

# Errors & Omissions:

## *Insurance for Technology Firms in Market Upheaval*



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Most High Technology firms face significant exposure to legal liability arising out of the sale or use of their products and services. Insurance to protect against claims for financial loss (as opposed to bodily injury or property damage) is commonly referred to as Errors & Omissions Insurance, or just E&O Insurance. Software providers face E&O risk in the form of product failure to perform or in the form of unintended consequences that shut down their customers' operations or otherwise negatively affect their customers' operations. Computer consultants and integrators face similar risks. Even makers of computer hardware or semiconductor products need E&O Insurance for potential failure of their products.

E&O Insurance has been available to technology companies for more than twenty years. Major insurers for E&O include market leaders Chubb and St. Paul as well as relative newcomers such as AIG, Hartford and Travelers. As with most commercial insurance products, prices and rates for E&O Insurance dropped as much as 40% on a cumulative basis in the late 1990s. Retentions (deductibles) were modest with average retentions in the low to mid five figures for all but the largest (\$1B sales and above) technology companies.

Loss ratios (a ratio of claims to premiums) have been rising however, quite dramatically for some insurers, in the past couple of years. The well-publicized disruption of service at eBay due to a bug in Sun Microsystems' software is just the tip of the iceberg in a world increasingly held captive by its IT systems. Whether simply as a result of lower rates or other factors, some insurers have experienced significantly poorer results, particularly in the past two to three years. Some insurers have also reported interesting new trends in the types of claims that they are experiencing. Items of particular note include the following:

- Larger technology companies that have higher contract or product prices are experiencing claims at a higher rate than smaller rivals who have smaller average sales per customer.
- Longer term development contracts have a strong correlation with increased claims activity
- Software products or services associated with billing systems have higher claims rates
- Internet consultants, systems integrators, and customized software firms are experiencing higher claims rates and greater demands for damages.
- Claims are just as high for sales outside the US as inside the US (dissimilar to many other types of liability risk)

A recent PriceWaterhouseCoopers survey<sup>1</sup> outlines litigation trends for all types of software and computer

<sup>1</sup> IT Litigation: Systems Failure (1976 – 2000), PriceWaterhouse Coopers, Washington, D.C.; 2000

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services firms for the past twenty-five years. While it shows no trends in the types of customers that bring litigation against technology companies, it does show that major allegations of litigation include:

- Breach of Warranty
- Breach of Contract
- Fraud
- Negligence
- Misrepresentation

Higher hazard technology firms are prone to losing large settlements or judgments under these allegations where provisions of their contracts are ambiguous or plainly unfavorable to the supplier. In these cases, settlements may exceed contractual limits of liability.

Insurance companies, in response to these trends, have increased the intensity of underwriting for technology companies. Insurers are requiring the completion of more lengthy questionnaires, and insurers are meeting with their insureds, particularly to review the terms of contracts between the IT firms and their customers. Premiums have gone up along with retentions for the last three years – doubling and sometimes even tripling. In order to obtain the most favorable results from these surveys and to avoid large premium rate increases, WGA recommends a focus on risk control via improvement of internal controls and contract language.

Contracts should be very specific about promises to customers. In particular, they should seek to clearly define terms such as “beta test”, “venue”, “acceptance”, “compatibility”, “down time”, or “unintended consequences”. Performance requirements of other systems and hardware should be clearly understood and enforced. The lifespan of products or services should be clearly communicated since customers often become dissatisfied if the supplier or a competitor introduces an improved system during an old product’s lifespan, as will inevitably happen. Guarantees for supporting an aging product line must be met even when a new product or version of a product is introduced.

Favorable contracts also should include provisions such as: a disclaimer of warranties, exclusive remedy, limitation of damages (consequential), and criteria for acceptance. Also, formalized change control procedures should be in place for customized development and for mid-contract changes. Such changes should be approved in writing by the customer and appropriate amendments to contracts made. Any deviation from standard contracts should be reviewed by legal counsel. Quality procedures including written product/system/service methodology should be in place, which will provide a consistent structure and approach to systems development and implementation. This should result in better quality systems and fewer errors and defects upon delivery.

Software makers have also been supporting legislation known as the Uniform Computer Information Transactions Act (UCITA). Consumers would lose some of their rights to pursue legal action under UCITA. But the prospects for passage of the legislation appear cloudy at best. In any case, WGA recommends a comprehensive survey of risk and contractual provisions in order to minimize risk and the impact of fast rising insurance rates. Insurers like those mentioned above also can work with IT firms to provide this type of service.

To discuss more about Errors & Omissions Insurance and risk management, please contact Philip J. Edmundson at (617) 261-6700 or pedmundson@WGAins.com.