

Guest Editorial

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All There Is To Say About Y2K

by Michael Maglaras

Many of our clients and friends have expressed an interest in having more information regarding the ways in which existing commercial property and casualty insurance programs may respond to claims arising from the so-called "Y2K problem" and how, as we now move inexorably toward "zero hour," risk managers and others can begin to consider the impact of the insured and uninsured exposures connected with their coverage portfolios and the Y2K issue. First, it is important to consider the facts. We should also separate what, among all the of possibilities for potential loss, might be possible or probable and separate this reality from the kinds of catastrophes portrayed in the general media and the insurance industry trade press on an almost daily basis. The truth of the impact of Y2K on insurance, risk management and risk financing exposures, lies somewhere between a non-event, and what some in the media would have us believe is the end of civilization as we know it.

The Definition

Computer systems generally use two digits in referring to date-based data related to any given year. Remember COBOL? That early programming language set the stage for the Y2K problem. Its earliest versions could not support entering years in a four-digit format, and because of the popularity of COBOL, many early COBOL-based systems started to use this approach as well. The number of systems still using this methodology in 1998 is, simply put, staggering. In the current year, for example, "98" generally refers to the year "1998" in most software programs installed in personal computers. Most hard drives contain memory and/or systems which also use the same two digit identifier. It's easy to see how, when one gets beyond the year 1999, the year 2000 will create a problem for any system based on logic and which may be COBOL-derivative. The very simple question is (and it is very simple), will the computer think, when it reaches 2000, that it is really 1900? The entire Y2K issue, from top to bottom is defined by this simple example. What is not so simple, is the effect millions of failing PC's, many of which are interactive among themselves or with larger server systems, will have on the way we manage every aspect of our lives and businesses on January 1, 2000. While it seems clear that most very recently constructed computer systems are partially, if not fully Y2K compliant in most respects, many older systems drive the engine of commerce in our country and elsewhere, and what is absolutely clear is that there exists a great deal of uncertainty about how to quantify what is, at least potentially, a catastrophic insurance exposure, using generally accepted risk management standards and principles. Even as we approach "zero



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hour" most insurance professionals are not nearly as prepared as we need to be regarding this important area of potential exposure.

The Facts

Most conservative estimates place Y2K remediation costs at better than \$1 trillion in the U.S. alone. A global figure of \$5 trillion is frequently mentioned in the insurance trade press, and while perhaps somewhat exaggerated, may not be far from the truth. When one is dealing with a truly global problem the odd \$100 million here or there can seem like pocket change.

As of the end of November, 1998 significant Y2K-connected litigation has already emerged -- well in advance of January 1, 2000 -- concerning one or more aspects of insurance coverage and the Y2K issue. Generally speaking, the allegations made in this litigation involve a breach of implied or actual warranty of merchantability, a violation of a federal or local consumer protection act or some allegation related to general unfair business practices. One such suit has already reached \$45 million in legal fees and is expected to continue in litigation well beyond the year 2000.

Clearly, as we approach 2000, this litigation will increase, with claims extending to a broader range of businesses, particularly those businesses with contracts for services renewing on or before 2000 and where it may become increasingly apparent as time moves on, that the contracted service may not be Y2K compliant. Among service providers, it's easy to see how healthcare providers may be particularly vulnerable. We can expect class action suits in record numbers. We can also expect claims to arise as a result of systems thought previously compliant, which fail Y2K tests now, well before January 1, 2000, as businesses increasingly refuse to accept statements of Y2K compliance at face value.

We can also expect a wave of legislation stemming from the Y2K issue which will attempt to limit in advance (probably without much success) liability derived from Y2K liability claims. Senator Bob Bennett (R-UT) has already introduced legislation in the Senate in this regard (S.1518). His bill, known as "CRASH" (the Computer Remediation and Shareholder Protection Act) would require disclosure by all publicly traded companies, either in their initial offerings, or through the means of quarterly reports to shareholders, of their Y2K compliance efforts. This bill, as it now stands, would require companies to estimate Y2K liability and associated costs and is already being seen in the risk management industry as giving a boost to captive insurance company formations and other alternative risk financing vehicles. The idea here will be to anticipate the magnitude of uninsured loss and fund, if possible, it's reasonable present value through a captive insurer. Some pundits have already begun to declare that the liability insurance market will harden soon as a direct result of the anticipated drain on underwriters' capital as Y2K claims begin to assert themselves in a steady and increasing flow of litigation.

What's the Risk?

The underlying principle of all insurance coverage, particularly for liability and related underwriting lines, is the concept of fortuity. Under this generally applied underwriting concept, insurance claims should be the result of unforeseen and accidental occurrences. In other words, the insured saw the truck speeding toward him and should have stepped out of the way. To the extent the insured had warning of his impending doom, could have taken steps to avoid being flattened, and did not do so, the loss is not accidental, not fortuitous, and probably not covered. Unless someone is not a current resident of this planet (underwriters will argue) there should be little reason not to have foreseen the basic and evident business

risks associated with all forms of Y2K exposure.

This is a strong argument. And among those underwriters who plan to use "fortuity" as a valid defense for not honoring a Y2K claim, it is being more and more loudly proclaimed as the underwriter's defense of choice. We do not think that it will be that simple all the time and risk managers and others will want to explore, policy by policy, coverage by coverage, portfolio by portfolio, whether coverage exists now for a Y2K claim, and if so, how underwriters are apt to begin restricting coverage now and over the next twelve months, as the dread day of reckoning approaches.

As a further support of the fortuity defense, underwriters will claim that insureds had plenty of warning, well prior to January 1, 2000 and will point to one or more of the following dates as now universally acknowledged as signaling a business in advance as to the potential of a Y2K problem.

- January 1, 1999: Some systems will recognize "99" as a field-end program command or a default program command.
- August 21, 1999: This is the scheduled date for the switch over to the new Global Positioning Satellite (GPS) system serving much of the transportation industry. If your delivery is a trifle late on the 22nd C this will probably be the reason why.
- September 9, 1999: Again, this is a default or field-end program code problem for those systems that recognize "9999" as a default code.

After January 1, 2000, there will be at least two critical dates, February 29, 2000 (because of some programs' inability to correct for leap year calculations) and September 9, 2001 (because in some UNIX software, date this shows as 999,999,999).

Again, fortuity is the key. Did the insured recognize that the problem was going to occur before it did? Did the insured take sufficient steps to prevent the loss from occurring? For many insureds, a documented "due diligence" effort may be the only defense available under which to assert any potential coverage for a Y2K event.

Property, Time Element and Related Coverages

We believe that it is in property and related insurance coverages where the scope of the Y2K risk issue may be most strongly felt. In particular, we believe that Business Interruption losses may account for the largest group of potential Y2K claims. Those underwriters who intend to use the fortuity defense to deny Y2K claims are hanging their hats on proving that insureds had significant warning of the danger and scope of the Y2K problem with regard to the continuity of their businesses. As insureds consider their property and related insurance exposures and the Y2K problem, we suggest a close look at the following issues

1. Many property policies rely on the provision of coverage through the idea of a "covered peril." These perils are listed in the coverage document and the peril must cause some level of physical damage to whatever property is insured. We have not seen, as of yet, one commercial property policy which defines Y2K and any related event as a "covered peril." The other type of generally employed policy is an "all risk" form. In an all risk policy form, what is not excluded is, by definition, generally included subject to the insuring agreements and this is important with regard to Y2K planning.

Also, it is important to beware of so-called "faulty workmanship" exclusions in property policies. Some underwriters may take the position that if a hardware or software system is badly designed (that is to say, non-compliant) it constitutes "poor materials or workmanship" and thus a claim stemming from a hardware or software failure may be excluded from coverage.

2. Defining "physical damage" may be key to identifying whether Y2K coverage exists under a property policy. Underwriters are not at all clear, for example, that a loss of data or a corrupted database represents "physical damage." Additionally, we should note the distinction between, for example, a fire, water damage, or other loss resulting indirectly from a Y2K problem, and the direct costs of fixing the computer system itself after breakdown. The former may be covered; the latter, probably not.

3. Business interruption and other time element exposures are, as we have said, potentially the most important risk areas to look at closely -- again, the event must be covered for the coverage to apply and there must be direct linkage between the Y2K event and the interruption of business. Of particular concern to us, with regard to time element coverage, is whether customers, suppliers, support businesses and others are Y2K compliant. Their loss can become your loss very quickly. Risk managers also need to understand that you simply cannot guarantee Y2K compliance by all suppliers. It's just simply impossible and we need to understand and realize this in advance.

4. The difference between an "all risk policy" and a "named peril policy" is, as we have said, critical when considering whether Y2K coverage can be afforded under a property policy. Typical exposures, such as sprinkler leakage, explosion, fire etc., if the direct result of a Y2K exposure will probably be covered. Here again, in a named peril policy it will be necessary to walk through all the possible loss scenarios which might occur as a result of a Y2K incident to make certain that any reasonably unforeseen peril can be accounted for, and thus, may be properly covered.

5. Property Insurers have begun to employ arcane or deceptive language in an attempt to disguise potential Y2K exclusions from coverage. For example, we have recently seen an "Electronic Data Recognition Clause" in a CIGNA property policy -- which is, simply put, a Y2K exclusion. There's no time like the present to review the "exclusions" section of your property policy for terminology which may appear benign, but is in fact, the opposite.

Directors and Officers Liability Insurance

Next to property and time element coverage, D&O liability insurance coverage may be one of the most important sources (or lack of it, depending on policy wordings) of Y2K coverage for any organization. Many underwriters are now "suggesting" that insureds complete Y2K

questionnaires which will become a material part of the policy at its next renewal. Without exception, we are urging our clients not to complete any Y2K questionnaires or specific Y2K questions on related applications unless required as a condition precedent to coverage, as we believe that, of all the existing commercial coverages purchased as part of a traditional portfolio, the standard D&O insurance contract currently affords the insured the most potential coverage with regard to an allegation that the organization's trustees, directors and officers breached their responsibility with regard to the Y2K issue. Many of the questionnaires we have seen contain questions which, if answered by an insured, may imply a warranty or other guarantee of implied or explicit compliance, not only by the named insured -- but of the insured's suppliers as well. It's important to remember that most new and renewal applications for D&O coverage require the signature of the CEO. Underwriters will argue, that if the CEO said you were compliant -- then you were compliant and may use this affirmation to attempt to deny coverage. With regard to D&O liability coverage and the Y2K problem, we offer the following observations:

1. Again, the issue of fortuity rears its head. Did the entity's directors and officers foresee the probability of Y2K non-compliance? Increasingly, healthcare providers and all businesses must assume responsibility for Y2K compliance at the highest levels within the organization. It is going to be a difficult argument to make, that a corporate board could not have reasonably foreseen an organization's potential Y2K problem, and thus, did not take steps to avoid an uninsured loss.

2. Among taxable and traded entities, we expect to see shareholder derivative actions alleging a failure of directors and officers to evaluate, test, or generally prepare for the likelihood of a Y2K problem. Similarly, with respect to public documents, there may be securities class actions under which shareholders allege failure to properly divulge the organization's lack of due diligence on this matter. On January 12, 1998 the SEC released Bulletin #5 in which that government agency provided guidelines for disclosure requirements associated with Y2K projected uninsured expenses and anticipated losses. Everyone will feel the impact of this guideline as companies struggle with what they must divulge and when.

Medical Professional and Other Liability Coverages

While we have not seen much Y2K policy exclusion language yet for medical professional and related liability lines, it seems clear that we will begin to see a substantial tightening of terms and conditions over the next few months in anticipation of January 1 and July 1, 1999 renewals. The Insurance Services Office ("ISO") has developed wording for insurers which can be used as an endorsement to standard contracts to exclude coverage for Y2K claims. What's not clear yet is the extent to which underwriters will use the language proposed. What's being discussed by several underwriters is an absolute Y2K exclusion, meaning that any claim related to a "defined Y2K incident or claim" will be completely excluded.

With respect to the issue of fortuity, it will be a hard case for insureds to make that they could not have reasonably foreseen the possibility of a patient-related claim stemming from a Y2K incident or occurrence. Healthcare providers and, in particular, hospitals and healthcare

systems, have had plenty of warning and time to prepare. Insurance company underwriters will argue that very little patient-related bad news, should be a surprise to anybody, come January 1, 2000.

With medical professional and general liability as well as with umbrella liability coverages, we expect that insureds will need to look closely at the following key elements of their programs:

1. In the patient care area, risk management professionals are now getting prepared for the possibility of claims stemming from the following areas:

- General safety and operational systems, including telecommunications, security operations, fire detection, boiler systems and related operations.
- Medical record systems and management information systems.
- Medical devices, including those implanted surgically in patients.
- Diagnostic equipment and potential related treatment errors, as well as those involving patient monitoring devices.

We can expect to see potentially significant claims connected with patient care emerging from the following areas.

A. Incorrect Medication Issues: The possibilities are limitless. What leaps to mind are the many programs that use two-digit year identifiers to calculate dosage requirements. Teletherapy and radiation therapy programs are among the many examples we can think of.

B. Diagnosis Issues: Any software designed to assist in a general diagnosis of a patient could be a high risk factor.

C. Treatment Issues: Care plan reminder notices to patients, expiration dates etc. are all potentially major sources of Y2K professional liability exposure.

Of course, the embedded-chip issue is the real Boogie Man here. It's going to be particularly difficult to identify where problems are likely to occur in advance in this regard. Literally thousands of devices, monitoring and otherwise, are at risk of failure.

2. Perhaps just as important for risk managers, will be potential losses that may stem from the healthcare provider's business operations. Ordinarily, what comes to mind first are billing and payment systems and Medicare/Medicaid intermediary systems. We think that any organization that credentials providers

may be a source of potential exposure as well.

3. Most healthcare providers purchase professional liability coverage on a claims-made basis. To the extent that a Y2K loss is covered at all, it should be easy to trigger coverage on a claims-made, claims-reported basis. However, almost all general liability coverage is underwritten on an occurrence basis and may pose significant coverage problems for healthcare insureds and self-insureds. We think that underwriters will fall back on the fortuity defense with CGL to keep themselves protected from Y2K losses. They will argue that general liability coverage is triggered by an "occurrence," (defined as an "accident") and will further argue that all losses reported should have been easily foreseeable. ISO is scheduled to produce language for use by the underwriting community to endorse some limited Y2K coverage to the standard general liability policy form. The specimen endorsement language we've seen includes everything from endorsing coverage for specific activities or locations, to excluding coverage altogether for products and completed operations. Of particular interest to underwriters are potential losses which may arise from embedded chip claims. These will almost certainly be excluded. Language excluding claims related to "... all liability arising out of a computer or computer-related actual or alleged failure, malfunction, inadequacy or inability to correctly recognize, distinguish, interpret or accept the year 2000 and beyond..." will probably start showing up in many CGL policies in the next few months.

4. We will probably see the last hurrah of the true "following form" excess policy shortly, as umbrella underwriters seek to limit their exposure by carefully worded exclusionary language. Just because some existing or limited Y2K coverage may apply in a primary HPL program does not mean we should expect to see excess layer coverage. We will begin to see manuscripted wordings excluding Y2K-related events, regardless of underlying policy terms and conditions, appearing with the January 1, 1999 renewals. Lastly, there are no existing Medicare regulations currently defining precisely what aspects of the standard professional general liability wordings are covered under a Medicare reimbursement trust or under a captive created by a healthcare provider seeking Medicare reimbursement. To the extent healthcare providers seek to re-construct their self-insured professional and general liability programs to include Y2K coverage, say at a primary level, we're not entirely certain that funding paid to self-insurance mechanisms to support that Y2K coverage may be an allowable Medicare expense. How do we know that the Feds won't adopt the fortuity argument to deny reimbursement? We don't, and we're probably going to find out only after January 1, 2000.

In Summary

Beginning now, there are some steps which risk managers and those charged with oversight of the process can take today to prepare

themselves for the risk management and risk financing uncertainties associated the Y2K problem.

1. Question your broker and consultant in detail about what they are "hearing on the street" about Y2K policy language, warranty questions in new and renewal applications, and other issues. Most insurance professionals are following this issue closely and will, if pressed, tell you what they're hearing.

2. Make sure that any year-end stewardship reports from brokers include detailed Y2K commentary about the marketplace in general and your underwriters in particular.

3. Begin scheduling meetings with underwriters now to review existing or renewal policy language in depth. Attempt to determine where gaps in coverage may occur. We recommend that risk managers begin this process soon, even though their renewals may be months away. Y2K issues are going to be on everybody's radar screen over the next six months and the line is going to get pretty long.

4. Unfortunately, in most healthcare organizations, risk management and risk financing have, up to now, sometimes been an after-thought with respect to the general Y2K planning process. If the risk manager is not an integral part of the organization's Y2K compliance strategy, as a full partner at the table, we should not be surprised when there are uninsured Y2K losses which could have been otherwise avoided.

5. The time is now for regular Y2K briefings of directors and trustees by risk managers. It is important to remember that the fortuity argument can only be refuted by visible evidence of due diligence by a provider's officers and trustees. The rule of thumb, is that if it could not have been reasonably foreseen C then coverage may exist. Proving that the organization took all the steps it could to anticipate any Y2K exposure before it occurred may be the only defense available. This will be particularly true of directors and officers liability claims.

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