Volume 7, No. 2 | March–April 2024

RAIL

The Journal of Robotics, Artificial Intelligence & Law

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THE JOURNAL OF ROBOTICS, ARTIFICIAL INTELLIGENCE & LAW (ISSN 2575-5633 (print) /ISSN 2575-5617 (online) at $495.00 annually is published six times per year by Full Court Press, a Fastcase, Inc., imprint. Copyright 2024 Fastcase, Inc. No part of this journal may be reproduced in any form—by microfilm, xerography, or otherwise—or incorporated into any information retrieval system without the written permission of the copyright owner. For customer support, please contact Fastcase, Inc., 729 15th Street, NW, Suite 500, Washington, D.C. 20005, 202.999.4777 (phone), or email customer service at support@fastcase.com.

Publishing Staff
Publisher: Morgan Morrissette Wright
Production Editor: Sharon D. Ray
Cover Art Design: Juan Bustamante

Cite this publication as:

The Journal of Robotics, Artificial Intelligence & Law (Fastcase)

A Full Court Press, Fastcase, Inc., Publication

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729 15th Street, NW, Suite 500, Washington, D.C. 20005
https://www.fastcase.com/

POSTMASTER: Send address changes to THE JOURNAL OF ROBOTICS, ARTIFICIAL INTELLIGENCE & LAW, 729 15th Street, NW, Suite 500, Washington, D.C. 20005.

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ISSN 2575-5633 (print)
ISSN 2575-5617 (online)

Start-Up Corner

Buying Certainty in an Uncertain World Through Litigation Risk Insurance

Kevin V. Small, Patrick M. McDermott, and Alex D. Pappas*

In this column, the authors discuss litigation risk insurance.

If one thing is certain in litigation, it is uncertainty. While eliminating all litigation-related uncertainty is impossible, litigation risk insurance is a potentially helpful first step.

Litigation risk insurance has been around in some form for decades. But no matter its background presence, it has only recently become more prevalent. As businesses keep looking for ways to manage litigation risk, they should consider whether litigation risk insurance is right for them.

This important suite of insurance products may be tailored to any type of litigation risk, but it is generally divided into two types of insurance products: adverse judgment insurance and judgment preservation insurance. Both insurance products might be helpful business and risk management tools.

The Benefits of Litigation Risk Insurance

The broad idea behind litigation risk insurance is to off-load litigation risk from one organization onto the insurance markets. Transferring risk away from an organization facing or pursuing substantial litigation can be a fruitful business strategy. Litigation risk insurance can be used to insure just about any type of litigation risk that one can imagine.

Take mergers and acquisitions as an example. When a target company is facing substantial litigation, would-be acquirers may understandably be reluctant to acquire that basket of liabilities.

Robotics, Artificial Intelligence & Law / March–April 2024, Vol. 7, No. 2, pp. 163–166.

ISSN 2575-5633 (print) /ISSN 2575-5617 (online)

Litigation risk insurance offers a potential solution by taking that litigation exposure off of the target's books.

Litigation risk policies can also serve as collateral for loans in some cases. For example, suppose a defendant in a class action wants to settle with the class but does not have the liquidity to pay and its insurers refuse to fund the settlement. The defendant sues its insurers and looks to take out a loan to fund the class action settlement in the meantime. In this context, the defendant could offer its lender as collateral a litigation risk policy insuring the risk that the defendant does not prevail in the lawsuit against its insurers.

Litigation risk insurance can also be important for a business's cash flow. By off-loading risk, businesses may release corporate funds that were set aside to pay a judgment. And investors or financiers may condition funding on obtaining litigation risk insurance, so this insurance can position a business favorably when raising capital.

Transferring litigation risk also has the potential to create favorable settlement dynamics. For example, defense counsel could use the existence of adverse judgment insurance as leverage in settlement negotiations to effectively cap the defendant's exposure at that policy's attachment point. The reason is that the defendant would have every incentive to inform its adversary that it is willing to proceed to trial unless a settlement is reached at an amount below the policy's attachment point. That dynamic can, in some circumstances, weed out overzealous plaintiffs who are unwilling to take their case to trial.

In sum, litigation risk insurance offers a wide array of possible benefits that can accrue to different businesses depending on their goals and preferences.

The ABCs of Litigation Risk Insurance: Adverse Judgment Insurance and Judgment Preservation Insurance

Given the bespoke nature of litigation risk insurance, it is possible to procure a policy for just about any type of litigation risk. Generally, however, there are two types of litigation risk insurance: adverse judgment insurance and judgment preservation insurance.

Adverse judgment insurance protects defendants against significant (or even catastrophic) judgments. The goal with this insurance product is to allow businesses to transfer the risk of an adverse judgment to insurance markets. And depending on the context, adverse judgment insurance can be thought of as a way to increase the amount of coverage available in an existing insurance tower. For example, a defendant with $50 million in insurance coverage may take out an adverse judgment insurance for liability over $50 million.

Adverse judgment insurance typically only covers final, non-appealable judgments. It also seldom, if ever, covers defense costs.

Judgment preservation insurance, by contrast, protects plaintiffs who have already received a favorable judgment, but now face the prospect of an appeal in an ongoing litigation matter. The main goal of this insurance product is to mitigate appellate risk by contractually guaranteeing a prevailing party recovery of all or some of the amount awarded in the trial court judgment. In other words, if the trial court judgment is reversed on appeal, the insurer pays at least some amount awarded in the original trial court judgment.

Underwriting Litigation Risk

Litigation risk insurance, whether adverse judgment insurance or judgment preservation insurance, is often a bespoke and highly negotiated insurance product. The reason is that the exposures are not standardized and vary depending on the facts underlying a specific litigation.

Insurers will generally need information about the specific case, including the legal theories being advanced and the factual support for those legal theories. Often, the underwriting process is easier for more advanced cases because the more developed factual and legal records provide the would-be insurers with more information to assess the risks surrounding a specific case. Underwriting can also be easier for judgment preservation insurance than for adverse judgment insurance because judgment preservation insurance by its nature involves a fixed and knowable factual record. That is, because a judgment has already been rendered, the facts have already been decided, which may make it easier for insurers to analyze risk. Adverse judgment insurance, by contrast, involves circumstances where the case is ongoing and therefore subject to more possible changes as the parties learn the facts.

Because litigation risk insurance underwriting turns on the specific facts more than other types of insurance coverage, underwriters may consider features of a case that might strike a would-be litigation risk policyholder as odd. For example, depending on the circumstances, it could be harder to underwrite a case proceeding in the Eastern District of Virginia's "rocket docket," which can truncate the time allotted for factual and legal development and in turn minimize available information about the magnitude or probability of a given risk.

Key Considerations

While litigation will always bring with it uncertainty, litigation risk insurance products can be a helpful tool for organizations looking to minimize that uncertainty. For businesses considering whether to procure litigation risk insurance, working with experienced coverage counsel and brokers can be essential because litigation risk insurance products are highly negotiated and thus may require considerable industry expertise to get right.

Note

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