

COUNTING DOWN TO THE YEAR 2000: AN UPDATE ON THE LITIGATION AND INSURANCE FRONTS

By Stephen Tucker

LITIGATION:

Lawsuits Thus Far

With just over four months to go before the turn of the millennium, it is somewhat surprising, considering the initial fervor associated with early predictions, that there are currently just 71 Y2K related lawsuits pending. Despite the relatively small amount of litigation that is on file thus far, some commentators are predicting that swords are presently being readied to be thrust in every direction, the attacks to come just as soon as the year 2000 arrives.

Most of the litigation filed to date takes the class action form -- put forward by lawyers who specialize in this multi-party type of litigation. The underlying subject matter involved in the cases generally concerns software designed for such uses as: accounting, retail sales, office administration, and operation of communication systems. And the common threads running through almost all of this litigation are: a large user base, the failure of a software company to make a free upgrade available for remediation purposes, and Plaintiffs' lawyers who stand to make large amounts of money while individual claimants would potentially receive little benefit.

Besides the class actions, the other cases on file of note involve: so-called sue and labor clauses contained in insurance policies (*GTE v. Prudential* pending in Federal Court in Newark, New Jersey), insurance coverage for actual Y2K failures (*Cincinnati Insurance Company vs. Service Data Systems* pending in Federal District Court in Iowa), liability of consultants for computer system related advice (*Young v. Baker* involving Andersen Consulting and its advice to a retail store advising which accounting system to purchase, such suit being filed in Massachusetts state court).

Predicted Future Actions

According to those from the Plaintiffs' bar, potential future actions will likely be couched in terms of: fraud, misrepresentation, negligence, breach of contract, strict liability, director and officer liability for failure to exercise reasonable business judgment, deceptive trade practices, and failure to pay insurance claims, among other theories.

Although all commentators are not in agreement, some predict explosive growth in lawsuit numbers once the millennium turns. These prognostications are based on a variety of premises, including allegations that companies: started too late in their remediation efforts, allotted insufficient numbers of trained personnel to the problem, allowed insufficient time for testing, have taken insufficient account of contaminated data from outside systems, and have taken insufficient account of the potential for utility failures.

With respect to volume and pace of litigation filings, some are predicting a partially cascading effect along the following path once matters begin in earnest: breached contracts, resulting in defective products/services, followed by accidents, then business interruptions, followed by stock price declines, then shareholder suits, and finally insurance claims.

Some Judicial Protection

With respect to judicial protection in connection with the issue of standards for expert testimony associated with the applied sciences, such as engineering, insurers have applauded the recent Supreme Court decision in *Kumho Tire Co. vs. Carmichael*. In that case, the Supreme Court extended the Daubert standards for admissibility of purely scientific expert testimony (such standards including whether a theory has been: tested, subject to peer review, published, or subjected to error analysis) to cases involving expert testimony in the so-called applied sciences. And the Supreme Court has left the actual test to be fashioned in each case to the discretion of the Federal District Court Judges -- giving the Judges wide latitude in this regard.

As an indication of the high stakes involved in *Kumho*, numerous amicus briefs were filed in the Supreme Court on behalf of a number of interested parties including: manufacturers, insurance groups, engineers, scientists, trial lawyers, and academics. Of particular interest here, were the briefs filed on behalf of various insurance groups.

The essential point made by insurers in their briefs was that the proliferation of mercenary engineering type "experts" has had the effect of corrupting the litigation system in the United States (through the application of "junk science") and has made the accurate rating of risks difficult, if not, in some cases, impossible. And the insurance related groups urged that the application of Daubert type standards in connection with, for example, testimony delivered by engineers, is actually more important to the health of the litigation system than applying those standards to scientific testimony. The insurers reasoned that juries tend to understand that science is legitimately subject to being questioned, while information that is of an engineering nature, engineering being a discipline which rests upon scientific knowledge, is generally accepted as true by lay people. Accordingly, they argued, a gatekeeper is actually more needed in connection with testimony relating to the applied sciences.

Underscoring the importance of having Daubert type standards in connection with Y2K related litigation, the American Insurance Association indicated the following in its amicus brief:

"Actual malfunctioning of software or microprocessors may be the biggest cause of litigation [after the turn of the millennium]. . . [And] [t]hese claims may not be limited to orthodox . . . theories. . . In the vast majority of these disputes, the expert testimony of software engineers or computer science experts will be essential to appropriately decide the claimant's case. Expert testimony will be needed to determine whether the software or microchip contained a Y2K defect; whether it was feasible to detect that problem; whether there were alternative and safer designs for the software product that were technologically feasible; and whether the Y2K defect was the proximate cause of the asserted computer malfunction or other loss."

In connection with potential insurance related litigation, the issue of fortuity, among others, will surely be the subject of expert battles ultimately turning on issues of engineering. It should be of some comfort to insurers that, at least in the Federal Courts, a Federal Judge will be standing sentry as a gatekeeper who has the power to turn away experts whose offered testimony lacks intellectual rigor. As a parenthetical note, this may have the side effect of forcing Plaintiffs attorneys to forum shop for more attractive state forums. And this effect may ultimately lead to state courts adopting standards similar to the ones to be used in the Federal Courts.

INSURANCE:

Insurance related journals and publications are generally predicting a swarm of insurance claims premised on Y2K related causations. If this does occur, insurer resources will be stretched to the limit in trying to process a large volume of extremely complex claims in a short time. Coverage will turn on, among other things: policy wordings, fortuity, due diligence, and declarations made by the insured during the policy placement process. And the stakes will be high. On the one hand, wholesale denials of coverage could bankrupt some insureds. On the other, widespread coverage could bankrupt some insurers. If the predictions regarding volume do come true, clearly some middle ground will have to be found.

Policies at Potential Risk

Potential claims are chiefly expected under the following types of policies: D&O, CGL, Business Interruption, E&O, Products, and All-Risk.

Fortuity

In order for any insurance claim to be potentially covered, it must arise out of a fortuitous event -- that is, an event that is neither expected nor intended from the standpoint of the insured. That is because insurance is, as the case law provides, a game of chance, not a matter of financial guaranty. Although the requirement of fortuity underlies all insurance, policies often explicitly address the concept in the insuring agreement clause, most times in terms of the word "occurrence" and its included definition.

What makes fortuity an especially difficult issue to assess is the fact that there is no universally agreed upon legal definition concerning just what qualifies as a fortuitous event. And policy wordings vary substantially in this regard -- many "all-risk" policies containing little or no relevant wording regarding the issue of fortuity. Some states define fortuity broadly with terms like "known or should have known". This approach obviously favors insurers. Other states define fortuity narrowly, requiring actual knowledge. This would, of course, favor claimants. And whatever the general approach, the issue can be exceedingly complex when applied to the circumstances of a particular claim. As an illustration, one court recently wrestled with the question of whether to grant coverage where a product somehow decayed or deteriorated without the intervention of any unexpected outside forces. As another example of the potential complexity involved, another court took its inquiry down so far as the movement

of electrons insofar as the issue of unexpectedness was concerned.

Further adding to the uncertainties, because it can be argued in many cases that fortuity depends on an insured's subjective knowledge, it may be that less sophisticated insureds may more easily get over this hurdle than more advanced ones.

Finally, insofar as the difficulties associated with the issue of fortuity are concerned, one law review article has suggested that insurers own actions and experience with their own computers could be relevant to actions brought by insureds where insurers have advanced a defense of lack of fortuity.

Declarations and Exclusions

Coverage for Y2K related claims may also turn on policy exclusions and whether these exclusions are viewed as clarifications or a change in coverage over that provided by previous policies.

Coverage may also be effected by how an insured answered a questionnaire required by underwriters in connection with policy placement, such material ultimately being attached to policies that issued. The questions generally take the form of inquiry into the assessment an insured has made of potential Y2K problems, who was on the team involved therein (as examples: executives, information technology employees, legal representatives, and accounting related employees), whether the potential insured produced a written plan, where the insured is involved in the assessment process, how the process has been funded, and whether any problems have been found at the time the questionnaire is completed.

Due Diligence and Mitigation

Many policies contain the following language within their Conditions:

"the Named Insured shall use due diligence and do and concur in doing all things reasonably practicable to avoid or diminish any loss under this policy".

Even if the words are not contained in a policy, the law generally requires the insured to act in this accord in order for a claim to be covered. Stated another way, an insured can only recover to the extent it acts as if it were uninsured and do everything it could to mitigate a loss. These requirements are especially significant in the Y2K context as they impose a duty on the insured to take reasonable steps to avoid or diminish Y2K related losses, something that requires a special kind of diligence since the potential for problems is well known.

CONCLUSION

Insurers should be familiar with the matters addressed above in order to make an accurate assessment of the potential liability they face in connection with Y2K related claims. Although no one can know for sure what the future holds, it is undisputable that a number of dangerous conditions are going to align on Friday December 31, 1999. The most prudent course therefore

is to plan for all reasonable eventualities.