, trademarks, applications), Copyright Office, WIPO, Whois (domain names)
- Inquire as to what material nonregistered IP is owned by the debtor and available as collateral.
- Verify ownership and encumbrances of the identified IP assets.
  - Is it subject to any security agreements or assignments to others? Who has standing to sue?
- Is there licensed IP? Are the licenses transferrable? Are there any restrictions on rights or use?
- Verify that the IP is still valid and enforceable; conduct a search for challenges to ownership, enforceability, exclusivity, and validity.
  - This will significantly impact the value of the IP.
- Determine projected lifetime of IP.
- Inquire as to any infringement of the IP assets by third parties or infringement of third-party IP by the debtor.

# KEY ISSUES IN UNDERWRITING CONTINGENT RISK LITIGATION

- Forum
- Standards of review
- Key merits issues
- Possible outcomes and relationship to a Loss



# KEY ISSUES IN UNDERWRITING CONTINGENT RISK FORUM

- Know Your Audience
  - Venue
  - Judge or Judges
- Obtain Relevant Data
  - Statistics
  - Outcomes In Prior Matters

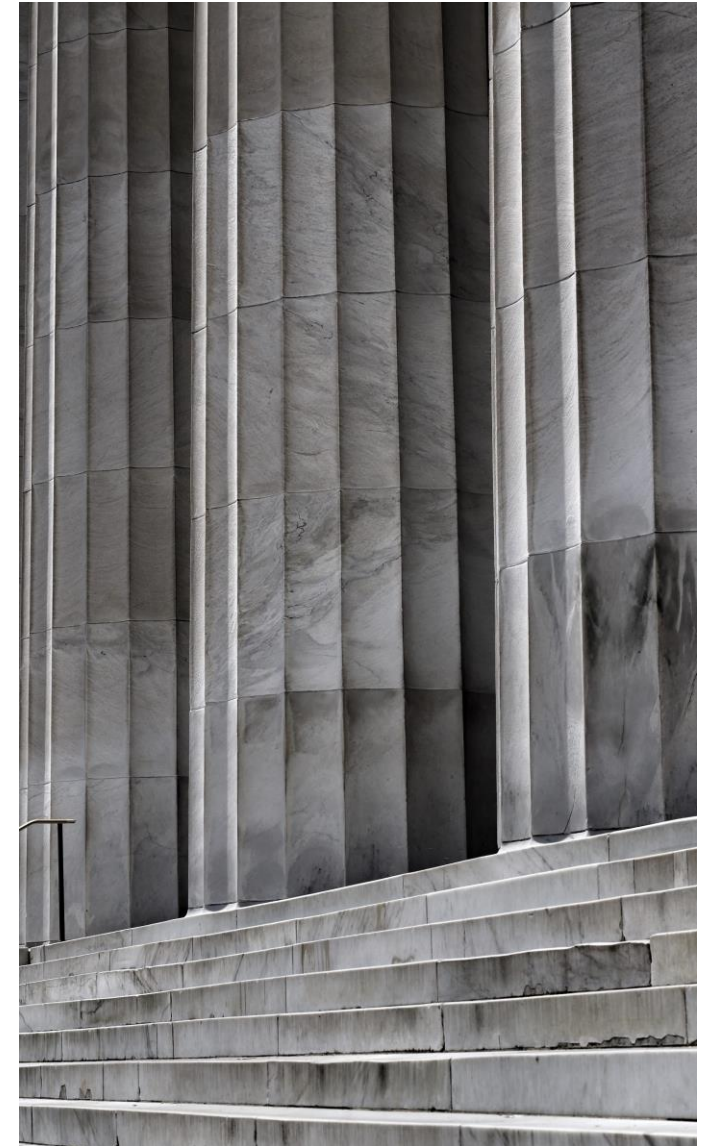




## KEY ISSUES IN UNDERWRITING CONTINGENT RISK

# STANDARDS OF REVIEW

- Fact Issues = Clear Error
- Discretionary Determinations = Abuse of Discretion
- Legal Issues = De Novo
- Specialized Standards – e.g., Arbitration Awards



## KEY MERITS ISSUES

- Understanding The Substance
- Strengths And Vulnerabilities
- Potential “Knock Out” Determinations



## POSSIBLE OUTCOMES AND RELATIONSHIP TO A LOSS

- Claims And Cross-Claims
- Map Out Potential Scenarios
- How Do Possible Outcomes Affect Bottom-Line Judgment
  - Even More Important, Interaction With The Policy Definition Of A Loss



# POLICY ISSUES IN UNDERWRITING

- Typically Not Covered But Open for Negotiation:
  - Defense Costs
    - Typically, insurer has no duty to defend.
    - Insured bears the cost of defending the judgment.
  - Settlements
    - Typically, the policy will not cover or will require insurer consent.
    - After the appeal has progressed or following an unexpected change, permitting settlement on certain terms could limit insurer's exposure.
  - Collecting on Judgment

# POLICY ISSUES IN UNDERWRITING

- Ensuring Insured's counsel protects the judgment, and the judgment is not reversed
  - Insurer has right to monitor the litigation.
  - Insured has obligations to provide updates and cooperate with insurer.
  - Insured keeps most of the control over the strategy.
- Compare:
  - "Insured has sole discretion for the prosecution, defense, and handling of the Lawsuit. Insurer shall have no rights or obligations to control any aspect of the Lawsuit."
  - "Insurer shall be entitled to reasonably and meaningfully participate in the prosecution, defense, and appeal of the Lawsuit."

# POLICY ISSUES IN UNDERWRITING

- What must Insured do to defend the judgment:
  - at all times in the litigation, act to maximize the amount of the judgment, up to the Limit of Liability;
  - vigorously contest and defend any appeal and any post-trial motions in the Lawsuit, in good faith, and as if no insurance were in place;
  - in the event of remand, prosecute the Lawsuit vigorously, in good faith, and as if no insurance were in place;
  - cooperate as is reasonably required to maintain the judgment and instruct counsel to cooperate as is reasonably required.
- Insurer can require Insured to:
  - inform Insurer of any material developments in the Lawsuit as soon as reasonably practicable;
  - provide the Insurer with written status updates following any material change in the Lawsuit;
  - provide the Insurer with all substantive motions, briefs and other filings in connection with the Lawsuit at least monthly;
  - provide the Insurer with all material orders, decisions, and judgments at least monthly;
  - advise the Insurer of any settlement offer;
  - participate in good faith discussions with the Insurer regarding litigation strategies upon reasonable request.



# POLICY ISSUES IN UNDERWRITING

- Exclusions Are Limited:
  - Exclude any Loss related to a material inaccuracy or omission in Insured's representations.
    - Policy will usually require Insured to make representations regarding the veracity of the information provided and the status of the lawsuit.
  - Fraud exclusion.
    - "Insurer shall not be liable to pay any portion of Loss if it is proximately related to deliberate fraudulent conduct by the Insured's Knowledge Persons or by or on behalf of the Insured in obtaining this Policy."
  - Settlements.
  - Insured's failure to contest, defend, or appeal the Lawsuit.
    - Only to the extent the Insurer is actually prejudiced.

PANEL III

# Artificial Intelligence Risks and M&A



# PANEL III

## ARTIFICIAL INTELLIGENCE RISKS AND M&A



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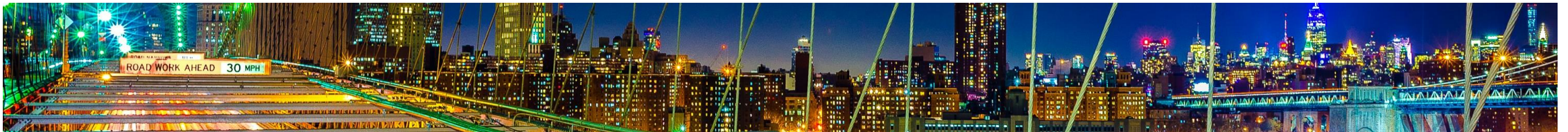
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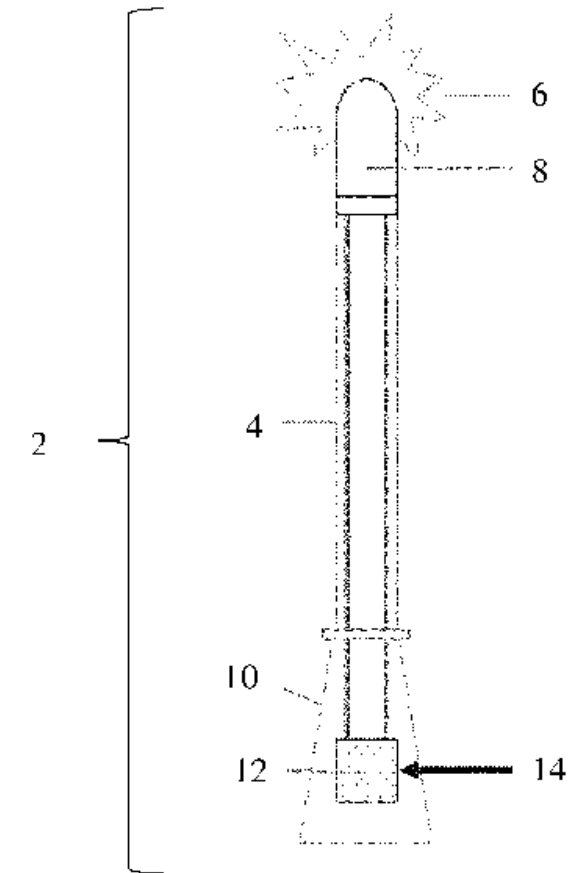
# PROTECTION OPTIONS AND OVERVIEW OF CURRENT ISSUES

- Copyrights
  - Training data and fair use question
  - Uncertainty regarding ownership of generative output
- Trade Secrets
  - Allows protection of all aspects of AI, but only against those that wrongly acquire
- Patents
  - Uncertainty related to inventorship and application of certain patentability standards, e.g., §§ 101, 103, and 112
- Contractual Provisions
  - Until increased clarity of scope of IP protection, contractual provisions will be key to define rights and obligations with AI and the outputs

# AI COMPLICATES INTERNAL PATENT INVENTORSHIP DETERMINATION

## PATENT DECISIONS (USPTO AND COURTS)

- In re Application No. 16/524,350 (Devices and Methods for Attracting Enhanced Attention) (April 22, 2020)
- Application was filed listing an AI tool, DABUS, as the sole inventor.
- USPTO determined based on plain reading of statute (35 U.S.C. § 100(f)) that under US law, inventor must be a human.
- Federal Circuit upheld decision: "Here, Congress has determined that only a natural person can be an inventor, so AI cannot be." Thaler v. Vidal (Fed. Cir. 2022)
- Left open AI-assisted inventions



**Figure 1**

## COPYRIGHT DECISIONS (USCO)

- Author attempted to register a comic book that included her original work and images created with Midjourney, an AI image tool
- On February 21, 2023, the US Copyright Office refused to extend protection to those AI images:
  - “the images in the Work that were generated by the Midjourney technology are not the product of human authorship”
  - USCO unimpressed with alleged creativity of prompts
- Courts have come to similar conclusion
  - *Thaler v. Perlmutter*, at D.C. Circuit
  - Appellate Court affirmed summary judgment finding that Thaler’s Creativity Machine could not obtain copyright on visual art created by system



## EMERGING IP RISKS IN GENERATIVE ARTIFICIAL INTELLIGENCE

- Rights in Training Data. Does the AI vendor have sufficient rights in the training data used to create and refine the AI tool?
- Risk to availability of tool (vendor enjoined)
- Legal risk to tool user (claims by training data rightsholder)
- Pending cases/disputes in computer code (GitHub Copilot), stock imagery (Stable Diffusion, Midjourney), musical performances (Drake), comedy routines (Sarah Silverman), and news content (NY Times)
  - Tip of the iceberg on training data lawsuits



# EMERGING IP ISSUES IN ARTIFICIAL INTELLIGENCE

- **RIGHTS IN TRAINING DATA.**

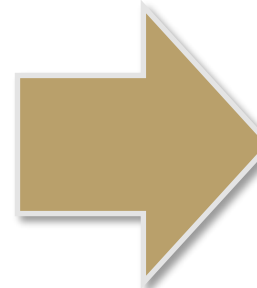
Does the AI vendor have sufficient rights in the training data used to create and refine the AI tool?

- Risk to availability of tool
- Legal risk to tool user

- **RIGHTS IN GENERATIVE AI OUTPUT.**

Does the AI user need to assert rights in the output of the AI tool?

- Unresolved questions on the copyrightability or patentability of AI output



# KEY LEGAL ISSUE IN GENERATIVE AI: FAIR USE

- **FAIR USE.**

The doctrine of fair use renders certain uses of copyrighted works legal. 17 U.S.C. § 107

- Four factors: (1) purpose of use; (2) nature of copyrighted work; (3) amount used; and (4) effect on the market.

- **TRAINING DATA USAGE.**

Many pending cases could turn on whether the use of training data constitutes fair use

- Unlikely to be resolved on a motion to dismiss
- Could take many years to get definitive answer, barring Congressional action



# EXAMPLE: GitHub CoPilot

- **THE PROMISE.**

“GitHub Copilot empowers developers to complete tasks 55% faster with contextualized AI coding assistance.”

- **RISKS.**

Raises issues on both input and output

- Pending litigation on training data by a proposed class action of programmers; will it affect users?
- Will the generated code be subject to OSS licenses or infringement claims?
- Will the tool ingest proprietary code?



**GitHub**  
Copilot



The Official Microsoft Blog

<https://blogs.microsoft.com> › 2023/09/07 › copilot-co... ⋮

[Microsoft announces new Copilot Copyright Commitment](#)

# ADDITIONAL IP RISKS IN USING AI (BOTH GENERATIVE AND OTHER AI)

- **RIGHTS IN COMPANY DATA.**

If the AI user is going to have the tool customized with company data, does the company have sufficient rights to license that data for training?

- Could involve third-party data and materials, as well as personal data

- **CONFIDENTIALITY BREACHES.**

Either through day-to-day use or customized training, is the company jeopardizing rights in its own confidential information or that of others?

- Will users be able to upload company documents to the AI tool?



PANEL IV

# Claims Handling – Perspectives from Outside Counsel



# PANEL IV

## CLAIMS HANDLING – PERSPECTIVES FROM OUTSIDE COUNSEL



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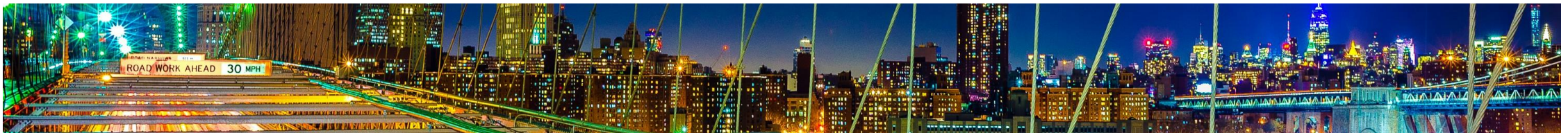
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# ***NOVOLEX V. ILLINOIS UNION\****

## OVERVIEW

- Novolex, package manufacturer, acquired TWG, manufacturer and distributor of consumer products like plastic plates, cutlery, and cups.
- Novolex purchased tower of RWI Policies
- Buyer sued insurer over alleged representations commonly encountered
  - New York Supreme Court (Trial Court)
  - Applied Delaware law
  - Rulings on motions for summary judgment
- Court focused on contract language

\* *Novolex Holdings, LLC. v. Illinois Union Ins. Co.*, Index No. 655514/2019, Supreme Court of the State of New York, County of New York.



# NOVOLEX V. ILLINOIS UNION

## FACTS/ALLEGATIONS

- Equity Purchase Agreement signed in May 2018
- Undisputed: nonparty Costco, as TWG's third largest customer, was a "Material Relationship"
- Novolex allegation: shortly after closing, buyer learned:
  - before closing, Costco informed TWG of its intent to take substantially all of its business elsewhere,
  - which followed lengthy period of repeated failures by TWG to deliver on what it had agreed to.



# ***NOVOLEX V. ILLINOIS UNION***

## **CUSTOMER CONTRACT PROVISIONS**

- Customer Rep: TWG had not received any notice that any Material Relationship has “terminated , cancelled, or adversely and materially modified any Contract” between TWG and such Material Relationship (or intends to).
- “Contract” “means any contract, agreement. . . sales or purchase order or other legally binding commitment in the nature of a contract... .”
- Costco intended to terminate, cancel or adversely and materially modify its contract with target.

# ***NOVOLEX V. ILLINOIS UNION***

## **COSTCO CONTRACT ALLEGATIONS**

- Costco contract was June 2012 Basic Vendor Agreement
- Novolex assertions:
  - Basic Vendor Agreement incorporated, as part of contract, periodic purchase orders that have been or ***will be signed***:
  - When Seller became aware that Costco planned to reduce its volume of business with target,
    - Seller was obligated to inform Novolex of this alleged modification of the contract involving ***future purchase orders not yet signed*** in accordance with Customer Rep of EPA.

# **NOVOLEX V. ILLINOIS UNION**

## **COURT'S RULING**

1. Novolex's allegation that Contract included "'purchase orders that will be signed' means there is an **intent** to actually sign and enter into those purchase orders." (p. 8)
  - But future purchase orders did not even exist.
2. Costco's failure to enter into future purchase orders does not modify Basic Vendor Agreement.
  - Costco Standard Terms provide that purchase orders, **once accepted**, are Contracts.
  - Thus, a future purchase order is not a binding Contract. (p. 9)

Costco's failure to enter into future purchase orders at the same volume as in the past was not a modification of the Basic Vendor Agreement or any past purchase order. (p. 9)

# ***NOVOLEX V. ILLINOIS UNION***

## MATERIAL ADVERSE EFFECT (MAE) PROVISION

- MAE means: “any change, effect or event . . . that has been or is reasonably expected to be ***materially adverse*** to the condition (financial or otherwise) or results of operations of the Business or the Purchased Companies, taken as a whole... .” (p. 10)
- Novolex allegation: Target’s business suffered an adverse change:
  - Costco declined to feature certain of TWG’s products in Costco’s October and Thanksgiving multi-vendor mailers, and
  - TWG earlier shipped defective products in defective packaging.



# ***NOVOLEX V. ILLINOIS UNION***

## **MATERIALITY SCRAPE (RWI POLICY) VS. MAE PROVISION**

- Materiality Scrape: “Both the existence of any Breach and the amount of any Losses resulting from such breach shall be determined without giving effect to any ‘material,’ ‘materiality,’ ‘Material Adverse Effect,’ or similar qualification contained in or otherwise applicable to the representations or warranties contained in [the EPA].” (p. 11)
- Insurers’ argument: applying materiality scrape to MAE would render MAE meaningless.
- Court—Applying Material Scrape to MAE removes MAE from Policy, creating ambiguity in Policy
  - Construe against drafter—which here was insurer (pp. 12-13)
- Determination of “Adverse Effect”—fact issue for trial

# **NOVOLEX V. ILLINOIS UNION**

## LOSS

- Insurers asserted Novolex bore burden of showing seller's breach ***proximately caused*** Novolex's loss.
- RWI policy defines Loss to mean: "any loss . . . ***arising out of*** or resulting from a Breach... ."
- Delaware law: "arising out of" "broadly construed to require some meaningful linkage" between 2 contractual provisions. (p. 17)
- Court rejects insurers' argument.

# DAMAGES

## REVENUE RECOGNITION

- Percentage of completion
  - To recognize revenue on long-term contracts
    - Cost incurred vs. **estimated** total costs
    - Risk estimated total costs is understated/overstating profitability
- Other complex revenue recognition arrangements
  - Multiple performance obligations
  - Billing for services that haven't been performed (deferred revenue)
  - Recognizing revenue for services that haven't been billed (unbilled accounts receivable)
- Common theme – requires judgement

# DAMAGES

## OTHER ISSUES

- Accounts Receivable
  - Easy to verify billings/hard to estimate what won't be collected
  - Judgment in creation of allowance/reserve
    - New FASB Guidance – CECL
- Other financial reporting areas requiring judgement
- Seller fraud?
- Issues created by poor quality claim submission

# BREACH OF COMPLIANCE WITH LAWS R&W

- Engage subject matter/technical experts early.
- Research beyond text of statute, rule and case law.
- Investigate insured's historical and post-Closing legal compliance.
- Try to engage with outside counsel for insured.
- For third-party claims, be proactive.
  - Monitor docket and create Google alerts for insured.
  - Request information from insured early and often.
  - Be aware of what effect different compliance decisions will have on Breach.



# BREACH OF CONDITION OF ASSETS R&W

- Engage industry-specific technical experts early.
  - Best experts are sometimes former executives with industry expertise.
  - Different experts for Breach and Loss.
- Obtain historical data for asset for appropriate past period.
  - Develop information requests with help of expert to go beyond operational and maintenance data.
- On damages:
  - Consider alternatives to curing the Breach, other than course of action chosen by insured.
  - Be mindful of Policy's definition of Loss and any law expanding covered damages beyond direct cost of repair.

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