

Insurance Coverage For Computer Losses

Reliance upon computers has expanded exponentially as a result of the technological advances of the 1990s. Increased reliance upon electronic media has naturally placed businesses at greater risk of suffering computer losses.

Consider a specialized architectural firm that relies



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exclusively upon a database of drawings. A power surge or computer virus could essentially put it out of business. The firm might sue those it believes are responsible for the loss. However, because of collection issues, a general counsel of the firm will need to be familiar with other sources of recovery, particularly insurance coverage for such computer losses.

First-Party Property Insurance

The firm's own first-party property insurance might pay for the loss. To obtain property insurance coverage, a policyholder must, among other things, demonstrate that it has suffered: (a) "direct physical loss or damage" to (b) covered "property."

Covered "property," should be defined in the policy. If not, computer hardware is generally considered covered "property" because it is tangible personal property, but there is some disagreement as to whether electronic data and software is covered "property." A policyholder can attempt to avoid this conflict by couching the description of the damage as damage to the computer itself.

The more interesting issue is whether there has been "direct physical loss or damage." The seminal case is *American Guaranty & Liability Insurance Co. v. Ingram Micro, Inc.* In that case, a wholesale distributor of microcomputer products experienced a power outage that caused its computer system to become inoperable for eight hours. Because the distributor's business depended entirely upon operation of its computers, the distributor suffered

eight hours of business interruption. Its first-party property insurance company denied coverage for the loss.

In subsequent coverage litigation, the sole issue was whether there was "direct physical loss or damage" to the computer system, which was unquestionably covered personal property. The insurance company argued that there was no such physical loss or damage because the computers at all times remained intact and capable of performing their intended functions, even though accidentally deleted programming needed to be reinstalled to make them operational. The distributor disagreed, arguing that loss of use and functionality itself constitutes "direct physical loss or damage." The court sided with the distributor, holding that "[a]t a time when computer technology dominates our professional as well as personal lives, the Court ... finds 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."

Other cases suggest that damage to electronic data might not be covered because such property is "intangible." The argument is that "intangible" property is incapable of being "physically" damaged because, by definition, "intangible" means lack of "physical" characteristics. However, these other cases involved third-party liability policies. The only case construing the issue in the first party context, *Ingram Micro*, held otherwise. More importantly, as stated above, in many cases, injury can be stated in terms of loss of use of the "tangible" computer itself, and in other contexts there is significant authority holding that loss of use can constitute "physical loss or damage" under a first-party property insurance policy.

Third-Party Insurance

Because litigation against the tortfeasor is another option, counsel needs to understand how liability insurance responds to computer loss liabilities to ensure that the tortfeasor's liability insurance provides funds to help pay a judgment.

General Liability Insurance

A typical general liability policy obligates the insurance company to defend and indemnify its policyholder for liabilities resulting from "property damage" suffered by another. Liability policies typically define "property damage" as either "physical injury to tangible property" or "loss of use of tangible property that is not physically injured."

Case law on whether computer losses constitute "tangible" property is sparse but evenly split. On the one hand, the Fourth Circuit recently found no coverage. In *America Online, Inc. v. St. Paul Mercury Insurance Co.*, the policyholder issued a new version of its internet service software which altered software, disrupted network connections, deleted stored data, and caused operating systems to crash. Several customers instituted a class action suit. The policyholder submitted the claim to its comprehensive general liability insurance company, which denied coverage for the claim. In a subsequent insurance coverage suit, the trial court entered summary judgment for the insurance company. On appeal, the Fourth Circuit affirmed, finding that the data and software were "intangible" property, and, therefore, losses with respect to software and data were not "property damage." Although it held that claims for loss of computer use were "property damage" because a computer is "tangible" property, the court held that such "property damage" was excluded by an impaired property exclusion, which "bars coverage for loss of use of tangible property of others that is not physically damaged by the insured's defective product."

On the other hand, in *Retail Systems, Inc. v. CNA Insurance Companies*, the policyholder was a data processing consultant that developed a computer program and processed data regarding voter preferences for the Republican Party of Minnesota. A voter survey was recorded on a computer tape and given to the policyholder for processing. During renovations, the tape was lost. The Republican Party sued for damages caused by the loss of the computer tape and the data stored thereon. The insurance company refused to defend and indemnify the policyholder for the underlying suit. The trial court granted the policyholder's motion for summary judgment on the duty to defend. On appeal, the Minnesota intermediate appellate court affirmed, finding the policy ambiguous and holding that the computer tape and data were tangible property

under the insurance policy.

Professional Liability Insurance

If the tortfeasor's general liability insurance cannot be reached, another source of coverage would be the tortfeasor's professional liability insurance policy. Those policies generally provide coverage for economic and intangible losses, containing the promise to pay for all losses arising out of a claim first made during the policy period and based upon a negligent act, error, or omission in the performance of professional services. The central issue will be whether the claim arose out of a negligent act, error, or omission in the performance of the third-party's professional services. Case law suggests that if computer losses are not covered under general liability insurance of the third-party because such losses are "intangible," such losses would likely be covered under the tortfeasor's professional liability insurance policy.

Conclusion

Computer losses can be staggering. Policyholders faced with such losses would be advised to consult their own first-party property insurance policies first. If litigation becomes the preferred mechanism for cost recovery, a policyholder should consider the third-party tortfeasor's general liability and professional liability insurance policies before initiating suit because such policies may provide the only available sources to pay for the losses.

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