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THE BETTERLEY REPORT

TECHNOLOGY ERRORS & OMISSIONS MARKET SURVEY — 2008

PRIVACY CONCERNS DRIVE PRODUCT ENHANCEMENTS AND THE MARKET

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Editor's Note: We are pleased to present our eighth evaluation of Technology Errors & Omissions insurance (Tech E&O) in which we review eighteen of the leading carriers active in the market. We welcome Admiral, a carrier new to our Report.

Tech E&O is coverage for the liability of organizations and individuals that provide products and services utilizing technology. Depending upon the carrier, insureds can include manufacturers, software developers, consultants, service providers (such as systems integrators) and telecommunication companies.

While each insurance carrier was contacted in order to obtain this information, we have tested their responses against our own experience and knowledge. Where they conflict, we have reviewed the inconsistencies with the carriers. However, the evaluation and conclusions are our own.

In most cases, we examined actual policy forms and endorsements provided by the carrier. Rather than reproduce their exact policy wording (which can be voluminous), we in many cases have paraphrased their wording, in the interest of space and simplicity. Of course, the insurance policies govern the coverage provided, and the carriers are not responsible for our interpretation of their policies or survey responses.

In the use of this material, the reader should understand that the information applies to the standard products of the carriers, and that special arrangements of coverage, cost and other variables may be available on a negotiated basis. Professional counsel should be sought before any action or decision is made in the use of this information.

INTRODUCTION

Coverage for the liability arising out of the design and manufacture of technology-related products, the creation and implementation of software, and the provision of related services, is a growing business, with specialty coverages designed for the Errors and Omissions liability that may not be covered under traditional liability policies. Tech E&O coverages can be purchased for technology consultants, systems integrators, application service providers, Internet service providers, Internet retailers, network electronics manufacturers, medical technology manufacturers, and telecom companies. With a wide variety of coverages available, each written on a non-standard form, insureds and their advisors can be confused and bewildered at the choices.

Coverage for Breach of Data Privacy is the hot topic in Tech E&O product discussions, as both service providers and site owners grow increasingly anxious about loss of data. While most of the news has been about data breaches suffered by site owners, technology service providers have been—or ought to be—concerned about their own exposures. Privacy Risk has been described as "The Next Asbestosis?" in a recent article by investment banker Ferris Baker Watts (December 10, 2007). There is a lot of reason for both service providers and site owners to worry about privacy risk.

NEXT ISSUE:

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Pollution Liability Insurance Market Survey

List of Tables

Data Privacy insurance comes in three basic forms: liability, remediation, and fines or penalties coverage. To illustrate the types of coverage offered by each insurer, we have developed six new Data Privacy tables:

- Types of Coverage and Limits Available
- Coverage Provided
- Coverage Triggers
- Types of Data Covered
- Remediation Costs Covered
- Remediation Coverage Services

There is confusion in the marketplace about Data Privacy coverage and how it is provided for service providers (Tech E&O) and site owners (CyberRisk [see our June Report]), we have tried to rationalize this discussion by asking our participants broad questions about their coverages, recognizing that a service provider's risk can arise from a breach of their own data, their failure to prevent a breach of their client's data, and/or their own loss of client data while in its possession. We hope this approach brings some coherence to the discussion.

Please see our discussion under Data Privacy on page 4 of this Report (and the tables) for details.

Insureds looking for Tech E&O coverage are presented with a choice of buying individual policies that supplement their core General Liability policy, or a policy that includes both GL and E&O. In our experience, most insureds purchase separate policies, although carriers such as Beazley and Travelers offer a combination of the two.

Tech E&O policy provisions should always be reviewed in connection with the insured's CGL policy provisions, especially with respect to new or emerging exposures of concern. Some carrier markets offer coordinated E&O and CGL coverage, whereas other markets may offer monoline E&O only. Coverage not provided or excluded by an E&O policy may well be addressed by the CGL. Given the complexity of the coverage choices, a good insurance broker can offer a lot of useful advice to prospective insureds, and their value in negotiating coverage is not to be underestimated.

STATE OF THE MARKET

Annual premium volume information about the U.S. Tech E&O market is hard to come by, but in asking several of the product managers, we have concluded that the annual gross written premium may now be as high as $1.5 to 2.0 billion. We are a bit skeptical, as last year's consensus was in the $850-900 million range, and individual carrier reported growth rates don't begin to get us to $1.5 billion. We see accelerating interest in this coverage, and it may well be that forecasted growth rates are understating the actual opportunity.

It is also likely that there is much more premium to be found in the more traditional markets, but it is not being reported as Tech E&O. We continue to expect that there are many more potential insureds that need Tech E&O, but are either not aware of its existence, or underestimate its value. This is likely to be true for the smaller service firms.

Educating the technology community of the value of this coverage is important to the future growth of the line; we suspect that, as privacy lawsuits become more common, there will be better market penetration.

We asked carriers about the health and interest of the reinsurance market that supports Tech E&O products, and they generally reported that reinsurers still like the product. Stable or increasing interest in Tech E&O product support was reported by the responding carriers.

As for growth in premiums written, carriers are pretty reticent about responding. Though this can be a bit misleading, as Tech E&O coverages are often written as a part of other products, and not reported separately for premium purposes. Eleven carriers responded to our question about their premium growth rates (2007 vs. 2006):

- Down 1
- 0 to 10 percent increase 5
- 11 to 25 percent 4
- 26 to 50 percent 0
- 51 to 100 percent 1

Premium volumes are similarly not widely reported; eleven responded. As in 2007, though, we see one carrier writing a relatively large amount of business (over $100 million), with other carriers also writing a significant book of business:

- Under $1 million 0
- $1 to 5 million premium 1
- $6 to 10 million 2
- $11 to 25 million 2
- $26 to 50 million 3
- $51 to 100 million 2
- $100 million plus 1

State of the Market—Rates

We asked the carriers whether, or not, they planned rate decreases (or increases) during the upcoming year, and what they expect their competitors are planning. Most offered their thoughts.

Rates for Tech E&O insurance, like most commercial insurance, are softening significantly, as the general insurance market softens and as carriers ramp up their marketing for this relatively new growth opportunity. Several carriers report plans to reduce rates 10 to 20 percent or as needed, with fewer planning reductions of 3 to 5 percent.

State of the Market—Retentions

The level of retentions or deductibles that carriers are willing to write continues flat. No carrier reported plans to increase retentions, and that was mostly to bring them into line with their competitors. Isolated prospective insureds may be able to achieve lower retentions but we don't feel that it represents any type of trend.

TARGET MARKETS AND PROHIBITED INSUREDS

Unlike most of our surveys, there are significant classes of business that some carriers indicate are prohibited. Problem classes seem to include process control and robotics, automated manufacturing systems, financial transaction systems, Internet service providers, and security-focused risks.

Read the *Target Markets* table carefully as a guide to which carriers like (or don't like) certain classes of business, but also keep in mind that these can change, and are often subject to reconsideration.

CAPACITY AND RETENTIONS

Significant liability limits capacity remains, and reasonable (account appropriate) retentions or deductibles are available. Hiscox can provide up to $30 million, while $25 million can be arranged by ACE, AIG, Chubb, OneBeacon, SafeOnline, and Travelers. Up to $20 million is available from Beazley, while $15 million can be bought from CNA and Media/Pro, and $10 million from Darwin, Euclid, The Hartford, and Philadelphia.

Lower limits can be arranged with Evanston and NAS ($5 million), Admiral ($3 million), and Indian Harbor ($2 million).

Most carriers can secure limits above those indicated when necessary, noting in particular Euclid's interest in writing excess limits.

Deductibles or retentions can be quite competitive; the *Limits, Deductibles,Coinsurance and Comissions* table shows minimums. Lower deductibles are generally available from the carriers offering lower limits, those that may best appeal to the smaller insureds that desire low deductibles.

Carriers are still reluctant to state commissions, but they are typically similar to those paid on traditional commercial lines products.

POLICY FEATURES

With the wide variance in coverages included in Tech E&O products, paying close attention to key features is important.

For example, in the table *Policy Type*, note that several carriers are willing to offer General Liability coverage to their Tech E&O insureds, either as a separate policy (ACE, AIG, Chubb, CNA, Evanston, The Hartford, OneBeacon, and Philadelphia) or as an optional endorsement (Beazley and Travelers). Only Darwin, Euclid, Hiscox, Indian Harbor, Media/Pro, NAS, and SafeOnline do not offer a GL coverage option. Note that Beazley's GL option is available on a claims-made basis.

Coverage for liability arising out of the actions of subcontractors while working on behalf of the named insured is generally included in the basic policy form. However, most will not include coverage for the subcontractor itself, unless special arrangements are made.

The definition of Products and Services is critical for proper coverage; the policies define the products and/or services that are covered. There are two different ways this can be done: either the declarations page specifies the products and/or services covered (which comes from the application) or the policy definition itself defines the activities covered. For example, Admiral, Evanston, Hiscox, and NAS specify the covered activities on the declarations page. The other carriers use policy definitions instead.

Either way, it is critical that the products and/or services of the insured be listed properly or defined as included in the policy. Wording is shown under "Definition of Products and/or Services Defined in Policy" included in the table *Definition of Products and Services*.

DATA PRIVACY

We are often asked whether, or not, coverage in a Tech E&O policy includes losses arising out of data breaches. For the acts, errors, or omissions of the service provider, they often do. If the provider's services fail(ed) to protect the client's systems such that a data breach occurs, then it may well find coverage in its E&O policy even if there is no specific reference to privacy concerns.

However, policies are evolving to specifically address privacy breach claims, in part so the coverage may be more specific to such claims, and in part because the worry about liability shouldn't be the only worry.

We also note that electronic data breaches are generally everyone's first concern, but nonelectronic data losses are also a worry. Some Tech E&O carriers have addressed these concerns by including affirmative coverage grants.

As a result of our research into privacy exposures and coverage, we have identified six key areas that should be considered.

The Types of Coverage and Limits Available

There are three fundamental coverage types: liability for loss or breach of the data, remediation costs to respond to the breach, and coverage for fines and/or penalties imposed by law or regulation.

Liability coverage is pretty self-explanatory—protection for the insured should it be sued for negligence leading to a security breach. Often the coverage does not explicitly list data breach as covered, rather, including coverage as a part of a more general coverage grant for, as an example, unauthorized access to a client's computer system.

Some carriers offer more explicit coverage, such as an act, error, or omission that results in a theft of data from a computer system. Both methods can work, but it is very comforting to see a term like Theft of Data included in the coverage grant.

Coverage Provided

Coverages fall into three categories, and varies widely between the carriers:

- Liability—defense and settlement costs for the liability of the insured arising out of its failure to properly care for private data

- Remediation—response costs following a data breach, including investigation, public relations, customer notification, and credit monitoring

- Fines and/or Penalties—the costs to investigate, defend, and settle fines and penalties that may be assessed by a regulator; most carriers do not provide this coverage, although there can be coverage for defense costs.

Coverage Triggers

Coverage can be triggered by:

- Failure to secure data
- Loss caused by an employee
- Acts by persons other than insureds
- Loss resulting from the theft or disappearance of private property (such as data that resides on a stolen laptop or missing data-storage media).

Types of Data Covered

Some carriers specify the types of data covered, others do not. Specific types covered can include:

- An individual's personally identifiable information
- Nonpublic data, such as corporate information
- Nonelectronic data, such as paper records and printouts

Remediation Costs Covered

Remediation is an area that is new for Tech E&O; this coverage is for the costs of responding to a loss of data. Organizations that suffer a data loss may be required to notify their customers and clients with notice of the data loss, which can be expensive. Typically, they may also want to mitigate the negative impact on their reputation by providing credit-monitoring services for those same customers; this cost can also be significant.

Remediation costs are not covered by a number of insurers, though we predict that they will have to start offering these coverages in order to compete. For service providers, they may be less important than they are for site owners.

They can include:

- Crisis management services
- Notification of potentially affected customers
- Credit monitoring
- Costs to resecure (that is, make secure again) data

We spoke with Mark Greisiger about the magnitude of risk for organizations that keep customer data. Mark is the President of NetDiligence, a leading cybersecurity assurance services company with extensive experience in protecting companies against privacy breach (www.NetDiligence.com).

According to Mark, external post-breach expenses (not all of these are necessarily insured) can be thought of as:

- Cyber-crime attorney services: fees run $700 per hour (note: A lawyer knowledgeable on security/ privacy standards and the 39+ state laws that require customer notice following a data breach notice is important).
- Investigation: computer forensics fees ranging from $300 to $700 per hour to:
    - Stop the attack or close the security hole.
    - Determine whether there a breach, how, when, what machine, did they access and steal client data.
    - Which customer's NPI data was impacted and where do they reside?
    - What type of data was breached (i.e., credit card alone; name/address; more sensitive data such as SS#, drivers license, date of birth, medical records)?
        - Determine – source and method of attack.
        - Gather e-discovery evidence properly for criminal and civil litigation.
        - Purchase and install new software/hardware to strengthen defenses.
- Notification Costs: Mail a breach event notice letter to customers at as much as $14 per customer.
- Credit Monitoring: post breach package – $10 to $12 per year per person.
- Public Relations Experts: to deal with the media with charges running perhaps $10,000/month billed at rates of $400 per hour

Remediation Coverage Services

There can be great benefit to the insured if the remediation services are prenegotiated and prepackaged; much like Kidnap and Ransom coverage, knowing how to respond to a loss can be daunting.

Carriers often offer prepackaged and prenegotiated services provided by third-party vendors. In some cases the insured is required to use designated vendors. In addition, some policies require the written consent of the carrier to use the services. A few of these services have a time limit for use, especially credit monitoring.

Claims Reporting, ERP Options, and Counsel

Each liability policy reviewed is a claims-made form so Extended Reporting Period (ERP) options are important. All carriers include a Supplemental Extended Reporting Provision (SERP), but they range in length. Carriers that offer up to a one-year SERP include Admiral, Beazley, CNA, Indian Harbor, NAS, and Philadelphia. Up to two years is available from Media/Pro, while up to three years is offered by ACE, AIG, Evanston, and Hiscox. Euclid offers up to five years, while Chubb, OneBeacon, and Travelers offer an unlimited period. Darwin, The Hartford, and SafeOnline offer an unspecified "various' length of reporting period.

Selection of counsel continues to be a delicate issue with insureds, but as we frequently see in other new lines of coverage, carriers typically reserve the right to select, or at least approve, counsel. In practice, carriers are generally willing to use legal counsel that is satisfactory to both the insured and the insurer.

Carriers that offer specific control (or at least, influence) to the insured include AIG, CNA, and Hiscox (indemnity form only), offering an optional Choice of Counsel form where the insured chooses counsel. Beazley, Chubb, Evanston, Indian Harbor, OneBeacon, and SafeOnline allow the insured to select counsel, subject to carrier's approval. As with all questions of counsel choice, we recommend that insureds discuss and agree with their carrier beforehand on the counsel they want to use; as an example, The Hartford, Media/Pro, and Travelers reserve the right to choose counsel, but indicate prenegotiated counsel will be considered on a case-by-case basis.

Generally, carriers can impose the infamous hammer clause on lawsuits that an insured may not want to settle. The use of "soft" hammer clauses has not penetrated this product as it has in Employment Practices and Management Liability products. Last year, the important exception to this was Darwin, which provides a 50 percent soft hammer clause. They are now joined by Media/Pro and Philadelphia, indicating that there may be a trend in offering soft hammer protection.

Prior Acts Coverage and Territory

All carriers offer Prior Acts coverage, with previous coverage usually required by all carriers, although some may require previous coverage based upon underwriting criteria.

Technology is a worldwide business, and one of the liability problems is that the legal standards of many countries differ from those of the U.S. For example, a well-known legal case in Germany was brought against a U.S. e-commerce portal, was based on German legal standards, and was brought in Germany. True worldwide coverage is important!

All carriers offer worldwide coverage if a suit is brought in the U.S., Canada, or possessions. True worldwide coverage (suit brought anywhere) is available from each of the carriers reviewed except Admiral and Indian Harbor.

Exclusions

Exclusions are many and varied, as would be expected; please read those tables carefully.

Rather than try to recite them here, the information for each carrier is found in the *Exclusion* tables. Unlike our other Reports, we have categorized the exclusions into:

- General Insurance exclusions (bankruptcy, dishonesty, intentional acts, expected or intended damages, SEC, unfair competition, piracy, and punitive damages)

- Product related (product recall, cessation of support, direct property damage, direct bodily injury, loss of property, contingent bodily injury/property damage, prior to customer's acceptance of your work, breach of warranty, and hardware)

- Service and Security related (contractual liability, cost estimates exceeded, performance delay, security breach, failure to prevent virus passing or data theft)

- CyberRisk related (personal injury, advertising injury, intellectual property, and Public Key Infrastructure[PKI])

A few comments on some of the exclusions that are specific to Tech E&O:

- Cost estimates exceeded—this refers to exclusions for claims by customers that the cost of a project exceeded the estimate or proposed fee. Carriers do not want to pay claims for poor pricing decisions of their insureds.

- Performance delay—this arises out of the insured's failure to meet project time deadlines, and is included in policies to protect carriers against an insured's overly optimistic promises.

- Security breach or unauthorized access—this is a very important set of exclusions for any insured that offers services related to secure data, including ecommerce. Some carriers will provide coverage if the insured is providing services related to security, while others will include coverage as long as the breach is on the system of others (i. e., not the insured), which is (after all), the intent of E&O coverage.

- Intellectual property—infringement of patents, copyrights, or trademarks is a source of much litigation, and coverage is rarely available when an insured is sued. Each carrier handles this very differently; read this portion of the *Exclusions* table carefully.

- Public Key Infrastructure—the term used to describe technology that enables secure online transactions.

RISK MANAGEMENT SERVICES

Supplemental loss avoidance and control services are now much more prevalent in Technology E&O, which we approve of, considering the ability of such services to reduce or eliminate losses, for the benefit of both insureds and insurers. Please see our *Risk Management Services* table for a description of the many services that carriers are including in their offerings to insureds.

SUMMARY

Technology E&O is an important coverage line, supporting the risk strategies of a key component of the U.S. (and world) economy. Marketing (smaller tech companies may not buy E&O, large tech companies may not think they need it) and product design (exploding privacy risk the most important) present challenges, as does rate adequacy. Sharp underwriting skills are needed in this line of coverage, as numerous types of business segments seek coverage.

We always encourage readers and their advisors to carefully consider the type of coverage that they need and whether the policy they are considering is really the right answer to their needs. The large carrier offering may not be the best one for them, but then again, the smaller carriers may not offer enough capacity.

Innovation, driven in part by privacy risk concerns, is having a major impact on this line; we look forward to examining its continuing evolution.

The Betterley Report is a series of six comprehensive Reports published annually. Each Report exhaustively reviews a single hot insurance product, covering topics such as:

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- Risk Management services

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