Y2K Insurance Coverage

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Introduction
Any “damage or risk assessment” conducted to address the Y2K problem must include an assessment of insurance coverage.

By now, most of us are familiar with the types of actual and potential costs/liabilities associated with the Y2K problem, primarily:

- Failure of the company’s own equipment or software to perform in accordance with specifications, and ensuing losses,
- Remediation costs to upgrade, repair or maintain the company’s equipment and/or software,
- Damage to the company’s property because of equipment and/or utility failures,
- Interruption of the company’s business, and consequent lost profits,
- Company liability to third parties in contract and/or tort, and
- Director and officer liability to shareholders.

A heretofore background issue that will soon come to the forefront is whether insurance coverage will be applicable to help defray such costs and liabilities.

Policy Types
Standard policy types which may provide some coverage for one or more of the above costs/liabilities include the following:

- Comprehensive general liability (CGL) policy (aka third-party liability coverage),
- First-party property policy,
- First-party business interruption policy,
- Directors and officers (D&O) liability policy, and
- Errors and omissions (E&O) policy.

In most instances, it is recommended that the company examine all of its policies to explore coverage possibilities.

Coverage Issues
The unique nature of the Y2K problem makes it potentially fertile ground for new and novel coverage claims, and hence, coverage disputes. Among the coverage disputes to be anticipated are the following:

- What is the date of loss? Insurers providing coverage under an occurrence-based policy may try to argue that the occurrence was either the date of programming or the date of failure, whichever suits their purpose. Most likely, the occurrence will be deemed to have happened when the damage occurs. This, however, will not always be obvious.
- Was the event a “fortuitous” event? Typically, insurance policies insure against the risk of unexpected and unknown future events. Insurers can be expected to argue that a programming decision to use only two digits instead of four to indicate a year was a deliberate and intentional choice to save programming space rather than an
accident or fortuitous event. Insurers will also argue that an insured's failure to prepare for Y2K, in light of the widely known and probable consequences, is not a fortuitous event.

- **How does a Y2K equipment failure fit into the standard notion of “property damage?”** Most third-party losses expected from Y2K equipment failures would be economic losses which do not result in physical injury to tangible property. Thus, if the company’s products fail and thereby cause economic injury to a third party, the company’s CGL insurer can be expected to deny coverage.

- **Does the claim sound in “tort” or “contract?”** CGL and E&O policies do not typically provide coverage for claims for breach of contract, but the tort and contract issues are arguably merged in many cases.

- **Is the event an “insured peril” under a business interruption policy?** Most business interruption policies require a “physical loss” to property as a condition of providing coverage. In the case of malfunctioning equipment, there will be considerable debate on that issue.

- **Do the “business risk” exclusions apply?** Typical CGL policies contain exclusions for “business risks.” The Y2K problem is unchartered territory in that regard.

- **Is that new Y2K exclusion enforceable?** The insurance industry was generally “ahead of the curve” on the Y2K problem. Accordingly, many insurers issued Y2K exclusions. The question that will necessarily arise from any mid-policy-term exclusions is whether such exclusions are enforceable.

**Hypothetical**
The following chain reaction sequence of events is not out of the question: the company buys equipment from a supplier and incorporates the equipment into the company’s products for sale to its customers; a Y2K problem exists with the supplier’s products; remediation efforts are undertaken but unexpectedly fail; such failures cause interruption not only to the company’s business but its customers’ businesses, plus property damage and personal injury; as a consequence, the company’s shareholders are upset and bring a derivative action against the company’s officers and directors.

The above hypothetical brings into play coverage issues under virtually any policy, including a CGL policy, first-party property policy, first-party business interruption policy, D&O policy or E&O policy. Whether coverage exists under any or all of these policies will likely be a matter of genuine dispute.

**Current Battlefronts**
Several high-profile lawsuits have already been filed around the country addressing Y2K coverage issues, including lawsuits involving Sunbeam Corporation, GTE, and Xerox.

**Conclusion**
Rather than simply “grin and bear it,” it would probably be in most companies’ best interest to review their insurance coverage with an eye toward exploring possible coverage for remediation efforts already undertaken and damages already suffered, and for readiness preparation for asserting claims as circumstances develop in the future.
Snell & Wilmer has formed a Year 2000 Task Force to counsel and assist business clients in addressing what has become known as “the Year 2000 problem” — the potential inability of computer software programs and embedded microchips to distinguish between dates in different centuries, and particularly between the years 1900 and 2000. The problem stems from the prevalent past use of two-digit date codes in computer programs to register the year in which an event took place.

Terry Morris Roman and Daniel J. McAuliffe, partners in Snell & Wilmer’s Phoenix office, co-chair the Task Force, which includes lawyers from the Firm’s business and finance, commercial litigation, intellectual property, and product liability litigation practice groups.

Our Year 2000 Task Force provides services to our clients in the following areas:

- Organizing Y2K steering committees
- Documenting Y2K compliance and remediation programs
- Initiating enterprise-wide testing procedures
- Developing a Y2K communications plan
- Corporate disclosures
- Y2K shareholder proposals
- Director and officer responsibilities
- Merger and acquisition transaction considerations
- Vendor compliance questionnaires and warranties
- Field testing

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