Physical Loss to *Tangible* Property?

Emerging Law on Electronic Data Insurance

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Courts and insurers grapple with how to treat electronic data under first party property and liability policies.

With the integration of computers, BlackBerrys and iPhones into virtually every aspect of our lives, questions surrounding insurance coverage involving these devices and the data that they process have moved to the forefront of insurance law. Today, insurance companies, insureds and even courts must deal with whether electronic data is covered under insurance policies. Two significant questions have emerged: (1) whether data can suffer "direct physical loss or damage" under first-party property insurance policies; and (2) whether data is considered "tangible property" under liability insurance policies.

This article will discuss cases addressing these questions and how insurers have modified policies to specify how they apply to electronic data.

Policyholders Introduce Data Coverage Issues in Court

A federal court in Kansas appears to have been the first to publish a decision raising the issue of whether a standard-form property policy protected an insured when it lost computer data. In *Home Indemnity Co. v. Hyplains Beef, L.C.*, 893 F. Supp. 987 (D. Kan. 1995), *aff'd without opinion*, 89 F.3d 859 (10th Cir. 1996), the insurer sought a declaratory judgment from the court that it had no obligation to pay $2.5 million for lost income stemming from a slowdown in operations and decreased efficiency due to computer problems at the insured's beef-packing plant. Basically, a newly purchased computer system failed to retain the electronic data fed into it, causing a decrease in orders and lower than normal carcass yields. The court observed that the claim raised several interesting questions:

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

Id. at 990.

The court did not answer these questions, holding instead that the policy did not cover the packing plant's business interruption claim because the plant only experienced decreased efficiency, while under the pol-

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icy coverage required a complete "suspension" of plant operations. *Id.* at 991.

In 2000, another court considered one of the questions posed in *Hyplains Beef*—could loss of computer data constitute "physical loss or damage" to property? In *American Guarantee & Liability Insurance Company v. Ingram Micro, Inc.*, 2000 U.S. Dist. LEXIS 7299 (D. Ariz. Apr. 18, 2000), a federal court in Arizona held that the loss of computer data was physical damage to the insured's computer equipment under a business interruption policy. There, the policy insured against "All Risks of direct physical loss or damage from any cause, howsoever or wheresoever occurring, including general average, salvage charges or other charges, expenses and freight." *Id.* at *3. The insured's computers were insured property under the policy. Custom programming information stored in the computers' random access memory was lost when the data center experienced a brief power outage. Additionally, the insured lost data-processing capability at its data center location for several days while the system's technicians replaced default programming with custom programming configurations.

American argued that the insured's computers had not suffered "physical damage" because their capacity to perform their intended functions remained intact. According to American, the power outage did not adversely affect the equipment's inherent ability to accept and process data and configuration settings when they were subsequently reentered into the computer system. *Id.* at *5–6. Ingram argued that just because the computers retained the ability to accept the restored information and eventually operate as before, it did not mean that they did not undergo "physical damage." Ingram argued for a broad definition of "physical damage," which included loss of use and functionality. *Id.* at *6. The court agreed with Ingram, finding that "physical damage" was not restricted to the physical destruction or harm of computer circuitry but included the "loss of access, loss of use, and loss of functionality." *Id. Ingram Micro* did not precisely decide whether loss of computer data could constitute "physical loss or damage." Rather, it seemed to say that when computer data stored in a computer is altered, a computer has suffered "physical loss or damage."

Subsequent courts have rejected extremely expansive interpretations of "physical loss" in other contexts. *See, e.g., Source Food Technology, Inc. v. United States Fidelity & Guaranty Co.*, 465 F.3d 834, 838 (8th Cir. 2006) (finding that the insured suffered no "direct physical loss to property" as a result of a government bar of importation of beef products from Canada for fear of mad cow disease); *Pentair, Inc. v. Am. Guarantee & Liab. Ins. Co.*, 400 F.3d 613, 616 (8th Cir. 2005) (refusing to adopt the position that "direct physical loss or damage is established whenever property cannot be used for its intended purpose" and thus finding no coverage when an earthquake caused a loss of power to two factories that could not supply products to a subsidiary of the insured for two weeks).

The Insurance Industry and Courts React to *Ingram*

The question of whether loss of computer data constitutes "physical loss or damage" was not truly answered for the first time until 2003 when the Fourth Circuit tackled the question. In the interim, however, the first-party property insurance industry addressed the issue through Insurance Service Office, Inc., (ISO) forms. In an apparent attempt to address the *Ingram Micro* decision, the 2002 edition of the "Building and Personal Property Coverage Form" excluded electronic data from coverage, except as provided under the additional coverage form. The most recent version of the "Building and Personal Property Coverage Form," released in 2007, has a section dealing with electronic data that specifies that a policy covers:

> the cost to replace or restore electronic data which has been destroyed or corrupted by a Covered Cause of Loss. To the extent that electronic data is not replaced or restored, the loss will be valued at the cost of replacement of the media on which the electronic data was stored, with blank media of substantially identical type.

CP 00 10 0607, §A(4)(f)(2).© (The ISO forms are copyrighted by Insurance Services Office, Inc.)

Interestingly, under the ISO standard policy, while a virus is covered, damage as a result of employee manipulation is not:

> The Covered Cause of Loss includes a virus, harmful code or similar instruction introduced into or enacted on a computer system (including electronic data) or a network to which it is connected, designed to damage or destroy any part of the system or disrupt its normal operation. But there is no coverage for loss or damage caused by or resulting from manipulation of a computer system (including electronic data) by any employee, including a temporary or leased employee, or by an entity retained by you or for you to inspect, design, install, modify, maintain, repair or replace that system.

Id. at §A(4)(f)(3)(d).© This additional coverage is also subject to a $2,500 annual, aggregate limit. *Id.* at §A (4)(f)(4).

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Some commercial property insurers developed their own language providing specific coverage for electronic data. As with the ISO's provision, they typically begin by excluding electronic data. They then provide coverage with much higher limits than the ISO for electronic data, programs and software, and they specifically state that this includes coverage for malicious manipulation of data on the part of an individual.

Although the ISO form provision and insurance policies with other coverage extensions for data have been in existence for several years now, recent cases rarely have addressed this language. Instead, most courts continue to find coverage for loss of electronic data even if a property policy has not expressly afforded it.

In *NMS Services, Inc. v. The Hartford*, 62 Fed. Appx. 511, 2003 U.S. App. LEXIS 7442 (4th Cir. Apr. 21, 2003), NMS suffered a business interruption loss when a former employee sabotaged its computer system, erasing vital computer files and

databases necessary for business operations. NMS's system administrator, while still an employee of NMS, wrote a series of "backdoor" programs that allowed him to access the NMS systems and encrypted passwords. After he was fired from NMS, the former administrator accessed the NMS computer system and deleted and destroyed data. *Id.* at 512–13.

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NMS sought coverage under a business income additional coverage provision, which stated that Hartford "will pay for the actual loss of Business Income you sustain due to the necessary suspension of your 'operations' during the 'period of restoration'. The suspension must be caused by *direct physical loss of or damage* to property at the damaged premises…." *Id.* at 514 (emphasis in opinion, but not policy). The court, ruling in favor of NMS, found that there was "no question that NMS suffered damage to its property, specifically, damage to the computers it owned, and this Court has already concluded that the damage constitutes a covered cause of loss." *Id.* This is similar to the ruling in *Ingram Micro*. It was Judge Widener's concurring opinion, however, that further explained why the erasure of the computer data itself constituted "direct physical loss":

> My concurrence is dependent on the fact that, when the employee erased the data on NMS' computers, this erasure was, in fact, a 'direct physical loss' under the requirements of the policy. Indeed, a computer stores information by the rearrangement of the atoms or molecules of a disc or tape to effect the formation of a particular order of magnetic impulses, and a meaningful sequence of magnetic impulses cannot float in space. It is the fact that the erasure was a 'direct physical loss' that enables NMS to recover under the policy and enables me to concur.

Id. at 515.

A few weeks after the *NMS* decision, a Texas appellate court ruled similarly in another matter involving data loss, but in this matter, the policy specifically mentioned electronic data. In *Lambrecht & Assoc., Inc. v. State Farm Lloyds*, 119 S.W.3d 16 (Ct. App. Tex. 2003), the court considered whether destruction of data by a virus introduced by an outside hacker constituted "direct physical loss to business personal property," which would have entitled the insured to coverage under its insurance policy for lost business income while it could not use its computer system to communicate with prospective customers. The insured sought coverage for the information that was stored on the computer based on two policy provisions. The first was the loss of income provision, stating that State Farm would not "pay for any loss of 'business income' caused by accidental direct physical loss to 'electronic media and records' after the longer of sixty consecutive days from the date of the loss or the amount of time necessary to repair, rebuild or replace other property at the premises caused by the same occurrence." This implied that business interruption resulting from loss of electronic records would be covered for up to 60 days. The second provision was an extension of coverage for "valuable papers and records." It covered the insured's "expense to research, replace or restore the lost information on valuable papers and records, including those which exist on electronic or magnetic media, for which duplicates do not exist." *Id.* at 24.

State Farm argued that the loss of information on the computer system was not a physical loss because the data on the computers did not exist in physical or tangible form. *Id.* at 23. Disagreeing with State Farm and finding coverage, the court noted that the policy's coverage for "data" stored electronically "dictates that such property is capable of sustaining a 'physical' loss." *Id.* at 26. In other words, the court viewed the coverage for "electronic media and records" as illusory if electronic data could not sustain "physical damage."

A federal district court in Tennessee followed the above reasoning, finding a direct physical loss in a case in which the insured's pharmacy computer data was corrupted due to a power outage. In *Southeast Mental Health Center, Inc. v. Pacific Ins. Co., Ltd.*, 439 F. Supp. 2d 831 (W.D. Tenn. 2006), Southeast lost electrical and telephone service at its health clinic as a result of Hurricane Elvis. Southeast claimed that the loss of electrical service damaged its pharmacy computer, resulting in the loss of data. Southeast also contended that it lost income because it was unable to conduct patient appointments, schedule appointments and fill patients' prescriptions. Pacific moved for summary judgment, arguing that the losses were not caused by direct physical loss of or damage to the insured property and also that the losses were precluded under the policy exclusions for "power interruption or power failure" and "failure, malfunction or inadequacy of computer hardware…." *Id.* at 836. The court found in favor of Southeast and, relying heavily on *Ingram*, found that "the corruption of the pharmacy computer constitutes 'direct physical loss of or damage to property' under the business interruption policy." *Id.* at 837. With regard to the exclusions in the policy, the court found ambiguity as to whether the exclusions in the All Risk Form (mentioned above) applied to the business interruption loss. Construing the ambiguity in favor of the insured, the court found that the power outage could reasonably be considered a covered cause of loss under the business interruption portion of the policy, and it granted Southeast's motion for partial summary judgment. *Id.* at 839.

Not all courts, however, have found that damage to data constitutes "direct physical loss of or damage to property" under property insurance policies. In *Ward General Insurance Services, Inc. v. Employers Fire Insurance Co.*, 7 Cal. Rptr. 3d 844 (Cal. Ct. App. 2003), the insured was updating its computer data when the operator inadvertently pressed the "delete" key on the keyboard. Ward lost the electronically stored data used to service clients' insurance policies and sought insurance coverage for labor expenses to restore the database, in addition to income lost during the recovery period. Ward relied on various policy provisions, all which required direct phys-

ical loss of or damage to property. Ruling on cross-motions for summary judgment, the trial court found that the losses were not covered because Ward had not experienced direct physical loss. *Id.* at 847.

The appellate court affirmed. It ruled as a matter of law that the loss of the database alone, and the resultant economic loss, without loss of or damage to tangible property, was not a "direct physical loss or damage to" covered property under the policy. *Id.* at 851. The court stated that "the loss of a database is a loss of organized information, in this case, the loss of client names, addresses, policy renewals dates, etc." *Id.* As the court further explained:

> Here, the loss suffered by plaintiff was a loss of information, *i.e.*, the *sequence* of ones and zeros stored by aligning small domains of magnetic material on the computer's hard drive in a machine readable manner. Plaintiff did not lose the tangible material of the storage medium. Rather, plaintiff lost the stored *information*. The sequence of ones and zeros can be altered, rearranged, or erased, without losing or damaging the tangible material of the storage medium.

Id. (emphasis in original).

Clearly, this court took a very different approach to determining what constituted "physical" loss or damage than Judge Widener did in *NMS*. The *Ward* court limited the scope of "physical" to "tangible," and considered the magnetic sequence of binary digits as intangible. This approach is similar to the approach taken by courts that have interpreted liability insurance policies, as discussed below.

Data Has Been Found Not to Be "Tangible Property" in Liability Policies

Courts have also considered whether insurance policies cover computer data in the third-party liability context. Interestingly, while courts generally have been inclined to find that data loss constitutes "direct physical loss" in the first-party arena, they generally have reached the opposite conclusion when dealing with third-party claims. This is mostly because liability policies typically provide coverage for "physical damage to *tangible* property," rather than coverage for "physical loss or damage to property," as in first-party policies. It has been much more difficult for insureds to convince the courts that data stored in computers constitutes "tangible property." "Tangible" is commonly understood as something that can be touched and felt. It should be noted, however, that while this is the commonly understood definition, the Webster's definition of "tangible" is, "1 a : capable of being perceived esp. by the sense of touch… 2 : capable of being precisely identified or realized by the mind." Merriam-Webster's Collegiate Dictionary 1276 (11th ed. 2008). While Webster's first definition conforms with the most commonly understood notion of the word, the second definition could open a door to expansive coverage under liability insurance policies.

As in the first-party context, the ISO has drafted language that would cover liability for damage to the data of third parties:

> We will pay those sums that the insured becomes legally obligated to pay as damages because of 'loss of electronic data' to which this insurance applies. We will have the right and duty to defend the insured against any 'suit' seeking those damages….

Insurance Services Office, Inc., ISO Form CG 00 65 12 07, §I(1)(a).© Electronic data is defined as:

> Information, facts or programs stored as or on, created or used on, or transmitted to or from computer software (including systems and applications software), hard or floppy discs, CD-ROMs, tapes, drives, cells, data processing devices or any other media which are used with electronically controlled equipment.

Id. at §VI(5).© While courts have not had the opportunity to interpret the electronic data language, two courts have considered and found no coverage under policy language in old forms that did not specifically cover data.

In *Seagate Technology, Inc. v. St. Paul Fire and Marine Ins. Co.*, 11 F. Supp. 2d 1150 (N.D. Cal. 1998), Seagate was a manufacturer of disk drives for personal computers and small business machines. A customer that manufactured personal computers sued Seagate, alleging that Seagate supplied defective disk drives. Seagate's liability insurer declined to provide a defense. The policy under which Seagate was insured provided liability coverage for "physical damage to tangible property of others." *Id.* at 1153. The federal district court first concluded that applicable law would not provide insurance coverage for the defective disk drives. It then turned to the customer's allegation of "loss of customer's information." The court noted that "absent from the complaints is any suggestion that components of the host computer, other than the Seagate drives, suffered damage." *Id.* at 1155. In other words, *Seagate* strongly implies the unstated conclusion that loss of data alone is not "physical damage to tangible property."

Similarly, in *America Online, Inc. v. St. Paul Mercury Ins. Co.*, 207 F. Supp. 2d 459 (E.D. Va. 2002), American Online faced many lawsuits by customers alleging that version 5.0 of its internet access software caused their computers to "crash," rendering them "inoperable." *Id.* at 462. American Online's commercial general liability carrier, St. Paul, denied coverage. As in *Seagate*, the policy covered liability for "physical damage to tangible property of others." *Id.* Finding in favor of St. Paul, the court held:

> computer data, software and systems are not 'tangible' property in the common sense understanding of the word. The plain and ordinary meaning of the term 'tangible' is property that can be touched. Computer data, software, systems are incapable of perception by any of the senses and are therefore intangible.

Id.

The court further explained, "Similar to the information written on a notepad, or the ideas recorded on a tape, or the design memorialized in a blueprint, computer data, software and systems are intangible items stored on a tangible vessel—the computer or a disk." *Id.* at 468. This has been the last word from the courts on liability coverage for electronic data loss, at least in policies without specific coverage for data.

Conclusion

As society in general and courts in particular become more familiar with electronic data, they more readily accept it as something "physical." The insurance industry responded to the demand for protection against data loss, through both property policies and liability policies. We have not reached the point, however, where electronic data is viewed as "tangible" property. FD