HUNTON& WILLIAMS

Byline

December 19, 2014

NJ Insureds Benefit From Broad Reading Of Physical Loss

by Robert Morrow, Michael Levine and Matthew McLellan

Published in Law360

Commercial property insurance coverage protects policyholders against the consequences of "physical" loss or damage to their insured property. Insurers have long argued that such coverage is narrow, applying only where the insured property sustains some physical damage resulting in a structural alteration of the property requiring repair or replacement. Consequently, insurers have urged that coverage is unavailable, even when the policyholder's property is unusable or uninhabitable as a result of the loss event, unless the structure of the property was altered. A New Jersey federal court recently rejected the insurance industry's narrow application, however, holding in Gregory Packaging Inc. v. Travelers Property Casualty Co. of America, No. 12-4418 (D.N.J. Nov. 25, 2014), that certain types of loss are still within the scope of coverage afforded under commercial property policies, even though there may be no physical loss of or damage to the insured property that requires some form of repair or replacement. This article discusses the recent decision in Gregory Packaging and the principles underlying that decision. The article also discusses the reasons presented by insurers in support of a more restrictive policy application.

In Gregory Packaging, a New Jersey federal court held that a manufacturing company was entitled to coverage for "direct physical loss of or damage" to its property when an ammonia release at one of the company's facilities interrupted business operations. The leak of gas seriously contaminated the facility, but did not alter the plant's structure in a manner that required repair or replacement. Gregory Packaging makes and sells juice cups. As part of an expansion of its operations, the company acquired facilities in Newnan, Georgia. Renovations of the new facilities included installation of a refrigeration system. During installation of the refrigeration system, ammonia was accidentally released throughout the facility. The facility was evacuated following the release and various governmental agencies arrived on the scene. Gregory Packaging hired a contractor to remediate the ammonia in the building. The remediation process lasted five days, during which time the facility was uninhabitable by Gregory Packaging employees or its renovation contractors. The evacuation resulted in a five-day delay in opening the facility for business operations.

The Gregory Packaging facility was covered under a commercial property policy issued to Gregory Packaging by the Travelers Property Casualty Company of America. The policy afforded coverage for, among other things, "direct physical loss of or damage to Covered Property caused by or resulting from a covered Cause of Loss." Gregory Packaging tendered a claim to Travelers for loss sustained by the five-day interruption of its renovations, which were all but complete, and the corresponding five-day interruption of its business operations. Travelers rejected Gregory Packaging's claim on the ground that there had been no "physical loss of or damage to" covered property. Travelers explained that " 'physical loss of or damage' necessarily involves a 'physical change or alteration to insured property requiring its repair or replacement.' " Because the ammonia release did not result in a physical change or alteration to the facility, Travelers reasoned that the claim did not fall within the scope of coverage afforded under its policy. Gregory Packaging sued Travelers for breach of contract and moved for partial summary judgment on the issue of whether it experienced "direct physical loss of or damage to its property" as a result of the ammonia release.

Gregory Packaging argued that New Jersey courts have expressly rejected the requirement that "physical" in the context of property insurance coverage means material alteration or damage. Rather, in the case of Wakefern Food Corp. v. Liberty Mut. Fire. Ins. Co., 968 A.2d 724, 733 (N.J. App. Div.), the court held that a business had incurred "physical damage" when a nearby power grid was unable to provide electricity to the business. Because the transmission lines on the grid were incapable of performing their "essential function," the court found that physical damage had occurred for purposes of triggering coverage. Gregory Packaging also compared the ammonia release in its building to Western Fire Ins. Co. v. First Presbyterian Church, 437 P.2d 52 (Colo. 1982), a Colorado case referenced in the Wakefern decision. In Western Fire, the court held that a church suffered a "direct physical loss" when the presence of gasoline vapors rendered the building unusable.

Travelers argued, in contrast, that Wakefern is inapplicable because there it was undisputed that equipment along the power grid had actually been physically damaged and needed to be replaced. According to Travelers, the court's broader discussion of how interruption of the power grid's operation could potentially constitute physical damage was mere dictum. Instead, Travelers compared the ammonia release to a Third Circuit case, Port Authority of New York and New Jersey v. Affiliated FM Ins. Co., 311 F.3d 226 (3d Cir. 2002), which held that the presence of asbestos in various buildings was not in such large quantities so as to have caused "physical loss or damage." Travelers also analogized the ammonia release to a Georgia appellate court's decision in AFLAC Inc. v. Chubb & Sons, Inc., 581 S.E.2d 317, 319-20 (Ga. Ct. App. 2003), where the court found that a computer system that was incapable of processing four digit dates — the so-called "Y2K" problem — did not suffer physical loss or damage. According to the court there, this was because the computer had not incurred a physical alteration or change mandating repair.

The court rejected Travelers' arguments and held that under both New Jersey and Georgia law, the phrase "physical loss of or damage to" does not require actual structural alteration. Rather, the court found that, as in Wakefern, the loss of function of the facility as a whole is sufficient to amount to "physical loss of or damage to" property. The court also explained that Travelers' reading of Port Authority contradicted the plain text of the decision. While the court in that case did not find coverage, it found that the building owner would suffer "a distinct loss" if the

presence of asbestos in the air is sufficient to make the structure uninhabitable and unusable. The court found this to be precisely the situation that Gregory Packaging faced, where the presence of the ammonia rendered its facility uninhabitable for five days. The court also held that, unlike in AFLAC, where there had been no fortuitous event preceding the alleged damage (the computer problem was due to an existing problem in the way the system had been designed), here there had been such an event that altered the conditions in Gregory Packaging's facility.[1]

As a result of its interpretation of Georgia and New Jersey law, the court held that the ammonia discharge had inflicted "direct physical loss of or damage to" Gregory Packaging's facility because the heightened ammonia levels had physically changed the facility's condition to an unsatisfactory state mandating repair. The event at the Gregory Packaging facility — release of ammonia — was a physical event as opposed to a nonphysical event such as a management decision or governmental order. The damage to the plant — contamination by ammonia gas — was physical. The conditions required for coverage as set forth in the insurance contract were met. The court declined to impose the additional requirement of "structural alteration" urged by the insurer.

While Gregory Packaging represents an application of property insurance coverage favorable to insureds, its reasoning would not extend coverage to all instances of economic loss. For instance, in MRI Healthcare Center of Glendale Inc. v. State Farm General Ins. Co., 115 Cal. Rptr. 3d 27 (Cal. Ct. App. 2010), a California court held that there was no "accidental direct physical loss" where an MRI machine malfunctioned and required repair after it was shut down to accommodate roof repairs resulting from a heavy storm. The court explained that there is no "physical" loss where the insured "merely suffers a detrimental economic impact." Id. at 779.

Additionally, what constitutes "uninhabitable" for purposes of determining whether direct physical loss has occurred to a property may vary from court to court. In Universal Image Productions Inc. v. Chubb Corp., 703 F. Supp. 2d 705 (E.D. Much. 2010), for instance, a court held that there was no "direct physical loss" to a building even where it experienced a pervasive odor resulting from mold bacteria contamination. The insured was required to seal the air ducts in the facility to cleanse them, which caused excessive heat and interrupted business activities. However, the court in that case held that the building was not rendered uninhabitable even where the occupants of the first floor were instructed to wear respirators and the entire ventilation system had to be remediated. While a strong argument could be made that physical damage had occurred in this instance, the Universal Image case may suggest that a mere disruption in an insured's business activities is not sufficient to trigger coverage without evidence that the insured's property was rendered truly uninhabitable.

Gregory Packaging represents a victory for policyholders in pushing back against insurer efforts to narrow the scope of property insurance coverage. The decision interprets the scope of commercial property coverage in a manner consistent with policyholders' reasonable expectations of coverage under policy language designed and understood to protect against the inability to use covered business property. The decision also recognizes that fortuity continues to play a prominent role when determining the availability of coverage under commercial property policies. Policyholders, therefore, should consider seeking coverage under their commercial property policies for losses of income or increased operating expenses even in the

absence of any structural alteration or damage to insured property. However, not every instance of business interruption is likely to be covered. Even where an insured's property is affected by the presence of harmful substances requiring remediation, should the facility not be rendered fully uninhabitable, some courts may be inclined to reject a claim that coverage is triggered.

Robert Morrow is a partner in Hunton & Williams' New York office.

Michael Levine is counsel in Hunton & Williams' McLean, Virginia, and New York offices.

Matthew McLellan is an associate in Hunton & Williams' McLean, Virginia, office.

[1] The court also considered other decisions where courts determined whether the presence of dangerous gases or bacteria rendered properties uninhabitable. See Motorist Mut. Ins. Co. v. Hardinger, 131 Fed. Appx. 823, 825 (3d Cir. 2005) (contamination of a home's water supply constituted a "direct physical loss" when it rendered the home uninhabitable); Essex v. BloomSouth Flooring Corp., 562 F.3d 399, 406 (1st Cir. 2009) (unpleasant odor rendering property unusable constituted physical injury to the property); TRAVCO Ins. Co. v. Ward, 715 F. Supp. 2d 699, 709 (E.D. Va. 2010), aff'd, 504 F. App'x. 251 (4th Cir. 2013) (finding "direct physical loss" where home uninhabitable due to toxic gases released by defective drywall).