

“PHYSICAL DAMAGE” IN BUSINESS INTERRUPTION COVERAGE

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There is no coverage more fundamental to a technology company than its business interruption policy. And any BI policy will have in its coverage clause a requirement that the interruption be the result of physical damage. But when the claim arises, notwithstanding the 21st century underwriting the insurance company did (and 21st century premiums the company paid), the claim process can be mired in a nineteenth century understanding of the key phrase “physical damage.” How do the courts react to competing policy interpretations?

Physical damage means a “distinct, demonstrable, and physical alteration” to insured property. *Port Authority of New York and New Jersey v. Affiliated FM Ins. Co.*, 311 F.3d 226, 235 (3d Cir. 2002). One California appellate court followed this rule, holding that for there to be physical damage, some external force must have acted upon the insured property to cause a physical change in its condition. *MRI Health Care Center of Glendale, Inc. v. State Farm General Ins. Co.*, 187 Cal.App.4th 766, 780 (2010).

Eighteen years ago, a power shortage hit Ingram Micro Inc.’s data center, causing the company’s mainframe computer to lose its programming information and the customer configurations necessary for it to function. *American Guarantee & Liberty Ins. Co. v. Ingram Micro, Inc.*, No. 99-185 TUC ACM, 2000 WL 726789 at *1 (D. Ariz. Apr. 19, 2000). The court held that physical damage includes loss of function and found for the insured. *Id.* at *2. In a New Jersey case decided the previous year, the court found that an electrical grid was physically damaged because it and its component generators and transmission lines were “physically incapable of performing their ‘essential function of providing electricity.’” *Wakefern Food Corp. v. Liberty Mutual Fire Ins. Co.*, 406 N.J. Super. 524, 540 (1999).

Courts recognize that the meaning of “physical damage” evolves as technology develops. A data storage network’s loss of reliability due to changes on a microscopic level caused by covered cause of loss constituted physical damage, according to a federal court in Kentucky. *Ashland Hosp. Corp. v. Affiliated FM Ins. Co.*, No. 11-16-DLB-EBA, 2013 WL 4400516 *5 (E.D.Ky. Aug. 14, 2013). In Louisiana, a federal court held that electronic data is physical and is therefore susceptible to “direct, physical ‘loss or damage.’” *Landmark American Ins. Co. v. Gulf Coast Analytical Laboratories, Inc.*, No. 10-809, 2012 WL 1094761 *4 (M.D.La. Mar. 6, 2012).

Strained or archaic definitions of “physical damage” superimposed on new policies will and should be challenged in court so the policyholder receives the benefit of its bargain.



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 - What's the insurance really for?
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 - Event
 - Repair/restoration
 - No detail too large
 - The Story
 - The Storyteller
 - Policy Interpretation
 - Three-part analysis: underwriting and loss together inform the policy interpretation
 - Policy provisions
 - If provisions are unclear, consider the reasonable expectations of the insured
 - If still unclear, the policy is interpreted in favor of the insured
- AIU Ins. Co. v. FMC Corp.*, 51 Cal.3d 807, 822-23 (1990)

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- Unreasonable denial of insurance benefits is a breach of the obligation of good faith and fair dealing. CACI § 2331.

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