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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

When IT Fails: Software Vendor Liability Is Expanding

Law360, New York (June 09, 2014, 10:20 AM ET) -- As the software industry grew at lightning speed over the last few decades, software vendors earned billions of dollars on large corporate contracts written with extensive limitations on liability. In this rush, corporate America often received software programs and system implementations that did not function as promised, and those failed implementations sometimes caused a substantial disruption in operations that resulted in significant financial damages.

Michael Dagley

Failed software and information technology implementations often proved to be catastrophic and caused serious harm to corporations, while most contracts were written to limit vendor damages to unreasonable levels. As a result, companies from nearly all industry sectors have long struggled to obtain any significant compensation because of such exposure-limiting contract clauses.

The tide is shifting, however. Under an increasingly accepted legal theory based on misrepresentations made about the functionality and capabilities of software during the sales process, courts and arbitrators are awarding large damages to corporations when software systems have failed to operate as promised. In one recent arbitration victory, a North Dakota health care system recovered $102 million in damages, based on a $2 million software contract with a limitation of liability provision with Cerner Corp., a global software vendor. This case has received considerable industry attention because it was one of the first major awards by a hospital against a software vendor.

The Challenge of History

Historically, some software vendors have engaged in the practice of testing their products on successive customers. If problems arose, failed software implementations were often met with a litany of excuses, which seemed to make sense due to a "trial and error" philosophy that some software vendors held with respect to software and IT implementation.

Software companies also blamed company employees and their performance during a troubled launch, claiming the problems were due to compatibility, customization, or user error, and seeking additional payment for further "customized" or additional solutions and services.

If all else failed, software providers would "generously" let customers out of their

expensive contracts or negotiate minimal discounts.

The Health Care Breakthrough

In the health care industry, correctly working software is essential to meeting regulatory and compliance requirements for patient care and financial reimbursement. Dysfunctional software does not just slow business processes; executives can be sent to prison for financial and other irregularities.

Until now, health care organizations have been reluctant to litigate because they tend to accept the vendors' blame; they look at the contract and think they have no legal remedy; and they fear that converting back to the previous platform or a new platform is too expensive and risky. Software companies must be pressured to deliver or be held accountable for their promises because the implications of failure are too great for healthcare companies.

As a result, there are numerous noteworthy disputes involving healthcare companies battling against software providers. For example, in North Carolina, a class action is pending regarding failed software to pay Medicaid claims. Another matter is underway in Tennessee. A failed health care exchange in Oregon also resulted in investigations and litigation.

The Solution: A Tort-Based Legal Theory

The innovative legal theory taking center stage shifts the blame back to software companies and is based on the sales and marketing claims software providers make. This theory expands the vendor's liability beyond what it would be under the limits in the vendor-written contract. Courts and arbitrators are recognizing that vendors should be held accountable for the promises they make regarding the functionality of their software.

Why? Because purchaser-companies rely on those promises and real damages occur to the bottom line beyond the lost investment in the failed technology. In addition, software vendors have been far too aggressive and cavalier about whether the software they are selling actually does what they advertise. They sometimes don't disclose known problems and glitches to potential clients. Nor do they disclose lack of functionality or problems that other customers are facing, which is material information to a potential buyer.

Preventative Steps to Prevent Such Litigation

Customers buying large software implementations should consult legal counsel and review software and information technology contracts to better understand the vendor's specific performance obligations, existing remedies and damage limitations. Further, software companies and other information technology vendors should revise their contracts in response to recent decisions and allow for contractual remedies reasonably aimed at compensating an injured buyer.

Conclusion

Software companies who knowingly misrepresent the capabilities and functionality of their products will now be held accountable. Courts are holding that software companies have a legal obligation to disclose problems in their sales process. This new result will not be confined to health care industry but will have major implications for the health care industry and providers.

—By Michael L. Dagley and Brittain W. Sexton, Bass Berry & Sims PLC

Michael Dagley is a member and Brittain Sexton is an associate in Bass Berry's Nashville,

Tennessee, office.

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