LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
TUESDAY, MAY 5, 2020

PERSPECTIVE

Ruling may shed light on physical losses and COVID-19

By Peter S. Selvin

In the context of the numerous lawsuits have recently filed by policyholders seeking compensation for lost business income occasioned by the pending pandemic, a key issue will be whether those policyholders have suffered "direct physical loss or damage" to their businesses. A case decided earlier this year (albeit in a different factual context) sheds some light on whether this requirement can be satisfied in the present circumstances.

In *Nat'l Ink & Stitch, LLC v. State Auto Prop. & Cas. Ins. Co.*, 2020 WL 374460 (D. Md. Jan. 23, 2020), plaintiff policyholder was the victim of a ransomware attack on her business' computer server and networked computers. Following the attack, plaintiff employed a security company to replace and reinstall its software, and to install protective software on its computer system.

Although plaintiff's computers still functioned after these remedial measures, the installation of the new protective software slowed the system and resulted in a loss of efficiency. In addition, computer experts retained by plaintiff testified that "there are likely dormant remnants of the ransomware virus in the system, that could 're-infect the entire system.'"

Presumably based on the possibility that plaintiff's system could be re-infected at a later date, the plaintiff evidently purchased an entirely new server and components and sought reimbursement from her property insurer for this loss. The insurer denied the claim.

Like many business interruption policies, the policy at issue obligated the insurer to pay for "direct physical loss of or damage to Covered Property." The key issue in the case was whether plaintiff experienced "direct physical loss of or damage to" its computer system, to justify reimbursement of the replacement cost for the entire system under the policy.

The insurer in *Nat'l Ink* argued that because plaintiff's computer system was not fully incapacitated, there could be no recovery for the replacement cost of the entire system. In rejecting this argument, the court emphasized the independent significance of the word "damage" in the phrase "direct physical loss or damage to." Because "direct physical loss" and "damage" are in the disjunctive, "the plain language of the Policy … protects against not only 'physical loss' but also 'damage' to the media and the data."

In emphasizing this language, the court held that plaintiff had demonstrated damage to the computer system itself, despite its residual ability to function:

"In the instant case, State Auto seems to equate 'physical loss or damage' to Plaintiff's computer system to require an utter inability to function. The Policy language, and the relevant case law, impose no such prerequisite. The more persuasive cases are those suggesting that loss of use, loss of reliability or impaired functionality demonstrate the required to a computer system, consistent with the "physical loss *or damage to*" language in the Policy (emphasis added). Indeed, in many instances a computer will suffer 'damage' without becoming completely inoperable."

See also Ashland Hospital Corp. v. Affiliated FM Ins. Co., 2013 WL 440516 at *1 (E.D. Ky. Aug.14, 2013) (threat to computer system's future reliability caused temporary failure of hospital's air conditioning system deemed to satisfy policy's requirement of "direct physical loss or damage" to insured property).

These cases may be relevant to the pending business interruption litigation because they suggest that even minimal or temporary "damage", or even the threat of future "damage", might be enough to meet the "direct physical loss or damage" requirement in many of these policies. Thus, in *Ashland Hosp. Corp.* the court found that the "damage" requirement in the policy could be satisfied even if such damage occurs "on a microscopic level", which in that case arose "through a process called 'ionic migration', in which 'lubricants are thinned or … move around because they're more fluid [as a result of heat exposure].'" This conclusion is consistent with numerous cases holding that "direct physical loss" may exist in the absence of structural damage to the insured property. *See, e.g.*, *Sentinel v. New Hampshire Ins. Co.*, 563 N.W.2d 296 (Minn. Ct. App. 1997) (although asbestos contamination, through release of asbestos fibers, does not result in tangible injury to the physical structure of a building, a building's function may be seriously impaired or destroyed and the property rendered useless by the presence of contaminants). These cases suggest that in the context of the current pandemic a viral outbreak which renders property useless or impairs its functioning may satisfy the "physical loss or damage" requirement in business interruption policies. In this regard, the decision in *Nat'l Ink* is particularly noteworthy because of its suggestion that "loss of use" of the insured property may be sufficient to trigger coverage. Just as "a computer will suffer 'damage' without becoming completely inoperable," so too business premises may sustain sufficient "damage" as a result of the current pandemic to trigger an effective loss of use. This notion is in accord with language in *Hughes v. Potomac Ins. Co.*, 199 Cal. App. 2d 239 (1962) suggesting that the "direct physical loss or damage" requirement would be satisfied where a dwelling had become uninhabitable even though no tangible injury had been done to the building's structure.

> Just as 'a computer will suffer 'damage' without becoming completely inoperable,' so too business premises may sustain sufficient 'damage' as a result of the current pandemic to trigger an effective loss of use.

Finally, *Nat'l Ink* is also noteworthy it sanctioned a recovery for the complete replacement of the plaintiff's computer system based on the possibility of the threat of future harm — i.e., the remains of the ransomware virus could potentially re-infect the system. In the context of the current pandemic, the actions taken by business owners to close their businesses similarly arise in the context of avoiding the spread of the pandemic to their employees and customers. Thus even in the absence of evidence of actual infection, the threat of future harm should be sufficient to trigger coverage. *See, e.g.*, *Murray v. State Farm Fire and Casualty Company*, 203 W. Va. 477 (W. Va. 1998) (although plaintiff policyholders' house was not actually damaged by rockfalls, they were compelled to leave their house because of the possibility that additional rocks could fall. As such, and because the homes had therefore become unsafe for habitation, coverage was triggered). ■

Peter S. Selvin *is a partner at Ervin Cohen & Jessup LLP. You can reach him at pselvin@ecjlaw.com.*