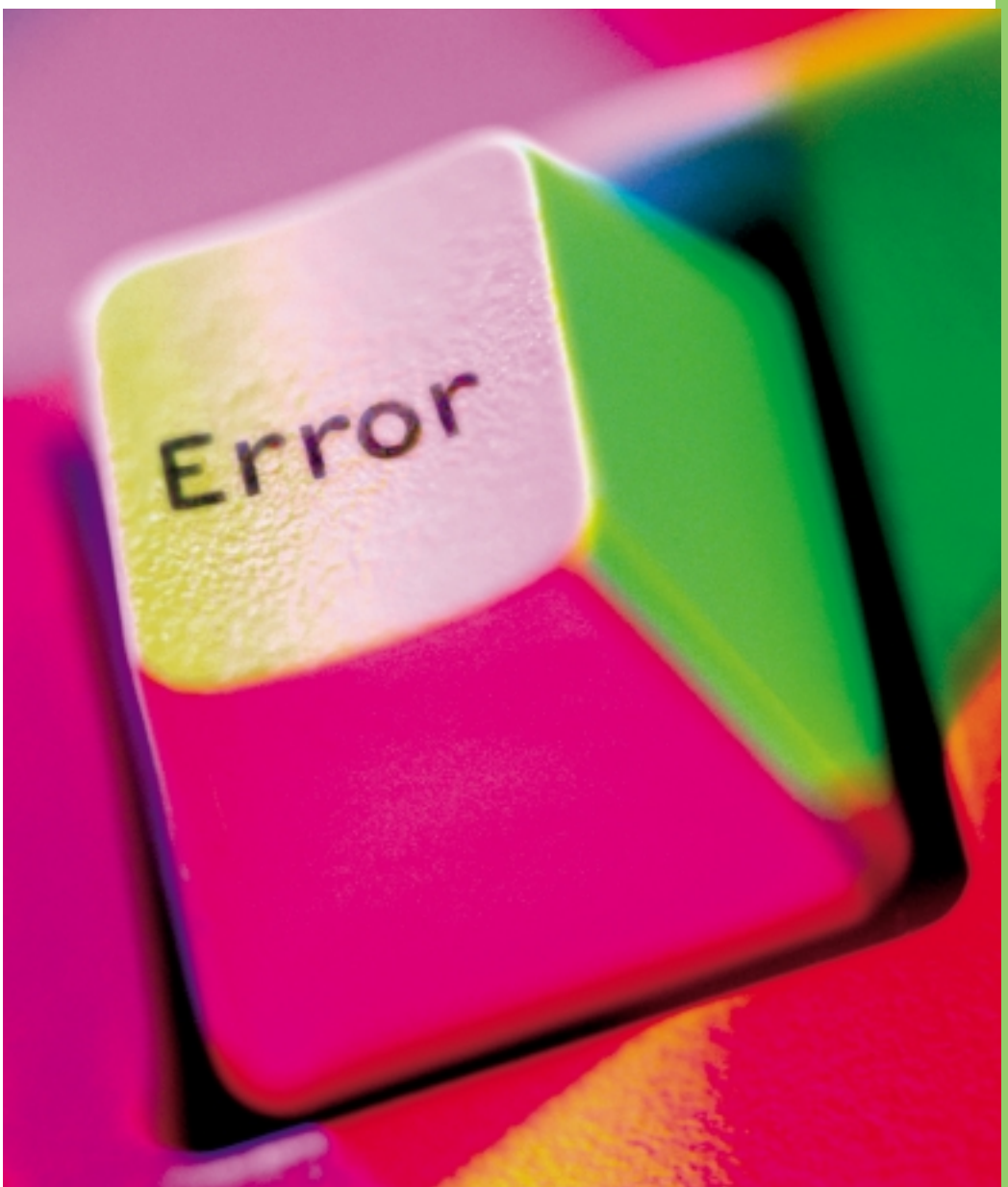
Errors & Omissions Risk Management Guide

For Information and Network Technology Companies



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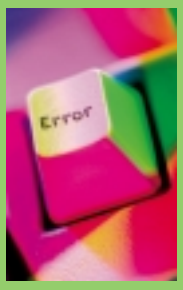

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Both the number and cost of information and network technology errors and omissions (E&O) claims have been steadily rising. At the source of increasing E&O litigation are a number of factors, including the following:

- The trend toward using third parties for information and network technology solutions on a contract basis.
- An increase in business partner litigation, arising from customers' increased willingness to sue long established business partners for performance failures.
- Dramatic increases in average contract size, increasing the likelihood that a performance failure will be "worth the fight."
- An increase in average contract length, causing changes in contract specifications to be more likely and problems with delivery or bugs to more dramatically affect the ongoing business of the customer.
- Greater competitive pressure on the information technology "provider side," increasing the chances that marketing and sales pressure will invite over-promising of provider capabilities.
- Greater dependence on information technology solutions, increasing the likelihood that software solutions will be core business solutions.
- An increase in the likelihood that customers will allege fraud and seek extra-contractual remedies that can compromise the waiver of consequential loss (which has become the standard in software contracts).
- An increase in the number of companies "going global," resulting in a host of new exposures arising from foreign laws and regulations.
- Greater dependence on interconnected networks and the Internet resulting in new exposures.

Chubb is a leading insurer of electronics manufacturers, assemblers, software developers and networking companies as well as a growing number of emerging information technology companies. We know how to manage risk in an environment where innovation is a business imperative, not a lofty goal. This guide, which is aimed at helping you avoid or mitigate exposure to E&O claims and litigation by gaining a better understanding of the risks associated with your business, will discuss in detail areas of potential E&O exposure for the information and network technology industry.

CONTRACTS AND AGREEMENTS

Legal review
Have legal counsel review all contracts, purchase orders, and license and service agreements, including those with subcontractors.

Customizing contracts
Avoid customizing contracts. If you must customize an agreement, take every precaution possible to protect yourself from litigation. For example, use boilerplate amendments that become "standard exceptions," or make sure your legal counsel reviews all deviations from standard.

Limitations of liability
Take advantage of all contract language measures that enable you to limit your liability. Tailor this language to your industry and customers. Completely limit all consequential, punitive and similar damages and ensure that your liability is limited to the cost of the contract or service provided by you.

Disclaiming warranties
Include warranty disclaimers in your contracts. They help minimize your exposure to litigation by limiting the types of warranties that you are willing to offer. These disclaimers should conform to the requirements of the Uniform Commercial Code with regard to typestyle and content, as well as any local jurisdictional requirements that may apply.

Warranties
Do not make warranties that are difficult to meet. Make the warranties as specific as possible, avoiding the use of "general warranties" wherever possible.

Severability
Include a severability clause in your contracts. Without it, your ability to rely on provisions in your contract that limit your liability may be jeopardized if a court finds another provision in your contract unenforceable.

Indemnities
Stipulate the indemnification procedures, terms and conditions that you want to follow in the event of a dispute. Protect the assets of your organization by having indemnification wording that inures to your benefit.

Arbitration
Consider including arbitration provisions in your contracts as a means to resolve customer disputes in lieu of litigation.

Force majeure
This wording is important for all information and network technology companies. It is especially critical if you operate in natural catastrophe-prone areas, particularly for online services or any business that relies on communications infrastructure to deliver services or products to its customers. Force majeure clauses limit your liability for losses or breaches resulting from external forces such as earthquakes, tornados, storms or other natural events, as well as events such as war. Specifically list the things you believe would be outside of your control rather than relying on a blanket clause stating "anything outside of your control."

Performance specifications
When negotiating contracts, ensure that all parties agree to the specific expectations, promises and contingencies regarding the performance of the contract. Complete RFPs (Request for Proposal) and contract performance obligations should be included. Confirm whether or not critical employees are expected to be present throughout the course of the contract. If consultants, value-added resellers or other third parties are involved with a project, make sure that your customer knows exactly what you are (and are not) providing. Likewise, be sure you have confidence in whatever systems you are using, acquiring or recommending. Contracts should be specific regarding agreed-upon definitions, performance specifications, timetables, measures for dealing with changes, and the processes and procedures to be used in dispute resolution.

Performance obligations
Be specific but brief with regard to performance obligations. This is not the place to be boastful about your abilities to achieve lofty performance standards.

Amendments and modifications
Specify the procedures for making amendments and modifications to your contracts. Document any changes made to product and service specifications and deliverables.

Contract length
If possible, implement smaller, shorter-term projects under multiple short-term contracts. Longer contracts tend to be more complex and may change over time, presenting more opportunities for missed completion dates, which can result in the failure or non-delivery of a project, which in turn can lead to litigation. If shorter-term contracts are not an option, conduct a thorough risk assessment of the entire project. Consider such factors as the scope and inherent feasibility of the project, the stability of customer requirements, the development and quality practices of the manufacturers, and how realistic the estimates are with regard to the time, money and other resources needed to successfully complete the project.

QUALITY AND SUPPORT OF PRODUCTS AND SERVICES

Quality control
Implement quality control systems at every phase of production. At a minimum, set standards for acceptable levels of reliability, performance, functionality and scalability, compatibility with integral systems, product life span, the time it takes for deployment, and ongoing support and service. Your checklist for the development of a quality product or service should include the following:

- Alpha testing
- Beta testing
- Formal customer acceptance procedures
- Prototype development
- Statistical process control
- Vendor certification process
- Total quality management
- A formal product recall plan
- Products or services produced to nationally or internationally accepted standards (e.g., IEE, DOD and FDA)
- Retention of critical contracts, documents and records for clearly defined time standards
- Written and formally implemented quality control program

Discontinued products or services
Openly communicate to your customers any plans you may have to discontinue producing a product or to discontinue its service. Give them sufficient advance notice of the phase-outs and, if possible, a migration path to some other suitable product or service.

Outsourcing and resellers of services
Include in your contracts language that limits your liability in the event one of your outsourced suppliers fails to deliver as promised. If you are unable to fulfill your contractual obligations due to a failure of an outsourced vendor, you could have significant E&O exposure created by breach of contract.

Merger or acquisition activities
Carefully review the prior liabilities and loss experience generated by any organizations being considered for merger or acquisition. Only purchase the assets of an organization having a history of litigation problems or difficulty with managing or completing projects.

OPERATIONAL CONTROLS

Legal review of advertising materials and product brochures
Ensure that legal counsel reviews all advertising and marketing materials with regard to the promises explicitly made or implied to customers. Set realistic expectations and avoid absolutes (e.g., the best, the most comprehensive, 100% foolproof) in marketing materials. Product and promotional literature may develop expressed or implied warranties not contemplated in the contracts that are being used. A thorough legal review can reduce unintentional warranties from being enforced during litigation.

Accounts receivable collection procedures
Be cautious of changing your accounts receivable collection procedures. For example, if you have not been aggressively closing out accounts, be wary of doing so. Changing such practices often leads to counterclaims from customers who allege that your products or services are not performing as intended. Your customers could make these allegations in an effort to evade their payment obligations.

Sales and marketing training
Seek legal counsel's assistance in developing sales and marketing training programs that control product oversell and puffery. If any confusion exists between what a salesperson tells a customer and what the contract says, a claim may be made for misrepresentation or fraudulent inducement.

Certificates of insurance
Require subcontractors and vendors supplying or doing work for you to name you as an additional insured on their insurance policies, including E&O. Obtain certificates of insurance from all vendors and subcontractors as evidence that they have complied with your requirement. The certificates should specify effective dates, limits and coverage afforded.

NETWORKING ISSUES

Network security

Any company connected to the Internet should have in place a formal security program and communicate its specifics to all employees. Ensure that the program is updated, documented and adhered to by your staff. Closely review the encryption, firewalls, virus protection, security protocols and intrusion detection used to safeguard the data of others stored on your networks and servers. The following risk management recommendations apply to companies' external networks (if any) as well as internal networks. An external network is defined as any network or combination of network elements that lie outside of the network you use to manage your business and is used to provide services to your customers.

- **Security manager**
  Assign an individual or team ongoing responsibility for monitoring security threats such as virus infestations, DOS attacks and password theft.

- **Testing and validation**
  Invest in regular, frequent network vulnerability scanning by an outside vendor to validate that your security program is being adhered to. If holes or weaknesses are found in the network, take immediate steps to fix the problems.

- **Incident logging and investigation**
  Record and investigate all security threats and incidents. Without quick and proper investigation, problems can spread throughout a company's network. If your entire external network is affected, you may be at risk for a multiple litigant, class action lawsuit.

- **Formalized disaster recovery program**
  Develop a formal disaster recovery plan. The absence of such a program may be construed as gross negligence by the courts.

- **Crisis management**
  Have in place a crisis management plan. Be prepared to quickly convey accurate information regarding security threats and incidents to all appropriate parties.

- **Access authorization/revocation**
  Establish access authorization procedures for all of your systems. Prevent former employees from accessing your systems by revoking their access or authorization codes.

- **Background and credit checks of employees**
  Conduct background checks of employees and potential employees. Avoid hiring or retaining those with the potential to be security risks or those who create potential litigation problems.

- **Security training**
  Provide all contractors and employees with security training commensurate with their level of access. Companies are using more and more contract labor when developing products and services. This could lead to serious security ramifications if the contractor does not receive the proper security training and adhere to the agreed-upon security procedures.

Network reliability, redundancy and availability
Additional areas of concern for network service providers are their customers' expectations with regard to network reliability, redundancy and availability. These issues, in addition to security, should be covered under your service level agreements.

- **Ensuring reliability**
  Adhere to best practices with regard to architecture design. Use high-quality software, hardware and outsourced service vendors. Perform ongoing maintenance and upgrades.

- **Ensuring redundancy**
  Design your network in such a way that traffic cannot be lost or interrupted due to a break in the network. Be capable of backing up or mirroring customer data on another part of the network to minimize or eliminate downtime in the event of an interruption to service.

- **Ensuring availability**
  In addition to building a redundant network, ensure that its design allows for load balancing in times of peak capacity.

DISPUTES AND ALLEGATIONS OF NON-PERFORMANCE

Loss history
Carefully analyze all non-performance losses, claims and litigation as well as their causes. Include in your review all suits, potential suits, complaint letters, disputes or any other circumstances alleging non-performance of your product or services. A thorough loss history can be a window on future litigation problems and should be used to help identify and eliminate potential sources of loss, claims and litigation.

Product rollbacks or recalls
If you have had product rollbacks or recalls in the past, document why they occurred and the remedies used for resolving customer loss of use.

Contract delays
Examine the causes of any contract delays you have experienced. If the delays arose from promising unrealistic deadlines or agreeing to unrealistic customer expectations, address the issue with your sales force and customers and negotiate more reasonable contract terms.

Contract disputes/non-payment
Once a contract is in dispute or a customer is withholding payment, you should strive to work with that customer to resolve the dispute and avoid litigation. Aggressive attempts to get paid for a project that remains in dispute tend to invite breach of contract claims. Instead, positive dialogue and frequent, open discussion concerning the viability of any project as it progresses enables both parties to resolve disputes before they get out of hand and take action when a project hits a snag. Projects can proceed, be cancelled or be redirected by scaling them back or changing the requirements, thereby resulting in a win-win for both parties.

Important Notice: This guide is advisory in nature. It is offered as a resource in developing or maintaining a loss prevention/risk management program. The guide is necessarily general in content and intended to give an overview of certain aspects of information and network technology errors & omissions liability. It should not be relied on as legal advice or a definitive statement of the law in any jurisdiction. For such advice, readers should consult their own legal counsel. No liability is assumed by reason of the information this document contains.

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Form 36-01-0056 (Ed. 02/02)