Y2K: THE FIRST PARTY PROPERTY PERSPECTIVE

JOSEPH A. GERBER, ESQUIRE
AND
RICHARD C. BENNETT, ESQUIRE
COZEN AND O’CONNOR
1900 Market Street
Philadelphia, PA 19103
(215) 665-2000
jgerber@cozen.com
rbennett@cozen.com

Atlanta, GA
Charlotte, NC
Cherry Hill, NJ
Chicago, IL
Columbia, SC
Dallas, TX
Los Angeles, CA
New York, NY
Newark, NJ
Philadelphia, PA
San Diego, CA
Seattle, WA
W. Conshohocken, PA
Westmont, NJ

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Much has been written about the potential for insurance claims arising from Y2K-related losses. The following article explores several of the key considerations and issues that will no doubt surface in connection with first party property claims traceable to the Year 2000 problem.

1. **Fortuity**

For most typical property forms, coverage is triggered only if an "occurrence" takes place. The term "occurrence" is frequently defined to mean:

A sudden, unforeseen, unintended event, including continuous or repeated exposure to the same event, that results, during the Policy Period, in loss or damage to your "property," or in bodily injury, personal injury or property damage. Such loss or damage must neither be expected nor intended by you.

As the last sentence indicates, fortuity will be a defense to coverage in many Y2K claims. Indeed, many insurers appear to view the fortuity defense as a potential "silver bullet" that will ward off any first-party insurance claims. Certainly, the lack of fortuity with regard to Y2K will undoubtedly furnish a defense to many property damage and business interruption claims, but it will not apply to all such losses.

The fortuity doctrine may be outlined as follows. Even "all risk" coverage, which represents the broadest type of policy available today, covers only risks and affords no coverage for loss that is certain to occur.¹

Seventy years ago, Judge Augustus Hand observed: "the perils insured against are risks."² The concept of risk is expressed by the term "fortuity." To be compensable then, the loss must be fortuitous, which is to say that it must be caused by a fortuitous event.³ A fortuitous event is one that is not certain to occur.⁴ It is an event that results from a risk, as contrasted with "an ordinary and almost certain consequence of the inherent qualities and intended use of the property."⁵
Furthermore, even forms that are bereft of "expected or intended" language do not rob the carrier of a fortuity defense. The U.S. Third Circuit Court of Appeals has explained that "[i]n addition to the exclusions named in the policy itself every all-risk contract of insurance contains an unnamed exclusion -- the loss must be fortuitous in nature."\(^6\) This implied requirement of fortuity in all-risk insurance policies has been "universally recognized."\(^7\) It presents a question of law for the court to decide,\(^8\) and the burden of proof is generally borne by the insured rather than by the insurance company, as it would be in cases involving the applicability of the exclusionary language.\(^9\)

At first blush, fortuity would indeed appear a potent defense to any first-party Y2K claims. In deciding whether a loss is fortuitous, case law has generally directed the Court to examine the parties' perceptions of risk at the time the policy was issued.\(^10\) Only a loss that could not reasonably be foreseen by the parties at the time can be deemed to be a fortuitous one.\(^11\) Obviously, any court will be able to take judicial notice of the fact that information concerning Y2K and its implications, has been generally known for a number of years. Moreover, it is also well known when Y2K losses will occur. It has been held that even a loss that is certain to happen can be deemed to be fortuitous if no one knows exactly when disaster will strike.\(^12\) This is not the case with regard to the Y2K problem -- we know that losses will occur on or about January 1, 2000.

A review of the case law indicates that fortuity has traditionally been a burden that is "easily met" by insureds, however.\(^13\) The U.S. Third Circuit Court of Appeals has explained that:

Proving fortuity is not particularly difficult... The party must only show that a loss was unplanned and unintentional.\(^14\)

A leading case on the fortuity issue states that the standard in determining fortuity is a subjective one:
A fortuitous event ... is an event which insofar as the parties to the contract are aware, is dependent on chance. It may be beyond the power of any human being to bring the event to pass; it may be within the control of a third person; it may even by a past event, such as the loss of a vessel, provided that the fact is unknown to the party.¹⁵

Nearly every recent decision has adopted this subjective standard in describing a fortuitous event.¹⁶ Under such a standard, a loss is still fortuitous so long as it is not "a certainty."¹⁷ Otherwise stated, an occurrence is fortuitous if "the outcome of the event is not known in advance by the insured."¹⁸

The threshold question then becomes whether or not losses attributable to Y2K are fortuitous under such a standard. It is the Millennium that is certain to occur -- not a Y2K loss. Whether or not a particular policyholder suffers such a loss is largely --- potentially predominately --- going to be determined by whether or not the policyholder takes effective precautions by carrying out some kind of appropriate "fix" or remedy to anticipated Y2K problems.

A loss is not fortuitous if it is one "which the assured brings about by his act, for then he has not merely exposed the goods to the chance of injury, he has injured them himself."¹⁹ Thus, the courts generally do not recognize deliberate actions that produce predictable and anticipated damages as fortuitous events under all-risk insurance policies.²⁰

The key consideration is control. Accordingly the Sixth Circuit Court of Appeals held that a loss was non-fortuitous where an insured chose to remove asbestos-bearing material from its building even though it knew that this would lead to the contamination of the structure. The
Court explained:

[T]here was no element of surprise nor anything unexpected, about the property
damage incurred by plaintiff.

* * *

[F]ortuity involves unexpected damage, the occurrence of which is outside the
control of the parties.21

Generally speaking, the remedy necessary to prevent Y2K problems has two aspects.
First, all data stored on a company's drives must be changed from a two-digit format to a four-
digit format. This is a relatively straightforward and comparatively inexpensive process, for
such data is typically easy to recognize. In most cases, a computer program can be set up that
will do the lion's share of this automatically. The other aspect of the remedy, though, is far more
difficult and time-consuming, for it involves modifying all of the company's software programs
or applications in such a manner to make them "Y2K compliant."

The process of modifying a company's software to make it Y2K compliant is a lengthy
one. First, the company must identify which computer systems and their attendant software
might need to be modified. Then, each program must be analyzed and corrected by imputing
new data and examining and correcting each line of existing source code as necessary.
Computer systems may have to be taken down or off-line in order to do this. Finally, the fix
must then be tested and "debugged" to insure that it works.

Accordingly, then, in terms of fortuity, the solution to the Y2K problem is known. The
commencement and completion of such a process is manifestly within the control of each and
every policyholder. It is simply a matter of being willing to commit the resources of money and
personnel necessary to get the job done.

Depending on the size of the company, there may be hundreds of suspect programs and
these programs may contain literally millions of lines of code. Negligence can always occur --
even the most painstaking efforts will inevitably miss a program here or a section of code there, and these omissions will come home to roost on January 1, 2000, causing loss of one kind or another.

A key consideration in nearly all instances will be whether the policyholder has taken **reasonable** steps to avert this known danger. Policyholders who suffer damages as a result of the Y2K problem may be grouped into three broad categories. The first category is the policyholder who makes little or no effort whatsoever to avert the loss. For this policyholder, based upon case law dealing with fortuity, its losses should be deemed non-fortuitous in nature given all that is known about the Y2K problem.

The second category of policyholder is the one which has already mobilized its resources and begun to affect a "fix" by making comprehensive efforts to pinpoint all programs that need to be reviewed and then putting the actual process of a line-by-line evaluation into action. Claims will come from such policyholders because something or other "slipped through the cracks," and those claims will probably be deemed to be fortuitous in nature by the courts. It is likely that a policyholder that has done everything within his or her control to avert a loss will not be precluded from recovery because something has been missed.

Difficult and fact sensitive issues will be raised by the third category of policyholders - those who either wait too long to start the process of effecting a fix or, alternatively, those policyholders who are simply unwilling to allocate the necessary personnel and financial resources to do the job.

The question of fortuity will end up depending on the facts in such cases and on the degree to which the policyholders can demonstrate that the steps that they did effectuate represented "reasonable" efforts to avert a loss. The fact of the matter is that the fix is known,
and the time by which that fix must be completed is also known with considerable precision. These are not matters that are outside the control of the parties to any contract of insurance. A deliberate decision not to allocate the necessary resources should be deemed to be "an action that produces known consequences and causes predictable damage" to the insured property as a result.

2. **Covered Property**

The next issue for analysis under a first party property policy is the question of what constitutes covered property. Research has disclosed no first party cases on whether electronically-stored data should be considered "property" but there are at least a few third-party cases on this topic. However, none of them confronts the issue head or provides much in a way of definitive guidance. Additionally, the third-party cases usually focus on whether such data is tangible property, as most liability insurance forms define property damage as either physical injury to or loss of use of "tangible property." Most first-party forms do not include such a requirement.

Examining the third-party cases should help shed some light on the issue. In one matter, a computer company sought comprehensive general liability coverage after it was sued for accidentally erasing magnetically encoded data on a customer's disk cartridges. The court skirted the issue of whether this represented loss of "tangible property;" instead, it held that there was no need to decide this question. If, on the one hand, the computer information were deemed to be intangible property, then there would be no coverage. If, on the other hand, the information were deemed to be tangible property, then any claim would be barred by a policy exclusion for damage to property of others in the insured's custody.\(^{22}\)
In another case arising in the same jurisdiction, the policyholder was a data processing consultant who was sued after losing a computer tape with data on it. This time, the court held that there was coverage, after concluding that the "tangible" requirement was ambiguous. In the opinion, the court stated: The data on the tape was of permanent value and was integrated completely with the physical property of the tape.

* * *

The trial court did not err by finding that the computer tape and data were tangible property under the insurance policy.23

Finally, in a third matter arising in the same jurisdiction, the issue before the court was whether the misappropriation of confidential technical information by an ex-employee, who gave the information to a competitor, constituted damage to tangible property. In that matter, the court held that it did not constitute tangible property explaining:

[I]t was the loss of the confidential nature of the information that lead to [the insured] Boeing's damages, not the loss of the binders containing the information. Peter's actions did not make the information unusable; they only deprived Boeing of the exclusive use of the information.

The information was in a tangible form; it was put on paper. However, the information itself was not tangible. Therefore, we conclude the Boeing complaint did not allege damage to tangible property covered under St. Paul Fire's policy.24

The clear implication of these decisions is that the information itself is not "tangible," but that it becomes tangible once it has been "put on paper" or otherwise saved or stored in some fashion.

It is difficult to extrapolate any clear overall rule from cases such as these, but it is our opinion that courts will probably deem an irretrievable loss of magnetically stored data to be a species of property damage, and this is particularly true in light of the lack of any requirement of
"tangibility" and any specific definition of "personal property" in most first-party insurance forms.

3. **Direct Physical Loss**

Insuring agreement language from typical first-party coverage forms provides that the carrier is only affording coverage in instances of "direct physical loss of or damage to" insured property. Given the fact that one of the quintessential Y2K scenarios involves only the loss or inaccessibility of data, this raises the obvious question of whether a computer system has sustained a "direct physical loss" if its data is either inaccessible due computer shutdown or corrupted or lost because of the effect of the Y2K.

As with many aspects of the Y2K problem, the answer is problematic. At least a few courts have been faced with the question of whether loss of information constitutes direct physical loss in the business interruption context, but none have afforded a definitive answer. The reason lies in the fact that such policies frequently undertake to pay for a loss of business income occasioned by "the necessary suspension" of a policyholder's operations. Courts faced with such claims typically focus on this requirement and, as a result, they never reach the issue of direct physical loss. Thus in one matter, the policyholder renovated its facilities and added a computer system which was supposed to "collect electronic data and create records" which would enable the company to maximize the output of its processing operation. The system did not work properly, although the problems were not sufficient to cause the policyholder to shut down completely.

After repairing the system, the policyholder submitted a loss of income claim in the sum of $2 million dollars claiming that because it could not retrieve its data in usable form, its operations lost considerable efficiency and productivity.
The judge began his opinion by noting that the matter presented several "interesting" and "intriguing" questions.

Among these are whether there could in fact be a "direct physical loss" to the electronic data which was allegedly collected but never existed in a tangible form. Also, because the electronic data never existed in a usable form, was it in fact lost or rather did it never come into existence?  

Unfortunately, however, the court felt no need to address these issues, for it held that there was no coverage because the policyholder had not sustained a "necessary suspension" of its business, stating that such a term connoted "a temporary, but complete cessation of activity." In the judge's opinion, the policyholder had "showed at most that the alleged loss of its electronic data caused its operations to slow and become less efficient." This was simply not enough to constitute a "suspension" of operations.

Such authorities do demonstrate, however, that a computer shutdown occasioned by the Y2K virus that causes a total interruption of business operations may constitute an instance of direct physical loss.

4. Exclusions

Even a summary review of potential coverage issues under first-party property forms requires some attention to potentially applicable exclusions contained in most typical first-party policies. At least six such exclusions have potential application to a loss allegedly attributable to a Y2K problem. These are as follows:

(a) Hidden or latent defect. The courts define a hidden or latent defect as "one that could not be discovered by any known or customary test." Given the broad understanding of the Y2K problem and the general knowledge of those steps necessary to rectify the problem, it is unlikely that any court will deem the Y2K issues to be a species of "hidden" defect.
(b) **Artificially generated electric current.** The exclusion for "artificially generated electric current" is similarly unlikely to bar coverage, for the cases construing that language to date have dealt exclusively with instances of electrical arcing. These cases teach that this exclusionary language is generally confined to an electrical current that has escaped from and is traveling outside of its normal distribution pathways. By contrast, a current that will cause a Y2K loss is the normal line current that powers the computer.

(c) **Mechanical breakdown.** Mechanical breakdown could come into play in scenarios involving computer-monitored or controlled equipment that malfunctions as a result of the fact that Y2K has disabled its "brain." In most failure scenarios, however, there is little likelihood that this particular peril will be implicated. Mechanical breakdown has generally been held to connote a loss occasioned by:

a failure in the working mechanism of the machinery -- a functional defect in the moving parts of the equipment which causes the machine to cease functioning or to function improperly.32

The defects that will cause computers to shut down or crash on January 1, 2000 are not faults in the "working mechanism" or "moving parts" of such devices, but rather computational errors by their software algorithms.

(d) **Errors in processing.** With respect to "errors in processing" or in the manufacturing of the policyholder's products, this is an exclusion that has not been the subject of many cases. The few decisions involving this exclusion deal with complex chemical manufacturing operations. Given the language -- errors in processing or in the manufacturing of your products -- there seems little likelihood that a court would extend the wording to losses occasioned by incorrect computer operations or by the shutdown of the computers themselves.
(e) Acts or decisions. The "acts or decisions" exclusion is another exclusion that is rarely found in case law. In one matter, a Massachusetts court determined that a policyholder had coverage under his homeowner's policy for home heating oil that had been negligently spilled on a neighbor's lot and migrated underground to his own property and contaminated it. The insurance company attempted to set up a similar "acts or decisions" clause as a defense to coverage. However, the court would not accept this defense. As the decision explained:

Massachusetts Bay concedes that its insurance policy covers negligent acts that cause covered losses. It argues, however, that the "acts or decisions" clause excludes coverage where negligence causes an excluded loss, as here. The clause, as Massachusetts Bay recognizes, cannot be taken literally. If it were to be so taken, it would exclude coverage from all acts or decisions of any character of all persons, groups, or entities. Such an interpretation would leave the insurance policy practically worthless.34

Accordingly, then, like the fortuity defense, the "acts or decisions" exclusion may well operate to preclude coverage where an insured company is stubborn to the point of unreasonableness in failing to recognize and take effective steps to head off its Y2K problem. In cases of negligence, however -- negligent failure to fully rectify the problem or to effectively provide against each and every contingency -- it will not preclude recovery.

(f) Faulty workmanship or design. Finally, the faulty workmanship and design language would also appear to be of little use, for a perusal of the terms and conditions of the typical exclusion demonstrates that it is aimed at construction problems such as surveying, remodeling, grading, or compaction.

In summary, it is fair to say that none of the above-referenced exclusions were written with Y2K in mind. Similarly, none have been applied in situations that closely resemble the typical kinds of losses likely to result from Y2K problems. As a result, it may be difficult to
"shoe horn" Y2K scenarios into the language of these provisions or to convince a court that they operate to preclude coverage for such problems.

5. **Sue and labor considerations**

Typical sue and labor provisions might read:

> 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 or 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 acceptance of abandonment. The insured and the company will bear the expenses incurred proportionate to their respective interests.

Sue and labor claims impose an affirmative obligation on the policyholder to take all reasonable steps to avert or minimize a loss. Indeed, the purpose of such clauses is "to encourage and bind the assured to take steps to prevent a threatened loss for which the underwriter would be liable if it occurred, and where a loss does occur to take steps to diminish the amount of the loss."36

Sue and labor provisions are basically a type of "separate insurance" for the benefit of the insurance carrier alone, and the fact that the policyholder bears an obligation to "sue and labor" for the carrier's benefit imposes a concomitant obligation of reimbursement on the insurer.

An insured who avoids or minimizes insurable loss acts for the benefit of the insurer. It is the benefit conferred which creates the duty on the part of the insurer to reimburse the insured for prevention and mitigation expenses.37

The only major limitation on the breadth of such clauses is that "[r]eimbursement under the sue and labor clause is only available if the labor was to prevent a loss that the policy would have covered [and if the damage claimed] is attributable to anything within the policy's exclusionary clauses, no sue and labor compensation is required."38 In other words, because the
purpose of the clause is to reimburse the insured for expenses incurred in satisfying his duties to
the underwriter, there is no such duty where the policy, for whatever reason, simply does not
afford coverage.39

It appears that the best defense to most first-party Y2K claims will be that they are non-
fortuitous in nature. The losses attributable to the policyholder's failure to either take any steps
to rectify the problem or its affirmative decision not to commit the necessary personnel and
financial resources to its cure fall into this category. Such a defense does not exist until after a
loss has occurred, however, and this will not take place in most instances until on or after

Policyholders may begin to make sue and labor claims long before that date, seeking to
effectively enlist the insurance company's aid and making the company the policyholder's partner
in connection with rectification efforts. Policyholder's will argue that the loss is certain to occur
unless appropriate steps are taken, and the policyholders may also be heard to argue that any
refusal by the carrier to fund such efforts effectively undercuts any fortuity defense down the
road because it deprives the policyholder of the financial wherewithal to get the job done in time.

Conclusion

In summary, it is fair to say that none of the above-referenced exclusions were written
with Year 2000 in mind. Similarly, none have been applied in situations that closely resemble
the typical kinds of losses likely to result from Year 2000 problems. As a result, it is unclear
how the language of these provisions will be applied to Year 2000 scenarios.
ENDNOTES


4. Avis, 195 S.E.2d at 548.


6. The quotation is from Cozen & Bennett, "Fortuity: The Unnamed Exclusion," XX Forum, 222, 223 (Winter 1985). With all due modesty, this twelve-year-old article is still the most comprehensive source of information on the doctrine.


   The Third Circuit has recently held that the burden of proof with respect to this issue is one that the carrier must bear. See Koppers Co. v. Aetna Casualty and Surety Co., 98 F.3d 1440, 1447 (3d Cir. 1996) ("[I]f an insurer has issued a policy that on its face covers the loss at issue and seeks to deny coverage on the basis that enforcing the policy as written would offend the public policy against indemnification of non-fortuitous losses, we predict that the Pennsylvania Supreme Court would place on the insurer the burden of proving that the circumstances of the loss were such that coverage would be inconsistent with that public policy.").

10. Magi at 1048.

11. Id.

12. See, e.g., Insurance Company of North America v. United States Gypsum Co., 678 F.Supp. 138, 141 (W.D. Va. 1988), aff'd 870 F.2d 148 (4th Cir. 1989) ("All the expert testimony in the case demonstrated that the loss was certain to occur [but] the parties themselves were not aware that the loss would occur at a particular time," as a result of which it was deemed to be fortuitous).

14. PECO Energy Co. at 858.


17. Sentinel Management at 300.


19. Avis, 195 S.E.2d at 548.

20. New York State Electric & Gas Corp. v. Lexington Ins. Co., 204 A.D.2d 226, 612 N.Y.S.2d 43 (1994) (finding that a plaintiff's deliberate removal of a component from its generating plant, which resulted in expected downtime, was not a fortuitous event under an all-risk insurance policy).


    Indeed, as the Sixth Circuit also noted, any contrary rule which ignored "plaintiff's control over its loss in deciding the fortuitness of plaintiff's claim ... would convert plaintiff's all-risk insurance policy into a cash fund for plaintiff's business plans." University of Cincinnati at 1282.


23. Retail Systems at 737, 738.


27. Hyplains at 990.

28. Id.

29. Hyplains at 991.

27. Quadrangle Development Corp. v. Hartford Ins. Co., 645 A.2d 1074 (D.C. App. 1994) (summary judgment for the insurer affirmed on the basis of an "artificially generated electric current" exclusion where damage in one of the insured hotel's switchboards was caused exclusively by electrical arcing, with no ensuing loss by fire); Home Ins. Co. v. American Ins. Co., 147 A.D. 2d 353, 537 N.Y.S. 2d 516 (1st Dist. 1989) (Judgment against the insurer affirmed, despite an "artificially generated electric current" exclusion, where electrical arcing between two bus bar phases of an electrical distribution system was itself precipitated by the accidental introduction of steam and water into the mechanical equipment room, causing a moisture-related breakdown of insulation); Associated Electric Cooperative v. Mutual Boiler & Machinery Ins. Co., 492 F.Supp. 410 (W.D.Mo. 1980) (summary judgment in favor of a boiler & machinery insurer affirmed where the policy excluded loss caused by or resulting from "electrical current artificially generated provided fire or explosion ensues," and the loss was limited to electrical arcing followed by a resulting fire in a power plant's switchgear).


33. Bold Corp. v. National Union Fire Ins. Co. of Pittsburgh, Pa; 216 Ga.App. 382, 454 S.E.2d 582 (1995) (exclusion given effect where two products manufactured by a herbicide manufacturing and blending facility were contaminated by the presence of a chemical residue from an earlier manufacturing operation that had not been properly flushed and washed out of the processing equipment); N-Ren Corp. v. American Home Assurance Co., 619 F.2d 784 (8th Cir. 1979) (exclusion was not given effect where the refractory in an anhydrous ammonia producer's component unit collapsed, destroying catalyst and rupturing piping, due to design errors).


38. J.F. Shea at 367, n. 5.