1-1-1999

Legal Aspects of the Year 2000 Problem

James Blythe Hodge
Grant P. Fondo
Grant P. Fondo

Follow this and additional works at: http://digitalcommons.law.scu.edu/lawreview

Part of the Law Commons

Recommended Citation
James Blythe Hodge, Grant P. Fondo, and Grant P. Fondo, Legal Aspects of the Year 2000 Problem, 39 SANTA CLARA L. REV. 657 (1999).
Available at: http://digitalcommons.law.scu.edu/lawreview/vol39/iss3/1

This Article is brought to you for free and open access by the Journals at Santa Clara Law Digital Commons. It has been accepted for inclusion in Santa Clara Law Review by an authorized administrator of Santa Clara Law Digital Commons. For more information, please contact sculawlibrarian@gmail.com.
ARTICLES

LEGAL ASPECTS OF THE YEAR 2000 PROBLEM

James Blythe Hodge,* Grant P. Fondo,** and Carlo F. Van den Bosch***

The year 2000 is not rocket science, but it is the largest project ever to be undertaken by the [Information Technology] organization. The complexity of the project is not in the solution but rather in the size and scope of the project itself. This means that the year 2000 requires "world class" project management.1

I. INTRODUCTION

Professionals all over the country are working hard to discover, cure, disclose, and allocate the costs of the so-called "Year 2000 bug."2 Many of those professionals are computer

* James Blythe Hodge, Esq. is a partner in the San Francisco office of Sheppard, Mullin, Richter & Hampton. He is a member of the Real Estate Department and of the Firm's Year 2000 Task Force. Mr. Hodge received his B.A. from the University of Washington and his J.D. from Columbia University.

** Grant P. Fondo, Esq. is a senior associate in the San Francisco office of Sheppard, Mullin, Richter & Hampton. He is a member of the Litigation and Intellectual Property Departments and of the Firm's Year 2000 Task Force and is a columnist for the American Bar Association's Computer Litigation Journal. Mr. Fondo received his B.A. from the University of Vermont and his J.D. from the University of Virginia.

*** Carlo F. Van den Bosch, Esq. is an associate in the Los Angeles office of Sheppard, Mullin, Richter & Hampton. He is a member of the Intellectual Property Department, a founding member of the Firm's Information Technology and Cyberlaw Practice Group, and a member of the Firm's Year 2000 Task Force. Mr. Van den Bosch received his B.S.M.E. from U.C.L.A. and his J.D. from the University of Southern California.


2. This article focuses on legal aspects of the so-called "Year 2000 prob-
programmers. But many others are lawyers. It seems appropriate that the programmers are working hard, for it is their predecessors who caused the problem. In the days when software space was valuable and computers were slow, programmers saved costs and space, and increased computer speed and efficiency, \(^3\) by using two-digit rather than four-digit computer fields, to represent a year. \(^4\) Software was programmed to assume that all years were in the twentieth century. Perhaps, no one thought that those computers and programs might still be in use in the year 2000, or that at the turn of the twenty-first century the year “00” would be read as 1900 and not 2000. As a result of what now seems to be shortsightedness, many computers cannot distinguish between the year 2000 and the year 1900. \(^5\) This problem must be corrected or “remediated,” \(^6\) at a cost estimated to be $300 billion to one trillion dollars. \(^7\)

---


4. For instance the year 1978 was represented as “78.”

5. The technical aspects and practical results of this problem are discussed in detail infra Part II.A.

6. The word “remediate” is used in the environmental and computer fields as a verb to mean the act of correcting or remedying a problem. The noun is “remediation” and the adjective is “remediated.” Although they have not yet found their way into lexicographical reference works, the terms are widely used by lawyers and other professionals in contracts and reports, see *Year 2000 International State of Readiness: Hearing on International Year 2000 Issues Before the U.S. Senate Special Comm. on the Year 2000 Technology Problem*, 105th Cong. (1999) (expert testimony of Lou Marcoccio); Disclosure of Year 2000 Issues, Exchange Act Release No.40277, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,041, at n.32 (July 29, 1998) [hereinafter SEC Release]; Phillips Petroleum Co., Form 10-Q FOR THE PERIOD ENDED JUNE 30, 1998, at 28 (1998). The terms will be used throughout this article to conform with industry practice.

While programmers created the Year 2000 problem, lawyers will play a key role in solving it. Lawyers are now involved in due diligence investigations, risk assessment, mitigation, securities law and other disclosure, financial reporting, counseling, documentation, risk allocation and contingency planning. Lawyers are also involved in the regulatory and legislative process. And they will play an important part in the Year 2000 aftermath, as a significant amount of litigation is expected to be generated by the failure of many organizations to solve their Year 2000 problems by the deadline.

According to a study by the Connecticut-based Gartner Group, fifty percent of United States companies will not fully eradicate the Year 2000 problem by December 31, 1999. This problem may prevent these companies from manufacturing their products, processing their accounts, maintaining calendars or schedules, or maintaining essential services such as telecommunications or electric power.

This article addresses some of the legal aspects of assessing and dealing with the Year 2000 problem. Part II provides an overview of the technological problem and the technical solution. Part III examines the management strategies for dealing with potential problems. Part IV discusses the legal aspects of the Year 2000 problem, including legal measures either to reduce or contractually shift the risk of impact, regulatory disclosures, financial reporting, tax treatment, and how to recover the cost of due diligence, testing, correction, and damages. Part V reviews the legal implications of non-compliance, focusing specifically on the types of litigation likely to result from the Year 2000 problem, the role that insurance will play, and the defenses likely to be asserted. Parts VI and VII examine pending lawsuits and federal and state legislative activity regarding the dilemma.

II. THE YEAR 2000 PROBLEM

A. Technical Problem

Congress has defined the Year 2000 problem as "any problem which prevents information technology from accu-
rately processing, calculating, comparing, or sequencing date or time data: 1) from, into, or between the twentieth and twenty-first centuries, or the years 1999 and 2000; or 2) with regard to leap year calculations."

The Year 2000 problem arises from the widespread representation of annum numbers as two-digit variables in computer programs. For example, much of the world's computer code uses the number "78" to represent the year 1978. In the early days of computing, this two-digit scheme was born out of the dual considerations of system speed and the preservation of expensive memory resources. Now, the two-digit system may create havoc when a program encounters dates beyond 1999. Beginning with the year 2000, the two-digit representation may be mistaken for years at the beginning of the prior century and may not be able to produce a standardized presentation or comparison of dates. In many cases, rather than misinterpret dates, a computer may simply shut down.

A related but slightly different problem is a computer systems inability to recognize the Year 2000 as a leap year. Under the Gregorian calendar system, the first year of each century is only a leap year if it is divisible by 400, in which case it must be a leap year. The year 1900 is not divisible by 400; the year 2000 is. A computer that mistakes the Year 2000 for the Year 1900 will not add February 29 to its calendar, and will leave one whole day out of its calculations and calendaring. In addition, there are numerous other milestone dates after the Year 2000 that must be addressed by

10. In fact, the field is the familiar six digit field (yymmdd) with the first two digits reserved for the year.
12. For instance, unremedied software may interpret the year "10" as having occurred in 1910—90 years ago—rather than in 2010, 10 years in the future. Some schools have sent notices to people born in 1890 to recruit them for kindergarten because their computer systems interpreted the centenarians' birth date as 1990. See DeJesus, supra note 7, at 53. In 2000, non-compliant computers could calculate the age of a person born in 1960 to be negative 60 years old, rather than 40. Id.
13. See YOURDON & YOURDON, supra note 3, at 357-58.
14. See id.
As a further complication, testing or validating systems once they are remediated is complicated and time consuming. The standard advice is that remediation should have been completed by December 31, 1998, leaving all of 1999 for testing and fine tuning.  

A Year 2000 error can occur anywhere dates are used and in any level of hardware or software from microcode to large scale, fully integrated applications. The most severe impact may be on old-style mainframe computers using outdated software programs. This software was designed in the 1970s and 1980s with the belief that these systems would not be functioning in the year 2000. However, these systems are still extensively used. Although old style mainframes will be most severely affected, systems need not be archaic to be non-compliant. The problem affects many smaller and more contemporary computer software systems.
Furthermore, even compliant systems are threatened by the problem, because interaction with non-compliant systems could cause the compliant system to malfunction.23 The Year 2000 problem extends beyond the mainframe, network, or desktop computer; any device containing embedded date-sensitive computer chips could be affected.24 The number of embedded chips expected to cause problems is small relative to the number of possible failures in other areas, and those that do cause problems may cause little damage.25 Still, small problems may have larger ramifications. Security systems may present a problem because they are programmed to be date sensitive and are usually programmed to open all doors in the case of an error26 though jails and prisons have been alerted in time.27 A telephone may show the wrong date on its screen or a security report may print the wrong date on a report. Therefore, date sensitive calculations may be based on an erroneous date and cause a system failure. This could ultimately affect financial accounting, interest calculations, legal commitments, record keeping, inventories, maintenance, records, file retention, and scheduling. It is also possible, although unlikely, that small defects in medical equipment or other products could cause physical injury or even death.28

Although the Year 2000 problem will gain more attention near the turn of the century, some companies already have encountered it. A survey conducted by the Information Technology Association of America indicates that forty-four percent of responding companies have experienced Year 2000

24. An embedded system is "computer technology that monitors, controls, or in some way facilitates the functioning of a machine, component device, or an environment." HAYES & ULRICH, supra note 7, at 150. Many embedded chips in telephones, cell phones, pagers, personal information systems such as address, calendar, and task storage devices, security systems, motor vehicles, automobiles, appliances, medical equipment, and other devices are date-sensitive. See Lee Gomez, How Do Chips Fit into the Year 2000 Mess?, WALL ST. J., Nov. 19, 1998, at B1.
26. See id.
27. See id.
disruptions in their businesses.  

An area of concern is federal and state compliance. The Internal Revenue Service admitted it will not be ready for the Year 2000 after discovering in 1998 that approximately 33 million lines of code remained to be analyzed and corrected. IBM has indicated that many of its computers used by the Federal Aeronautics Administration (FAA) for on-route control facilities will not be year 2000 compliant. The General Accounting Office (GAO) reported that the FAA had not completed an assessment of its year 2000 compliance by the end of January 1998 as required. This will affect a number of government functions including certain functions of the Department of Defense and the Department of Agriculture. Moreover, most states are behind schedule in correcting the problem as well.

Fortunately, the news is not all bad. The FDA has predicted that most hospital equipment will be unaffected. The major stock exchanges are currently running (and passing) tests indicating that they have corrected the problem. Most major banks in this country seem well on the way to becoming Year 2000 compliant. However, smaller banks may be slow to correct their problems and foreign banks in many countries are also lagging behind. While arguments rage over the effect that the problem will have, it is clear that most organizations will be impacted in some way.

31. See id.
32. See id.
33. See id.
39. See Hansell, supra note 37.
B. Technical Solutions

What are the technical solutions to the Year 2000 problem? A company with a Year 2000 problem may 1) re-engineer the workflow to by-pass the program, 2) totally rewrite the offending applications, 3) replace the applications, or 4) modify the program code. A program may be modified either by expanding the two-digit field for the year to four digits or by reconfiguring the two-digit code to represent a broader "window" that spans both the twentieth and twenty-first centuries.\textsuperscript{40} Expansion requires thorough testing since all data files must be changed. On the other hand, windowing may be ineffective where dates extend backward and forward more than a total of 100 years. Hence, companies may choose windowing for applications that they plan to replace soon and expansion for applications that they expect to keep for a longer time.

In concept, solving a Year 2000 problem is relatively simple: assess the problem, fix and test the software, and fix any problems exposed by the tests. However, in practice the sheer number of fields and the number of programs involved make the Year 2000 problem extremely difficult to remedy. Variations in programming styles, calculating for the Year 2000 as leap year, and the potential for data corruption from interactions with customers and suppliers dramatically increase the burden of solving a Year 2000 problem.

By any measure, a Year 2000 project is a difficult and costly endeavor. Cost estimates run between $0.35 and $2.00 per line of code.\textsuperscript{41} Furthermore, diversion of resources and software testing increases the expense of the Year 2000 problem.\textsuperscript{42} Large companies expect to pay upwards of $900 million each to become Year 2000 compliant.\textsuperscript{43}

From an accounting perspective, the Emerging Issues Task Force of the Fair Accounting Standards Board has de-

\textsuperscript{40} In "windowing," a programmer might make the program read all years "50" or higher as for instance 1950, and make it read all years "49" and lower as for instance 2049. For a discussion of the application of windowing and some reasons for its selection, see Ingram Book Group Web Site Y2K Information Center (visited Feb. 28, 1999) <http://www.ingrambook.com>.

\textsuperscript{41} See Counting the Cost of Year 2000, Computer Finance, March 1, 1996.


\textsuperscript{43} See Marcia Stepans, Y2K Is Worse than Anyone Thought, BUS. WK., December 14, 1998, at 38, 39.
clared that companies accounting according to generally accepted accounting principals should expense costs of fixing the problem as they occur rather than capitalizing the estimated costs over a number of years. Accordingly, project funding and division of financial responsibility among the software vendor, the company, and the insurer are major issues in Year 2000 problems.

III. STRATEGIES FOR DEALING WITH THE PROBLEM

As complex as it may be, an organization can solve or significantly mitigate its Year 2000 problem. However, success requires a focused, comprehensive, time consuming, organization-wide strategic plan. There are consultants who will help an organization develop such a plan. There are also excellent written materials that set out procedures to discover and attack a Year 2000 problem. The General Accounting Office (GAO), for instance, has developed a five-step process.


47. Those five steps are: 1) Developing Awareness—defining the problem and getting executive level support and sponsorship; 2) Assessment—determining the impact of the problem on the enterprise; 3) Renovation—conversion, replacement or elimination of the problematic platforms, applications, databases and utilities, and modification of the problematic interfaces; 4) Validation—testing to verify and validate the converted or replaced items; and 5) Implementation—implementation of the converted or replaced platforms, applications, databases, utilities and interfaces, and implementation of any contingency programs. See id.
These plans emphasize two elements that should be included in any organization’s strategy. The first is speed. Organizations that have not begun a Year 2000 transition project must begin immediately. Even organizations well into the process will likely encounter serious time constraints to meet the millennium deadline. 48

The second critical element of the strategic plan suggested by all of these experts is technological, in that an organization must discover and then remedy any noncompliance. The systems affected extend beyond servers and network equipment; they include databases, interfaces between systems (internal and external), phone systems, security systems, and facilities equipment. 49 An organization must investigate all technical aspects of its business to determine Year 2000 compliance.

A third element of the strategic plan should be a thorough legal audit. This audit should review all contracts and agreements relating to the technological aspects of the year 2000 problem. It should also review insurance agreements, advertising programs, whether officers and directors are faithfully executing their duties in investigating and remediating problems, and other matters. For example, a vendor or supplier of Year 2000 sensitive products might focus on determining any potential legal liability to customers, third parties, and shareholders. In order to decrease risks, an organization might examine: 1) service agreements; 2) distribution and supply agreements; 3) third-party development agreements in which software or databases are bundled or incorporated; 4) maintenance and support arrangements; 5) licensing agreements; 6) manuals and booklets; and 7) service and maintenance capabilities. 50 These steps help preserve the organization’s ability to perform by mitigating the problem. They also determine and limit litigation exposure that may arise from the organization’s failure to deliver goods or services in a timely manner.

48. See McAlvany, supra note 18. Incorporating new requirements and design changes takes time, as does the collection of the necessary resources and skills. The necessary testing and inevitable modifications of any potential remedy will take more time yet. See id.


Alternatively, a vendee or user of Year 2000 sensitive products, must focus on its ability to perform and preserve claims against vendors, while limiting liability to third parties such as customers, clients, innocent third parties, and shareholders. It is critical to determine whether the software vendor bears the responsibility for making its applications Year 2000 compliant. Because vendors are unlikely to voluntarily assume responsibility for the Year 2000 problem, an organization should seek legal counsel to determine responsibility for vendor contracts. Vendors’ claims to be Year 2000 compliant should not be blindly trusted. Rather, organizations should create binding agreements to cover the possibility that the vendor’s claims are inaccurate.

An audit of a vendee or user requires that an organization review: 1) purchase agreements for hardware, software, and all essential materials; 2) license and development agreements for software or databases; 3) computer maintenance, support, and service agreements; and 4) accounting and scheduling systems. It is important that the organization solicit written confirmation of certain matters from vendors and other third parties regarding the extent to which they will be affected by the Year 2000, so as to determine the impact on the organization. It is also essential that an organization review advertising, packaging, and promotional materials, to verify that it has not made any commitments it cannot keep. One company was sued because it falsely warranted that its software product would operate into the next century.

Owners and tenants of physical facilities must thoroughly test all building systems, including elevators, security, heat, air conditioning, and fire protection to ensure continued operation after December 31, 1999. In addition, leases or purchase and sales agreements should be reviewed to determine the respective contractual obligations of owners and tenants.

51. For a more detailed discussion of this issue, see infra Part IV.
52. It is essential that a vendee examine all agreements with its critical suppliers. A compliant automated manufacturing line is of no use if the raw material suppliers cannot meet their obligations.
53. This solicitation and its content are discussed infra Part IV.
55. See Peltin, supra note 49, at 9. See infra Part IV.B.
Finally, as part of its legal audit, an organization must review insurance policies to ascertain a realistic assessment of coverage. In some cases, coverage may be limited by an exclusionary provision that could be interpreted to exclude losses due to Year 2000 related failures. In addition, insurance companies are now including specific exclusion provisions for Year 2000 problems. Organizations should consider obtaining Year 2000 insurance, but given the high cost, it is unlikely to be a realistic option.

A fourth element of the Year 2000 strategy deals with disclosure. Regulatory authorities at all levels are promulgating regulations and other directives regarding the Year 2000 problem. The Securities and Exchange Commission (SEC), Federal Financial Institutions Examination Council (FFIEC), Fair Accounting Standards Board (FASB), and others have issued numerous statements and bulletins regarding disclosure, compliance procedures, and mandatory deadlines that bear on the Year 2000 problem. Every organization that comes under the purview of a federal or state agency, or that reports its financial results according to generally accepted accounting principles (GAAP), must conduct a

56. See Stepanek, supra note 43, at 40. The legal aspects of this area are discussed in more detail infra Part IV.C.

57. Insurance issues are discussed in more detail infra Parts IV.F, V.E.

58. Disclosure is discussed in detail infra Part IV.F.

59. See infra Part IV.F.1.

60. The FFIEC, which is composed of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration, has issued a number of inter-agency statements which provide a guideline for facing the Year 2000 problem. As part of the FFIEC’s efforts, the bank regulatory agencies are examining businesses that provide services to banks, savings and loans, thrift institutions, and other entities regulated by members of the FFIEC and will provide the results of those examinations to the federally insured financial institution clients of those services. The bank regulatory agencies also will inspect software vendors that agree to examinations, and where those software vendors consent, the agencies will release the results of the examinations to the service institutions. See Federal banking law reports C No. 1748, at 3. Examination Parity and Year 2000 Readiness for Financial Institutions Act, Pub. L. No. 105-164, 112 Stat. 32 (1998) (codified at 12 U.S.C. § 1811 (1998)), gives federal thrift and credit union regulators the same authority in examining outside contractors as other federal banking agencies have. This law extends to the Office of Thrift Supervision and the National Credit Union Administration the same powers of examination that the regulatory authorities and other parts of the financial institution industry have. See Fed. Banking L. Reports (CCH) ¶¶ 2506, 3008.

61. See infra Part IV.F.2.
thorough review to ensure compliance. In addition, an organization may have common law and state statutory disclosure obligations.

A fifth element of the strategy is the preparation of contingency plans, which are necessary in the event that critical systems or suppliers fail. A contingency plan should specify the steps necessary to minimize the consequences of the failure of any Year 2000 remediation program. The plan should be set out in detail, transmitted to those who will have to carry them out, and should be practiced in advance.

In addition to the five elements discussed, there are three other elements of a strategic plan not generally considered by the technically oriented planner, but that seem central to success. These are 1) avoiding Year 2000 pitfalls in future contractual relationships; 2) preparing for potential Year 2000; and 3) financing the remediation program and any future losses arising from Year 2000 problems. Many organizations have already expended significant time and money in an effort to remedy their Year 2000 problem and will continue to do so throughout the rest of this century. The costs are escalating well beyond what companies budgeted only months ago. For example, AT&T's estimate jumped from $300 million in early 1997 to $900 million in late 1998; Chase Manhattan Corporation's estimate increased from $300 million to $363 million in the span of two quarters. Both the cost of remediation and the likely losses from Year 2000 problems should be estimated. It would also be prudent to establish a reserve for unforeseen expenses and losses.

62. Compliance issues are discussed in more detail infra Part IV.F.2.
63. See infra Part IV.F.
64. See supra notes 46-47.
65. See infra Part IV.E.
68. See id.
69. See id.
Although resolution of the Year 2000 problem at first glance seems best suited for computer engineers and business managers, it seems clear, after considering the varied elements of a strategic plan, that legal assistance is required. Part IV will expand upon the strategies outlined in Part III and will outline some of the ways that a lawyer can add value to the remediation process.

IV. LEGAL ASPECTS AND THE ROLE OF LEGAL COUNSEL PRIOR TO LITIGATION

Lawyers will surely play a major role when Year 2000 problems are litigated. However, legal experts can play a productive and important role before then by carrying out due diligence; reviewing leases and other physical facilities agreements; determining Year 2000 compliance by third parties; documenting the review process in an effort to avoid liability; drafting contract representations, covenants and indemnities; and preparing securities law, accounting, and other disclosures.

A. Internal Due Diligence

The SEC requires certain companies to disclose their own Year 2000 compliance, the fact that third parties may not be Year 2000 compliant, and the impact on those companies of such noncompliance. For such companies, due diligence regarding its own readiness and that of third parties with which it deals is not just prudent business, it is a legal requirement. However, whether required or not, organizations should catalog and review licenses, agreements, contracts, and warranties relating to both hardware and software, paying particular attention to relevant representations, warranties, covenants, and limitations of liability.

These steps should be performed for three reasons. The first is to ensure that any required disclosures are accurate. The second is to prepare the organization to recover for, or defend against, any claims for actual damages. The third and perhaps most important reason is to find those parties who have a legal responsibility to identify, solve, and pay for Year 2000 problems. Once those third parties are found they

70. See infra Part IV.F.1.
can be required to help remediate the problem.\textsuperscript{71}

B. Physical Facilities

Office buildings, apartment buildings, shopping centers, warehouses, factories, hospitals, museums, airports, and many other types of buildings and facilities depend upon computers, microchips, and other data processing devices. Therefore, these facilities will almost certainly be affected by Year 2000 problems.\textsuperscript{72}

Owners or lessees may not be aware of all the uses of computers and microchips in a facility, and should contact suppliers and vendors of fire, security, environmental and other systems to determine the status of their systems Year 2000 compliance.\textsuperscript{73} Any contracts related to such systems should be analyzed to determine if there are warranties or other provisions for the allocation of costs and risks. Effort should be made to get additional representations and warranties from the manufacturer or the vendor of the systems, but even with such a representation or warranty, the system

\textsuperscript{71} The GAO recommends that a contract specialist be a part of the audit and contract review team and emphasizes the need for legal advice. \textit{See GAO Conversion Model, supra} note 46. As part of the step that the GAO calls validation—the testing to verify and validate modified or replaced items—the GAO suggests that testing be complemented by a careful review of warranties and guaranties. \textit{See id.} If a system does not work, such a review will tell the organization what recourse it has to third parties.

\textsuperscript{72} An organization should list all such computer systems and their functions. In an office building, for instance, the heating, ventilating, and air conditioning systems, generators, and CO\textsubscript{2} monitoring systems are controlled by computers that must turn on and off on schedule. Most modern security systems and fire alarm systems have computer processors at their core. Elevators are computer-operated according to schedules and their maintenance schedules may be dependent upon computers. Lighting and telephone systems may be computer driven as well. Key card and other access systems are date and time sensitive. In some cases, more mundane operations such as fire control systems may not operate. While the failure to operate within a day or a week of the Year 2000 may not in most cases be a problem, a fire on such a day could be disastrous.

\textsuperscript{73} The Public Building Service of the U.S. General Services Administration is assessing the Year 2000 condition of its buildings across the United States. It has identified building components that may be impacted by Year 2000 issues and has contacted vendors and manufacturers. It has established a website listing the systems and reporting the responses of the suppliers of over 129,000 products by system name and manufacturer. \textit{See Public Building Service of the U.S. General Services Administration} (visited Dec. 16, 1998) <http://y2k.lmi.org/gsa/y2kproducts/search.htm>. This website is a good source for the types of building systems that may be at risk.
should still be tested to ensure compliance. Moreover, the manufacturer should come to the facility to carry out its own tests where possible. If the system is not compliant and a representation or warranty is not forthcoming, legal steps that may be taken against the owner should be considered. However, if the service provider does not satisfy the owner, the owner may have a duty to mitigate or solve the problem and seek recovery at a later time.\

Lease agreements should be analyzed to determine if they allocate the responsibility for testing, the burden for replacing, or the cost of any loss or damage arising from Year 2000 noncompliance. Tenants clearly have a right to seek the landlord's assurances that the premises are compliant. Most leases contain provisions that protect the landlord from liability for service interruption, including the interruption of environmental, security, alarm, and elevator services. The lease may contain specific provisions relating to abatement of rent in the event of termination of services. Although some legal theories support a tenant's claim for a failure of the building to properly operate or provide a safe environment, most leases place the risk of the facility's failure to operate on the tenant. Landlords are responsible for damages or li-

---

74. Section 350 of the American Law Institute's Second Restatement of the Law of Contracts states that damages in a contract action are not recoverable for losses that a party suffers if that party could have avoided them without undue risk, burden or humiliation. RESTATEMENT (SECOND) OF CONTRACTS § 350 (1979). As a proviso, the Restatement adds that the injured party is not precluded from recovering damages to the extent that it makes reasonable but unsuccessful efforts to avoid the loss. Id. The rule reflects the policy of encouraging the injured party to attempt to avoid the loss. 75. See e.g., Barkett v. Brucato, 264 P.2d 978 (Cal. Ct. App. 1953) (negligence theory); Butt v. Bertola, 242 P.2d 32 (Cal. Ct. App. 1952) (negligence theory). In Becker v. IRM Corp., 698 P.2d 116 (Cal. Ct. App. 1985), overruled by Peterson v. Superior Court, 899 P.2d 905 (Cal. 1995), the California Supreme Court held a residential landlord strictly liable in a tort action for injuries sustained by a tenant from a latent defect in the premises that existed when the premises were leased to the tenant. Two California appellate cases have held that this analysis does not apply to commercial leases but the issue has not been decided by the California Supreme Court. See Hahn v. Superior Court, 3 Cal. Rptr. 2d 502 (Ct. App. 1991); Muro v. Superior Court, 229 Cal. Rptr. 383 (Ct. App. 1986). 76. For instance, the form lease contained in the California Continuing Education of the Bar's guide to commercial real property lease practice contains several such clauses. The form section on provision of utilities and services states that in a free standing building or multi-tenant commercial retail building the tenant will provide its own services. MICHAEL A. DEAN ET AL., 3 COMMERCIAL REAL PROPERTY LEASE PRACTICE § 3.69 (1976). In other multi-
ability arising from negligence, provided there is a duty to correct a problem. Most landlords will want to remedy the problem in order to preserve the integrity of the building, but should also do so to avoid liability.

Parties should look to the lease to determine whether the cost of capital improvements and repairs will be paid by the landlord or shared by the tenant. Extensive testing for Year 2000 compliance will be required. However, the lease may be silent as to who must pay for the cost of testing. Landlords will want to treat the cost of testing and compliance as operating expenses, in which case, the tenant would probably bear its allocated portion of the cost. Likewise, tenants will argue that these are capital expenses, especially if the lease does not require the tenant to pay its portion of such capital expenses. However, a lease may require such capital expenses to be amortized and require the tenant to share part of the cost.

77. Maintenance expenses are deductible if they are for the purpose of keeping the premises in operating conditions and do not materially increase the useful life of or value of the asset. See Treas. Reg. § 1.162-4 (1999). Those expenditures are often allocated between the landlord and the tenant or are paid on a percentage basis by all of the tenants in a commercial building. Capital expenditures are expenditures that result in a permanent improvement or betterment of the asset. See id. Such an expenditure has, or is given, a useful life of longer than a year. See id. Such expenditures are usually the responsibility of the landlord in a commercial situation. That is the reason that the tenant would probably argue that the expenditure is capital in nature. See infra Part IV.G for a discussion of tax treatment once the parties have decided who is responsible for paying the expenditures.

78. When the organization is buying or leasing new property or premises,
C. Due Diligence to Determine Compliance by Third Parties

An organization should undertake due diligence in evaluating the Year 2000 compliance of third parties upon whom it materially relies. The nature of the due diligence obviously depends upon the nature of the organization. In addition, the company may have computer systems that interface with others such as payroll providers that are directly linked to its computer systems. Interfaces need to be identified and legal and preventive measures need to be taken regarding passing or receiving data that is not Year 2000 compliant.

A business cannot fully evaluate its own Year 2000 risk until it assesses the Year 2000 compliance of its material customers and suppliers. The FFIEC has recognized the importance of investigating third parties. It recommends that organizations 1) identify all third parties who may represent material Year 2000 related risks, 2) evaluate the preparedness of the third parties, 3) assess the aggregate year 2000 risk to the organization's business, and 4) develop appropriate controls to manage and mitigate the risk.

Lawyers can help prepare a standard set of questions or forms to deliver to third parties asking for information and

79. Depending on the type of business, an organization should question its suppliers of raw materials (if it is a steel manufacturer, will it be able to depend on suppliers of raw materials or electric power; will a computer manufacturer be able to rely on its chip makers); its vendors and service providers (if it is a retailer, will it receive its inventory from its suppliers); its shipping and transportation companies (if it is a supermarket chain, will it be able to depend on railroads and truckers to deliver goods on a timely basis); its sources of information (if it is an investment bank, will it be able to depend on financial markets, news and wire services, and telecommunications companies); its sources of government payments (if it is a hospital, will it be able to receive timely and accurate payments from Medicare, Medicaid, and insurance companies); and its sources of financial services (if it is a multinational company, will it be able to transfer funds domestically or abroad).

80. See GAO CONVERSION MODEL, supra note 46.

81. See Federal Financial Institutions Examination Council Interagency Statement (Mar. 1, 1999) <http://www.ffiec.gov/y2k/impact.htm> [hereinafter FFIEC Interagency Statement]. In this statement, directed primarily at banks and others in the financial industry, the FFIEC outlined a program for dealing with funds takers, funds providers, and capital market and asset management counter-parties. Id.

82. See id.
seeking representations or certifications regarding Year 2000 compliance. The questions should elicit complete and informative responses and should be binding on the respondents. Once the risk is assessed, the organization can develop appropriate strategies and controls to manage and minimize the risk.

The first step in managing and controlling the risk is to review existing contracts and other materials relating to the relationships with material third parties. Such contracts may contain terms that were not intended to cover the Year 2000 problem when they were drafted, but may be applicable nonetheless. The contract could contain representations or covenants that a product or a service will meet certain standards. It could allocate the responsibility for correcting the problem or it may provide for payment of costs or damages. It could also provide the basis for an action requiring correction.\(^{83}\) The organization should also review its insurance contracts to discover whether they could provide corrective relief or recovery for damages.\(^{84}\) The organization and its counsel should use information garnered through such due diligence to prepare binding certifications or representations to be signed by third parties. These serve several useful functions. First, they identify third parties unwilling to sign such a certification and provide early warning of potential problems. Second, if the third party does sign such a certification, the burden of loss may be shifted to the third party. Finally, if a certification is negotiated and discussed in detail, responsibilities can be reviewed and allocated.

If possible and practical, the organization should bind the third party to a written agreement that goes beyond a representation or certification. The provisions of that agreement should be based on subjective circumstances, but might include some or all of the following terms: 1) the third party's covenant to carry out its own due diligence and to complete remediation; 2) the third party's agreement to disclose future plans and problems relating to the Year 2000 and to make periodic reports to disclose its progress in carrying out such remediation; 3) the third party's granting the organization

---

83. Several actions have already been undertaken, albeit unsuccessfully, by organizations against providers in an attempt to force corrections or recover costs or damages. See infra Part V.E.

84. See infra Part V.C for a discussion of insurance coverage.
permission to make periodic audits of the third party to study its status and progress; 4) the organization's right to terminate or modify existing agreements in the event of the third party's failure to remediate; 5) a shift of the costs of remediation or damages to the third party in the event of a failure or a loss; 6) a grant of security to support contractual obligations; and 7) a tolling of the statute of limitations at least until a problem has been discovered.

The FFIEC suggests that once an organization has identified and assessed a problem, it should control the problem through the development and implementation of a mitigation program. If third parties are not and will not be Year 2000 compliant, they should be replaced with parties that will be, if to do so would not result in significant cost to the business. If third parties are not compliant, but are willing to correct the problem, the organization can, through contract or otherwise, request the third party to remediate the problem and report on its progress. The parties can allocate responsibilities and costs of correction before problems arise.

In an innovative example of mitigation, a number of companies have agreed to arbitrate, rather than litigate, any disputes that might arise. Such agreements may affect or eliminate a company's rights to collect damages from its insurance carriers and must be crafted carefully. But this is a good example of using a legal mechanism to mitigate the results of potential Year 2000 problems.

D. Documenting the Process

In the course of setting up procedures for reporting, disclosing, and preparing for litigation relating to Year 2000 problems, thought must be given to the key matter of documentation. A well-documented review and remediation process would appear necessary to prepare disclosures and financial statements, prepare for litigation, monitor progress, and demonstrate an organization's good faith efforts to comply with legal or regulatory requirements. Such documentation could provide a defense to many causes of action, including fraud, misrepresentation, and negligence. This is important

85. See supra note 60.
86. See discussion infra Part V.F.8 and accompanying notes.
87. See infra Part V.
THE YEAR 2000 PROBLEM since even exhaustive testing may not ensure compliance. However, it is important to recognize that if an organization's efforts do not comply with the requirements or for some other reason create liability, the documentation process may create a discoverable paper trail of damaging information.

Legal counsel should be involved in decisions regarding the extent, form, and content of an organization's documentation efforts. Such decisions are often based largely on how to best avoid liability. These decisions must be made in the context of common law, SEC disclosure requirements, and other reporting requirements. Once the decision to document has been made, counsel should be involved in the preparation of forms for reporting, and should review reports for thoroughness and accuracy. Counsel should also assist in decisions as to whether the documentation should be retained to support claims of good faith remediation efforts, and how such documentation should be distributed.

E. New Transactions

Legal counsel should ensure that an organization is protected when entering into any new transaction or relationship relating to or dealing with the Year 2000 problem. Protections include representations that the other party is and will remain Year 2000 compliant. For any new contracts, counsel should obtain a contractual agreement to extend the statute of limitations to a time after damages may be discovered. At the same time, counsel should insure that the organization has enough time to discover the damages and either bring an action or negotiate a resolution.

Once an existing system is upgraded, it must be tested. This is a time consuming process and users often find the repair work is strewn with errors. Therefore, when contracting for consulting work to remedy Year 2000 problems, an organization should prepare written contracts that include written representations as to the quality of the work con-

88. Organizations that document or publicly disclose information on their websites or otherwise must be aware that this information later could be used to support claims of fraud, breach of contract, defamation, or shareholder litigation. To some extent this risk is mitigated by the Year 2000 Information and Readiness Disclosure Act. See infra Part VI.A.
89. See infra Part IV.F.1.
90. See supra note 60.
tracted. Specifically, the contract should contain covenants and warranties that will force the outside entity to repair any shortfalls, and to bear the risk of damages. An organization should explore whether insurance will cover the risk. In any case, the organization should confirm that the consultant has the financial strength to comply with the warranties.

When preparing new contracts or licenses relating to computer hardware, software or any other electronic equipment, Year 2000 compliance should be a central issue of negotiation and should be addressed in detail. Representations, warranties, and covenants should be clear and the obligations for any repairs clearly set forth. The computer item should be subject to objective testing in a live operating environment to determine compliance.

A merger or acquisition presents a unique case in which the problems of a third party or the other party in the merger or acquisition can become those of the organization. Representations, warranties, and covenants in the agreement should include provisions as to all practicable Year 2000 matters. Covenants of material third parties should be obtained requiring third parties to resolve any problems. Measures should provide, where possible, for adjustments to the purchase price or payments of damages in the event that Year 2000 problems result after the transaction is concluded. The organization must be careful to do due diligence as to its own internal matters and to be accurate in its own disclosures. It should also attempt to obtain disclaimers or other protection in the event a problem does arise in the future. Counsel should carefully consider the question of the survival of representations for any period after the closing.

91. An organization should consider written agreements with its business partners to deal with the cost of preventing the problem. An anticipatory business contract that allocates the cost of prevention and then allocates or limits the damages is preferable to incurring the damages and then litigating.

92. Insurance may play a significant role in the allocation of losses associated with the Year 2000 problem. It is imperative that companies check all current insurance policies to determine whether losses related to the Year 2000 problem are covered. In addition, it is important when negotiating new policies that companies be aware of this issue, especially when reviewing exclusion provisions in each policy. Insurance issues are dealt with in greater detail infra Part V.C.

93. This is often not a possible practicality in the event of a transaction between public companies in which the price is rarely, if ever, subject to post closing adjustments.
F. Disclosing and Accounting for the Risk

An important legal aspect of the Year 2000 problem relates to the extent of Year 2000 disclosure in public reports, financial statements, and other communications. The SEC has taken several steps to require and encourage disclosure. Groups regulating financial audits and reporting have both recent and long established promulgations that require disclosure of Year 2000 matters in financial statements. 94


Full and fair disclosure of matters material to investors is mandated by the Securities Act of 193395 and the Securities Exchange Act of 1934.96 The SEC usually relies on the general framework of the securities laws and its regulations to encourage disclosure. However, in the case of the Year 2000 disclosures, the SEC decided to provide “more extensive guidance,” following a determination that many companies were not providing the quality of detailed disclosure that investors expected.97 Furthermore, the SEC noted that it intended “to intensify” its efforts to “elicit meaningful disclosure” about Year 2000 issues.98

This “more extensive guidance” focused on three areas: 1) whether a company’s Year 2000 matters are known material

---

94. A survey of statutory and common law theories requiring disclosure of possible or actual Year 2000 problems is beyond the scope of this article. However, one should consider state securities registration and antifraud statutes, see, e.g., CAL. CORP. CODE, §§ 25000-25707 (West 1999), the duty not to make misleading or incomplete statements, see California Service Station v. American Home Assurance Co., 73 Cal. Rptr. 2d 182 (Ct. App. 1988), the duty to disclose where the parties stand in some confidential or fiduciary relation to one another, see Byrum v. Brand, 268 Cal. Rptr. 609, 617 (Ct. App. 1990), the duty to disclose when the circumstances are such that the failure to disclose would violate a standard requiring conformity to what the ordinary ethical person would have disclosed, see W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 106, at 739 (5th ed. 1984), the implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement, see Crisci v. Security Insurance Co., 426 P.2d. 173, 177 (Cal. 1967), and intentional misrepresentation or fraud, see Randi W. v. Muroc Joint Unified Sch. Dist, 929 P.2d 582, 591 (Cal. 1997).
97. SEC Release, supra note 6, at 80,723.
98. Id.
events, trends, or uncertainties that should be disclosed in the Management’s Discussion and Analysis of Financial Condition and Results of Operation (MD&A) section of the company’s disclosure documents; 2) Year 2000 financial statement considerations; and 3) requirements under other rules and regulations. The SEC stated its belief that a company must provide Year 2000 disclosure in the MD&A if: "(1) its assessment of its Year 2000 issues is not complete, or (2) management determines that the consequences of its Year 2000 issues would have a material effect on the company’s business, results of operations, or financial condition, without taking into account the company’s efforts to avoid those consequences."

The Release stated that a company’s “assessment” is not complete until it has 1) considered whether third parties with whom it has a material relationship or that could cause a material impact are Year 2000 compliant; 2) taken “reasonable steps to verify” the readiness; and 3) has considered its own liability to third parties. In order to determine whether the consequences are “material,” the company must evaluate its exposure on a “gross” basis, assuming (absent clear evidence of readiness) that it will not be Year 2000

---

99. The purpose of the MD&A is to allow investors to see the company from the point of view of the company’s management by giving those investors a short and long term analysis of the company’s business, with an emphasis on the future prospects of the company. MD&A requires information regarding liquidity, capital resources, results of operations, and other items related to the company’s financial condition and changes in financial condition. See id. at 80, 727. Item 303(b) of Regulation 5-B, 17 C.F.R. § 229-303(b) (1998), sets out the MD&A requirements for interim reports. See also Management’s Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosure, Exchange Act Release No. 6835, [7 Financial Reporting, Finding Lists, Case Table] Fed. Sec. L. Rep. (CCH) ¶ 72,436, at 62,143 (May 18, 1989).

100. See SEC Release, supra note 6, at 80,727.

101. See id. at 80,731-32.

102. See id. at 80,733.

103. Disclosure of Year 2000 problems in disclosure reports raises problems relating to so-called forward-looking information. The SEC recognized this problem in the Release and went so far as to provide interpretive guidance relating to application of the safe-harbors for forward looking information set out in the Private Securities Litigation Reform Act of 1995. The SEC said that most Year 2000 disclosures would fall within the statutory safe harbors that apply to forward-looking statements. See SEC Release, supra note 6, at 80,726.

104. SEC Release, supra note 6, at 80,728.

105. Id.
compliant. As part of this analysis, the company must assume that third parties will not be ready unless they have delivered written assurances that they expect to be compliant in time. Additionally, the company must measure and report the consequences if it is not prepared, rather than the amount of money the company has spent or will spend to address the matter.

If the company has a disclosure obligation, what information should it disclose? Although the SEC clarifies that the decision about what to disclose is subjective, and depends on the circumstances of the company, the SEC believes that four categories of information should be disclosed in the MD&A, prospectuses, annual reports to shareholders, and periodic reports contained in Forms 10-K and 10-Q. These are: "1) the company's state of readiness; 2) the cost of addressing Year 2000 issues; 3) the risks of Year 2000 issues; and 4) the company's contingency plans." The SEC makes it clear that the disclosures should be specific, should be quantified to the extent practicable, and should avoid generalities and boilerplate disclosure. It warned that providing the minimum disclosure set forth may not be enough to meet disclosure obligations.

The Release included suggestions to help companies meet their disclosure obligations. With respect to readiness, the company should first describe its Year 2000 issues so that

106. See id.
107. See id.
108. See id.
109. A company is a "reporting" company because it has registered a class of equity securities under Section 13(a) of the Securities Exchange Act, 15 U.S.C. § 77a (1998), or because it has registered an offering of securities pursuant to Section 15(d) of the Act. Reporting companies are required to file with the Securities and Exchange Commission an annual report on Form 10-K, which must be filed within 90 days after the end of the company's current fiscal year. See 17 C.F.R. § 240-13a-1 (1998). Reporting companies in most cases also must file with the Securities and Exchange Commission a quarterly report on Form 10-Q, which must be filed within 45 days of the end of each of the company's first three fiscal quarters. See 17 C.F.R. § 240-13a-13 (1998). No 10-Q report is filed for the fourth quarter. The 10-K contains a description of the company's business, its properties, legal proceedings, financial information and other matters. The 10-Q contains financial, management, legal, and other company information relating to the reporting period.
110. SEC Release, supra note 6, at 80,729.
111. See id.
112. See id. at 80,731.
investors can fully understand the "challenge" to the company. The description would generally include 1) information technology and non-information technology systems; where the company is in the process of becoming compliant, the phases of preparation, and the estimated timing of the completion of each phase; and 3) a description of the company's issues relating to those third parties with whom the company has a material relationship, discussing the nature and level of importance of the material relationships and the status of the assessment of third party risks.

Regarding the costs to address the Year 2000 problem, the Release stated that a company must disclose the material historical and estimated cost of remediation, including the replacement cost of non-compliant information technology systems, unless such systems were to be replaced at the time anyway.

What may be most alarming to investors and perhaps most informative as well, is the requirement that companies include "a reasonable description of their most reasonably likely worst case Year 2000 scenarios," including estimated material lost revenues. If the company cannot answer these questions, it must disclose such uncertainty, the efforts it has made to analyze the uncertainty, and how the company intends to deal with it. In describing its contingency plans, the company must discuss how it plans to deal with the most

---

113. The Release carefully avoids the use of the term "Year 2000 problem," preferring the word "issue" or "challenge."
114. SEC Release, supra note 6, at 80,729.
115. The Release referred specifically to non-information systems such as embedded technology and the readiness of any hardware or software products of the company. Id. at 80,729. For a discussion of embedded technology, see supra Part II.A. As the Release pointed out such systems are difficult to assess and repair and only a few companies had addressed such disclosures in pre-Release disclosures. SEC Release, supra note 6, at 80,729.
116. The SEC said that reporting companies should consider the phases—awareness, assessment, renovation, validation and implementation—suggested by the General Accounting Office. Id. at 80,729. See also discussion supra Part III.
117. SEC Release, supra note 6, at 80,730. As an example, the SEC said that if a major telecommunications provider has told the disclosing company of the possibility of a business interruption, the disclosing company also may have to disclose the possible interruption if it will be material. Id.
118. Id.
119. Id.
120. See id.
reasonably likely worst cases, and if a company does not have a contingency plan, it should disclose that fact, whether it intends to create one and the schedule for its creation. The Release points out that the minimum disclosure required by these four categories might not be enough. Moreover, the Release concluded by setting out a number of other rules and regulations that might require disclosure. These rules and regulations relate to disclosures on the following topics: 1) description of business, 2) legal proceedings, 3) material contracts, 4) risk factors, 5) any additional material information necessary to make the required disclosure not misleading, 6) disclosure by investment advisors and investment companies, and 7) disclosures by municipal issuers. Finally, the Release discussed Year 2000 financial statement considerations and auditor responsibilities.

2. Accounting Under Generally Accepted Accounting Principles

Some Year 2000 problems may have to be disclosed in a

---

121. See id.
122. Id. The SEC suggested that companies consider at least the following disclosures:

1) Historical and estimated costs related to Year 2000 issues, including a breakdown of costs to show, for instance, costs to repair software problems and costs to replace systems and equipment.
2) As of the end of each reporting period, how much of the total estimated costs have been incurred.
3) The source of funds for Year 2000 costs, including the percentage of information technology budgets used for remediation.
4) Any other information technology expenditures that have been put off and the effects of such delays.
5) The use of any independent processes to verify and validate the company’s process especially in the testing phase.

SEC Release, supra note 6, at 80,731.
123. Id. at 80,733-36.
127. See Item 503(c) of Regulation S-K and S-B.
129. See SEC Release, supra note 6, at 80,733-35.
130. See id. at 80,735-36.
131. See id.
132. See id. at 80,732. The substance of that discussion is covered in Part IV.F.2.
company's financial statements. These matters are more the realm of the accountant than the lawyer, but those involved in financial management, securities law, acquisitions and mergers, litigation, and certain other fields should be familiar with the accounting rules to be applied.

a. Accounting for the Cost of Modifying Existing Software

A significant portion of the cost of Year 2000 remediation will be in the modification of existing software. How are the costs treated when incurred? Management would usually prefer to amortize them over a number of years. But the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) has issued Accounting for the Costs Associated with Modifying Computer Software for the Year 2000, a guide on accounting for the cost of modifying computer software for the Year 2000. The consensus of the EITF is that "external and internal costs specifically associated with modifying internal-use software for the Year 2000 be charged to expense as incurred," instead of being spread over a number of years. In addition, the EITF made it clear that it would object to the accrual of expected future costs to modify software for Year 2000 problems before those costs were incurred. Much of the substantial costs of Year 2000 remediation will have to be treated as current expenses on financial statements, which will be deducted from current revenues and diminish reported earnings on the company's income statement.

b. Revenue and Loss Recognition, Possible Impairment Issues, and Disclosure Under SOP 94-6

Operating costs expected to result if an organization, vendors, suppliers, customers, or other material third parties

133. See supra Part II.B.
134. EITF 96-14, supra note 44.
135. Id.
136. See id. The guide states that it deals solely with the upgrading of existing internal-use software for the Year 2000 and does not address purchases of hardware or software that replace existing non-compliant software. See id. The EITF does not discuss impairment or amortization issues relating to existing assets. See id.
137. See supra note 66.
are not Year 2000 compliant are recognized only as they are incurred. But how should a company deal with revenues that are affected by, and losses arising from, Year 2000 problems once they are incurred? Existing accounting rules offer some assistance. Software Revenue Recognition, Statement of Position 97-2, offers guidance on the amount and timing of revenue recognition, and arrangements in which certain specific factors may be present, including uncertainty of customer acceptance, customer cancellation privileges, and multiple elements such as upgrades, enhancements, and post-contract customer support. The Year 2000 issue could affect one or more of these factors and could have an unexpected effect on the timing of revenue recognition. For example, if a vendor licenses a product that is not Year 2000 compliant and commits to upgrade it in the future, the revenue should be split and allocated part to the software and part to the upgrade.

Year 2000 problems may foster product defect liability, product return, or product warranty questions for software or hardware vendors or for those selling products that contain software. FASB Statement of Financial Accounting Standards, Accounting for Contingencies, relates to product warranty or product defect liability issues. FASB Statement No. 48, Revenue Recognition When Right of Return Exists,

138. See SEC Release, supra note 6, at 80,731.
141. Id.
143. See SEC Release, supra note 6, at 80,731.
144. See AICPA Guidance, supra note 142, at 7.
deals with product return issues where products might be returned for failure to be Year 2000 compliant. Issues include whether necessary conditions have been met to recognize revenue in the period of sale, whether revenue should be deferred, or whether an allowance for returns should be established. These are central issues for manufacturers or vendors of noncompliant software or hardware.

If inventories of hardware devices that are not Year 2000 compliant are subject to a loss in value, they are subject to the "lower of cost or market" test. Certain costs a company incurs to produce or purchase software that is to be sold, leased, or otherwise marketed can be capitalized. However, if the software is not Year 2000 compliant and that results in lower than expected estimated future gross sales, the company may be required to write down capitalized software development costs or to accelerate amortization. The Year 2000 problem may also impair long-lived fixed assets containing software or hardware components and capitalized costs of software developed or obtained for internal use that has not been modified to be Year 2000 compliant. Accounting for the Impairment of Long-Life Assets and for Long-Lived Assets to be Disposed of, Statement of Financial Accounting Standards No. 121, offers guidance on evaluating, recognizing, measuring, and disclosing impairment losses for such assets. The Year 2000 problem might also affect the estimated useful lives that are part of the calculation of amortization and depreciation of such assets.

Disclosure of Certain Significant Risks and Uncertain-

147. See SEC Release, supra note 6, at 80,731.
148. See Restatement and Revision of Accounting Research Bulletins, ACCT. RESEARCH BULL. 43, ch. 4, ¶ 8. (June 1953).
150. See id.
152. See FASB Statement No. 121, supra note 151.
ties, Statement of Position No. 94-6 (SOP 94-6) and Accounting for Contingencies, Statement of Financial Accounting Standards No. 5, might require additional financial statement disclosures related to the Year 2000. SOP 94-6 requires that a company disclose any risk or uncertainty of a reasonably possible change in its near term estimates that would be material to the company's financial statements.

For instance, a company should consider the impact of Year 2000 matters on the warranty liability, capitalized software costs, reserves for product returns, inventory, deferred revenues, and litigation. A company may need to disclose payments that it is required to make under contracts or commitments to remediate products that are not Year 2000 compliant, or payments of debts that may be accelerated due to defaults related to Year 2000 issues. Losses that might result from claims of breach of contract or warranty related to Year 2000 noncompliance—whether asserted or unasserted—must 1) be disclosed in notes to a company's GAAP financial statements and 2) be recognized as a liability if those losses are probable and reasonably estimable. Companies selling products with express or implied warranties of Year 2000 compliance may have potential liability that needs to be reevaluated as of the date of each balance sheet. Under Accounting for Contingencies, Statement of Financial Accounting Standards No. 5, a company must disclose potential lawsuits if there is a reasonable possibility of loss or further loss, even if the amount of loss cannot be reasonably estimated.

c. Auditor's Responsibilities

An auditor has the responsibility of planning and performing an audit to determine whether the financial statements are free of material misstatements caused by error or
This includes determining whether data processing errors caused by the Year 2000 issue could result in a material misstatement of the financial statements under audit. The auditor may conclude that the Year 2000 issue could result in a material misstatement of the financial statements under audit. The auditor is not required to disclose the fact that future financial statements may be inaccurate due to a Year 2000 problem. However, should the auditor identify matters that, in the judgment of the auditor, are not reportable conditions, he or she may still choose to communicate such matters.161

G. Federal Tax Requirements

The treatment of Year 2000 related expenditures for federal tax law purposes is not as clear as the accounting guidelines. A taxpayer would prefer that the expenses be treated as a deduction in the current year rather than as a capitalized cost that must be amortized over the useful life of the expenditure. In that way the expense can be deducted from current income and will reduce the tax liability. If the cost must be capitalized, taxpayers prefer the amortization period


161. See COMMUNICATION OF INTERNAL CONTROL RELATED MATTERS NOTED IN AN AUDIT: AUDITING INTERPRETATIONS OF SECTION 325, Professional Standards AU sec. 9325.03 (American Institute of Certified Public Accountants 1997). Auditors must consider a plethora of other requirements and suggestions that are outside the scope of this article. These include Year 2000 disclosures made outside of the financial statements. See OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS, Professional Standards, Vol. 1, AU sec. 550 (American Institute of Certified Public Accountants 1996). For instance, an auditor would also evaluate disclosures that are made voluntarily, those that are required by the SEC, and disclosures made by non-public entities on a voluntary basis. The AICPA recommends that auditors communicate with their clients to detail the auditors' responsibilities in regard to discovery and disclosure of the Year 2000 problems. These communications should include audit engagement letters, management letters and other direct correspondence, discussions with management and the Audit Committee, and brochure and pamphlets. AICPA YEAR 2000 INTRODUCTION, American Institute of Certified Public Accountants. The Audit Issues Task Force (AITF) of the AICPA's Auditing Standards Board, has approved for issuance an interpretation of AU section 3.11 Planning and Supervision, that deals with the Year 2000 problem. In June of 1998, the AITF issued a guidance on the application of Statement on Auditing Standards (SAS) and No. 59, THE AUDITOR'S CONSIDERATION OF AN ENTITY'S ABILITY TO CONTINUE A GOING CONCERN, Professional Standards, Vol. 1, AU sec.341 (American Institute of Certified Public Accountants 1997), relating to the Year 2000 issue.
to be as short as possible in order to deduct the expense as quickly as possible.

A taxpayer usually may deduct from gross income the ordinary and necessary expenses of carrying on a trade or business that are paid or incurred in the tax year.\(^{162}\) However, a current deduction is not permitted for expenditures that are capital expenses. An expense that adds to the value or useful life of property is considered a capital expense and usually cannot be claimed as a current deduction.\(^{163}\) It is deducted through depreciation or amortization over its useful life.

Expenditures that keep property in an ordinarily efficient operating condition and do not add to its value or appreciably prolong its useful life are usually deductible as repairs.\(^ {164}\) The deductibility of an expenditure made in remediating an asset will depend on the facts relating to the asset. The taxpayer should carefully consider and document the effect the remediation has on the operating condition of the asset and whether remediation has increased the value of the asset or appreciably prolonged its life.

Costs of research in the laboratory or for experimental purposes may be currently deducted.\(^ {165}\) It seems unlikely that modification of software is eligible for such treatment as research and experimental costs. However, the costs of developing software, for the taxpayer's use or for sale or lease to others, may be deducted currently or amortized over a five year period, or a shorter period in some cases, so long as those costs are treated consistently by the taxpayer.\(^ {166}\) Thus, new or replacement software placed into service as part of the remediation of a Year 2000 problem might be currently deductible.

V. OTHER LEGAL IMPLICATIONS

The Year 2000 problem has a variety of legal implications. For example, intellectual property attorneys may examine ownership and infringement issues relating to the modification of non-compliant systems. Insurance and tax

\(^{162}\) See I.R.C. § 162 (1998); Treas. Reg. § 1.162-1.

\(^{163}\) See Treas. Reg. § 1.263(a)-1.

\(^{164}\) See Treas. Reg. § 1.162-4.


attorneys may closely watch the effects of any costs associated with remedying a company’s defective software. In the event of a failed transaction, corporate attorneys may examine exposure to officer and director liability, especially where a company fails to remedy a malfunction that should have been anticipated. As awareness about the Year 2000 problem increases within the legal community, the legal implications will likely increase.

A. Intellectual Property

The Year 2000 problem raises numerous intellectual property issues. In its efforts to remedy defective software code, the unwary licensee may fall victim to a copyright infringement trap. The problem arises when software licensors are unable to participate in the remediation project or have ceased operations. Some licensors might simply ignore the problem, especially if the government enacts emergency regulations shielding them from liability. As a result, software licensees might be forced to use in-house staff or outside “fix-it” companies to modify the code. Where source code is unavailable, the object code must be decompiled or reverse engineered. However, the modification of software by a party other than its original author or assignee raises copyright issues, because the U.S. Copyright Act assigns to a copyright owner the exclusive right “to prepare derivative works based upon the copyrighted work.” Many software licenses expressly prohibit the licensee from modifying, decompiling, or reverse engineering the software. Others may simply attempt to rely on the copyright owner’s exclusive right to prepare derivative works based on the underlying software.

The U.S. Copyright Act defines a “derivative work,” in part, as “a work consisting of editorial revisions, annotations,
elaborations, or other modifications which, as a whole, repre-
sent an original work of authorship.

170 The additional matter injected into the prior work must constitute more than a minimal or trivial contribution. It is possible, though unlikely, that Year 2000 modifications may be sufficient to render the remedied software a derivative work in violation of the copyright owner's exclusive rights.

Prudence dictates that a licensee should attempt to obtain the licensor's consent prior to modifying any software code. Licensees who do not succeed in obtaining the licensor's permission may rely on the copyright "fair use" doctrine, or section 117. The fair use doctrine permits the use and copying of a protected work of authorship for limited purposes, such as "criticism, comment, news reporting, teaching, scholarship, or research." A copyright fair use analysis considers 1) the purpose and character of the use, including whether it is for commercial or non-profit educational purposes, 2) the nature of the copyrighted work, 3) the amount and substantiality of the portion used in relation to the work as a whole, and 4) the effect of the use upon the potential market for or value of the work. The likely outcome of this argument is uncertain and will likely be decided on a case by case basis, although there is a strong argument that modifications relating solely to the two-digit annum designation fall within "fair use".

The better alternative is section 117 which addresses the "fairness" of some types of copying and modification of software and which provides in pertinent part:

Notwithstanding the provisions of Section 106, it is not an infringement for the owner of a copy of a computer program to make or authorize the making of another copy or

171. See United States v. Hamilton, 583 F.2d 448 (9th Cir. 1978); Batlin & Son, Inc. v. Snyder, 536 F.2d 486 (2d Cir. 1976).
175. See, e.g., Sega Enters. Ltd. v. Accolate, Inc., 977 F.2d 1510, 1520 (9th Cir. 1992) ("Where there is good reason for studying or examining the unprotected aspects of a copyrighted computer program, disassembly for purposes of such study or examination constitutes a fair use."); see also Adobe Sys. Inc. v. Southern Software, Inc., 45 U.S.P.Q.2d 1827 (1998) (finding that fair use defense failed because copying was intended to avoid license agreement and was unnecessary to determine the unprotectable aspects of the software).
adaptation of that computer program provided:

(1) that such a new copy or adaptation is created as an essential step in the utilization of the computer program in conjunction with a machine and that it is used in no other manner . . . .\textsuperscript{176}

This "adaptation privilege" recognizes the need for limited modifications to render software operable and strikes a compromise between the software copyright owner and the licensee. On the one hand, the adaptation right of section 117 does not deprive the owner from its copyright in the underlying program.\textsuperscript{177} On the other hand, the licensee is entitled to make such limited modifications as are reasonably necessary to render the software functional, which includes fixing Year 2000 problems.

However, in the absence of a source code escrow agreement, a company may have difficulty obtaining the source code necessary to affect new millennium configurations. Therefore, express or implied warranties may need to be invoked to obtain that source code.

B. Director and Officer Liability

The Year 2000 may be problematic for directors and officers. In addition to the daunting task of ensuring that their companies become Year 2000 compliant, they face the threat of potential lawsuits from customers, vendors, and shareholders.\textsuperscript{178} For directors and officers, the significance of the Year 2000 problem will vary depending on the type of corporation. For example, a corporation that neither sells software or products that rely on computers, nor relies significantly on computers in operating their business, may not be at significant risk. In contrast, for companies who rely extensively on computers, such as banks or other financial institutions, failing to be Year 2000 compliant could be disastrous. Similarly, companies that manufacture products that cease to function in the Year 2000 or whose production lines shut down could face a multitude of lawsuits, for everything from

\textsuperscript{178} Corporations should re-examine their directors and officers insurance policies to determine if coverage is adequate given the risks of Year 2000 non-compliance. See Benjamin Love, \textit{Y2K Coverage for Damages, Losses Is Mired in Debate}, DALLAS BUS. J., Nov. 30, 1998, at ¶ 21.
breach of warranty to fraud to product liability. It is for these latter companies and their directors and officers, that the Year 2000 is most troubling and potentially litigious.

Generally, lawsuits filed against directors and officers will take one of three forms: 1) shareholders alleging that the failure to become Year 2000 compliant is a breach of the directors' and officers' duty of due care; 2) lawsuits filed pursuant to state and federal disclosure statutes and regulations due to the directors' and officers' failure to disclose the corporation's non-compliance, or 3) lawsuits filed because an officer or director misrepresented the company's compliance or a product's compliance to another person or entity. Given the real possibility of litigation, companies are advised to reexamine their directors and officers insurance policies to determine if coverage is adequate to cover these risks.

The first type of lawsuit is based on the duty of directors and officers to exercise due care when managing a corporation. This standard of care requires a director or officer to use the degree of care that an ordinary, careful, and prudent person would use given the circumstance, and is for the benefit of shareholders.

An important aspect of this duty of due care is to avoid the potential problems of Year 2000 non-compliance, such as the company's inability to conduct its business or lawsuits filed because of the corporation's failure to be Year 2000 compliant. Moreover, the most common defense used by di-

179. See, e.g., Year 2000 Lawsuits and Arbitrations that Have Been Filed (visited Mar. 1, 1999) <http://www.thefederation.org/Public/Y2K/lawsuits.htm>. Poller v. Micro Focus was filed on Dec. 4, 1998 and alleges violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5. Id. The complaint specifically alleges that the price of Micro Focus' stock was inflated due to "materially false and misleading statements concerning the retention of key personnel critical to the success of the company's North American Y2K products and operations, among others." Id.

180. This duty is generally the same for officers and directors. See Model Act, § 8.42 (1984); CAL. CORP. CODE § 300 (Deerings 1998).


183. An example of the latter is a product that stops working at 12:01 a.m., January 1, 2000 causing injury to a third-party, resulting in either personal, property or business interruption damages. For a more in-depth discussion of possible tort actions resulting Year 2000 non-compliance, see infra Part V.D. An additional example is simple breach of contract.
rectors and officers, the "business judgment rule," may be difficult to assert. In its most basic form, the business judgment rule is a decision by lawmakers that not all poor business decisions should be actionable. While the actual language of this rule varies from state to state, the rules generally are similar in language and effect to Delaware's:

A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of his duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

Plaintiffs will argue that this defense should not be permitted, as directors and officers have a duty to "keep their eyes open." Furthermore, plaintiffs will assert that the Year 2000 problem is not a sudden problem, but rather one that officers and directors have been or should have been aware of for some time.

Moreover, directors and officers may not even have to wait until the Year 2000 to be sued for their breach of the duty of due care. Given the time needed to become compliant, it is certainly foreseeable that stock analysts and related market experts will begin to identify those corporations that clearly will not become compliant by the Year 2000 in early 1999. This may cause a dramatic drop in stock price and,

185. Interestingly, a company in the Year 2000 remediation business, PRT Group, has been sued by its shareholders for allegedly misrepresenting the amount of revenue it would generate fixing Year 2000 defects. See David Schachter, New Cases Emerge to Test Y2K Issues, DENV. BUS. J., Oct. 26, 1998 at A30.
188. Nevertheless, corporations should be on guard, as the lack of awareness among senior executives is surprising. In 1996, the Olsen Corporation conducted a survey of senior executives in North America, finding that approximately 15% were not aware of the Year 2000 problem. See Jeff Jinnett, Legal Issues Concerning the 'Millennium Bug,' 13 COMPUTER L. 16, 17 (1998).
189. Some analysts have predicted that the year 2000 problem will actually begin on January 1, 1999. See Warren S. Reid & Steven Brower, Ten Manage-
consequently, a shareholder lawsuit.

If it appears that the Year 2000 problem will be unresolved by the millennium, directors and officers may be required to disclose this information. Similarly, disclosure may be required if the costs of remediation will have a material impact on the financial condition of the company.

When selling securities, section 12(2) of the 1933 Act requires that any statements in a prospectus or oral communications contain true statements of material facts and not omit any material facts. Similarly, section 10(b) of the 1934 Act and SEC Rule 10b-5 provide shareholders with a civil remedy for the inclusion in a prospectus of "any untrue statement of a material fact or [failure] to state any material fact required to be stated therein or necessary to make the statements therein . . . not misleading." Disclosure of information is based on the materiality standard. A fact is material and must be disclosed "if there is a substantial likelihood that a reasonable investor would consider it important in making a decision to buy or sell a security." Therefore, if the corporation is issuing or selling securities, it may have to disclose Year 2000 non-compliance or remediation costs and its effect on the company.

Additional disclosure requirements for public corporations are found in section 13 of the 1934 Act and in SEC Regulation 5-K. Both provisions include specific reporting requirements for a public corporation's quarterly and annual reports and their financial statements. The Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) requires directors and officers to disclose material information that might render current finan-

191. See, e.g., SEC Staff Legal Bulletin supra note 190.
cial information in a corporation's annual and quarterly reports and financial statements not necessarily indicative of future financial conditions.²⁰⁰

Some state courts have created an additional duty of disclosure.²⁰¹ This duty creates a legal obligation for directors to provide shareholders with material information that a reasonable shareholder would deem important when deciding whether to buy or sell stock.²⁰² While noteworthy, this duty may only arise in the context of a solicitation of shareholder action such as a tender offer.²⁰³

There is no doubt that the failure to become Year 2000 compliant can have serious, adverse effects on the directors and officers of a corporation. Directors and officers could also be subject to liability for their representations to third-parties. A director or officer may be personally sued for fraud for false representations personally made regarding Year 2000 compliance of either the company or its goods and services.²⁰⁴ Furthermore, a particularly ominous and expensive aspect of non-compliance is the shareholder lawsuits that are sure to follow.

C. Organizational Liability for Non-Compliance

The potential litigation resulting from the Year 2000 problem is enormous. For example, a recent survey reported that approximately fifty percent of the companies that will not be Year 2000 compliant will have their computer systems shut down or produce incorrect data by the millennium.²⁰⁵ For each company not in compliance, there exists the risk of litigation. It appears that the most common types of litigation will comprise seven general categories: 1) shareholder litigation,²⁰⁶ 2) lawsuits by purchasers or lessees of computers or software; 3) failure to supply goods or services due to a

²⁰⁵ See Jinnett, supra note 188, at 16.
²⁰⁶ For a discussion of shareholder litigation, see supra Part V.B.
shutdown or error; 4) personal injury lawsuits; 5) lawsuits against Year 2000 consultants; 6) lawsuits against financial and investment institutions; and 7) insurance coverage disputes.

Obvious potential litigants are consumer purchasers or lessees of computers or software that become ineffective in the year 2000. Many lawsuits that involve consumers may be filed as class actions. In fact, the majority of Year 2000 lawsuits filed to date are consumer class actions for allegedly non-compliant software. These claims are and will continue to be made pursuant to state and federal consumer protection laws and laws dealing with unfair and deceptive business practices. As numerous as consumer lawsuits may be, they could pale in comparison to lawsuits filed by companies that purchased or leased non-compliant computers or software.

It is possible the Year 2000 problem will cause production lines to stop, errant or late deliveries, and the production of inferior or defective goods. This will result in lawsuits based on the Uniform Commercial Code (U.C.C.), contract, or tort law. U.C.C. claims will most likely be for breach of express warranty, breach of implied warranty of merchantibility, and anticipatory repudiation of contract. Contract claims will be for breach of contract, rescission, breach of warranty, and breach of the implied duties of good faith and fair dealing. Tort claims will include negligence, fraud and deceit, and product liability.

It is possible, although unlikely, that the Year 2000

---

207. See infra Part V.E.
208. See infra Part V.E.2.
210. For example, a travel agency system could shut down, preventing reservations, tour booking, and access to current reservation information. Unlike the purchaser of consumer software, a company impacted like this hypothetical travel agency may have a financial incentive and the resources to bring suit.
211. See Stepanek, supra note 43, at 38.
212. See CAL. COMM. CODE §§ 2313, 2314, 2610 (Deerings 1998).
214. See Pineville, No. 98-CI-00302, ¶¶ 26-29.
problem will cause significant personal injury or death. Traffic lights, public transportation systems, medical equipment, security systems, and numerous other computer-based machines could all fail, causing injury and death. A single plane crashing due to a Year 2000 problem could spur a multitude of wrongful death lawsuits.\textsuperscript{215}

Litigation against Year 2000 consultants, similar to the cycle often seen in construction litigation is likely. First, there is a boom of activity resulting in quick real estate development. This encourages individuals, often inadequately skilled or trained, to become involved in the construction industry. When the boom stops, problems from rapid development appear, but by this time it is too late. While a claim may be valid, the ability to recover is limited because either the company has disbanded or gone broke.

It is conceivable that a similar cycle will be seen with Year 2000 consultants. Currently, the demand for Year 2000 consultants is strong,\textsuperscript{216} resulting in a dilution of the quality of consultants and sky rocketing remediation costs.\textsuperscript{217} Moreover, the duration of this work is by definition limited, the consultants' perspective short-term, and defects are inherent in software no matter how extensively tested. This is a recipe for both failure and litigation.\textsuperscript{218} Experts estimate that the cost to fix Year 2000 "fixes" will be in the billions of dollars.\textsuperscript{219} It is this fear of litigation that is causing the "Big 5" accounting firms to refrain from providing Year 2000 audit and consulting services.\textsuperscript{220}

\begin{footnotesize}

\begin{itemize}
  \item \textsuperscript{215} For example, suppose this hypothetical airplane crash took place in early 2000 because the replacement parts system was not compliant. Undoubtedly, the airline-company and/or airplane-manufacturer could bring suit against the maintenance-company, which in turn would sue the software-company, who then might sue its insurer.
  \item \textsuperscript{218} One can envision a company returning to work on January 2, 2000, after spending hundreds of thousands or millions of dollars to become compliant, only to find that its system still failed. The costs for repairing the ineffective compliance work, in addition to business interruption costs, could be staggering.
  \item \textsuperscript{219} See Steven V. Bryll, \textit{Then There's the Cost of Fixing the Fixes} \ldots , BUS. WK., Dec. 14, 1998, at 38, 40.
  \item \textsuperscript{220} See Bruce Caldwell, \textit{Few Options for Year 2000 Liability Insurance}, INFORMATIONWEEK (October 26, 1998) (on file with SANTA CLARA L. REV.).
\end{itemize}

\end{footnotesize}
However, the amount of litigation may be tempered due to issues of recoverability and hold-harmless agreements. Because many of these consultants may be short-lived and have limited resources, efforts to recover damages may prove difficult. In addition, a consultant’s service agreement may have hold-harmless provisions, further limiting a company’s ability to recover.

Lawsuits against financial and investment institutions might be the most complex and disquieting of all potential Year 2000 litigation. Banks may shut down for months as they attempt to become compliant. Although banks have been aware of the problem for sometime and are proceeding rapidly towards compliance, even the best of efforts does not guarantee compliance. The problems with investment companies may be just as severe, impeding the ability to buy and sell bonds. Wall Street is also addressing the problem and appears to have succeeded, but again, there are no guarantees. Litigation against these entities may involve lawsuits against investment advisors who recommended investments in companies that lose value due to non-compliance.

In many ways, insurance litigation will be the most interesting and least predictable. Both coverage claims and defenses are sure to be fact intensive, depending in part on the extent of a claimant’s remediation efforts and disclosure of potential Year 2000 problems. The insurance industry’s fear of Year 2000 litigation has led to language excluding Year 2000 coverage from commercial policies. The insurance industry also has created high priced policies to provide Year 2000 coverage.

Business interruption claims are an area ripe for Year 2000 litigation since a consequence of non-compliance may be

221. A hold-harmless agreement is an agreement that one party (i.e., the purchaser of the services) will not hold the other party (i.e., the consultant) liable for any losses or liability occurring from its work. See Matthew Bender, California Forms of Pleading & Practice, V. 25, Ch. 300, at 8, 17 (1998).
224. In fact, as discussed infra Part V.E.4, one insurer has already filed suit seeking a declaration from the court that its insured is not covered under the terms of the insurance policy.
225. See Scott, supra note 50, at 7; Stepanek, supra note 43, at 40.
226. See infra text accompanying notes 249-251.
an inability to conduct business. However, coverage for computer failures may be problematic given the limited scope of protection typically afforded by business interruption policies. Generally, such coverage is limited to catastrophic events such as fire and floods.228 Insurers will argue that the Year 2000 problem was foreseeable, preventable, and not covered under a business interruption policy.229

Claims also will be made pursuant to commercial general liability (CGL) policies. For example, insureds will seek coverage for property damage caused by Year 2000 failures. CGL policies usually limit coverage to "bodily injury" or property damage resulting from an "occurrence" during the policy period. Similarly, coverage usually is limited to sudden or unexpected occurrences. Therefore, insurers will argue, that losses caused by the Year 2000 problem are not sudden or unexpected, since this is a known problem. Not surprisingly, specific Year 2000 exclusions are being inserted into standard insurance policies, much like pollution exclusions after the environmental litigation explosion. Therefore, companies with claims-made policies (as is common) may not be covered when the injury actually occurs.

This raises the issue of when the "occurrence" transpired in order to determine which policy is effective. Insurers will argue that the effective policy is the one in force when damages actually occur. This would most likely be in 1999 or 2000, when policies contain Year 2000 exclusions. Courts, however, may apply the manifestation and exposure triggers used in asbestos and pollution cases to find coverage based on policies that pre-date the actual injury. These policies did

228. See Scott, supra note 50, at 8.
229. See id.
234. Claims-made polices are policies in which coverage is provided for events occurring during the policy term.
not generally contain specific Year 2000 exclusions. Another issue sure to arise is whether data is a "tangible" or "intangible" property. Property damage is defined in insurance policies as physical injury to tangible property. Courts frequently hold that data is not tangible property and is thus not insured. In a first salvo in this expected battleground, the Connecticut State Insurance Department has ruled that unless specifically stated, CGL policies do not cover costs associated with Year 2000 problems.

A seemingly unrelated legal dispute currently before the United States Supreme Court is attracting the attention of the insurance industry. *Kumho Tire Co. v. Carmichael,* is a product liability case in which the insurance industry submitted an amicus brief requesting that the court "apply testimony on the technical issues . . . to the same standards for admissibility principles . . . on scientific issues." The reason for the insurance industry's interest is its desire to have the standard required for the admission of scientific expert witness testimony applied in Year 2000 coverage litigation. The standard is "whether the theory or technique has been tested, subjected to peer review and publication, has a known or potential error rate, and whether it is generally accepted by the relevant scientific community." Issues such as whether a company conducted Year 2000 due diligence will be key in many coverage disputes, and will require expert testimony.

Another type of insurance likely to result in claims is directors' and officers' insurance (D&O) which covers damages resulting from lawsuits against the directors and officers of

---

237. *See Wojcik, supra* note 235.
242. *Id.*
243. *Id.*
companies.\textsuperscript{244} The typical scenario may be a shareholder suit when a company suffers significant losses due to Year 2000 non-compliance. If the directors and officers recognize and make reasonable efforts to remedy the problem, it may be difficult to deny coverage. Nevertheless, given the dollar amounts at stake and the unsettled nature of the issues, insurance companies may make every effort to deny coverage. Likely reasons for denial of coverage include an insurer’s claim that the directors or officers failed to act in a timely manner or failed to disclose or misrepresented the fact that the company would not be compliant by the Year 2000.\textsuperscript{245}

Errors and Omissions (E&O) insurance is liability or malpractice insurance which may provide vendors and consultants with insurance coverage should their software or remediation efforts fail and result in litigation.\textsuperscript{246} E&O insurance may also provide malpractice coverage for lawyers who fail to adequately address the Year 2000 problem in contracts, mergers or acquisitions, or mandated disclosures.\textsuperscript{247}

While most insurance companies now include provisions to specifically exclude Year 2000 coverage, some are actually providing insurance coverage for this problem. Currently, only three insurers provide coverage, and the cost of these policies is so prohibitive that it is unlikely to be widely purchased. These insurance providers are J&H Marsh McLennan (J&H),\textsuperscript{248} AON Risk Services, Inc. (AON),\textsuperscript{249} and AIG.\textsuperscript{250}

\textsuperscript{244} See DCI, supra note 230.
\textsuperscript{246} See id.
\textsuperscript{247} See id.
\textsuperscript{248} J&H coverage is referred to as “2000 Secure.” This policy provides coverage for wrongful acts, business interruption, and “hot site” expenses. Hot site expenses are expenses incurred in “going live with a disaster recovery provider such as SunGuard Recovery Services, Inc. or Comdisco Inc.” Policy premiums range from $1 to $10 million, with coverage up to approximately $200 million. J&H’s 2000 Secure policy requires a thorough audit by the insurer at a cost between $40,000 and several hundred thousand dollars.
\textsuperscript{249} AON’s Year 2000 policy, “ARM2000”, covers business interruption, general liability, D&O, and E&O. Here too, the insured pays a non-refundable premium in exchange for coverage up to $200 million.
\textsuperscript{250} AIG’s Year 2000 policy is “D&O Gold.” See AIG’s American International Companies Introduces New Directors, Officers and Corporate Liability Policy with Year 2000 Coverage (April 23, 1998) <http://www.AIG.com/corpsite/pr1998/04_23_98a.html>. The policy provides coverage for directors and officers for securities, customer contract, and third-party claims relating to the Year 2000. Id. The policy requires the insured to fill out a questionnaire re-
They vary as to the degree of coverage but all require extensive audits and have costly premiums.\textsuperscript{251}

D. Legal Defenses

Many creative defenses are likely to be asserted in Year 2000 litigation. Perhaps the best defense will be a good faith effort at investigating and addressing Year 2000 problems, supported by extensive documentation. It could be argued that because "bugs" are inevitable in computer systems, it is not realistic to assume that every single contingency can be tested. At a minimum, compliance efforts should help to minimize damages and fraud claims.

The statute of limitations may also be a viable defense. If a party knew that the software, computer, or other product that it purchased was not Year 2000 compliant and failed to file suit within the relevant statute of limitations, recovery might be barred. Similarly, the failure to mitigate damages may play a prominent role in much of this litigation. Numerous software or consultant defendants may claim that but for a plaintiff's delay in obtaining a Year 2000 consultant, the plaintiff would have suffered little or no injury (save costs of remediation) because the problem could have been remedied in time. Similarly, defenses are being asserted that the costs to make a program Year 2000 compliant even just a few years ago were greater than current costs to remediate it.\textsuperscript{252} Other defenses may include the state of the art,\textsuperscript{253} assumption of risk,\textsuperscript{254} no real injury, and simply that software generally is not expected to be used for more than a few years.

E. Pending and Settled Litigation

Year 2000 litigation has already begun. Class actions for

\textsuperscript{251} See Scott, supra, note 50 at 11.
\textsuperscript{252} See infra text accompanying note 307.
\textsuperscript{253} See Crispin v. Volkswagenwerk A.G., 591 A.2d 966, 973 (N.J. Super. Ct. App. Div. 1991) ("The state of the art refers to the existing level of technological expertise and scientific knowledge relevant to a particular industry at the time a product is designed.").
\textsuperscript{254} See Baldwin v. Harris Corp., 751 F. Supp. 2, 5 (D.D.C. 1990). The elements of assumption of risk are "actual knowledge and comprehension of a danger caused by the defendant's negligence and the plaintiff's voluntary exposure to that known danger." Id. (quoting Morrison v. MacNamara, 407 A.2d 555, 567 (D.C. 1979)).
non-compliant software predominated the first wave of litigation. However, the second half of 1998 saw the litigation expand to include business-to-business litigation, lawsuits involving consultants, and insurance coverage actions.

1. Produce Palace: The First Lawsuit

The first lawsuit was filed by a grocery store in Michigan state court on July 7, 1997, and settled one year later for $260,000. Produce Palace’s complaint alleged breach of warranty, violation of the Magnuson-Moss Warranty Act, breach of warranty of fitness, revocation, breach of duty of good faith, negligent repair, misrepresentation, breach of contract, and violation of the Michigan Consumer Protection Act. Plaintiff sought damages in excess of $10,000, including damages for repair costs, insurance, a refund of the purchase price, loss of wages, loss of use and profits, attorneys’ fees, costs, and expenses.

Produce Palace alleged that Tec-America’s computer system could not conduct transactions with credit cards containing expiration dates past 1999. Consequently, the system failed or shut down over 100 times in less than two years and required daily rebooting. Although the vendor attempted to service the problem, it could not remedy the problem. Interestingly, Produce Palace also alleged that the daily rebooting permitted its manager access to sensitive financial information that the manager might otherwise not be privy to.

Year 2000 lawsuits generally allege that non-compliant software was sold to consumers or small business within the

260. Produce Palace, No. 97-03330, ¶¶ 33-34.
261. See id. at ¶¶ 12-13.
262. See id. at ¶¶ 11, 16.
263. See id. at ¶ 19.
264. See id. at ¶ 17.
last few years and the vendor has refused to provide a cost-
free remedy for the problem. They further allege that while
the vendor knew or should have known about the Year 2000
defects in its software, the vendor sold and continued to sell
the defective software.

2. Class Action Lawsuits

The first class action was *Atlaz International, Ltd. v. Software Business Technologies Inc.* The complaint alleged
that defendants sold non-compliant software, stating causes
of action for breach of warranty, fraud and deceit, and
fraudulent and unfair business practices pursuant to Californi-


2. Class Action Lawsuits

The first class action was *Atlaz International, Ltd. v. Software Business Technologies Inc.* The complaint alleged
that defendants sold non-compliant software, stating causes
of action for breach of warranty, fraud and deceit, and
fraudulent and unfair business practices pursuant to California Business and Professions Code section 17200. Plaintiffs
sought compensatory damages, disgorgement, imposition of a
constructive trust, impounding or attaching defendants' ill-
gotten monies, freezing defendants' assets, restitution, attor-
neys fees, costs, and expenses. This lawsuit alleged that
the defendants sold non-compliant software in the mid-1990s
and improperly required these buyers to purchase upgrades
to make the programs compliant.

Defendants Software Business Technologies Inc. and its
subsidiary SBT Accounting Systems Inc. (collectively SBT)
develop and sell accounting software entitled “Pro Series” to
small and medium sized companies. It was alleged that on
March 1, 1997, SBT upgraded its non-compliant Pr Series
3.0i with the compliant Pro Series 3.2i, and refused to pro-
vide free upgrades to its 3.0i customers. Plaintiffs' claim
this was a breach of 3.0i’s warranty, which provides that “Li-
censor warrants that the product will operate in substantial
conformity with its written specifications for a period

---


266. Id.


269. See id.

270. See id. at ¶ 20.
of . . . five years after the date of license . . . .  

In addition, plaintiffs alleged that SBT committed fraud by its knowledge of, or reckless disregard for, the Year 2000 problem and the fact that it failed to disclose that its 3.0i software was not compliant. 272 This was also the basis for plaintiffs' claim of fraudulent and unfair business practices pursuant to Business and Professions Code section 17200. 273 Subsequent to the filing of this lawsuit, SBT announced a free patch 274 available to prior purchasers in order to address 3.0i's non-compliance. 275 In addition, SBT asserted it could fix the Year 2000 problem for free, but was never asked to do so by any purchasers. 276

This case settled with SBT agreeing to provide free Year 2000 fixes to their customers and $565,000 in attorneys' fees and costs. 277 While this case does not provide any binding legal precedent, as the first class action to settle, it may provide a framework for future settlements of similar litigation.

Symantec Corporation earned the unfortunate distinction of being the first company sued twice for noncompliance. 278 The two lawsuits, Capellan v. Symantec Corp. 279 and Cameron v. Symantec Corp. 280 allege that Symantec's Norton AntiVirus Software versions sold prior to September 1997 are

271. See id. ¶¶ 30-53.
272. See id. ¶¶ 54-62.
273. See id. ¶¶ 63-69.
274. A patch is a remedy designed to address a specific problem in a program, such as Year 2000 non-compliance.
276. See Nick Budick, Attorneys: This Bugs for You, RECORDER, Feb. 6, 1998, at 1.
277. See id.
278. Symantec is not alone in the defense of multiple lawsuits. Six class actions now have been filed against Intuit. Three of the six cases have been consolidated: Issokson v. Intuit, Rubin v. Intuit, and Colbourn v. Intuit, have been consolidated as In re Intuit, Inc. Year 2000 Cal. Litig. No. 773646 (Cal. Super. Ct. Santa Clara County filed Oct. 9, 1998). The other three cases are Chillelli v. Intuit Inc., No. 98-013559 (N.Y. Sup. Ct. N.Y. County filed May 13, 1998), Stein v. Intuit, Inc. No. 13968 (N.Y. Sup. Ct. N.Y. County filed June 25, 1998), and Faegenburg v. Intuit, Inc., No. 98602587 (N.Y. Sup. Ct. N.Y. County filed May 27, 1998). Each of these lawsuits also allege that the defendant improperly requires the purchasers of its software to pay for upgrades that are Year 2000 compliant.
defective because they are not Year 2000 compliant, and Symantec is requiring owners to purchase upgrades. Supra. Symantec asserts that because anti-virus software requires constant updates, free upgrades are not required. Supra.

In Issokson v. Intuit, Inc., the court granted Intuit’s demurrer in pertinent part because of plaintiffs’ failure to allege any actual defect. Supra. Intuit successfully asserted that any claims of injury were premature, as the Year 2000 was still over a year away and any injuries were hypothetical and speculative. Supra.

On October 9, 1998 plaintiffs amended their complaint to allege injury by claiming that even though Intuit’s Quicken 98 software, a personal financial management application, is currently functional, the software’s prior versions were not, and Intuit’s recent decision to provide free upgrades was too little, too late. Supra. Further, the amended complaint alleges that without judicial intervention, Intuit could rescind its offer of free upgrades at any time. Supra. Similarly, plaintiffs allege that free upgrades do not help those who already paid for the upgrades, which Intuit required its customers to pay for prior to the lawsuit. The complaint also alleges that the upgrades will not be available until the second quarter of 1999, whereas plaintiffs need an immediate fix to the problem. Supra.

Not surprisingly, Intuit filed a demurrer to the amended complaint as well, contending that plaintiffs still have suffered no injury and have been made whole by the upgrade. Supra. On January 27, 1999, the court sustained Intuit’s demurrer without leave to amend as to all of the plaintiff’s causes of action except for unfair business practices. The court held that

281. See Capellan, No. 772147, ¶¶ 9-16; Cameron, No. 772482, ¶¶ 9-16.
286. Id.
287. Id.
the amended complaint still failed to state a "legally-cognizable current injury or damage." It also held "that Intuit's offer of a free fix by the end of the Second Quarter of 1999 negates" plaintiffs' claims for anticipatory breach and adequate assurances. The court did permit plaintiffs to amend their complaint as to its unfair business practices claim, but required the plaintiffs to do so with more particularity, e.g., by alleging Intuit told its customers that the upgrade it provided for a fee was the only one available to remedy the software's Year 2000 problem.

The Supreme Court of New York adopted the reasoning of Issokson v. Intuit, Inc. in dismissing three similar class actions against Intuit—Fagenburg v. Intuit Inc., Stein v. Intuit Inc. and Chilelli v. Intuit, Inc. The court dismissed these lawsuits on the identical grounds that plaintiffs' alleged no economic damage and the defects have yet to manifest themselves. In a class action similar to the Intuit cases, the court in Paragon Networks International v. Malcolm, dismissed plaintiffs' claims on the ground that the licensing agreement between the parties made limited warranties and prospective Year 2000 compliance was not one of them. These cases are significant because they provide the first substantive rulings pertaining to a Year 2000 lawsuit and they indicate that courts may not be receptive to Year 2000 non-compliance claims when no manifestation of the defect has actually occurred.

3. Company Director, Officer, Sued by Vendee for Year 2000 Failures

In the first lawsuit of its kind, a hospital in Kentucky filed suit against a software manufacturer and a director, officer, and shareholder of the software manufacturer for the failure of the hospital information system to be Year 2000 compliant. In Pineville Community Hospital Ass'n v. Keane Inc., plaintiff alleges that defendants misrepresented the

---

290. *Id.*
292. *See id.*
293. No. 98-0119 (Ohio Ct. C.P. filed April 1, 1998).
Year 2000 compliance of its software. The complaint alleges breach of contract, fraud and deception and violation of the implied duties of good faith and fair dealing. Plaintiff’s claim for damages includes punitive damages as to all defendants.

This case is significant because it is the first time a plaintiff has sued a director, officer or shareholder for a Year 2000 failure. Furthermore, since fraud has been alleged, the individual defendants may be subject to punitive damages, which are not covered by insurance. As the Year 2000 draws closer, it is expected that similar lawsuits will become more prevalent. This case should be seen as a warning for companies to make representations carefully and to closely examine their directors’ and officers’ insurance.

4. First Insurance Coverage Action Filed

In what may be the first of its kind, the Cincinnati Insurance Company recently filed a complaint in federal court, seeking to avoid providing coverage of the underlying dispute in Pineville. Cincinnati Insurance is seeking a declaration from the court that it has no duty to defend or indemnify its insured under a general liability policy because no “occurrence is alleged in the Pineville complaint, there is no allegation of ‘property damage’ as defined under the policy,” and because it was a known, rather than fortuitous, loss to one of the defendants, Source Data Systems, Inc. Cincinnati also seeks to recover the defense costs it has already incurred on the insured’s behalf. A decision on the insurance coverage issues will provide valuable precedent for future litigation.

5. Computer Consultant Files Pre-emptive Strike, Wins

295. Id.
296. Id.
297. See id.
298. See CAL. INS. CODE § 533 (West 1998).
300. See id. See also Cincinnati Financial Sues Over Y2K Cover <http://dailynews.yahoo.com/headlines/tc/story.html>.
302. See id.
303. See id.
Arbitration and Settles

Taking the initiative for tactical advantages, Andersen Consulting, LLP (Anderson) filed a declaratory relief action against a former client in an effort to protect its reputation against anticipated fraud claims. J. Baker Inc. (Baker) retained Andersen in 1989 to assist in the selection, design, customization, and implementation of a third-party retail computer software package. The system was fully functional by 1991. In June 1998, Baker sent a demand letter to Andersen alleging that Andersen was negligent, in breach of contract, in breach of the covenant of good faith and fair dealing, and guilty of misrepresentations and of unfair trade practices because the system was not Year 2000 compliant.

Andersen filed suit seeking a determination that J. Baker is barred from seeking relief on the grounds that 1) Baker has sustained no damages because the costs of making its system Year 2000 compliant in 1989-91 would have exceeded the costs of its repairs to date; 2) the statute of limitations on all claims has expired; and 3) Massachusetts’ economic loss doctrine bars recovery. Following non-binding arbitration, the arbitrator ruled in Andersen’s favor, finding that Anderson had met all of its contractual obligations. As a result of the arbitrator’s decision, the parties resolved their differences and dropped all claims against each other. Andersen’s preemptive strike and defenses raise interesting issues that may be litigated in future disputes between consultants and their clients. Furthermore, the arbitrator’s decision provides an early indication of how courts may address similar claims.

6. Licensee Sues Licensor Because It Cannot Meet Federal Banking Regulations

Anticipating the disruption of its business and the inability to meet Federal Bank Regulation requirements regarding Year 2000 compliance, a large credit card processor

305. See id.
306. See id.
307. See id.
308. See id.
309. See id.
filed suit against the licensor of a customer retrieval and charge back dispute software system due to the system's failure to be Year 2000 compliant. The complaint in *SPC, Inc. v. NeuralTech, Inc.* alleges that NeuralTech is in default under the representations and warranties made in its contract with SPC. Specifically, the complaint alleges that the system is not Year 2000 compliant, the representations and warranties were false and misleading when made, that NeuralTech failed to correct problems as required under the contract, and refused to provide required upgrades, constituting an anticipatory repudiation of the contract. Interestingly, SPC asserts that not only will it be financially harmed by the system's failure to operate properly, but these failures, if not remedied, will cause SPC to violate Federal Banking Regulations as to Year 2000 compliance. SPC sought a temporary restraining order and a preliminary and permanent mandatory injunction enjoining NeuralTech from ceasing to provide maintenance and support for the system and from failing to provide updates to its software or to provide its new release.

7. *Year 2000 ADR Agreement*

Fearing an explosion of Year 2000 litigation, twelve large companies have signed a pledge to resolve their Year 2000 disputes through negotiation, and if unsuccessful, through non-binding mediation. This pledge encompasses all stages of disputes from fixing the problem to insurance coverage. The sponsor of this pledge, CPR Institute for Dispute Resolution, is actively seeking to increase the number of signatories to 5,000 by March 1999.

---

311. Id. ¶ 6-7.
312. Id.
313. Id.
314. See id.
316. See id.
317. See id.
8. Governmental Litigation

A development worth watching is the proposed class action announced by Mike Easley, North Carolina's Attorney General. On January 29, 1998, Mr. Easley issued a press release stating that he is considering a $132 million lawsuit against computer companies for the costs associated with the repair of non-compliant multi-million dollar computer systems.\(^{318}\) The essence of his claims is that these companies sold systems they knew were non-compliant and failed to disclose this information.\(^{319}\) The damages sought are costs incurred by North Carolina to become Year 2000 compliant.\(^{320}\) California also is considering a similar lawsuit.\(^{321}\)

VI. LEGISLATIVE INITIATIVES

The impending and immovable January 1, 2000 deadline has led to a flurry of recent legislative activity.\(^{322}\) The legislative initiatives generally take one of three forms: 1) private limitations of liability; 2) public immunity; or 3) efforts to ensure governmental compliance.

A. Private Immunity

The most important legislation enacted to limit private liability is the Year 2000 Information and Readiness Disclosure Act.\(^{323}\) While it does not limit liability for Year 2000 defects, it does provide limited immunity for statements made addressing a company's Year 2000 capabilities, product or service capabilities, or readiness. The goal of this Act is to encourage the disclosure and exchange of information about the Year 2000 problem by providing limited protections to the maker of a "Year 2000 Statement" or a "Readiness Disclosure."\(^{324}\)

\(^{318}\) See ITAA Year 2000 Home Page, supra note 282.

\(^{319}\) See id.

\(^{320}\) See id.

\(^{321}\) See Budnick, supra note 276, at 1.

\(^{322}\) See ITAA Year 2000 Home Page, supra note 282.


\(^{324}\) On January 19, 1999, Senator John McCain (R. Ariz.) introduced a bill that would limit liability in Year 2000 lawsuits to actual damages. McCain's Bill Limiting Y2K Liability Also Would Permit Good Faith Defense, BNA YEAR 2000 MONDAY MEMO, Jan. 25, 1999, ¶ 3. The bill limits losses to actual losses so as not to punish defendants who have made good faith efforts at remedia-
The Act protects the maker of a Year 2000 Statement\(^\text{325}\) (Statement) by requiring a plaintiff bringing an action based on an allegedly false, inaccurate, or misleading statement, to show by clear and convincing evidence that the Year 2000 Statement was material and made "with actual knowledge that the year 2000 statement was false, inaccurate, or misleading... with [the] intent to deceive or misleading[,] or with a reckless disregard as to the accuracy of the year 2000 statement."\(^\text{326}\) The same standards apply if the Statement was republished. The only exception is that instead of "reckless disregard as to the Statement's accuracy," the standard is the maker's failure to include notice in the Statement that either "the maker has not verified the contents of the republication... or... the maker is not the source of the republication and the republication is based on information supplied by another person or entity identified in that year 2000 statement or republication."\(^\text{327}\) If the claim is for defamation, trade disparagement, or another similar claim, the same standards apply except that the plaintiff is not required to prove the Statement was material.\(^\text{328}\)

The second major component of the Act is an evidentiary

---

Id. Additional noteworthy features include the following: (1) a notice requirement for plaintiffs to provide the defendant an opportunity to fix the problem; (2) a limitation on damages that could be awarded; (3) no joint liability among defendants; and (4) protections for retailers without expertise in technology who sell products with Year 2000 defects. Id.


The term "year 2000 statement" means any communication or other conveyance of information by a party to another or to the public, in any form or medium—

(i) concerning an assessment, projection, or estimate concerning year 2000 processing capabilities of an entity, product, service, or set of products and services;

(ii) concerning plans, objectives, or timetables for implementing or verifying the year 2000 processing capabilities of an entity, product, service, or set of products and services;

(iii) concerning test plans, test dates, test results, or operational problems or solutions related to year 2000 processing by—

(I) products; or

(II) services that incorporate or utilize products; or

(iv) reviewing, commenting on, or otherwise directly or indirectly relating to year 2000 processing capabilities.

Year 2000 Information and Readiness Disclosure Act § 3(11).


protection for "Year 2000 Readiness Disclosures (Disclosure)."\textsuperscript{329} The Act provides that a Disclosure is not admissible against its maker to prove the accuracy or truth of any Statement contained therein.\textsuperscript{330} Much like the hearsay rule, however, this implies that a Disclosure is admissible if admitted for any other reason. For example, the Act specifically permits its admissibility to serve as the basis for a claim of anticipatory breach or repudiation of a contract or similar claim, and that a court in its discretion can permit the admission of a Disclosure if the Disclosure "amounts to bad faith or fraud, or is otherwise beyond what is reasonable to achieve the purposes of this Act."\textsuperscript{331} Therefore, the actual protections are limited and any party making a Disclosure should assume that the Disclosure will be admitted into evidence.

The Act also provides a limited antitrust exemption.\textsuperscript{332} The Act exempt conduct (including making and implementing an agreement) done solely for the purpose of correcting or avoiding a Year 2000 failure, or communicating or disclosing information regarding the same.\textsuperscript{333} However, the Act provides no protection for actions brought under federal and state securities laws with respect to documents or materials filed with the SEC.\textsuperscript{334} Furthermore, it does not protect statements made to a consumer in solicitations, including an advertisement or offer to sell by a seller, manufacturer, or

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{329} Year 2000 Information and Readiness Disclosure Act § 4(a).
  \item \textsuperscript{330} Year 2000 Information and Readiness Disclosure Act § 3(a).
  \item \textsuperscript{331} Year 2000 Information and Readiness Disclosure Act § 4(a).
  \item \textsuperscript{332} Year 2000 Information and Readiness Disclosure Act § 4(a).
  \item \textsuperscript{333} Year 2000 Information and Readiness Disclosure Act § 5.
  \item \textsuperscript{334} Year 2000 Information and Readiness Disclosure Act § 6(a).
  \item \textsuperscript{335} Year 2000 Information and Readiness Disclosure Act, Pub. L. No. 105-271, § 3(11)(b), 112 Stat. 2386 (1998). If the Statement is made concerning a Year 2000 remediation product or service and makes specific disclosures as required under the Act, the Statement is not excluded from the protections afforded under the Act. Year 2000 Information and Readiness Disclosure Act § 3(9)-(10).
\end{itemize}
\end{footnotesize}
provider of a consumer product.\textsuperscript{335}

It is not surprising that Silicon Valley would be leading the way for private immunity. Much like the Year 2000 Information and Readiness Disclosure Act,\textsuperscript{336} California enacted legislation providing limited immunity from liability to persons who in good faith disseminate or disclose information regarding the Year 2000 problem for any tort action brought for injury caused by or arising from the use of the disclosed information.\textsuperscript{337}

California is not alone in its efforts to limit liability. In 1999, Florida will be taking up the Commerce Protection Act of 1999.\textsuperscript{338} This Act provides legal protection to businesses and government entities if they make good-faith efforts to be Year 2000 compliant.\textsuperscript{339} The Act limits class actions to cases where each member of the class suffered $50,000 or more in damages (unless the suit involves information technology products), limits punitive damages to three times the compensatory damages, prohibits punitive damages against state agencies, and provides limited immunity to directors and officers.\textsuperscript{340} The Act further provides that companies notifying customers by September 1, 1999 that they will not be compliant by the Year 2000 will not be held liable for Plaintiff's legal costs if the company has made a good-faith effort to become compliant.\textsuperscript{341}

B. Governmental Immunity

The most significant portion of the legislation considered and enacted by state legislatures seeks to protect their respective states from lawsuits deriving from the Year 2000 problem.\textsuperscript{342} Not only does Year 2000 immunity extend to state and local governments and their employees, but quite often to state contractors and agents as well. States enacting

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{335} Year 2000 Information and Readiness Disclosure Act § 6(b)(2).
  \item \textsuperscript{337} Year 2000 Information Disclosures, CAL. CIV. CODE §§ 3269-3271 (West 1998).
  \item \textsuperscript{339} See id.
  \item \textsuperscript{340} See id.
  \item \textsuperscript{341} See id. at 1, 3.
  \item \textsuperscript{342} See ITAA Year 2000 Home Page, supra note 282.
\end{itemize}
\end{footnotesize}
or considering such legislation include California, Florida, Georgia, Hawaii, Illinois, Nevada, New Hampshire, Pennsylvania, South Carolina, Virginia, and Washington.

C. Task Forces and Readiness

The federal government and several states have passed legislation establishing task forces to review governmental compliance, mandate inter-agency cooperation, and mandate compliance. On the federal level, Congress enacted the Examination Parity and Year 2000 Readiness for Financial Institutions Act. This Act requires each federal banking agency and the National Credit Union Administration Board to offer seminars to all depository institutions and insured credit unions regarding the Year 2000 problem and the effect it could have on each institution and their transactions with other financial institutions.

While Congress has yet to enact further legislation, there are several other bills currently under consideration to assist

354. The states include Illinois, 1998 Ill. Legis. Serv. 90-666 (West), and Iowa, 1998 Iowa Legis. Serv. 1224 § 8 (West).
various sectors of government in becoming compliant. These include the USDA Year 2000 Compliance Enhancement Act, the Millennium Computer Act of 1997, the Commission on the Year 2000 Computer Problem Act, the Millennium Act, the National Year 2000 Readiness Act, Senator Bennet's Year 2000 bill and Senate Resolution 208. Senate Resolution 208 would establish a special senate committee to study the impact of the Year 2000 problem on government and the private sector and make recommendations accordingly.

D. Other Legislation

State legislatures have introduced and enacted numerous other Year 2000 legislation. For example, the state of New York has legislation pending that would provide tax credits for money spent in an effort to become Year 2000 compliant. Curiously, in New Jersey, legislation has been introduced to urge the IRS to grant an automatic four-month

357. H.R. 3280, 105th Cong. (1998). This legislation would create the position of Chief Information Officer within the Department of Agriculture to assist the department in meeting Year 2000 systems requirements. Id.
358. H.R. 1177, 105th Cong. (1998). This legislation would require the head of each Federal agency to ensure that computer systems of the agency are capable of performing their functions after December 31, 1999. Id.
359. S. 22, 105th Cong. (1997). This legislation would create a commission to study and make recommendations to the President, Congress, and the Secretary of Defense. Id.
360. S. 1218, 105th Cong. (1997). This legislation, if enacted, seeks to assure the integrity of information, transportation, and telecommunications upon the arrival of the Year 2000. Id.
362. S. 2000, 105th Cong. (1998). This legislation if enacted would seek to ensure that business, financial markets and the Federal government are taking the steps necessary to ensure compliance by the Year 2000. Id.
extension for filing tax returns in the Year 2000.\textsuperscript{366} The state of Virginia enacted legislation requiring public entities that spend money for goods or services in an effort to become Year 2000 compliant to solicit responsible bidders through competitive negotiation or competitive sealed bidding.\textsuperscript{367} Florida enacted legislation providing its governor with authority to transfer resources between agencies if it is likely that an agency will have a computer failure.\textsuperscript{368}

Other attempts by states to regulate the problem have failed. For example, the Washington Legislature, in recognizing the severe shortage of qualified computer specialists who can rectify the Year 2000 problem, attempted to enact legislation that would permit retired public employees to work in making systems Year 2000 compliant without risking the loss of retirement benefits.\textsuperscript{369} Moreover, in West Virginia the legislature failed to pass legislation requiring certain warranties on information systems and software.\textsuperscript{370}

\textbf{VII. CONCLUSION}

The Year 2000 problem is already costing billions of dollars and countless hours to resolve, and will continue to do so beyond the new millennium. Lawyers are playing an integral role in addressing this problem by responding to Year 2000 inquiries, ensuring proper disclosure pursuant to state and federal law, drafting contractual agreements, assisting in mergers and acquisitions, initiating and defending lawsuits, and assisting in the enactment of legislation. While organizations that address this technical and legal problem in a timely manner may suffer severe consequences in the next century, those that do not risk widespread technology failures, lost clients, litigation, and even bankruptcy. Through prudent and well-thought-out legal planning, an organization can hedge its bets against an unhappy New Year.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{367} See 1998 Va. Act ch. 250.
\item \textsuperscript{368} Year 2000 Computer Systems Failure Act, Ch. 98-331, § 1, 1998 Fla. Sess. Law Serv. 1950, 1950 (West 1998).
\item \textsuperscript{369} See H.B. 2996, 55th Leg., Reg. Sess. (Wash. 1998).
\item \textsuperscript{370} See H.B. 4691, 73rd Leg., 2d Sess. (W. Va. 1998).
\end{itemize}
\end{footnotesize}