

would likely be coverage. If, however, you did not anticipate the security need at all, then you may very well be without insurance protection.

Insurers know that security is a cat and mouse game between professionals and hackers, and that any given security is good only for a certain period of time, and they avoid this risk. With a little scenario based planning, you would be cognizant of this and work to reduce the scope of this exclusion.

#### INTELLECTUAL PROPERTY

Intellectual property is at the very heart of what computer software and services are all about. Information, data and ideas are the stock in trade of these professionals, and every day they run the risk of unintentionally interfering with the rights of others. That's covered because it's unintentional, right? If you have a typical policy, the following will likely be found in the exclusion section (actual language from a policy form in circulation):

***“This insurance does not apply to any claims arising out of:***

***Actual or Alleged:***

***Theft, infringement or violation of patent, trademark, service mark, trade name, trade dress, copyright or style of doing business; Wrongful appropriation or disclosure of trade secrets; or***

***Violation of any other intellectual property right or law.”***

Note that this exclusion would apply not only to your own violation, but also if it was your software that allowed the violation to occur. In a case where a software flaw caused a company's trade secrets to appear on the Internet, this would create a loss not addressed by most Errors and Omissions insurance. Intellectual property is a vast source of first party and third party risk.

The consolation: insurance is not all there is. Risk management (risk identification, risk stratification, loss control, risk transfer) is a process that works.

You're trekking out front, in the lead; realize that you're insurance company is a half mile behind. At least you have your risk adviser out there with you, right?

**Massachusetts Society  
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c/o

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# The Adviser

Massachusetts Society of Licensed Insurance Advisers

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Spring 2000

## Upcoming Events

**Tuesday, April 25, 2000**

**Speaker:** Dr. James Howell

**Topic:** The State of the New England Economy

**Thursday, May 18, 2000** (Breakfast Meeting: 8:00 am)

**Speaker:** Commissioner, Linda L. Ruthardt

**Topic:** The Changing insurance Regulatory Climate

**Note:** April's meeting will be held at the Downtown Harvard Club. Registration is at 11:30 a.m. The May meeting will be held at the Downtown Harvard Club at 8:00 a.m. Cost for each is \$35.00. For additional information and reservations, call the Insurance Library of Boston, at 617-227-2087.

## President's Corner

By: C. Dick Dyer, IV [dick\\_dyer@aon.com](mailto:dick_dyer@aon.com)

The year 2000 began with gusto but with some real uncertainty in the insurance and risk management arena. There has been a spate of mergers, acquisitions, consolidations and reorganizations recently in both the company ranks and the brokerage community and there does not appear to be any end in sight. The companies continue to look for ways to improve their efficiencies, and when there is a good fit, the results can be very positive. The ACE experience suggests that growth through acquisition can be dynamic. However, in many cases, the results have seemed far more fitful, with both insiders and outsiders wondering what happened and where do they go from here. This is true for both brokers and insurers.

Ironically, as all of this turmoil was unfolding, the market seems to be moving inexorably toward a tightening. Prices are at the least stabilizing, and many companies seem to be in almost a panic mode, analyzing and re-analyzing their books of business, and making decisions based on underwriting criteria today that are literally 180 degrees from their tenets a few short weeks before. Regardless of whether these reversals and belt tightening are driven by external forces, such as treaty renewals, or by internal dynamics like "we haven't tried that in a while", the result is a confused buying public. In the face of record economic growth and prosperity in the United States, many insurers here are languishing in pools of red ink and are bound and determined to improve their results.

Combine the two aforementioned issues with a sea change that has occurred in risk management, and you have the ingredients for the growth of risk management consultancy at an unprecedented rate. The only caveat is that the consultant/adviser must be ahead of the curve and take advantage of the changes as they occur. Enterprise risk is not a concept but a reality that is changing risk management for the better. But it does require out of the box thinking more than ever before. For those willing to learn, the value of an adviser will continue to grow. The number of choices may be dwindling but the complexity of the choices will only increase. The astute adviser will be an invaluable advocate to your organization in making this decision-making process less complicated.

## THE CHARITABLE TRUST

### Benefit Charity, Benefit Children, Disinherit IRS

By: Edward L. Wallack Esq., CLU, ChFC

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A Charitable Remainder Annuity Trust ("CRAT") and a Charitable Remainder UniTrust ("CRUT") fall under the broader heading of Charitable Remainder Trusts ("CRT"). A CRT, in general, has four main components. First, there is the designation of the income beneficiaries (usually the Grantor and/or his or her family). Second, there is the income term (which may be established by reference to a term of years not to exceed 20 years, or may be for one or more lives). Third, there is the required income payment (which is established as a fixed amount in the case of a CRAT, or a percentage of asset value in the case of a CRUT). Finally there must be a charitable remainder beneficiary to receive the trust assets at the end of the income term.

From an income and estate tax perspective, a CRT has several beneficial attributes. ***An income tax deduction is permitted for the fair market value of contributions*** to the trust. The trust is a tax-exempt entity. Thus when highly appreciated property is contributed to the CRT, ***the CRT may sell the property without incurring any tax obligation with the result that the CRT retains 100% of the fair market value in the***

**trust.** The CRT may invest these funds in a diversified portfolio, and the income earned on **these investments inside the CRT is also income tax free.** A combination of these tax-favored attributes is likely to result in the following:

- **increased current income to the Grantor** and/or his or her family,
- **an increase in the value of assets transferred to the Grantor's heirs,** and
- **a reallocation of social capital** (i.e. estate tax dollars) to charitable purposes that are important to the Grantor.

It is within this framework that a CRT can be tailored to each client's particular reason for considering a CRT. These may be quite varied, and include those who are simply philanthropically inclined; those who are motivated by the combination of tax savings, social good and the desire to redirect tax dollars to a specific charitable purpose of their choice; those for whom charitable giving is a tradition; and those who feel an obligation to repay a social debt or obligation. The concept may be further expanded to include a private foundation as the remainder beneficiary, thus involving children in the perpetuation of the legacy. The end result of planning with a CRT is that you benefit your family, you benefit your chosen charity, and you disinherit the IRS.

The example that follows is intended to present one situation in which a CRAT should be considered. There are many factors that are incorporated in the final CRAT design. The example does not explain, in detail, a number of these factors. However, the results of each of the options discussed are based upon identical assumptions.

Example: Mr. and Mrs. X, both age 65, have 3 children and 3 grandchildren. They are in the 40% income tax bracket and 55% estate tax bracket. X owns highly appreciated stock worth \$2,500,000 with a basis of \$100,000. The stock does not pay any cash dividends. They want to sell the stock and diversify their portfolio. Their goal on the new portfolio is to generate a 10% return. They desire to gift an aggregate of \$55,000 annually to their children and grandchildren. There are three options to consider (all of which assume a 10% return). (Option 1) They sell the stock and invest the net sale proceeds. (Option 2) They gift the stock to a CRAT that pays them \$105,000 *after tax*, for their joint lives. Under current IRS assumptions, this gift generates an income tax deduction of \$830,000 that is assumed to be realized over 6 years. (Option 3) They invest the excess income and tax savings from the CRAT in a variable life insurance policy owned by an irrevocable life

insurance trust. Assume the survivor of Mr. and Mrs. X dies at age 86.

- Under Option 1, the IRS receives \$2,453,000; the heirs \$2,007,000; and the charity nothing.
- Under Option 2, the IRS receives \$1,733,000; the heirs \$1,418,000; and the charity \$4,790,000.
- Under Option 3, the IRS receives \$0; the heirs \$4,651,000; and the charity \$4,790,000.

## IT'S RISKY OUT FRONT OF THE PACK

### INSURANCE GAPS PLAGUE COMPUTER SOFTWARE AND SERVICES FIRMS

By: Frank Licata [fjlicata@ARIRisk.com](mailto:fjlicata@ARIRisk.com)

Computer consultants and software developers are not cautious by nature. They're more comfortable taking risks than worrying about managing them, and to date this approach has worked for (most of) them. Going forward, this approach won't be wise.

Several high profile legal cases have foreshadowed what the Wall Street Journal termed on 1/4/99 as "the threat of increased legal scrutiny" for the computer services industry. A great number of cases involve the wild west of the internet, of course, but there is also a changing atmosphere in the more mundane areas such as enterprise resource planning (ERP). Courts have had a high degree of tolerance for imperfection in computer equipment and services due to the speed of product innovation, but clearly that tolerance has eroded lately.

Computer consultants and software developers have begun to consider the flow of liabilities emanating from engagements and product launches and the resulting exposure to financial loss. Those who blindly rely on insurance will be unpleasantly surprised as insurance products for the tech segment are riddled with gaps. A risk management program based on risk identification and stratification, loss control, contractual risk transfer, *and then* insurance, will keep tech firms out of the quicksand.

### SOME CASES

Let's consider some hypotheticals based on actual recent news events.

SAP AG, a large enterprise resource planning software maker, has been unflatteringly profiled recently because of disputes with two customers, Hershey Foods and Whirlpool Corp. Software problems have prevented the two companies from distributing their products to cus-

tomers, and damages will involve current and future loss of income, market share and customer good will. One thing for sure: the dollar value will be substantial.

SAP's size may preclude their need to make a panic call to their insurance broker, but most software companies would in fact do just that. The calls may not be reassuring. The policy form issued by one of the leading insurers operating in this niche starts out fine, offering to cover the insured for: *"...failure of your electronic products (defined to include services) to perform the function and serve the purpose intended..."* This certainly appears to describe the problem facing SAP in general terms. Only further in the policy, under the ever-present "Exclusions" section does the coverage problem become apparent.

The policy in question excludes:

*"...any loss, cost or expense incurred by you or others for the loss of use, withdrawal, recall, inspection, repair, replacement, adjustment, removal or disposal of: Your [products] or your work..."*

This exclusion appears under the title "Product Recall" but refers to much more than what is typically understood to be the meaning of recall. Remediation in the two SAP cases would unavoidably involve "replacement" and "adjustment" of the SAP products or services. And at the *end* of a large project the cost of the remediation would be painfully large.

Insurance policy language must be reviewed and appropriately structured given your specific exposures. The first approach would be to whittle down the exclusion to cover a pure product recall situation (a recall of a distinct product from store and warehouse shelves).

#### CONTRACTUAL LIABILITY EXCLUSION

W.L. Gore Co., the maker of GoreTex, is suing Deloitte Consulting for \$3.5 million over a human resources software package fiasco. In this case, let's consider the relationship between Deloitte and its subconsultants. At all times, contracting parties attempt to transfer liabilities to others via agreement, i.e. to get others to absorb their defense and indemnity costs. Deloitte, it will be assumed, used their clout to intimidate all subconsultants to assume Deloitte's liability arising out of acts of the subs. In a large job that goes bad, all parties on the job get caught in the plaintiff attorneys' dragnet. Here, the litigation-related confusion swirling about would have little Subcontractor A obligated to pay the legal bills of worldwide consulting firm Deloitte.

To add insult to injury, the indemnification of Deloitte would most likely not be covered by the sub's insurance. Virtually all unmodified errors and omissions liability policies contain *an exclusion for "contractual liability."* Be assured, paying the legal costs and damages of the leading consultant on a major job will put most companies out of business (individuals will be staring at personal bankruptcy).

#### PRIVACY AND SECURITY PROBLEMS

Another case involved Sony Entertainment Inc.'s "InfoBeat" online newsletter. The company disclosed that a software flaw had allowed advertisers to gain access to the email addresses of subscribers.

Privacy is perhaps the number one concern of Internet users and any invasion of privacy will expose companies to substantial liability. In fact, two class action lawsuits seeking monetary compensation have recently been filed against another company, RealNetworks Inc., over alleged violation of the privacy of its customers. The company's RealJukebox unit which plays music online had been collecting information about users' listening habits without advising them.

Intentional data collection is outside the scope of this research, but in the Sony case the company claims that the data collection was due to an error in the software. You can be sure that if the company is liable for damages, they or their insurance companies will be looking to the software manufacturer and/or consultant for restitution. Again, insurance is not the answer. Based on the policy form of another segment leader, this claim would not be covered. Most Errors and Omissions policies, in fact, contain a *personal injury exclusion* which is the mechanism by which invasion of privacy claims are barred. Assume for the moment that the privacy invasion was due to a security breach. A leading insurer provides the following exclusionary language with respect to security, and many other insurers follow suit:

*"This insurance does not apply to failure or lack of your electronic products to prevent unauthorized access to or use of an electronic system or program.*

*This exclusion does not apply if such unauthorized access is the result of a malfunction of your electronic products"*

This is not an ancient Chinese riddle. What actual meaning it would have to a jury, though, is open to speculation. Our interpretation is that if you anticipated an attack of a certain type, built software protocols to deter such an attack, and the protocols simply did not work, then there