

**FORC QUARTERLY JOURNAL
OF
INSURANCE LAW AND REGULATION**

Fall 1998 September 12, 1998 Vol. X, Edition III

THE Y2K BUG: NOTICE TO THE INSURANCE INDUSTRY,

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If the pundits are correct, the Year 2000 ("Y2K") computer problem will cause failures and errors in computers resulting in over \$1 trillion dollars in damage worldwide.¹ The question on everyone's mind is, who will pay? If the losses are passed through to insurers, the Y2K problem could have an impact on insurer solvency which exceeds the impact of asbestos and environmental (A&E) losses.

Overview

The Y2K problem results from a decision in the 1950s and 1960s to limit date fields in computer programs to two digits. With the new millennium, many computer programs will not process data correctly. For example, a computer may attempt to read the year 2000, but process or store the date as 1900. For some computers, the problem may start as early as September 9, 1999, because many computer programs use the numbers "99" to signify the end of data or an unknown file.

The inability of a computer to identify the date may seem harmless, but many computers are organized by date fields. If the computer can not process the date field, the computer may malfunction, or shut down completely. Y2K "failures" have been observed in tests of financial and accounting software, inventory software and many governmental systems. Furthermore, the problem is not just localized to "computers." The Y2K problem affects "embedded systems," micro processes or other "changes" in many products. Loss scenarios from failure of embedded systems include shutdowns in manufacturing processors, failures of medical devices and environmental monitoring systems, as well as such minor annoyances as shutdowns of ATMs, fax machines and microwaves.

Y2K failures are exacerbated by the interdependence which characterizes the modern economy. Even companies that have taken steps to make their own systems Y2K compliant are likely to be impacted by failure in the systems of those upon whom they rely. For example, many are predicting that manufacturers will experience disruptions in their supply chains caused either by vendor failures or failures in the transportation industry.

In addition to losses caused directly by Y2K failures, many anticipate a substantial wave of litigation arising out of the Y2K problem. Potential litigation scenarios include derivative claims against officers and directors of corporations which fail to adequately plan for the Y2K problem, securities fraud and other claims against companies and persons who fail to properly disclose potential Y2K problems, fraud and consumer protection claims against the manufacturers and sellers of non-compliant goods and products, and professional negligence claims relating to Y2K failures.

The precise impact of the Y2K problem is unknown. Predictions vary widely from delay and inconvenience, to worldwide recession.² The only certainty is the need for proper planning.

Insurance Industry

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Lines Most Likely to be Affected. Both liability and property coverages may be substantially impacted by Y2K claims. In the third party liability insurance area, lines under which claims may be anticipated include general liability, products liability, errors and omissions, directors and officers and manufacturers' liability. First party property insurance coverages, including inland marine and ocean marine, can expect claims for property damage, business interruption and extra expense.

Factors Affecting the Impact on Insurers. There are several factors which may significantly affect the impact of the Y2K problem on the financial performance of insurance companies. These factors include resolution of a number of open insurance coverage issues, the viability of policy exclusions and the possibility of legislative changes which may reduce certain risks.

Coverage Issues. Y2K claims present a number of novel insurance coverage issues. In understanding the scope of these coverage issues, it is helpful to compare the scope of the coverage issues presented by Y2K claims with the coverage issues which were presented by asbestos and environmental claims. Like asbestos and environmental claims, Y2K claims involve substantial dollars, which are often disproportionate to the limits and cost of insurance, and allocation and trigger issues arising from a delayed manifestation of the problem. Unlike asbestos and environmental coverage issues, Y2K claims are likely to involve many different kinds of coverage, including those which have not been widely litigated and many different kinds of lawsuits and liabilities. Thus, it is possible that the Y2K coverage issues will prove more costly and more difficult to resolve than the coverage issues associated with asbestos and environmental claims.

The principal coverage issues presented by Y2K claims include the question of whether or not a Y2K loss is fortuitous, the question concerning trigger point coverage, and questions concerning whether there is the requisite physical injury or damage required for first and third party property damage claims.

The fortuity issue goes to the heart of the question of whether the risk of Y2K liability or loss is an insurable risk. Although all jurisdictions recognize that only fortuitous losses are insurable, courts have differed in their interpretation of the fortuity requirement. Some courts, for example, have found that losses are insurable unless the policyholder knew of its legal liability. Other jurisdictions, however, have taken a more expansive view of the fortuity requirement and have focused more on what a policyholder knew of the anticipated damage or loss at the inception of the policy. There is no doubt that the use of the two-digit date field was intentional and that the arrival of the 21st century is inevitable. The question to be resolved, however, is whether those facts are sufficient to render Y2K losses, known losses which are not fortuitous. A closely-related issue is the question of whether or not the loss is "expected or intended" from the standpoint of the insured. Most comprehensive general liability policies define an occurrence so as to exclude losses which are expected or intended by the insured. The question, again, is whether the insured actually expected or intended damage resulting from the Y2K problem.

A second issue which will be common across most lines of insurance is the question of the relevant trigger of coverage. Policyholders may attempt to analogize Y2K claims to asbestos and environmental claims and argue for a continuous trigger from the date the defective software or chip is installed in a product or computer system to the date of actual loss. A continuous trigger has the effect of spreading risk horizontally across coverage years and maximizing exposure for those insurers on the risk at the primary and low to mid-level excess layers. Insurers may be expected to argue for a single trigger of coverage, either manifestation or installation, on the theory that unlike environmental claims, the Y2K problem does not really involve a continuous or progressive damage but simply a failure of a discreet item at a particular point in time. Application of a single trigger will result in vertical allocation of coverage in a relevant policy year and, for those policyholders with insufficient coverage in any given year, raises the possibility of exhaustion of limits and corresponding uninsured losses.

A third question common to most lines of coverage is the question of whether damage to software or data is property damage within the meaning of the insuring provisions of the relevant policies. Many CGL policies, for example, insure against "physical injury to tangible property." Similarly, many first party property insurance policies require "direct physical loss or damage to property insured." Case law on these questions is scant and conflicting. Policyholders claiming under CGL policies are likely to argue that there is a "physical injury" when equipment is rendered unusable or, in any event, that there is coverage for loss of use of tangible property under a CGL policy even if there is no "physical" injury. Insurers are likely to point to some decisions which suggest that defective software does not constitute "physical injury" and that data is not "tangible property." The cases are similarly inconsistent with respect to the requirement of direct physical loss or damage required for coverage under a first party property insurance policy. Some cases have held that there is no coverage for

required for coverage under a first party property insurance policy. Some cases have held that there is no coverage for economic loss which is not associated with physical damage to property. An unresolved question is the impact that decisions in other areas of the law, such as trade secrets and copyright, will have on the question of what constitutes "tangible property" or "property insured" as courts increasingly recognize the value of information and develop greater rights of ownership in information.

There are other issues which may arise under various policy forms. For example, there may be exclusions on CGL policies for things such as damage to "your product," damage for impaired property, completed operations exclusions, products recalled exclusions and exclusions for design errors which may be applicable to a particular claim. For those property insurance policies written on a named peril basis, computer malfunction may not be a named peril. There may also be issues arising out of notice provisions to the extent that an insurer can establish that a loss was known or foreseeable substantially prior to the time it was reported.

Exclusions. Many insurers are moving to limit their exposure by adding exclusions to their policies. ISO has filed exclusions for both property and liability coverages in most, if not all, jurisdictions and has received approval for those exclusions or endorsements in many jurisdictions. As with all exclusions, the extent to which those exclusions will limit insurer losses will be determined only later in coverage litigation over the meaning and effect of a particular provision.

Legislation. There are bills in many states which seek to limit liability for some classes of persons arising out of Y2K problems or for certain acts associated with the Y2K problem. The most prevalent form of legislation seeks to limit the liability of governmental entities for Y2K failures. Other legislation seeks to limit liability for disclosures concerning Y2K compliance status. To date, only a handful of jurisdictions have adopted this legislation. Accordingly, it is premature to evaluate the extent to which legislation may limit insurer liability or the scope of losses passed through to insurers.

Endnotes

1. Emma Conners, [It's a \\$1 Trillion Jigsaw Puzzle Without Borders](http://www.afr.com.au/content/98042/survey/survey1.html), AFR NET SERVICES, (April 20, 1998) <<http://www.afr.com.au/content/98042/survey/survey1.html>>.

2. SEC Interpretation: Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisors, Investment Companies, and Municipal Securities Issuers, Release Nos. 33-7558; 34-40277; IA-1738; IC-23366, (July 31, 1998) <<http://www.sec.gov/rules/concept/33-7558.html>>.