COVID Insurance Rulings Are Misinterpreting 'Physical Loss'

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All-risks property insurance policies typically insure against direct physical loss of or damage to covered property.

If asked, pre-pandemic, whether a policyholder's loss of use of property — in the absence of any structural alteration or destruction — constitutes insured direct physical loss of or damage to property, the answer would have been a qualified yes. Such an understanding was supported by the historical purpose of all-risks insurance, the ordinary meaning of the operative policy language and pre-pandemic case law.

Yet, in a spate of cases, decided in response to claims of business interruption insurance for COVID-19 losses, courts have held that the loss of use of property, standing alone, does not constitute insured physical loss of or damage to property. Those courts reason that the alteration or destruction of covered property is a necessary predicate to satisfying the physical loss of or damage to property requirement.

On July 2, the U.S. Court of Appeals for the Eighth Circuit in Oral Surgeons PC v. The Cincinnati Insurance Co. continued that trend in the first federal court appellate decision on this emerging issue:

> The policy here clearly requires direct "physical loss" or "physical damage" to trigger business interruption and extra expense coverage. Accordingly, there must be some physicality to the loss or damage of property—e.g., a physical alteration, physical contamination, or physical destruction.

As posited in this article, the holdings in Oral Surgeons and the other recent COVID-19 insurance cases trending in favor of insurers fail to comport with the historical purpose of all-risks property insurance, the ordinary meaning of the salient policy language, and the majority of court holdings pre-pandemic.

Indeed, shortly after the Oral Surgeons opinion, on July 13, a Pennsylvania Common Pleas court embraced those very same precepts in Brown's Gym Inc. v. Cincinnati Insurance Co., while ruling in favor of a policyholder:

> Prior to the onset of the COVID-19 pandemic, courts throughout the country adopted the contamination theory in recognizing that the existence of odors, bacteria, and other imperceptible agents such as ammonia, salmonella, lead, e-coli bacteria, and carbon-monoxide, may constitute physical damage or loss to a property if its presence renders the structure uninhabitable or unusable, or essentially destroys its functionality.

Under the contamination theory adopted in Brown's Gym and scores of other cases, the physical loss or damage requirement for recovering all-risks insurance is satisfied when a foreign agent, including a coronavirus, renders property uninhabitable or unusable, or destroys its functionality.

The Historical Purpose and Function Of All-Risks Property Insurance

The modern-day all-risks property insurance policy evolved out of the standard fire insurance policy developed initially in New York in 1866.The standard fire policy insured "against all direct loss or damage by fire."The operative phrase made no reference to the term "physical"; property exposed to fire would always undergo a tangible, concrete and observable alteration.

The requirement that loss or damage be physical first appeared in marine cargo and inland marine policies in the 1930s and 1940s. Some have speculated that this requirement was added to clarify the underwriters' intent that there was no coverage for intangible losses.

Whatever the reason, the "physical loss or damage" language was later incorporated into the all-risks property insurance policy when it was introduced in the 1950s.

As summarized by the New Jersey Superior Court in its 1986 opinion in Ariston Airline & Catering Supply Co. v. Forbes, all-risks insurance is special and designed to provide exceptionally broad coverage:

> [A] policy of insurance insuring against "all risks" is to be considered as creating a special type of insurance extending to risks not usually contemplated, and recovery will usually be allowed, at least for all losses of a fortuitous nature, in the absence of fraud or other intentional misconduct of the insured, unless the policy contains a specific provision expressly excluding loss from coverage.

Thus, a policyholder is entitled to recover on a policy of all-risks insurance upon establishing a fortuitous loss, unless a specific exclusion applies. As the Seventh Series of the American Law Reports explained: "Under an all-risks policy, while the insured bears the burden of showing that it suffered a loss and that the loss is fortuitous, the insured need not demonstrate the precise cause of damage for the purpose of proving fortuity."

Conditioning coverage under an all-risks policy on the policyholder also establishing that covered property was altered or destroyed, as some courts have held in response to COVID-19 claims, is contrary to the purpose of all-risks insurance — to provide coverage for fortuitous losses unless a specific exclusion applies — and to the ordinary meaning of the operative policy language.

The Ordinary Meaning of the Operative Policy Language

Interpreting the phrase "direct physical loss of or damage to" in a manner that requires policyholders to plead and prove the actual structural alteration of property is not supported by the ordinary meaning of the operative policy language.

The term "physical" is defined by the Oxford English Dictionary as "[r]elating to things perceived through the senses as opposed to the mind; tangible or concrete."

Thus, as stated by the Superior Court of New Jersey, Appellate Division in its 2004 decision, Customized Distribution Services v. Zurich Insurance Co., the term "'physical' can mean more than material alteration or damage."

Indeed, according to the Tort, Trial and Insurance Practice Law Journal, "an insured can suffer a physical loss of property through theft, without any actual physical damage to the property."

"Loss," in turn, is defined as "[t]he fact or process of losing something or someone" or "[t]he state or feeling of grief when deprived of someone or something of value."And, "damage" is defined as "[p]hysical harm caused to something in such a way as to impair its value, usefulness, or normal function."

When its constituent terms are so defined, the phrase "physical loss of or damage to" means the tangible or concrete deprivation of something of value or when the value, usefulness or normal function of something is impaired. The value, usefulness and normal function of property is tangibly impaired whenever an insured is deprived of its use, irrespective of whether the property has been structurally altered or destroyed.

The Pre-Pandemic Case Law

Courts throughout the country have long held that the alteration or destruction of property is not a prerequisite to finding direct physical loss or damage. As succinctly stated by the Minnesota Court of Appeals in its 2001 opinion in General Mills Inc. v. Gold Medal Insurance Co.:

> We have previously held that direct physical loss can exist without actual destruction of property or structural damage to property; it is sufficient to show that insured property is injured in some way. In Sentinel, we noted that the function of a residential apartment building, to provide safe housing, was seriously impaired or destroyed by the presence of asbestos fibers, although the building itself did not suffer a "tangible injury."

Shortly thereafter, in 2002, the U.S. Court of Appeals for the Third Circuit in Port Authority of New York and New Jersey v. Affiliated FM Insurance Co. also addressed this issue in the context of a loss caused by asbestos.

The Port Authority court held under New York and New Jersey law that "[w]hen the presence of large quantities of asbestos in the air of a building is such as to make the structure uninhabitable and unusable, then there has been a distinct loss to its owner." Three years later, the Third Circuit followed the Port Authority holding in Motorists Mutual Insurance Co. v. Hardinger, a case governed by Pennsylvania law:

> We predict that the Pennsylvania Supreme Court would adopt a similar principle as we did in Port Authority. Applying Port Authority's standard here, we believe there is a genuine issue of fact whether the functionality of the Hardinger's property was nearly eliminated or destroyed, or whether their property was made useless or uninhabitable.

Most recently, the Brown's Gym court followed Port Authority, Hardinger and other pre-pandemic holdings in a case involving insurance for COVID-19 business interruption losses:

> Under the "reasonable and realistic standard for identifying physical loss or damage" established in Port Authority and Hardinger for cases "where sources unnoticeable to the naked eye" substantially reduce the use of property, an insured may satisfy the "direct physical loss or damage" prerequisite for coverage if the invisible agent renders the property "useless or uninhabitable," or the property's functionality is "nearly eliminated or destroyed" by that source. In pre-COVID-19 case law, including the Western Fire Insurance decision cited by Port Authority and Hardinger, the requisite "physical loss or damage" was established when vapors, odors, fumes, and other contaminants from ammonia, carbon-monoxide, arsenic, salmonella, lead, and other nonvisual sources made property uninhabitable or unusable, or nearly destroyed or eliminated its functionality.

Under the contamination theory adopted in Brown's Gym and other cases, both pre- and post-pandemic, the physical loss or damage requirement for recovering all-risks insurance is satisfied when a foreign agent, such as coronavirus, renders covered property uninhabitable or unusable, or destroys its functionality.

To be sure, there is case law going the other way.

For example, the U.S. Court of Appeals for the Eighth Circuit in the recently decided Oral Surgeons case, relied on two of its pre-pandemic decisions interpreting Minnesota law: Source Food Technology Inc. v. U.S. Fidelity and Guaranty Co. decided in 2006 and Pentair Inc.v. American Guarantee and Liability Insurance Co. in 2005.

Neither the Source Food nor Pentair decisions, however, may be as supportive of the insurers' current position on insurance for COVID-19 claims as they might appear to be on the surface. Specifically, the courts in both Source Food and Pentair cited the contamination theory with approval.

In distinguishing the prior Minnesota state court holdings in General Mills and Sentinel — where physical contamination, but no structural alteration, of property was alleged and the court found that there was coverage — the Eighth Circuit reasoned that no physical contamination was alleged in either Source Food or Pentair and, for that reason the denials of coverage were upheld in those cases.

As reflected in Source Food and Pentair, and the cases employing the contamination theory such as Brown's Gym, the physical loss or damage requirement may be satisfied when physical contamination causes the loss of use of property that is not otherwise altered or destroyed.

In all, the conclusion that a policyholder cannot recover business interruption insurance for COVID-19 losses unless it first satisfies the burden of establishing that covered property has been structurally altered, contradicts the purpose of all-risks insurance, the ordinary meaning of the operative policy language and pre-pandemic case law.

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