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Tech Means Risk, And Risk Means E&O Coverage

Law360, New York (September 27, 2010) -- It was the end of highly anticipated launch day of Apple's iPhone 4 and the total tally was staggering, with nearly 2 million iPhones sold in one day. Then the "death grip" news hit. If you held the iPhone 4 a certain way, reception suddenly dropped. Rumors of a recall reverberated through the techno blog world. The potential design flaw garnered international attention and embarrassment for the cutting-edge company. Apple states on its website:

> Upon investigation, we were stunned to find that the formula we use to calculate how many bars of signal strength to display is totally wrong. Our formula, in many instances, mistakenly displays 2 more bars than it should for a given signal strength. For example, we sometimes display 4 bars when we should be displaying as few as 2 bars. Users observing a drop of several bars when they grip their iPhone in a certain way are most likely in an area with very weak signal strength, but they don't know it because we are erroneously displaying 4 or 5 bars. Their big drop in bars is because their high bars were never real in the first place.
>
> We will issue a free software update within a few weeks that incorporates the corrected formula. Since this mistake has been present since the original iPhone, this software update will also be available for the iPhone 3GS and iPhone 3G.

Shortly thereafter, *Consumer Reports*, one of the most influential ratings guide, says: "...Apple needs to come up with a permanent—and free—fix for the antenna problem before we can recommend the iPhone 4."

There was no recall but Apple did offer free a "bumper" that surrounds the iPhone and prevents calls from dropping.

It is precisely these kinds of design flaws that a Technology Errors & Omissions insurance policy is designed to cover. The costs of the bumper program and the delay in shipment to various customers are all damages that may result from the death grip. The Coverage Grant in Technology Errors & Omissions Policy typically provides the following coverge:

> Subject to the applicable Limits Of Insurance, and in excess of the Deductible, we will pay damages the **insured** becomes legally obligated to pay for any **claim** arising out of a **wrongful act**, to which this insurance applies, by or on behalf of the **insured**:
>
> > in the performance of or failure to perform **electronic and information technology services**; or
> >
> > in the failure of **electronic and information technology products** to perform the function or serve the purpose intended.

Depending on the definitions contained in the policy, any technology company would be well-served by investing in Technology Errors & Omissions insurance. A knowledgeable broker could help negotiate favorable policy terms meant to protect the start-up company from financial ruin. A standard products liability or CGL policy may not cover the modern day technology E&O claim. Examples of claims covered by Technology Errors & Omissions insurance include:

<u>Failing to Meet Specifications</u>
Jury renders multi-million dollar verdict against a computer systems hardware and software vendor because the system it sold was "inadequate" for a customer's needs, causing the customer to go bankrupt. The system failed to achieve performance criteria promised by contract.

<u>Defective Components Halt Production</u>
An assembler of point of sale systems sued a small computer manufacturer. The assembler argued that defective components caused an abnormally high failure rate, bringing production to a halt.

<u>Switch Fails to Perform</u>
A digital telecommunications switch performed erratically, causing a customer to suffer a significant loss of revenue and reputation when people were cut off mid-conversation. The customer sued the switch manufacturer and settled for $12 million.

Despite its unique form of coverage, familiar issues arise under a Technology Errors & Omissions insurance. For example, insureds are prohibited from voluntarily settling a claim and must obtain insurance company consent ahead of time. What about the situation where a customer sues a software maker for failing to deliver on time and the executives of each company decide to settle for a waiver of invoices?

First is the issue of complying with the voluntary payment clause and second is the issue of whether a waiver of invoices is considered "damages."

An insurer could face bad faith liability if it improperly withholds consent to executing a settlement vital to the insured's business. The fundamental principle of the implied covenant of good faith and fair dealing is "that neither party will do anything which will injure the right of the other to receive the benefits of the agreement." *Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566, 573, 108 Cal.Rptr. 480, 484. The implied covenant requires the insurer to "give at least as much consideration" to the interests of its insured as it does to its own. *Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809, 818-819, 169 Cal.Rptr. 691, 695. "A party violates the covenant if it subjectively lacks belief in the validity of its act or if its conduct is objectively unreasonable." *Carma Developers (Calif.), Inc. v. Marathon Develop. Calif., Inc.* (1992) 2 Cal.4th 342, 372, 6 Cal.Rptr.2d 467, 484.

The law in California is that the insurer has a duty to accept a reasonable settlement, and where the insurer refuses to do so, the insured is entitled to settle on its own and then sue the insurance carrier to recover the settlement amount:

> The general rule placing the burden on the policyholder to establish facts to trigger coverage is subject to the exception explained in *Isaacson v. California Ins. Guarantee Assn.* (1988) 44 Cal.3d 775 [244 Cal.Rptr. 655, 750 P.2d 297]: When the insurer refuses to accept a settlement and the insured meets its burden of proving the settlement was reasonable, then the insured is entitled to a presumption in his favor - a presumption that the insured is indeed liable to the claimant and that the amount of his liability is the amount of the settlement.

In *Isaacson*, the California Supreme Court reiterated the rule that if an insurance carrier breaches its contract with the insured and erroneously denies coverage or refuses to defend, the insured is entitled to make a reasonable settlement with the claimant and to sue the carrier to recover the settlement amount. (44 Cal.3d at p. 791); see also *Clark v. Bellefonte Ins. Co.* (1980) 113 Cal.App.3d 326, 335.)

Further, in such an action for reimbursement of the settlement, the settlement is presumptive evidence of the insured's legal liability on the third party's claim and the amount of the insured's liability. (*Isaacson, supra,* 44 Cal.3d 775; see also *Peter Culley & Associates v. Superior Court* (1992) 10 Cal.App.4th 1484, 1493-1494, 1497.

The *Isaacson* court went on to say that even if the insurer has not denied coverage or refused to defend, the insurer has a duty to accept a reasonable settlement, and the insurer's refusal to settle may give rise to the insured's action for settlement reimbursement. (44 Cal.3d at p. 792); see also *Crisci v. Security Ins. Co.* (1967) 66 Cal.2d 425, 430; *Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 659.

The other issue is if waived invoices, a common demand in settling a technology errors and omissions claim, are compensable. In a case of first impression, a trial court in San Francisco Superior Court ruled, that absent a definition of the term "damages," waived invoices could indeed be compensable under a Technology Errors and Omissions policy. In a breach of contract and bad faith suit against an insurance company, the Honorable Robert Dondero ruled that coverage existed for a waiver of invoices because:

> These are the guiding principles applied by this Court in determining the meaning of "damages" that controls Phase I of this case. The reasonable inclusion of non-cash consideration within the meaning of "damage" under the Errors & Omission policy would then allow this case to proceed to Phase II of the suit. It would provide a *legal* predicate for the duty to indemnify on the part of Defendant acknowledging the non-cash consequences of Plaintiff's settlement....
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> The coverage language of the policy does not preclude the Plaintiff's position. This Court cannot state that the plain meaning of the policy is clear and unambiguous so as to support Defendant's position. "Damages" as developed in the "Coverage" portion of the policy is not limited in any way except by the trigger of a legal obligation on the part of the insured that originates from a wrongful act covered by the E&O policy. Forsaking the value of Plaintiff's invoices and inventory are at least sufficient legally to be considered damages under this policy.

> Such ambiguity allows this Court to consider whether it is objectively reasonable for the insured to conclude these policies allowed for recovery of non-cash consideration such as inventory and invoices.

The Court went on to rule in favor of the plaintiff and the case settled between Phase I (the bench trial on coverage) and Phase II (the bad faith jury trial).

From Apple down to the little-known insured company that filed suit in San Francisco Superior Court, the protection offered by a Technology Errors & Omissions policy could prove invaluable to the business at hand. New technology is dependent on constant innovation and inherent in all innovation is the risk of failure. To offset the risk, a company with a Technology Errors & Omissions policy could find its value quite high.

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