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BUSINESS INSURANCE: FIRST-PARTY COMMERCIAL PROPERTY INSURANCE AND THE PHYSICAL DAMAGE REQUIREMENT IN A COMPUTER-DOMINATED WORLD

AMY R. WILLIS*

I. INTRODUCTION

We live in an intangible world—a world where computers dominate business operations at a level that would have been unheard of twenty years ago. Vital ingredients of a business, such as customer and proprietary information, product design data, and accounting information, are now stored on computers.[1] This intangible information often constitutes a large portion of a company's assets.[2] If this information is lost or computers malfunction during some fortuitous event, the affected businesses may suffer devastating losses, and operations may be interrupted for an extended period of time.[3] When this occurs, businesses will turn to their insurance companies for coverage.

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1. *See* Hazel Glenn Beh, *Physical Losses in Cyberspace*, 8 CONN. INS. L.J. 55, 55-56 (2001).
2. *Id.* at 57.
3. *See, e.g.*, Robert L. Carter, Jr. & Donald O. Johnson, *Power to Policyholders: Court Supports Insurance Recoveries for Loss of Electronic Data*, 86 A.B.A.J. 66, 66 (2000); Paula M. Yost, Paul E.B. Glad & William T. Barker, *In Search of Coverage in Cyberspace: Why the Commercial General Liability Policy Fails to Insure Lost or Corrupted Computer Data*, 54 SMU L. REV. 2055, 2061 (2001) (noting that large economic losses can result from "the deletion or corruption of valuable business data," and "[i]n a digital economy in which information is the new currency, businesses are increasingly dependent upon their ability to access, store, and transmit computerized data . . . . Any interference with that ability can, and does, translate into titanic financial losses").

First-party commercial property policies provide insurance benefits directly to the affected business when there is a loss.[4] Business interruption insurance, also known as business income insurance, is often purchased as part of a first-party commercial property business insurance package to protect against lost earnings that a policyholder would have earned absent the interruption in business.[5] Virtually all first-party property coverage, including business interruption insurance, will not provide coverage unless a covered peril causes actual physical damage resulting in loss or interruption.[6] For decades this coverage was sufficient because businesses typically faced physical perils that caused tangible damage.[7] Today, this coverage is insufficient because it often fails to cover significant intangible assets, such as electronic data.[8]

To determine whether a policy covers losses that result from loss of electronic data, a court will first look at the language of the insurance policy.[9] Insurance companies often use boilerplate language from standard insurance forms created by the Insurance Services Office (ISO) to draft policies.[10] Thus, the policies and practices adopted by the ISO encourage insurance companies to follow suit. The current ISO language in first-party policies excludes or limits electronic data from coverage.[11] Despite the ISO's position, the issue of coverage for electronic data and other intangibles remains widely discussed and litigated, and not all insurance companies strictly follow ISO forms.

In today's business world, coverage that excludes electronic data is unworkable because property forms have changed.[12] Many businesses

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4. Anna Lee, Note, Why Traditional Insurance Policies Are Not Enough: The Nature of Potential E-Commerce Losses & Liabilities, 3 VAND. J. ENT. L. & PRAC. 84, 85 (2001).

5. *See, e.g.*, Robert J. Brennan & Laura C. Conway, *Business Income Insurance Coverage*, 32 THE BRIEF 65, 65 (2003). To recover under business interruption insurance, the business must actually show a loss of income. *Id.* at 69. Business interruption policies may also contain extra expense coverage, which covers extra costs incurred as a result of the event, such as rental or transportation expenses. *Id.* at 66.

6. *See, e.g.*, Beh, *supra* note 1, at 67. Individual policy language will determine what perils are covered; however, common losses covered in business interruption policies include "fire; explosions; power failures; earthquakes; closure by order of civil authority . . . hail; floods; riots and civil commotions." Brennan & Conway, *supra* note 5, at 67.

7. *See* Beh, *supra* note 1, at 64-68.

8. *See id.* at 64.

9. Under standard contract law, the plain and unambiguous meaning of policy provisions will be given effect. *See, e.g.*, Ward Gen. Ins. Servs., Inc. v. Employers Fire Ins. Co., 7 Cal. Rptr. 3d 844, 852 (Cal. Ct. App. 4th Dist. 2003).

10. Michelle E. Boardman, Contra Proferentem*: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105, 1113 (2006).

11. *See* Insurance Services Office, *Building and Personal Property Coverage Form*, 2007, at § (A)(2)(n), *available at* LEXIS ISO Policy Forms No. 00 10 06 07; Insurance Services Office, *Business Income (and Extra Expense) Coverage Form*, 2007, at § (A)(5)(d), *available at* LEXIS ISO Policy Forms No. 00 30 06 07; William K. Austin, *Cyber Risk—Data Damage and Destruction Beyond the Naked Eye*, IRMI ONLINE, July 2009, http://www.irmi.com/expert/articles/2009/austin07-commercial-property-insurance.aspx.

12. *See* Beh, *supra* note 1, at 55.

have abandoned physical storefronts and the familiarity of face-to-face transactions and operate exclusively on the Internet as electronic businesses (e-businesses).[13] Bricks and mortar businesses that once stored valuable data in office filing cabinets now store most data electronically. Businesses are evolving, but the insurance industry has intentionally lagged behind, ensuring businesses will have inadequate coverage for electronic assets.

ISO standard forms, insurance policies, and case law contain inconsistencies that further confuse and leave policyholders uncertain as to property and business interruption coverage involving electronic data. Drafters of ISO policy language should take a step back and reconsider their positions on electronic data exclusions. Some insurance companies are providing endorsements to policies notwithstanding the language,[14] and courts have recognized the physicality of electronic data.[15] Additionally, courts and scholars failing to recognize electronic data loss as physical damage often cite third-party commercial general liability policies (CGL) as support, which is inappropriate due to first- and third-party coverage differences.[16]

As we move ahead in the twenty-first century and become increasingly more dependent on computer-run businesses, the number of possible events that may not meet the physical damage requirement continues to grow. Why has the insurance industry failed to make changes to standard first-party commercial property policies that reflect the modern realities of our computer-dominated world?

I will address this question and argue that the physical damage requirement in standard first-party policies is outdated or unsuitable for the evolving insurance needs of modern businesses because it excludes electronic data from coverage. First, I will discuss the impact cyberspace has had on property forms, business operations, and insurance needs, and I will explore current problems many businesses face when obtaining cyber-related coverage. Second, I will provide an analysis of the issues and case law surrounding the physical damage requirement

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13. E-businesses transact business over the Internet instead of at a physical location. *Id.* at 56.

14. *See* Lambrecht & Assocs., Inc. v. State Farm Lloyds, 119 S.W.3d 16, 22 (Tex. App. 12th Dist. 2003).

15. *See* Am. Guar. & Liab. Ins. Co. v. Ingram Micro, Inc., No. 99-185 TUC ACM, 2000 U.S. Dist. LEXIS 7299, at *6 (D. Ariz. Apr. 18, 2000).

16. Courts should not use third-party liability policies as a guide in interpreting first-party property policies because, from an insurer's perspective, coverage risks in each policy are very different. *See* Erik S. Knutsen, *Confusion About Causation in Insurance: Solutions for Catastrophic Losses*, 61 ALA. L. REV. (forthcoming 2009) (manuscript at 11, on file with author). In a liability policy, an insurer's scope of coverage is as broad as tort law, and in a property case insurers have greater control over underwritten risks. *Id.* Although courts and scholars have argued for the different treatment of first and third-party policies, comparisons continue to be made. *See id.* at 70; *see also* Ward Gen. Ins. Servs., Inc. v. Employers Fire Ins. Co., 7 Cal. Rptr. 3d 844, 852 (Cal. Ct. App. 4th Dist. 2003).

in a computer-related context, and I will briefly introduce problems the requirement creates in other insurance contexts. Lastly, I will discuss the implications of boilerplate language in insurance contracts, dissect current ISO forms, present theories on why the industry has not evolved, and make recommendations for the future.

II. CYBERSPACE

Computers have taken the world by storm. Many businesses' most valuable assets now exist in cyberspace.[17] Businesses are changing, and traditional insurance products should be updated to reflect these changes. The rise in e-businesses and specialized cyber insurance products evidence the need for change. Businesses that once cautiously flirted with cyberspace now trust the cyberworld with some of their most precious information.

A. The New Form of Property

Electronic data has become a significant form of commercial property.[18] Many businesses have purged familiar steel filing cabinets, opting instead to transfer paper data into an electronic form. Other than the occasional post-it note, people today rarely use handwritten materials to communicate information, and typewriters are practically extinct. Businesses likely believe they are keeping up with technology by engaging in these practices and may not realize the insurance implications.

Much of the electronic data stored by businesses is the same data previously stored in filing cabinets and, thus, has simply changed forms. The ability to store data in an electronic form has enabled companies to go "green" by reducing their environmental impact.[19] Storing data electronically may also provide additional safeguards because paper can be more easily destroyed by fires, floods, and other natural disasters. While this kind of damage is easily seen with the naked eye, damage to data stored on computer systems is intangible and cannot be seen.[20] Property forms have changed so drastically that if a natural disaster destroys all of a company's computers, the company will probably be more concerned about the intangible information the computer held than the loss of the physical system.

The emergence of electronic data as a major property form is a significant reason why the current physical damage requirement is

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17. *See* Beh, *supra* note 1, at 55.

18. *See id.*

19. The paper production process comes with significant costs to the environment. Many companies are finding that reducing paper consumption saves money, is more efficient, and may bolster their reputations for being "environmentally conscious." Heather Sarantis, Business Guide to Paper Reduction, September 2002, pp. 1-4, *available at* http://www.environmentalpaper.org/documents/REDUCE-BUSINESS-GUIDE.pdf.

20. *See id.* at 56.

outdated. Businesses are simply choosing to store data in a different way. Their choice is an optimal one for the environment, and wording in standard insurance policies should not incentivize businesses to regress. For insurance purposes, it should not matter what form a company uses to store data. Insurance companies themselves likely use computers as their major source of data storage.

B. E-businesses

Cyberspace has changed conventional business operations. E-businesses are on the rise. Without having to maintain a physical location, e-businesses are important for the economy because they can expand and break into markets faster than conventional businesses, thus maximizing profits.[21] E-businesses can potentially reach an unlimited number of customers through the Internet, and conducting business online reduces transaction costs.[22] These business forms have no use for an insurance policy that covers only physical losses and physical perils even though they desperately need business interruption and property protection. If a policyholder's entire business is conducted online, any interruption that keeps the business offline could result in huge losses.[23] Further, any data loss or software corruption could also result in substantial interruptions.[24]

One reason traditional first-party policies are inadequate is that e-businesses face different risks and damages in the cyberworld than those that threaten the traditional business.[25] The risks that affect e-businesses are different than the physical risks once contemplated by traditional commercial property policies.[26] E-perils, such as computer viruses[27] and computer hacking,[28] threaten to harm e-businesses more

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21. *See id.* at 57.
22. *See id.*
23. *See id.* at 59-60.
24. Yost, Glad & Barker, *supra* note 3, at 2061.
25. *See id.* Modern traditional bricks and mortar businesses face many of the same risks as e-businesses. Viruses and worms may be the most serious threat facing corporations today. Robert W. Hahn & Anne Layne-Farrar, *The Law and Economics of Software Security*, 30 HARV. J.L. & PUB. POL'Y 283, 289-90 (2006).
26. *See* Beh, *supra* note 1, at 55-56 ("The perils that face these new business forms are not the traditional perils of fires, floods, and other physical forces of man and nature, but perils that exert no apparent physical force and leave no sign of physical damage behind.").
27. Worms and computer viruses are self-replicating programs that usually arrive via email and corrupt data and programs on computers. One infamous worm, the Love Bug, spread from Asia in 2000 and even reached government computers at Congress, the White House, and the Pentagon. The Love Bug may have caused up to $10 billion in damages. Hahn & Layne-Farrar, *supra* note 25, at 289.
28. Computer hackers often use social engineering tactics to invade secure networks. They may send fraudulent emails to customers to trick them into divulging confidential information, or they may gain access to networks when employees and consumers select unoriginal passwords or fail to keep passwords private. In these cases they are posing as legitimate users when they hack into sites. *Id.* at 290-91.

than any physical peril.[29] E-perils include the risks of "information theft, insertion of malicious codes, denial of service attacks,[30] access violations, failure of computer security, programming errors, and misuse or misappropriation of intangible assets."[31] Because e-businesses face more danger in the cyberworld, they need business interruption and property coverage for e-perils instead of physical perils.[32]

Similar to the way fires and floods interrupt the business of a shopkeeper, e-perils interrupt the operations of an e-business. Surprisingly, even the slightest website interruption can have devastating consequences on profits due to the impatient nature of e-customers.[33] If Amazon.com and Overstock.com are both selling the same product at the same price, a customer will naturally prefer the site that is working properly. A prudent e-business owner will seek to insure for these interruptions, particularly because they could last for extended periods of time.[34] E-businesses today should shy away from traditional first-party commercial property policies and look for an e-commerce policy with some kind of business interruption coverage.[35]

C. E-Commerce Insurance

Despite the radical changes cyberspace has brought to modern businesses, many traditional insurance products have remained the same. Both first-party commercial property policies and CGL[36] policies require the incurrence of some kind of physical damage.[37] Instead of modifying traditional products, some insurance companies

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29. *See* Beh, *supra* note 1, at 56.

30. A denial of service attack is when a network is overwhelmed with traffic that shuts down and prevents customers from accessing the network. Hahn & Layne-Farrar, *supra* note 25, at 288.

31. *See* Beh, *supra* note 1, at 58-59.

32. *See id.*

33. *See id.* at 60 (noting that the average web surfer will only wait approximately eight seconds for a website to load before moving on to a different site).

34. Claims for web interruptions may be more successful when interruptions last for extended periods of time. The majority of courts require business operations to be completely suspended and will not provide coverage for slowdowns. *See* Clark Schirle, *Time Element Coverages in Business Interruption Insurance*, 37 THE BRIEF 32, 34 (2007). This requirement is problematic because e-commerce-related losses often involve brief interruptions or network slowdowns.

35. *See* Robert H. Jerry, II & Michele L. Mekel, *Cybercoverage for Cyber-Risks: An Overview of Insurers' Responses to the Perils of E-Commerce*, 8 CONN. INS. L.J. 7, 13 (2001).

36. CGL policies will be referred to in this Note because courts and scholars often use these cases as a guide in interpreting *physical* damage under first-party property cases due to the requirement in CGL policies of damage to *tangible* property. *See, e.g.*, Ward Gen. Ins. Servs., Inc. v. Employers Fire Ins. Co., 7 Cal. Rptr. 3d 844, 852 (Cal. Ct. App. 4th Dist. 2003); Kendall Bodden, Note, *Tangible Cash for an Intangible Loss? Insurance Coverage for Damage or Loss of Third-Party Data*, 1 SHIDLER J.L. COM. & TECH. 6, *2 (2005), *available at* http://www.lctjournal.washington.edu/Vol1/a006Bodden.html.

37. *See* Jerry & Mekel, *supra* note 35, at 10, 15-16.

have created new products that are specifically tailored to e-perils.[38] These e-commerce or cyber policies are specialized and aim to cover intangible assets.[39] For example, insurance giant AIG recently created a new cyber-breach package that covers many risks including network interruptions, cyber extortion, and network security.[40] Businesses that want insurance for electronic data can purchase e-commerce policies designed to cover cyber risks. These policies provide coverage for e-perils and will often compensate the insured for loss of income when a website becomes inoperable during a cyber event.[41] Although these products sound desirable, many believe the cyber insurance market is under used because of expensive premiums.[42] Many of these products were created at the beginning of the decade and because of their relatively short history, there may be uncertainty regarding their scope of coverage.[43]

Cyber products may be effective for some businesses, but they do not appeal to all clients.[44] Fortune 1000 companies may not want to negotiate and administer these stand-alone policies.[45] These companies have the clout to induce insurance companies into drafting endorsements or individualized policies, but smaller companies may find that standardized cyber policies are their only option.[46] Many cyber insurers require businesses to implement certain IT security standards before providing coverage, and these security measures may be too costly for smaller businesses.[47] Modern brick and mortar businesses that have significant intangible assets but are not involved in e-commerce may be stuck between a rock and a hard place. Traditional first-party policies will not provide electronic data coverage, and standardized e-commerce policies may not cover businesses that are not engaged in e-commerce.[48] Business owners may believe their standard first-party policy is enough, they may fail to appre-

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38. *See* Beh, *supra* note 1, at 56-57.

39. It is important to distinguish between commonly used cyber insurance terminology for first-party policies (often called e-business or e-commerce insurance) and third-party policies (often called cyber-risk insurance). These terms are often used interchangeably in material and due to this trend both terms will be used in this Note. *See* F. LAWRENCE STREET, LAW OF THE INTERNET § 13.02 (2009).

40. Pete Brush, *Ailing AIG Rolls out New Cyber-Breach Product*, LAW 360, Jan. 27, 2009, http://www.law360.com/print_article/84826. AIG's cyber-breach product is a third-party policy and is only for businesses with annual revenue of over $500 million. *Id.*

41. *See* Jerry & Mekel, *supra* note 35, at 13.

42. Ross Anderson & Tyler Moore, *The Economics of Information Security*, SCIENCE, Oct. 27, 2006, at 610, 612.

43. *See* Jerry & Mekel, *supra* note 35, at 13.

44. *See id.* at 28.

45. *Id.*

46. *Id.* at 28-29.

47. *See* Bodden, *supra* note 36, at *5.

48. *See* Insurance Services Office, *Electronic Commerce (E-Commerce)*, 2007, *available at* LEXIS ISO Policy Forms No. CP 00 30 06 07.

ciate their coverage needs, or their insurance agent may misrepresent the extent of coverage.[49]

1. E-Commerce Insurance and Conflicts of Interest

One reason obtaining insurance can be a hazard to businesses seeking e-commerce-related coverage is that there is an inherent conflict of interest between insurance agents and the insured.[50] Both experienced and rookie insurance agents are faced with ethical dilemmas when clients ask coverage questions.[51] Both agents want to make the sale and may be tempted to lead clients to believe policies will provide coverage.[52] An experienced insurance agent knows he cannot accurately predict coverage.[53] Businesses spend thousands—even millions of dollars on premiums and they want to be assured of coverage.[54]

When selling a policy, insurance agents may be tempted to suggest that traditional policies will cover e-commerce-related losses. Insurance agents may also misinform policyholders of coverage available under specialized products and may not spend enough time accurately assessing businesses' coverage needs. It may be particularly problematic for insurance agents to accurately predict coverage scenarios under specialized e-commerce or cyber products because they are relatively recent editions to insurance companies' inventories.

An insurance agent's temptation to misinform or inability to accurately predict coverage is nothing new and is certainly not limited to e-commerce-related coverage; however, businesses should be aware of the uncertainty that may accompany e-commerce policies. Until nuances in these policies have been litigated, it is impossible for the conscientious agent to accurately estimate coverage, and it may be easier for the rookie agent to engage in insincere sales tactics. Clients may expect some degree of "puffing" by any salesperson, but they will likely expect their insurance agents to provide clear answers regarding coverage.

III. THE PHYSICAL DAMAGE REQUIREMENT

What is physical damage? This seems to be the million dollar question when it comes to cyber-related commercial property and

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49. *See* Lee Roy Pierce, Jr., *The Ethical Dilemma Insurance Agents Face Which May Tempt Some to Mislead Their Clients Regarding Coverage, and What to Do to Protect Your Business from the Consequences of Such Conduct*, 19 W. ST. U. L. REV. 507, 507-08 (1992) (providing general information on the problems that may arise as a result of the conflict of interest between insurance agents and their clients).

50. *See id.*

51. *See id.* at 508.

52. *See id.*

53. *Id.* at 509-10.

54. *Id.* at 511.

business interruption litigation. Can the concept of physical damage change with advances in technology, or is it a static concept?

Generally, to meet the physical damage requirement, the insured must prove there was a "material or substantive physical change to the insured property;"[55] however, policy definitions may differ. If the term physical damage is undefined in the contract between the parties, courts often differ in interpretations of what constitutes physical damage.[56] These inconsistencies threaten to leave policyholders uncertain about what property will be covered. If insurance companies and courts strictly construe the concept of physical damage, many businesses could be left without electronic data coverage.

A. The Physical Damage Requirement and Computers

Insurance companies and policyholders disagree over what constitutes physical damage.[57] Policyholders argue that physical damage occurs when magnetic changes occur within the computer's memory.[58] Policyholders can also analogize computer-related losses to other invisible forms of damage like mold spores, odors, and gasses.[59] Insurance companies will likely consistently oppose these arguments and contend that changes in electronic information are intangible and do not constitute physical damage.[60]

E-commerce-related losses could be covered in first-party commercial property policies that are written on an all-risk basis.[61] All-risk policies typically provide coverage when a fortuitous event causes physical loss *or* damage.[62] There is some confusion over whether the word "physical" applies merely to losses or applies to damages as well.[63]

Businesses may have more luck with e-commerce-related losses in all-risk business interruption policies. A leading case on the subject, *American Guarantee & Liability Insurance Co. v. Ingram Micro, Inc.*,[64] demonstrates that some courts will stretch traditional business

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55. Peter E. Kanaris, *Analytical Approach to Business Interruption, Extra Expense, and Civil Authority Coverage Issues*, 43 TORT TRIAL & INS. PRAC. L.J. 113, 114 (2007).

56. *See, e.g.*, Am. Guar. & Liab. Ins. Co. v. Ingram Micro, Inc., No. 99-185 TUC ACM, 2000 U.S. Dist. LEXIS 7299, at *10 (D. Ariz. Apr. 18, 2000) (holding that physical damage included loss of use or functioning of computer); Ward Gen. Ins. Servs., Inc. v. Employers Fire Ins. Co., 7 Cal. Rptr. 3d 844, 850 (Cal. Ct. App. 2003) (holding that loss of electronic database did not constitute physical damage).

57. *See* Beh, *supra* note 1, at 66.

58. *See id.*

59. *Id.* at 66-67.

60. *Id.* at 66.

61. Lee, *supra* note 4, at 86.

62. *Id.*

63. *Id.*

64. *See generally* No. 99-185 TUC ACM, 2000 U.S. Dist. LEXIS 7299 (D. Ariz. Apr. 18, 2000) (holding that damage to a computer system resulting from a power outage constituted "physical damage").

interruption policies to find coverage.[65] Ingram, "a wholesale distributer of microcomputer products," purchased an all-risk property policy from American to insure against business interruption losses.[66] The policy insured against "[a]ll [r]isks of direct physical loss or damage from any cause."[67] Ingram's business operations depended solely on the functioning of a computer network used to conduct daily business.[68] As a result of a power outage, Ingram's computer lost all programming information from the random access memory, and it took almost eight hours for Ingram to return to full operation due to a malfunctioning matrix switch.[69] American argued that there was no physical damage because the matrix switch and the computer had not lost the ability to accept data.[70] Ingram argued that physical damage includes loss of use and functionality.[71]

The court referenced language in penal statutes that defined computer damage and held in favor of Ingram, stating the following:

> At a time when computer technology dominates our professional as well as personal lives, the Court must side with Ingram's broader definition of "physical damage." 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.[72]

The court found language in penal statutes to be relevant to insurance because "[l]awmakers around the country have determined that when a computer's data is unavailable, there is damage; when a computer's services are interrupted, there is damage; and when a computer's software or network is altered, there is damage."[73]

Ingram served as a warning to the insurance industry, and some companies drafted electronic data exclusions.[74] Notwithstanding possible exclusions, the *Ingram* case is evidence that businesses may be covered under all-risk policies for business interruption losses that result from corruption or loss of electronic data.[75] Although *Ingram* has not been widely accepted,[76] some courts still follow the *Ingram*

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65. *See, e.g.*, Beh, *supra* note 1, at 68-69; Lee, *supra* note 4, at 86.
66. *Ingram*, 2000 U.S. Dist. LEXIS 7299, at *2-*3.
67. *Id.* at *3.
68. *Id.* at *3.
69. *Id.* at *4-*5.
70. *See id.* at *5.
71. *Id.* at *6.
72. *Id.*
73. *Id.* at *7.
74. *See, e.g.*, Beh, *supra* note 1, at 68-69; Felix's Rest., Inc. v. Aspen Specialty Ins. Co., No. 07-4290, 2008 U.S. Dist. LEXIS 82815, at *15 (E.D. La. Oct. 17, 2008) (interpreting policy containing endorsement that excluded electronic data from coverage unless damage was caused by a covered peril).
75. STREET, *supra* note 39, at §13.02.
76. *Id.*

holding.[77] In *Southeast Mental Health Center, Inc., v. Pacific Insurance Co., Ltd.*, the plaintiff's operations were interrupted after a storm and a power outage caused data loss to the pharmacy computer.[78] Although the storm did not physically damage plaintiff's real property, plaintiff sought recovery for business income losses that resulted from its inability to fill customer prescriptions on the pharmacy computer.[79] The court, noting that the *Ingram* court's reasoning was persuasive, held that "the corruption of the pharmacy computer constitutes 'direct physical loss of or damage to property' under the business interruption policy."[80]

Despite *Ingram*'s persuasiveness, the recent trend in CGL cases is to find that electronic data is not tangible property.[81] Although there are vast differences between third-party and first-party policies that should not be ignored, some courts follow the reasoning in third-party cases.[82] In *Ward General Insurance Services, Inc., v. Employers Fire Insurance Co.*, the court held that loss of electronically stored data was not a physical loss without any "loss or damage to the storage media or to any other property."[83] The court used dictionary definitions of the term physical and followed holdings in third-party cases, including a widely-cited case, *America Online, Inc., v. St. Paul Mercury Insurance Co.*[84] In the *America Online* case, the court held that "computer data, software and systems are not 'tangible' property in the common sense understanding of the word."[85] The court declined to follow *Ingram*, stating the following:

> The court in *Ingram Micro* did not apply the plain meaning of the word "physical." Rather, the court relied on the increased importance of computers in our lives and the reflection of this level of importance in various state and federal statutes qualifying loss of computer data as physical damage. Although the importance of computers in our personal and professional lives cannot be overstated, this Court is bound by the terms of the insurance policy. [86]

Both the *Ingram* and the *America Online* courts recognized the importance of computers in today's society; however, the *America On-*

77. *See* Se. Mental Health Ctr., Inc. v. Pac. Ins. Co., 439 F. Supp. 2d 831, 837-38 (W.D. Tenn. 2006).

78. *Id.* at 833.

79. *Id.* at 834, 836.

80. *Id.* at 837.

81. STREET, *supra* note 39, at §13.02.

82. *See* Ward Gen. Ins. Servs., Inc. v. Employers Fire Ins. Co., 7 Cal. Rptr. 3d 844, 852 (Cal. Ct. App. 4th Dist. 2003) ("We see no reason to attribute different meanings to 'direct physical loss,' as used in first-party coverage provisions, and 'physical damage to tangible property,' as used in third-party coverage provisions.").

83. *Id.* at 851.

84. 207 F. Supp. 2d 459 (E.D. Va. 2002).

85. *Id.* at 462.

86. *Id.* at 469-70.

line court was unwilling to use public policy in its decision. Also, the *America Online* court failed to recognize that property forms have changed, while in *Ingram* the court recognized that strict construction of the definition of physical damage would be "archaic."[87]

The physical damage requirement should be modified because electronic data can be damaged and is merely a different form of data storage. Electronic data can be manipulated, altered, and changed[88] and is used as a substitute for paper records. These changes should be considered to constitute physical damage. Further, there are important public policy reasons to change the way we view physical damage. Computers have changed our lives and the way we do business. Computers are important for the economy and have aided businesses in maximizing profits by lowering transaction costs. Computers have become the premier storage device utilized by businesses, and electronic data is a vital asset that should be covered in first-party policies. As discussed in *Ingram*, legislators have already recognized that electronic data can be damaged. Businesses today already face a precarious existence. Leaving modern businesses without adequate coverage of intangibles will only further the problem.

B. The Physical Damage Requirement in Other Contexts

The cyberworld is not the only context in which the physical damage requirement has started controversy.[89] Litigation over the definition of physical damage still ensues and is anticipated in other situations. A power grid stops functioning—physical damage? Swine flu contaminates a work place—is the contamination physical damage? These are just a few of the many issues that arise in litigation involving business interruption insurance.

The recent swine flu pandemic has alarmed many businesses and encouraged them to reexamine their insurance coverage.[90] The number of swine flu cases has continued to grow, and businesses are worried about coverage when business operations shut down.[91] Attorneys expect insurance companies will contend that swine flu losses do not constitute property damage.[92] These disagreements will likely lead to litigation. Under applicable law, some contamination is considered

87. Am. Guar. & Liab. Ins. Co. v. Ingram Micro, Inc., No. 99-185 TUC ACM, 2000 U.S. Dist. LEXIS 7299, at *7 (D. Ariz. Apr. 18, 2000).

88. *See* Beh, *supra* note 1, at 66.

89. This Note focuses on the physical damage requirement and electronic data; however, it is useful to examine other areas in which the requirement has created confusion regarding scope of coverage.

90. *See* Christie Smythe, *Swine Flu Prompts Cos. to Examine Insurance*, LAW 360, May 1, 2009, http://www.law360.com/print_article/99373.

91. *See id.*

92. *Id.*

physical damage to property.[93] Businesses should be covered for losses sustained during the time they were decontaminating the property, but only time will tell.[94]

Power outages can wreak havoc on business operations, and there is controversy regarding whether outages constitute physical damage. In a recent case, *Wakefern Food Corp. v. Liberty Mutual Fire Insurance Co.*, a New Jersey appellate court found that an electrical grid was physically damaged when it was unable to provide electricity.[95] As a result of this case, Liberty Mutual was ordered to cover a group of supermarkets for losses they suffered during a power outage that lasted four days.[96] The trial court had found there was no physical damage to the power grid because it was able to function after the interruption.[97] The appellate court found that "the trial court construed the term [physical damage] too narrowly, in a manner favoring the insurer and inconsistent with the reasonable expectations of the insured."[98] The plaintiffs in this case had paid a $5.5 million dollar premium for a policy that included coverage for power outages.[99]

Many of these concepts are obvious, and perhaps drafters of traditional business interruption insurance policies anticipated these risks and chose not to provide coverage. Notwithstanding policy language, many businesses urge courts to stretch the term physical damage, and sometimes courts agree. The power outage case and the possibility of swine flu litigation provide additional support for the modification of the physical damage requirement. Not all physical damage can be easily seen with the naked eye, but this does not mean damage does not exist. Businesses spend fortunes in premiums and are being denied coverage on technicalities. Although insurance litigation in our society will continue, some courts are construing the definition of physical damage broadly, and insurance companies and the ISO should take note.

IV. BOILERPLATE LANGUAGE

Boilerplate language can make even the most attentive reader's eyes glaze over with confusion. Like many contract drafters, the insurance industry is no stranger to ambiguous boilerplate language.[100]

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93. Richard P. Lewis, *Securing Business Income Coverage in a Pandemic*, LAW360, May 1, 2009, http://www.law360.com/print_article/99440.

94. *Id.*

95. 968 A.2d 724, 734 (N.J. Super. Ct. App. Div. 2009); Tina Peng, *Liberty Must Cover Markets for Power Outages: Court*, LAW 360, Apr. 23, 2009, http://www.law360.com/print_article/98222.

96. *Wakefern Food Corp.,* 968 A.2d at 739.

97. *Id.* at 734.

98. *Id.*

99. *See* Peng, *supra* note 95.

100. *See* Boardman, *supra* note 10, at 1111.

Insurers likely use boilerplate language not because clients understand it, but because courts have already interpreted the language. Insurers continue to use ambiguous language even though courts often construe such language against them.[101]

In her article, Contra Proferentem*: The Allure of Ambiguous Boilerplate*, Professor Michelle E. Boardman evaluates the insurance industry's attraction to boilerplate language despite incentives to draft clearer policies.[102] Professor Boardman makes the following observation about courts' attempts to incentivize insurance companies: "Courts try to improve the language of insurance policies, as a parent tries to improve a child's behavior, both by punishment and by encouragement. The frustration of courts in this endeavor suggests that they realize their efforts are being wasted."[103] When courts construe ambiguous boilerplate language against insurance companies, the result is less than optimal.[104] Instead of redrafting language to increase policy clarity, insurance companies use ambiguous language to their advantage. They retain language that is unreadable, but has been interpreted by courts because they know courts will use precedent in the future to interpret the provisions.[105] They may retain language that has been construed in their favor but is confusing to policyholders, or they may even retain language that has been construed against them but will mislead policyholders into believing they have no meritable claim.[106] Boilerplate language takes on a private meaning between courts and insurers, but policyholders are left out in the cold.[107] The result only perpetuates path dependency.[108]

A. *Insurance Services Office*

As discussed in the Introduction, the ISO drafts standard insurance forms that many insurance companies use as models for their own first- or third-party policies. The ISO copyrights these forms and sells them to insurance companies.[109] The ISO also seeks approval of policy language from state insurance commissioners, and after courts interpret policies and data on losses is received, the ISO may begin redrafting forms.[110] The ISO maintains that this process increases clarity in standard language.[111] However, redrafts usually only in-

101. *Id.* at 1106.
102. *Id.*
103. *Id.* at 1107.
104. *See id.* at 1111.
105. *See id.*
106. *See id.*
107. *See id.*
108. *See id.* at 1113.
109. *Id.*
110. *Id.*
111. *Id.*

crease clarity for courts and insurers.[112] Professor Boardman contends that "[i]t should be questioned both whether language does indeed evolve from less to more clear and who benefits from the language changes that are made."[113] ISO forms are ideally supposed to represent current changes in the law, the insurance industry, and market conditions.[114] Despite sweeping changes in technology and new markets for cyber-related coverage, current ISO forms primarily exclude or limit electronic data coverage.[115]

Under the ISO form for first-party coverage, electronic data is listed as one of the items that is not covered.[116] The form does contain a $2,500 extension of coverage for the cost to *replace* electronic data, but not for the data itself.[117] This limit is too small for most businesses,[118] and the form further provides that "the loss will be valued at the cost of replacement of the media on which the electronic data was stored."[119] The ISO form for business interruption coverage also contains a $2,500 limit and will only provide coverage for electronic data related interruptions that are caused by covered perils.[120] The ISO e-commerce form provides business interruption coverage, but only for businesses engaged in e-commerce.[121] This specification means modern brick and mortar businesses will not be eligible for e-commerce policies modeled after ISO forms. These forms essentially provide no workable solutions for brick and mortar businesses that do not engage in e-commerce.[122]

Because courts may look to third-party policy language as a guide, it is useful to examine ISO forms for CGL policies. Businesses often rely on these third-party policies when they lose or damage their customers' data.[123] In 2001, the ISO changed the standard CGL form to exclude electronic data from property coverage.[124] The definition of property damage in the ISO form contains the following language:

> For the purposes of this insurance, electronic data is not tangible property. As used in this definition, electronic data means infor-

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112. *Id.*
113. *Id.*
114. *See id.*
115. Austin, *supra* note 11.
116. Insurance Services Office, *Building and Personal Property Coverage Form*, 2007, at § (A)(2)(n), *available at* LEXIS ISO Policy Forms No. 00 10 06 07.
117. Austin, *supra* note 11.
118. *Id.*
119. Insurance Services Office, *Building and Personal Property Coverage Form*, 2007, at § (A)(4)(f), *available at* LEXIS ISO Policy Forms No. 00 10 06 07.
120. *See* Insurance Services Office, *Business Income (and Extra Expense) Coverage Form*, § (A)(5)(d), *available at* LEXIS ISO Policy Forms No. 00 30 06 07.
121. *See Id.*
122. Austin, *supra* note 11.
123. Bodden, *supra* note 36, at *1.
124. *Id.* at *2.

> mation, facts or programs stored as or on, created or used on, or transmitted to or from computer software, including systems and applications software, hard or floppy disks, CD-ROMS, tapes, drives, cells, data processing devices, or any other media which are used with electronically controlled equipment.[125]

This language ensures that data loss will not be covered under CGL policies that adopt ISO language. However, "the new language does not exclude the third party's loss of use of undamaged hardware (i.e. tangible property) caused by data loss (i.e. intangible property)."[126] If insurance companies follow ISO forms, businesses will be forced to try to obtain e-commerce policies or litigate their claims.[127]

The current ISO forms present a significant obstacle to reform of the physical damage requirement. ISO forms greatly influence insurance companies. Ideally, these forms should be modified to reflect modern realities. The ISO is setting an unworkable example, and some insurance companies have recognized this and have added endorsements providing for e-commerce-related losses.[128] Restricting e-commerce policies to businesses engaged in e-commerce prevents modern brick and mortar businesses from obtaining sufficient electronic data coverage. If insurance companies follow these standard forms, modern brick and mortar businesses will not be covered under traditional first-party policies and will not be eligible to obtain e-commerce insurance.

While the ISO reports that its standardized policy forms are actually drafted to benefit consumers, it seems that electronic data exclusions were drafted to shield insurers from taking on risks in a relatively novel area. This behavior makes sense, and insurers are not expected to serve as saviors to modern businesses. Property forms have drastically changed in a relatively short period of time. The insurance industry may be cautious because they are alarmed by the rapidity of the changes, or they may be using changes in technology as an excuse to withhold coverage under traditional policies, thus creating an insurance market for expensive cyber products.

The industry is getting its feet wet by offering limited e-commerce coverage and seems to have no immediate plans to broaden coverage under traditional first-party policies. Insurance companies may be worried about accurately assessing risks presented by insuring electronic data. There may be concern about how to accurately measure electronic data damages. Insurance companies could also be worried

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125. *Id.* at *4.
126. *Id.* at *5.
127. *See id.*
128. Policy endorsements issued by some companies do not contain the e-commerce requirement. *See* Lambrecht & Assoc., Inc., v. State Farm Lloyds, 110 S.W.3d 16, 22 (Tex. App. 12th Dist. 2003).

about proof—if filing cabinets go up in smoke, the extent of the damage can be easily seen, but there is no obvious sign of damage to electronic data. If insurance companies are worried about proof, they should consider that, as a practical reality, proof is an issue when it comes to insuring any kind of data. If a business's filing cabinet goes up in smoke, it will be difficult to ascertain the *extent* of damage even though it can be easily seen. The cabinet could have been filled with blank sheets of paper. If a business is going to commit insurance fraud, they will likely be motivated to do this whether or not electronic data is involved.

By maintaining forms that exclude or limit electronic data from coverage, the ISO is doing the insurance industry a disservice. Under current ISO extension forms, paper is insurable. The provision provides that: "You may extend the insurance . . . to apply to the cost to replace or restore the lost information on valuable papers and records for which duplicates do not exist. But this Extension does not apply to valuable papers and records which exist as electronic data."[129] Many businesses are likely seeking insurance for the same data that was previously stored on paper. Insurance companies can cover electronic data and still restrict covered perils. Many insurance companies are missing out on profits because they are following ISO forms. Although other model forms exist, smaller insurance companies cannot afford to use non-ISO forms or to draft individualized forms. These smaller companies are missing out on a productive market while profits are being siphoned by specialty carriers offering e-commerce coverage.[130]

There could be additional motivations for following ISO forms that have nothing to do with insurance. For example, "an insurance executive may be able to keep her job and steadily advance, all the while endorsing ISO-drafted language that all other insurers are using, even if that language causes millions or billions of dollars in litigation."[131] An executive may be held accountable for a bad decision if she makes an individual decision to depart from ISO forms, but she will not be held accountable for following industry standards.[132]

President Barack Obama has stressed the importance of cyberspace in our lives,[133] and based on the government's recent trend of becoming involved in many industries, it is possible that someday the government could offer cyber insurance subsidies. If this happens, in-

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129. Insurance Services Office, *Building and Personal Property Coverage Form*, 2007, at § (A)(5)(c)(1), *available at* LEXIS ISO Policy Forms No. 00 10 06 07.

130. Telephone Interview with William K. Austin, Partner, Austin & Stanovich Risk Managers, LLC (Nov. 23, 2009).

131. Boardman, *supra* note 10, at 1128.

132. *See id.*

133. Austin, s*upra* note 11.

surers will lose money. Insurers are undoubtedly taking on some risk by insuring for electronic data loss; however, due to changing property forms, the benefits likely outweigh the risks. In ten or twenty years, businesses will have little to no use for a first-party policy that does not cover electronic data. The ISO should recognize the direction the world is heading and should change the physical damage requirement and protect itself by limiting covered perils or requiring the implementation of affordable security measures prior to underwriting the policy.

V. CONCLUSION

The Internet has seduced the world and changed the way we do business. People have become so accustomed to communicating through the World Wide Web that Twitter messages have even been sent from outer space.[134] Advances in technology have changed the way businesses operate, what they value most, and most importantly, how their most valuable data is stored. Businesses now operate in a computer-dependent world; however, the majority of the insurance industry is refusing to take the bait. The ISO is continuing to design cyber-excluding forms, and current e-commerce products are ill-suited for bricks and mortar businesses that have substantial intangible assets but are not engaged in e-commerce. If technology has changed, it only makes sense to redraft standard insurance forms.

An insurance policy is only as good as its drafter. Although the majority of insurance companies follow ISO boilerplate language that excludes electronic data from coverage, some policies may still have loopholes or remain ambiguous. When faced with an ambiguous policy, insurers will be dragged into court by businesses attempting to convince courts to stretch the physical damage requirement. Because these situations exist and litigation on these coverage issues will likely only increase, insurance companies would be wise to modify existing products instead of creating more specialized products. Adding newfangled products that have not stood the test of time and have not been litigated enough creates risks for the insurer and the insured.

Modern brick and mortar businesses now face the worst of both worlds. They face the traditional perils of floods and fires that threaten to destroy their business sites, and they face perils that threaten to destroy valuable intangible assets. Under standard ISO forms, businesses are likely not even covered for intangible damage that results from physical perils. A hurricane may strike and cause computers to lose important electronic data and software programs. Although this data has been manipulated, altered, or changed under

134. Clara Moskowitz, *First Twitter Message from Space Sent*, May 15, 2009, FOXNEWS.COM, http://www.foxnews.com/story/0,2933,520225,00.html.

standard forms, policyholders are not adequately covered and, even in an all-risk policy, courts could find that the physical damage requirement has not been met.

The physical damage requirement in first-party commercial policies is inadequate because property forms have changed. Property has become a much more intangible concept. Until the insurance industry recognizes that keeping traditional first-party policies the same is unprofitable, businesses must be cautious when assessing coverage needs. If insurance companies do not provide sufficient coverage solutions to meet the needs of modern businesses, the government could provide a public option for e-commerce-related coverage. Although this is an unlikely possibility, if the economy fails to recover and businesses are left uninsured for some of their most valuable assets, it is likely that demand for insurance reforms will arise.

Failing to update the physical damage requirement is like keeping archaic language in a statute—inefficient and confusing. Cyberspace is not the only area in which the physical damage requirement causes problems. Insurers may draft exclusions regarding electronic data but may still lose when it comes to litigation involving black-outs or property contamination. Case law reflects that courts often look at the reasonable expectations of the insured, and in ambiguous situations insurers could lose the physical damage battle. To prevent future litigation in the cyber context, it would be prudent to adopt a broader definition of physical damage that includes deletion or corruption of electronic data. Adopting this definition would be also be financially advantageous to insurers.

Until the ISO redrafts standard forms, insurance companies should decline to follow forms that contain electronic data exclusions because the insured is not the only loser when these forms are used. Insurers using these forms are missing out on a valuable insurance market. Brick and mortar businesses that have merely transferred data into an electronic form are willing to pay a premium to protect this data. These businesses are not engaged in e-commerce and do not need (or cannot afford) specialized cyber policies. They also may not have the complex security measures in place that many cyber policies require. While it may be prudent to set reasonable limits on electronic data losses, by excluding these losses altogether, insurers are shooting themselves in the foot. Insurers should discount for any perceived risks of providing coverage and should price premiums in accordance with these risks.

Insurers should consider petitioning the ISO to develop rates and forms for first-party electronic data coverage. This will enable companies to collect profits currently going to specialty carriers. The first step in the right direction for the ISO could be to design electronic policy endorsements. Coverage limits and certain exclusions could be

in place while still providing brick and mortar businesses with electronic data coverage. After these endorsements stand the test of time and insurers receive back statistics on policy claims, the ISO can incorporate coverage into standard first-party forms.

As technology progresses and the world becomes even more computer-dominated, the insurance industry should modify traditional policies to update coverage concepts. It is likely the standard business insurance package will soon be wholly inadequate to cover business assets. Businesses will not want to insure against paper losses when their valuable data exists in electronic form. Changes in technology should not provide a basis for insurers to change the essential function of first-party policies by failing to provide coverage for a business's most valuable assets. Insurance companies can dive into this new market by modifying existing products, assessing the costs of the risks of these modifications, and charging premiums accordingly. If insurance companies fail to take advantage of this lucrative market, they will have to watch large, specialized carriers rake in the profits they could have been making.