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CLAIMS ARISING FROM YEAR 2000 DATE RECOGNITION FAILURES

WORKING GROUP REPORT TO THE 32nd CONFERENCE OF THE

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1. SUMMARY

This paper considers claims matters affecting Machinery Insurers which may arise from Year 2000 Date Recognition Failures in computerised systems.

Year 2000 Date Recognition Failures are taken to include failures to recognise the date 9th September 1999 (9.9.99) and any date in Year 2000, including the failure to recognise the leap year date of 29th February 2000.

The scope of the paper does not extend beyond claims matters, except to the extent that other considerations have a direct bearing on claims. Neither does the paper extend beyond the concerns of Machinery Insurers, although the content will inevitably raise aspects which are common to Insurers of other classes of insurance.

The paper considers some legal, financial and underwriting implications before examining the practical matters affecting claims handling.

Fourteen recommendations are given to assist Machinery Insurers in their preparation for dealing with claims arising from Year 2000 Date Recognition Failures, alternatively known as Y2K dysfunction.

2. INTRODUCTION

At the IMIA Conference in 1998, a paper was presented with the title "The Year 2000; Responding to the Challenge" (1). The paper considered the reasons for and nature of the problems which could arise from date recognition failures in computerised systems. The consequences flowing from such failures were postulated and the implications for Insurers were considered, in particular the problems facing Machinery Insurers. The paper put forward some potential solutions and strategies to meet these problems, mostly with regard to mitigating the risk exposure accepted by Machinery Insurers although the paper also mentioned the impending claims arising from Y2K dysfunction.

The purpose of this subsequent paper is to concentrate on the claims matters affecting Machinery Insurers. For Y2K issues which do not affect the consideration and handling of claims, reference should be made to the paper "The Year 2000; Responding to the Challenge" (1) presented in 1998.

It has not been possible to produce an estimate for the potential financial impact of Y2K claims on Machinery Insurers. However, the paper presented in 1998 indicated that the worldwide remedial costs had been estimated in a range up to US $3,600 billion and Business Interruption losses up to US $2,000 billion. In addition, the costs associated with litigation are expected to be astronomical, reaching US $1,000 billion in U.S.A. alone.

3. LEGAL CONSIDERATIONS

3.1 Statutory Restrictions

Statutory restrictions vary enormously with regard to geographical area, the intention of the restriction and the interpretation (in foresight) of the statutory instrument. For example, European Union legislation applies across its member nations whereas in U.S.A. insurance regulations are applied on a state by state basis.

In the U.S.A., state law differs widely as to what action an Insurer can or must do regarding Y2K provision. Some states impose little or no limitation on the use of Y2K policy wording. Other states specifically dictate which components in the wording have to be present, how the wording can be applied, which premium considerations have to result and how Y2K underwriting activity has to take place. This presents many pitfalls for Insurers who may have to pay claims at the end, although they thought they had successfully excluded them by the use of an endorsement. It is expected that US lawyers will try to exploit violations by Insurers of procedures established by state insurance departments, in order to find coverage where none was intended.

3.2 Fortuity

There are two views on the matter of fortuity. Some consider that the arrival of the Year 2000 is inevitable and so are the events which occur as a consequence; they argue that such events are not fortuitous and therefore not indemnifiable under an insurance policy. A variant of this view is that on a case by case basis the specific facts of each case may permit an argument that the loss or damage claimed for was inevitable.

On the other hand it will usually be the case that if the insured has implemented a Y2K compliance programme which it was reasonable to believe would be adequate, then a Y2K dysfunctional event would be fortuitous.

There are advocates of both viewpoints, on each side some of the most respected participants in the legal, loss adjusting and insurance sectors. It remains to be seen how the courts will deal with this aspect, conceivably in differing ways under different jurisdictions. Perhaps the extent of damage will play a role, in that while Y2K problems were foreseen, how they actually manifested themselves was not reasonably foreseeable in a particular case, which therefore would be fortuitous.

3.3 Non-disclosure

When misleading or incomplete information has been provided to Insurers, perhaps as a response to a Y2K questionnaire which some Insurers have issued, then there may be grounds for repudiating the claim.

The test to be applied will vary between jurisdictions, but the need to show materiality and the effect of the fact on the underwriter's judgement will need to be shown. As Y2K is a novel situation, providing claims handlers and external investigators with guidelines on the underwriters' thinking will help them to identify situations where non-disclosure is material..

3.4 Physical Damage

Mealy's Year 2000 Report, June 1998 (2) stated that "if the equipment ceases operation or malfunctions because it is not Y2K compliant, it may not be physically damaged; rather it may be functioning as it is designed to function".

However there are risks where the policy does not clearly define what damage means or uses the word "damage" without qualification. Coverage may be deemed to extend beyond physical damage into areas where there has been loss of functionality or even value.

3.5 Events and Causes

Faced with a claim arising from multiple Y2K related failures, Insurers may advance the view that multiple individual events had occurred with separate deductibles or perhaps that it was one event with a single limit.

In U.S.A. from Caudle vs Sharp 1995 (3) there emerged three requirements for "one event":

- there must be a common factor
- a test of causation must be satisfied
- the event must not be too remote for the purpose of the definition of "each and every loss"

However, the interpretation is not clear-cut, and legal contention may be anticipated. This may be particularly so where words like "cause" and "loss" are used rather than event. Where the word "cause" is used there are better grounds for aggregating losses for the purpose of policy limits, though, conversely, a less acceptable position for Insurers arises if that word appears in a deductible wording.

3.6 Subrogation

Direct Insurers will be looking for recoveries against offending suppliers. Representations and warranties that products are Y2K compliant (but were not) will be a powerful argument in the Insurers' cause. There may also be recovery options elsewhere. Anyone who advised in connection with the procurement of equipment, advised or oversaw the conduct of a compliance programme or had at some stage maintained, upgraded or inspected machinery may be open to attack if it was decided that they failed to take account of the Y2K risk adequately or at all.

3.7 Defending Declinatures

Some Insureds are likely to persist in seeking indemnity through the courts despite the absence of cover in the policy, and these actions will need to be defended by Insurers. A particular risk will be claims by Insureds that the clause was not properly incorporated into the contract. Preparations for handling such challenges ought to be made in advance - documenting and quality checking of renewal procedures is advisable. There may not be time, if large volumes of claims arise, to search for evidence which may not exist anyway.

3.8 Legal Bias

It has been widely reported that the larger corporations have implemented thorough Y2K compliance programmes, but that small businesses are particularly unprepared. In the event of litigation, especially where a small business is financially vulnerable, the courts may find for the Insured on the basis of empathy even if the balance of legal argument favours the Insurer.

3.9 Legal Climate

The legal climate in the various insurance markets is very different. Law suits which may find merit by a U.S. or a U.K. court system may be rejected by, say, the Japanese legal system.

3.10 Inspection

Those companies which carry out engineering inspections (either for statutory or for loss prevention purposes) may be sued for negligent inspection if the Insured suffers a loss arising from a date recognition failure, especially if the same Insurer has declined a claim for Y2K dysfunction.

Precautions can be taken to ensure that no "expectation gap" exists between clients and inspection organisations. A client with a different view over the scope of a service to that of the inspection organisation is bound to lead to problems. Ensuring that inspection contracts, letters of engagement and post inspection reports make clear that Y2K risks have not been considered and the survey should not be relied on for that purpose, are sensible precautions.

3.11 Case Law

Since Y2K presents a new type of claims issue, an examination should be made of case law (precedents of courts' decisions) in the major insurance markets. Case law will provide some insight as to how courts are likely to rule if presented with a Y2K type of claim which has similarities to past technical claims. In the U.S. for example, some courts have ruled that simple lack of access to property can constitute physical loss or damage. This means if an Insured cannot access data after a Y2K induced shut-down, the Insured may file a claim for physical loss or damage to data, which in some insurance contracts are insured property.

4. FINANCIAL CONSIDERATIONS

Many, if not most, Machinery Insurers will have instigated some measures to mitigate the likelihood and extent of claims payments arising from Y2K date recognition failures. As a result, Machinery Insurers would be surprised if they found themselves having to pay extraordinary levels of claims payments for remediation costs. Business Interruption claims could give rise to greater concern.

Nevertheless, all Machinery Insurers will be vulnerable to having actions brought against them. A business severely affected by a Y2K event will be fighting for its financial life, and there will be no shortage of legal and technical experts to encourage them. It is therefore possible that the cost of mounting a defence against litigious Insureds will have a greater financial impact on Machinery Insurers than eventual claims payments for remediation costs. The huge sums of money at stake will tempt many Insureds to try to recover Y2K expenses from their insurance carrier. In U.S.A., a cottage industry of lawyers is already making sure of that. The first large Y2K remediation suit was recently filed by the City of Seattle against the Travelers Financial Group in the amount of $40m. Certainly Travelers would rather spend that amount in defence costs in order to discourage other speculative claimants than pay out any award. Insurance company lawyers have advised that the first "few" Y2K type law suits will be very expensive to defend as legal precedence is being established (between $2 to $5 million defence cost per suit) while later claims will cost "only" between $250k and $500k depending on the size of the claimed amount. Companies who do not employ a homogeneous Y2K strategy (i.e. do not have a streamlined way of applying identical Y2K exclusions to their policies) will incur much higher defence costs as each case will present different contractual and hence legal circumstances.

One area of Y2K type claims which has virtually been ignored by direct Insurers (but not Reinsurers) is the definition of what constitutes an occurrence. Unless a policy specifically addresses the occurrence and deductible issue there may be a massive litigation simply to answer these questions of how many losses and hence how many deductibles will be applicable in the case of an insured loss. It is also likely that primary and excess Insurers will end up in litigation over this issue when high deductibles are involved.

As Insurers start to pay for defence costs and legitimate physical loss or damage claims in early 2000, it is to be expected that Insurers' investment portfolios will experience changes in order to meet cash flow demands. Insurers are more likely to be invested in short term, fixed interest vehicles and will avoid putting too much money into stocks or long term bonds.

The impact on the financial markets could be significant as these latter instruments will be devalued and investment income derived from them will fall sharply. This will have a significant impact on the available surplus (and hence capacity) of the insurance industry. Some Insurers which are thinly capitalised may want to procure additional equity now, at a time when capital markets are expected to respond more favourably than they will in the Year 2000.

5. UNDERWRITING CONSIDERATIONS

5.1 Coverage - Y2K expressly included

The boldest of Machinery Insurers may be prepared to provide cover for Y2K related events. However, they are usually seeking mitigation of the likelihood and severity of the risk either by

(i) inclusion of a warranty, for example

"The Insured has carried out The Year 2000 Project Process in accordance with the British Standards Institution PD 2000-2: Managing Year 2000 Conformity or other similar internationally recognised process agreed in writing by the Company".

In order to monitor this in itself requires a high degree of expertise - at a cost.

(ii) requiring the Insured to complete a Y2K questionnaire

This has the danger that the Insurer is entirely in the hands of the Insured as to the quality of the information proffered. Also the questionnaire may omit to ask questions which are particularly pertinent to a given Insured and thus the Insured may fail to provide vital detail (unless it is volunteered as additional information) leaving the Insurer vulnerable in a dispute.

(iii) conducting risk assessment surveys

Very few Machinery Insurers have the staff to undertake competent Y2K risk assessment surveys, and even so, the effect is to dilute the onus on the Insured to ensure compliance.

5.2 Coverage - stay silent on Y2K

This is probably the riskiest course of all in many markets, being the approach most likely to bring a dispute into the courts, where defence costs (overall) are expected to exceed remediation costs. However, some markets are content to stay silent on Y2K and feel that their wordings are sufficiently robust to decline claims which were never within the underwriter's intention.

5.3 Coverage - exclusion clauses

This is the approach preferred by most Insurers although there are notable exceptions. Typical of many is the endorsement recommended by the U.K. Association of British Insurers:

ABI MODEL MARKET CONSTRUCTION AND ENGINEERING WORDINGS

DATE RECOGNITION EXCLUSION (DRE)

Excluding any loss damage expense or liability directly caused by or connected with performance or function of any equipment (whether or not owned by the Insured) and/or services (whether or not provided by the Insured) being affected by any failure to:

(i) correctly recognise register or establish any date as its true calendar date and/or

(ii) capture save or retain and/or correctly to manipulate interpret or process any data or information or command or instruction as a result of treating any date otherwise than as its true calendar date and/or

(iii) capture save retain and/or correctly to process any data as a result of the operation of any command which has been programmed into any computer software being a command which causes the loss of data or the inability to capture save retain or correctly to process such data as a result of treating any date otherwise than as its true calendar date.

SUBSEQUENT COVER CLAUSE
(to be added, where appropriate, to wording above)

This shall not exclude subsequent loss damage expense or liability which itself results from fire spontaneous fermentation or heating lightning explosion aircraft or other aerial devices or articles dropped therefrom riot civil commotion strikers locked out workers persons taking part in labour disturbances malicious persons theft earthquake subterranean fire storm flood escape of water from any tank apparatus or pipe or impact by any vehicle or animal provided such loss damage expense or liability is not otherwise excluded.

6. CLAIMS HANDLING

6.1 Numbers of Claims

Given the sheer numbers of potential Y2K problems, a high frequency of events may be predicted. Many of these will be simply cases of equipment not responding, with no other consequence occurring. Others will result in some damage. Thus claims staff may expect a deluge of enquiries in early January 2000, many questioning potential coverage, but not necessarily resulting in claims.

There is also the potential for an increase in fraudulent claims, whereby Insureds are affected by date recognition problems and, aware that there is no Y2K insurance coverage, attribute the cause of loss to other factors, such as a power surge. Others may cause deliberate damage either by physical impact or arson, and then declaring the cause to be accidental damage or fire.

6.2 Obscurity of Claims

It will undoubtedly be difficult for hard pressed claims departments to decide efficiently which losses are caused by Y2K and which by other factors. Machinery Insurers' claims staff are accustomed to dealing with mysterious causes of events, but the sheer potential for volume and obscurity suggested by Y2K may be overwhelming.

An indication of the complexity which may face claims handlers is given in the publication "Year 2000 Problems in Machinery" (4) which provides some useful preparatory material for Machinery Insurers' claims handlers.

Further claims complications can be found in the inadequacy of exclusions given the complex nature of many potential loss scenarios. To be added to this is the difficulty in many cases of establishing Y2K causation which may ultimately rely on detailed, costly and lengthy analysis. Establishing that a piece of machinery was non-compliant or that an Insured did or did not have a compliance programme will seldom be enough for an Insurer to rely upon an exclusion. The Insurer will need to show that a Y2K problem caused the loss.

These demands will fall on hard pressed claims staff who are having to grapple with Y2K claims for the first time ever, and without the benefit of supervisors with specific experience to guide them.

6.3 Claims other than Y2K

A further complication is the traditional rise in claims frequency usually experienced in the Christmas and New Year period in some markets, which could escalate beyond the usual annual peak due to Millennium activities, combined with the prospect of a large number of claims due to severe winter weather in the northern hemisphere.

6.4 Determination of Claims

For those Machinery Insurers which have expressly included Y2K events, a date recognition failure would be akin to a machinery breakdown incident. Obviously such companies would maintain a discrete loss code for Y2K events, but liability would probably not be in contention and a speedy settlement could be reached.

Those Machinery Insurers whose policies have stayed silent on Y2K events are highly likely to face some tortuous times, as claims handlers grapple with the identification of the cause and the intent of the policy - unless a clear interpretation of the policy has already been given to the claims handlers. This will take place against a background of intense activity by all insurance industry professionals and, possibly, with the Insured pressing for a speedy resolution of the claim.

Those Machinery Insurers whose policies contain a Y2K exclusion will have established the intent of the policy, but the determination of the cause becomes crucial to the position on liability. Again, this will take place at a time of intense activity by all insurance industry professionals, and business interruption considerations may add to the pressure.

6.5 Forensic Investigations

Where the intention of the policy is not to cover Y2K claims, for example where a Y2K exclusion is in place, and a claims handler suspects that a loss may have been fraudulently attributed to other causes, perhaps with deliberate damage to conceal the true cause, the options are to:

- make some elementary further enquiries (proof of Y2K compliance, age, etc)
- appoint a specialist loss adjuster
- accept the claim

It may often be cheaper to accept the claim rather than appointing a specialist loss adjuster when fairly low values are involved, for example the value of a Personal Computer, but cases of high value and dubiety would obviously be regarded differently.

6.6 Recoveries

For Y2K claims under the computer insurance class in particular, the position of manufacturers' or suppliers' guarantees needs to be investigated. The contracts for the supply of many systems may contain within their pages grounds for recovery or replacement. Even where not specifically stated, there is likely to be an implied duty along the lines of "fitness for purpose" or "merchantable quality" where manufacturers can be held liable for replacement and payment of compensation for loss or damage sustained. Time bars and other action-limiting constraints should receive particular attention in this respect.

6.7 Monitoring

To assist Insurers in dealing with the Y2K affair it would be advisable to record all claims where Y2K is the suspected proximate cause, with allocation of cause codes and other analytical support indicators. This would facilitate allocation of investigative resources, subrogation considerations and reinsurance recoveries amongst others.

6.8 Loss Adjusters

Most firms of Loss Adjusters used by Machinery Insurers will have developed the skills of those of their staff with an appropriate background and aptitude in preparation for adjusting Y2K claims. This will involve reading the relevant literature, attending seminars and discussion with colleagues.

Some firms of Loss Adjusters will have established prior liaison (or even entered into an agreement for the retention of services) with firms which provide specialist technical consultancy services in the computer field.

Of course, the Loss Adjusters will be in high demand in the early weeks of theYear 2000 - all the more reason for Insurers to prepare their own staff as well as possible to reduce their dependence on Loss Adjusters.

Some firms of Loss Adjusters have postponed all holiday leave during January 2000.

6.9 Lawyers

Legal practices which specialise in insurance industry matters have made similar preparations to that described for Loss Adjusters. They will also be in considerable demand in the early weeks of the Year 2000.

These legal practices will be in a position to provide advance advice on the legal climate and legal bias in the courts where Machinery Insurers' Y2K litigation will be heard. This will enable claims handlers to give added diligence to the search for and recording of those facts which could be effective in countering an adverse legal climate or legal bias. Furthermore, such advance advice would enable an early decision to be taken on the payment of the claim to avoid embarking on fruitless litigation, or to reach an out of court settlement before a case is heard in the courts.

6.10 Public Relations

The insurance industry is often viewed unfavourably by the insuring public, because of the perceived notion that Insurers are always looking for ways to avoid paying claims. The Y2K issue has received a great deal of publicity, but the potential lack of insurance cover may, intentionally or otherwise, not be fully understood. The situation is not being helped by the fact that Insurers have introduced exclusions providing varying degrees of cover, with different approaches in different territories and in some cases have simply remained silent on coverage.

There is every possibility that once Y2K related incidents start to occur the reaction of the insurance industry will be adversely reported - rightly or wrongly. The media will not report kindly on situations where a small company is "forced out of business" by an Insurer refusing to pay for the consequences of non-compliance.

7. CONCLUSIONS

7.1. It is to be expected that there will be tremendous pressure on the claims staff of Machinery Insurers during the first few weeks of the Year 2000. However, this need not be intolerable to bear nor should the systematic handling of Y2K claims grind to a halt if adequate preparations are put in place well before the event.

7.2. The consideration of the individual factors which affect Y2K claims has identified the specific aspects and the attention they require in order to reduce the financial and logistical impacts on Machinery Insurers. The various actions proposed are set out in the following Section 8, Recommendations.

8. RECOMMENDATIONS

8.1 Machinery Insurers should reach a firm conclusion as to the precise scope of Y2K coverage for each of the policy wordings they have issued. This should be established well before 1st January 2000 and preferably before 9th September 1999, in good time to give claims handling staff specific training on the scope of cover provided for each of the policy wordings. The adherence to standard policy wordings will facilitate this process and also help reduce defence costs in contested claims.

These aspects will include

- demonstrating how the coverage meets all statutory prescriptions
- precise stance on fortuity
- precise concept of physical damage
- precise procedure for dealing with multiple Y2K events
- precise procedure for dealing with non-disclosure.

8.2 Machinery Insurers should provide their claims staff with training to raise their competence and confidence in identifying claims which contain a Y2K element.

8.3 Machinery Insurers should establish clear procedures for securing recoveries, wherever possible, from manufacturers and suppliers of products which are not Y2K compliant.

8.4 Machinery Insurers should establish clear procedures for identifying, recording and monitoring claims which have a Y2K element.

8.5 Machinery Insurers should train some of their claims supervisors to a higher level, possibly with the help of Loss Adjusters, so that the supervisors may assist in training the claims staff and provide sources of referral for exceptional claims.

8.6 Machinery Insurers should postpone holiday leave for claims staff and supervisors trained to handle Y2K claims during the months of January, February and March 2000 to maximise claims handling capacity during these months.

8.7 Machinery Insurers should make provision for other claims staff to be diverted if necessary in order to relieve Y2K trained claims staff of non-Y2K claims matters.

8.8 Machinery Insurers should establish panels of loss adjusters, named individually, who are known to be trained and competent to deal with Y2K claims.

8.9 Machinery Insurers should establish panels of lawyers, named individually, who are known to be experienced in insurance industry matters and who are competent to deal with Y2K claims.

8.10 Machinery Insurers should consult their panels of lawyers to examine the legal climate in courts where the Insurers' Y2K litigation will be heard, with a view to taking advance measures to protect against adverse judgements. Similarly, the lawyers should be consulted to explore possible advance measures to mitigate the effects of legal bias.

8.11 Machinery Insurers should consult their panels of lawyers to examine the existing case law on litigation involving Insurers in order to gain some insight as to how courts are likely to find if presented with a Y2K claim having similarities to past technical claims, or indeed to recent Y2K claims which have already come before the courts.

8.12 Machinery Insurers should prepare and issue with every inspection contract an express condition disclaiming all responsibility for the consequence of any Y2K related problem.

8.13 Machinery Insurers should consider the procurement of additional equity in order to meet cash flow demands due to defence costs and legitimate remediation costs from early in Year 2000.

8.14 Machinery Insurers should take measures to reduce the risk of adverse public relations by

- giving clear messages, before the Year 2000, to the insuring public and brokers setting out a well argued stance on Y2K
- having well prepared responses available in the event of adverse publicity
- compiling and having available data on costs to Insurers of Y2K related claims (even if these are only estimates) and numbers of claims.

9. WORKING GROUP

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