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NEW JERSEY COURT EXPANSIVELY INTERPRETS TERM "PHYSICAL DAMAGE" IN PROPERTY POLICY

By Robert D. Chesler, Esq. and Michael David Lichtenstein, Esq.

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Traditional property policies provide coverage for loss resulting from "physical damage," a term that the insurance policy leaves undefined. Numerous cases in recent years have tested the boundary of "physical" in the insurance context. These cases broadly fall into two camps. Some courts have refused to cross the boundary of actual, tangible damage, requiring a physical "touching" of some kind to trigger coverage. Other courts have looked to society's changing ideas of what "physical" means in our increasingly virtual world, and have ruled more broadly that loss of functionality constitutes sufficient physical damage to qualify as covered physical damage. In *Wakefern Food Corp. v. Liberty Mutual, No. A-2010-0773* (N.J. App. Div. April 22, 2009), the New Jersey Appellate Division established itself as a leader in the latter approach.

Wakefern concerned food spoilage caused by the blackout of 2003 at a chain of supermarkets. The court recounted in considerable detail the chain of events that led to the electric grid's failure to function, and found "that based on the highly technical analysis in the [utility company's] Final Report, one could certainly argue that the [electric grid] system was not physically damaged." Basically, the system automatically shut itself off before it incurred "physical damage," while the insurance policy required such damage as the predicate for business interruption coverage. The court then held that such a "highly technical analysis" was not dispositive of the case before it, explaining that New Jersey courts analyzed insurance issues based upon well-established rules of construction. These included that courts (1) give undefined terms their ordinary understanding, and (2)

resolve ambiguities in favor of coverage. Applying these rules, the court found that an ordinary insured would regard the shut-down of the electrical grid to constitute physical damage, and that the phrase "physical damage" was ambiguous.

In particular, the court looked at the facts of the case before it. *Wakefern* was in the food business. One of the greatest perils that it faced, and for which it purchased insurance, was to protect its merchandise from spoilage. Indeed, it specifically purchased insurance against the risk of electrical failure. The court found it would be against the insured's reasonable expectations not to have coverage for that very loss because of a technical interpretation of the term "physical damage." As a result, the court found that "physical damage" included the loss of functionality of the electric grid.

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Policyholders may not enjoy this victory for long. Insurance companies have become prolific in adding exclusions to policies that might deny coverage for such claims in the future. For example, policies may contain exclusions for claims involving software, or define covered "property" as excluding data stored on computers.

Simultaneously, the insurance industry has created a number of new

insurance products directly designed to provide coverage for "intangible" damage. For example, policies are available that provide coverage for corrupted data and business interruption caused by computer system failure. Companies should examine their exposure to intangible or "non-physical" risks, review their insurance policies for coverage and, if questions arise, consider purchasing a "cyber-policy" to cover those risks.

For more information on our Insurance Law practice group, please contact:

Robert D. Chesler

973 597 2328

rchesler@lowenstein.com

Michael David Lichtenstein

973 597 2408

mlichtenstein@lowenstein.com

or visit us online at

**[www.lowenstein.com/
insurancecoverage](http://www.lowenstein.com/insurancecoverage)**

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www.lowenstein.com

Boston

One Bowdoin Square
Boston, MA 02114
617 725 0036

New York

1251 Avenue of the Americas
New York, NY 10020
212 262 6700

Palo Alto

590 Forest Avenue
Palo Alto, CA 94301
650 433 5800

Roseland

65 Livingston Avenue
Roseland, NJ 07068
973 597 2500

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