



*"The Perfect Fit for
Your Business"™*

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Insurance?

How often does the dealer offer “insurance” and the Blackjack player asks, “Now tell me again how that works?” Insurance is one of the most misunderstood commonly available Blackjack rules. In information technology (IT) services outsourcing, both service providers and their customers ask that same question almost as often. And, if they don’t, it’s because they don’t even think about the role that insurance should play in their business relationship.



Role Play

Outsourcing any business function presents risks that must be carefully evaluated by the customer. For financial services firms, banking regulators suggest two risks – operational (transaction processing) risk and reputation risk¹ – that offer a particularly significant role for insurance.

Business Continuity

Both operational integrity and business reputation are at risk during a business interruption, regardless of the cause. Financial institutions commonly recognize the insurance role in business continuity plans, sometimes referred to as “business resumption” or “disaster recovery” plans. The FFIEC sums it up this way:

Insurance is commonly used to recoup losses from risks that cannot be completely prevented. Generally, insurance coverage is obtained for risks that cannot be entirely controlled, yet could represent a significant potential for financial loss or other disastrous consequences. . . .

Financial institutions should be aware of the limitations of insurance. Insurance can reimburse an institution for some or all of the financial losses incurred as the result of a disaster or other

¹ FED. FIN. INST. EXAMINATIONS COUNCIL, INFORMATION TECHNOLOGY EXAMINATION HANDBOOK, OUTSOURCING TECHNOLOGY SERVICES (2004), http://www.ffiec.gov/ffiecinfobase/booklets/outsourcing/Outsourcing_Booklet.pdf [hereinafter OUTSOURCING BOOKLET].

significant event. However, insurance is by no means a substitute for an effective [Business Continuity Plan], since its primary objective is not the recovery of the business. . . .²

IT service providers that perform work for these financial institutions step into their shoes and must ensure business continuity (*i.e.*, the processing of transactions). Insurance gives these service providers some measure of financial predictability in the event of a catastrophic event and the necessity to recover operations quickly at unusual cost.

Financial Responsibility

There is, however, another important role for insurance that directly impacts both service provider and customer. Insurance provides a back-up source of financing for contract performance in the event of catastrophic losses that cannot be provided by, or that may threaten the financial viability of, the service provider. And, there is a close connection among indemnification, liability and insurance.

The FFIEC, recognizing this connection, suggests in its guidance on IT services outsourcing, that a potential customer carefully examine insurance coverage and its relationship to the service provider's liability under a proposed contract³ and whether limitations of liability "[bear] an adequate relationship to the amount of loss the financial institution might reasonably experience as a result of the service provider's failure to perform its obligations."⁴ To ensure that this consideration is given, IT examinations by FFIEC agencies will "[v]erify that the contract [for services] appropriately addresses . . . [i]nsurance coverage."⁵ FFIEC guidance does not detail how insurance and its interrelationship with indemnification and liability can protect customers.

Allocating Risk

Not only can insurance allocate risk between the insured and the insurer, but also it can be a tool, along with other contractual means, to allocate risk between service provider and customer.

Property and casualty policies for IT service providers probably include coverage for damage to the property of others while that property is within the control of the service provider. (The cost of this insurance is already built into overhead.) Yet, one vendor allocates property loss to the customer:

. . . Company shall maintain insurance . . . The proceeds of coverage for losses from fire, disaster and other causes contributing to the interruption of Company's provision of Services shall be payable to Company. Nothing in this Agreement shall be construed as to permit Customer to receive any of such proceeds, or to be named as an additional insured under any such insurance policy. . . . Customer will provide, at its own expense, such casualty insurance coverage for the

² OUTSOURCING BOOKLET at 14.

³ See OUTSOURCING BOOKLET at 9, 11.

⁴ OUTSOURCING BOOKLET at 16. In other words, has the service provider quantitatively limited its liability such that it can effectively avoid "hold[ing] the financial institution harmless from liability for [its] negligence"?

⁵ OUTSOURCING BOOKLET at A-6, A-7.

The Pirates Party On!

Strike another blow for freedom – data freedom, that is. The emerging, albeit fringe, political Pirate Party¹ has showed how even fringe movements can effect major change.

Apple CEO Steve Jobs answered European critics of Apple's data ownership policies by agreeing that the iTunes Music Store® would offer music downloads without digital rights management (DRM) if record companies would allow it to do so.²

Now, EMI, one of the world's largest music companies, has announced that it will sell parts of its music catalog without DRM.³ Apple and iTunes were major targets of European Pirates.

This small victory lays groundwork for all persons who own data and against those who seek to limit use of that data by digital means.

¹ See *The Ultimate Pirate Party* (sidebar) in *Taking Notice of Arbitration*, CARPENTER LAW OFFICE CLIENT NEWSLETTER 4 (Robert H. Carpenter, Jr., Plano, Tex.), Nov. – Dec. 2006, http://www.carpenterlaw.net/images/Taking_Note_of_Arbitration_Nov.-Dec.2006_2007.pdf.

² See *Apple Says "Uncle"*, CARPENTER LAW OFFICE CLIENT NEWSLETTER (Robert H. Carpenter, Jr., Plano, Tex.), Jan. – Feb. 2007, http://0093d40.netsolhost.com/images/Apple_Says_Uncle_Jan.-Feb.2007_2007.pdf.

³ Ethan Smith & Nick Wingfield, *EMI to Sell Music Without Anticopying Software*, WALL ST. J., Apr. 2, 2007, at B5.

loss of Customer records at the Data Center from fire, disaster or other causes . . .

This turns out to be a further limitation of liability for the vendor, not a protection for the customer. Other vendors carry insurance that covers their liability, however limited or extended by their contracts, for damage to customer's records or data.

A technology errors and omissions policy, coverage for customer losses caused by the acts or omissions of the IT service provider, is another tool for risk allocation. Such insurance back-stops the financial responsibility of the service provider. Benefits may also be extended to customers, via the additional insured mechanism, to extend limitations of liability to the insurance limits.

Additional Insured

An insurance policy protects the person who purchases it – the individual or legal entity named. There can be more than one “named insured,” usually groups of persons with close relationships or legal entities under common control or ownership; and the first named insured has special rights and obligations. These individuals or legal entities present the risks that have been underwritten and accepted by the insurer – they have agreed to a risk allocation between themselves.

An “additional insured,” sometimes called an “additional protected person,” is a different kind of risk allocation, one between two parties that employs insurance as a means to ensure financial responsibility or credit worthiness.⁶ The additional insured has a relationship, often a contractual one, with a named insured related to the work the named insured performs for the additional insured and that gives rise to an “insurable interest.”

An additional insured obtains proof of coverage from a “certificate of insurance” that names that person as an additional insured and lists coverages, policy numbers, insurers and the policy term. Such certificates also include a “best efforts” commitment to notify the additional insured of a policy change or cancellation. They do not, however, amend the policy or guarantee that coverage extends to the additional insured. Only reference to the policy itself can provide that assurance.

Insurance may cover the insurable interests of additional insureds in the terms and conditions of the policy itself; other times by endorsement. Errors and omissions policies probably do not include, except by endorsement, coverage for tort or contract liabilities created in the course of work done for others. There are endorsements that do not name additional insured persons, but rather cover them by a general reference or definition. Other types of endorsements may specifically name additional insureds.

In either event, the additional insured has fewer rights, and obligations, under the policy than a named insured and these are limited by its insurable interest. But, the additional insured can look to the insurer, rather than the service provider, in the event that there is a covered loss. The risk is re-allocated.

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⁶ The term “loss payee” sometimes appears with respect to property and casualty insurance. In the event of an insurable loss, a claims payment must be paid to the protected person named as loss payee. While similar to the additional protected person, the loss payee usually refers to one that has a security interest arising from a financing transaction.