

“Direct Physical Loss or Damage”: The Gatekeeper to Property Insurance Coverage and COVID-19

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Commentary on insurance coverage for businesses in the wake of coronavirus (COVID-19) has largely, and unsurprisingly, focused on business interruption losses, civil authority provisions, and virus exclusions. However, to get there, policyholders must *first* get past the gatekeeper to coverage: the “direct physical loss or damage” requirement. The key to coverage for COVID-19-related property claims will be whether the presence or threat of the virus on insured property satisfies this requirement.

While the science, economic impact, and most other aspects of COVID-19 are truly “novel,” insurers and policyholders have been arguing, and courts have been interpreting, the meaning of “direct physical loss or damage” for decades. In the inevitable COVID-19 coverage litigation to come,[1] we expect courts will look to cases analyzing non-structural “invisible” damage (e.g., from toxic gases, bacteria, and odors) to decide whether the presence or threat of the virus at insured property constitutes “direct physical loss or damage.”

What follows is a brief survey of these cases and how they might be applied to claims of “direct physical loss or damage” to property due to COVID-19. We also address whether government-ordered closures and declarations regarding damage caused by COVID-19 will affect the “direct physical loss or damage” analysis.

Non-Structural or Invisible “Direct Physical Loss or Damage”

Most all-risk commercial property policies do not define “direct physical loss or damage.” Courts cite the “widely accepted definition” of physical damage to property as a “distinct, demonstrable, and physical alteration” of its structure, e.g., visible damage resulting from fire or water.[2] However, “direct physical loss or damage” is no longer so limited in many jurisdictions. The Third Circuit, in the oft-cited case *Port Authority v. Affiliated FM Ins. Co.*,[3] held that “sources unnoticeable to the naked eye,” such as asbestos in the air, can be direct physical loss if it makes the building “uninhabitable and unusable.” However, “*mere presence* of asbestos or *the threat of its future release*” was not enough.[4]

In *Wakefern Food Corp. v. Liberty Mut. Fire Ins. Co.*,[5] the New Jersey appellate court held that, even where an electrical grid was returned to service after a blackout, the “physical damage” requirement was met because the grid was temporarily inoperable. The court reasoned that the electrical grid “was ‘physically damaged’ because due to a physical incident or series of incidents, the grid and its component generators and transmission lines were *physically incapable of performing their essential function* of providing electricity.”[6]

Applying *Port Authority* and *Wakefern*, a New Jersey federal court in *Gregory Packaging, Inc. v. Travelers Prop. Cas. Co. of Am*[7] found a release of ammonia in an insured facility to be “direct physical loss or damage” despite no “structural alteration” to the facility itself. Rather, “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.”[8] Similarly, in *Motorists Mut. Ins. Co. v. Hardinger*,[9] the Third Circuit held E.coli contamination of a home’s water supply could be “direct physical loss” *if it rendered the home uninhabitable*.

Other sources of non-structural and non-visible damage held to be “direct physical loss or damage” include:

- Gasoline vapors – *Western Fire Ins. Co. v. First Presbyterian Church*, 165 Colo. 34, 437 P.2d 52 (1968) (gasoline vapors penetrated the foundation of the insured church and accumulated, rendering building uninhabitable)
- Carbon monoxide – *Matzner v. Seaco Ins. Co.*, 1998 Mass. Super. LEXIS 407 (Mass. Super. 1998) (carbon monoxide at levels sufficient to render building uninhabitable)
- Odor from methamphetamine lab – *Farmers Ins. Co. of Oregon v. Trutanich*, 858 P.2d 1332 (Or. Ct. App. 1993) (building rendered uninhabitable)
- Sulfuric gas released by drywall – *TRAVCO Ins. Co. v. Ward*, 715 F. Supp.2d 699 (E.D. Va. 2010) (home rendered uninhabitable by the release)

Limitations on Non-Structural or Invisible “Direct Physical Loss or Damage”

Some courts continue to require something more akin to a visible, physical alteration, *i.e.*, that the “contaminant actually alters the structural integrity of the property.” [10] In *Universal Image Prods. v. Chubb Corp.*, [11] mold and bacterial contamination were confirmed in the insured building’s ventilation system. The insured’s expert recommended occupants wear respirators, order immediate shutdown and remediation of the ventilation system, and that an employee with bacterial pneumonia avoid the most affected floor. [12] Nonetheless, the court held that the insured did not show it suffered “structural or any other tangible damage” and that these “intangible harms” were not so pervasive as to render the premises uninhabitable. Accordingly, there was no “direct physical loss” under the policy. [13]

Other courts have cautioned against interpreting “direct physical loss or damage” too broadly in cases of no visible alteration to property. The Eight Circuit in *Pentair v. American Guarantee and Liab. Ins.*, [14] emphasized that **loss of function alone** was not “direct physical loss or damage” and that the requirement could not be interpreted to be met “**whenever** property cannot be used for its intended purpose.” [15] Rather, the loss of function must result from, and the insured must establish, a “physical loss.” [16] The court acknowledged “physical contamination,” *e.g.*, release of asbestos fibers, could satisfy the physical loss requirement, but this must be established in the first instance to find coverage for any resulting loss of function to property. [17]

Similarly, in *Newman Myers Kreines Gross, P.C. v. Great Northern Ins. Co.*, [18] the Southern District of New York conceded that “even invisible fumes can represent a form of physical damage.” However, for a insured’s closure or loss of use of its property to be covered, it must still result from some “**actual, demonstrable harm of some form to the premises itself**, rather than forced closure of the premises for reasons exogenous to the premises themselves, or the adverse business consequences that flow from such closure.” [19] Thus, the insured firm’s preemptive closure and inability to access its office during Hurricane Sandy, without any “demonstrable harm” to the building itself, was not “direct physical loss or damage.” [20]

Effect of Government Closures and Declarations of Physical Loss or Damage

Of course, many states have ordered the closure of “non- life sustaining” or “non-essential retail” businesses to address the public health emergency caused by COVID-19, including Pennsylvania [21] and New Jersey. [22] Will these government-mandated closure of businesses due to COVID-19 be sufficient to support a finding of “direct physical loss or damage” to property?

The court in *Wakefern* (finding temporary inoperability of an electrical grid to be a direct physical loss) acknowledged it would reach a “different result if, for example, a **governmental agency** had ordered that the power be shut off to conserve electricity.” [23] The court cited *Source Food Tech., Inc. v. U.S. Fid. & Guar. Co.*, [24] in which the insured sought coverage for “loss of function” of its beef product

due to a USDA order prohibiting importation of Canadian products after a cow in Canada tested positive for mad cow disease. The court held the insured did not experience direct physical loss to its property, reasoning that to characterize the inability to sell its beef, without actual contamination, as direct physical loss would “render the word ‘physical’ meaningless.”[25]

Additionally, it appears some cities are anticipating, and perhaps attempting to satisfy, the “direct physical loss or damage” hurdle for policyholders. The Mayor of New Orleans issued an emergency Proclamation that states, in part, COVID-19 has the “propensity to attach to surfaces for prolonged periods of time, thereby spreading from surface to person and causing **property loss and damage** in certain circumstances.”[26] Similarly, Mayor DiBlasio’s Emergency Executive Order No. 100 states the order is given, in part, “because the virus physically is causing **property loss and damage**.”[27]

Importantly, it is **unlikely** that these statements will have an effect on a court’s analysis of whether the “direct physical loss or damage” requirement is satisfied in a particular case. In *Easy Sportswear, Inc. v. Am Econ. Ins. Co.*,[28] an insured requested the court take judicial notice of certain statements within a “Proclamation of Disaster Emergency” issued by the Governor of the Commonwealth of Pennsylvania. Specifically, the insured sought judicial notice of statements that a storm occurred and that the storm “caused extensive damage to homes, roads, and business in Allegheny County.”[29] The court declined to take judicial notice of the purported facts, holding “the Governor’s ‘Proclamation of Disaster Emergency’ is not a source ‘whose accuracy cannot reasonably be questioned’ regarding the existence of a storm **or its damage**.”[30]

Conclusion

So is the presence or threat of COVID-19 “direct physical loss or damage” to property? The answer will still depend on the jurisdiction. However, two common requirements for non-structural or invisible “direct physical loss or damage” emerge from the case law:

1. The contaminant or other “source [of damage] unnoticeable to the naked eye” must be demonstrably present at the property; and
2. Its presence must render the property uninhabitable or unusable.

Thus, the mere **threat** of COVID-19 at the property or the **preemptive closure** of businesses due to the threat of COVID-19 should not be considered “direct physical loss or damage” to property. Additionally, neither **government-ordered closure** of businesses nor a **government’s official statement** regarding COVID-19 damage at properties generally should be sufficient for a court to find “direct physical loss or damage” to a particular property. However, those insureds that can prove the actual presence of the virus on the surfaces of or otherwise in covered property may be able to establish “direct physical loss or damage” to property.

If you have questions or would like further information, please contact Edward M. Koch (koche@whiteandwilliams.com; 215.864.6319).

As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates here

[1] Indeed, the first such suit has already been filed. See our March 17, 2020 Alert, “First Coronavirus Coverage Suit Filed For Business Interruption.”

[2] *Port Authority v. Affiliated FM Ins. Co.*, 311 F.3d 226 (3d Cir. 2002) (quoting 10 Couch on Insurance § 148:46 (3d ed. 1998)); see also *Universal Image Prods. v. Chubb Corp.*, 703 F. Supp. 2d 705, 709 (E.D. Mich. 2010) (“physical” is defined as something which has a “material existence: perceptible especially through the senses and subject to the laws of nature”) (quoting Merriam Webster’s Online

Dictionary).

[3] *Id.* at 235–36.

[4] *Id.* (emphases added).

[5] 968 A.2d 724 (N.J. App. Div. 2009).

[6] *Id.* at 734 (emphasis added).

[7] No. 2:12-cv-04418, 2014 U.S. Dist. LEXIS 165232 (D.N.J. Nov. 25, 2004).

[8] *Id.* at **14–17 (emphasis added).

[9] 131 Fed. Appx. 823, 825–27 (3d Cir. 2005).

[10] *Universal Image Prods. v. Chubb Corp.*, 703 F. Supp. 2d 705, 709 (E.D. Mich. 2010).

[11] *Id.*

[12] *Id.* at 710.

[13] *Id.*

[14] 400 F.3d 613 (8th Cir. 2005).

[15] *Id.* at 616 (second emphasis in original).

[16] *Id.*

[17] *Id.*

[18] 17 F. Supp.3d 323 (S.D.N.Y. 2014).

[19] *Id.* at 330–31 (emphasis added).

[20] *Id.*; see also *Bragg-Taylor v. Neighborhood Spirit Prop. & Cas. Co.*, No. 12-CV-7219, 2013 U.S. Dist. LEXIS 196743, at *2 (E.D. Pa. Oct. 29, 2013) (focusing on whether “damage from unconventional sources,” such as asbestos and E.Coli contamination, was could be measured).

[21] Order the Governor of the Commonwealth of Pennsylvania Regarding the Closure of all Business that are Not Life Sustaining, March 19, 2020.

[22] Executive Order No. 107, March 21, 2020.

[23] 968 A.2d at 734 n.7.

[24] 465 F.3d 834 (8th Cir. 2006).

[25] *Id.* at 838.

[26] Mayoral Proclamation to Promulgate Emergency Orders During the State of Emergency Due to COVID-19, March 16, 2020.

[27] Emergency Executive Order No. 100, March 16, 2020.

[28] No. 05-01183, 2008 U.S. Dist. LEXIS 51402 (W.D. Pa. July 1, 2008).

[29] *Id.* at *1.

[30] *Id.* at **3–4 (citing Fed. R. Evid. 201(d) and *Trans Am. Recovery Services, Inc. v. Puerto Rico Maritime Shipping Auth.*, 850 F. Supp. 103, 104 (D.P.R. 1994)).

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