Lost Computer Data: “Physical Loss” or Damage to “Tangible Property” for Purposes of Insurance Coverage?
by Scott T. Schutte

Computer technology and the Internet have opened up a new world of opportunity for today’s businesses, but along with this opportunity comes a world of risks that could not have been contemplated even a decade ago. As businesses rely more and more on computers to manage their business and process transactions, they also expose themselves to the potential for huge losses if the data stored on those computers is damaged or destroyed, e.g., because of a power outage or in a fire. And businesses that open their doors to the world via the Internet also invite in viruses or hackers who can damage computer data in a matter of seconds.

Many businesses may have first-party property insurance (“Property Insurance”) and commercial general liability insurance (“CGL Insurance”) that they would expect to cover such losses. However, whether damage to data stored on a computer is covered by these traditional insurance products is the subject of a growing debate. The key question is whether lost computer data constitutes a “physical loss” or involves damage to “tangible property” such that traditional insurance will respond. Policyholders say that a computer is worthless without the data that becomes part of its hard drive as the computer is used, and damage to that data is damage to the computer – a clearly covered loss. Insurers say “physical means physical,” and because you can’t see, touch or smell computer data, it’s not physical – and it’s not covered.

This article discusses the state of the law with respect to whether lost computer data constitutes a “physical loss” or involves damage to “tangible property” under typical Property Insurance and CGL Insurance policies. The naggingly unsatisfactory answer – at least at this time – is that whether, under current case law, such losses are covered is an open question.

Old Concepts in a New World

Together, Property Insurance and CGL Insurance policies form the first line of defense for many businesses against unexpected financial losses. Property Insurance protects the policyholder from damages to the policyholder’s own property, while CGL Insurance – sometimes referred to as “lawsuit insurance” – protects policyholders from losses suffered by third parties who then make claims against the policyholder.
The typical Property Insurance and CGL Insurance forms in circulation today were drafted before the computer technology boom of the last decade, and the language in these policies therefore forces courts to apply old concepts in a new world. A typical Property Insurance policy covers “direct physical loss or damage from any cause . . . .” Most CGL Insurance policies cover losses “the insured becomes legally obligated to pay as damages because of . . . ‘property damage,’” which is further defined as “physical injury to tangible property, including resulting loss of use of that property . . . .” Lost computer data does not fit cleanly into this framework.

**Few Decisions to Follow**

To date, only four opinions discuss whether lost computer data constitutes a “physical loss” or involves damage to “tangible property,” and these courts have reached different conclusions.

In an unpublished but oft-cited decision that was lauded by policyholders but decried by the insurance industry, a federal district judge in Arizona held in April 2000 that programming data that was lost because of a power outage constituted “physical damage” under a first-party property policy. *American Guarantee & Liab. Ins. Co. v. Ingram Micro, Inc.*, No. 99-185 TUC ACM, 2000 WL 726789 (D. Ariz. Apr. 18, 2000). In *Ingram*, a power outage caused the policyholder’s computer system to go down for approximately eight hours. As a result of this shutdown, all programming information stored in the computer system’s random access memory was lost and had to be re-programmed. The policyholder filed a claim under its “Primary All-Risk Policy,” which covered “[a]ll risks of direct physical loss or damage from any cause . . . .”

In the ensuing insurance coverage lawsuit, the insurance company took the position that the computer system itself did not suffer “physical damage” because the system functioned adequately after the programming was restored. Thus, according to the insurer, the computer did not suffer “physical damage.” The policyholder offered a much broader interpretation of “physical damage,” asserting that the loss of use and functionality of the computer when the programming information was deleted constituted physical damage, irrespective of whether the programming information could later be re-created.

The court sided with the policyholder, finding as follows:

> At a time when computer technology dominates our professional as well as personal lives, the Court must side with [policyholder’s] broader definition of “physical damage.” The Court finds that “physical damage” is not restricted to the physical destruction or harm to computer circuitry but also includes loss of access, loss of use, and loss of functionality.

A New Mexico appellate court reached a similar result earlier this year. *Computer Corner, Inc. v. Fireman’s Ins. Co.*, No. 21,575, 2002 WL 1021905 (N.M. Ct. App. Mar. 28, 2002). In *Computer Corner*, the policyholder – a computer repair shop – made a claim under its CGL policy after it was sued by a customer for re-formatting the customer’s hard drive without first doing a back-up, thus causing the loss of data stored on that hard drive. Although it ultimately found no coverage, the trial court did find that lost computer data “was physical, had an actual physical location, occupied space and was capable of being physically damaged and destroyed.”

The trial court’s decision on the “physical data” issue was not appealed. However, en route to reversing the trial court’s finding of no coverage, the appellate court assumed that lost computer data was “physical”: “the property that was lost – [Plaintiff’s] files – clearly existed prior to and apart from any service or parts provided by Computer Corner.”

On the other hand, last year a federal district judge in Oklahoma reached the opposite result. *State Auto Property & Cas. Ins. Co. v. Midwest Computers & More*, 147 F. Supp. 2d 1113 (W.D. Okla. 2001). In *Midwest Computers*, the policyholder – also a computer repair business – was sued by a third party who alleged that the policyholder had negligently performed service work and as a result lost data stored on the computer. The policyholder filed a claim under a CGL insurance policy, which covered “property damage” to “tangible property,”
In the insurance coverage litigation that followed, the trial court was asked to decide whether computer data is tangible property. The court first recited the hornbook Oklahoma law that “[a]n insurance policy is a contract” and that “[i]f the terms [of the insurance contract] are unambiguous, clear and consistent, they are to be accepted in their ordinary sense and enforced to carry out the expressed intentions of the parties.” The court then held that “computer data is intangible, not tangible, personal property” because “computer data cannot be touched, held, or sensed by the human mind; it has no physical substance.”

In June 2002, a federal district court in the Eastern District of Virginia followed the reasoning of Midwest Computers when it held that America Online, Inc.’s (“AOL”) CGL policy did not cover a series of class actions against AOL. America Online, Inc. v. St. Paul Mercury Ins. Co., No. 01-1636-A, 2002 WL 1378832 (E.D. Va. June 20, 2002). These underlying lawsuits alleged that AOL’s software interfered with the functioning of the underlying plaintiffs’ computers by interfering with software for other programs that previously were on the computers.

The court found that the CGL policy’s definition of “property damage” – “physical damage to tangible property of others” – was unambiguous. Relying on the dictionary definition of tangible as “capable of being touched and seen,” the court – citing Midwest Computers – found that:

Computer data can be transmitted and stored in a variety of ways, but none of them renders the data capable of being touched. A “bit” on a computer disk or hard drive is not palpable. Electrical impulses that carry computer data may be observable with the aid of a computer, but they are invisible to the human eye. An ordinary person understands the term “tangible” to include something she can touch, such as a chair or book, not an imperceptible piece of data or software that can only be perceived with the help of a computer.

The court also rejected AOL’s argument that the underlying complaints alleged “physical damage,” finding that the allegations were more properly characterized as a loss of use of the computer (which the court later found was excluded under the impaired property exemption). The court summarily found that the complaints did “not allege physical injury to the body or substance of the computer[s].” It refused to follow Ingram Micro because “the court in Ingram Micro did not apply the plain meaning of the word ‘physical.’”

Where Do We Go from Here?

These four cases illustrate the uncertainty that policyholders and insurers alike face with respect to predicting whether there will be insurance coverage for loss of

(continued from page 2)
computer data. In addition to the holdings in these cases, policyholders and insurers alike can cite to “analogous” cases from other contexts (e.g., cases discussing whether videos or movies (as opposed to the tapes or reels they are stored on) are “tangible property”) that they each can claim supports their radically different views. However, these cases reach mixed conclusions as well, and how a given court will rule on this complex issue remains unclear.

This uncertainty does not necessarily mean doom and gloom for policyholders. Depending on the specific policy language and the particular facts surrounding the loss, the policyholder may very well have good arguments for coverage. In addition, uncertainty cuts both ways, and insurance companies may be willing to compromise rather than litigate to an all-or-nothing result. Under these circumstances, a policyholder who has suffered damages because of a computer data loss should certainly consider filing a claim under traditional Property Insurance or CGL Insurance.

Policyholders also should take a proactive approach by reviewing their insurance portfolios to determine whether they need to supplement their traditional insurance with one of the specialty policies now available that would expressly cover claims relating to data loss. This is especially true now that the insurance industry is taking steps to modify its form policies to make clear that lost computer data is not covered under traditional insurance products. For example, the 2001 revision of the Insurance Services Office, Inc.’s form CGL policy clarifies that it does not cover claims relating to lost or damaged computer data. The insurance industry now offers numerous specialty risk policies, but these require the payment of additional premium.

Whether or not such specific products are needed requires a careful analysis of the policies that are in place and the nature of the policyholder’s business.

Conclusion

Whether or not lost computer data constitutes a “physical loss” or involves damage to “tangible property” remains an open question. As this issue works itself out in the courts, policyholders should carefully analyze whether they have an argument for coverage under their policies as applied to the facts and circumstances of their particular loss. In addition, policyholders should analyze their coverage portfolio to determine whether they are protected from computer data loss damages under their traditional policies, or whether a specialized policy is necessary.

Scott T. Schutte is an associate in the Chicago office of Jenner & Block. Along with Jenner & Block partners John H. Mathias, Jr., and David M. Kroeger, he is the author of the forthcoming treatise on Insurance Coverage for E-Commerce and Internet Risks and Liabilities. Mr. Schutte can be reached at sschutte@jenner.com.

INSURANCE UPDATE

“All Sums” Approach Adopted in Ohio

The Ohio Supreme Court is the latest state high court to adopt the “all sums” allocation approach first applied in Keene Corp. v. Insurance Co. of North America. As a result, the policyholder, Goodyear Tire & Rubber Co., will be allowed to select the policy period to apply to cover its liability at each of two environmental sites where allegedly continuous pollution took place. Finding no language in the insurance policies to support the insurance companies’ pro-rata allocation argument, the court, therefore, enforced the “all sums” language found in standard-form general liability insurance policies. Goodyear Tire & Rubber Co. v. Aetna Cas. & Sur. Co. (Ohio June 26, 2002).

The Ohio Supreme Court also found that questions of fact precluded summary judgment in the insurance companies’ favor on the issue of the timeliness of notice. Similarly, the court found that the expected/intended exclusion does not preclude coverage if the policyholder did not expect or intend hazardous substances to migrate from the landfill in which they were deposited.
In the food-manufacturing industry, the decision to recall a product is perhaps the most difficult, both professionally and emotionally, for any company to make. Decision-makers are confronted with a myriad of concerns, and their actions in effecting the recall will undoubtedly be second-guessed by others in the company, stockholders, media, customers and consumers, governmental regulators, public health agencies, insurance providers, attorneys for persons claiming injury from the product, and a judge or jury. Indeed, balancing all of these competing interests may seem impossible.

Nevertheless, the primary concern for the company must be to protect the public health. A company with a good product that also demonstrates appropriate responsibility and concern for consumer health and safety will not only minimize its long-term business risk associated with the recall, but also will reap the rewards of being viewed publicly as a responsible corporate citizen.

Should There Be a Recall and if so, What Should Be Recalled?

While there will be many big decisions to make throughout the recall process, the most important decisions will have to be made quickly: Should there be a recall, and how broad should it be?

The first question can be answered only on a case-by-case basis. A guiding principle, however, is that a product should be recalled if there is credible evidence that it has caused any illnesses due to suspected contamination or any other unsafe condition in the product. Credible evidence can be developed by government agencies, which often rely on epidemiology, microbiology and molecular testing to find the source of similar illnesses. Your own internal investigation and testing also may lead to a conclusion that your product might cause illness. No matter the source of such evidence, using good judgment, listening to government recommendations and, ultimately, being intent on protecting consumer safety is the best way to tackle this difficult decision.

The second question — what should be recalled? — can prove as difficult to decide as the first. Of course, if a recall is necessary, your company would prefer a very small recall with little or no publicity. This approach may not only be unrealistic, but it also has the potential to create more severe problems for the company in the future.

The goal should be to effectuate the recall as quickly and as broadly as necessary. This means that the company should not delay its recall while it waits to receive “all available information” or until it conducts “a thorough internal investigation,” which are analyses that companies generally undertake before making major decisions. In the recall context, time is of the essence. Also, the company must determine the appropriate scope and range of the recall by looking broadly at what dates of production should be included in the recall, as well as whether any additional products could be adversely affected as a result of cross-contamination or the use of common manufacturing equipment or similar processes. Of course, in determining the scope of the recall it is imperative that a company seriously consider any recommendations by governmental regulators such as the FDA or USDA. Like it or not, government agencies will be heavily involved in the recall process, particularly for recalls that impact consumer health. In meat and poultry recalls, for example, the Food Safety & Inspection Service will assign a recall classification based on an evaluation of the risk posed to public health, followed by instructions about the recommended depth and scope of the recall and, later, effectiveness checks to determine how well the recall is being implemented.

Although these government agencies cannot mandate a recall, failure to abide by a regulatory agency’s recommendations could subject your company to harsh regulatory reprisals, such as a withdrawal of inspectors from a plant or fines, while also causing a deterioration of the future relationship between the company and its regulators. Intuitively, a company that is seen as cooperating with its regulators is more likely to receive information they may have regarding the recall-related issues, as well as assistance in generating as much favorable public relations information as possible. Ignoring a government agency’s recommendation can subject the company to...
pany to public criticism and may lead to highly unfavorable evidence against the company in any civil or criminal investigations and proceedings.

The best approach is to designate one or two senior company officials to interface as much as possible with government regulators and any public health agency involved in the investigations. Having open lines of communication with the government will be instrumental in arriving at a mutually agreed-upon recall plan. Undertaking an appropriately broad recall at the outset may eliminate the need to issue a second or third recall which, if required, will cause additional negative publicity and erosion of consumer and customer confidence in your company.

Create a Written Recall Plan Now

Because the primary goal of any recall plan should be protecting consumer safety, it is imperative that your company put measures in place before a crisis arises so that you can act immediately and with a clear understanding of the next steps. Any recall, no matter how small, diverts attention from your usual business operations. Companies that succeed in keeping recall-related disruption to a minimum often have in place well-planned and tested strategies that focus on one goal: getting the affected product out of the hands of consumers and other end-users as quickly as possible.

Components of an Effectively Written Recall Plan

Designate a recall coordinator. A recall coordinator should be prepared to handle all recall activities at a moment’s notice and should have sufficient authority within your company to make decisions in a timely fashion, without having to report to top management, and to put them into effect immediately. The FSIS recommends that your recall coordinator be knowledgeable about every aspect of your company’s operations, including purchasing, processing, quality assurance, distribution, and consumer complaints, and that the recall coordinator select other members of your recall team.

Designate a recall team. Your recall team should be a microcosm of your company: managers of key departments such as quality assurance, operations, sales and marketing, customer service, transportation, risk management, human resources and accounting. The FSIS recommends preparing a contact list of all internal and external personnel who are to be involved in recall actions and specifying an alternative for each identified employee.

Have recall protocols in place. Each member of the recall team should be assigned specific responsibilities and procedures should be put in place so that they can be accomplished in the midst of the flurry of activity that accompanies a recall. Here are examples of the issues each department represented on your recall team should contemplate so that your recall action plan is as comprehensive as possible:

- Sales and marketing: Because getting your product out of the marketplace is the goal of your recall, sales and marketing representatives on your recall team should devise a system for communicating with your customers not only to announce a recall but to provide instructions about what to do once the product has been identified and removed from the shelf, storeroom and warehouse. It is vital that contact information for all customers be up-to-date. You should determine how your sales force, including any independent sales brokers, will be utilized during a recall.

- Community and media relations: It is imperative, both for public health as well as community relations purposes, that your company provide consumers with answers to their questions. A toll-free hotline reserved exclusively for consumer-related recall questions should be established, particularly if the recall involves brand name products that could already be in consumers’ refrigerators and cabinets.

If you have a website, warnings and reminders not to eat the recalled product should be prominently displayed with links to
important information. Also, the company should designate only one person to speak publicly to avoid conflicting communications.

- Transportation/receiving: Your transportation department should be prepared to effectuate retrieval immediately by scheduling product pickups from customers. There are companies that specialize in retrieval of recalled product from retailers, wholesalers and consumers.

  Once the product is returned to you, disposal and storage of the product will become an issue. If litigation is pending or anticipated, consult with your company’s attorney to determine the extent to which you are required to preserve returned product to avoid spoliation of evidence liability.

- Accounting/customer service: In order to maintain good customer relations, you may wish to give — and customers may expect — reimbursement or account credits for all recalled product. You should formulate a reimbursement plan that provides incentives for customers to get products off their shelves as quickly as possible.

- Quality assurance/marketing: As your quality assurance team works with government inspectors to determine the source of the problem, your marketing department, depending on the scale of the recall, may wish to make arrangements for alternative production so that you do not lose market share.

- Risk management: Your risk management department should not only be knowledgeable about the extent of your recall-related insurance coverage, but should also be aware of the notice requirements imposed by the insurance policies you hold.

This article is based on an article that was published in the May 2002 issue of Food Processing magazine. All the articles in the series are available online at www.jenner.com.

Authors: Anton R. Valukas, Jeffrey D. Colman, Dean N. Panos and Edward F. Malone are partners at Jenner & Block, Chicago. Julie L. Bentz, Molly J. Moran and Chaka M. Patterson are associates at the Firm. Jenner & Block has extensive experience in food recalls and food product litigation.

### Upcoming Speaking Engagements

**August 6, 2002**
PricewaterhouseCoopers Annual Training Seminar for Partners, Directors, and Managers: D&O Issues
Orlando, FL
*John H. Mathias and Timothy W. Burns*

**August 9-10, 2002**
American Bar Association Annual Meeting: Insurance Coverage for Terrorism
Washington, DC
*Lorelie S. Masters*

**September 19-20, 2002**
Mealey’s Conference on Directors and Officers and Errors and Omissions Insurance Issues
Short Hills, NJ
*Timothy W. Burns*

**September 25, 2002**
World Research Group’s 3rd Semi-Annual Insuring e-Business Summit
Chicago, IL
*Lorelie S. Masters*

**October 18, 2002**
Washington, DC
*Timothy W. Burns*
Equitas’ Long-Term Solvency “Highly Uncertain”
Due to U.S. Asbestos Liabilities
by David M. Greenwald

Equitas, the reinsurer of most Lloyd’s pre-1993 non-life liabilities, recently released its annual report. The Report makes one thing absolutely clear: U.S.-based asbestos liabilities make the long-term solvency of Equitas “highly uncertain.”

Equitas Chairman Hugh Stevenson reported that “gross undiscounted asbestos liabilities amounted to £ 0.4 billion, equivalent to more than 50 percent of the Group’s total gross undiscounted claim reserves.” Stevenson concedes that asbestos claims are the “single greatest” threat to the long-term viability of the Equitas enterprise. “Equitas’ future remains highly uncertain,” he concludes, “and the Auditors rightly point to this uncertainty in their qualified report on the Group’s accounts.”

Scott Moser, the Claims Director for Equitas, explained that, due to adverse asbestos claims trends in the United States, particularly claims filed by “unimpaired” plaintiffs, “asbestos remains the most serious issue facing Equitas.” To illustrate the magnitude of growing of asbestos liabilities, Moser cites the Manville Trust report that tallied 90,000 new asbestos claims in 2001, compared with 58,000 in 2000, and various multi-million-dollar asbestos recoveries, including a recent Mississippi trial in which six unimpaired claimants received verdicts of $25 million each in compensatory damages.

Despite these dramatic adverse trends, Equitas concluded that it did not need to increase its provisions for future asbestos claims. This decision appears to be founded largely upon optimism that new document requirements imposed on direct policyholders and ceding insurers will decrease future payments, particularly for “unimpaired” claims. Moser admits that, while initial results are positive, “we cannot say with certainty whether these initiatives will ultimately be successful.” Indeed, the new document requirements face challenges in the U.S., both in courts and before arbitration panels.

Despite the recency of the new document requirements, and substantial challenges to them in the U.S., Equitas’ auditor, PricewaterhouseCoopers, relied on potential improvement from this new “management strategy” in projecting future claims. PWC warns, however, that, based on uncertainties related both to asbestos and other financial risks, future adjustment, “if adverse in the aggregate,” could be material enough to exceed the amount of shareholders’ funds.

PWC also notes the possibility that Equitas, at some time in the future, may implement “proportionate cover.” As set forth in the Reinsurance and Run-off Contract that was executed in 1996, in the event that Equitas determines that its commitments exceed its assets, it may impose a plan by which it pays no more than a portion of otherwise covered claims.

At this time, “. . . the Directors believe that the assets should be sufficient to meet all liabilities in full!” However, time and the American court system will tell the full story. Stay tuned.

David M. Greenwald is a partner in the Chicago office of Jenner & Block. He is a member of the Firm’s Insurance Litigation and Counseling, Reinsurance, Government Contracts, and Appellate and Supreme Court Practices. Mr. Greenwald received his J.D. with honors from the University of Michigan Law School. He may be reached at dgreenwald@jenner.com.

The August 2, 2002 edition of The Daily Deal published an article by Mr. Greenwald on this subject.