

ARTICLE

WATERCLOUD MUDDIES THE WATER FOR PATENT COVERAGE DISPUTES

HOWARD ROSS CABOT[†]

Table of Contents

I.	INTRODUCTION	267
II.	THE WATERCLOUD DECISION	267
III.	THE COURT OF APPEAL'S REASONING	268
	A. Direct Infringement as Opposed to Inducement	268
	B. Willfulness	270
	C. Unfair Competition	274
III.	CONCLUSION	274

I. INTRODUCTION

On September 21, 1993 the Fourth District Court of Appeal of California held in *Aetna Casualty & Surety Co. v. Superior Court*¹ ("*Watercloud*") that two insurers did not owe a duty to defend to a policyholder who was a defendant in a patent case. In my view, the case was wrongly decided because it misinterprets fundamental principles of patent and insurance law. There can be little doubt, however, that *Watercloud* has significant consequences for policyholders involved in intellectual property coverage disputes. A summary of the *Watercloud* case and its impact on comprehensive general liability policies is set forth below.

II. THE WATERCLOUD DECISION

Watercloud arose from a patent infringement dispute between Somma Mattress Company and Watercloud Bed Company. Somma sued Watercloud in federal court contending that Watercloud infringed (and

© 1993 Howard Ross Cabot. Previous versions of this article appear as *Watercloud Muddies the Water for Patent Coverage Disputes*, MEALEY'S LITIG. REP. INT. PROP., Nov. 30, 1989, at 22, and *Storms Ahead on Infringement Coverage?*, NAT'L L.J., Nov. 15, 1993, at 23.

[†] Howard Ross Cabot is a partner with the law firm of Brown & Bain in Phoenix, Arizona, where he specializes in the trial of high technology cases and counsels policyholders regarding intellectual property and other insurance coverage disputes.

1. 23 Cal. Rptr. 2d 442 (Cal. App. 1993).

actively induced others to infringe) Somma's water mattress patent after Somma denied Watercloud's request for a license to manufacture and sell the patented mattresses.² After the dispute was settled, Watercloud sued its insurance companies (Aetna and Industrial Indemnity) seeking, among other things, a declaration that they were liable to indemnify Watercloud for its defense costs.³

Watercloud later filed summary judgment motions against the insurers on the duty to defend issue. The trial court held that although there could be no coverage for direct infringement, the insurers had a duty to defend Somma's claims for inducing infringement.⁴ The insurers' petitions for review were the subjects of the *Watercloud* appeal.

III. THE COURT OF APPEAL'S REASONING

The issue before the Court of Appeal was whether a standard comprehensive general liability policy (CGL), which includes coverage for "advertising injury,"⁵ potentially affords coverage for inducing patent infringement so as to trigger an insurer's duty to defend.⁶ The court held that it does not. In so holding, the court addressed three main issues: (A) direct infringement as opposed to inducement; (B) willfulness; and (C) unfair competition.

A. Direct Infringement as Opposed to Inducement

The court first held that "the patent infringement allegations against Watercloud create no potential recovery of covered damages because the alleged infringement could not occur 'in the course of the named insured's advertising activities.'"⁷ The court reached this conclusion for two reasons: a claim for direct infringement under 35 U.S.C. § 271(a) does not arise out of "advertising activity"; and a party subject to liability for direct infringement cannot also be held liable for inducing infringement.⁸

As to the first point, the *Watercloud* court joined what has become a long line of insurance coverage decisions ruling that direct infringement

2. *Id.* at 444.

3. *Id.* at 445.

4. *Id.*

5. The clause at issue (like that found in many similar policies) defined advertising injury as "injury arising out of an offense committed during the policy period occurring in the course of the named insured's advertising activities, if such injury arises out of libel, slander, defamation, violation of the right of privacy, piracy, unfair competition, or infringement of copyright title or slogan." *Id.* at 444.

6. *Id.* at 445.

7. *Id.*

8. *Id.* at 446.

cannot arise out of one's "advertising activities."⁹ The rule appears consistent with substantive patent law as well because direct infringement requires the infringer to actually make, use, or sell an infringing device and not merely to encourage others to do so.¹⁰ But *Watercloud* and this line of authority do not entirely preclude the possibility that advertising can constitute actionable infringement in some circumstances. Several patent cases suggest that some forms of advertising, such as trade show demonstrations, may constitute direct infringement (either as an unlawful "use" or "sale") if it results in an actual sale of the allegedly infringing device.¹¹

As to the second point, the court ruled that one who is liable for direct infringement cannot also be liable for inducing infringement.¹² The court reasoned that since inducement requires proof of direct infringement by someone, a person who infringes a patent by selling a product cannot also be held liable for inducing his customer to buy and use it.¹³ Otherwise, a plaintiff would be able to obtain a double recovery for the same product.¹⁴ That ruling, however, ignores that in some circumstances an infringer can be guilty of both direct infringement and inducement for related conduct. For example, an alleged infringer may try not only to persuade its retail customers to buy and use its products, but also to encourage third-party licensees to make and market their licensed products or to induce end-users to use the third-party licensees' allegedly infringing devices. In the former case the infringer would be

9. *Big Sur Waterbeds v. Maryland Cas. Co.*, No. CV 92-4298-WMB, slip. op. at 14 (C.D. Cal. Dec. 28, 1992); *Intex Plastics Sales Co. v. United Nat'l Ins. Co.*, 1992 WL 437984 (C.D. Cal. June 10, 1992) (insured was not entitled to indemnity for underlying patent claim because the alleged infringement did not arise out of advertising activity); *National Union Fire Ins. Co. v. Siliconix*, 729 F. Supp. 77, 80 (N.D. Cal. 1989) (though patent infringement claim may have come within the ambit of "unfair competition" or "piracy," it did not arise out of advertising activities); *Tandon Corp. v. Industrial Indem. Co.*, No. BC 025272, slip op. at 9 (Cal. Super. Ct. Nov. 20, 1992) (patent infringement claim did not satisfy the "advertising activity" requirement).

10. *E.g.*, *Eli Lilly & Co. v. Medtronic, Inc.*, 915 F.2d 670, 673 (Fed. Cir. 1990) ("A threat of sale does not constitute an act of infringement.").

11. *Intermedics, Inc. v. Ventritex, Inc.*, 775 F. Supp. 1258, 1285-86 (N.D. Cal. 1991) (noting that "demonstration of an accused device does not constitute an act of infringement unless the 'totality of the circumstances' also reveals concurrent 'sales oriented' activity which results in or at least substantially advances, an actual sale of the accused device"; no infringement because no sale (emphasis added)); *Grinnel Corp. v. American Monorail Co.*, 285 F. Supp. 219, 227 (D.S.C. 1967) (ruling that the trial installation of weave cleaning equipment in a prospective customer's weave room was direct infringement under section 271(a), even though defendant retained ownership of the demonstration model); *cf.* *Celotex Corp. v. V.E. Power Door Corp.*, 204 U.S.P.Q. (BNA) 636, 638 (E.D.N.Y. 1979) (use of a demonstration model that did not result in a sale was not an infringing "use").

12. *Watercloud*, 23 Cal. Rptr. 2d at 446.

13. *Id.*

14. *Id.*

liable for direct infringement to the extent it made and sold the products it is accused of infringing. In the latter case, it would be liable for inducement because the third-party licensees' "making, use, or sale" (and the end-users' "use") would constitute "direct infringement."

Also, *Watercloud's* reasoning on this point is wrong because it ignores, as a matter of insurance coverage law, an important rule regarding the duty to defend. The duty arises if there "is any potential for liability under the policy."¹⁵ To recover, an insured does not have to show it is entitled to indemnity or that the third-party claimant will ultimately succeed on its claim against the insured. The insured only has to show that there is some possibility that there may be a covered claim for the defense duty to arise.¹⁶

Direct infringement and inducement claims typically are pled in the alternative. When a patent infringement complaint is filed, there may be at least a possibility that the defendant, though accused of direct infringement, may ultimately be liable only for inducement. Where that is the case, and the inducement arose out of the defendant's advertising activities, the duty to defend should be triggered, even if it is later found that the defendant was liable only for direct infringement.¹⁷

B. Willfulness

The second principal issue considered by the court in *Watercloud* was whether inducing infringement is "willful" conduct under California Insurance Code section 533¹⁸ and therefore barred from coverage. The court ruled that a "willful act" will exonerate a carrier from a duty to defend under section 533 if done with a "preconceived design to inflict injury."¹⁹ Relying on *Manville Sales Corp. v. Paramount Systems*,²⁰ the court ruled that inducing infringement met the intent requirement because inducement requires a "specific intent to encourage another's infringement."²¹

The ruling suffers from several flaws. Most seriously, the court misapprehended what *Manville* requires. Admittedly, *Manville* is confusing because it appears to require a finding of specific intent.

15. *Horace Mann Ins. Co. v. Barbara B.*, 846 P.2d 792, 797 (Cal. 1993).

16. *Id.*

17. The *Watercloud* court arguably did not have to face this issue because it was "undisputed that *Watercloud* made and sold the product it is accused of infringing." 23 Cal. Rptr. 2d at 447. The opinion does not provide enough information to determine whether this finding could be an undisputed fact based on information available at the time *Watercloud* tendered the case to Aetna and Industrial Indemnity.

18. CAL. INS. CODE § 533 (West 1993).

19. *Watercloud*, 23 Cal. Rptr. 2d at 448.

20. 917 F.2d 544 (Fed. Cir. 1990).

21. *Watercloud*, 23 Cal. Rptr. 2d at 448.

However, *Manville* itself states (just after the sentence suggesting that “a specific intent” is required) that “[t]he plaintiff has the burden of showing that the alleged infringer’s actions induced infringing acts and that he knew or *should have known* his actions would induce actual infringement.”²² By defining the necessary intent as requiring that the defendant “knew or should have known” actual infringement would result, *Manville* appears to adopt a standard more akin to showing negligence or recklessness than to “a preconceived design to inflict injury.”

This interpretation of *Manville* has been followed—and stated even more clearly—in at least two other cases. In *Symbol Technologies v. Metrologic Instruments*,²³ the court adopted a standard very close to *Manville*, ruling that the intent necessary to be found liable for inducement requires only “knowledge of an infringement controversy”:

Although not explicitly stated in the statute, the second step for proving intent to aid and abet is showing that an alleged infringer “knowingly aid and abet another’s direct infringement. Knowing is equated with a specific intent to infringe.” [citations omitted] Generally, knowledge has been construed as knowledge of an infringement controversy.²⁴

Similarly, in *Marsh-McBirney, Inc. v. Jennings*,²⁵ the court ruled that, under *Manville*, “[a]lthough plaintiff must show that defendant had knowledge of the facts, plaintiff need not show that defendant was subjectively aware that his or her acts constituted infringement.”²⁶ Thus, a defendant’s objective belief that he was not infringing was found to be irrelevant because he “should have known” that his actions would lead to infringement.²⁷

Whatever may have been the view before *Manville*, it now appears that a claim for inducing infringement requires something less than *actual* knowledge that the inducing act will cause infringement. Most likely, it will be sufficient to show that the alleged infringer “knew or should have known his actions would lead to infringement” or that he had knowledge of an infringement controversy. Such a standard sounds in negligence or recklessness, rather than in an intent to inflict a specific harm as is required under section 533.

Based on its erroneous reading of *Manville* (concluding that “liability for inducing patent infringement can only be imposed where the

22. *Manville*, 917 F.2d at 553 (emphasis added).

23. 771 F. Supp. 1390 (D.N.J. 1991).

24. *Id.* at 1404 (citing 3 P. ROSENBERG, PATENT LAW FUNDAMENTALS § 17.02(2)(a), at 17-25 (1991)).

25. 22 U.S.P.Q. 2d (BNA) 1621 (C.D. Cal. 1991).

26. *Id.* at 1624.

27. *Id.*

defendant 'knowingly' induced the infringement"²⁸), the court mistakenly ruled that California Insurance Code section 533 barred a defense. The dispositive issue as to whether section 533 applied, according to the *Watercloud* court, was whether the insured was "aware of the harm inherent in the act."²⁹ But an insured accused of infringement may not, as a matter of law, be aware of the harm inherent in its act if it merely "should have known" that the act would induce infringement. Thus, where mere negligence or recklessness provides the basis for liability, section 533 should not apply to bar a defense.³⁰

In sum, it does not appear that liability for inducement requires a showing that the alleged infringer actually knew its acts would induce third parties to infringe. Rather, it need only be shown that the alleged infringer was aware of the patent controversy or knew or *should have known* of the infringement. Since liability for inducement to infringe arises from what is essentially negligent or reckless conduct—conduct expressly excluded from section 533—inducing infringement of a patent should not be deemed "willful within the meaning of section 533."

Besides misreading *Manville*, the court also improperly ignored the distinction that patent law draws between ordinary infringement and willful infringement. *Watercloud* argued that 35 U.S.C. § 284, which provides for the enhancement of damages for willful conduct, presupposes that an infringing act can be committed in an unwillful manner.³¹ Ignoring any policy behind section 284, the court dismissed the argument by stating that the section pertains only to the assessment of damages.³²

In so ruling, the court failed to recognize that treble damages for "willful infringement" in patent law and exclusion of coverage for "willful conduct" under section 533 are directed towards the same end, that is, to discourage the commission of willful conduct. In fact, the court erroneously states that 35 U.S.C. § 284 "merely provides the court with the discretion to award treble damages if necessary to adequately compensate the plaintiff for the infringement."³³ However, the purpose of treble damages is not merely to compensate the plaintiff but also to punish the defendant:

Whether the purpose of an increased damage award should be exemplary (i.e. to punish and deter flagrant acts of patent infringe-

28. *Watercloud*, 23 Cal. Rptr. 2d at 448.

29. *Id.*

30. See *Shell Oil v. Winterthur Swiss, Inc.*, 15 Cal. Rptr. 2d 815, 832 (Cal. App.) ("[I]t is now clear that section 533 does not prohibit coverage for reckless conduct"), *modified on other grounds*, 1993 Cal. App. LEXIS 156 (1993).

31. *Watercloud*, 23 Cal. Rptr. 2d at 448.

32. *Id.*

33. *Id.*

ment) or compensatory (i.e. to compensate the patent owner for unmeasurable expenses and losses) is a long-standing controversy in the law. Perhaps the best view is that increased awards combine both purposes.³⁴

And the Federal Circuit has stated, "Under our cases, enhanced damages may be awarded only as a penalty for an infringer's increased culpability, namely willful infringement or bad faith. Damages cannot be enhanced . . . to rectify what the district court views as an inadequacy in the actual damages awarded."³⁵

Furthermore, the court's failure to properly compare its standard to those policies underlying the patent laws is evident from its analysis of Watercloud's conduct. The court noted that Watercloud had begun to manufacture, use, and sell copies of Somma's mattresses after Somma had denied it a license to do so.³⁶ Applying its "intent" standard to the facts, the court held that Watercloud's conduct was intentional and inherently harmful, and therefore willful.³⁷ Ironically, however, this conduct is also "willful" under the patent laws.³⁸ This implies that the court's standard of "willfulness" is the same as that required for treble damages under 35 U.S.C. § 284. And, because this "willfulness" standard under 35 U.S.C. § 284 is greater than that for inducing infringement, it follows that the intent requirement for inducing infringement must be less than that required for exclusion under section 533. Otherwise, every act of inducement would yield a potential treble damage award under 35 U.S.C. § 284.

Besides misinterpreting patent law, *Watercloud's* ruling also misapprehends section 533's scope as a matter of insurance law: As the statute's language itself makes clear, section 533 does not bar the defense of intentional or willful acts—it only bars coverage for such acts.³⁹ Summary treatment is not justified where potential for coverage exists, particularly where the insurance company accepted insurance premiums

34. DONALD S. CHISUM, PATENTS § 20.03[4] (1993).

35. *Beatrice Foods Co. v. New England Printing & Lithographing Co.*, 923 F.2d 1576, 1579, *appeal filed* 930 F.2d 1572 (Fed. Cir. 1991). *See also* *Ziggity Sys. v. Val Watering Sys.*, 769 F. Supp 752, 795 (E.D. Pa. 1990) ("[C]ommon sense mandates that the 'knowing' requirement [for inducing infringement] cannot be equal to the 'willful' requirement . . . [T]he 'knowing' requirement judicially imposed [for inducing infringement] is merely a requirement that the [inducer] be conscious and aware of his activities—not that he was aware that his activities amounted to infringement.").

36. *Watercloud*, 23 Cal. Rptr. 2d at 444.

37. *Id.*

38. *See Spindelfabrik Suessen-Schurr, Stahlecker & Grill v. Schubert & Salzer Maschinfabrik Aktiengesellschaft*, 829 F.2d 1075, 1085 (Fed. Cir. 1987) (infringing conduct after an unsuccessful attempt to obtain a license evidence of willful conduct), *cert. denied*, 484 U.S. 1063 (1988).

39. *Watercloud*, 23 Cal. Rptr. 2d at 446; *see* *Horace Mann Ins. Co. v. Barbara B.*, 846 P.2d 792, 797-98 (Cal. 1993).

in exchange for a covenant that it would defend even frivolous, false or fraudulent claims that arose out of inherently intent-based torts (i.e., libel, slander, infringement of copyright, title or slogan, unfair competition, etc.).⁴⁰

C. Unfair Competition

Finally, the *Watercloud* court ruled that Somma's patent infringement claim against Watercloud did not constitute "unfair competition" as that term was defined by the California Supreme Court in *Bank of the West v. Superior Court*,⁴¹ and therefore was not covered under the "unfair competition" language in the policy's advertising injury clause.⁴² The court, however, overlooked the fact that common law "unfair competition" is not limited merely to "passing off"; it describes a family of related causes of action.⁴³ Among the torts in that family is "misappropriation of valuable business values," a common law cause of action permitting recovery when a defendant misappropriates a property right created by the plaintiff with a substantial investment of time, effort, and money.⁴⁴ But with regard to federal preemption concerns, patent infringement would appear to be encompassed in this definition because it is sufficiently related to the common law family of "unfair competition."⁴⁵

III. CONCLUSION

Despite the decision in *Watercloud*, policyholders can and should continue to argue that: (1) a policyholder is entitled to a defense even if the underlying complaint alleges both a direct infringement claim and an inducement claim; (2) patent infringement actions involving inducement claims are not excluded by section 533 of the California Insurance Code; and (3) a patent infringement claim is a species of "unfair competition" within the letter and spirit of *Bank of the West*.

40. See *CNA Casualty of California v. Seaboard Surety Co.*, 222 Cal. Rptr. 276, 285 n.8 (Cal. App. 1986) (rejecting insurer's argument that section 533 barred insurer's duty to defend because, among other things, the duty to defend arose out of charges for "defamation, unfair competition, and idea misappropriation, as to which [insurer's] policy expressly agreed to provide a defense.").

41. 833 P.2d 545 (Cal. 1992).

42. *Watercloud*, 23 Cal. Rptr. 2d at 444.

43. J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARK AND UNFAIR COMPETITION § 1.05, at 1-23 (3d ed. 1992).

44. *Id.* § 1.25, at 1-97 to -98.

45. Curiously, the court did not address whether the "piracy" term in the Aetna policy would include patent infringement. Nor did it address whether the phrase "misappropriation of style of doing business" would include patent infringement. The meaning of these terms remain open for future court interpretation.