

Physical But Not Tangible: Electronic Data Losses

Law360, New York (November 30, 2010) -- 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. Two significant trends have emerged.

First, data damage has begun to be viewed (though not uniformly) as “direct physical loss or damage” under first-party property insurance policies. At the same time, coverage for third-party losses has proved harder to obtain because courts have refused to consider lost electronic data as the kind of “tangible property” usually covered by third-party policies.

Loss of Computer Data as Physical Loss

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. The policy insured against “All Risks of direct physical loss or damage from any cause, howsoever or wheresoever occurring.”

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. The court found 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.”

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 sought coverage under a business income additional coverage provision, which stated that Hartford would “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.

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 [that the] Court has already concluded that the damage constitutes a covered cause of loss.” In a concurring opinion, Judge H. Emory Widener explained that the rearrangement of atoms or molecules of a disc or tape is a “physical” change.

Courts in Texas and Tennessee have issued similar rulings on matters involving data loss coverage, finding such loss created

the physical damage necessary to invoke coverage. See *Lambrecht & Assoc. Inc. v. State Farm Lloyds*, 119 S.W.3d 16 (Ct. App. Tex. 2003) (Insurer required to cover costs necessary to restore data after introduction of a computer virus, otherwise policy provision that implied coverage for business interruption resulting from loss of electronic records would be “illusory”.); *Southeast Mental Health Center Inc. v. Pacific Ins. Co. Ltd.*, 439 F. Supp. 2d 831 (W.D. Tenn. 2006)(Insured proved necessary direct physical loss where the insured’s pharmacy computer data was corrupted due to a power outage).

Or Not

Not all courts 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, wiping out critical data. The insured sought coverage for labor expenses to restore the database, in addition to income lost during the recovery period. The trial court found that the losses were not covered and the appellate court affirmed.

Ruling as a matter of law, the appeals court said that without loss of or damage to tangible property, the losses related to the database deletion were not a “direct physical loss or damage to” covered property under the policy. *Id.* at 851. The court 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.*

Electronic Data Loss Still Not “Tangible”

Data-loss claims in the third-party arena have not received a warm reception. Most liability policies typically provide coverage for “physical damage to tangible property,” rather than coverage for “physical loss or damage to property,” as found in first-party policies. To date, insureds have not been able to convince the courts that data stored in computers constitutes “tangible property” unless the policy has specific coverage for data.

In *America Online Inc. v. St. Paul Mercury Ins. Co.*, 207 F. Supp. 2d 459 (E.D. Va. 2002), America 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. America Online’s commercial general liability carrier, St. Paul, denied coverage. The policy covered liability for “physical damage to tangible property of others.” *Id.* Finding in favor of St. Paul, the court held:

"[C]omputer 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.*; see also [Seagate Technology Inc. v. St. Paul Fire and Marine Ins. Co.](#), 11 F. Supp. 2d 1150 (N.D. Cal. 1998), (Strongly implying that loss of data alone is not “physical damage to tangible property.”).

Conclusion

As society in general and courts in particular become more familiar with electronic data, they more readily accept it as something “physical.” We have not reached the point, however, where electronic data is viewed as “tangible” property and,

for the time being, coverage for third-party losses remains elusive and intangible.

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