The Clash for COVID Coverage

Business Interruption Insurers May Have Won More Battles, But New Jersey Policyholders Still Can (and Should) Win the War

by Sherilyn Pastor, Anthony Bartell, and Mario S. Russo

Fundamental principles of insurance policy interpretation require courts to construe insurance policy language as would a layperson, and not as would an insurance expert, attorney or legal scholar. New Jersey courts apply this basic tenet of insurance policy interpretation, giving "words in an insurance contract…the meaning of common parlance," and if the language remains susceptible to different meanings, adopting the one most favorable to the policyholder. Insurers litigating cases involving insurance coverage for COVID-19 business interruption losses cannot dispute legitimately these fundamental principles. They, instead, ask and expect courts to ignore the established rules of insurance contract interpretation on the ground that insurers, at least thus far, have "won" the majority of COVID-19-related insurance cases.

Those tracking COVID-19-related coverage litigation have observed the disturbing trend that courts addressing coverage for business interruption losses largely have foregone the required legal analysis, "in favor of treating the issue as determined by what one might term the 'first wave' of trial court decisions." They observe that "a cascade effect appears to have taken hold, with attendant reflexive resistance to COVID coverage rather than the required, closer and more sophisticated analysis the matter deserves."

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Around the country, some courts have obliged, denying policyholders the business interruption coverage for which they paid substantial premiums based not on a rigorous legal analysis, but on the insurers' flawed "headcount" theory. These courts have accepted the proposition that they should follow their fellow jurists' rulings against policyholders even when the previous rulings involve materially different facts and/or governing law. This approach is troubling, particularly in New Jersey where courts must apply carefully established pro-policyholder precedent to the specific facts under consideration. We demonstrate below that at least in New Jersey, the appropriate legal analysis weighs heavily in favor of policyholders, especially where the dispute turns on the policy's "direct physical loss of or damage to property" language.

Insurance companies primarily have asserted two substantive bases for denying coverage for COVID-19-related business interruption insurance claims: (1) COVID-19 does not result in "direct physical loss of or damage to property," as required by most policies; and/or (2) the involved policy purportedly has some version of a "virus exclusion." Thus far, many New Jersey decisions involving coverage for COVID-19-related business interruption losses have involved only the latter issue. Meaning, New Jersey state courts have not yet opined directly on whether COVID-19 satisfies an insurance policy's "direct physical loss of or damage to property" language.

New Jersey, like most other states, abides by certain well-settled principles governing insurance policy interpretation. Courts must construe liberally insurance policies "to the end that coverage is afforded 'to the full extent that any fair interpretation will allow.'" Courts also must construe policy ambiguities "in favor of the insured and against the insurer." "If the controlling language will support two meanings, one favorable to the insurer, and the other favorable to the insured," then a court must apply "the interpretation sustaining coverage." Courts, in fact, must construe policy language against the insurer drafter "even if a 'close reading' might yield a different outcome, or if a 'painstaking' analysis would have alerted the insured that there would be no coverage." Equally importantly, "in the absence of a specific definition in a policy," or "when the meaning of a phrase in a policy is ambiguous," courts must resolve policy language interpretation disputes "in line with the insured's objectively reasonable expectations." Courts accomplish the goal by, among other things, construing insurance policy language in accordance with its ordinary meaning or, stated differently, in conformance with how an ordinary layperson would understand it. New Jersey courts, finally, refuse to construe insurance policies in a way which renders any language thereof meaningless surplusage.

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disturbing trend that courts addressing coverage for business interruption losses largely have foregone the required legal analysis, "in favor of treating the issue as determined by what one might term the 'first wave' of trial court decisions." They observe that "a cascade effect appears to have taken hold, with attendant reflexive resistance to COVID coverage rather than the required, closer and more sophisticated analysis the matter deserves." At least one court has recognized that this inclination constitutes "an abdication of [courts'] judicial role."

Analysis under controlling law and the involved policy language remains critical. It cannot be replaced by reliance on non-binding decisions, especially those rendered out of state and on facts and policy language materially different than those before the court. Building on the momentum generated by these often easily distinguishable and legally flawed cases, insurers have asserted the term "physical," as used in the phrase "direct physical loss of or damage to property," necessarily means "structural." Insurers also argue—contrary to the prohibition against meaningless policy language—that the words "loss" and "damage" mean the same thing, and that both require "alteration" or "destruction." Such positions run afoul of New Jersey's "ordinary person" policy interpretation rule for several reasons. Even if certain other jurisdictions have interpreted "direct physical loss of or damage to property" consistently with the insurance industry's proffered interpretation, ordinary laypeople generally lack knowledge of, and access to, such court opinions. Ordinary laypeople, therefore, have no idea how courts define specific policy language. Moreover, and perhaps more importantly, to construe insurance policy language as would an ordinary layperson requires courts, by definition, to interpret such language based upon its ordinary meaning, not as courts or the lawyers litigating before them might interpret it or previously have interpreted it.

An average layperson most likely would not expect the term "physical" to mean only "structural," or the words "loss" and "damage" to mean the same thing and both to require the "alteration" or "destruction" of property. An ordinary layperson more likely would assign the term "physical" a more general, dictionary definition encompassing anything "of or relating to material things." An ordinary layperson also likely would believe the words "damage" and "loss" mean different things—especially when separated by the disjunctive "or"—and would give the latter word a broad meaning encompassing a myriad of circumstances, including "deprivation." Courts cannot reject these ordinary layperson understandings of policy language without contravening well-settled rules of insurance policy interpretation. To do so also moots one of the judicial system's primary objectives in the insurance context; *i.e.*, to force insurers to draft policies in a way that allows a layperson to ascertain correctly the contours of its purchased coverage.

The insurance industry's proffered policy language interpretation arguments conflict directly with controlling New Jersey law respecting physical damage. As the court recognized in *Optical Services USA/JCI v. Franklin Mutual Insurance Co.*, the Appellate Division held in *Wakefern Food Corp. v. Liberty Mutual Fire Insurance Co.*, that "[s]ince the term 'physical' can mean more than material alteration or damage, it is incumbent on the insurer to clearly and specifically rule out coverage in the circumstances where it was not to be provided."

Wakefern involved a policyholder cooperative, whose members do business under the "ShopRite" banner. The cooperative purchased insurance coverage for damage caused by an interruption of electrical power. The case involved the 2003 Northeast blackout, a cascading power outage that affected major parts of the northeastern United States, and which resulted in food spoilage at the cooperative's stores and warehouses. The involved policy provided coverage for interruption of power resulting from "physical damage to off-site electrical equipment," a phrase significantly narrower than the "loss or damage" language appearing in most property policies. Liberty Mutual there argued the blackout resulted not from "physical damage to" the off-site power grid, but from safety relays that automatically shut-down and de-energized the transmission lines and succeeded in *preventing* physical damage to the equipment. The trial court agreed with Liberty's no physical damage position, but the Appellate Division reversed, finding the trial court's decision "inconsistent with well-settled principles of insurance

law," and entered summary judgment in Wakefern's favor.

The *Wakefern* decision rests largely on the Appellate Division's finding that the phrase "physical damage" is ambiguous:

We conclude that the undefined term "physical damage" was ambiguous and that the trial court construed the term too narrowly, in a manner favoring the insurer and inconsistent with the reasonable expectations of the insured. In the context of this case, 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.

The court relied on the "well settled" proposition that "those purchasing insurance 'should not be subjected to technical encumbrances or to hidden pitfalls,' and that insurance policies 'should be construed liberally in their favor to the end that coverage is afforded to the full extent that any fair interpretation will allow.'" The court also noted that prior precedent from both New Jersey and other jurisdictions support its conclusion regarding the ambiguity of the term "physical damage." The Appellate Division cited a New Jersey case involving whether the loss of value of a soft drink product in a warehouse constituted a "physical loss." The Appellate Division there explained: "Since 'physical' can mean more than material alteration or damage, it was incumbent on the insurer to clearly and specifically rule out coverage in the circumstances where it was not to be provided, something that did not occur here."

The *Wakefern* court also cited with approval the Colorado Supreme Court's decision in *Western Fire Insurance Co. v. First Presbyterian Church*. The court there held that a church, required by the local fire department to close its doors due to the accumulation of gasoline vapors under and around the premises, had suffered a "physical loss" within the meaning of its insurance policy because that phrase could encompass a "loss of use."

The *Wakefern* court, moreover, discussed *Southeast Mental Health Center, Inc. v. Pacific Insurance Co.*, which concluded "physical damage" could include loss of "functionality," even if the affected machinery remained intact following a power outage. The Appellate Division also cited with approval *American Guarantee & Liability Insurance Co. v. Ingram Micro, Inc.*, which found "'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."

Insurers in pandemic-related coverage cases have tried to twist footnote 7 of the *Wakefern* decision, which states:

We would reach a different result if, for example, a governmental agency had ordered that the power be shut off to conserve electricity. *See Source Food Tech., Inc. v. U.S. Fid. & Guar. Co.,* 465 F.3d 834 (8th Cir.2006) (no coverage for insured's inability to obtain beef product due to government action prohibiting importation of Canadian beef)."

That *dicta*, however, does not support the insurer's position because (among other reasons) the coverage-triggering language in *Wakefern* required "*physical damage to* off-site electrical equipment." This language remains much narrower than that found in most property policies, which provide coverage for "physical *loss of* ***or*** damage to" property. Although a purely unprompted and prophylactic government order to shut down electrical equipment may not constitute "physical ***damage to"*** that equipment, such an order would constitute a "physical ***loss of"*** the equipment. This conclusion flows precisely from footnote 7's citation to *Source Food*.

The Eighth Circuit in *Source Food* noted that a one-word change in policy language would have made all the difference in that case: "Moreover, the policy's use of the word 'to' in the policy language 'direct physical loss to property' is significant. Source Food's argument might be stronger if the policy's language included the word 'of' rather than 'to,' as in 'direct physical loss *of* property' or even 'direct loss *of* property.'"The government-ordered prohibition in *Source Food*, therefore, would have fallen within the policy's coverage had the policy contained the coverage-triggering language contained in most policies, requiring "physical loss of or damage to" covered property.

Notwithstanding the fact that New Jersey substantive insurance law remains strongly on the side of COVID-impacted policyholders, insurers litigating in this state likely will continue asking courts to abdicate their responsibilities to conduct a rigorous legal analysis based upon New Jersey precedent and insurance principles. This is shocking given that insurers, themselves, concede and have represented to courts that loss of use constitutes "physical loss or damage" under New Jersey law and, relatedly, that "physical loss or damage" to property exists when the presence of a physical substance renders property unfit for its intended use, despite causing no structural alteration to property. Despite their prior inconsistent positions, insurers shamelessly will urge the easiest path for courts already burdened by heavy dockets is to follow previous COVID coverage rulings even when inapplicable or simply wrong. New Jersey state courts should reject this approach and, instead, embrace their judicial role. They can and should apply the state's rock-solid precedent, which almost certainly will result in deserved coverage victories for policyholders. ⚖

Endnotes

1. *See, e.g., Hooters of Augusta, Inc. v.*

Am. Glob. Ins. Co., 272 F. Supp. 2d 1365, 1372 (S.D. Ga. 2003) ("The policy should be read as a layman would read it and not as it might be analyzed by an insurance expert or an attorney." (citation omitted)), *aff'd*, 157 F. App'x 201 (11th Cir. 2005); *accord Park Univ. Enterprises, Inc. v. Am. Cas. Co. of Reading, PA.*, 314 F. Supp. 2d 1094, 1107–09 (D. Kan. 2004), *aff'd sub nom. Park Univ. Enterprises, Inc. v. Am. Cas. Co. Of Reading, PA*, 442 F.3d 1239 (10th Cir. 2006).

2. *See Rudolph v. Home Indem. Co.*, 138 N.J. Super. 125, 136 (Law. Div. 1975).
3. *President v. Jenkins*, 180 N.J. 550, 563 (2004) (quoting *Kievit v. Loyal Protective Life Ins. Co.*, 34 N.J. 475, 482 (1961)); *accord Sandler v. N.J. Realty Title Ins. Co.*, 36 N.J. 471, 479 (1962).
4. *Doto v. Russo*, 140 N.J. 544, 556 (1995) (citations omitted).
5. *Mazzilli v. Accident & Cas. Ins. Co. of Winterthur, Switzerland*, 35 N.J. 1, 7 (1961); *accord Voorhees v. Preferred Mut. Ins. Co.*, 128 N.J. 165, 173–74 (1992); *Atl. Emp'rs Ins. Co. v. Chartwell Manor School*, 280 N.J. Super. 457, 465 (App. Div. 1995); *Danek v. Hommer*, 28 N.J. Super. 68, 77 (App. Div. 1953) (citation omitted), *aff'd*, 15 N.J. 573 (1954).
6. *Flomerfelt v. Cardiello*, 202 N.J. 432, 441 (2010) (internal and external citations omitted).
7. *Fairlawn Indus., Ltd. v. Gerling Am. Ins. Co.*, 342 N.J. Super. 113, 118 (App. Div. 2001) (citing *Crest-Foam Corp. v. Aetna Ins. Co.*, 320 N.J. Super. 509, 519 (App. Div. 1999), and *Voorhees*, 128 N.J. at 174); *see also Sparks v. St. Paul Ins. Co.*, 100 N.J. 325, 336 (1985) (noting insurance contracts must be enforced "in accordance with the reasonable expectations of the insured").
8. *See Rudolph*, 138 N.J. Super. at 136.
9. *See Homesite Ins. Co. v. Hindman*, 413 N.J. Super. 41, 47 (App. Div. 2010) (refusing to "read one policy provision in isolation when doing so would render another provision meaningless"); *Zurich Am. Ins. Co. v. Keating Bldg. Corp.*, 513 F. Supp. 2d 55, 64 (D.N.J. 2007) ("[W]hen interpreting an insurance policy, [a] court must endeavor to give effect to all terms in a contract and the construction which gives a reasonable meaning to all its provisions will be preferred to one which leaves a portion of the writing useless or inexplicable.") (internal quotations omitted) (quoting *Linan-Fay Constr. Co. v. Housing Auth.*, 995 F. Supp. 520, 524 (D.N.J. 1998)); *accord J. Josephson, Inc. v. Crum & Forster Ins. Co.*, 293 N.J. Super. 170, 216 (App. Div. 1996).
10. Erik Knutsen & Jeff Stempel, *Knutsen & Stempel on the Federal Court Rush to Judgment,* Univ. Penn. Carey Law School (July 25, 2021), cclt.law.upenn.edu/2021/07/25/knutsen-stempel-on-the-federal-court-rush-to-judgment/.
11. *Id.*
12. *See MacMiles, LLC v. Erie Ins. Exchange*, No. GD-20-7753, 2021 WL 3079941, at *5 n.12 (Pa. Com. Pl. May 25, 2021) (quoting *Fayette Cty. Hous. Auth. v. Hous. & Redevelopment Ins. Exch.*, 771 A.2d 11, 15 (Pa. Super. Ct. 2001), *appeal granted, cause remanded*, 568 Pa. 126 (2002)).
13. *Physical,* Meriam-Webster, merriam-webster.com/dictionary/physical (last visited Aug. 18, 2021).
14. No. BER-L-3681-20, 2020 N.J. Super. Unpub. LEXIS 1782 (N.J. Super. Ct. Law Div. Aug. 13, 2020).
15. 406 N.J. Super. 524 (App. Div.), *certif. denied*, 200 N.J. 209 (2009).
16. *Id.* at 535.
17. *Id.* at 529.
18. *Id.* at 540.
19. *Id.* at 539.
20. *Id.* at 541–42 (citing *Customized Distribution Servs. v. Zurich Ins. Co.*, 373 N.J. Super. 480, 491 (App. Div. 2004), *certif. denied*, 183 N.J. 214 (2005)).
21. *Id.* at 541–42 (citation omitted).
22. 165 Colo. 34, 437 P.2d 52 (1968).
23. *Id.* at 540 (citation omitted).
24. 439 F. Supp. 2d 831 (W.D. Tenn. 2006).
25. *Id.* at 543 (citation omitted).
26. No. CIV. 99-185 TUC ACM, 2000 WL 726789, at *2 (D. Ariz. Apr. 18, 2000).
27. *Id.*
28. *Id.* at 540 n.7.
29. *Source Food Tech., Inc. v. U.S. Fid. & Guar. Co.*, 465 F.3d 834, 838 (8th Cir.2006) (emphasis in original).
30. *See, e.g.*, Plaintiff Factory Mutual Insurance Company's Motion *In Limine* No. 5 Re Physical Loss or Damage at 3, filed Nov. 19, 2019 in *Factory Mut. Ins. Co. v. Fed. Ins. Co.*, No. 1:17-cv-00760-GJF-LF (D.N.M.) (conceding that (1) "case law… broadly interprets the term 'physical loss or damage' in property insurance policies," and (2) "[n]umerous courts," including those applying New Jersey law, "have concluded that loss of functionality or reliability… constitutes physical loss or damage," and citing cases).