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Client Alert: First Circuit Parses Underlying Complaint to Find Duty to Defend and to Defeat Exclusions

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The duty of a liability insurer to defend a policyholder from litigation is typically described as broad and expansive, extending beyond the insurer's duty to indemnify. The duty to defend generally obliges an insurer to defend a policyholder against lawsuits raising even the mere possibility of coverage. But does the duty to defend extend to potential liability not expressly pleaded in the underlying complaint? And can a duty to defend apply to a trade secrets case alleging bad faith, where the policy contains exclusions related to knowing conduct and misuse of trade secrets? A recent decision by the United States Court of Appeals, First Circuit, *Lionbridge Technologies, LLC v. Valley Forge Insurance Co.*, 53 F.4th 711 (1st Cir. 2022), answers these questions in the affirmative and provides a comprehensive introduction on the potential scope of the duty.

The insurance coverage case in *Lionbridge* arose out of an underlying trade secrets case between competing language translation companies. The policyholder, Lionbridge Technologies, LLC (Lionbridge), faced a lawsuit from TransPerfect Global (TPG) for allegedly engaging in a scheme to obtain access to TPG's sales models, pricing information, and customer lists by faking interest in a potential acquisition. Relevant to the coverage dispute, TPG alleged Lionbridge personnel "falsely told TPG's customers that Lionbridge was purchasing TPG and that they should contract with Lionbridge directly before the sale." Further, the complaint alleged that Lionbridge acted in bad faith by contacting TPG's existing and prospective clients to misrepresent separate litigation related to the company's cofounders and to "introduce doubt" about TPG's stability. As a result, the complaint alleged that some TPG clients reduced their business with TPG.

Valley Forge Insurance Co. (Valley Forge) had issued a commercial general liability policy to Lionbridge. The policy covered personal and advertising injury, including the oral or written publication of material that slanders or libels an organization or disparages the organization's goods, products, or services.

Valley Forge initially defended Lionbridge from the TPG lawsuit under a reservation of rights. However, the insurer and insured engaged in numerous disagreements over what eventually grew to multi-million-dollar attorney fees. Lionbridge eventually filed suit in the United States District

Court for the District of Massachusetts for its defense costs. Valley Forge counterclaimed for a declaration that it was not obligated to pay more that certain reduced rates of one defense firm and a portion of joint defense costs shared with Lionbridge's corporate owner.

The parties filed cross motions for summary judgment on the issue of whether Valley Forge owed Lionbridge a duty of defense. Focusing on certain "pleading infirmities," the district court ruled in favor of Valley Forge and held that the duty did not apply. Lionbridge appealed.

The First Circuit's opinion set forth the general principles found in Massachusetts law that an insurer must defend its insured where the underlying complaint's allegations could be reasonably construed as "roughly sketching" a covered claim, provided that no policy exclusion applies. Rather than focusing on the specific causes of action, the court would focus on the types of losses that might be proved within the range of the complaint's allegations, and determine whether such losses fit the reasonable expectations of coverage of the policy. Further, the First Circuit would resolve any uncertainties in favor of the insured.

To answer the threshold question of potential coverage, the First Circuit considered whether the allegations of the underlying complaint could reasonably fit within the policy's coverage for disparagement claims. By focusing on the complaint's claims of reputational harm, the appellate court found that the pleading did sketch a defamation claim. Therefore, even though the complaint did not "map expressly" onto the causes of action covered by the policy, the policy created a reasonable expectation of coverage for claims alleging reputational injury.

Moving to four policy exclusions related to knowing conduct and trade secrets, the First Circuit found that Valley Forge failed to meet its burden of establishing the exclusions apply to the entirety of the allegations in the underlying complaint.

First, the knowing conduct exclusions applied to personal and advertising injury performed "with the knowledge that the act would violate the rights of another and would inflict personal and advertising injury" or with knowledge of the falsity of the statements. As noted by the insurer, the underlying complaint alleged that Lionbridge made misrepresentations about underlying litigation involving TPG's cofounders "in bad faith for the purpose of damaging TPG" and "to undercut TPG." Arguably, an allegation of bad faith could be equated with intentional conduct such as is contemplated by the exclusion. However, the First Circuit decided that even if that was the case, the knowing conduct exclusions still would not apply. The First Circuit rejected the insurer's argument by highlighting the remainder of the allegation from which the insurer had quoted: Lionbridge "*both misrepresented the nature of the underlying [cofounders'] litigation and introduced doubt regarding the stability of TPG* in bad faith for the purpose of damaging TPG." In context, the First Circuit found that the insurer had not shown that the complaint conclusively alleged bad faith as to the misrepresentations about the underlying litigation between TPG's cofounders. Rather, the bad faith referenced in that allegation may have only been related to the introduction of doubt regarding TPG's stability.

The First Circuit buttressed its finding by comparing the allegation about misrepresentations against other allegations in the complaint. The complaint's fraud count included the allegation that Lionbridge employees "deliberately misrepresented to TPG's clients that Lionbridge would be acquiring TPG, and that future business inquiries should be directed to Lionbridge." Because the fraud count clearly and specifically alleged Lionbridge acted with knowledge, the First Circuit concluded that TPG may have purposefully chosen not to make allegations of intentional conduct with respect to the misrepresentations about the underlying litigation between TPG's cofounders.

The insurer also argued that the underlying complaint did not allege negligence, and therefore the conduct alleged therein fell under the knowing conduct exclusions. The First Circuit was not persuaded because the lack of negligence allegations did not disprove all potential liability. Although the insurer argued that a finding of coverage required "speculative reinventions of the claims" in the underlying complaint, the First Circuit framed the issue as whether, "as a matter of law, a defamation claim premised on negligent or reckless conduct is legally impossible." The insurer failed to meet that high standard.

The First Circuit's analysis regarding the knowing conduct exclusions is particularly noteworthy in light of the dearth of Massachusetts case law analyzing whether the possibility of liability for negligent conduct could defeat a knowing conduct exclusion. The First Circuit leaned on decisions from other jurisdictions to support the conclusion that defamatory statements could be made negligently and thus were not subject to a knowing conduct exclusion.

Second, the trade secrets exclusions applied to injuries arising out of the infringement of trade secrets or out of access to confidential or personal information such as trade secrets and financial information. Here, TPG again took a holistic approach to the complaint, arguing that the entire subject of the underlying lawsuit arose out of the alleged misappropriation of trade secrets. Yet the First Circuit held to its earlier conclusion that the complaint roughly sketched out a claim for defamation, and that defamation claim need not conclusively arise out of the misappropriation of trade secrets. In other words, the allegations of misrepresentation may not depend entirely upon TPG's trade secrets. The First Circuit therefore quickly disposed of the insurer's arguments that a trade secrets exclusion applied.

The First Circuit thus reversed the district court's grant of summary judgment in favor of the insurer and directed judgment on the issue of the duty to defend in favor of the insured. The remainder of the opinion addressed discovery disputes.

The level of detail and creativity exhibited by the First Circuit makes the *Lionbridge* opinion an excellent primer on the breadth of an insurer's duty to defend. The insurer's arguments hold at least a superficial appeal: each of TPG's causes of action were tied to misappropriation of trade secrets, breach of contract, and fraud—not defamation; the express allegation of bad faith and the lack of allegations of mere negligence could arguably support application of the knowing conduct exclusions; and the allegations of harms arising from the misappropriation of trade secrets could

arguably invoke the trade secrets exclusions. Nevertheless, the First Circuit held steadfast to traditional principles of interpretation that are generous to the policyholder. The allegations of reputational harm provided a sufficient "hook" to bring the underlying complaint within the insured's reasonable expectation of coverage under the policy. In addition, the careful parsing out of the phrases preceding the allegation of bad faith, as well as the legal possibility of negligence (even where not expressly pleaded in the underlying complaint), spared the insured from the knowing conduct exclusions. And the insurer's reliance on the "entire subject" of the underlying lawsuit arising out of the misappropriation of trade secrets was defeated by the rough sketch of an implicit and independent defamation claim.

We encourage policyholders to read the First Circuit's analysis of the duty to defend carefully and to consider the nuanced treatment the First Circuit gave to both the policy and underlying pleading. The *Lionbridge* opinion stands for the proposition, applying Massachusetts law, that the obligation to defend an insured is not limited to the specific causes of action expressly stated in a complaint. Moreover, while an insurer may assert that the overall subject matter of a complaint triggers exclusions, the opinion demonstrates that a policyholder may benefit from considering specific allegations—or, as in the *Lionbridge* case, select portions of allegations—that could arguably survive independently from the excluded conduct. The First Circuit offered an artful example of the extent to which the duty to defend favors policyholders, including the heavy burdens on insurers to escape the duty behind exclusions. Policyholders may find persuasive arguments in the opinion to assert in future disputes over the duty to defend.

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