

WHAT CONSTITUTES PHYSICAL LOSS OR DAMAGE IN A PROPERTY INSURANCE POLICY?

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I. INTRODUCTION

Most property insurance policies require “physical loss or damage” to insured property as a threshold requirement for coverage.¹ In most property damage losses, this requirement is easily met. When, for example, insured property is damaged by fire, water, or wind, there always will be a physical change or structural damage to that property. But when the insured property’s structure is unaltered, at least to the naked eye, and the insured claims the property’s value, usefulness, or functionality has been lost or diminished, questions arise whether coverage is triggered.

Courts have not uniformly interpreted the physical loss or damage requirement in these types of cases. Some courts, using the dictionary definition of “physical” as a guide, have found that physical loss or damage requires that the insured property suffer a distinct, demonstrable physical alteration or change. But other courts have determined that the loss of use, functionality, or reliability can, under specific circumstances, constitute physical loss or damage even in the absence of any demonstrable structural damage or other alteration to the insured property.

This article discusses how courts have interpreted and applied the physical loss or damage requirement. It begins with a brief history of the origin of the physical loss or damage requirement. Next, this article examines how courts have defined the phrase “physical loss or damage.” It then reviews the cases that have addressed the physical loss or damage requirement in a myriad of fact patterns that have arisen. These cases illustrate that while in some circumstances courts uniformly apply the physical loss or damage requirement, in other circumstances courts have very different views of what constitutes “physical loss or damage.”

II. HISTORICAL DEVELOPMENT OF THE “PHYSICAL LOSS OR DAMAGE” REQUIREMENT

The “physical loss or damage” requirement in property insurance policies is of relatively recent origin and can be traced to the introduction of

1. See, e.g., ISO Standard Property Policy (CP 00 99 10 12); ISO Building and Personal Property Coverage Form (CP 00 10 10 12). Many insurance policies also include the word “direct” before “physical loss or damage” to describe the kind of physical loss or damage required to trigger coverage. Courts generally have found that the word “direct” means proximate cause as opposed to a remote or incidental cause. See, e.g., *Universal Image Prods. Inc. v. Fed. Ins. Co.*, 475 F. App’x 569, 573 (6th Cir. 2012); *Phoenix Ins. Co. v. Infogroup, Inc.*, 147 F. Supp. 2d 815, 826 (S.D. Iowa 2015); *Fred Meyer, Inc. v. Cent. Mut. Ins. Co.*, 235 F. Supp. 540, 543, 547 (D. Or. 1964); *Fisher v. Certain Interested Underwriters at Lloyds*, 930 So. 2d 736, 759 (Fla. Dist. Ct. App. 2006); see also *Advance Cable Co. LLC v. Cincinnati Ins. Co.*, 788 F.3d 743, 746 (7th Cir. 2015) (stating that “common sense suggests that [direct] is meant to exclude situations in which an intervening force plays some role in the damage”). See generally JOHN GARAFFA, APPLEMAN ON INSURANCE LAW & PRACTICE § 42.02[1] (2014).

all-risk policies in the late 1930s, several hundred years after the development of the first property insurance policies.² The first property insurance policies, introduced in England during the 17th century, insured against only one peril—fire.³ At that time, fire was the most common risk of loss because most structures were made primarily out of wood.⁴ There was no physical loss or damage requirement in those early fire insurance policies. Nor was one needed because fire would always cause a physical alteration of insured property.

Standard fire policies were developed in the United States in the late 1800s.⁵ The standard fire policy, initially developed in New York in 1866 and later adopted by other states, insured “against all direct loss or damage by fire.”⁶ Even 150 years later, the current standard form insures against “direct loss” by fire and lightning.⁷ There was no requirement in the standard fire policy that the loss be “physical” because insured property damaged by fire or lightning would always undergo a physical change or alteration.

The standard fire policy became the basis of modern property insurance policies. Initially, perils other than fire and lightning could be added

2. LEONARD E. MURPHY ET AL., PROPERTY INSURANCE LITIGATOR’S HANDBOOK § 1.01(b), at 10 (2d ed. 2013). The Great Fire of London on September 2, 1666, is the event that led to the development of fire insurance. F. C. Oviatt, *Historical Study of Fire Insurance in the United States*, 26 ANNALS OF THE AMERICAN ACADEMY OF POLITICAL & SOCIAL SCIENCE, 155–56 (Sept. 1905); G. Barry Klein, *The Great Fire of London*, IRMI RISK & INSURANCE (June 2001), <http://www.irmi.com/expert/articles/2001/klein06.aspx>. The Great Fire of London burned for five days and destroyed thirteen thousand buildings, eighty percent of the city. In the following year, 1667, the world’s first insurance company was formed. Klein, *supra*.

3. *Id.* The first insurance company was known as The Insurance Office. It eventually went out of business. Royal & SunAlliance is the oldest insurance company in business today, and it dates back to 1710. It was originally known as the Sun Fire Office. The Sun Fire Office, through many mergers and acquisitions, became Royal & SunAlliance, England’s largest insurance company. G. Barry Klein, *The World’s First Insurance Company*, IRMI RISK & INSURANCE (July 2001), <http://www.irmi.com/expert/articles/2001/klein07.aspx>.

4. *Simon Mktg., Inc. v. Gulf Ins. Co.*, 57 Cal. Rptr. 3d 49, 53 n.6 (Ct. App. 2007) (“Historically, property insurance grew out of the insurance against the risk of fire which became available for ships, buildings, and some commercial property at a time when most of the structures in use were made wholly or primarily of wood.”).

5. See generally S.S. HUEBER & KENNETH BLACK, JR., PROPERTY INSURANCE 23 (1957). The National Board of Fire Underwriters undertook the first attempt to adopt a standard form in 1867 and 1868. *Id.* In 1873, Massachusetts enacted a law providing for a standard form of fire insurance. *Id.* The New York legislature adopted a standard form in 1886 and again in 1918 and 1943. *Id.* at 23–24.

6. Oviatt, *supra*, note 2, at 174. The New York state legislature developed the standard fire policy and, by statute, required it to be used. See generally DAVID B. GOODWIN ET AL., APPLEMAN ON INSURANCE § 41.01[1] (2014). The 1943 standard fire policy was adopted by most states. Douglas G. Houser & Thomas W. Rynard, *Introduction*, in 1 INSURING REAL PROPERTY § 1.06[1], at 1–43 (Stephen A. Cozen ed., 2017); see also *Proc v. Home Ins. Co.*, 217 N.E.2d 136, 1398 (N.Y. 1966).

7. A copy of the Standard Fire policy can be found at Appendix 1-A in 1 INSURING REAL PROPERTY, *supra* note 6.

by an extended coverage endorsement. Extended coverage included perils like windstorm, hail, explosion, riot, civil commotion, aircraft, vehicles, and smoke.⁸ Later, additional perils could be added as part of extended coverage, including water damage from plumbing and heating systems, rupture or bursting of steam or hot water heating systems, vandalism and malicious mischief, fall of trees, objects falling from weight of ice, snow, or sleet, freezing of plumbing and heating systems, collapse, landslide, and glass breakage.⁹ Named peril policies were subsequently introduced that provided coverage for certain identified perils, typically those included in the extended coverages.¹⁰ Neither the extended coverage endorsement nor early named peril policies included a “physical loss or damage” requirement in the insuring clause. But again, it was not necessary because damage from the extended and named perils would always cause a physical alteration to the insured property.¹¹

But that changed with the introduction of all-risk insurance policies. In the 1920s, marine and inland marine insurers introduced policies that insured against “all risk of loss or damage to the insured property”¹² and covered “all risks and perils of transportation.”¹³ The all-risk policy was originally developed by marine and inland marine underwriters in response to an increasing demand for broader coverage for the perils of transportation.¹⁴

Shortly thereafter, the requirement that loss or damage be “physical” began to appear in marine cargo and inland marine policies. Marine cargo insurance policies have included the “physical loss or damage” requirement

8. HUEBER & BLACK, *supra* note 5, at 149.

9. *Id.* at 152.

10. There are eleven traditional named perils: fire, lightning, explosion, windstorm or hail, smoke, aircraft or vehicles, riot or civil commotion, vandalism, sprinkler leakage, sinkhole collapse, and volcanic action. “Named peril” policies cover only losses caused by one of the specified perils. *See generally* 2 BARRY R. OSTRAGER & THOMAS R. NEWMAN, *INSURANCE COVERAGE DISPUTES* § 21.01[b] at 1717 (18th ed. 2017); Houser & Rynard, *supra* note 6, § 1.06[7][b][i], at 1–66.

11. *See* Port Auth. of N.Y. & N.J. v. Affiliated FM Ins. Co., 311 F.3d 226, 235 (2d Cir. 2002) (“Fire, water, smoke and impact from another object are typical examples of physical damage from an outside source that may demonstrably alter the components of a building and trigger coverage.”).

12. *See* HERBERT S. DENENBERG ET AL., *RISK AND INSURANCE* 338 (1964).

13. *See* JOHN HENRY MAGEE & OSCAR N. SERBEIN, *PROPERTY AND LIABILITY INSURANCE* 61 (1967).

14. *See* DENENBERG ET AL., *supra* note 12, at 338; *see also* SOLOMON S. HUEBNER ET AL., *PROPERTY AND LIABILITY INSURANCE* 209 (1968) (“The all risks policy was developed through recognition of the fact that the insured needed indemnification for any loss large enough to hurt him financially regardless of the cause.”).

in all-risk insuring clauses since at least the 1930s.¹⁵ The same requirement has appeared in all-risk inland marine policies since at least the 1940s.¹⁶

Courts and commentators have not explained why marine underwriters initially included the “physical loss or damage” requirement. It seems likely that this requirement was added to clarify the underwriters’ intent that there was no coverage for intangible losses such as loss of market, loss of value, losses due to delay, loss of use, or purely financial losses, like loss of profit.

When property insurers introduced the all-risk policy in the 1950s, they incorporated the “physical loss or damage” language from existing marine and inland marine all-risk policies into the insuring agreement.¹⁷ That or very similar language remains in wide use today in commercial property insurance policies.¹⁸

III. THE MEANING OF “PHYSICAL LOSS OR DAMAGE”

As used in the insuring clause, “physical” modifies both “loss” and “damage.”¹⁹ The terms “loss” and “damage” are not necessarily synonymous.²⁰ Physical damage is only one cause of “physical loss” of property. For example, an insured can suffer a physical loss of property through theft, without any actual physical damage to the property.²¹

15. See, e.g., *Curacao Trading Co. v. Fed. Ins. Co.*, 137 F.2d 911, 912 (2d Cir. 1943) (marine cargo policy in effect in 1935 insured “against physical loss or damage from any external cause, including non-delivery”); see also *Betesh v. Fire Ass’n of Phila.*, 92 F. Supp. 527, 528 (S.D.N.Y. 1950) (marine cargo policy issued in June 1940 insured “[a]gainst all risks of physical loss or damage to the property insured from any external cause whatsoever”).

16. See, e.g., *Wagner v. Aetna Ins. Co.*, No. 499, 1948 Pa. Dist. & Cnty. Dec. LEXIS 68, at *8–9 (Pa. D. & C. Aug. 25, 1948) (inland marine policy in effect in 1945 insured “against all risks of physical loss or damage from any external cause except as provided in the policy to which this rider is attached”). Inland marine insurance grew out of marine insurance. See ROBERT H. JERRY, II, *APPLEMAN ON INSURANCE LAW & PRACTICE* § 1.06[4] (2014).

17. See, e.g., *Hughes v. Potomac Ins. Co.*, 18 Cal. Rptr. 650, 651 (Ct. App. 1962) (homeowners policy issued in 1956 insured against all risks of physical loss or damage); *Shaffer v. Phoenix Ins. Co.*, No. 273, 1959 Pa. Dist. & Cnty. Dec. LEXIS 37, at *3–4 (Pa. D. & C. Sept. 21, 1959) (homeowners policy in effect in 1957 insured “against all risks of physical loss to the property except as otherwise excluded”); see also MURPHY ET AL., *supra* note 2, § 1.01(b), at 12 (all-risk policy introduced in 1950s).

18. As some commentators have noted, courts may not care about the history or evolution of policy language. But knowledge of the history and evolution of the insuring clause in property insurance policies may lead to a better understanding of the underwriting intent. See, e.g., MURPHY, ET AL., *supra* note 2, § 1.01(b), at 10 (noting that an understanding of history can often lead to a deeper understanding of present-day insurance coverage and can allow the practitioner to distinguish certain case law).

19. See, e.g., *Phila. Parking Auth. v. Fed. Ins. Co.*, 385 F. Supp. 2d 280, 287–88 (S.D.N.Y. 2005); *Ward Gen. Ins. Servs., Inc. v. Emp’rs Fire Ins. Co.*, 7 Cal. Rptr. 3d 844, 849 (Ct. App. 2003); *AFLAC, Inc. v. Chubb & Sons, Inc.*, 581 S.E.2d 317, 319 (Ga. Ct. App. 2003).

20. *Mangerchine v. Reaves*, 63 So. 3d 1049, 1056 (La. Ct. App. 2011); *Corban v. United States Auto. Ass’n*, 20 So. 3d 601, 612 (Miss. 2009).

21. *Mangerchine*, 63 So. 3d at 1056; *Corban*, 20 So. 3d at 612.

Because insurance policies usually do not define “physical,” courts often look to dictionaries to determine the plain and ordinary meaning of that term.²² Dictionaries define “physical” to mean “of or relating to things perceived through the senses as opposed to the mind; tangible or concrete.”²³ Many courts have used this definition to determine the meaning of “physical loss or damage.”²⁴ Some of these courts have stated that the “common usage of physical in the context of a loss therefore means the loss of something material or perceptible on some level.”²⁵

But other courts have not relied on a dictionary to determine the meaning of “physical loss or damage.” For example, “physical damage” has “a widely accepted definition,”²⁶ and it means “a distinct, demonstrable, and physical alteration” of property’s structure or appearance.²⁷ Still other courts have concluded that “[t]he language ‘physical loss or damage’ strongly implies that there was an initial satisfactory state that was changed by some external event into an unsatisfactory state—for example, the car was undamaged before the collision dented the bumper.”²⁸

The dictionary definition of “physical” and these other courts’ expressions of the meaning of “physical” suggest that that physical loss or damage requires a demonstrable physical change to insured property. And prior to 1968, no court had interpreted “physical loss or damage” otherwise.

22. See, e.g., *Phoenix Ins. Co. v. Infogroup, Inc.*, 147 F. Supp. 2d 815, 823 (S.D. Iowa 2015); *Patel v. Am. Econ. Ins. Co.*, No. 12-cv-04719-WHO, 2014 U.S. LEXIS 63935, at *14–15 (N.D. Cal. May 8, 2014); *Crestview Country Club, Inc. v. St. Paul Guardian Ins. Co.*, 321 F. Supp. 2d 260, 264 (D. Mass. 2004). Courts generally give undefined contract terms their plain and ordinary meaning. See, e.g., *Pierce v. Farm Bureau Mut. Ins. Co.*, 548 N.W.2d 551, 555 (Iowa 1996); *Minn. Mining & Mfg. v. Travelers Indem.*, 457 N.W.2d 175, 179 (Minn. 1990); *Acuity v. Burd & Smith Constr., Inc.*, 721 N.W.2d 33, 36 (N.D. 2006). And courts often look to dictionaries to determine the plain and ordinary meaning of words. See, e.g., *Scott v. Cont’l Ins. Co.*, 51 Cal. Rptr. 2d 566, 571 (Ct. App. 1996); *Farmers Union Mut. Ins. Co. v. Horton*, 67 P.3d 285, 289 (Mont. 2003); *W. Nat’l Mut. Ins. Co. v. Univ. of N.D.*, 643 N.W.2d 4, 9 (N.D. 2002); *Boeing Co. v. Aetna Cas. & Sur. Co.*, 784 P.2d 507, 511 (Wash. 1990).

23. NEW OXFORD AMERICAN DICTIONARY 1282 (2d ed. 2005); see also OXFORD ENGLISH DICTIONARY 744 (2d ed. 2001) (defining “physical” as “of or relating to material nature, or to the phenomenal universe perceived by the senses; pertaining to or connected with mater; material; *opposed to* *psychical, mental, spiritual.*”); MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 935 (11th ed. 2008) (defining “physical” to mean “having material existence : perceptible esp. through the senses and subject to the laws of nature”).

24. See, e.g., *Infogroup*, 147 F. Supp. 2d at 823; *Patel*, 2014 U.S. LEXIS 63935, at *14–15; *Crestview Country Club*, 321 F. Supp. 2d at 264.

25. See, e.g., *Infogroup*, 147 F. Supp. 2d at 823.

26. Port Auth. of N.Y. & N.J. v. Affiliated FM Ins. Co., 311 F.3d 226, 235 (3d Cir. 2002) (applying New York and New Jersey law).

27. *Id.*

28. *Trinity Indus., Inc. v. Ins. Co. of N. Am.*, 916 F.2d 267, 270–71 (5th Cir. 1990); see also *AFLAC, Inc. v. Chubb & Sons, Inc.*, 581 S.E.2d 317, 319 (Ga. Ct. App. 2003) (concluding that the phrase “direct physical loss or damage” “contemplates an actual change in insured property then in a satisfactory state, occasioned by accident or other fortuitous event directly upon the property causing it to become unsatisfactory for future use or requiring that repairs be made to make it so”).

In that year, the Colorado Supreme Court in *Western Fire Insurance Co. v. First Presbyterian Church*²⁹ broadly interpreted the physical loss or damage requirement when it held that a church building sustained physical loss when it was rendered uninhabitable and dangerous because of the accumulation of gasoline under and around the church.³⁰ While the court acknowledged that loss of use alone did not constitute direct physical loss, it said that loss of use “must be viewed in context” and not in isolation.³¹ The court then concluded that the church’s particular “loss of use”—caused by the gasoline accumulation around and under the church building, which rendered the premises uninhabitable and dangerous—“equates to a direct physical loss.”³²

The only authority the *Western Fire* court cited in support of its decision was *Hughes v. Potomac Insurance Co.*, a 1962 California Court of Appeal decision.³³ In *Hughes*, the court decided that a homeowner’s policy insuring a “dwelling” had to respond to a claim that a landslide had deprived the dwelling of subjacent and lateral support.³⁴ While the *Western Fire* court said that the insurer in *Hughes* “contended that the insured suffered no direct physical loss,” the insurer made no such argument in *Hughes*.³⁵ Rather, the insurer in *Hughes* argued the policy covered only the insured’s dwelling and not the land beneath it.³⁶ In rejecting that argument, the *Hughes* court concluded that to interpret the policy in that manner “would be to render the policy illusory.”³⁷ The *Hughes* court then concluded that the policy should not be interpreted to allow an insurer to deny coverage for a dwelling that was “rendered completely useless to its owners . . . unless some tangible injury to the physical structure itself could be detected,” in the absence of a provision specifically limiting coverage in such a manner.³⁸

The court in *Western Fire* used this language (which was the basis for the *Hughes* court’s finding that a “dwelling” included the land beneath it) to support an entirely different proposition—that there was physical loss or damage to the church despite any actual physical change to the church building. As will be seen, numerous other courts have expanded on *Western*

29. *W. Fire Ins. Co. v. First Presbyterian Church*, 437 P.2d 52 (Colo. 1968).

30. *Id.* at 55. In *Western Fire*, the insured, acting on orders of the local fire department, closed its church building because gasoline infiltration in the soil under and around the church building and gasoline vapor accumulation inside the church made it uninhabitable. *Id.* at 54. *Western Fire* denied the insured’s claim for the cost to remedy the infiltration and contamination problem. *Id.*

31. *Id.*

32. *Id.* at 55.

33. *Hughes v. Potomac Ins. Co.*, 18 Cal. Rptr. 650 (Ct. App. 1962).

34. *Id.* at 655.

35. *Western Fire*, 437 P.2d at 56.

36. *Hughes*, 18 Cal. Rptr. at 653.

37. *Id.* at 655.

38. *Id.*

Fire to find that the loss of use, functionality, or reliability can, under certain circumstances, constitute physical loss or damage even in the absence of any demonstrable structural damage or other alteration to the insured property.

IV. COURT INTERPRETATIONS OF “PHYSICAL LOSS OR DAMAGE”

A. *Pure Financial Losses*

If damage from perils like fire, water, and wind are at one end of the physical loss or damage spectrum, pure financial losses are at the other. Courts have uniformly agreed that pure economic or financial losses do not constitute physical loss or damage under a property insurance policy.

In *Source Food Technology, Inc. v. United States Fidelity & Guaranty Co.*,³⁹ for example, the Eighth Circuit Court of Appeals found no coverage for the insured’s extra expense and business income losses sustained after the United States Department of Agriculture prohibited the importation of beef products from the insured’s Canadian supplier because of the potential for contamination from “mad cow disease.”⁴⁰ The court rejected the insured’s argument that the closing of the border caused direct physical loss to its beef products because those products were treated as though they were physically contaminated by mad cow disease.⁴¹ The court reasoned that this argument rendered the word “physical” meaningless.⁴²

Other courts also have found no coverage for pure financial losses.⁴³ In *Simon Marketing v. Gulf Insurance Co.*,⁴⁴ a California appellate court held that the costs to settle litigation against the insured and the costs of winding up the insured’s business did not constitute physical loss or damage. These costs were incurred after a Simon Marketing employee responsible for “seeding” high-value winning “Monopoly” and “Who Wants to Be a Millionaire” game tickets to McDonald’s restaurants across the country funneled \$21 million in game-winning tickets to a network of accomplices

39. *Source Food Tech., Inc. v. U.S. Fid. & Guar. Co.*, 465 F.3d 834 (8th Cir. 2006) (applying Minnesota law).

40. *Id.* at 834–36.

41. *Id.*

42. *Id.* at 838. The court found significant the use of the word “to” (and not “of”) in the policy language “direct physical loss to property,” noting that Source Food’s argument might be stronger if the policy’s language included the word “of” rather than “to,” as in “direct physical loss of property.” *Id.*

43. See, e.g., *Blaine Richards & Co. v. Marine Indem. Ins. Co.*, 635 F.2d 1051, 1055 (2d Cir. 1980) (concluding that losses from cancellation of sales contract after the cargo of vegetables was detained by the FDA would not constitute “physical loss or damage” if cancellation were the result of delay); *Nevers v. Aetna Ins. Co.*, 546 P.2d 1240, 1241 (Wash. Ct. App. 1976) (noting that a defect in title to a boat is not “physical loss or damage” under all-risk yachtman’s hull policy).

44. *Simon Mktg. v. Gulf Ins. Co.*, 57 Cal. Rptr. 3d 49 (Ct. App. 2007).

in exchange for a kickback.⁴⁵ This scheme led to lawsuits against Simon, cancellation of the contract between McDonald's, loss of other customers, and eventually the business itself.⁴⁶ The court found that "detrimental economic impact unaccompanied by a distinct, demonstrable, physical alteration of the property" was not compensable under a property insurance policy.⁴⁷

A similar result can be seen in *J & J Pumps, Inc. v. Star Insurance Co.*,⁴⁸ where a California federal court decided that the payment of tax penalties and interest incurred after one of J & J's employees failed to pay J & J's taxes did not constitute physical loss or damage. J & J sought recovery for the amounts it paid in penalties and interest under its commercial property insurance policy that also included employee dishonesty coverage.⁴⁹ Noting that "the threshold requirement for recovery under a contract of property insurance is that the insured property has sustained physical loss or damage," the court concluded that the "payment of tax penalties and interest simply do not constitute physical loss or damage."⁵⁰

And in *Lissauer v. Fireman's Fund Insurance Co.*,⁵¹ the Second Circuit Court of Appeals determined that losses suffered by an investor as a result of Bernard Madoff's Ponzi scheme were not "direct physical losses" recoverable under a homeowners policy.⁵² The court concluded that "Lissauer cannot demonstrate that the account suffered a 'direct physical loss,' as required for coverage under the policy."⁵³

Similarly, courts have found that the diminution in value of property alone does not constitute physical loss or damage. In *Crestview Country Club, Inc. v. St. Paul Guardian Insurance Co.*,⁵⁴ a Massachusetts federal court found no coverage for the cost to redesign a golf hole after the loss of a tree near the hole reportedly changed the hole's slope, rating, and character.⁵⁵ The court reasoned that the plain meaning of "physical" was "material" and that "an intangible loss in value of a golf course because of its slope rating, difficulty, etc. does not fit within this meaning."⁵⁶

45. *Id.* at 50.

46. *Id.*

47. *Id.* at 53 (quoting 10A LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE 3D § 148:46 (2005)).

48. *J & J Pumps, Inc. v. Star Ins. Co.*, 795 F. Supp. 2d 1023, 1029 (E.D. Cal. 2011).

49. *Id.* at 1025.

50. *Id.* at 1028–29.

51. *Lissauer v. Fireman's Fund Ins. Co.*, 459 F. App'x 67, 67–68 (2d Cir. 2012) (applying New York law).

52. *Id.* at 67.

53. *Id.* at 68.

54. *Crestview Country Club, Inc. v. St. Paul Guardian Ins. Co.*, 321 F. Supp. 2d 260 (D. Mass. 2004).

55. *Id.* at 264.

56. *Id.*

As illustrated by these cases, courts have rejected attempts by policyholders to recover pure economic or financial losses under a standard property insurance policy. Courts have uniformly agreed that these types of losses do not constitute physical loss or damage.

B. *Cosmetic or Aesthetic Changes*

In some insurance claims, an event causes only cosmetic or aesthetic changes to the insured property with no discernable effect on the insured property's value. Coverage in these types of cases depends on the specific policy language.

Where the policy insures against physical loss *or* damage, courts have found coverage for purely cosmetic damage. This issue arose in two recent cases where hail dented a metal roof but did not diminish the roof's function, value, or life expectancy.

In *Advanced Cable Co., LLC v. Cincinnati Insurance Co.*,⁵⁷ hail dented a metal roof of a commercial building owned by Advanced Cable, but none of the dents were visible from the ground, and there was no evidence that the roof had been compromised or had its useful life shortened.⁵⁸ The policy in question insured against "direct physical loss."⁵⁹ "Loss" was defined as "accidental loss or damage."⁶⁰ A Wisconsin federal court ruled that the roof had sustained physical damage and physical alteration. The trial court reasoned that even though the denting was minor, it was "still a tangible alteration to the roof" and the policy did not require that damage be visible from a particular vantage point or that it reduce the useful life of the property to trigger coverage.⁶¹ The Seventh Circuit affirmed, concluding that "denting changes the physical characteristics of the roof" and, thus, satisfied the "physical loss or damage" requirement.⁶²

A Kansas federal court in *Great Plains Ventures, Inc. v. Liberty Mutual Fire Insurance Co.*⁶³ reached the same conclusion in a factually similar case. As in *Advanced Cable*, a hail storm caused indentations to the insured's roofs that were purely aesthetic in nature. The indentations were not visible from the ground and did not affect the functionality or service life of the roofs.⁶⁴

57. *Advanced Cable Co., LLC v. Cincinnati Ins. Co.*, No. 13-cv-229-wmc, 2014 U.S. LEXIS 32949 (W.D. Wis. Mar. 12, 2014), *aff'd*, 788 F.3d 743 (7th Cir. 2015).

58. *Id.* at *5-9.

59. *Id.* at *4.

60. *Id.*

61. *Id.* at *31-32. The trial court framed the issue as "whether 'purely cosmetic' denting in the metal roof constitute[d] direct, physical and accidental loss or damage as a reasonable insured would understand those terms." *Id.* at *4.

62. 788 F.3d at 747.

63. *Great Plains Ventures, Inc. v. Liberty Mut. Fire Ins. Co.*, 161 F. Supp. 3d 970 (D. Kan. 2016).

64. *Id.* at 975.

Finding the *Advanced Cable* case persuasive, the court similarly concluded that “cosmetic hail dents physically alter an insured’s property.”⁶⁵

But in *Rankin v. USAA Casualty Insurance Co.*,⁶⁶ a Colorado federal court came to a different conclusion in a case where the policy insured against “direct, physical loss.” There, water leakage caused increased longitudinal cracks, known as “checking,” in the logs of the Rankins’ log home. There was no dispute that the “checking” was normal and that the logs remained structurally sound.⁶⁷ The Rankins, however, asserted that a “physical loss” had nothing to do with financial detriment and that they were entitled to the cost to tear down the house and rebuild it with logs containing smaller checks, at a cost \$1.3 million. USAA agreed that the checking was “direct” and “physical,” but not a “loss,” which it defined to be a “financial detriment.”⁶⁸ The court, noting the absence of the “or damage” language in the insuring agreement, agreed with USAA and held that there was no coverage because the new and increased checking caused no financial detriment to the insured.⁶⁹

In short, whether there is coverage for purely cosmetic or aesthetic changes to the insured property with no discernable effect on the insured property’s value depends on the policy language. Where, as in *Advanced Cable* and *Great Plains*, the policy insures against “physical loss or damage,” courts have found coverage. But where, as in *Rankin*, the policy insures against “physical loss,” there may be no coverage.

C. Loss of Warranty

Some policyholders have sought coverage for the loss of a manufacturer’s warranty on commercial property. In *Glens Falls Insurance Co. v. Covert*,⁷⁰ a Texas appellate court found that the loss of warranty without proof of any demonstrable physical damage to the property did not trigger coverage. In *Covert*, the manufacturer of vehicle safety stabilizers owned by the insured (for eventual resale to others) withdrew its warranty after the stabilizers fell from a storage area to the floor below.⁷¹ The stabilizers were in sealed units and, thus, could not be inspected for internal damage. Under these circumstances, the court found that there was no coverage because there was “no evidence of physical loss or damage” and because the loss of warranty “was a type of loss not covered.”⁷²

65. *Id.* at 978.

66. *Rankin v. USAA Cas. Ins. Co.*, 271 F. Supp. 3d 1218 (D. Colo. 2017).

67. *Id.* at 1221.

68. *Id.* at 1226.

69. *Id.* at 1231.

70. *Glens Falls Ins. Co. v. Covert*, 526 S.W.2d 222 (Tex. Ct. App. 1975).

71. *Id.* at 222.

72. *Id.*

D. *Loss of Merchantability*

A similar issue is whether the loss of merchantability of insured merchandise constitutes “physical loss or damage.” Court interpretations in these cases have not been uniform.

Some courts have found that the loss of merchantability does not constitute physical loss or damage. In *Columbiaknit, Inc. v. Affiliated FM Insurance Co.*,⁷³ the insured sought to recover for dry garments that were packed away with goods saturated by rainwater and later opened up. An Oregon federal court ruled that a retailer’s decision not to sell certain garments as new, “in the absence of distinct and demonstrable physical change to the garment necessitating some remedial action that would preclude honestly marketing as first quality goods, is not a covered loss.”⁷⁴ The court cautioned that “[t]he recognition that physical damage or alteration of property at the microscopic level does not obviate the requirement that physical damage need be distinct and demonstrable.”⁷⁵ The court ruled that that to be covered, Columbiaknit had to demonstrate that its garments and fabric had been water-soaked, that they had developed an odor, mold, or mildew, or that the goods had been physically changed in such a way that the goods would develop an odor, mold, or mildew.⁷⁶

The case *Meridian Textiles, Inc. v. Indemnity Insurance Co. of North America*⁷⁷ is in accord. There, Meridian sought coverage for the diminution in value of the yarn stored in a warehouse damaged by fire even though it was not burned, water-soaked, or otherwise affected by fire, smoke, water, or humidity. Meridian claimed that its customers would not purchase the yarn at full value once they learned that it had been exposed to fire, smoke, heat, water, and mold.⁷⁸ Citing as examples the *Covert* and *Columbiaknit* cases, a California federal court concluded that a customer’s perception of loss of value was not, by itself, sufficient to trigger coverage.⁷⁹ Rather, the court found that the policy required proof of an actual physical loss, specifically that the yarn was water-damaged or that there was some tangible or detectable physical change in the yarn.⁸⁰

73. *Columbiaknit, Inc. v. Affiliated FM Ins. Co.*, No. 98-434-HU, 1999 U.S. Dist. LEXIS 11873 (D. Or. Aug. 4, 1999).

74. *Id.* at *18.

75. *Id.*

76. *Id.* at *21. The court noted that “if an article of retail clothing has an odor strong enough that it must be washed to remove it, (and the garment therefore cannot be sold as new) it has sustained physical damage and would be covered under an ‘all-risk’ property insurance policy.” *Id.* at *17.

77. *Meridian Textiles, Inc. v. Indem. Ins. Co. of N. Am.*, No. CV 06-4766 CAS, 2008 U.S. Dist. LEXIS 91371 (C.D. Cal. Mar. 20, 2008).

78. *Id.* at *2–3. Meridian Textiles made a claim for the diminution in value of the yarn that it sold in the secondary market. *Id.* at *3.

79. *Id.* at *17.

80. *Id.* at *18.

A similar result can be seen in *Borton & Sons, Inc. v. Travelers Insurance Co.*⁸¹ In *Borton*, a Washington appellate court decided there was no coverage for an insured's claim that it was unable to sell apples stored in an undamaged warehouse after its sale of "inferior" apples that were exposed to leaking ammonia at a different warehouse eroded customer confidence in all of the insured's apples.⁸² *Borton*, citing *Western Fire* among other cases, argued that "direct physical loss" can occur in the absence of any physical damage to the property.⁸³ The court, however, disagreed, concluding that "Borton's inability to sell the apples was not a 'direct physical loss' covered under the deluxe property coverage form."⁸⁴

But in contrast to these cases, several other courts have found that a loss of merchantability can constitute physical loss or damage. In *General Mills, Inc. v. Gold Medal Insurance Co.*,⁸⁵ a Minnesota appellate court found coverage for oat stocks (destined for use in Cheerios cereal) that the FDA would not allow to be used in food products as a result of a contractor treating the oats with an unapproved pesticide.⁸⁶ The court reasoned that the function of General Mills' food products was to be sold with an assurance that they meet certain regulatory standards and that this function was "seriously impaired."⁸⁷ The court held that this "impairment of function and value" of the oat stocks constituted physical loss or damage.⁸⁸

A New York appellate court reached a similar conclusion in *Pepsico, Inc. v. Winterthur International America Insurance Co.*,⁸⁹ which involved a claim for "off-tasting" soft drink products, resulting from faulty raw ingredients

81. *Borton & Sons, Inc. v. Travelers Ins. Co.*, No. 18100-6-III, 2000 Wash. App. LEXIS 93 (Ct. App. Jan. 25, 2000).

82. *Id.* at *3. The roof of one of Borton's apple storage facilities collapsed from the weight of accumulated ice and snow. *Id.* at *2. All of the apples, including Fuji apples, stored in the building were exposed to the elements as well as to leaking ammonia. *Id.* at *2. Nonetheless, Borton repackaged and sold some of the apples without informing buyers that the fruit had involved in a roof collapse or exposed to ammonia. *Id.* Borton sought coverage for Fuji apples stored in a different warehouse that it was unable to sell allegedly because the sale of "inferior" apples from the damaged warehouse eroded confidence in all of Borton's apples. *Id.* at *3

83. *Id.* at *11. Borton cited *Sentinel Management Co. v. New Hampshire Insurance Co.*, 563 N.W.2d 296 (Minn. Ct. App. 1997), *Western Fire Insurance Co. v. First Presbyterian Church*, 437 P.2d 52 (Colo. 1968), and *Murray v. State Farm Fire & Casualty Co.*, 509 S.E.2d 1 (W. Va. 1998). *Id.* The Borton court distinguished *Sentinel* (asbestos contamination) and *Western Fire* (gasoline contamination), noting that "there was some physical effect on the covered property that triggered coverage" and that the home involved sustained damage because they were unsafe for habitation. *Id.* at *12. The court distinguished *Murray*, a case involving potential physical damage from falling rocks, reasoning that "there was no real or even potential physical damage to the 1,089 bins of Fuji apples" and because the case conflicted with Washington law. *Id.* (citing *Fuji v. State Farm Fire & Cas. Co.*, 857 P.2d 1051 (Wash. Ct. App. 1993)).

84. *Id.* at *13.

85. *Gen. Mills, Inc. v. Gold Medal Ins. Co.*, 622 N.W.2d 147 (Minn. Ct. App. 2001).

86. *Id.* at 150-51.

87. *Id.* at 152.

88. *Id.* (citing *Sentinel Mgmt. Co. v. N.H. Ins. Co.*, 563 N.W.2d 296 (Minn. Ct. App. 1997)).

89. *Pepsico, Inc. v. Winterthur Int'l Am. Ins. Co.*, 806 N.Y.S.2d 709 (App. Div. 2005).

supplied by third-party suppliers. The court rejected the insurer's argument that the insured's products were not physically damaged.⁹⁰ The court concluded that the insured did not have to prove a distinct demonstrable alteration of the physical structure of the products and that it was "sufficient under the circumstances of this case involving the unmerchantability of beverage products that the product's function and value have been seriously impaired, such that the product cannot be sold."⁹¹

The New Jersey court in *Customized Distribution Services v. Zurich Insurance Co.*⁹² went even further when it ruled that customers' change in perception of a product constituted physical loss or damage. There, the insured failed to rotate products it stored for Campbell Soup Company and some shipments were made after the product expiration date.⁹³ In finding coverage for the insured's losses, a New Jersey appellate court concluded "that it was not necessary that the product's material or chemical composition be altered" and that the customers' change in perception was the "functional equivalent of damage of a material nature or an alteration in physical composition."⁹⁴

In sum, the cases involving a loss of merchantability illustrate two distinct approaches. In *Columbiaknit*, *Meridian*, and *Borton*, the courts found that a loss of merchantability alone was not enough to satisfy the "physical loss or damage" requirement and that physical loss or damage requires proof of a distinct, demonstrable physical alteration of the insured property. But in *General Mills*, *Pepsico*, and *Customized*, the courts, faced with no demonstrable change or alteration of the insured property, relied on a loss of functionality and a change in market perception. But these interpretations of the term "physical" appear at odds with the word's plain meaning and essentially rendered that term meaningless.

E. Loss of Functionality or Reliability

As noted, the courts in *General Mills* and *Pepsico* found that the "functional impairment" of food and beverage products constituted physical loss or damage. Similar arguments have been made in claims involving electronic equipment with mixed success.

Some courts have found that the mere failure of electronic equipment to operate or function properly is not physical loss or damage. In *MRI Healthcare Center of Glendale, Inc. v. State Farm General Insurance Co.*,⁹⁵ a California

90. *Id.* at 710.

91. *Id.*

92. *Customized Distrib. Services v. Zurich Ins. Co.*, 862 A.2d 560 (N.J. Super. Ct. App. Div. 2004).

93. *Id.* at 562.

94. *Id.* at 565–66.

95. *MRI Healthcare Ctr. of Glendale, Inc. v. State Farm Gen. Ins. Co.*, 115 Cal. Rptr. 3d 27 (Ct. App. 2010).

appellate court found no coverage for an MRI machine that failed to turn on after it was “ramped down” to make repairs to a rain-damaged roof.⁹⁶ The court reasoned that for coverage to apply, “some external force must have acted upon the insured property to cause a physical change in the condition of the property.”⁹⁷ The court cited the absence of any “distinct, demonstrable [or] physical alteration” of the MRI machine and that the failure of the MRI machine to satisfactorily “ramp up” was not physical damage.⁹⁸

The court in *AFLAC Inc. v. Chubb & Sons*⁹⁹ reached the same conclusion in a claim for the costs of converting computer systems from two-digit to four-digit date recognition capability in anticipation of the Y2K computer problem. The Georgia Court of Appeals concluded that the phrase “direct physical loss or damage” contemplates “an actual change in insured property then in a satisfactory state, occasioned by accident or other fortuitous event directly upon the property causing it to become unsatisfactory for future use or requiring that repairs be made to make it so.”¹⁰⁰ The court concluded that there was no requisite physical loss or damage and no actual change in the computer systems from a fortuitous event

But some courts have determined that the loss of use, functionality, or reliability of electronic equipment constitutes physical loss or damage. *Wakefern v. Liberty Mutual Fire Insurance Co.*¹⁰¹ is one example. There, Wakefern’s supermarkets suffered food spoilage and business income losses during the August 2003 blackout, which occurred after the proper operation of protective relay devices caused the de-energizing of transmission lines.¹⁰² After finding the undefined term “physical damage” to be ambiguous, the New Jersey appellate court held that “the electrical grid was ‘physically damaged’ because, due to a physical incident or series of incidents, the grid and its component generators and transmission lines were physically incapable of performing their essential function of providing electricity.”¹⁰³

96. As a result of storms in the spring of 2005, MRI Healthcare’s landlord had to repair the roof over the room housing the MRI machine. *Id.* at 31. These repairs could not be undertaken until the MRI machine was demagnetized, or “ramped down.” *Id.* But once the machine was ramped down, it failed to ramp back up. *Id.*

97. *Id.* at 38.

98. *Id.* Because the accidental direct physical loss requirement was part of the policy’s insuring clause, the court noted that MHC bore the burden of proof. *Id.* at 36.

99. *AFLAC Inc. v. Chubb & Sons*, 581 S.E.2d 317 (Ga. Ct. App. 2003).

100. *Id.* at 319.

101. *Wakefern v. Liberty Mut. Fire Ins. Co.*, 968 A.2d 724 (N.J. Super. Ct. App. Div. 2009).

102. *Id.* at 727, 731.

103. *Id.* at 734. Liberty’s service interruption coverage required “physical damage” to certain off-premises electrical equipment and property. *Id.* at 728.

A similar result can be seen in *Stack Metallurgical Services Inc. v. Travelers Indemnity Co. of Connecticut*.¹⁰⁴ There, the insured's furnace used to heat treated medical devices could no longer be used for that purpose after the furnace became contaminated with lead particles from a disintegrating lead hammer that was left behind in the furnace.¹⁰⁵ In ruling that the insured established the requisite physical loss or damage for its business income claim, an Oregon federal court concluded that "the physical change in the furnace from a release of lead particles, which prevented the furnace from being used for its ordinary expected purpose, is fairly characterized as a 'direct physical loss of or damage to' the furnace."¹⁰⁶

Finally, the court in *Ashland Hospital Corp. v. Affiliated FM Insurance Co.*¹⁰⁷ determined that the "loss of reliability" of electronic equipment constituted physical loss or damage. In *Ashland*, a hospital's computer equipment used to store medical records was subjected to elevated temperatures when the air conditioning equipment failed.¹⁰⁸ Thereafter, the equipment manufacturer recommended replacement because it could "no longer confirm the long term reliability" of the exposed equipment.¹⁰⁹ In finding coverage, the Kentucky federal court decided that the "core function and value" of the equipment was to provide the insured hospital with "99.999% guaranteed reliability of critical data" and the equipment's "value—its insurable risk—is its reliability."¹¹⁰

As these cases illustrate, courts have taken two distinct approaches in claims involving the loss of functionality of electronic equipment. Some courts have relied on the traditional definition of "physical" in finding that physical loss or damage requires a distinct, demonstrable physical alteration of the equipment. But other courts have given "physical" a broader interpretation in finding that the loss of use, functionality, or reliability constitutes physical loss or damage.

104. *Stack Metallurgical Servs. Inc. v. Travelers Indem. Co.*, No. 05-1315-JE, 2007 U.S. Dist. LEXIS 9267 (D. Or. Feb. 7, 2007).

105. *Id.* at *2-3.

106. *Id.* at *25.

107. *Ashland Hosp. Corp. v. Affiliated FM Ins. Co.*, No. 11-16-DBL-EBA, 2013 U.S. Dist. LEXIS 114730 (E.D. Ky. Aug. 14, 2013).

108. *Id.* at *2. Alarms within the equipment alerted EMC that various component parts of the unit had been exposed to increased temperatures. The EMC equipment ultimately went into a failed state, rendering the system unavailable for a period of several hours. *Id.*

109. *Id.* at *4. According to an EMC engineer, the event logs from the overheat event showed that hundreds of components failed from thermal over-temperature conditions. *Id.* at *3. Some drives reported "media errors" meaning that they either could not read new data, or could not have new data written onto them. *Id.* Other drives reported hardware errors. *Id.*

110. *Id.* at *15.

F. *Loss of Use from Threat of Damage, Lack of Access, or Lack of Power*

Some insureds have claimed that the loss of use of insured property from the threat of future damage, lack of access, or lack of power constitutes physical loss or damage. In most cases, courts have found that the loss of use in these circumstances does not constitute physical loss or damage.

In *Phoenix Insurance Co. v. Infogroup, Inc.*,¹¹¹ an Iowa federal court held that loss of use of insured property due to the threat of flood was not physical loss or damage.¹¹² Citing the dictionary definition of “physical,” the court said that the “common usage of physical in the context of a loss therefore means the loss of something material or perceptible on some level.”¹¹³ The court found that “mere loss of use does not constitute physical loss or damage.”¹¹⁴ The court noted that while a loss of use may in some cases constitute a physical loss, it found that “interpretation of physical loss as requiring only loss of use stretches ‘physical’ beyond its ordinary meaning and may, in some cases, ‘render the word ‘physical’ meaningless.’”¹¹⁵

Similarly, the court in *Roundabout Theatre Co. v. Continental Casualty Co.*¹¹⁶ found that physical loss or damage did not include loss of use when the insured’s theatre became inaccessible because the city closed a nearby street after a building collapsed. The New York appellate court found that a policy requiring “loss of, damage to, or destruction of property” did not encompass the “loss of use” of property.¹¹⁷ In doing so, the appellate court

111. *Phoenix Ins. Co. v. Infogroup, Inc.*, 147 F. Supp. 3d 815 (S.D. Iowa 2015).

112. *Id.* at 825. The insured relocated its business due to a threat of flooding from the nearby Missouri River. *Id.* at 820.

113. *Id.* at 823.

114. *Id.* at 825. The court rejected Infogroup’s claim that it lost use of its facilities because a small group of employees, equipment, and key internet servers remained at the facilities. *Id.* at 824.

115. *Id.* at 825 (quoting in part *Source Food Tech., Inc. v. U.S. Fid. & Guar. Co.*, 465 F.3d 834, 838 (8th Cir. 2006)). The court added that “physical loss or damage” therefore “requires a material loss amounting to something greater than the threat of loss, even if that loss is tangential or minimal.” *Id.*

116. *Roundabout Theatre Co. v. Cont’l Cas. Co.*, 751 N.Y.S.2d 4 (App. Div. 2002). The Roundabout was staging the musical Cabaret at the Kit Kat Club. *Id.* at 5. After the street closure, Roundabout canceled 35 performances of Cabaret. *Id.* The theatre sustained minor damage to its roof and air conditioning system, which was repaired within one day. *Id.*

117. *Id.* at 6. The policy’s business interruption coverage included the following “Insuring Agreement”:

The Company agrees to pay to the Insured such loss . . . as the Insured shall necessarily incur in the event of interruption, postponement or cancellation of an Insured Production as a direct and sole result of loss of, or damage to, or destruction of property or facilities (including the theatre building occupied . . . by the Insured and [certain equipment]), contracted by the Insured for use in connection with such Protection, caused by the perils insured against, and occurring during the term of coverage

rejected the trial court's finding that the phrase "loss of" would be redundant to "destruction of" property if it did not mean "loss of use."¹¹⁸ The court reasoned that the "loss of" language was not redundant because it could refer to theft or misplacement of theatre property.¹¹⁹

Likewise, another New York appellate court in *Newman Myers Kreines Gross Harris, P.C. v. Great Northern Insurance Co.*¹²⁰ ruled there was no coverage for the insured law firm's business income losses sustained after Consolidated Edison preemptively shut off power to lower Manhattan in advance of Superstorm Sandy. The court found that the loss of use of the insured's law offices did not constitute physical loss or damage because the "physical loss or damage" requirement "unambiguously, requires some form of actual, physical damage to the insured premises."¹²¹

In the same way, the Eighth Circuit Court of Appeals in *Pentair, Inc. v. American Guarantee & Liability Insurance Co.*¹²² determined that the inability of the insured's suppliers to function after a power failure did not constitute physical loss or damage. Lacking power, the suppliers could not manufacture products they were supplying to Pentair.¹²³ When production resumed two weeks later, Pentair shipped orders from Taiwan via airfreight to meet its customers' needs for the Christmas season, resulting in additional costs.¹²⁴ The court rejected the insured's argument that its suppliers' inability to function after the power outage constituted direct physical loss or damage, reasoning that this "would mean that direct physical loss or damage is established *whenever* property cannot be used for its intended purpose."¹²⁵

And in *Heller's Gas, Inc. v. International Insurance Co. of Hannover Ltd.*,¹²⁶ a Pennsylvania federal court found no coverage where the insured's bulk propane storage tanks were rendered unusable because sinkholes

Id. at 5. The "Perils Insured" clause in the policy provided that "This coverage insures against all risks of direct physical loss or damage to the property described in Paragraph I . . . , except as hereinafter excluded." *Id.* The policy did not include Ingress/Egress or Civil Authority coverage. *See id.* at 6.

118. *Id.*

119. *Id.* at 8.

120. *Newman Myers Kreines Gross Harris, P.C. v. Great N. Ins. Co.*, 17 F. Supp. 3d 323 (S.D.N.Y. 2014). Consolidated Edison shut off power to preserve the integrity of its utility system in the event of flooding from the oncoming storm. *Id.* at 325.

121. *Id.* at 331. The court observed that the "words 'direct' and 'physical,' which modify the phrase 'loss or damage,' ordinarily connote actual, demonstrable harm of some form to the premises itself . . ." *Id.*

122. *Pentair, Inc. v. Am. Guar. & Liab. Ins. Co.*, 400 F.3d 613 (8th Cir. 2005) (applying Minnesota law).

123. In *Pentair*, an earthquake that struck Taiwan caused a power outage to two Taiwanese factories that supplied products to Pentair. *Id.* at 614.

124. *Id.*

125. *Id.* at 616.

126. *Heller's Gas, Inc. v. Int'l Ins. Co.*, No. 4:15-CV-01350, 2017 U.S. Dist. LEXIS 151072 (M.D. Pa. Sept. 18, 2017).

developed at the base of tanks. The insured sought coverage for damage to the tanks, arguing that the sinkhole rendered the tanks unusable.¹²⁷ In rejecting the insured's argument, the court distinguished those cases where courts found coverage for loss of use due to the presence of bacteria or odors. The court reasoned that these cases did not address whether a non-gaseous or bacterial-related condition on non-covered property—in this case land—can constitute a physical loss.¹²⁸

But two courts have ruled otherwise. In *Murray v. State Farm Fire & Casualty Insurance Co.*,¹²⁹ West Virginia's highest court found coverage for homes rendered unusable or uninhabitable because of the threat of a future rock fall from an abandoned rock quarry, which had already caused extensive damage to neighboring homes.¹³⁰ The court determined that the insureds suffered "direct physical loss" to insured property even "in the absence of structural damage to the insured property."¹³¹ The *Murray* court reasoned that the homes "became unsafe for habitation, and therefore suffered real damage when it became clear that rocks and boulders could come crashing down at any time."¹³²

And in *Manpower Inc. v. Insurance Co. of the State of Pennsylvania*,¹³³ a Wisconsin federal court ruled that the inaccessibility of personal property constituted a physical loss. There, Manpower sought coverage for the value of its business personal property that became inaccessible after a portion of the office building in which it was located collapsed. The court found that the insured suffered a "loss" of its interest in this property when the collapse prevented it from using the property for its intended purposes.¹³⁴ The court reasoned that the loss was "physical" because it was caused by a physical event—the collapse—"which created a physical barrier between the insured and its property."¹³⁵ But the court acknowledged that an issue remained as to "how to calculate damages in light of the fact that the property is undamaged and probably will be recovered."¹³⁶ The court observed that when recovered, the property might have value, and that value may need to be deducted from Manpower's damages.¹³⁷

127. *Id.* at *20.

128. *Id.* at *23.

129. *Murray v. State Farm Fire & Cas. Ins. Co.*, 509 S.E.2d 1 (W. Va. 1998).

130. *Id.* at 4–5.

131. *Id.* at 17.

132. *Id.*

133. *Manpower Inc. v. Ins. Co. of Penn.*, No. 08C0085, 2009 U.S. Dist. LEXIS 108626 (E.D. Wis. Nov. 3, 2009).

134. *Id.* at *23–24.

135. *Id.* at *21.

136. *Id.* at *24–25 n.11.

137. *Id.* at *25 n.11.

In short, courts are fairly uniform in finding that loss of use from the threat of damage, lack of access, or lack of power does not constitute physical loss or damage. *Murray* and *Manpower*, however, are exceptions. Despite the clear absence of any demonstrable physical alteration of insured property, the *Murray* and *Manpower* courts found that property rendered unusable from the threat of structural damage or the loss of access constituted physical loss or damage. Several courts, however, have declined to follow the reasoning in *Murray*, including those in *Infogroup* and *Newman Myers*.

G. Loss of Use from Bacteria, Odor, or Noxious Gases

The presence of bacteria, odor, smoke, or noxious gases may constitute physical loss or damage where insured property has been rendered uninhabitable or unusable for its intended purpose. As discussed previously, the Colorado Supreme Court in *Western Fire Insurance Co. v. First Presbyterian Church*¹³⁸ held that a church building sustained physical loss when it was rendered uninhabitable and dangerous because of the accumulation of gasoline under and around the church.¹³⁹

Other courts have relied on *Western Fire* to find that the “physical loss or damage” requirement has been satisfied in cases involving a variety of odors. For instance, the Oregon appellate court in *Farmers Insurance Co. of Oregon v. Trutanich*,¹⁴⁰ found that odor from methamphetamine cooking by tenants in the insured’s leased home constituted physical loss or damage.¹⁴¹ The court held “that odor was ‘physical’ because it damaged the house.”¹⁴² The court found the *Western Fire* case “on point and persuasive” and concluded that the “pervasive odor” that persisted in the house was evidence of physical damage.¹⁴³

Similarly, in *Mellin v. Northern Security Insurance Co.*,¹⁴⁴ the New Hampshire Supreme Court concluded that cat urine odor that entered the insured’s condominium unit from a neighboring unit could constitute physical loss or damage.¹⁴⁵ The court conceded that “physical loss” required “a distinct

138. *W. Fire Ins. Co. v. First Presbyterian Church*, 437 P.2d 52 (Colo. 1968).

139. *Id.* at 55. In *Western Fire*, the insured, acting on orders of the local fire department, closed its church building because gasoline infiltration in the soil under and around the church building and gasoline vapor accumulation inside the church made it uninhabitable. *Id.* at 54. *Western Fire* denied the insured’s claim for the cost to remedy the infiltration and contamination problem. *Id.*

140. *Farmers Ins. Co. v. Trutanich*, 858 P.2d 1332 (Or. Ct. App. 1993).

141. The Oregon appellate court held “that odor was ‘physical’ because it damaged the house.” *Id.* at 1335. The court found the *Western Fire* case “on point and persuasive” and concluded that the “pervasive odor” that persisted in the house was evidence of physical damage. *Id.* at 1335-36.

142. *Id.* at 1335.

143. *Id.* at 1335-36.

144. *Mellin v. N. Sec. Ins. Co.*, 115 A.3d 799 (N.H. 2015).

145. *Id.* at 801.

and demonstrable alteration of the insured property.”¹⁴⁶ But the court found that this included “not only tangible changes to the property that can be seen or touched” but also “changes that are perceived by the sense of smell and that exist in the absence of structural damage.”¹⁴⁷ The *Mellin* court reasoned that “[e]vidence that a change rendered the insured property temporarily or permanently unusable or uninhabitable may support a finding that the loss was a physical loss to the insured property”¹⁴⁸ The court expressed no opinion as to whether the Mellins’ loss met this standard and remanded the case back to the trial court for that determination.¹⁴⁹

Similarly, two courts decided that the presence of a noxious odor from the “off-gassing” of sulfide gases and other toxic chemicals from “Chinese Drywall” constituted physical loss or damage. In *Travco Insurance Co. v. Ward*,¹⁵⁰ a Virginia federal district judge rejected the insurer’s argument that physical damage required some physical alteration or injury to the property’s structure and found that the insured’s residence had suffered a direct physical loss because “the building in question has been rendered unusable by physical forces.”¹⁵¹ Likewise, a Louisiana federal court in *In re Chinese Manufactured Drywall Products Liability Litigation*,¹⁵² concluded that the Chinese drywall caused a “distinct, demonstrable, physical alteration” of the insureds’ homes by corroding the silver and copper elements in the homes, as well as by emitting odorous gases.¹⁵³ But in both of these cases, the courts ultimately found that the losses were still not covered due to policy exclusions.¹⁵⁴

Courts also have found that the presence of bacteria may constitute physical loss or damage. In *Motorists Mutual Insurance Co. v. Hardinger*,¹⁵⁵ the Third Circuit Court of Appeals applying Pennsylvania law ruled that the issue of whether the presence of *E. coli* bacteria in the well of the insureds’ home constituted physical loss or damage was a fact issue for the

146. *Id.* at 805.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Travco Ins. Co. v. Ward*, 715 F. Supp. 2d 699 (E.D. Va. 2010), *aff’d on other grounds*, 504 F. App’x 251 (4th Cir. 2013).

151. *Id.* at 702–04, 708.

152. *In re Chinese Manufactured Drywall Prods. Liab. Litig.*, 759 F. Supp. 2d 822 (E.D. La. 2010).

153. *Id.* at 831.

154. In *Travco*, the court found that the latent defect, faulty materials, corrosion, and pollution exclusions barred coverage for the cost of removing and replacing the Chinese drywall and for all of the damages claimed to have been caused by the Chinese drywall. *Travco*, 715 F. Supp. 2d at 710–18. The court in *In re Chinese Drywall* found that claims were excluded by exclusions for “faulty materials” and “corrosion” and that the damages did not constitute a covered “ensuing loss.” *In re Chinese Drywall*, 759 F. Supp. 2d at 843–51.

155. *Motorists Mut. Ins. Co. v. Hardinger*, 131 F. App’x 823 (3d Cir. 2005) (applying Pennsylvania law).

jury.¹⁵⁶ The court found persuasive its previous decision in *Port Authority of New York & New Jersey v. Affiliated FM Insurance Co.*,¹⁵⁷ decided under New York and New Jersey law, in which it found that the release of asbestos that resulted in the loss of function or utility of the building or made the building useless or uninhabitable constituted physical loss or damage.¹⁵⁸ The court concluded that the jury would determine whether “the functionality of the Hardingers’ property was nearly eliminated or destroyed, or whether their property was made useless or uninhabitable.”¹⁵⁹

In the same manner, courts have found that smoke and noxious gases may constitute physical loss or damage. In *Oregon Shakespeare Festival Ass’n v. Great American Insurance Co.*,¹⁶⁰ an Oregon federal court determined that smoke from a nearby wildfire that infiltrated a partially enclosed, open-air theater constituted physical loss or damage. In rejecting the insurer’s argument that air was not “physical,” the court concluded that “while air may often be invisible to the naked eye, surely the fact air has physical properties cannot reasonably be disputed.”¹⁶¹ The court concluded that it was “undisputed that the interior of the building had to be cleaned, the air filters had to be changed multiple times, and smoke in the air within the theater had to dissipate before business could be resumed.”¹⁶²

Finally, a New Jersey federal court in *Gregory Packaging, Inc. v. Travelers Property Casualty Co. of America*,¹⁶³ found that the release of ammonia refrigerant from a refrigeration system at the insured’s juice packaging facility constituted physical loss or damage.¹⁶⁴ The court determined that the ammonia release rendered the insured’s facility “physically unfit for

156. The court found persuasive its previous decision in *Port Authority of New York & New Jersey v. Affiliated FM Insurance Co.*, 311 F.3d 226 (3d Cir. 2002) in which the court found that the release of asbestos that resulted in the loss of function or utility of the building or made the building useless or uninhabitable constituted physical loss or damage. *Hardinger*, 131 F. App’x at 826–27.

157. *Port Auth. of N.Y. & N.J. v. Affiliated FM Ins. Co.*, 311 F.3d 226 (3d Cir. 2002).

158. *Motorists Mut.*, 131 F. App’x at 826.

159. *Id.* at 826–27. The appellate court also found there was a genuine issue of fact as to whether the loss predated the inception of the policy and directed the trial court to consider whether the policy’s pollution exclusion applied to the presence of *E. coli* bacteria in the insureds’ well. *Id.* at 827.

160. *Or. Shakespeare Festival Ass’n v. Great Am. Ins. Co.*, No. 1:15-cv-01932-CL, 2016 U.S. Dist. LEXIS 74450 (D. Or. June 7, 2016).

161. *Id.* at *15.

162. *Id.* at *17. At the parties’ joint request, the court later vacated its order. See *Or. Shakespeare Festival Ass’n v. Great Am. Ins. Co.*, No. 1:15-cv-01932-CL, 2017 U.S. Dist. LEXIS 33208 (D. Or. Mar. 6, 2017).

163. *Gregory Packaging, Inc. v. Travelers Prop. Cas. Co.*, Civ. No. 2:12-cv-04418 (WHW) (CLW), 2014 U.S. Dist. LEXIS 165232 (D.N.J. Nov. 25, 2014).

164. The court granted Gregory Packaging’s motion for summary judgment, holding that the ammonia discharge inflicted “physical loss of or damage to” Gregory Packaging’s facility under New Jersey law. *Id.* at *13–17. The court also examined the issue under Georgia law and reached the same conclusion. *Id.* at *18.

normal human occupancy and continued use until the ammonia was sufficiently dissipated.”¹⁶⁵ The court concluded that “[w]hile structural alteration provides the most obvious sign of physical damage,” it noted that “property can sustain physical loss or damage without experiencing structural alteration.”¹⁶⁶

But at least one court decided that an odor does not constitute physical loss or damage if it does not render the insured premises uninhabitable. In *Universal Image Productions, Inc. v. Chubb Corp.*,¹⁶⁷ a Michigan federal court ruled that a foul odor caused by bacterial contamination inside in a building’s ductwork did not constitute physical loss or damage. Relying on the dictionary definition of “physical,” the court found that the insured had not shown that it suffered “any structural or any other tangible damage to the insured property.”¹⁶⁸ In rejecting the insured’s argument that the strong odors and the presence of mold and bacteria in its building rendered the premises useless, the court concluded that even physical damage that occurs at the molecular or microscopic level must be “distinct and demonstrable” and that “there is no evidence that this stench was so pervasive as to render the premises uninhabitable.”¹⁶⁹

As these cases illustrate, some courts have found that “physical loss or damage” does not require that the physical loss or damage be tangible, structural, or even visible. These courts have determined that the presence of bacteria, odors, or noxious gases in a building may constitute physical loss or damage if the property is rendered uninhabitable or unfit for its intended purpose. In doing so, these cases have further broadened the interpretation of the “physical loss or damage” requirement and have decided that it is satisfied where the property’s value, usefulness, or functionality has been destroyed or diminished. But coverage for these types of claims may still be excluded by contamination and pollution exclusions.

H. *Asbestos and Lead*

The issue of whether asbestos or lead in buildings constitutes physical loss or damage has arisen in several cases. Courts have concluded that the mere presence of undamaged or intact materials containing lead and asbestos

165. *Id.* at *17.

166. *Id.* at *13.

167. *Universal Image Prods., Inc. v. Chubb Corp.*, 703 F. Supp. 2d 705 (E.D. Mich. 2010). The foul odor became apparent after a heavy rainfall. *Id.* at 708. Subsequent testing revealed bacterial contamination in the air and water inside the duct work. *Id.* As a result, the building owner shut down and cleaned the air handling system and ductwork and installed temporary cooling units. *Id.*

168. *Id.* at 709–10 (quoting in part *Merriam Webster’s Online Dictionary*, available at <http://www.merriam-webster.com>).

169. *Id.* at 710.

do not constitute physical loss or damage but that the presence of friable asbestos and non-intact lead-based paint does.

In *Great Northern Insurance Co. v. Benjamin Franklin Federal Savings & Loan Ass'n*,¹⁷⁰ for example, an Oregon federal court found no coverage for the cost to remove asbestos, loss of use, and other expenses after the insured's tenant discovered asbestos during a remodel. The court concluded that the "building has remained physically intact and undamaged" and that the "only loss is economic."¹⁷¹ The court reasoned that the policy, by its terms, covered only direct physical loss and the "inclusion of the terms 'direct' and 'physical' could only have been intended to exclude indirect, non-physical losses."¹⁷²

A similar result can be seen in *Port Authority of New York & New Jersey v. Affiliated FM Insurance Co.*¹⁷³ There the Second Circuit Court of Appeals observed that the "widely accepted definition" of physical loss or damage was "a distinct, demonstrable, and physical alteration" of the insured property.¹⁷⁴ The court drew a distinction between the mere presence of asbestos and the release of asbestos, concluding that only the latter constituted physical loss or damage.¹⁷⁵ The court concluded that the "mere presence of asbestos, or the general threat of future damage from that presence, lacks the distinct and demonstrable character necessary for first-party insurance coverage."¹⁷⁶

The same rationale has been applied in cases involving lead. In *Pirie v. Federal Insurance Co.*,¹⁷⁷ the Massachusetts appellate court held there was no coverage for the cost to abate lead paint in the insured's 154-year old house.¹⁷⁸ The Massachusetts Department of Public Health ordered the lead paint abatement after finding the lead levels in the house were many times the legal limit.¹⁷⁹ The court reasoned that the presence of lead paint was "an internal defect" in the insured property that "does not rise to the level of a physical loss."¹⁸⁰

170. *Great N. Ins. Co. v. Benjamin Franklin Fed. Sav. & Loan Ass'n*, 793 F. Supp. 259 (D. Or. 1990), *aff'd*, 953 F.2d 1387 (9th Cir. 1992).

171. *Id.* at 263.

172. *Id.*; *see also* *Leafland Group-II, Montgomery Towers Ltd. P'ship v. Ins. Co. of N. Am.*, 881 P.2d 26, 28 (N.M. 1994) (holding that the diminution in value of the insured property because of the presence of asbestos was not a covered loss).

173. *Port Auth. of N.Y. & N.J. v. Affiliated FM Ins. Co.*, 311 F.3d 226 (3d Cir. 2002) (applying New York and New Jersey law).

174. *Id.* at 235.

175. *Id.* at 235-36.

176. *Id.* at 236.

177. *Pirie v. Fed. Ins. Co.*, 696 N.E.2d 553 (Mass. Ct. App. 1998).

178. In *Pirie*, local authorities ordered abatement of lead paint in the insured's 154-year old house after finding the levels of lead in the house were many times the legal limit. *Id.* at 554.

179. *Id.*

180. *Id.* at 555.

But courts have found coverage where asbestos has become friable or lead has become non-intact. In *Yale University v. CIGNA Insurance Co.*,¹⁸¹ a Connecticut federal court determined that contamination by the presence of friable asbestos and non-intact lead-based paint in the university's buildings constituted physical loss or damage.¹⁸² The court drew a distinction between claims for the "mere presence of intact materials containing lead and asbestos" and the "presence of friable asbestos and non-intact lead-based paint."¹⁸³ The court agreed that there was no coverage "for costs incurred due to the mere presence of asbestos-and-lead-containing materials in its buildings."¹⁸⁴

The court in *Sentinel Management Co. v. New Hampshire Insurance Co.*¹⁸⁵ also found coverage where asbestos fibers from asbestos-containing materials in ceiling and floor tiles, surface treatments, and insulation in an apartment building were released by abrasions from normal residential and building maintenance activities.¹⁸⁶ The Minnesota appellate court rejected the insurer's argument that asbestos contamination, absent structural damage, did not constitute a physical loss.¹⁸⁷ The court reasoned that while there may not have been any tangible injury to the structure, "a building's function may be seriously impaired or destroyed and the property rendered useless by the presence of contaminants."¹⁸⁸

To sum up, courts have concluded that claims involving the mere presence of intact materials containing lead and asbestos do not constitute physical loss or damage. But courts have found coverage for claims involving the presence of friable asbestos and non-intact lead-based paint. This distinction appears logical in light of the requirement that there be distinct, demonstrable, physical alteration of insured property to constitute physical loss or damage. Of course, many property policies exclude contamination and pollution, which may preclude coverage in claims involving the release of asbestos or lead. Indeed, the court in *Yale University* found that the policy's contamination exclusion precluded coverage for the insured's asbestos claims.¹⁸⁹

181. *Yale Univ. v. CIGNA Ins. Co.*, 224 F. Supp. 2d 402 (D. Conn. 2002).

182. *Id.* at 413–14. The *Yale* court found that the policy's contamination exclusion precluded coverage for Yale's claim for asbestos contamination but not the claim for lead contamination. *Id.* at 421–24. While the court found that asbestos met the definition of "contaminants" or "pollutants" within the meaning of the contamination exclusion, it found the exclusion ambiguous as to whether lead was a "contaminant" or "pollutant." *Id.* at 423–24.

183. *Id.* at 404.

184. *Id.* at 412.

185. *Sentinel Mgmt. Co. v. N.H. Ins. Co.*, 563 N.W.2d 296 (Minn. Ct. App. 1997).

186. *Id.* at 298. *Sentinel* sought coverage under its property policy, which insured against "all risks of direct physical loss." *Id.*

187. *Id.* at 300.

188. *Id.* (citation omitted).

189. *Yale Univ. v. CIGNA Ins. Co.*, 224 F. Supp. 2d 402, 423–24 (D. Conn. 2002). The policy in *Yale* excluded coverage for "loss or damage caused by, resulting from, contributed

I. Mold

Mold is somewhat unique because it can be either a type of damage or a cause of loss, depending on the circumstances. As damage, most courts have found that mold resulting from a covered cause of loss is physical loss or damage.

In *Sullivan v. Standard Fire Insurance Co.*,¹⁹⁰ the Delaware Supreme Court ruled that mold that developed inside the insured's condominium walls and insulation after a windstorm opened a hole in the roof constituted a "physical loss."¹⁹¹ Noting that the dictionary definition of "physical" was "having material existence," the court held that mold spores and other bacterial associated with mold "undoubtedly have a 'material existence,' even though they are not tangible or perceptible by the naked eye."¹⁹² Therefore, the court found that mold contamination constituted a physical loss.¹⁹³

Similarly, a Texas appellate court in *De Laurentis v. United Services Automobile Ass'n*¹⁹⁴ concluded that mold that developed on the insured's furniture, art work, clothing, and other personal property as a result of water leaking from an air conditioning unit constituted physical loss.¹⁹⁵ Relying on the dictionary definition of "physical," the court found that a "physical loss is simply one that relates to natural or material things."¹⁹⁶ Applying this standard, the court held that mold damage was a physical loss to the insured's personal property.

But not all courts have found that mold is physical loss or damage. In *Universal Image Productions, Inc. v. Federal Insurance Co.*,¹⁹⁷ for example, the Sixth Circuit Court of Appeals concluded that mold and bacterial contamination of a building discovered after a rainstorm did not constitute physical loss or damage.¹⁹⁸ The court reasoned that the insured's claim for cleaning and moving expenses and lost business income were economic losses, not tangible physical losses.¹⁹⁹ The court noted that while the insured cleaned several pieces of personal property to remove any possible mold or bacterial contaminant using hot water and a household cleaner, it did not believe

to, made worse by actual or alleged or threatened release, discharge, escape or dispersal of CONTAMINANTS or POLLUTANTS. . . ." *Id.* at 421.

190. *Sullivan v. Standard Fire Ins. Co.*, 956 A.2d 643, 2008 Del. LEXIS 66 (Del. 2008) (table).

191. *Id.* at *7.

192. *Id.*

193. *Id.*

194. *De Laurentis v. United Servs. Auto. Ass'n*, 162 S.W.3d 714 (Tex. Ct. App. 2005).

195. *Id.* at 716.

196. *Id.* at 723.

197. *Universal Image Prods., Inc. v. Fed. Ins. Co.*, 475 F. App'x 569 (6th Cir. 2012) (applying Michigan law).

198. *Id.* at 573.

199. *Id.*

that Michigan courts would find “basic cleaning to constitute physical loss or damage.”²⁰⁰

Courts also have found that mold does not constitute physical loss or damage where mold was not the result of a covered cause of loss. In *Mastellone v. Lightning Rod Mutual Insurance Co.*,²⁰¹ the Ohio Supreme Court held that mold discovered on the exterior rough-sawn cedar siding of the insured’s house did not constitute physical loss or damage. There, experts from both parties agreed that the mold was present only on the surface of the wood and could be removed without causing any harm to the wood.²⁰² The court rejected the insured’s argument that “the mere existence of dark staining on the siding showed physical injury to the siding.”²⁰³ The court reasoned that the term “physical injury” meant “a harm to the property that adversely affects the structural integrity of the house” and that the presence of mold did not alter or otherwise affect the structural integrity of the siding.²⁰⁴

Finally, the New Jersey Superior Court in *Kavesh v. Franklin Mutual Insurance*²⁰⁵ decided that mold growth on interior plywood surfaces of a home’s attic was not physical loss or damage. The court there distinguished between mold that was the direct result of a covered cause of loss and mold that was not.²⁰⁶ The court rejected the insured’s argument “that mold growth by itself was a material intrusion into the home that meets the requirement of ‘physical’ damage.”²⁰⁷

In sum, whether mold constitutes physical loss or damage largely depends on whether mold is the result of a covered cause of loss. Where mold develops but not as a result of some external event, courts have found that it does not constitute physical loss or damage.

J. *Electronically Stored Data*

Claims for the loss of computer data have presented a unique challenge to courts because of the intangible nature of electronic data. Predictably, the court decisions have not been uniform.

In *Ward General Services, Inc. v. Employers Fire Insurance Co.*²⁰⁸ a California appellate court held that the loss of the insured’s electronically stored data that occurred when human error caused the database system to “crash” did

200. *Id.* at 573 n.8.

201. *Mastellone v. Lightning Rod Mut. Ins. Co.*, 884 N.E.2d 1130 (Ohio 2008).

202. *Id.* at 1144.

203. *Id.* at 1144–45.

204. *Id.* at 1143, 1144–45.

205. *Kavesh v. Franklin Mut. Ins.*, No. A-5210-13T1, 2015 N.J. Super. Unpub. LEXIS 1378, at *8 (N.J. Super. Ct. June 10, 2015).

206. *Id.* at *7.

207. *Id.*

208. *Ward Gen. Servs., Inc. v. Emp’rs Fire Ins. Co.*, 7 Cal. Rptr. 3d 844 (Ct. App. 2003).

not constitute physical loss or damage.²⁰⁹ The court noted the word “physical” was defined in the dictionary to mean “having material existence” and “perceptible esp. through the senses and subject to the laws of nature.”²¹⁰ Citing dictionaries, the court also observed that “material” implies “formation out of tangible matter” and that “tangible” means, “capable of being perceived esp. by the sense of touch.”²¹¹ Relying on these definitions, the court reasoned that the loss must be to tangible matter.²¹² But the court determined that Ward sustained a “loss of information,” an intangible matter.²¹³ The court said that it “fail[ed] to see how *information, qua* information, can be said to have a material existence, be formed out of tangible matter, or be perceptible to the sense of touch.”²¹⁴

In contrast to *Ward*, an Arizona federal court in *American Guarantee & Liability Insurance Co. v. Ingram Micro, Inc.*²¹⁵ found coverage for the costs to reprogram a computer system that lost its data after a power outage.²¹⁶ The court rejected the insurer’s claim that Ingram’s computer systems were not physically damaged because their capability to perform their intended functions remained intact.²¹⁷ Instead, the court concluded “that physical damage is not restricted to the physical destruction or harm of computer circuitry but includes loss of access, loss of use, and loss of functionality.”²¹⁸

209. *Id.* at 846. Ward, an insurance broker, was in the process of updating its computer database when human error caused the database system to “crash,” resulting in the loss of Ward’s electronically-stored data used to service its clients’ insurance policies. Ward sought coverage for the extra expenses incurred in restoring its data and for the business income loss sustained because of the disruption. *Id.* Except for a small payment of \$5,000, Employers Fire denied Ward’s claim, asserting that none of the other loss or damage was a “direct physical loss.” *Id.*

210. *Id.* at 849 (quoting MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 875 (10th ed. 1993)).

211. *Id.* (quoting MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY, *supra* note 210, at 715, 1200).

212. *Id.*

213. *Id.* at 851.

214. *Id.* The court concluded that “the loss of the database, with its consequent economic loss, but with no loss of or damage to tangible property, was not a ‘direct physical loss of or damage to’ covered property under the terms of the subject insurance policy, and, therefore, the loss is not covered.” *Id.*

215. *American Guar. & Liab. Ins. Co. v. Ingram Micro, Inc.*, No. 99-185 TUC ACM, 2000 U.S. Dist. LEXIS 7299 (D. Ariz. Apr. 18, 2000).

216. As a result of a power outage at its data center, Ingram lost information stored in the random access memory of its mainframe computers and lost connections between its data center and six other Ingram locations in the United States and Europe for approximately eight hours and, as result, could not do business. *Id.* at *4. Ingram’s computer system had to be reprogrammed with the necessary custom configurations, which had been lost. *Id.*

217. *Id.* at *5.

218. *Id.* Notably, the *Ingram* court relied on the federal computer fraud statute that defined “damage” as “any impairment to the integrity or availability of data, a program, a system, or information” and on several state statutes with similar provisions. *Id.* at *6. The court cited 18 U.S.C. § 1030 (West 1999), CONN. GEN. STAT. § 53a-251 (2000), MINN. STAT. § 609.88

A Tennessee federal court followed this reasoning in *Southeast Mental Health Center, Inc. v. Pacific Insurance Co.*²¹⁹ There, a power outage damaged the insured's pharmacy computer, which resulted in a loss of data from the computer.²²⁰ Relying principally on *Ingram Micro*, the court held that "the corruption of the pharmacy computer constituted 'direct physical loss of or damage to property.'"²²¹

Similarly, the court in *NMS Services Inc. v. The Hartford*²²² decided that the erasure of files and data by computer hackers constituted physical loss or damage.²²³ The Fourth Circuit Court of Appeals, with little analysis, concluded that "[t]here is no question that NMS suffered damage to its property, specifically, damage to the computers it owned."²²⁴ One concurring judge gave the issue more analysis and reasoned that the erasure of computer data satisfied the "physical loss or damage" requirement because "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.'"²²⁵

In sum, computer data is intangible, and courts have reached different conclusions on the issue of whether computer data can sustain physical loss or damage. But this may not be a significant issue going forward because many commercial property policies now have a specific coverage, often limited, for loss or corruption of computer data.²²⁶

V. CONCLUSION

Physical loss or damage remains a necessary predicate to property insurance coverage. Using the dictionary definition of "physical" as a guide, many courts require that an insured demonstrate that the insured property suffered a distinct, demonstrable, and physical change or alteration

(1999), MO. ANN. STAT. § 569.093 (West 1999), and N.Y. PENAL LAW § 156.20 (McKinney 1999). The court acknowledged that these definitions were not in insurance coverage cases but found them relevant nonetheless. *Id.* This reasoning, however, appears flawed because the meaning of "damage" in a criminal fraud statute is not the same as "physical loss or damage" in an insurance contract

219. *Se. Mental Health Ctr., Inc. v. Pac. Ins. Co.*, 439 F. Supp. 2d 831 (W.D. Tenn. 2006).

220. *Id.* at 833.

221. *Id.* at 837.

222. *NMS Servs. Inc. v. Hartford*, 62 F. App'x 511 (4th Cir. 2003) (applying Virginia law).

223. In *NMS*, an employee installed two computer hacking programs on NMS's computer system, which allowed the employee to bypass security codes and erase files and data. *Id.* at 512.

224. *Id.*

225. *Id.* at 515 (Widener, J., concurring) (citations omitted; quoting in part *Comptroller of the Treasury v. Equit. Trust Co.*, 464 A.2d 248, 261 (Md. Ct. App. 1983)).

226. *See, e.g.*, ISO Building and Personal Property Coverage Form (CP 00 10 10 12).

to satisfy the threshold requirement for coverage. Some courts have even found that the insured has this burden even where the claimed physical damage occurs at the molecular or microscopic level. But other courts have adopted a much broader interpretation of the “physical loss or damage” requirement. These courts have found coverage in the absence of a distinct, demonstrable physical alteration of the property where the insured property has become uninhabitable or where a property’s function or reliability has been impaired. Thus, in some courts’ view, loss of property’s use, functionality, or reliability can constitute physical loss or damage. But in doing so, these courts have largely rendered the word “physical” meaningless and have failed to account for the historical origins of the “physical loss or damage” requirement.