Technology Companies: When a Product Complaint Arises, Will Your Insurance Cover the Claims?

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- Sometimes, technology products contain flaws.
- Purchasers may complain to the manufacturer about the flawed products, and some complaints become multi-million dollar liabilities.
- After receiving such a claim, the manufacturer that purchased "errors and omissions" insurance to protect against such liabilities might breathe a sigh of relief.

But, in reality, the insured manufacturer can find itself torn between the business imperative of repairing a threatened customer relationship, while simultaneously seeking to preserve access to the benefits of its insurance policy.

If your company has found itself on the receiving end of such a claim, you need to proceed carefully to manage the tension of these conflicting obligations.

Consider a typical scenario:

> *After Semiconductor Manufacturer ships tens of thousands of its state-of the-art chips, Major Customer angrily advises that the chips are flawed and that its costs are mounting as a result. (Although this scenario involves a hardware component, the same issues arise for finished products, software, other technology products and technology services.) In response, the Manufacturer jumps into action: It deploys personnel to investigate and to fix the technical flaw, to repair the threatened customer relationship, and to assess whether it will owe compensation.*

What is missing here? The simple answer—Notice to the insurer. Most Errors and Omissions policies are "claims made and reported" policies that require timely notice as a ***condition precedent*** to coverage. But, the customer may demand immediate satisfaction or at least action. An Insurer may want to investigate the

claim and may want argue there is no liability. The insurer may investigate whether the customer is mistaken or also somehow at fault. In short, the insurer may take a more protracted approach to resolution. When caught in the conflict between business imperatives and policy obligations, here are some of the challenging questions that the policyholder manufacturer will likely struggle with:

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When do we notify the insurer? E & O policies typically require that a policyholder notify the insurer of a claim "as soon as reasonably practicable" or within a specified time period, often no later than within 45 or 60 days from the end of the policy period. In most circumstances, the failure to provide the insurer with timely notice will imperil the existence of coverage. This can create challenges for the insured manufacturer. First, a customer's notice of a flawed product does not necessarily constitute a "claim." If the customer demands any kind of relief, this may fall within a broad policy definition of "Claim." But, if the customer demands compensation, then a "claim" is surely made. Second, many organizations fail to get the necessary information to the proper people on a timely basis. If a customer complaint is made to the sales organization or engineering personnel, the company needs to make sure that information is conveyed on a ***timely basis*** to the proper legal or finance personnel (who typically know about available insurance policies).

- **Must we admit the product was defective?** These policies typically provide coverage only if the product fails to perform properly or, in other words, is defective. But, if an insured ***admits*** liability this could well imperil coverage. When the initial complaint is made, it may not be clear whether the product is actually defective. There may be factual and technical questions of which component or process actually caused the malfunction, or whether the customer or someone else caused the flaw after the product was shipped. While the nature and cause of the flaw remains uncertain, the policyholder manufacturer may not know that its product is actually defective. Or, for various reasons, it may not want to "admit" that its product was defective. One tactic may be to advise the insurer of the circumstances, while explicitly advising that the existence and nature of the defect remains under investigation. This will avoid the hazard of admitting liability and thus allowing the insurer to refused coverage based on the company's "voluntary settlement."
- **Can we control negotiations with customer?** Understandably, a manufacturer confronted with a displeased customer will be laser-focused on preserving the relationship, a task that may require sensitive and strategic handling by a select team. Also understandably, the manufacturer's team does not relish the prospect of an insurance claims representative intruding into those negotiations or second-guessing the approach. But, based on typical policy terms, the insurer has the contractual right to "associate" or "participate" in the defense of any claim, including participation in negotiations that result in the insurer paying a settlement. Some policies may go further and give the insurer the absolute right to control settlement discussions. Under either type of language, the conflict is a real one: If excluded from negotiations, the insurer may refuse to fund any settlement and the policyholder may lose its policy right to indemnity coverage. There is thus a choice to be made by the manufacturer: Take the risk of imperiling customer relations to preserve coverage by ceding some level of control of the negotiations to the insurer? Or, forego involving the insurer but, by making that choice, the manufacturer may not be able to obtain any benefit from its insurance.
- **Can we compensate the customer?** Like most insurance policies, E&O policies typically prohibit the policyholder from making payments or agreeing to a settlement, without the insurer's consent. This is why notifying the insurer of the claim at the outset is so important to preserving coverage. The manufacturer may be asked to take immediate steps to address the defect, by providing replacement products, by agreeing to a discount or rebate, or by reimbursing expenses the customer has incurred because of the product problem. In some situations, the customer will press for assurances and promises (perhaps even written assurances) that the manufacturer will agree to compensate future expenses. If such remedial action is taken without the insurer's participation or consent, any such payments or assurances will likely bar coverage. Thus, the policyholder manufacturer is well advised to obtain the insurer's consent ***before*** promising or paying compensation to the customer.
- **Will the insurer reimburse all expenses incurred due to a defective product?** Insurance policies typically define the types of expenses that are covered, and often have exclusions that specify expenses that are not

covered. Expenses paid to compensate a customer for a defective product are usually covered. But, policy exclusions frequently exclude expenses incurred to recall a defective product, for example. More subtle is the situation where the policyholder manufacturer wants to reimburse expenses (such as staff time or engineering costs) that the customer incurred to address an issue. While it may be good customer relations to reimburse those costs, the insurance company can be expected to argue that those expenses are not covered.

These are subtle and difficult questions. There are no easy answers. Experience teaches that, in making the judgment calls required on these sorts of claims, the manufacturer should fully evaluate all the circumstances—the nature and cause of the defects, the nature and amounts of expense at issue and, of course, the particular terms of the policy and the advice of coverage counsel.

Delay can have dire consequences. The policyholder may lose its policy benefits entirely if it does not give the insurer timely notice and the opportunity to participate in negotiations.