



THE BETTERLEY REPORT

INTELLECTUAL PROPERTY INSURANCE MARKET SURVEY 2006:

A PRODUCT THAT DESERVES MORE ATTENTION THAN IT GETS

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Editor's Note: We are pleased to present our seventh evaluation of Intellectual Property Insurance, in which we review seven of the leading sources active in the market. The 2005 Survey included eight sources; SwissRe is reconsidering its role in the IP market and chose not to participate in this survey (more later in this report).

As before, our focus is on the two most prominent forms of IP coverage: enforcement (also called pursuit coverage) and defense (liability) coverage.

This year, we have included four carriers and one Managing General Agent, open to all brokers, and two broker proprietary programs (Aon France and Miller) that are only available through them.

We have also included a separate article on the Kiln/Open Source Risk Management policy and risk management service that provides coverage against claims under Representations and Warranties in Mergers and Acquisitions transactions.

This article is based on our review of leading carriers and their products. As with our other Market Surveys, we reviewed the policy forms and endorsements of each of the participants, and asked them to complete a survey about their products and market interest. While we have asked the carriers to review our tables, the conclusions are our own, and the carriers are not responsible for the information contained herein.

In the use of this material, the reader should understand that the information applies to the standard products of the carriers, and that special arrangements of coverage, cost, and other variables may be available on a negotiated basis. Professional counsel should be sought before any action or decision is made in the use of this information.

INTRODUCTION

Intellectual Property (IP) continues to be a prime asset of many organizations, not only corporations. Although the turmoil in the more traditional property and casualty insurance lines has settled down, the challenges in underwriting IP insurance have made coverage more difficult to acquire. But, the need to protect against losses arising out of Intellectual Property remains.

IP is not just important for large companies; many smaller companies possess as their primary assets the knowledge and skills needed to make their product or provide their services. These companies can be particularly vulnerable to attacks on their IP, as larger, more established competitors with deeper pockets seek to eliminate them. Protecting their company's IP may be their most important responsibility, and the difference between success and failure.

Insurance against IP loss continues to be important for smaller- and mid-sized companies with a limited ability to sustain loss. Most IP carriers are focused on these insureds, with the exception of Swiss Re, which had been concentrating on the biggest companies, especially those with which it has other relationships. Unfortunately they are now reconsidering their role in the IP insurance market and are no longer accepting new insureds. For the rest of the potential insureds, although the IP market has limited capacity, there are meaningful limits worth considering.

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Improperly using the IP of another company also provides an opportunity for problems. A company that infringes—or is even alleged to have infringed—on the IP of a competitor is likely to be threatened with lawsuits that are, at best, expensive to defend. In 2003 the *American Intellectual Property Lawyers Association (AIPLA) Economic Survey* estimated that it will cost a defendant in a patent action filed in Texas with between \$1 million and \$25 million at stake roughly \$1.5 million just to get through discovery. Even worse, for that same amount at stake, the defendant is looking at spending more than \$2.5 million if it has to go through trial (source: *Texas Lawyer*, 9/20/04).

According to the *2005 AIPLA Economic Survey* (just recently published), the following represent median infringement total costs (including disbursements for travel, expert witnesses, local counsel, photocopies, etc., plus any appeal costs, if applicable):

Where damages are less than \$1 million:

- Patent infringement = \$650,000
- Copyright infringement = \$250,000

Where damages are \$1 to \$25 million:

- Patent infringement = \$1.25 million
- Copyright infringement = \$440,000

Damages greater than \$25 million:

- Patent infringement = \$4.5 million
- Copyright infringement = \$975,000

The Wall Street Journal (September 14, 2005) reported on its front page about companies whose primary purpose is to pursue patent litigation against successful businesses. Unfortunately dubbed “patent trolls” and “parasites on successful businesses,” some of these companies can well-afford to pursue their claims until the defendant cries “uncle.” Plaintiffs’ law firms now are willing to take patent cases on a contingency basis. Targets include the famous, such as Microsoft and Research in Motion (maker of the Blackberry) and the less famous, such as Boston Communications Group, which allegedly misused a 1998 patent. The NASDAQ-listed company with 400 employees and \$108 million of revenues in 2004, lost and its adversary was awarded \$128 million in damages.

We still hear that “scrubbing” a company’s IP is a better solution than protecting with insurance. We still disagree. Although scrubbing is the first defense, even a well-scrubbed intellectual property is subject to loss that may need to be insured. A combination of effective scrubbing and competent insurance needs to be considered.

Even if the defendant is “right,” it can be put out of business just by the cost of litigation, and the fear of investors or customers that it may not win. The need to defend an alleged infringement can distract management’s attention, and dissuade investors. Even a successful defense can result in business failure. Many well-entrenched companies will attempt to defeat new competitors by challenging their patents; rather than compete in the marketplace, they are competing in court.

An alleged infringer has few options:

- Abandon its IP rights
- Negotiate a license from a position of weakness
- Defend the suit

Patent holders are not the only potential targets of patent infringement lawsuits. Retailers, distributors, and others that contribute to the alleged infringement can be—and often are—sued as participants in the stream of commerce.

IP can be a tough sell for insurance brokers, as the perceived need for IP protection is often challenged by IP lawyers, who may view the involvement of insurance companies in a previously uninsured realm to be restrictive and possibly intrusive. This is unfortunate, since carriers generally are very supportive of their insured’s choice of counsel. IP is an extremely specialized area of the law, and the carriers recognize that legal counsel will be expensive.

This year, there is one fewer carrier than in our 2005 Survey; Swiss Re has indicated that “we cannot participate in this year’s Intellectual Property survey as we are only offering our capacity to the clients who have an existing Intellectual Property Rights programme with us.” (Neil Arklie, Casualty Underwriter – Corporate Clients – Globals & Large Risks S R International Business Insurance Company Limited). We are disappointed to see them depart from our survey, and hope that they will resume offering their product to new insureds.

NEED FOR SPECIALIZED COVERAGE

Typical commercial insurance programs (even sophisticated ones) do not cover IP claims. Although some would argue that Advertising Liability provides some coverage, insurance companies believe that they do not cover IP. Thus, an insured, at best, has a difficult time in settling a claim, which is especially damaging for smaller employers.

Most court cases involving IP coverage in a Commercial General Liability (CGL) policy have ended in victory for the carrier. Most Advertising Liability coverages are written to narrowly focus coverage on actual advertising activity; even piracy coverage only applies when it is committed in the course of advertising products or services.

Since alleged infringement can occur in many situations not involving advertising, it is apparent that a CGL policy even with advertising liability coverage is an ineffective source of coverage.

Another problem with Commercial Liability coverage is that an infringement can be construed as an intentional act, quickly denied by the GL carrier. Look for intentional acts coverage in an IP policy, at least until the intent is established in fact.

STATE OF THE MARKET CARRIERS

In 2006, we see that IP coverage continues to be a challenge to underwrite profitably. We understand that significant losses have occurred. Losses are primarily a problem of severity, rather than frequency.

The IP insurance market currently offers three basic types of IP policies:

- First-Party IP coverage, which can protect the value of an insured’s direct loss sustained when its revenue streams are diminished from a direct and resultant impact upon its IP rights. Similar to a Business Interruption cover.

- IP Abatement Coverage (so-called Offense or Enforcement coverage), which funds an attack on a party that improperly uses the insured’s IP.
- IP Defense Cost (so-called Defense coverage), which protects a company against allegations that it improperly used the IP of another.

IP Abatement coverage is available from few markets. While still offered by IPISC and Miller, abatement coverage may be attractive to such a limited market that most carriers may view it as a niche product line and outside their interest. It strikes us that this is a product that requires very specialized underwriting, and will always be a niche product, but a useful one nevertheless.

When considering which carrier to use, keep in mind that each product is unique, so coverage terms should be the deciding point. However, also keep in mind that IP is a very complex product to underwrite, requiring great skill and knowledge of IP law and business.

VOLUME

The amount of IP premium written is still small, although carriers are reluctant to tell us exactly how much they write. In fact, carriers will not even tell us about changes in their volume; we suspect that the market is stable or even shrinking, although increasing rates could be causing limited growth.

To the extent there is growth, it is in Defense products. This coverage is likely to be more familiar, and thus easier to underwrite, than Enforcement and First-Party coverage. Certainly, legal counsel is generally more concerned with defending against major claims, less interested in funding a pursuit of infringers.

However, First-Party IP can be a very valuable coverage and could be extremely attractive to many companies. If Kiln can continue to grow this product, especially adding to its capacity, we predict good things for both them and their prospective insureds.

One reason for the growth in Defense coverage is the perception by senior management and investors that smaller companies are very vulnerable to larger competitors that use the legal system to cripple or defeat them. Without adequate financial and management resources, court battles over IP rights can tie up and destroy a company. Wise investors, particularly in technology startups, make sure that their companies have the wherewithal—or Defense coverage—to defend against IP attacks.

Having said this, there is still interest in Enforcement coverage, and we expect it will continue to grow. In fact, the *Wall Street Journal* specifically mentioned Enforcement coverage in their September 14th article.

CLAIMS EXPERIENCE

There is little data in the public domain about claims experience, and, with relatively small amounts of premium being written, loss ratios are not meaningful.

Most of our claims information is anecdotal; there have been a number of insured claims, and some of them are significant (\$1 million-plus). We will try to gather additional information for future studies.

In the Enforcement coverage side, there has been some limited claims activity. Since this is a very specialized product, we would not expect many claims.

POLICY CONSIDERATIONS

Unless noted, the balance of our comments relate to Defense or Enforcement products (that is, not First-Party products).

WHO IS COVERED

Keeping in mind that there are two types of coverage (Enforcement and Defense), most policies cover the usual insureds:

- Corporate Entity
- Directors
- Officers
- Stockholders
- Employees

Other parties, such as distributors, can be named in suits, so it is important to identify them if you wish to extend Defense coverage.

WHAT IS COVERED ENFORCEMENT COVERAGE

Enforcement policies typically cover the cost of attacking a third-party infringer, including:

- IP infringement suits brought by the insured against third parties for infringement initiated during the policy period

- The cost to defend against countersuits alleging that the insured's patent is invalid
- Costs to reexamine the insured's patent in the Patent Office, if the defendant tries to invalidate the patent
- Costs to reissue the patent, if required to strengthen the claim

DEFENSE COVERAGE

This more traditional coverage protects the insured against allegations that it has infringed upon the IP of another. Coverage usually includes:

- Defense costs
- Settlements, judgments and other expenses, including prejudgment interest

Judgments and settlements might include compensation for a claimant's lost profits or royalties, and arise out of manufacture, use, distribution, advertising, or sale of an infringing product or process.

PRIOR ACTS COVERAGE ENFORCEMENT COVERAGE

The question of coverage for Prior Acts does not apply to Enforcement Coverage, which is written more as a property form. Coverage applies to situations where an insured's IP is being misused by another, and the insured wishes to take enforcement action.

DEFENSE COVERAGE

Prior Acts clearly is an appropriate question for Defense Coverage, which, of course, is a liability protection.

Fewer carriers are now willing to cover IP Prior Acts:

- IPISC includes Prior Acts coverage in the standard policy form
- Prior Acts coverage is available as an option by AIG/Lexington and National Union, as well as Chubb

Keep in mind that, even if a carrier includes Prior Acts coverage, it may still be subject to a retroactive date. And, as far as we know, no carrier covers known infringement.

**COVERAGE TERRITORY
ENFORCEMENT COVERAGE**

IPISC provides worldwide coverage if the applicable country's IP is listed as an Insured IP.

DEFENSE COVERAGE

All carriers will cover suits that originate anywhere, if the suit is brought in the United States, its territories, Canada, or Puerto Rico. Kiln and Miller automatically provide worldwide coverage, protecting suits brought anywhere in the world. IPISC requires that the insured IP be listed on the policy; if that country's IP is listed, then coverage applies if reimbursement is made to a U.S. entity.

AIG/Lexington can provide true worldwide coverage as an option. AIG/National Union and Chubb do not.

RISK MANAGEMENT SERVICES

Value-added services are not commonly offered by IP insurers, and that is not a bad thing, considering the very technical nature of IP loss avoidance. Services are primarily provided by the brokers offering IP products.

However, we do note that Chubb offers its new *Risk Management Guide* for insureds. The guide can be used by the insured to test themselves against industry best practices.

SUMMARY

Why isn't more Intellectual Property insurance bought? Frankly, we are puzzled. The business press is full of stories about IP litigation, and there are enough big cases and awards that surely senior management, directors, and investors must be concerned. And they are—but this concern often does not extend to buying insurance protection.

Is it because the limits of coverage available aren't high enough to protect large companies against a catastrophic loss? Is it because negotiating coverage is cumbersome (carriers are understandably cautious about insuring IP risk)? Because IP counsel does not think insurance is necessary (or does not want to lose control over litigation to an insurance company)? Coverage isn't seen as necessary because our IP rights are strong? Or is it because the coverage is just not well known?

We're not sure, but we think it may be a combination of all five. We hope that IP insurance will, on a more regular basis, be considered a part of an insured's basic insurance protection, leading to a market that is broad, reasonably priced, and able to withstand an occasional large hit. It may take awhile for this to come about. We will watch with anticipation.

AN UPDATE ON OPEN SOURCE IP INSURANCE

Our April 2005 report described a proposed coverage for Open Source license compliance in Reps and Warranties. This coverage is now available from Kiln plc of London who, in partnership with Open Source Risk Management (OSRM), has created what we understand is the first Open Source Compliance Reps and Warranties insurance product.

REPS & WARRANTY PRODUCT MARKET NEED

Over 90 percent of companies are using Open Source within their infrastructure and/or products. Asserting that the seller is compliant with applicable licenses, especially the GNU General Public License (GPL), is fast becoming a standard deal term in M&A transactions. Inability to demonstrate compliance or remove the risk of non-compliance can lead to larger escrow agreements, sale price adjustments, or even failure of the deal. Reps and Warranties insurance allows both the buyer and the seller to enjoy the protection of a third party.

COVERAGE AVAILABLE

The Kiln product is the only insurance facility designed to cover the specialized risks faced by enterprises that include or rely upon elements of Linux and other Open Source software in their commercial products or internal IT infrastructure. The insurance provides up to USD \$10 million cover for:

- Loss of profits resulting from a legal settlement preventing the use or sale of the insured's product(s) resulting from the requirement to distribute certain code or products, in compliance with an Open Source software license;
- The impaired valuation of an acquisition agreement or adjusted sale price thereof, resulting from the requirement to distribute code or products exchanging Open Source software in compliance with an Open Source software license; and
- Costs to repair or replace code so that it complies.

The insurance operates on a claims-made basis covering the indemnified representations and warranties for periods as long as three years. Cover is available on a worldwide territorial and jurisdictional basis, necessary because of the global nature of Open Source use and exposure. Pricing is set on a per insured basis.

OSRM RISK MANAGEMENT APPROACH

Underpinning the program is OSRM's exclusive Open Source risk assessment services, which include:

- Creation of an automated risk profile of the client's product(s) and/or infrastructure, using sophisticated proprietary code scanning techniques and engineering protocols
- Evaluation of compliance with applicable Open Source licenses
- Assessment of Open Source compliance risk involved in the transaction
- Pricing of risk to the underwriters

OPEN SOURCE LEGAL LIABILITY AND DEFENSE COVERAGE

OSRM is also working with insurance partners to develop an Open Source Legal Liability and Defense coverage product for Open Source use, which is totally excluded from today's standard corporate liability coverage.

As large corporations grow to rely upon Linux and other Open Source software, their risk of facing third-party intellectual property infringement continues to grow. Vendor-provided indemnities do little to meet the true needs of large corporate users, as they are typically limited to replacement components or capped at the contract value, typically falling well short of the true cost of defense and possible settlements. In addition, according to a recent survey by Evans Data Corporation, 50 percent of corporate IT projects using Open Source do so without any vendor backing, leaving this group of corporations completely exposed to the possibility of an infringement claim.

PLANNED COVERAGE

OSRM's planned Open Source insurance product will provide end users of Open Source software with Legal Defense and Liability coverage for claims of title, copyright, and patent infringement arising from their use of defined, standard Open Source components. Coverage is expected to be provided on an indemnification basis. A panel defense approach is expected.



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- Critical coverage and claims differences
- Risk Management services

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- CyberRisk Policies
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