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## When The Lights Go Down In The City

COMMERCIAL PROPERTY INSURANCE MAY COVER POWER OUTAGE-RELATED DAMAGES

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In the past three months Connecticut has suffered two widespread power outages due to inclement weather. The first came in late-August with Tropical Storm Irene. Approximately 700,000 residents were left in the dark, some for almost a week. More recently, the state was hit by a rare October snowstorm, and power was knocked out for 830,000 residents and businesses, again lasting for almost a week. Many businesses – ranging from small, family owned bakeries to multi-location car dealerships – lost inventory or were forced to shut down while the power was out and suffered staggering financial losses as a result. Naturally, these businesses turned to their first-party property insurers to absorb these losses, but many have been greeted with coverage denials. Insurers contend that, because the origination of the power loss occurred away from the policyholder's premises, there was no "direct physical loss" sufficient to satisfy the insuring agreement. The analysis is not always so straightforward, however, and in many instances coverage may exist for these claims.

The main purpose of commercial property insurance is to protect businesses from damage to buildings and their contents which occurs because of a covered cause of loss. In general, there are two different types



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of commercial property insurance available to businesses: (1) "all risk," which provides coverage for "all risk of direct physical loss or damage to Covered Property" (with the additional caveat, on occasion, that the direct physical loss be at an "Insured Location"); and (2) "named perils," which limits coverage to "direct physical loss of or damage to Covered Property resulting from" specifically defined "Covered Causes of Loss." This article focuses on the scope and application of "all risk" policies, which are broader than named perils policies; however, policyholders and their counsel should consider the possibility that similar concepts and arguments may also apply in the "named perils" setting.

### "Physical Damage" Can Include Loss of Functionality

Under Connecticut law, "all risk" policies are broadly construed 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 . . . unless the policy contains a specific provision expressly excluding the loss from coverage." *Yale Univ. v. Cigna Ins.*

*Co.*, 224 F. Supp. 2d 402, 411 (D. Conn. 2002). "The language of all-risk policies is not to be given a restrictive meaning," *Costabile v. Metropolitan Prop. & Cas. Ins. Co.*, 193 F. Supp. 2d 465, 477 (D. Conn. 2002), and, as such, the all risk policyholder is not required to prove precisely what caused the loss but only that a fortuitous loss took place. *Std. Structural Steel Co. v. Bethlehem Steel Corp.*, 597 F.Supp. 164, 192 (D. Conn. 1984).

Other states that recognize a similarly broad definition of "all risk" coverage have further explained that such policies do not require any actual physical damage or change in material composition in order to trigger coverage. See, e.g., *Customized Distribution Services v. Zurich Ins. Co.*, 862 A.2d 560, 565 (N.J. Super. Ct. App. Div. 2004) ("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."). Moreover, the term "physical damage" can include a "loss of access, loss of use and loss of functionality" even if the affected property otherwise remains intact. *Am. Guar. & Liab. Ins. Co. v. Ingram Micro, Inc.*, 2000 WL 726789 (D. Ariz. Apr. 18, 2000). In the context of a power loss, "physical damage" can occur when electrical components are "physically incapable of performing their essential function of providing electricity" due to a physical incident. *Wakefern Food Corp. v. Liberty Mut. Fire Ins. Co.*, 968 A.2d 724, 734 (N.J. Super. Ct. App. Div. 2009); see also *Dundee Mutual Insurance Co. v. Marifjeren*, 587 N.W.2d 191 (N.D. 1998) (potato storage

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facilities were “damaged” by power outage “in the sense they no longer performed the function for which they were designed. In other words, the interruption of electrical power ‘damaged’ the storage facilities by impairing their value or usefulness.”)

### **Damaged Property vs. Business Interruption**

The damages resulting from the recent power outages generally fall into two categories: (1) damage to, or loss of, inventory or product; or (2) interruption of business. For example, one bakery in West Hartford suffered a loss of \$10,000 of perishable baked goods due to lack of refrigeration. (Harriet Jones, *Business Turned Away by Insurance After Power Loss*, WNPR (Nov. 10, 2011)). Other businesses, like automobile dealerships and retail stores, suffered losses from their inability to open their doors to customers. In the first situation, physical injury is clear: the loss of the baked goods, which is itself physical property, is a “direct physical loss.” Under the broad “all risk” insuring agreement, the cause is irrelevant (as is the issue of whether loss of power from an offsite location is a “direct physical loss”). As long as the policyholder can establish that its property (here, the baked goods) was damaged, coverage should apply.

In the second situation (i.e., the retail store that was unable to conduct normal business but suffered no readily identifiable damage to inventory or property) the loss implicates business interruption insurance coverage, a separate line of coverage purchased in tandem with the property insurance. “The essential purpose of business interruption insurance is to place the insured in the position it would have occupied if the interruption had

not occurred.” 46 C.J.S. Insurance § 1531 (2011). Thus, standard business interruption coverage forms provide insurance for loss of income or increased expenses resulting from physical damage: “We will pay for the actual loss of Business Income you sustain due to the necessary suspension of your operations . . . caused by direct physical loss of or damage to property.” For businesses whose losses consist mainly of lost sales due to the power outage, the required “direct physical loss” initially seems unclear. However, the breadth of the “all risk” language (which has been construed as not requiring actual, physical damage) and relevant case-law (interpreting “physical damage” to include loss of functionality) suggest that the loss of power itself at the insured’s business may be a “direct physical loss.”

Consider, for example, the court’s analysis in *Wakefern Food Corp. v. Liberty Mutual Fire Insurance Co.*, where it ultimately concluded that there was “physical damage” to an electrical grid because it was physically incapable of providing electricity:

[I]n concluding that the term “physical damage” is ambiguous, we consider the context, including the identity of the parties. These were not two electric utilities contracting about the technical aspects of the grid. Rather, the parties are an insurance company, in the business of covering risks, and a group of supermarkets that paid for what they believed was protection against a very serious risk—the loss of electric power to refrigerate their food. The average policyholder in plaintiffs’ position would not be expected to understand the arcane functioning of the power grid, or the narrowly-parsed definition of “physical

damage” which the insurer urges us to adopt. In this context, we conclude that if Liberty intended that its policy would provide no coverage for an electrical blackout, it was obligated to define its policy exclusion more clearly.

968 A.2d 724, 734-35 (N.J. Super. Ct. App. Div. 2009) (examining damage to an off-site power grid as directed by a coverage endorsement, but declining to address whether there was physical damage at the insured’s own location). Moreover, if the insuring agreement requires only “direct physical loss to Covered Property” and not “direct physical loss to Covered Property at an Insured Location,” the policyholder may reasonably argue that any physical loss that results in damage to the policyholder’s business – even physical loss at the power grid or to a downed power line away from the business site – satisfies the insuring agreement.

In the wake of the Connecticut storms, various parties have asserted that commercial property insurance is not intended to cover loss due to failure of power or other utility services and that denials based on this assumption are standard. At the end of the day, however, the terms of the insurance policy alone control the available coverage; terms that, if reasonably susceptible of two meanings, will be construed against the party that drafted them – the insurance company. Thus, it is imperative that policyholders faced with denials for these claims carefully scrutinize 1) the precise terms of their policies and 2) the nature of the losses resulting from these power outages in order to independently assess, and take appropriate steps to preserve, their rights.

