COLD HARD CASH FOR SOFT IP DISPUTES

by Martin H. Myers

Major software companies frequently are targets of significant, costly litigation brought by competitors, licensees/licensors, end users, nondisclosure agreement counterparties, and others. Perhaps just as frequently, software companies fail to investigate and fully exploit valuable insurance coverage they have to pay for such disputes. There are many reasons insurance is an oft-overlooked asset for software companies—from poor communication between legal and risk management groups, to an early misestimate of the seriousness of the claim, to a lack of understanding regarding the scope of coverage. But corporate counsel and risk managers have every reason to investigate coverage—at any point in the life cycle of a major dispute.

In fact, errors and omissions ("E&O") policies typically carried by major software companies in recent years provide coverage for a broad spectrum of claims, from breach of license or other agreements to consumer fraud to breaches of privacy or security. They cover many other traditional "soft IP" claims as well, such as copyright or trademark. Since many E&O policies carry a traditional "duty to defend," the presence of even one potentially covered allegation can compel the insurance company to pay *all* defense fees and costs *for the entire action*. This is true even if coverage for some—or even most—of the claims is barred by an "intellectual property" or other exclusion. And even though E&O typically is written on a "claims made" basis, in many jurisdictions and under many E&O policy forms, "late notice" of a claim—even for a period of *years*—will not preclude coverage.

Several of these important principles, and the value of reviewing potential coverage, are dramatically illustrated in a recent case between a major software company and its E&O insurer, *Adobe Systems, Inc. v. St. Paul Fire and Marine Insurance Co.*, 2007 WL 3256492 (N.D. Cal. Nov. 25, 2007) (vacated by stipulation pursuant to a confidential settlement agreement, Jones Day attorneys Marty Myers and Ray Sheen represented Adobe in the case).

THE *ADOBE* CASE

Adobe's coverage case arose from licensing agreements Adobe had entered with Agfa/International Typeface Corporation ("Agfa"), a font vendor, under which Adobe obtained authority to give its end users certain rights


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to use fonts that Agfa and its predecessors had originated, including the popular Times New Roman and Arial fonts. Adobe embedded various Agfa-originated font features into several products, including releases of its ubiquitous Acrobat® software, enabling Adobe end users to render and view the fonts, subject to Adobe end-user license agreements.

In the late fall of 2001, in connection with a license renewal, Agfa began to assert that Adobe's use of "editable" bits in fonts embedded in certain Adobe products violated Agfa's rights under the license agreements and common law and potentially violated the Digital Millennium Copyright Act ("DMCA"). Agfa further asserted that Adobe's end-user license agreements improperly condoned violations of its rights in the fonts. During this period, Adobe's legal department corresponded and met with Agfa representatives, discussed the issues and the "potential litigation" internally, and even engaged outside counsel to assess Agfa's legal positions. Eventually, in May 2002, Agfa made a formal demand to Adobe for damages by sending Adobe's general counsel a "Notice of Breach" of the license agreements. Through that time, Adobe had not provided notice of "claim" or tendered any aspect of the Agfa matters to its E&O insurer, St. Paul. Adobe's E&O policy from St. Paul covered claims first made between September 15, 2001, and September 15, 2002.

Adobe's negotiations with Agfa continued during 2002, when the parties reached an impasse. Believing that Agfa would attempt to file suit in its home forum in the U.S. (Illinois), in early September 2002, Adobe preemptively filed suit against Agfa for declaratory relief on certain issues in the Northern District of California. Adobe also invoked an arbitration clause in the Agfa license agreements and brought claims for declaratory relief on the agreements in London. True to form, Agfa quickly brought counterclaims in the London arbitration and filed two lawsuits against Adobe in Illinois—one asserting only a DMCA claim and the other asserting breach of contract and other claims, all based on the same conduct about which Agfa had been complaining for more than a year. Given the widespread use of Adobe products, collectively, Agfa's claims sought damages measured in the hundreds of millions or billions of dollars. Still, Adobe did not tender or give notice of the Agfa matters to its E&O insurer, St. Paul.

Finally, in the fall of 2003, more than a year into the litigation and arbitration, and after Adobe's risk management personnel were apprised of the Agfa matters, Adobe provided notice and made a tender to St. Paul. St. Paul denied the Agfa claim on numerous grounds, including alleged late notice, an intellectual property exclusion, and a willful acts exclusion. Adobe conducted its own defense, and after a very costly three-year battle, Adobe substantially prevailed against Agfa in the arbitration and litigation. Adobe and Agfa entered a confidential settlement, and Adobe approached St. Paul to recoup some of its losses. St. Paul declined to participate.

Adobe sued St. Paul, and the parties made cross-motions for summary judgment—Adobe on its claims that St. Paul owed but breached a duty to defend Adobe in the Agfa actions, and St. Paul asserting noncoverage for all claims. The court ruled for Adobe on all major coverage issues, finding that St. Paul had breached its duty to defend. The reasons Adobe prevailed are worth noting by software company risk managers and legal counsel.

COVERAGE FOR "WRONGFUL ACTS," INCLUDING BREACHES OF CONTRACT, IS BROAD

E&O policies purchased by major software companies today generally provide coverage of liability for "wrongful acts," which typically are broadly defined to include an "error, omission or negligent act" in connection with or resulting from the insured's "products" and/or "services." These terms apply to most software companies' core operations, activities, and exposures. Indeed, because a claimant may characterize virtually any act of or attributable to the software company as an "error" or as "negligent," the affirmative reach of policy coverage is virtually coextensive with the entire range of liabilities that a software company may face. However, some courts have found that where the word "negligent" precedes the entire phrase "act, error or omission," the "wrongful act" definition is not satisfied unless the claimant expressly alleges that the act, error, or omission at issue was "negligent," *e.g.*, *Group Voyagers, Inc. v. Employers Ins. of Wausau*, 2002 WL 356653 (N.D. Cal.), *aff'd* 2003 U.S. App. LEXIS 11366 (9th Cir. 2003).

Coverage of liability for "wrongful acts" also may expressly include various forms of misstatement and/or breaches of duty, and such allegations frequently are made in consumer class actions and soft IP cases. Many modern, industry-specific E&O policies will explicitly include in the definitions of "covered wrongful acts" specific soft IP exposures of great

concern to software companies, such as infringement of copyright, infringement of trademark, invasion of privacy, and misappropriation of trade secrets, often subject to significant self-insured retentions and a complex variety of exclusions and limitations.

One widely held misconception about software company E&O concerns coverage for damages from breaches of contract. By and large, such damages *are covered*—often expressly so—but once again ordinarily are subject to various exclusions and limitations. *See*, *e.g.*, *Continental Cas. Co. v. Cole*, 809 F.2d 891, 895–96 (D.C. Cir. 1987) ("error, negligent omission or negligent act" provision "encompasses intentional, non-negligent acts like those associated with breach of contract"). The *ex contractu/ex delicto* distinctions historically made by some courts in the context of general liability policies (even if erroneously—*see*, *e.g.*, *Vandenberg v. Superior Court*, 21 Cal. 4th 815, 824–25 (1999)) have not found footing in E&O jurisprudence. Nor has a recent trend of judicial hostility toward coverage for allegedly contractual damages in Directors and Officers Liability ("D&O") cases (*e.g.*, *Oak Park Calabasas v. State Farm Fire and Casualty Co.*, 137 Cal. App. 4th 557, 565 (2006), or *August Entertainment, Inc. v. Philadelphia Indem. Ins. Co.*, 146 Cal. App. 4th 565, 576–77 (2007)) seeped into E&O decisional authority, although exclusionary provisions applicable to contractual damages exposures have evolved substantially. As a consequence, the wording of exclusions and limitations on coverage for breach of contract is critically important and should be the subject of careful negotiation at the time that E&O policies are purchased and when coverage is renewed.

Despite the breadth of most software E&O coverage, insurers can be expected to attempt to characterize contested claims as not involving "wrongful acts" and as not sufficiently connected to or arising out of the insured software company's defined products or services. The *Adobe* case is instructive as to the broad scope of coverage for wrongful acts and contractual damages—and insurers' retroactive efforts to nullify it.

In *Adobe*, St. Paul took the position that, despite Agfa's allegations that Adobe Acrobat® releases had violated its contractual and other rights in fonts, the alleged losses were not "wrongful acts" because they did not "result from" Adobe's "products or work." Rather, St. Paul contended the losses arose from Adobe's decision to include editable bits in the products over Agfa's contemporaneous objections. St. Paul also argued strenuously that its E&O policy was not intended to cover such contractual claims by vendors or licensors—but rather, only claims by end users or consumers of Adobe products. The court quickly dispensed with those arguments, holding:

> The alleged damages in the Underlying Actions resulted from Adobe's "work" and "product," that is, they resulted from the production and distribution of Acrobat 5.0 with the circumvention technology. Further, the underlying allegations were that the damages suffered by Agfa/ITC were caused by wrongful acts, that is, alleged errors in deciding to include the disputed technology. Although St. Paul contends that the policy was intended merely to cover claims made by injured consumers of Adobe's products, there is nothing in the plain language of the policy that precludes coverage for claims made by Adobe's licensor.

As to coverage of liability for breach of contract, St. Paul had to admit it was "true" that the policy covered "amounts [Adobe] must pay as consequential damages for the breach of a contract or agreement" but argued unsuccessfully that the court should limit such coverage to contract claims of consumers and end users of Adobe products, even though the policy contained no such limitation.

INTENTIONAL OR WILLFUL ACTS EXCLUSIONS AND LIMITATIONS ARE NO BAR

Software company E&O policies typically contain exclusions for intentionally wrongful conduct. And, in many states, insurance for intentionally wrongful and/or criminal conduct is barred as a matter of law, *e.g.*, Cal. Ins. Code § 522. These provisions are intended to prevent insurance coverage for acts that are inherently harmful (*e.g.*, murder, child molestation) or that the insured consciously intends to cause the specific injury suffered (*e.g.*, deliberate sabotage of another company's programming operations). If these kinds of exclusions applied to the unintended consequences of intentional acts, however, then most liability insurance policies would provide little coverage. A driver who negligently made a turn and caused an accident would not be covered because she intended to make the turn; a restaurateur who negligently served spoiled food would not be covered because he intended to serve the food, even though he believed it was safe.

Despite the salutary intent of these provisions, and despite their actual language, insurers frequently contend—and occasionally courts will agree—that they bar coverage for claims arising from any acts or business decisions that the policyholder took or made intentionally. Ordinarily, however, courts reject such claims without much fuss. In *Adobe*, for example, the court made short work of St. Paul's claim that coverage was barred because Adobe "intentionally" distributed Acrobat 5.0 and other products with an editable embedding bit even after Agfa had objected:

> Clearly, the very provision of E&O coverage in this Policy contemplated some level of intentionality. However, this exclusion precludes coverage only when the act is intentionally wrongful, and there is no evidence in the record before the Court from which to infer that the business decision allegedly made by Adobe to include the circumvention technology in its release of Acrobat 5.0 was, at the time it was made, subjectively known to be wrongful.

However, not all courts appreciate these distinctions. In a very recent case, a district court in Minnesota held there was no E&O coverage for the intentional distribution of "spyware" that allegedly corrupted a user-claimant's system, because coverage for an "intended act that results in unintended injury … runs counter to the plain language of the ['wrongful act'] definition." *Eyeblaster, Inc. v. Federal Ins. Co*., 2008 WL 4539497 *6 (D. Minn. October 2008). But the "wrongful act" definition at issue in *Eyeblaster* was an "error, unintentional omission or negligent act" containing the same "error" trigger that was sufficient in *Adobe* and many other cases.

The *Eyeblaster* court did not elaborate or explain its reasoning, and *Eyeblaster* should be regarded as anomalous, perhaps driven in part by the low regard in which those labeled as "spyware" companies are held. In any event, under the weightier and better-reasoned authorities, software E&O will cover intentional conduct, as long as the specific harm suffered is not intentionally caused. *Adobe*; *see also Corporate Realty, Inc. et al. v. Gulf Ins. Co*., 2005 U.S. Dist. LEXIS 236182 at *8–*9 (E.D. La. 2005); *Continental Cas. Co. v. Cole*, 809 F.2d at 895–96 (D.C. Cir. 1987) ("error, negligent omission or negligent act" provision "encompasses intentional, non-negligent acts").

"INTELLECTUAL PROPERTY" EXCLUSIONS OFTEN DON'T BAR COVERAGE AT ALL, OR BAR ONLY SOME COVERAGE

Many software company E&O policies—even those written on industry-specific forms that expressly cover various soft IP causes of action—may contain so-called "intellectual property exclusions," which purport to carve out and exclude specified causes of action (*e.g.*, patent infringement). Insurers routinely invoke these exclusions, arguing, for example, that the claimant's assertion of a patent infringement claim negates coverage entirely, despite related trademark, license, or business tort claims that are potentially covered.

However, the existence of one or more claims that arguably fall within an IP exclusion should not bar coverage—or even substantially diminish it. First, under the law of most jurisdictions, depending, of course, on the E&O policy language, the exclusion of one claim or set of claims in an action will not prevent coverage for other claims not clearly and conspicuously excluded. And where the policy carries a duty to defend, the law almost everywhere is that the insurer must pay for defense of the entire action, including all claims for which there is no potential for coverage. This is subject in some states to the possibility of partial recoupment, but even then only if the insurer can apportion its defense costs between covered and noncovered claims. *See Buss v. Super. Court*, 16 Cal. 4th 35, 48 (1997).

Second, whether a specific claim falls within an IP exclusion is often open to question. Many IP exclusions are imprecise or vague, and in most U.S. states and other jurisdictions, such ambiguities are construed strictly against the insurer. An exclusion must conspicuously, plainly, and clearly apprise a reasonable policyholder—interpreted from a lay and not a professional or technical perspective—of the matters within its scope.

Again, these principles are illustrated dramatically by the *Adobe* case. The E&O policy there contained an exclusion for loss that "results from infringement or violation of any copyright, patent, trade dress … or other intellectual property right or law." St. Paul argued strenuously that this barred all coverage, since Agfa's claims all "resulted from" copyright infringement—including specifically the DMCA violations that Agfa had asserted in its very first court complaint against Adobe in Illinois, and on which Adobe had sought declaratory relief in its first court filing in California. But the court correctly recognized that "[b]ecause there are breach of contract claims

in the Underlying Actions that are not claims for infringement of an intellectual property law, the [IP] exclusion does not serve to preclude coverage completely" and St. Paul had a duty to defend the entirety of the Agfa underlying actions.

THERE MAY EVEN BE COVERAGE FOR "PROSECUTING" AFFIRMATIVE CLAIMS

An insurer's duty to defend is not always limited to matters in which the insured is technically and formally named as a defendant. It is often advantageous, and sometimes even necessary, for a company to preemptively file suit and seek declaratory or other relief in a proper forum, in order to prevent forum shopping (*e.g.*, the Western District of Texas) or other procedural abuses by wily claimants. However, hewing to allegedly strict construction of policy language, E&O insurers refuse to pay attorneys' fees under these circumstances, arguing that because the insured incurred fees in the course of *prosecuting* supposedly "affirmative claims," they do not fall within the scope of the insurer's duty *to defend*.

The *Adobe* court rejected this argument. Adobe had initiated two of the four primary proceedings that comprised the underlying Agfa dispute, in both cases seeking declaratory relief. The court correctly found that Adobe had filed the actions for defensive purposes and held that "even though an insured initiates a lawsuit, that fact does not automatically preclude coverage for defense-type legal fees and expenses where the insured is resisting a contention of liability for damages." This holding is significant for software developers—and indeed, for all insureds—as it recognizes the practical reality that even where the insured technically must be the plaintiff or take the lead in filing suit, the attorneys' fees and costs incurred in such proceedings may constitute covered costs of defense.

LATE NOTICE TO THE INSURER IS NOT NECESSARILY TOO LATE

Perhaps the most startling lesson embedded in the *Adobe* case is that a delay in tendering or providing notice of an E&O claim need not be fatal—and even may have no impact on the insurer's obligations. In *Adobe*, the court found that St. Paul had a duty to defend Adobe in the Agfa matters even though the matters were not formally tendered or noticed to St. Paul for approximately a year and a half after Agfa's claims were first made, about two years after Adobe had commenced negotiations with Agfa leading to the claims, and well over a year after the St. Paul policy had expired.

One key reason Adobe secured coverage was that the St. Paul policy was "claims made" but not "claims made and reported." Thus, coverage was available for claims like those Agfa had first made during the policy period but had not necessarily reported to the insurer until after the policy expired. While the majority of software company E&O policies written today are claims made and reported, a substantial minority do not require reporting during the policy period, and particularly where there is continuity of coverage, the policyholder may have significant flexibility in reporting.

Another key element in Adobe's recovery was the "substantial prejudice" rule, under which a notice delay will not bar coverage unless the insurer can prove that the delay substantially prejudiced its rights—a very significant, often impossible showing. While a majority of U.S. states apply the substantial prejudice rule to notice obligations under occurrence policies, the application of this rule to claims-made policies such as E&O is far more limited, and U.S. states also vary widely regarding recoverability of so-called "pre-tender" fees and costs. Nonetheless, the possibility of the no-prejudice exception to the notice requirement argues for careful consideration of giving notice, even after a seemingly long delay.

CONCLUSION

Software companies should evaluate their E&O policies in connection with all disputes of note—at the earliest time possible, but regardless of the stage of the proceedings. As the *Adobe* case demonstrates, these policies can apply to a tremendous variety of claims and suits, and they may provide a key resource for funding defense, as well as any resulting settlement or judgment. ■

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