



What is 'Physical Loss'? Court Opens the Door for Policy Holders



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In a recent decision by the United States District Court for the Western District of Missouri, Southern Division, the court denied an insurance company defendant's motion to dismiss based on the assertion that COVID-19 does not result in "direct physical loss or direct physical damage"^[1] to real property because the same requires an "actual, tangible, permanent, physical alteration of property." Instead, the court agreed with the plaintiff's argument that the term "physical loss" may include the loss of use of such property and the suspension of operations thereon.

In the case, *Studio 417, Inc., et al.* (collectively, "Plaintiff") v. *The Cincinnati Insurance Company* ("Defendant"), Plaintiff, several hair salons and restaurants located in the Springfield and Kansas City metropolitan areas of Missouri brought suit against the Defendant because the Defendant denied coverage under each of the Plaintiff's "all-risk" property insurance policies which included building and personal property coverage and business income coverage (collectively, the "Policies"). The Policies provided that the Defendant would pay for any "accidental [direct] physical loss" or "accidental [direct] physical damage" to the real property (subject to exclusions from coverage set forth in the Policies which Policies in question did not include a specific exclusion to coverage from an illness caused by a virus). The terms "physical loss" and "physical damage" were not defined in the Policies (which is standard).

Plaintiff argued that, during the COVID-19 pandemic, employees and patrons of their respective businesses may have been infected with COVID-19, that such persons could have infected the insured real properties with the virus making the same "unsafe and unusable" and therefore the same resulted in Plaintiff closing or significantly curtailing business at the insured properties. In addition, Plaintiff argued that Plaintiff was required to either close (e.g., the hair salons) or significantly curtail operations at the insured properties (e.g., the restaurants were limited to a take-out business) because of the local government shutdown orders (collectively, the "Shutdown Orders"). Plaintiff alleged that the physical presence of COVID-19 and the Shutdown Orders caused a "physical loss" or "physical damage" to the subject properties because Plaintiff was forced to suspend or reduce business at the insured real properties.

The Defendant responded to Plaintiff's complaint with a motion to dismiss, arguing, in part, that the Policies provide coverage only for the loss of income which is the result of physical damage to the property – tangible, physical loss – not “economic loss caused by governmental or other efforts to protect the public from disease” and, therefore, the loss suffered by Plaintiff based on COVID-19 and the Shutdown Orders were not covered risks under the Policy. Further, Defendant argued that the broad interpretation of the words “physical loss” proposed by Plaintiff (*i.e.*, one that includes a loss of use of the property) would result in “physical loss” being suffered “whenever a business suffers economic harm.”

The Court determined that since the terms “physical loss” and “physical damage” were not defined in the Policy, the Court could rely on the plain and ordinary meaning of such words and that the terms “loss” and “damage” are distinct terms with distinct meanings. Further, the Court held that the words “physical loss” are not limited to physical destruction or alteration and that “physical loss” may result when a property is “uninhabitable or unusable for its intended purpose.” Therefore, Plaintiff adequately alleged a direct physical loss since COVID-19 is a “physical substance” that is “active on inert physical surfaces” and “emitted into the air” and that the foregoing made the insured properties “unsafe and unusable,” resulting in a direct “physical loss” of the insured real properties. The Court also rejected Defendant's argument that if the Plaintiff's interpretation of “physical loss” were accepted, the same would result in “physical loss” being found “whenever a business suffers economic harm” because in this particular case the “physical loss” was specifically caused by COVID-19 and the Shutdown Orders.

Since the start of the COVID-19 pandemic, insurance companies have been receiving and denying claims from commercial policy holders who seek to recover business interruption insurance based on losses due to COVID-19 and various local government shutdowns. The insurance industry has argued that COVID-19 and the resulting government shutdowns are not a covered policy risk because the same does not cause “direct physical loss or damage” to the insured real property and, to date, insurance companies have been largely successful in court. The *Studio 417* case has opened the door for a counter-argument based on the plain meaning of the contract – that “loss” and “damage” are two distinct concepts and that the insured may suffer a “loss” which is not a “tangible physical loss” of real property, and that the same may be a covered risk under the policy. The court in *Studio 417* has not yet ruled on the merits of the case.

In addition, since the Policy in the *Studio 417* case did not have a specific virus exclusion to coverage which is an exclusion in “all risk” policies in many states including New York, Plaintiff was able to avoid an additional and perhaps unsurmountable hurdle for policy holders seeking to recover proceeds of business interruption insurance based on COVID-19 and related government shutdown orders.

Given the ongoing nature of the COVID-19 pandemic and the continued local government shutdowns to avoid the spread of COVID-19, we expect to see many more insurance claims by businesses who have lost all or a substantial portion of their revenue due to the pandemic, denials of coverage by insurance companies based on the “physical loss or damage” policy language, and judicial review of the foregoing.

[1] All quotations in this article are language from the court decision.