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COURTS DEFINE DIRECT PHYSICAL LOSS IN THE ABSENCE OF A POLICY DEFINITION

[Ref. Commercial Property , Para.1.03]

Insurance policies that provide first party property damage coverage typically state that the policy will cover direct physical loss or damage to covered property. This would seem to require that the covered property sustain some sort of visible harm or physical change. That is not, however, always the case. In some unique circumstances, courts have found that a loss satisfies the physical loss or damage requirement despite a lack of visible harm or physical alteration to the property.

PHYSICAL ALTERATION

Damage that resulted from unpleasant, and in some cases dangerous, fumes or odors has been held to constitute direct physical loss.

In *Gregory Packaging, Inc. v. Travelers Property & Casualty Co. of America*, 2014 U.S. Dist. LEXIS 165232 (D. N.J. 2014), Gregory, a New Jersey company, made a claim under its commercial property policy with Travelers for loss of property and business interruption after the release of ammonia in its juice packaging plant in Georgia. The plant's refrigeration system used anhydrous ammonia as its refrigerant. During start-up of the refrigeration system ammonia was released. The cause of the leak was disputed. Regardless, the facility had to be evacuated due to dangerous ammonia levels. Government authorities also evacuated a mile wide area surrounding the facility because of the ammonia leak.

Before the authorities would allow anyone to re-enter the facility Gregory was required to hire a remediation service to dissipate the ammonia, which took a week. Gregory and Travelers agreed that the ammonia release made the facility unfit for human occupancy or continued use until the ammonia was reduced to a safe level. Travelers denied Gregory's claims because the facility did not suffer physical loss or damage. Gregory filed a motion for summary judgment on the issue of

whether it had sustained “ ‘direct physical loss of or damage to’ property.” Travelers opposed the motion, arguing that physical loss or damage requires “a physical change or alteration to insured property requiring its repair or replacement.”

The court had to determine whether the incapacitation caused by ammonia was “direct physical loss of or damage to” insured property. This phrase was not defined in the policy. The court applied New Jersey law to resolve this issue. Although the New Jersey Supreme Court hadn’t addressed the issue of whether this type of loss is physical property loss or damage, the court observed that nonstructural loss of function had been recognized by New Jersey appellate courts as direct physical loss or damage. The appellate courts had also held that property could be physically damaged “when it loses its essential functionality” even though it did not undergo a structural alteration. The court explained:

In the present case, there is no genuine dispute that the ammonia release physically transformed the air within Gregory Packaging’s facility so that it contained an unsafe amount of ammonia or that the heightened ammonia levels rendered the facility unfit for occupancy until the ammonia could be dissipated. The court finds that the ammonia discharge inflicted “direct physical loss of or damage to” Gregory Packaging’s facility, as that phrase would be construed under New Jersey law by the New Jersey Supreme Court, because the ammonia physically rendered the facility unusable for a period of time.

The court concluded that Gregory had suffered physical loss or damage to its insured property.

A similar conclusion was reached by the New Hampshire Supreme Court in *Mellin v. Northern Security Ins. Co.*, 115 A3d 799 (N.H. 2015). The Mellins owned a condominium that was adversely affected by a cat urine odor that emanated from the condo of their downstairs neighbor who had two cats. The Mellins leased their condo to a tenant who was the first to notice the odor. After the Mellins’ tenant moved out due to the odor, the Mellins moved back in and also noticed the odor. The town health inspector determined the odor constituted a health problem. The health inspector told the Mellins that they would have to temporarily move out of the condo and hire a company to eliminate the odor. The odor was never completely eliminated but, nevertheless, the Mellins returned to the condo and attempted to rent it to new tenants. Due to the cat odor they were unable to rent the condo and eventually sold it.

The Mellins filed a claim for property damage with Northern, which was denied. The Mellins then filed a declaratory judgment action against Northern seeking a determination that there was coverage for the loss they sustained due to the cat urine odor. Claimed damages included loss of use and loss of value of the condo. The loss of value was based on the insureds’ claim that they sold the condo at a price significantly less than what a comparable condo in the area, unaffected by cat urine odor, would have sold for.

The policy at issue insured “against risk of direct loss to property ... if that loss is a physical loss to property.” The policy also provided coverage for additional living expenses and lost rental value. The Mellins argued that physical loss includes pervasive odors. Northern countered that although the policy did not define these terms, “direct” and “physical loss” are “commonly understood to require tangible change to the property.” The insurer argued that the odor did not cause a tangible change to the appearance, color, or shape of the condo and, therefore, was not a physical loss. The court focused on the meaning of the word “physical” to resolve the question of whether the claim was the result of a physical loss. The court found that the plain meaning of physical is broader than Northern’s interpretation. The court said that according to the Oxford Dictionary, physical “refers, in relevant part, to things of or pertaining to matter, or the world as perceived by the senses; material as opposed to spiritual.” The court found that physical loss should not be interpreted to include only

tangible changes to property that can be seen or touched but, rather, should include changes that can be perceived through smell.

The court's conclusion was supported by numerous other cases that involved various contaminating conditions and odors that were classified as physical loss to property. The court also analyzed cases from other jurisdictions and agreed with those that held physical loss provisions do not require destruction of property or structural damage. Property has sustained physical damage if it was changed in a way that caused previously satisfactory property "to become unsatisfactory for future use or requiring repairs be made to make it so." The court held that physical loss requires a "distinct and demonstrable alteration of the insured property." The court explained:

Accordingly, we hold that physical loss may include not only tangible changes to the insured property, but also changes that are perceived by the sense of smell and that exist in the absence of structural damage. These changes, however, must be distinct and demonstrable. Evidence 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.

The court remanded the case to the trial court to determine if, under this standard, the Mellins suffered a physical loss.

LOSS OF USE OR FUNCTION

In *Gregory Packaging and Mellin*, the courts held that a physical loss to covered property could occur when the property was altered, even if the alteration could not be seen or touched. Other courts have focused on the use or function of the affected property and held direct physical loss to include a loss of use or function of covered property without any accompanying physical alteration.

In *Widder v. Louisiana Citizens Property Ins. Corp.*, 82 So3d 294 (La. App. 2011), the insured claimed she suffered damage due to lead contamination. Louisiana Citizens (LCPIC) had the insured's house inspected and the inspection revealed excessive levels of lead. It was believed that lead dust had migrated from the attic into the walls of the house. The house and all of its contents were contaminated. Because of the dangerous level of the contamination the insured and her family had to move out of the house. LCPIC denied coverage because there was no direct physical loss. Widder sued LCPIC for breach of contract and bad faith.

LCPIC argued that because the home was intact there had been no direct physical loss to property. Direct physical loss was not defined in the policy. The court explained the meaning of this phrase:

The record is clear that Ms. Widder's home is contaminated with inorganic lead which makes it uninhabitable until it has been gutted and remediated. For the purpose of determining direct physical loss, this type of loss is similar to the type of loss experienced from Chinese drywall. The issue of what constitutes a direct physical loss was recently addressed in connection with Chinese drywall litigation. In *In re Chinese Manufactured Drywall Products Liability Litigation*, 759 F.Supp. 2d 822 (E.D. La. 2010), the court found that the presence of Chinese drywall, from which gaseous fumes were released, did in fact constitute a direct physical loss. The court stated that when a home has been rendered unusable or uninhabitable, physical damage is not necessary. ... In this case, we find the intrusion of the lead to be a direct physical loss that has rendered the home unusable and uninhabitable.

Courts that agree with this rationale have held that physical loss or damage includes loss of access, loss of use, and loss of functionality.

THE INFORMATION AGE

Courts have recognized the need to revisit the meaning of direct physical loss or damage in light of society's heavy reliance on computer technology. Many new businesses are internet-based and a policy that purports to cover physical damage, particularly one that limits coverage to damage to tangible property, does not appear to provide appropriate coverage to these businesses. Some courts, however, have expanded the traditional interpretation of these policy terms, finding a physical loss and damage to tangible property.

In *Ashland Hospital Corp. v. Affiliated FM Ins. Co.*, 2013 U.S. Dist. LEXIS 114730 (E.D. Ky. 2013), the court considered whether there was insurance coverage for a computer system loss of reliability. Ashland had contracted with EMC Corp. for the purchase, installation, and support of a data storage network, the DMX4, which provided the hospital's primary data storage, ran essential hospital functions, and was critical to patient care. The DMX4 had the highest degree of reliability and a guarantee of information availability as primary features. Ashland's data center overheated when the air conditioning system failed. Alarms within the DMX4 alerted EMC and the unit went into a failed state. As a result the hospital could not access important information, including doctors' orders, patient schedules, and medical history. Some of the data was corrupted and it was necessary to restore it from a backup. EMC analyzed error codes, DMX4 self-reported event logs and internal temperature readings, and it determined that hundreds of the system's components had failed. Some of its drives could not read or record new data. EMC concluded that the system had been severely compromised. Its long term reliability could not be confirmed and the system had to be replaced.

Ashland insured the system under an open perils policy provided by Affiliated and promptly notified the insurer of the loss. The Affiliated policy insured against direct physical loss or damage to covered property. Ashland argued that the system's loss of reliability was a direct physical loss or damage because components of the system were physically altered when the system overheated, the physical alteration compromised the system's reliability, and that reliability was the entire function or purpose of the unit. Ashland argued that the purpose of paying for insurance for the system was to protect its reliability. In response Affiliated argued that loss of reliability was an intangible concept as opposed to a direct physical loss that could be perceived by the senses. Affiliated also argued that there was no coverage without evidence a "demonstrable physical alteration rendered the DMX4 unable to function."

The court agreed with Ashland, holding that there was undeniable direct and physical harm to the system from the heat exposure because the harm flowed immediately from that exposure and there was a physical alteration of the system's components. The court ruled that it was not necessary for Ashland to provide visible evidence of microscopic disk drive damage to prove a loss of reliability. The court also agreed that "the core function and value of the DMX4 is to provide Plaintiff 99.999% guaranteed reliability of critical data" and that "its value – its insurable risk – is its reliability." It was not necessary for Ashland to wait for a total system failure to prove a covered loss. The loss or damage occurred when the system was exposed to excessive heat, not when the components failed. The court held "that the phrase 'direct physical loss or damage' is unambiguous and includes a loss of reliability caused by excessive temperature." Affiliated produced no evidence to counter the claim of damage to the system and none of the policy's exclusions applied, thus the court held that Ashland was entitled to coverage for the replacement of the DMX4.

There is a more difficult issue when a claim is for loss of data as opposed to impairment of a computer system. In *Landmark American Ins. Co. v. Gulf Coast Analytical Laboratories, Inc.*, 2012 U.S. Dist. LEXIS 45184 (M.D. La. 2012), the issue was whether electronic data can be subject to

direct physical loss or damage, that is, is data physical or non-physical? The policy at issue was an inland marine form that provided business personal property, business income and extra expense, and information systems coverage. Landmark filed a declaratory judgment action and argued that although it is covered property, electronic data is intangible and cannot sustain direct physical loss or damage. Landmark argued that electronic data is only covered if the associated hardware is damaged and it is that damage that causes a loss of data. Gulf Coast (GCAL) filed a counterclaim for breach of contract and bad faith. It argued that electronic data is physical and is susceptible to direct physical damage. GCAL's loss resulted from a failure of its hard disk storage system to read two hard disk drives. This failure caused data corruption. GCAL claimed \$112,000 in third party vendor recovery costs and over one million dollars in lost business income.

The court recognized that the Louisiana Supreme Court had previously held that “ ‘tangible, physical property’ is analogous to corporeal movable property.” The state high court had held that “the Louisiana Civil Code departed from the narrow Roman law conception that only ‘tangible objects’ were corporeal; instead, ‘the Louisiana Civil Code of 1870 declared that perceptibility by any of the senses sufficed for the classification of a material thing as corporeal.’ ” According to the state high court, when data is stored on a disk or computer chip it is “physically manifested in machine readable form” through the arrangement of electrons or use of electric current and that this machine readable code is a “physical manifestation of the information in binary form.” The district court held:

Contrary to the plaintiff's assertions, tangibility is not a defining quality of physicality according to Louisiana law. The Louisiana Supreme Court determined that though electronic data is not tangible, it is still physical because it can be observed and altered through human action. Therefore, according to Louisiana law, GCAL's electronic chemical analysis data must be considered corporeal, movable or physical in nature. Therefore, like the electronic software data in *South Cent. Bell*, GCAL's electronic data “has a physical existence, takes up space on the tape, disc, or hard drive, makes physical things happen, and can be perceived by the senses.” Since the GCAL's electronic data is physical in nature under Louisiana law, summary judgment is appropriate, declaring that electronic data is susceptible to “direct, physical ‘loss or damage’.” Nevertheless, judgment for the defendant does not affect the rights of the parties to litigate whether coverage is excluded under another provision of the contract provided it is not contrary to Louisiana law.

Whether electronic data qualifies as covered property subject to physical loss or damage has been litigated in a number of jurisdictions with mixed results. In response to claims for loss of electronic data, some insurers have added language to their policies that states such data is not covered property. Also, as was the case in *Landmark*, some insurers offer policies that specifically address information technology.

CONCLUSION

While over the years courts have expanded the definition of physical loss or damage, an insured's ability to prove physical loss or damage to covered property is just the first step. An insured may have to prove the damage was the result of a covered cause of loss, while the insurer can then argue an exclusion applies. Under an open perils policy an insurer can defend against coverage on the basis of a policy exclusion. These cases are fact sensitive. The outcome will depend on the exact language of the insurance policy at issue and how that language is interpreted by the court.