TIME IS MONEY!

A Look at the Most Expensive Second

By

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If the metaphor is indeed true, that Atime is money,@ then no time will cause more money to be spent than the second that bridges 1999 to the year 2000. One expert has estimated that Year 2000 (Y2K) problems will cost $3.6 ***trillion*** globally over a ten-year period, which includes the cost for repairs and damage.[1] Another firm has estimated that the cost to repair the Y2K problems could reach $600,000,000,000 worldwide, and went on to speculate that an estimate for punitive and compensatory damage awards could reach $1 trillion.[2] Although this estimate was based on an assumption that each dollar of actual damage would generate some multiple of compensatory and punitive damage -- an assumption that is not a foregone conclusion -- the numbers are nevertheless staggering, if not beyond comprehension. This paper will explore the potential causes of action that may be raised by Y2K plaintiffs, and how best to defend against a Y2K claim.

As the Clock Strikes...

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[1] *Year 2000 Bug Likely to Infest Courtrooms*, Los Angeles Times, September 8, 1998.

[2] *Id.*

The problems associated with the Y2K bug have been well documented. Back in the early days of computing, when a roomful of equipment had half the computing power of today=s laptop computers, memory storage was at a premium. Thus, if you could represent the date in the format of MMDDYY, you would save precious memory storage space, as compared to the format of MMDDYYYY. The simple fact is that no early computing pioneer believed that the systems they designed in the 1960s would still be in use at the turn of the century. However, year after year, these systems were modified, their capabilities extended. The more these programs were modified, the more difficult it has become to correct the problem. Furthermore, even though new computing systems were implemented, often the old methodology for date representation was carried forward as a legacy. In the late 1980s, there were rumblings afoot that each computer carried within it a bomb set to detonate as the clock strikes midnight of the year 2000. The effects of such a bomb could be devastating given that our society has become so dependent on our computing systems, which have infiltrated every aspect of our lives. Steps had to be taken to disarm the bomb, or at least to minimize the effects of an explosion.

Litigation Looms

For years there has been talk of litigation looming on the horizon as a result of Y2K problems. There are seemingly endless theories of liability, based on allegations of personal injury, breach of contract, breach of warranty, negligent misrepresentation, fraud, strict liability, negligent maintenance and repair, and various permutations of shareholder suits alleging, among other things, failure to take appropriate corrective action. The first salvo has already been fired, with the filing of a lawsuit in Michigan by Produce Palace. In that case, the Michigan based supermarket chain sued TEC America, alleging that the latter sold defective cash registers in that the machines could not handle credit cards with an expiration date after January 1, 2000.

In all, approximately 20 suits have been commenced with allegations of Y2K related problems. However, the major suits, that is, the ones involving significant damages, have not yet been commenced. At this time, law firms are apparently using the smaller cases as a marketing effort to promote their firm as one that is on the leading edge of this burgeoning area.

The SEC Disclosure Requirement: Salvation or Damnation?

From the perspective of a litigant, the answer to the rhetorical title of this section will depend on their position. Anyone bringing an action against a corporation for failure to act on Y2K issues will find the free discovery contained in the Securities and Exchange Commission (SEC) disclosure extremely helpful. On the other hand, the disclosing company, at best, will not be effected if it was a model citizen in its approach to remedying its Y2K deficiencies. More likely than not however, the company will be wounded by its own disclosures to the extent that it shows inaction, or slow reaction to the Millenium bug phenomenon.

The SEC is merely doing what it thinks is right. It has been greatly concerned about the effect a Year 2000 meltdown could have on the economy. As the SEC bluntly said: A[t]he Commission views the Year 2000 problem as an extremely serious issue. A failure to properly assess the extent of the problem, remediate systems that are not Year 2000 compliant, and then test those systems could endanger the nation's capital markets and place at risk the assets of millions of investors. In light of this, both the industry and the Commission's staff are working hard to address the industry's Year 2000 problems.@ [3] Consequently, the SEC has done a lot to promote awareness of the potential millenium problems among publicly traded companies. The approach taken by the SEC contains two significant elements:

(1) **<u>Industry Oversight</u>:** During 1998, the SEC has re-directed the focus of its efforts from educating companies to monitoring each company=s progress towards Y2K compliance. In support of that effort, the SEC has fully supported the Securities Industry Association's ("SIA") industry-wide testing program

[3] Second Report on the Readiness of the United States Securities Industry and Public Companies to Meet the Information Processing Challenges of the Year 2000, June 1998.

and is continually identifying those entities that have fallen behind in preparing for the Year 2000. Also, the SEC has participated in, and supported, contingency planning groups. The purpose of these coordinated actions is to promote remediation of as many systems as possible, so that the consequences of any Year 2000-related failures can be minimized, if not corrected.

(2) **<u>Company Disclosure</u>:** One of the bulwarks of the SEC=s plan to ensure Y2K compliance is its Staff Legal Bulletin No. 5, which provides specific instruction regarding what a company is required to disclose about its Year 2000 issues. Through this Bulletin, significant steps have been taken to heighten awareness, and to impart a sense of urgency that all publicly traded companies must disclose any material impacts that a Year 2000 problem will have on their business. Furthermore, the SEC has stated that Ait will issue an interpretation on Year 2000 disclosure requirements, and in the near future plans to write to the CEOs of public issuers reminding them of the importance of Year 2000 disclosure and the Commission's guidance regarding [a company=s] Year 2000 obligations.@ [4]

After a recent survey of disclosures being set forth by various companies, the SEC came to the conclusion that although more organizations were mentioning the term AYear 2000@ in their disclosures, the substance of the information was severely lacking. As such, the Commission issued an interpretive release that sets forth its views regarding the application of its disclosure requirements to the Year 2000 issue, which incorporated some of the issues raised by proposed Y2K legislation.[5]

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[4] *Id.*

[5] Year 2000 Computer Remediation and Shareholder Protection Act of 1997, Senate Financial Services and Technology Subcommittee, (S. 1518) (requires public companies to disclose their Year 2000 issues).

Specifically, when filling out the SEC=s "Management's Discussion and Analysis of Financial Condition and Results of Operations" form (AMD&A@), disclosure of any Year 2000 issues would be required if:

- The cost of addressing these issues is a ***material*** event or uncertainty that would cause reported financial information not to be necessarily indicative of future operating results or financial condition, or if
- The costs or the consequences of incomplete or untimely resolution of these issues represent a known material event or uncertainty that is reasonably expected to affect future financial results, or cause reported financial information not to be necessarily indicative of future operating results or future financial condition.

To provide guidance, the SEC defined that a Y2K issue is material if:

- the company has not yet started to assess its Year 2000 issues;
- the company has started to assess its Year 2000 issues but has not yet determined whether these issues are material; or
- after assessing its Year 2000 issues, the company has determined that these issues could be material to its business, operations, or financial condition, irrespective of any remediation plans or insurance coverage. In other words, the company must have

determined the materiality of its Year 2000 issues on a "gross" basis.

If a company should determine that it has discovered Y2K issues that are ***material***, then the SEC would expect the following information to be disclosed, at the very least:

- Its plans to address the Year 2000 issues that affect its business and operations; and
- Its timetable for carrying out these plans.
- An estimate of its Year 2000 costs and any material impact it expects these costs to have on its results of operations, liquidity and capital results;
- Its historical Year 2000 costs; and
- How it could be affected if its customers, suppliers and other constituents are not Year 2000 ready.

While the information sought by the SEC would allow investors to make informed decisions before investing hard earned money into a particular company, disclosing this information could have the disastrous effect of making a company a lightning rod for lawsuits.

What has been done, and why not?

One of the main targets of litigation will undoubtedly be the company=s Directors and Officers. For nearly three years the Y2K phenomenon has been written about and discussed endlessly. To compound the matter, the company will be charged with knowledge of the SEC reporting requirements described above. Therefore, at this point, a company will find it difficult, if not impossible, to convince others that it was not aware of the problem. Whenever Y2K problems do arise that adversely affect a company, shareholders are likely to bring an action against corporate officers, alleging a breach of the fiduciary duty of care owed to the corporation. These would-be plaintiffs will assert that the directors and officers should have known of the problem, and should have reacted quicker, which would have mitigated the loss that occurred. Alternatively, an action could be brought claiming that excess money and other company resources were wasted because the directors and officers failed to have a reasonable Y2K strategy in place. This is a well-documented Y2K concern -- that many directors and officers have been slow to react to implement Y2K corrections. The problem with defending such an allegation -- and most Y2K cases for that matter -- is that the standard of proof is by and large subjective.

Other potential areas of contention include the failure to evaluate the compliance efforts being undertaken by third parties and key suppliers, and the failure to examine Y2K compliance prior to engaging in a merger or acquisition. In any of these cases, defense counsel must attempt to employ the Abusiness judgment rule@ to ward off outsiders who try to use hindsight to pick apart the actions of the officers of the company. In that vein, defense attorneys must paint a picture of the enormous efforts expended by the corporation and its officers, in an attempt to defuse the millenium bomb. Meeting minutes, internal memoranda, work plans, and Requests for Proposals will be helpful in determining whether directors and officers took reasonable steps to minimize the Y2K effects. This may prove to be difficult with the lack of a trail in the form of Y2K SEC disclosures. Periodic disclosures directly to shareholders would also be very helpful. And of course, the conduct of other companies will be examined, depending on which side the attorney is on, to show conformity with the industrial standard of care, or the lack thereof. In sum, it will be necessary to show a timely, reasonable approach was taken to resolve the Year 2000 problem soon after the issue was identified. The only good news for directors and officers is that the corporate veil will typically shield them from personal liability, unless it can be proven that their acts were reckless, fraudulent, or that they intentionally committed harmful acts. Now for the bad news, one pessimistic pundit predicted that the careers of half of the senior executives in the United States will be damaged or ended as a result of the millenium.[6] Directors and Officers beware!

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[6] *Year 2000 Bug Likely to Infest Courtrooms*, Los Angeles Times, September 8, 1998.

Ask Me No Questions and I Will Tell You No Lies

With all of the above mentioned material in mind, it is of little wonder that companies have been reticent to hang Y2K dirty laundry for the world to see. Failure to disclose is a double-edged sword. On one hand, a company can shield itself during litigation, or at least prolong the disclosure until it has had the opportunity to prepare reasoned responses to discovery requests with the assistance of trial counsel.[7] On the other hand, it could also cause litigation to be brought in the name of Securities Fraud. In light of the detailed information the SEC would like to see disclosed, the ball is in the company=s court concerning how to respond. Thus, the inquiry in these potential lawsuits will focus on the breadth of the disclosure, and on how much an investor relied on that disclosure (or lack of disclosure) from the company.

Too Late to Eliminate, But Not to Mitigate

If a company has failed to develop a year 2000 strategy by now, more likely than not, it is too late to eliminate the problem, but not too late to reduce the effect. At first, many companies were simply paying lip service to the Y2K issue. Information Technology managers were starting to become aware of the problems, but upper management has been historically slow to respond. While it may be too late to eliminate a Y2K problem, it is not too late to mitigate the potential damage of a Year 2000 problem.

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[7]Certain Federal and State jurisdictions have enacted mandatory disclosure requirements, which may or may not be consistent with the SEC disclosure requirements.

He Said, She Said

Many of the cases that are bound to arise will deal with the cottage industry that has sprung up in the name of Year 2000 Computer Consultants. This group which employs programming skills that haven=t been used for years, such as COBOL, P/L1, Pascal and the like, typically entered into contracts with companies to evaluate and/or repair computer systems that may be infected with the millenium bug. Litigation that arises in this context will probably be brought in the name of breach of contract, breach of warranty, fraud, or product liability. Most of these cases are likely to sound in contract, in that a programmer had agreed to fix the company=s Y2K problems, but did not. One of the strangest matters to be brought in the fledgling arena of Year 2000 litigation was a declaratory judgment action initiated on August 28, 1998. In that case, Anderson Consulting, the world=s largest consulting firm, asked a Massachusetts court to rule that it had met its contractual obligations in providing a computer to J. Baker, a large retailer. Apparently, the work that has been performed by Anderson Consulting since 1989, is not Year 2000 compliant, and as such, J. Baker was demanding full reimbursement of the money paid to Anderson. The odd part of this case is that Anderson fired the first shot. Legally, there is no significant advantage to doing so, other than perhaps to get a more favorable venue. That consideration is significantly diminished when you have two companies battling rather than a company and a local person who has been injured in some way. This consideration is further diminished, where, in the instant case, J. Baker employs 600 people in Massachusetts, while Anderson employs only nine. Therefore, it would appear that the desired result of this move by Anderson may be the Ashot across the bow@ to all would-be plaintiffs. The message is that Anderson is ready to fight.

It is likely that the Anderson/J. Baker contract entered into in 1989 did not contain Y2K specific disclaimers. Most of the early contracts for software projects did not contain any Y2K specific language, and therefore, problems that arise under such a contract will be governed by the existing express or implied language. If the software was sold, rather than developed specifically for one customer, then the Uniform Commercial Code (UCC) would apply, since software is considered a good by the UCC. Therefore, software that failed to perform properly, after the clock strikes twelve on December 31, 1999, for instance, would have breached the UCC warranty of merchantability, and it would be a nonconforming good as it was unfit for its intended purpose. Damages in these cases would typically be limited to the cost of the software, which in most cases, will be very small. However, if you apply the small cost of one piece of software to the magnitude of a class action suit, the value of the case could rise dramatically.

Many plaintiffs= attorneys will make an attempt to recover in tort for negligence, negligent misrepresentation, fraud, and the like. Many states have adopted some form of the Economic Loss Doctrine, which states that one cannot recover in tort for purely contractual damages, absent personal injury, or damage to other property. The caveat with this doctrine is that some courts have carved out a niche for negligent misrepresentation. The cases stand for the proposition that the contract would not have been entered into but for the misrepresentation, and thus recovery for that tort should not barred. Obviously, with fraud or intentional misrepresentation, the contract would be *void ab inhitio*, and thus the tortfeasor would be exposed to unlimited liability in tort and perhaps even punitive damages.

Insurance: Bomb Coverage

As the millenium marches closer, the issue of insurance coverage is bound to come up. Implicit in every Aall-risk@ insurance policy is the requirement that the loss must be the result of a fortuitous event, which was neither intended nor expected. Accordingly, a policyholder will have a difficult time claiming that a Y2K related loss was fortuitous. As stated previously, Y2K issues have been well known by everyone with access to a newspaper, television, or computer.

The Insurance Commissioner for the State of Texas has apparently attempted to circumvent the fortuity requirement by announcing that small businesses and professional services that are sued for computer glitches will be covered unless expressly excluded by its insurance carrier. The Commissioner said, AProfessional people, mom and pop stores and other small businesses count on their liability insurance for financial protection. We want to maintain that coverage for small businesses and professional people who unknowingly have a year 2000 exposure and bought liability insurance for protection if they are sued.@[8] This statement seems to pave the way for an assured to put their head in the sand for Y2K compliance, since as long as they didn=t know about it, they will be covered.

Due Diligence: Doing Homework

An insured must take steps to prevent and/or mitigate a loss which can result in the denial of coverage. In short, they must act as if uninsured, or else risk actually being uninsured. With Y2K coverage disputes, diligence will be measured by:

1. the speed and quality of the response taken;
2. whether or not a Y2K team was established;
3. the Apaper trail@ of compliant activities;
4. a survey of all applications should be prepared and an outline of what types of modifications are needed;
5. detailed project implementation schedules need to be generated;
6. program schedules should include objective milestones, with ample time allocated for testing;
7. repair work should be performed offline to avoid major business interruptions;
8. objective test criteria must be developed, as well as how the tests are to be performed, and when the system is considered to meet the criteria; and
9. contingency plans must be developed to avoid computer problems at the inevitable turn of the century.

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[8] *Insurance Chief Establishes Liability Rule for Y2K Glitch*, Fort Worth Star-Telegram, August 8, 1998.

In short, a structured approach is essential to demonstrate that due diligence was employed to tackle the Year 2000 bomb.

In the aviation industry, Boeing for one has recently stated that A[our] airplanes will continue to fly safely when the clock strikes midnight in the year 2000.@[9] They stated that after analyzing thousands of components on Boeing planes, only three were found to be date sensitive, and in all cases involve the onboard navigation system.[10] To remedy the problem, Boeing has sent service bulletins to its customers detailing the changes to be implemented.

Notice Requirement

Prompt notice of an occurrence and/or a claim is required as a condition precedent to insurance coverage. Therefore, any insured that considers its property is at risk of being susceptible to a Year 2000 problem, should place its insurers on Notice immediately, providing full details of the risk of loss. This should also mirror the SEC disclosure requirements outlined above. The notice requirements vary between jurisdictions. In some, insurers must show that they were prejudiced by receiving late notice. In others, no such prejudicial showing is required and late notice is a bar to recovery from insurance.

Tell the Truth

An insured is obligated to provide truthful and accurate information to an insurer when seeking an insurance policy. In many

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[9] *Boeing Jets Past Y2K Riddle*, MSNBC, September 8, 1998.

[10] *Id.*

jurisdictions, an insurer is not limited to specific insurance application questions as a basis for denying coverage or rescinding a policy for misrepresentations made. Failure to provide information concerning the potential for a Year 2000 loss is considered material to the risk. Thus, even if not specifically asked, the assured may have the obligation to disclose all information material to the risk being placed. In some states, this requirement is ongoing as the nature of the risk changes. Therefore, even though there may be no misrepresentations made at the time the policy was obtained, the assured may have a duty to notify its insurer of changes to the risk during the life of the policy.

Conclusion

The tools that will be used to fight the Y2K battles in the courtroom will be similar to the ones used for other cases. But without judicial precedent, it is difficult to predict which ones will be most powerful. In any event, the most effective course a company and its officers can follow, is one paved with diligence, and notice. In that way, the Year 2000 may come in, not with a bang, but with a whimper.