

Taking the Spike Out of IT Claims

OVER THE PAST FOUR YEARS, claims severity for professional technology liability has soared, but the stunning five-fold increase is hardly a surprise. Seeds for this increase were planted a number of years ago when corporate spending on information technology (IT) ballooned. And while the spending frenzy has fizzled, the conditions that gave rise to these claims for professional negligence and non-performance by IT suppliers loom larger than ever.

During the late 1990s, concerns about potential Y2K problems spurred companies to take a hard look at their IT systems. Grinding under the weight of cumbersome legacy systems, companies could either temporarily patch them or upgrade to systems that promised greater efficiency, increased functionality, and improved management information.

At the same time, the commercial possibilities of the Internet created an e-rush. Hungry to maximize its e-commerce capabilities, corporate America hired hordes of consultants to open the portals, creating a demand for talented IT professionals that far outpaced supply.

But in spite of consultants' glowing forecasts of revenue and market share gains, it soon became apparent that there was no fast path in linking e-commerce portals to traditional retail systems. In fact, the effort required for this type of integration was equivalent to that of a major legacy-reengineering project.

Extracting data from the tangle of heavily coded mainframe systems and moving it to integrated distributed environments proved to be more intractable than most initially realized. Obstacles arose, deadlines slipped, and the final delivery of a project faded from view. As project costs surged



and promised benefits evaporated, the courts became the final remedy for many companies.

This has been the case for legions of organizations. Consider the pharmaceutical drug distributor that was plunged into bankruptcy because of an allegedly faulty inventory ordering system, or the bus line that spent millions on a reservation and bus-dispatching system only to see sales nosedive because agents were forced to write out tickets when the system crashed, or the thrift organization that dumped its IT supplier four years after the start of a \$30 million contract because of missed deadlines and misrepresentations about the project's progress.

Few industries have been spared the pain of a major IT foul-up. By one estimate, U.S. companies and governmental agencies spent a staggering \$145 billion on canceled or contested projects.

E-surety

Insurers initially responded to the liability needs of IT suppliers by tacking on coverage to general liability policies via manuscripted language. This patchwork of coverage was refined to specific technology liability forms by carriers that decided to focus on this segment. Coverage is typically provided for two of the most common forms of liability risk:

- Errors or omissions by an IT supplier for negligence in maintaining acceptable professional standards and
- Non-performance or failure to perform services within the time frame and terms of the contract.

From this standpoint, IT professional liability crosses product lines, responding like traditional professional liability coverage in instances of errors and omissions but also acting like brick-and-mortar performance surety bonds in cases of non-performance. As a result, some of the same risk factors such as experience, length of project, and diversity of products/services that affect underwriting results in these more traditional lines also drive the incidence of IT professional liability claims but for vastly different reasons.

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Inextricably tied to technology trends, these factors have converged in ways that have caused a spike in claims severity. Taken individually, they provide an understanding for this deterioration.

► **EXPERIENCE.** There's little question that there's no substitute for it when it comes to reducing professional liability exposure. But attracting seasoned IT professionals has been an especially ticklish issue over the past decade. The high demand for technology solutions created a dearth of talented experienced programmers, who could decode the mysteries of aging systems or open a company's Web portals to the bounty of e-commerce.

This shortage, however, didn't hinder some programmers from forming consultancy to take advantage of the revenue opportunity of corporations' growing IT needs. Imbalances in experience levels have set the stage for disaster.

Some litigants have charged that their IT suppliers used bait-and-switch tactics

in securing assignments. Lured into multimillion-dollar contracts by senior consultants, clients allege that their IT suppliers turned the project over to junior staff members who used the assignment as a training ground.

► **SIZE AND LENGTH OF A PROJECT.** Large IT projects with long rollout times tend to have a greater possibility of generating IT claims than do small, short-term projects. This is because the fluid environment in which businesses operate makes it difficult for a company to accurately predict its business needs far into the future. The longer the time horizon, the more difficult it is to see clearly into the future. Yet it is not uncommon for large IT projects to span 18 months or more. Changing needs result in mid-course corrections, which frequently create turmoil and disputes.

► **SIZE OF IT SUPPLIER.** Large IT suppliers tend to undertake large, sophisticated, long-term projects. Projects with long rollout times tend to develop worse loss his-

tory than do short-term projects.

► **APPLICATION OF IT PROJECTS.** Integration projects with far-reaching implications like enterprise resource planning (ERP) hold the promise of improved efficiency by knitting together the informational needs of far-flung functions like finance, human resources, marketing, and production areas. But software developed for one industry hasn't been easily adapted to the business needs of other industries or the same industry based in another country, resulting in the need for customizations. These adaptations haven't always worked but have always added enormous costs, especially when software needed to be upgraded frequently.

And while little software is problem free, IT packages with a specific focus like inventory control or standard software packages like those used on home or small office PCs have more predictable outcomes and therefore generate fewer claims than projects with wide applications, which can lead IT suppliers down dark passages they have never traveled.

► **DIVERSITY OF PRODUCT OFFERING.** Rapid changes in technology have forced some IT suppliers into product areas that they are ill equipped to support, especially during a tight employment market. These suppliers often end up getting into projects that are beyond their support capabilities and present a greater exposure than do IT suppliers with a defined, well-supported product.

► **CONTROLS.** Many times projects soured because team players strayed from basic best practices of systems development such as basic project management and requirements management. Keeping track of actual progress vs. estimated progress, the chief function of project management, allows client and IT supplier to quantify the gaps in performance. To track a project's progress, a list of the project's features or requirements is developed and used to set and estimate the project's milestones. Signing off on requirements assures that client and IT supplier have a mutual understanding of the scope and objectives of the project.

But in the flurry of activity surround-

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ing some projects, this basic protocol was ignored. This short cut allowed disagreements to fester and grow into major problems, which increased the risk of litigation. For this reason, accounts with a high frequency of small claims, the result of a lack of checks and balances, have become a concern because frequency often leads to severity when sound protocols are disregarded on a project.

► **CHANGE MANAGEMENT.** As new features were introduced into a project, client and IT supplier, in some cases, hadn't developed and implemented a formal process to manage additions and refinements to the project in order to minimize the counterproductive effect of scope creep—the cause of delays, missed deadlines, and disputes. Sidestepping this process, which frequently happened on projects with compressed time frames, increased the risk of claims.

► **CONTRACTS.** Customized contracts also contributed to the incidence of IT claims.

The use of untested, non-standard language by client and IT supplier often fueled misunderstandings and disputes because the parties were unfamiliar with the implications of contract language. Instead of clarifying an issue, customized contracts intensified disputes, especially under stressful conditions.

► **DISPUTE RESOLUTION.** When disputes occurred, participants needed to have a formal resolution process in place to reduce the possibility that disagreements would turn into costly lawsuits. The lack of a formal process caused a bad situation to deteriorate further.

► **ECONOMY.** These factors are converging at the start of an economic downturn, which is also contributing to the rise in claims related to IT professional liability. Companies' dwindling cash flows have caused some clients to delay final payment, which has set off a string of downwardly spiraling events, involving law-

suits for nonpayment and counter suits by the client for anything from misrepresentation to missed deadlines. Claims resulting from these tit-for-tat suits are only beginning to appear in insurers' results, since these claims lag an economy downturn by 18 to 27 months.

What's Ahead?

The eventual rebound in the economy will mitigate some claims activity, but a number of conditions that fostered current losses will remain: the lack of seasoned professionals in crucial IT fields, the evolution of ever-sophisticated and complicated software, IT suppliers' shifting product mix, the temptation to short circuit well-tested protocols. These conditions are likely to be part of the technology industry's landscape for some time to come, but they can be managed by understanding their individual and collective impact on IT professional liability.

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