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IT – Pioneering Professional Indemnity

Introduction

The objective of this paper is to summarise what in our experience are the major causes driving claims against software technology companies and we will also highlight some of the practical steps we as insurance professionals can discuss with our respective clients in order to help them avoid claims arising in the first place.

When we started to specialise in TMT claims around 12 years ago, the insurance landscape was very different. The availability of E&O policies for the technology sector was limited and those that were available were basic. Some Insurers adopted miscellaneous and standard E&O policies and relabelled them “Professional Indemnity – IT”. Those policies were largely nonsensical and irrelevant to the specific needs of the technology companies they were seeking to insure. Other companies including my own started to develop bespoke plain English policies for the emerging TMT markets and as the TMT market continues to change so do our policies and those of our competitors. The problem 12 years ago, was that the tech sector was starting to develop so dramatically it was difficult at times to understand what we were being asked to Insure.

Today there are numerous carriers offering a wide variety of insurance products for the technology sector from standard policies offering breach of contract; intellectual



property cover, and negligence cover to cyber liability policies catering for the range of exposures companies face today arising from their own web-sites.

Why do disputes escalate on IT projects and what can we do to manage and deal with the escalation?

Earlier this year we commissioned a Technology Partner at Taylor Wessing to review 100 of our technology claims which focused on the development and implementation of bespoke (rather than vanilla – "Off the shelf" package contracts) in order to identify the main causes of claims.

The results were interesting.

Contract negotiation, Design, and Planning Stage (pre-contract);

Of the 100 claim files reviewed Taylor Wessing reported that 66% of the claims were in part caused by inadequate understanding of the requirements for the system; an underestimation of the amount of time required to implement the system and a lack of appreciation as to how much the system would ultimately cost.

When we investigate the background to a new claim and review the project correspondence file in order to comment on coverage and to take a view on the underlying dispute, we often find that the seeds of discontent are sown by both the claimant and Insured in the early days of their relationship by:

- Accepting/making unrealistic tenders in terms of time, functionality and cost;



- Signing off poorly constructed and ambiguous functional specifications and contracts and;

- Poor Project documentation and lack of training

In many cases the claimant has issued an ITT (Invitation to Tender), and yet at the time of issue or indeed acceptance of the tender from our Insured's, they have not appreciated what they wanted, or what they needed, or what clear objectives they were hoping to achieve by investing in a new system. Nor do they ever appreciate the real cost of changes. Instead, at the contracting stage and when they make the claim they deal in generalities. The system or service must make their business more efficient and enhance the profitability. They are of course, generally not discouraged from thinking this by our Insured's enthusiastic sales teams. However, contrary to mischievous assertions in claim letters or recollections from the tender stage; I.T. systems do not make companies profitable or successful. That is the sole remit of a competent workforce led by an effective management team. Systems are merely the tools of our trade.

To address this obvious difficulty in understanding their own technical needs and objectives, some claimants refer to third party consultancies who (when considering bespoke systems in particular) play key roles in the drafting of the functional specification. Unfortunately, these people often feed back into the claimant company at Board level and rarely engage end-users effectively, or at all, despite the fact that it is the end-users who appreciate more than anyone what will work and what will not. Remember it is the end-users who ultimately test the system and "sign it off". If end-users are not referred to at the tender stage this will certainly create problems later in the development.



Many claimants also fail to appreciate the amount of time their own staff will have to invest in a bespoke development and this is clearly demonstrated when they set out unrealistic time frames for “Going Live” in their tender documentation. The vast majority of bespoke developments are partnerships in their purest form. Neither party will succeed in fulfilling its obligations if the other party fails to fulfil theirs. It is a

symbiotic relationship. A reality most claimants forget when articulating their claims. We must make sure that our clients manage theirs and emphasise this when responding to tenders to ensure that there are no fundamental misunderstandings from the outset that can derail a project further down the line. Our Insured’s, for their part, must ensure that they are not misrepresenting their resource capabilities or their software’s functionality and that their marketing literature reflects a modicum of realism as opposed to outright fantasy.

When responding to an ambiguous invitation to tender there is too great a temptation to make assumptions as to what the claimant wants and too little time spent trying to obtain clarification. If the claimant doesn’t understand what it wants how can our Insured’s competently set out a substantive response in terms of software capabilities; initial costing and time-frames?

Discussions regarding functionality and cost, and comments made at the sales pitch, before signing the contract, are fundamental when the contracts do not contain “Entire Contract” clause provisions. These clauses mean that the contract itself represents the entire agreement between the two parties. What was said before the contract was signed loosely speaking becomes irrelevant. Although there have been some successful challenges to these clauses in the last couple of years.



As far as “sales speak” is concerned, on a number of occasions we have witnessed cases where our Insured’s have promised the earth, but are cut off from, or simply do not communicate with, their companies’ Project management implementation teams: the guys that deliver the promises.

The salesmen get the contract, and their commission, and disappear leaving the appointed Project Manager to “hold the baby”. The point here is that we should be emphasising to our clients that in terms of internal risk management their sales teams reward structure should be directly linked to a successful “Go-Live” – i.e. performance related not purely sales related. Secondly, no-one should approve a contract or have the authority to amend standard terms without the involvement of either a contract committee consisting of senior personnel or departments including the project delivery teams and quality assurance departments. We should be asking what the processes are for agreeing contracts and amending standard clauses and we will discuss contracts in further detail shortly.

Our Insured’s and the Claimants must be realistic about the time and cost of a Project

Our Insured’s often have to set out a basic cost appraisal before the contracts are signed because several technology companies may be invited to tender for one project and often the cheapest quote wins the contract. This is where common sense often clashes with commercial pressure. When inviting a tender and responding to one, both parties must understand how much the Project will realistically cost and how long it is likely to take? These are the burning issues for all claimants. Technology costs for any business are significant and those costs need to be controlled and properly allocated. Agreeing budgets for I.T. Projects can be highly political and contentious



within the claimants organisation and the fall guy for any unexpected overspend is often the claimants Finance Director. They are the ones that will “get it in the neck” and they are the ones that can, and generally do make our Insured’s lives very difficult. If they are not properly advised from the outset and kept informed throughout the project of issues regarding unanticipated costs, they will become very unhappy very quickly.

There is a fundamental distrust between the Buyer and the Supplier of I.T. systems. We know controlling costs are important and yet cost overruns and inadequate change control processes are more often than not an area of contention in most I.T. disputes. (Poor Change control processes and arguments as to whether a change request for a project was outside the scope of the contracted functionality appeared in 59% of the claims Taylor Wessing reviewed this year).

In the market place, the general perception is that all I.T. Projects overrun and cost more than originally estimated. When the original estimates are re-examined, the claimants say the position as to cost was misrepresented at the point of sale and were consequently misled into entering into the contract.

Our Insured’s say there was “scope creep” which may or may not be proved by reference to the agreed functional specification document and may or may not be accounted for in the change control documentation. There is then of course the debate about what is a genuine “change control” and therefore a legitimate additional cost payable by the claimant and what falls within the originally agreed specification and estimate. If the Functional Specification and contract drafting are rushed – this will more likely than not come back to haunt our clients at a later stage.

It is not surprising then given this backdrop, that claimants want “fixed based” contracts and our Insured’s want “time and materials” based contracts. In



terms of “go-live”, Claimants want to make “time of the essence” and our Insured’s want “best endeavours”. Both parties want to be able to blame the other. This is where a carefully drafted functional specification and properly constructed contract can come in very useful.

Functional Specification.

Once the tender has been awarded the precise content of the contract will be negotiated and it is also usual for the technology company at this time to meet with the business departments and to fine tune what the software is needed to do and what it can do in order to produce the functional specification which will specify the functions that a system must perform. This is a critical process which involves both parties and requires both parties to sign off ideally before the development can commence – although we can recall several projects where software development had commenced even before a functional specification was agreed. When this happens our

Insured’s became snared in what amounts to an “open-ended” contract. In this scenario the Claimant will say *“we expected the system to do all of these functions too”*. Clearly the obvious point is to ensure that the Functional Specification has been signed off and agreed by both parties and that it is clear and unambiguous. Of the 100 files reviewed by Taylor Wessing 19% of the cases experienced difficulties because project development work had started even before a specification had been agreed.

Contract Construction

With regards to the contract some people may say, *“Don’t worry about the tender or pre-contractual discussions. Don’t worry about the functional specification even though it wasn’t signed off. If it all goes wrong, we can rely on the contract”*.



Unfortunately, both the claimants and our Insured's think the same thing which is why it is so important to ensure that the contract at least addresses the basics. As advisors we must remind our clients that claimants and their lawyers draft contracts with disputes in mind. They ensure that all of the bases are covered and that the clauses are beneficial to them. So before our clients sign the contracts that are often imposed upon them; set aside the smiley faces and warm relationships that may exist for a moment and fast forward 6 months. Imagine a contract termination; and a full blown dispute and if you are still comfortable with all of the clauses in the contract - sign it. If you are not happy; discuss the terms again with your internal or external counsel; and refer to your insurance brokers and your insurers. There isn't much point buying an E&O policy if you then sign a contract that the insurance policy will not respond too.

The contract and any agreed variations to it form the "bible" document of any Project. The contract should be constantly referred too during the life time of a project and any issues identified should be addressed immediately and not simply ignored. Problems only get worse; they rarely disappear.



So what are the basics a contract should contain.

The Contract:

- **Should be drafted in plain terms** and accurately and fairly represent both parties' obligations. Everyone should appreciate what they are signing up for and what they have to do. Remember that bespoke development contracts require both parties to perform. These contracts are partnerships. A lack of co-operation from the claimant was a relevant factor in 59% of the claim files audited by Taylor Wessing.

e.g. We dealt with one dispute a couple of years ago, where we went to the Supplier's premises for a preliminary meeting, the Project had been terminated. The claimant had lost all confidence because the Project was 12 months behind schedule. The Insured felt that they had done nothing wrong and were amazed that the claimant had not even tested the system. We read the contract, and asked "where has this issue been addressed in the contract? Who was supposed to be testing the system? The Insured emphatically answered "They (the Claimant) were". That is not what the contract said. In fact, it was silent on the issue. Acceptance testing had not even been addressed. The Claimant had not appreciated this because when they signed the contract no-one discussed it. The contract negotiation had been conducted too quickly.



- **Should set out a mutually agreed escalation mechanism** that both parties can turn to in the event that one or the other or both, fail to fulfil their obligations under the contract. The alleged breach may not be “material” and may be capable of remedy. Failures on both sides should be documented properly and dealt with at the time they arise at minuted Project review meetings. Again the message we should be sending is “*do not bury your head in the sand*” – deal with problems and issues as they arise.
- **Should set out a dispute/termination mechanism** which outlines an effective dispute resolution procedure. This should ideally start with Without prejudice (off the record) meetings with the Project Management team, escalating to senior management (FD’s), then CEO’s and then Mediation. Failing Mediation, either party should be free to litigate as an absolute last resort. We should be strongly advising our clients to mediate disputes because the average case that goes to the TCC (Technology & Construction Court) in London costs us £1.5m. Technology litigation is very expensive; and the irrecoverable costs for our clients are significant. Project staff engaged in prolonged litigation are unable to do billable work for clients. This cost alone to “the business” can be significant.



- **Should detail an effective “change management” control procedure in order to strictly control “Scope Creep”.** Scope creep was an issue in 59% of our 100 claims reviewed by Taylor Wessing. This is where we agree to deliver various functions as set out in the functional specification but when we start developing the system, the claimant staff want to change things and add extra functionality. This is where the agreed scope starts to creep. This can have a massive impact on cost and the delivery schedule so in the contract we need to address what the parameters are for change requests? Who can raise them? Who authorises them? Who is responsible for actioning them? Who is responsible for evaluating the impact on the Go-Live date? Who is responsible for discussing the impact with the claimant?
- **Should limit our Insured’s liability fairly and realistically.** If a contract is worth £1m do not agree a liability cap of £20m. Our clients should be carefully considering the wording of this clause and what specific heads of damage the cap applies too. Define what direct and indirect losses are; set out those heads of damage you want to exclude whether or not they may be defined as direct or indirect losses. The bottom line is that if you want to exclude it you have to say so very clearly. It is also sensible that we encourage our



- clients to speak to us – the insurance broker and insurer to ensure that they have sufficient E&O coverage and that their uninsured financial exposure is limited.
- **Should outline a clear payment structure.** Our Insured's should know what they are getting, when they are getting it, and enforcing the agreed payment protocol. Do not let outstanding invoices mount up. There may be a good reason why they have not been paid.
- **Should be referred to external Counsel** for independent review if the contract is originally drafted in-house and the contract is significant. If a mistake is then made, you are not left "*carrying the can*" insofar as you may have an option to recover from the external solicitors PI Insurers.
- **Should be signed by a suitably senior person** within the claimants and Insured's organisations but not before discussing the contract with the people that negotiated it and who have to deliver the project.

After signature:

- **Our Insured's should think about who at their company is responsible for contract management after signature?** In a recent survey



- in the UK it was reported that less than half of all of the companies surveyed had procedures for contract management after signing. If the contract is not being managed actively throughout the project how will our Insured's be able to proactively identify issues arising?
- **Our Insured's should think about who and how the escalation process in the contract can be effectively managed.** It is imperative that both parties do not just give lip-service to the provisions in the contract but that the mechanisms in it are used to keep the project on track.

Poor documentation

It would be very helpful, for both parties if, when a dispute arises, that both can refer to correspondence or minuted meetings that clearly deal with the issues. If the

claimant is making unreasonable requests for extra functionality which will have an impact on "go-live", our clients should tell them and document it. We appreciate that it is impossible to document everything, but if our Insured's do not document the right things, like project steering committee meetings; project management meetings etc, then when a dispute escalates they will not be able to diffuse it because it will simply boil down to their word against the claimants. Lack of proper documentation can be very damaging to both the claimant and our Insured's in a dispute that is ultimately litigated. It is also worth noting that taking a note that dodges or ignores difficult aspects of a meeting are incredibly unhelpful. We have lost count of the amount of times when we have read a meeting note that contradicts what our Insured's have told us happened at the meeting. The notes read as though they were written by a management consultant – "touchy feely" rather than truthful and robust.



It's worth bearing in mind that a single line on one document can mean the difference between either winning or losing a technology claim.

Lack of training and understanding

Even after what may have been a difficult contracting, development and implementation process if the work force of the claimant company do not understand how to use the system or appreciate all of the functionality then the "Go-Live" will be a disaster. Again we are often surprised that such an obvious issue can become an element of a claim. If too much time is spent ironing out last minute bugs before "Go-Live" and not enough resources are allocated to training the staff to actually use the system, then the "go-Live" will not be a success. By illustration this was one contributing factor to a \$200m claim made against an SAP implementer a few years ago. The system went live, and few people knew how to use it properly which meant that the business came to grinding halt and 40% was wiped off the share price of the claimant company.

What else can Brokers and Insurers do to assist their Technology clients either before or after a claim arises?

On one side of the coin we have a thriving diverse technology industry ranging from the one man band to the multi-billion bound goliath and all have different exposures, requirements and needs. On the other side, there is a huge amount of relevant knowledge within the London insurance market from placing TMT business, and risk management to Claims management and our TMT clients want to tap into that knowledge. Being able to do that is purely down to us – we are after all a people business so why do our claims teams hide behind their desks and a bank of lawyers? Too often we hear clients talk about a lack of engagement, a lack of understanding and poor



communication with insurers and brokers. *“They just don’t understand what we do – they take our premiums but never pay up”*. The high level of apathy and suspicion levelled at insurers is noteworthy – and should concern all of us. At the moment in the UK in terms of technology E&O we are in a soft market and there is no sign of it hardening any time soon – so every little thing counts.

As a claims manager I look forward to the day when all insurers push their claims departments to the forefront of their businesses. Claim departments are the shop window of our businesses – they deliver the promise we make when we sell our policies – The promise to pay. Doesn’t it make sense then, that the claims teams understand what tech clients our underwriters are targeting; and what renewals are coming up. Doesn’t it make sense to encourage the claims department to pro-actively work with our TMT clients to resolve claims at a commercial level without referring everything to external counsel? Shouldn’t our claims staff support underwriters at pitch meetings for new business and renewal meetings? Shouldn’t we be encouraging them to market themselves and the business they represent to our TMT clients. Why can’t we send them to the Insured’s businesses with our broker partners to talk to their staff about avoiding claims; contract management; legal developments. Hiscox learned that lesson a long time ago and our TMT claims team deal exclusively with

TMT clients and are directly contactable (with the brokers approval). They do not just handle claims they manage relationships; they engage with prospective clients at “pitches” and renewal meetings; they meet with placing brokers and play a key role in product development and business acquisition. In a soft market this involvement can be critical and can mean all the difference between keeping an account and losing it. What does this mean for our TMT clients? Well we are accessible; and have full authority to settle



claims. We work with their legal departments to resolve disputes at a commercial level and only outsource to law firms as a last resort. We really get to know the client and their businesses ourselves and before a claim arrives. We do not need to be anonymous; we can be highly visible and get the credit for it. Knowing who we insure is important because when you are trying to deal with a £20m claim, it is not the best time to be meeting a client for the first time. Our clients genuinely like all of this but the sad thing is from their perspective all of this is quite unusual. Our point here today is that it shouldn't be. None of this is rocket science it is just good business practise. We are sure there is still a lot of room for improvement and we are continually working on it, but the fact is that the more sophisticated our TMT clients become the more sophisticated and personal a service they will expect from all of us. Let's not disappoint them.