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EXECUTIVE SUMMARY

- The coming of the year 2000 is marked with a unique risk due to the so-called "Y2K" problem. Countless millions of dollars have already been spent on correcting the Y2K bug, and much more will be spent before all Y2K problems are finally resolved.

- Many corporations should be able to recover a portion of the respective expenditures for Y2K costs, losses and damages under their insurance policies.

- Potential coverage may be available under first-party property policies and third-party general liability policies.

- The first and most important first-party property issue to arise relates to claims for reimbursement of the costs for remediation of the millennium bug pursuant to the "sue and labor" clause and similar provisions of first-party property policies.

- First-party coverage may also be available for the costs of pre-millennium "damages" to hardware, software, or imbedded microchips.

- CGL coverage will depend upon third-party liabilities, which arise from failures occurring after January 1, 2000 by virtue of defective hardware, software or imbedded microchips.

- Coverage may also be available under other types of policies such as business interruption, directors and officers policies, errors and omission coverage, and special data processing or other computer-specific policies.

- The actual coverage available to a given policyholder will depend on the facts and precise policy language involved. Case law in this field will develop over the next several years. However, general guidance for this analysis can be derived from analogous principles developed in related contexts.

- ➢ Both historical and current policies may in certain circumstances be tapped for Y2K-related recovery.
- ➢ Insurers will assert a number of viable defenses to coverage depending on the nature of the claim and type of policy involved.
- ➢ Coverage defenses which will be widely asserted include trigger of coverage defenses, allocation issues, late notice, absence of physical damage to tangible property, non-fortuity, suit limitation clauses, Y2K exclusions, and others.
- ➢ Many newly issued policies include Y2K exclusions which may severely limit coverage pursuant to those policies.
- ➢ In many cases, the defenses asserted by insurers may be overcome to support recovery.
- ➢ It will also be important for policyholders to become informed about potential Y2K recovery under their insurance policies.
- ➢ Businesses are well advised to conduct a prompt and professional assessment of potential insurance coverage of their Y2K-related losses and expenditures.
- ➢ The first issues to arise will relate to recovery of remediation costs experienced prior to January 1, 2000.
- ➢ Other issues will arise as failure (and resulting damage) occurs at the turn of the milllennium.
- ➢ Steps to take now are summarized at the conclusion of this article.

Introduction

The coming of the next millennium will bring a unique new business risk arising from the so-called "Y2K" problem. The computerized systems (including hardware, software and imbedded microchips) upon which modern civilization depends face substantial risk of failure when confronted with the software coding ambiguity attending the date 2000. Prudent corporations have acted in advance of the year 2000 to remediate such computer problems. Costs arising from remediation of Y2K-related computer problems to date are substantial. It is probable that untold additional expenditures relating to Y2K failures and liabilities will be incurred before all Y2K problems are finally resolved. Under the most optimistic assumptions, the final number will be very, very high.

The good news is that many corporate insurance policies should provide mechanisms for recovering some portion of the expenses and losses incurred due to the Y2K problem. In this article, Dispute Resolution Management, Inc. (DRM) briefly assesses certain concepts related to potential recovery of Y2K-related expenses and losses under various types of corporate insurance policies.[1] DRM is a management consulting practice specializing in business-oriented solutions to insurance-related disputes. DRM welcomes inquiries concerning potential Y2K insurance recovery for new and existing clients.

This article offers an overview of Y2K liabilities and potential insurance coverage for them. It includes an overview of possible coverage, first-party coverage, third-party coverage, directors and officers liability coverage, errors and omissions coverage, and specialty Y2K coverage. Following the conclusion of this article is a checklist of "Steps to Take Now," enumerating critical steps to take today to preserve opportunities for Y2K recovery.

[1] This article is of a general nature. It is intended to introduce certain concepts related to areas of the law, and is not intended to constitute legal or accounting advice. DRM offers consulting services on particular factual settings for Y2K coverage to its clients and welcomes inquiries on that basis.

OVERVIEW OF Y2K LIABILITIES

The ultimate scope of Y2K remediation, litigation and liability is unknown, but undoubtedly it will be substantial. Business Insurance reported that worldwide costs to address the Y2K problem might total $3.5 trillion.[2] The Gartner Group, an information technology consulting firm, has projected the total costs of Y2K compliance at between $300 billion and $600 billion.[3] Software Productivity Research, a consulting group, projects that corporations can expect average annual legal fees in the range of $750,000 related to the Y2K transition, and estimates that Y2K costs could ultimately reach $3.6 trillion. Actual expenses are, in many cases, already exceeding projections. For example, the costs of upgrading computers at U.S. banks rose from $3.46 billion to $3.6 billion within a few short months.[4] Several large U.S. corporations have reported that they are spending more than $500 million apiece, and medium-sized companies are spending an average of $4 million each to correct Y2K problems.[5] The final tally of Y2K remediation expenses will unquestionably be highly significant for many businesses.

As companies incur significant Y2K expenses, they are beginning to turn to their insurers for coverage. This attempt is well founded. A prominent actuarial firm recently reported that U.S. insurers could pay from $15 billion to $35 billion for claims and litigation related to Y2K problems.[6] Similarly, a Business Insurance report stated, "up to three-quarters of British companies could have legitimate grounds for claiming compensation for Year 2000-related losses under their all risk policies."[7] Insurance schemes in the U.S. and the U.K. are substantially parallel and similar prognostications apply on both sides of the Atlantic.

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[2] Sarah Goddard, *Year 2000 Problem May Cost Trillions*, BUSINESS INSURANCE at 6 (Oct. 6, 1997).

[3] The Gartner Group is an established, Connecticut-based technology industry-consulting group. *See* James Taranto, *The Year 2000 Problem,* WALL ST. J., Jan. 28, 1997, at A16.

[4] Rick Brooks, *Big Banks' Estimated Costs for Fixing Year-2000 Bug Rise 4% to $3.6 Billion*, WALL ST. J., March 31, 1999.

[5] *See Gartner Group Report,* available at <www.gartner.com>.

[6] Deborah Lohse, *Insurers' Y2K Payout is Pegged Above $15 Billion*, WALL ST. J., June 21, 1999, at A2.

[7] *See* Edwin Unsworth, *U.K. Companies Urged to Prepare for Year 2000*, BUSINESS INSURANCE, September 15, 1997, at 68 (reporting on the Association of British Insurers Year 2000 Study).

The insurance industry is not optimistic about its Y2K exposure. Insurers at Lloyds of London have projected that Y2K litigation costs alone will exceed $1 trillion.[8] Another expert group, predicting that insurers could incur hundreds of billions of dollars in litigation over claims denials, recently proclaimed, "The impact of the year 2000 crisis on the insurance industry could be more significant than any insurers have seen."[9] Meanwhile, certain insurance industry representatives have announced that historical and current policies will not cover Y2K problems.[10] Several insurance companies have also introduced special high-priced Y2K policies.[11] Other insurance companies have not yet formally taken a position on the issue.[12] Meanwhile, the insurance industry has collectively hedged its bets against potential coverage under current insurance policy forms by obtaining ISO approval for language expressly excluding Y2K coverage under new policies issued in at least 46 states.[13] Similar efforts are also underway in Canada.[14]

The docket of lawsuits against insurers for coverage of Y2K-related claims is growing rapidly and will continue to grow.[15] Although insurance coverage for Y2K problems presents a new issue for the legal system, the issue does not lack analogous precedent. Commenting on insurers' efforts to

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[8] Reported in Jon Swartz, *Year 2000 Computer-Bug Expected to Cost $1 Trillion/Grim Report from Lloyd's of London*, S.F. CHRON., June 20, 1997, at A9.

[9] *Insurance firms face Y2K losses* (quoting Andrew Pegalis, President of Next Millennium Consulting a US risk management consulting firm dedicated exclusively to Y2K problems), wire report available at <www.jrnl.com/news/98/Jul/jrnl25140798.html>.

[10] *See, e.g., Insurers Wash Hands of Claims Over Y2K Losses*, SCITECH (7/22/98); *see also* Y2K/THE YEAR 2000 NEWSLETTER (Nixon Hargrave Devans & Doyle, LLP), June 1998 ("Who is going to pay for all of this? Not the insurance industry. Standard insurance policies will not cover Year 2000 problem claims.").

[11] B. Zerega, *No Y2K safety net: Most insurance policies have holes*, INFOWORLD ELECTRIC (Aug. 7, 1998).

[12] In light of these conflicting approaches, certain insurers are still contemplating: 1) whether current policies, as written and when renewed, will cover Y2K problems; 2) whether the current policy, as written and when renewed, will exclude claims for Y2K problems; or 3) whether to offer policy holders a special insurance rider to cover Y2K problems. As reported at <www.Geo'sY2Kpage/Tekquity>.

[13] Many of these exclusions went into effect on April 1, 1998. "To date, the process has been largely cloaked in secrecy." Thomas M. Reiter, *Policyholder's Guide to Coverage for Year 2000 Losses* at 18, Kirkpatrick & Lockhart LLP Monograph (March 1998) (to be published in THE JOURNAL OF INSURANCE COVERAGE). *See also* Hakhi Alakhun El, *Insurers May Deny Y2K Coverage,* INFORMATIONWEEK, August 10, 1998 (reporting that the remaining four states – Alaska, Texas, Maine and Massachusetts – are considering granting insurance companies the same right); Blaise Zerega, *No Y2K safety net: Most insurance policies have holes,* INFOWORLD ELECTRIC (Aug. 7, 1998).

[14] *See* Nigel Kent, *Y2K Corporate Chaos: A Litigation and Insurance Nightmare* (Clark, Wilson, Barristers & Solicitors, Sept. 1998) <www.cwilson.com/Y2K/publications/npk1/Y2Kins.htm> (reporting that the Insurance Bureau of Canada circulated model wording for Y2K exclusions in April 1998).

[15] At the time of this writing, over one hundred Y2K-related cases had reportedly been filed. *See* Scott Seaman & Eileen Bower, *The Year 2000 Problem: The Good, The Bad, & The Ugly*, MEALEY'S LITIGATION REPORT: INSURANCE, July 7, 1999, at 29. Not all of these cases involve insurance recovery efforts. A report described in *Investigating the Year 2000 Problem: The 100 Day Report,* issued by the Senate Special Committee on the Year 2000 Technology Problem on Sept. 22, 1999, enumerated the following categories of Y2K lawsuits filed as of June 30, 1999: 65% involve non-compliant product cases alleging product defect or malfunction; 13% are class action shareholder suits; 9% concern remediation efforts; 7% involve organizations' nondisclosure of Y2K status; 4% are insurance claims; and 2% concern contractual disputes. *Id.* At 158 (citing PriceWaterhouseCoopers survey available at <www.pwcY2K.com>).

deny Y2K coverage, some legal analysts have observed: "The insurance industry has taken similar measures before, without much success, in attempting to avoid paying out on environmental and asbestos-related liabilities. Insurers should similarly fail in their efforts to avoid coverage for Year 2000 losses."[16] Other experts concur, stating that the Y2K problem "involves third-party systems and many kinds of possible claims . . . [that] could conceivably be much bigger than any hurricane or catastrophic event we've ever seen."[17]

Unquestionably, then, insurers' concerns about their ultimate liability for Y2K-related claims are realistic. In fact, certain experts have noted that some Y2K liability projections exceed the cash reserves of the entire insurance industry in North America, which total only $380 billion.[18] More conservative estimates tag the final insurance obligation at $35 billion, which still amounts to about ten percent of the industry's total surplus.[19] Dispute Resolution Management believes that tens of billions of dollars will pass from insurers to policyholders by virtue of the Y2K issue.

In this environment, negotiating settlements with insurers presents an attractive solution to many policyholders. Companies that have experienced the travail of environmental claims litigation know the pain of a litigated solution. In contrast, negotiated settlements offer several advantages. First, negotiated settlements offer a more prompt and secure recovery, without the risk of zero recovery. Second, they minimize the impact of any procedural hurdles imposed by new Y2K legislation.[20] Third, a settlement strategy minimizes transactional costs, both internal and external. Finally, negotiated settlements allow policyholders to preserve their confidentiality with regard to specific details of Y2K-related losses and to avoid negative publicity. In summary, policyholders would be well advised to act

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[16] Matthew Jacobs & Eric Lammers, *Pursuing Insurance Coverage for Year 2000 Losses: Problems and Possibilities* at 1, Kirkpatrick & Lockhart LLP Monograph (Spring 1998).

[17] Statement from Conning & Co. Assistant vice-president Mark Trencher, reported in *Insurers face potential Y2K risks—Conning Study* (Aug. 7, 1998), Reuters newswire at <www.year2000.com/lawcenter/NFlawcenter3.html>.

[18] Analysts with this view include David Schaefer, a principal at Armfield, Harrison and Thomas (an insurance broker specializing in technology risk). *See* Blaise Zerega, *supra,* note 11.

[19] Figures cited in Scott Seaman & Eileen Bower, *The Year 2000 Problem: The Good, The Bad, & The Ugly,* MEALEY'S LITIGATION REPORT: INSURANCE, July 7, 1999, at 36.

[20] The federal Y2K Act imposes several procedural limitations on the litigation of Y2K claims, including notice and timing requirements. The bill (H.R. 775) was signed into law on July 20, 1999. In addition, several states have enacted Y2K-related legislation. *See generally State Legislation Relating to Liability For Computer Date Errors,* 2 BNA Year 2000 L. Rep. at 477-487 (Nov. 1999).

promptly to seek coverage for their Y2K-related losses and expenses and to do so without resort to litigation. When evaluating their range of options, policyholders should consider strategic settlement processes a viable alternative to the litigation of Y2K-related claims against insurers.

INSURANCE COVERAGE OF Y2K LOSSES AND LIABILITIES

Various insurance policies may cover many potential types of Y2K losses and expenses. The relevant time period for policy coverage may include all years since the purchase and installation of a computer system, microchips or software. Although the exact coverage in a specific case will depend upon the particular policies and facts involved, the following primary categories of Y2K-related losses and expenses may be covered under current or historical insurance policies.

First-Party Insurance Claims

- ♦ Remediation Cost Claims (including costs of auditing computer systems for Y2K compliance, identifying problems and potential solutions, and taking corrective and remedial actions) made pursuant to "sue and labor" and similar clauses of first-party coverage, or made directly as a damage claim pursuant to such coverage;
- ♦ Business Interruption Claims (caused by partial or complete shutdowns during periods of repair for Y2K problems) made pursuant to business interruption insurance and related forms of coverage;
- ♦ First-Party Property Claims for consequential damages resulting from Y2K failures (such as timers failing, elevators crashing, machinery seizing up, etc.) made pursuant to first-party coverage;

Third-Party Liability Insurance Claim

- ♦ Third-Party Claims for indemnity for defense and liability as to suits against corporations for third-party damages resulting from computer equipment, microchip and software malfunctions;
- ♦ D&O Claims for indemnity for defense and liability as to shareholder derivative suits brought against companies, their officers and directors for:
    - Breach of fiduciary duties and duty of care for failure to ensure Y2K compliance and to take timely and effective compliance measures;

  - Waste of corporate assets for failure to pursue appropriate cost recovery actions and for delaying compliance actions; or
  - Violation of federal or state securities statutes for failure to properly disclose Y2K problems, and related fraud and negligent misrepresentation claims.

- ♦ E&O Claims for malpractice brought against business professionals, such as doctors, accountants, lawyers, brokers, agents, or others dealing in professional services or performing fiduciary tasks, for mistakes made in the course of conducting business, due to Y2K-related failures.

Of these various claims, those relating to remediation costs made under first-party policies will arise prior to January 1, 2000. The others will follow as the millennium passes and adverse consequences from the Y2K failures are manifested.

Insurers will attempt to defeat coverage by asserting an array of defenses. The precise composition of the defense package will depend on the nature of the claim and the type of coverage involved. Generally, defenses will include:

- Trigger of Coverage Issues
- Fortuity
- Expected & Intended Issues
- Late Notice/Suit Limitation Issues
- Absence of Physical Injury to Tangible Property
- Absence of a Covered Loss.

The following sections examine the general parameters of these various issues relating to potential coverage for Y2K losses and liabilities, and summarize key factors involved under each type of policy. In the following sections, first-party policies, third-party policies, directors and officers policies, errors and omissions policies, and specialty Y2K policies will be discussed in turn.

A. First-Party Policies and Y2K Claims

Most corporations purchase first-party property policies to cover property damage losses incurred. First-party insuring instruments are written on either a "named perils" or "all risk" basis. A "named perils" policy would cover any losses resulting from the particular kinds of perils named in the policy provisions. In the Y2K context, damages such as fires or floods resulting from Y2K failures might be covered under such "named perils" policies.

In addition, many businesses also have "all risk" first-party policies to cover the remainder of damages not covered under "named peril" policies. Because of their broader scope, Y2K coverage is "more likely to be widely available under 'all risk' rather than 'named perils' first-party policies."[21] In fact, some legal analysts state that "many first-party policies written on an all risk basis were issued as some of the broadest, most far-reaching insurance policies ever underwritten."[22] Thus, it appears probable that Y2K coverage should be available under many, if not most, first-party property policies.

This section generally discusses primary aspects of first-party property policy coverage in the Y2K context. It first discusses the potential types of coverage that may be available under various first-party property policies. It then discusses potential coverage under "sue and labor" and similar preservation clauses, business interruption insurance, and special policy extensions. It next reviews the important "trigger" of coverage issue in the Y2K context. Finally, this section addresses certain defenses that may be asserted by insurers. Key among these purported defenses are the so-called "fortuity doctrine" and the "suit limitation" provision. This section concludes with discussions of key defenses and rebuttals to them.

1. First-Party Property Claims for Y2K Losses and Damages

Initially, first-party property policies should be examined for potential coverage of Y2K-related losses and damages. This coverage may take several forms. Of particular note, some policies expressly

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[21] Matthew Jacobs and Eric Lammers, *Pursuing Insurance Coverage for Year 2000 Losses: Problems and Possibilities* at 2, Kirkpatrick & Lockhart LLP Monograph (Spring 1998).

[22] Terry Budd & Curtis Krasik, *The Y2K Timebomb – Run for Coverage* 5, Kirkpatrick & Lockhart LLP Monograph (April/May 1998)(citing Insurance Co. of N. Am. v. United States Gypsum Co., 870 F.2d 148, 151 (4th Cir. 1989) (observing that insurers during the late 1970s and early 1980s often followed the practice of cash-flow underwriting, and used broad all-risk policies to attract premium moneys for investment, because of high interest rates at the time).

cover data corruption or physical losses including the “accidental, intentional or malicious distortion, corruption, manipulation, erasure or loss of data or software.” Coverage for many Y2K-related problems with data and software is more likely to be available where a policy includes data corruption coverage or a definition of physical loss similar to the quoted language.

Even in the absence of such express language, coverage of Y2K losses and damages may be available under the general coverage provisions for property damage found in first-party policies. Many first-party “all-risk” policies are designed to cover “all risk of direct physical loss of, or damage to the property insured” arising from a “covered cause of loss.” Some policies do not define “physical loss” or “damage.” Others define covered damage and loss as “physical injury to tangible property” or “loss of use of tangible property that is not physically injured.” Issues relating to the occurrence of physical injury to tangible property are discussed below. Regardless of the particular language used, although first-party policies are obtained to protect the insured’s own property, the insured must be prepared to show that the policy covers Y2K-related damages and losses to the insured property.

In the Y2K context, two different types of losses and damages can be identified. First, certain losses and damages are associated with replacing or restoring computer systems, software programs and microchips to correct Y2K problems. This category would include both the “damage” which has occurred by virtue of the very defective programming that constitutes the millennium bug (i.e., the millennium bug by itself constitutes damage), and the damage to computer assets which occurs when those items fail by virtue of that defective programming. Second, Y2K losses or damages can also result from the malfunction of unremediated (or improperly or incompletely remediated) computer or computer-dependent equipment. Each of these types of loss or damage requires separate discussion.

Losses and damages to computer systems, software or data have not been widely litigated in the insurance context. However, a careful reading of language defining “physical loss” or “damage” shows that the provision may often not cover “physical damage” alone, but rather “physical loss of or damage to” insured property. Thus, this sort of provision arguably covers both physical losses and

other less tangible Y2K damages. Under settled case law, this definition should include economic losses since diminished economic value of a product constitutes damage to that property.[23]

However, even if "physical" damage is found to be a requirement for recovery under policy terms, case law precedent supports a broad reading of the terminology that would encompass damages of this sort.[24] The Y2K "bug" can unquestionably corrupt computer systems and data, rendering them wholly or partially unreliable. The level of tangibility may be microscopic, or even molecular, but the coding which represents the corrupted software is recorded in physical form on a hard drive or a disk. In a very real sense, there is no distinction between software written on a disk and notation written in ink on a slip of paper. No one could reasonably argue that the paper is not tangible property. The coding written on magnetic or electronic medium is as tangible.[25] Thus, this situation ought to generally meet the standard required to show physical damage of insured property.

Coverage for the second consequential type of loss or damage should also be available in many cases. Secondary losses or damages to covered property due to Y2K-related failures will often readily meet the required definition. Many scenarios can be envisioned in which computer malfunctions cause critical systems to fail, resulting in secondary damages to covered property. Under many first-party policies, such losses and damages would be recoverable.

2. "Sue and Labor" and Other Preservation Clause Claims

Policyholders should also consider whether potential coverage of Y2K claims may be available under "sue and labor" and similar clauses found in some first-party policies. Several claims for Y2K remediation cost coverage have recently been filed under the "sue and labor" clause and similar

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[23] *See, e.g.,* Hampton Foods, Inc. v. Aetna Cas. and Sur. Co., 787 F.2d 349 (8th Cir. 1986).

[24] *See, e.g.,* Retail Sys., Inc. v. CNA Ins. Cos., 469 N.W.2d 735 at 736 (Minn. 1991) and Centennial Ins. Co. v. Applied Health Care Sys., Inc., 710 F.2d 1288 (7th Cir. 1983) (supporting finding of coverage).

[25] This issue was directly addressed in the third-party policy context by the Minnesota appeals court in *Retail Systems, Inc. v. CNA Insurance Companies,* 469 N.W.2d 735 (Minn. Ct. App. 1991). In that case, the court considered whether lost computer tapes constituted a loss to tangible property. The court found that the tangibility requirement was ambiguous, at best, and found in favor of coverage, observing: "The data on the tape was of permanent value and was integrated completely with the physical property of the tape. Like a motion picture, where the information and celluloid medium are integrated, so too were the tape and data integrated at the moment the tape was lost." *Id.* at 737-38.

provisions of first-party policies.[26] Many more will follow.

DRM believes that this approach will be predominant and will constitute one of the largest areas of Y2K insurance dispute. Recovery based upon such preservation clauses should be available to virtually every company which experiences remediation costs and which has purchased first-party property coverage. Given the stakes, it is also probable that insurers will resist this sort of claim. DRM believes, however, that most insurers will receive a properly postured claim-settlement approach with favor.

The "sue and labor" clause originated in marine insurance policies of the seventeenth century. Although the precise language has sometimes changed from that found in historical policies, a "sue and labor" clause or similar "preservation" provision is often found in first-party policies today. Because of its long history, case law and legal analysis pertaining to this type of provision is plentiful.

A typical "sue and labor" clause reads:

> In case of any loss or misfortune, it shall be lawful and necessary for the Assured, his or their factors, servants and assigns, to sue, labor and travel for, in and about the defense, safeguard, and recovery of the aforesaid subject matter of this insurance, or any part thereof, without prejudice to this insurance; the charges whereof this Company shall bear in proportion to the sum hereby insured.

Precise language varies from policy to policy. Some policies label this coverage provision as a "protection of property" clause. A version of the clause used by the London market and some domestic insurers is as follows:

> In case of direct physical loss or damage by an insured peril, the Insured will take reasonable steps to protect, recover or save the insured property and minimize any further potential loss. The acts of the Insured or the Company in protecting, recovering or saving the insured property will not be considered a waiver or an

[26] *See, e.g.,* GTE Corp. v. Allendale Mutual Ins. Co., Case No. 99-2877 (D. N.J. filed June 18, 1999); American Guarantee and Liability Ins. Co. v. Xerox Corp., Index. No. 603169/99 (N.Y. Sup., N.Y. Co., filed July 1, 1999); Xerox Corp. v. American Guarantee & Liability Ins. Co., No. CV 99-1073064-S (Conn. Super., Stamford, filed July 2, 1999); Port of Seattle v. Lexington Insurance Co. et al., No. 99-2-26938-1-SEA (Wash. Super., King. Co., filed Nov. 16, 1999).

> acceptance of abandonment. The Insured and the Company will bear the expenses incurred proportionate to their respective interests.

Depending on the particular language used, the scope of coverage may differ somewhat, and so individual policies must be analyzed carefully to determine the scope of coverage provided under a specific "sue and labor" or similar "preservation" clause.

Regardless of the particular language involved, however, several basic aspects of the "sue and labor" clause are important to note. The clause is basically designed to reduce insurers' ultimate liability by requiring policyholders to take necessary steps and spend the sums required to prevent or mitigate covered losses. It also imposes a corresponding responsibility on the insurer to reimburse the policyholder for the costs of such efforts. The obligation under a "sue and labor" clause is separate and distinct from other contract provisions. As such, reimbursement under this clause is neither limited by, nor credited against, the policy limits. However, that recovery is limited to actual expenses incurred in remediating, mitigating or preventing losses. Finally, the scope of covered losses under the policy must also be examined to ensure that remedial efforts were necessary to prevent a greater loss covered under the terms of the policy. Insurers will look critically at the "damage" being prevented by the remediation expenses and will be prone to deny that such potential "damages" are covered under the policy.

Despite insurers' defenses, the "sue and labor" clause found in many first-party policies should allow policyholders to seek coverage for expenses incurred in preventing or mitigating covered losses due to Y2K problems. In the Y2K context, a policyholder's remediation of Y2K-related problems may well prevent more substantial claims against the insurer for covered losses that would have resulted from failure to take prompt and effective remedial action. Given the various types of damage that might arise if Y2K "bugs" are not remediated in advance, it is true that the remediation benefits the insurer by stopping, among other problems, property damages which might arise absent remediation. It is important that a corporation presenting such a claim develop the case to support this requirement prior to beginning to pursue the claim.

The policies involved will be those containing a "sue and labor" or similar clause in force at the time when preventative expenses were incurred. It is likely that policies for the last few years, beginning from the time when remediation efforts began, will be impacted. For this reason, both current policies and all historical policies in effect at the time when remediation efforts were undertaken should be reviewed for potential "sue and labor" clause coverage.

Where such Y2K remediation efforts are necessary and required under a "sue and labor" clause or its equivalent, the expense of such efforts should be recoverable. Thus, policyholders incurring remedial Y2K costs should consider the "sue and labor" clause in seeking reimbursement of their expenses. This is an area of Y2K claims as to which the door has opened and will not shut again. These claims will ripen prior to January 1, 2000, and policyholders should not delay in developing, documenting, and tendering the claims.

3. Claims Under Business Interruption, Extra Expense or Expense to Reduce Loss Provisions

As part of their first-party coverage package, policyholders often purchase special types of policies related to loss of business income. These may include business interruption coverage and extra expense coverage or coverage for expenses to reduce losses from repairs of covered property. These special provisions may provide coverage for certain Y2K-related losses. Depending on timing and the existence of negotiated exclusions, this area of Y2K claims may be very significant.

Business interruption coverage is generally designed to reimburse policyholders for lost income resulting from covered losses. Conversely, the extra expense or expense to reduce loss provisions underwrite costs of responding to a covered loss. In explaining the relationship between these forms of coverage, one treatise states:

> In a sense, extra expense insurance is the *opposite* of business interruption coverage. Business interruption insurance substitutes for or replaces the ordinary income derived from the operations of a business during a period when normal operations cannot be continued. Extra expense coverage, on the other hand, provides the funds necessary

to insure that operations *can be continued*, thus allowing the business to generate the earnings needed to cover fixed expenses.[27]

These forms of first-party insurance ensure comprehensive coverage of costs and losses associated with an interruption or suspension of ordinary business operations.

The language of business interruption provisions typically covers "loss resulting directly from necessary interruption of business caused by physical loss or damage of the type insured against to real or personal property of the type covered located on described premises." As such, this coverage would generally apply to lost earnings, including those resulting from Y2K problems. Business interruption coverage should be available to policyholders that, having taken prudent Y2K corrective measures, nonetheless suffer suspended operations resulting from Y2K problems. Such losses will not become apparent until January 1, 2000.

Coverage for extra expense or expenses to reduce loss is designed to provide the funds necessary to insure that business operations can be continued. These provisions cover the cost of responding to a loss. The typical wording of "extra expense" provisions allows compensation for costs incurred to "replace or restore . . . lost information on damaged . . . records." Under the plain meaning of such provisions, coverage should be available for the costs of replacing or restoring computer systems, software programs and microchips that fail due to Y2K problems. Again, this sort of loss will arise after January 1, 2000.

Unanswered questions remain as to whether or not a complete cessation of activities is required under business interruption insurance for lost business recovery. Some policies appear to require a complete cessation in business operations to trigger coverage.[28] Others explicitly provide "for coverage in lesser amounts for each day of partial prevention of business."[29] Even in the absence

[27] Stephen A. Cozen, Insuring Real Property, § 3.02[2][e] (1997).

[28] *See, e.g.,* The Home Indem. Co. v. Hyplains Beef, 893 F. Supp. 987 (D. Kas. 1995), *aff'd* 89 F.3d 850 (10th Cir. 1996) (holding that policy did not cover computer malfunction which resulted only in business delays and not in suspension of business).

[29] Simkins Indus. Inc. v. Lexington Ins. Co., 401 A.2d 181, 191 (Md. Ct. App. 1979).

of explicit provision for “partial prevention of business,” however, the insured may be able to defeat any assertion that complete cessation of business is required to trigger coverage. That is because such an assertion would place the policyholders in the predicament of having to resume operations in order to mitigate loss of earnings, as many property policies require, but causing them to lose business interruption coverage if they do so. At least one court has recognized that imposing a requirement of this sort would be unreasonable.[30]

Business interruption and related provisions have not been widely litigated. There is therefore little judicial guidance on their interpretation or application. Of interest in the Y2K context, these special provisions may not tie coverage obligations to the direct and physical damage requirement frequently imposed under other types of first-party coverage. Policyholders should consider the possible application of these provisions to their Y2K-related losses and expenses.

4. Claims Under Other Policy Extensions

Finally, many companies have purchased special policy extensions that may cover Y2K-related damages and losses to computer equipment and related media.[31] For example, the building and personal property form contains an extension of coverage for valuable papers and research with potential application to Y2k-related losses and damages. Other policyholders may have purchased optional computer coverage, such as data processing coverage. One form of electronic data processing coverage issued by the London market provides:

> It is understood and agreed that this Policy is hereby extended to cover Electronic Data Processing Equipment and Media, in an amount not to exceed the limit of liability of this Policy as follows (located at Insured’s premises covered hereunder): (A) Data Processing Systems, including equipment and component parts hereof, owned by the Insured or leased, rented or under the control of the Insured. (B) Data Processing Media, meaning all forms of converted data and/or program and/or instruction vehicles employed in the Insured’s data processing operations, and blank magnetic

[30] Linnton Plywood Assoc. v. Protection Mut. Ins. Co., 760 F. Supp. 170 (D. Ore.1991).

[31] For example, the 1993 *Corporate Computing Survey* performed by Loughborough University in the U.K. found that 83 per cent of all companies surveyed had some form of computer-related insurance. Sommer, *Insuring the Computer-Dependent Company,* (1997),<www.virtualcity.co.uk/insure.htm>.

> recording or storage media for electronic data processing, being property of the Insured or property of others for which the Insured may be liable.

Such provisions may provide for special valuation procedures to control the determination of loss. For example, the coverage may provide that data processing systems are valued at actual retail replacement cost at the time of loss, or that data processing media is valued at actual reproduction cost.

In some cases, policyholders have purchased optional coverage to fill a void where their first-party property policy expressly excludes coverage for data corruption. [32] Thus, policyholders whose all-risk policies expressly exclude coverage for computer-related losses and damages should review their current and historical insurance package to see whether special coverage or extensions may fill this void. Optional coverage may cover certain Y2K claims.

5. Trigger of Coverage Issues

In the Y2K context, "trigger of coverage" will be an important issue. Old-year policies may be triggered that were in effect when Y2K-related decisions were made. Trigger theory will affect which policies may be called upon for coverage.

Trigger theory has evolved primarily in the context of third-party policies, as is discussed in greater detail below. There is, however, some precedent in the first-party context. Some first-party cases support the argument that, where there is progressive latent damage, all policies from the beginning to the end of the damage process are obligated, subject to their terms and conditions, to respond and cover the ultimate loss.[33] Under this interpretation, all policies since purchase of Y2K-affected equipment could be called on for coverage. Other cases have adopted a "manifestation of loss" trigger, holding that only those policies in effect when property damage manifests are responsible to cover continuous injury claims.[34]

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[32] Some policies specifically exclude the costs of restoring or replacing computer records.

[33] *See, e.g.,* Aluminum Co. of America v. Accident & Cas. Ins. Co., No. 92-2-28065-5 (Wash. Super. March 8, 1996 and October 10, 1995) (applying a form of continuous trigger in environmental insurance coverage action involving first-party policies).

[34] *See, e.g.,* Prudential-LMI Com. Ins. v. Superior Court, 798 P.2d 1230 (Cal. 1990).

Because of the importance of trigger theory in the Y2K context, this issue will undoubtedly receive additional development in the first-party context as Y2K claims are resolved. The outcome in the few first-party cases that have considered trigger theory illustrates a striking similarity to the results in third-party cases involving occurrence-based policies. The third-party issue is discussed in more detail below. There is reason to believe that future developments in the first-party policy context may follow along similar lines.

6. Overcoming Possible Defenses to First-Party Y2K Policy Coverage

Insurers can be expected to raise several defenses inY2K coverage litigation. A preliminary defense already being asserted is the so-called "non-fortuity defense." Another defense is likely to be the "suit limitations" argument. In addition, some more recent policies may explicitly exclude Y2K claims. This section discusses these potential defenses in turn.

Insurers are already beginning to assert a "non-fortuity defense" against Y2K claims. Traditionally, fortuity theory developed in the context of first-party policies, although insurers are attempting to expand its scope to include third-party claims, as well. However, the "non-fortuity defense" should fail in most Y2K cases involving policyholders that were innocent purchasers of noncompliant computers or software, in either the first- or third-party context.

In the first-party context, fortuity theory developed in the early days of insurance as an extra-contractual "exclusion" for loss or damage that was certain to occur. Although courts still occasionally cite the doctrine today, the scope and effectiveness of a defense based on fortuity theory are extremely limited. The only real context for a viable "non-fortuity defense" *per se* remaining in modern law involves fraud or misrepresentation.

Insurers are asserting that Y2K losses are not fortuitous – that is, caused by "chance" – and, hence, are not insured risks under insurance policies. They claim that the nature of the Y2K problem has been "well publicized," will happen "on a date known well in advance" and that "effective preventive measures are usually available."[35] To some extent, the facts in a particular case will pertain

[35] *Potential Impact of Y2K Claims on Various Insurance Coverages* (Federation of Insurance & Corporate Counsel), <www.thefederation.org/public/Y2K/impact.htm>.

to this matter. For example, a software manufacturing firm is more likely to have been aware of the problem and in a position to prevent it than the average corporation buying computer equipment, particularly if purchases were made more than a couple of years ago. However, regardless of circumstances involved, fortuity theory does not support the vigorous defense that insurers promote.

Under most modern interpretations, determining whether a loss was fortuitous depends on the policyholder's subjective knowledge of the certainty of the loss at the time the insurance contract was entered, not on a "reasonable person," objective or "should have known" standard. If a loss becomes certain only in hindsight, first-party coverage cannot be denied. Furthermore, insurers' attempts to assert a "non-fortuity defense" by arguing that the policyholder "subjectively" anticipated the losses should fail upon the policyholder's showing of significant, recent business expenditures designed to prevent the Y2K losses incurred. Finally, if insurers assert that Y2K problems were foreseeable, policyholders can counter that such problems were equally foreseeable to the insurers who did not exclude Y2K coverage from the policies.

In summary, the "non-fortuity defense" is rarely effective under the interpretations of many modern courts.[36] It is unlikely that the doctrine will be revived or reformulated in the context of Y2K litigation. Also, the doctrine cannot be effectively employed in the Y2K context, due to the particular circumstances surrounding this technological problem. For these reasons, most policyholders' Y2K claims are unlikely to fail before a "non-fortuity defense."

Concerning other possible defenses, certain first-party policies may include "electric apparatus" exclusions. Insurers may try to expand this definition in ways not originally intended to exclude Y2K claims. Examining the language, intent and scope of these exclusions, where they exist, will help policyholders avoid any unintended effects of this exclusion to Y2K-related claims.

Finally, insurers may attempt to assert "suit limitations" provisions as precluding Y2K claims. These provisions are often found in first-party policies. A typical provision reads as follows: "No suit or action on this policy for the recovery of any claim shall be sustainable in any court of law or equity

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[36] *See, e.g.,* Stephen A. Cozen and Richard C. Bennett, *Fortuity: The Unnamed Exclusion*, 20 FORUM 222 (1985).

unless all of the requirements have been complied with, and unless commenced within twelve months next after inception of loss." Alternate wording of the section may tie the obligation to bring suit to the occurrence of the loss, rather than its inception. This provision thus may contravene statutes of limitation under applicable laws. In the Y2K context, insurers may also argue that the provision implicates state and federal legislation concerned with litigation of Y2K claims.

Some "suit limitation" provisions are fairly forgiving. A common provision stipulates that:

> No suit or action on this Policy for the recovery of any claim will be sustainable in any court of law or equity unless the Insured will have fully complied with all the requirements of this Policy. The Company agrees that any action or proceeding against them for recovery of any loss under this Policy will not be barred if commenced within two years and one day next after the occurrence becomes known to the Insured unless a longer period of time is provided by applicable statute.

Such a provision appears not to limit bringing claims or suits, but rather to expand any lesser statute of limitations.

Policyholders may rebut "suit limitations" arguments with several arguments. First, some states have statutorily invalidated such provisions altogether, as constituting invalid attempts to preempt state statutes of limitations.[37] Second, most states require insurers attempting to invoke such provisions to prove that they were prejudiced by any delay in bringing suit.[38] Furthermore, a majority of courts have held that suit limitations provisions may not begin to run until, at the earliest, the policyholder becomes aware of a previously latent loss.[39] Millennium bug problems are uncovered on the basis of a line-by-line search of the software coding. As each entry is found, it is repaired. Each individual software-coding problem therefore constitutes a separate risk of failure. The result of this process should be that at the very least, costs incurred inside the notice period should be covered as problems discovered and noticed

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[37] *See, e.g.,* Mass. Gen. Laws. Ch. 175, §22 (1998); Me. Rev. Stat. Ann. Tit. 24-A, §2433 (1999).

[38] The reasoning in such cases typically notes that insurance policies are adhesion contracts; that technical forfeitures are to be discouraged as against public policy; and that insurers should not be allowed to avoid coverage when they have not been prejudiced by the delay in notice. *See, e.g.,* Weaver Bros., Inc. v. Chappel, 684 P.2d 123 (Alaska 1994); Foundation Reserves Ins. Co. v. Esquibel, 607 P.2d 1150 (N.M. 1980); Independent School Dist. No. 1 of Tulsa v. Jackson, 608 P.2d 1153 (Okla. 1980).

[39] *See, e.g.,* Prudential-LMI Commercial Ins. v. Superior Court, 798 P.2d 1230 (Cal. 1990).

in a timely manner. Finally, a careful reading of some policy provisions shows that their suit limitation notice period is triggered by a written denial of coverage. In many cases, this may not yet have taken place. Thus, through countering suit limitations arguments, policyholders may be able to access historical policies to cover suits arising many years later for Y2K-related claims.

In recent years, insurers have attempted to limit Y2K liability by adding exclusions for Y2K claims. Such exclusions may limit or block potential recovery. The impact of such exclusions will depend upon the policyholder's insurance renewal cycles (i.e., when was coverage purchased and for how many years) and the negotiations at the time of renewal. Policies should be examined for such exclusions, and the impact of the exclusions must be evaluated on a policy-by-policy basis.

B. CGL Policies and Third-Party Y2K Claims

Commercial general liability (CGL) policies may also cover policyholders for certain Y2K damages. Such policies obligate the insurer to defend and indemnify the insured against third-party claims. Because CGL policies cover all third-party claims and liabilities that are not specifically excluded, they may provide "substantial coverage for Year 2000-related liabilities."[40] They will cover certain losses incurred by a corporation where litigation results in damage awards or where the threat of legal proceedings prompts the corporation to negotiate a settlement. Both personal injury or property damage claims are included.

This section discusses the general range of claims that may be covered under CGL policies. It then considers the potential "triggers" of coverage under Y2K claims that may implicate policies in effect at various times involved in the causation of Y2K losses and damages. Finally, this section discusses possible defenses to Y2K claims under CGL policies and offers several rebuttals to those insurer defenses.

1. Potential Y2K Coverage under CGL Policies

The extent of coverage available for Y2K-related claims under a given CGL policy will depend on several factors. Relevant issues will include the nature of damage to property or bodily injury

[40] *Reiter, supra* note 13, at 5.

involved, and whether the damages were "expected or intended" from the policyholder's standpoint. The total recovery available will also depend on the "trigger" of coverage determining the range of consecutive and concurrent policies that can be called upon to respond to the claims. There may also be specific policy exclusions that preclude particular claims.

For property damage claims, the property that is the subject of the claim may impact coverage. Most CGL policies define "property damage" as "physical injury to tangible property, including all resulting loss of use of that property." One important hurdle in the Y2K context will be the showing of "physical injury" and "tangible property" required under this typical definition. In many respects, the property damage analysis parallels the first-party policy issues discussed above. However, some additional unique questions arise for CGL insurance policies.

As mentioned above, the standard-form CGL definition of property damage covers loss of or damage to "tangible" property. Insurance case law involving the loss of or damage to information stored on computer media in the third-party policy context is sparse. Legal precedent can be cited for both sides of the question of whether or not data and computer programs constitute tangible property under such provisions, a determination that is highly fact-dependent.[41] In at least one case, a court found that loss of information on computer tape was "tangible property" under a CGL policy.[42] Application of the reasoning developed under analogous patent and tax law cases should provide support in defining tangible property so as to include such Y2K-related damages as data loss and corruption.

"Loss of use" has been part of the "property damage" definition in standard form policies since 1973. The term "loss of use" is typically not defined in the policy. In some cases, coverage has been found in cases where, although the property can still be used, the claimant has a diminished or impaired ability to use the property. Some courts have also found favorably for the policyholder on the "loss of use" issue even while adopting the insurer's definition of "physical injury." Thus, with competent guidance, many policyholders should be able to find coverage of claims and liabilities

[41] *See*, e.g., Retail Sys., Inc. v. CNA Ins. Cos., 469 N.W.2d 735 at 736 (Minn. Ct. App. 1991); Centennial Ins. Co. v. Applied Health Care Sys., Inc., 710 F.2d 1288 (7th Cir. 1983) (supporting finding of coverage).
[42] Retail Sys. Inc. v. CNA, Ins. Cos., 469 N.W.2d 735 (Minn. Ct. App. 1991).

resulting from partial or complete failures of equipment due to Y2K problems.

Another key issue in the CGL context is trigger of coverage. To "trigger" a policy, the property damage or bodily injury at issue must occur within the policy period. The question of timing is more complex than it first appears. As the new Y2K exclusions approved by the ISO are implemented and added to new and reissued CGL policies, the trigger of coverage for previously issued policies will become increasingly important.

In cases involving latent damage, determination of the appropriate trigger of coverage is a matter of some complexity. Courts have applied a wide variety of approaches in analogous cases. In asbestos litigation, for example, some courts have held that coverage is triggered when asbestos-containing material is installed and continues at least until the damage or injury manifests.[43] In other cases, courts have held that the only coverage triggered is that which is or was in force when the property damage first manifests.[44] In still other cases, courts have held that the only policies triggered are those in effect when exposure to the injury-producing product occurred, even if the injury could not have been detected at that time.[45] Yet another approach holds that policies in effect during the exposure and at the date of manifestation of injury or damage are on the risk, whereas intervening policies are not.[46] A fifth approach holds that all policies in effect during the entire injurious process are triggered, beginning with first exposure, continuing while the damage progresses through to at least the discovery of that damage.[47]

The causation chain of Y2K damages is complex. Possible trigger points include: (1) the point or points of software coding, (2) the point or points of software installation on hardware, (3) the point of awareness, actual or imputed, of software or hardware defects, (4) the point of purchase or

[43] This is known as the "actual injury" or "injury-in-fact" trigger. *See, e.g.,* Maryland Casualty v. W.R. Grace, 23 F.3d 617, 628 (2d Cir. 1993), *cert. denied*, 513 U.S. 1052 (1994).

[44] This is called the "manifestation" trigger. The seminal case for this theory is *Eagle-Picher Indus., Inc. v. Liberty Mutual Ins. Co.*, 523 F. Supp. 110 (D. Mass. 1981), *modified,* 682 F.2d 12 (1st Cir. 1982), *cert. denied,* 460 U.S. 1028 (1983).

[45] This is known as the "exposure" theory. *See, e.g.,* Insurance Co. of North America v. Forty-Eight Insulations, Inc., 451 F. Supp. 1230 (E.D. Mich. 1978), *aff'd*, 633 F.2d 1212 (6th Cir. 1980), *clarified,* 657 F.2d 814 (6th Cir. 1981), *cert. denied*, 454 U.S. 1109 (1981).

[46] This is known as the "double trigger" theory. *See, e.g.,* Zurich Ins. Co. v. Raymark Industries, Inc., 514 N.E.2d 150 (Ill. 1987).

[47] This is known as the "continuous" or "triple trigger" theory. *See, e.g.,* Keene Corp. v. Insurance Co. of N. Am., 667 F.2d 1034 (D.C. Cir. 1981), *cert. denied*, 455 U.S. 1007 (1982).

installation of any product with defective microchips or software, (5) the point or points of spending for remediation, (6) the point or points of failure to properly repair any software or hardware defects, and (7) the point of failure, presumably January 1, 2000. The various trigger theories developed in other contexts are arguably analogous to the Y2K scenario. Courts are likely to adopt various approaches to Y2K claims as they have under other coverage situations. In light of this reality, many policyholders will successfully tap some historical and current CGL policies for coverage of Y2K claims.

2. Overcoming Defenses to CGL Y2K Claims

There has been a distinct phenomenon of growing media attention to Y2K issues; insurers are likely to assert that the insured parties either intended or expected Y2K damages. Hence, they will argue, such damages should be excluded from coverage. However, this exclusion will probably not defeat coverage for most policyholders.

Most courts apply a subjective standard in determining whether injuries are expected or intended. Under this subjective approach, coverage is precluded only upon showing that the insured actually expected or intended the damage or injury at issue. Moreover, the majority of jurisdictions permit only an expected or intended injury (as opposed to expected or intended acts) to preclude coverage.

Under the majority approach, insurers would have to establish the actual expectation or intention of injury at the time the action leading to the damage was taken, such as when computer systems, software or microchips were purchased or installed. In this regard, expectation or intent must be contrasted with speculation or worry. Recognition of mere possibility does not suffice. Moreover, in fact, such damages were generally neither expected nor intended, subjectively or objectively. Most policyholders were unaware of the Y2K issue until recently. Furthermore, the Y2K problem is highly technical in nature and it has been difficult for average policyholders to grasp the damages that may be entailed. This difficulty is compounded by the fact that vendors of computer equipment and software have not always been forthright about revealing the Y2K defects in their products. Even now, the scope of actual Y2K liability remains speculative and highly indeterminate. In light of these factors, insurers will have difficulty showing that policyholders intended or expected Y2K losses.

Another likely insurer defense against Y2K CGL claims will be the argument that certain "business risk" exclusions preclude coverage. One such exclusion in standard-form liability policies precludes coverage for damages to the insured's product arising out of that product. Some courts have ruled that the "own product" and "work product" exclusions preclude coverage for business costs incurred to replace or repair the insured's product. However, they have not precluded recovery for damages caused by that product to a third party's property. Thus, these limitations will leave insured companies with considerable recovery for both third-party damages and the costs of removing and replacing products that are not Y2K compliant.

Another business risk exclusion that insurers may attempt to invoke is the impaired property exclusion. Since 1986, the standard exclusion has precluded coverage for "impaired property" or property that has not been physically injured, arising out of a defect, deficiency, inadequacy or dangerous condition in the insured's own product or work product. This definition of "impaired property" is limited to "tangible property." The courts have rarely construed the impaired property exclusion. Cases considering it have limited the "impaired property" exclusion to "damage done to property which could not be restored to use through repair, replacement, adjustment or removal of the insured's product."[48] Some courts have further found that this provision is ambiguous, and hence, unenforceable.[49] The exclusion does not therefore appear to present a significant obstacle to Y2K recovery.

In summary, a number of defenses may be asserted against CGL claims for Y2K damages. However, a knowledgeable policyholder should be able to overcome many potential defenses to coverage. For damage or injury to be excluded as intended or expected, the subjective standpoint of the insured at the time the action was taken controls. Y2K damages were neither expected nor intended by most policyholders, under this definition. Business risk exclusions should not preclude coverage because they do not operate against the third-party claims. Finally, the "impaired property" exclusion has rarely been interpreted, but some courts have invalidated it as ambiguous. It therefore

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[48] *See, e.g.,* Oscar W. Larson Co. v. United Capitol Ins. Co., 847 F. Supp. 445, 448-9 (W.D. Mich. 1993), *aff'd*, 64 F.3d 1010 (6th Cir. 1995).

[49] *See, e.g.,* Transcontinental Ins. Co. v. Ice Sys. of Am., 847 F. Supp. 947, 950 (M.D. Fla. 1994).

does not appear to pose a significant obstacle to Y2K coverage. Thus, these defenses to Y2K coverage can often be overcome through knowledgeable rebuttals by policyholders and their representatives. DRM believes that the policyholder's case in this regard must be developed and ready to present to the insurer prior to any effort to negotiate a settlement.

C. D&O Coverage for Y2K Claims

In addition to the forenamed types of insurance policies, certain Y2K claims may also be covered under directors and officers (D&O) policies. This section evaluates the general types of Y2K-related claims that may arise against directors and officers of corporations. It also discusses potential insurance coverage for these types of claims.

In connection with the Y2K problem, there is a potential for shareholder derivative suits based on alleged "breach of fiduciary duty" and waste of corporate assets for failure to implement timely Y2K response measures. Such claims might be based on reporting requirements under Statement on Financial Accounting Standards No. 5, Statement on Auditing Standards Nos. 53 and 59, and Sections 319 and 325 of the Codification of Statements on Auditing Standards. These standards deal with determination and disclosure of certain Y2K costs or liabilities, potential loss contingencies, description and disclosure of Y2K compliance efforts, and the identification of potential Y2K impacts on a company's future earnings.[50]

Securities fraud claims might also arise for failure to disclose Y2K costs and liabilities in financial statements and public reports such as 10Ks and 10Qs. The SEC issued a June 1997 Y2K Report to Congress[51] and a subsequent Y2K Staff Legal Bulletin on companies' disclosure obligations with regard to Y2K costs and liabilities. This guidance, highlighted by growing widespread media

[50] *See* Terry Budd, *The Y2K Liability Explosion: A Practical Guide to Defusing the Year 2000 Time Bomb* at 4, Kirkpatrick & Lockhart LLP Monograph (1998).

[51] Staff Legal Bulletin No. 5 notes that companies are required to disclose material costs and uncertainties arising in connection with Y2K compliance activities under existing SEC Regulations S-K and S-B. It states that companies should include disclosure in any of their "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of any material Y2K compliance efforts. It states further that Y2K issues which materially affect a company's services or competitive conditions may also need to be disclosed in the "Description of Business" section. Additionally, the SEC Staff suggests that Y2K costs or consequences may reach a level of importance to investors that would necessitate filing a Form 8-K.

attention to the Y2K problem, establishes certain duties of corporate management in disclosing and dealing with Y2K problems.

D&O coverage should generally be available for Y2K-related shareholder derivative claims unless the alleged failures were intentionally fraudulent or criminal. D&O coverage typically covers wrongful acts, which may include reckless conduct. Rarely will Y2K shareholder claims identify proscribed conduct that would preclude coverage.

Although fraud claims in general require the element of scienter (i.e., intentional fraudulent, criminal-like misconduct) that would seemingly defeat coverage, D&O coverage may even be available in securities fraud contexts. First, many cases have held that liability for securities fraud may be premised on a showing of "recklessness" rather than the scienter generally required for fraud. Further, securities fraud suits can include separate claims for "negligent misrepresentation" and other claims that do not contain a "scienter" element. Since such claims would obviate the need for proving scienter, coverage may be available for them. At least one court has held that D&O coverage is applicable to directors and officers liabilities for "intentional" conduct.[52] Thus, depending on the coverage provided under a given D&O policy's definition of "wrongful act," D&O coverage may be available for Y2K-related securities fraud claims.

D&O coverage is typically provided on a "claims-made" basis. Generally, coverage would be available for claims made only during the policy period. A limited exception to this requirement exists under most D&O policies. The "extended reporting" or "discovery" period enhancements often provided permit policyholders to purchase additional coverage for claims made within a specific time after the policy period has expired. Such claims must be based on wrongful acts committed before the expiration of the policy. This coverage may also be available for post-period claims based on an "occurrence" reported to the insurer during the policy period.

One issue of importance in the Y2K context is determining who is a named insured under a D&O policy. "Directors and Officers" are typically defined to encompass, at a minimum, "any

[52] Independent School Dist. No. 697, Eveleth v. St. Paul Fire & Marine Ins. Co., 515 N.W.2d 567 (Minn. 1994).

persons who were, now are, or shall be directors or officers . . . ." Some policies expressly require that the director or officer be "duly elected or appointed." The question of whether information management decisions are covered under D&O policies may become particularly critical in the Y2K context. Some corporations are now electing or appointing upper level technical officers to ensure D&O coverage for efforts made in Y2K compliance operations.

D. E&O Coverage of Y2K Claims

In the Y2K context, claims against corporations may also be covered under the companies' errors and omissions (E&O) policies. This section first discusses the types of claims that may arise in this area. It then briefly discusses potential insurance coverage for those claims.

In cases involving alleged securities fraud or material omissions in a company's financial statement, professional firms may be impleaded for alleged failures to advise the defendant company of its financial reporting obligations regarding Y2K costs and liabilities. Similarly, computer consultants may be impleaded for alleged failures to properly advise the defendant company of Y2K liabilities.

E&O policies typically insure against "claims for damages . . . arising out of a negligent act, error or omission in the performance of [professional] services." These policies may come in various forms, including malpractice insurance and professional liability insurance. This coverage is frequently obtained as part of a corporate insurance package when the CGL policy is encumbered by professional liability exclusions. There is some case law authority for triggering computer consultants' E&O coverage for claims brought by computer consultants' customers.[53] Thus, this form of potential coverage for certain Y2K claims should not be overlooked.

E. Specialty Y2K Policies

As previously mentioned, certain insurance companies are now offering specialty policies to cover Y2K losses and liabilities. According to some analysts, the Y2K policies "are heinously

[53] *See* U.S.M. Corp. v. First State Ins. Co., 652 N.E.2d 613 (Mass. 1995).

expensive. No one but the largest companies can afford such coverage."[54] Some such Y2K policies limit coverage to $200 million for a premium payment of $20 million.[55] Most companies will deem the purchase of such coverage to be uneconomical, but for those companies that elect to pay the price, coverage for various Y2K liabilities will be available under these special policies.

The upside to the purchase of Y2K coverage is that such a policy would fill in any gaps for Y2K losses and liabilities, and assuage investor concern that the millennium bug may adversely impact the company. The price, however, is high and the benefit relatively limited. Moreover, the purchase of such coverage might imply the policyholder's recognition that existing and historical policies do not cover Y2K claims, and so undercut recovery efforts.[56]

In summary, DRM believes that few policyholders will find it advantageous to subscribe to specialty Y2K coverage. Such policies are unlikely to play a major role in Y2K insurance recovery.

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[54] B. Zerega, *No Y2K safety net: Most insurance policies have holes*, INFOWORLD ELECTRIC (Aug. 7, 1998) (quoting David Schaefer, a principal at Armfield, Harrison and Thomas, an insurance broker specializing in technology risk).

[55] *Id.* (citing address of William Kelly, senior vice president at J.P. Morgan, and president of the International Federation of Risk and Insurance Management Associations (IFRIMA) to IFRIMA directors).

[56] *E.g.,* Terry Budd & Curtis Krasik, *The Y2K Timebomb – Run for Coverage* at 13 (on newly marketed "millennium coverage"), Kirkpatrick & Lockhart LLP Monograph (1998).

CONCLUSION

Although the Y2K coverage fight is just beginning, the issues pertaining to Y2K insurance coverage are analogous to more traditional liability insurance issues. It is possible to anticipate with fair probability how the issues will evolve. Current Y2K exclusions being included in some new and rewritten policies may defeat claims under current policies. There are, however, many strong arguments for finding coverage under historical policies based on analogous precedent largely drawn from the environmental insurance field.

The question of the bottom line nonetheless will plague efforts to resolve Y2K problems and renders particularly uncertain the probability of actual recovery from insurers after prolonged litigation. Predicted losses and liabilities threaten to put insurance industry reserves in jeopardy. With projected litigation costs alone soaring into trillions of dollars, an expedited approach through negotiated settlements may for many companies be preferable to litigation of Y2K disputes.

Ultimately, for many businesses, a satisfactory resolution of Y2K problems will depend upon their ability to obtain insurance recovery to cover Y2K losses and liabilities. DRM's list of recommended steps to be taken in advance of the new millennium is set forth at the conclusion of this article. Expertise in the negotiated resolution of complex insurance disputes uniquely qualifies DRM to achieve timely insurance coverage for the Y2K-related claims of its corporate clients. Dispute Resolution Management, Inc. cordially invites inquiries into its Y2K-related recovery solutions for new and existing clients.

Steps to Take Now

DRM recommends that companies with potential Y2K impacts take the following steps as expeditiously as possible:

1. Integrate **Asset Recovery Strategy** to Complement Liability Management Program.
   - ✓ Insurance Inventory and Recovery
   - ✓ Warranty Inventory and Recovery

2. Give **Notice of Claims** to Insurers with Respect to "Sue and Labor" Clause for Remediation Costs As Soon As Possible.

3. Conduct **Inventory of Insurance** that may relate to the Y2K problem. Do not wait to conduct archaeology later and do not risk destruction of coverage evidence.
   - ✓ Assemble Proof of Coverage
     - 1st party Property (Personal)
     - 3rd party Liability (Property)
     - Business Interruption
     - Directors and Officers Liability
     - Errors and Omission Coverage
   - ✓ Analyze all policies to understand available coverage and key terms
   - ✓ Management awareness of coverage issues

4. Create **Accounting System** to track Y2K compliance costs. Preserve complete Proof of damages for insurance claims.
   - ✓ Forward looking accounting
   - ✓ Capture undocumented past costs NOW before more time goes by.

5. Consider any **Accounting Treatment Issues** that may pertain to your characterization of software, hardware and data as property.
   - ✓ Corporate Treatment of Software
   - ✓ Corporate Treatment of Hardware
   - ✓ Corporate Treatment of Data and Information
   - ✓ Remember that Insurance Claims are not governed by GAAP or Tax Standards

6. Document **Compliance Program** Carefully. Prepare now for "Expected and Intended," "Fortuity," Physical injury and tangible property, mitigation of covered loss, and other Coverage Defenses
   - ✓ Implement State of the Art Compliance Program
   - ✓ Board Level and Senior Executive Management Support and Mandate
   - ✓ Document carefully all aspects of the remediation as pertaining to covered property losses
   - ✓ Document carefully all aspects of expectation and intent
   - ✓ Include Necessary Elements in the Compliance Program:
     - Employee Awareness

- Software and Hardware (imbedded chip) Inventory
- Prioritization and Planning
- Remediation
- Testing and Confirmation
- Asset Recovery Plan
  - ➢ Insurance and Warranty Inventory
  - ➢ Claim Documentation Accounting
  - ➢ Claim Reporting System

✓ Integrate all pertinent Corporate Perspectives in the Program
- IT
- Legal
- Operations
- Financial & Accounting
- Marketing
- Procurement
- HSEQ
- Risk Management
- Human Resources
- Stakeholder and Client

7. IMPLEMENT A CAREFUL **PROGRAM TO REPORT AND DOCUMENT** PRESENT EFFECTS AND EFFECTS PRIOR TO OR AT Y2000.

✓ Employee Awareness of Claims Potential

✓ Reporting and Documentation Structure to capture all potential claims
- Property Damage Claims
- Business Interruption Claims
- Third-Party Claims

8. CONSIDER **EARLY NOTICE OF CLAIM** TO CARRIERS. TYPICAL "ALL-RISK" PROPERTY POLICIES REQUIRE THAT A SUIT BE FILED EARLIER THAN YOU WOULD EXPECT; FAILURE TO COMPLY CAN RISK COVERAGE.

✓ Understand the Notice and Suit provision of coverage

✓ Make knowledgeable decisions about early lawsuits

✓ Consider a tolling agreement

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