



Win for Policyholders in New Jersey on COVID-19 Business Interruption Losses: “Physical Loss” May Include Loss of Functionality

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The New Jersey Superior Court in *Optical Services USA/JC1 v. Franklin Mutual Ins. Co.* (N.J. Super. Ct. Bergen Cty. Aug. 13, 2020) provided a boon for insureds whose businesses were shuttered by the issuance of COVID-19-related executive stay-at-home orders and who seek to recover lost business income as a result. Interpreting the relevant property policies’ language requiring the occurrence of a “direct physical loss,” the court relied on New Jersey precedent in denying the insurer’s motion to dismiss and held that physical loss may occur where a policyholder loses “functionality” of its property.¹

The plaintiffs in *Optical Services* sought coverage for lost business income after New Jersey’s March 21, 2020, stay-at-home order compelled the closure of their retail operations, which the insureds alleged were non-essential businesses under the order and therefore deemed unsafe. Notably, the plaintiffs alleged in their complaint that “[t]here is no known instance of COVID-19 transmission or contamination within the premises of plaintiffs’ businesses.”² Relying on the New Jersey Appellate Court’s opinion in *Wakefern Food Corp. v. Liberty Mutual Fire Insurance Co.*, the plaintiffs noted that “physical” does not necessarily require “material alteration” to particular property, and therefore argued they were entitled to business interruption coverage under the terms of their policies because they were not able to operate their businesses.³ *Wakefern* involved a claim for business interruption coverage by a grocery store that had lost power after an electrical grid’s protective system shut down the grid to prevent physical damage to equipment included under the relevant policy. After stating that “based on the highly technical analysis in the Final Report, one could certainly argue that the system was not physically damaged,” the court held that “from the perspective of the millions of customers deprived of electric power for several days, the system certainly suffered physical damage, because it was incapable of providing electricity” and therefore found the language to be ambiguous, resulting in coverage.⁴

While the policies at issue in *Optical Services* contained exclusions for loss caused by contamination by any virus, the defendant-insurer admitted, given the complaint’s allegations, that the exclusions were inapplicable.⁵ The insurer argued that, pursuant to New Jersey law, “[i]f the complaint had alleged that there was contamination on the premises, then there probably would be direct physical loss, but there would also be exclusion of coverage under that virus exclusion.”⁶ According to the insurer, which relied on case law from a variety of other jurisdictions, the lack of “contamination on the premises” meant that there was no “direct physical loss” and therefore no coverage for the insureds.⁷ The *Optical Services* court found that *Wakefern* was precedential and rejected the insurer’s contentions that decisions from other jurisdictions should be deemed persuasive and that “physical loss” necessarily required the presence of coronavirus on the insureds’ premises.⁸

The *Optical Services* court's decision is important because it addresses a common set of facts faced by countless insureds. Insureds now have additional support for the notion that "physical loss" does not require structural damage, material impairment, or the like. Rather, "physical loss" can include, at least in certain jurisdictions, a business's loss of functionality stemming from a dangerous condition the exact locations of which are unknown but that lead a civil authority to issue orders compelling the closure of businesses to protect against that condition.

1. Transcript of Oral Argument at 29:15-20, *Optical Services USA/JC1 v. Franklin Mutual Ins. Co.* (N.J. Super. Ct. Bergen Cty. Aug. 13, 2020).

2. *Id.* at Tr. 8:14-16.

3. *Id.* at Tr. 27:17 – 28:4. (citing 406 N.J. Super. 524, 542 (App. Div.), *cert. denied*, 200 N.J. 209 (2009)).

4. 406 N.J. Super at 541.

5. *Id.* at 8:22 – 9: 1.

6. *Id.* at 9:1-5.

7. *Id.* at 11:10-21.

8. *Id.* at 9:8-19.

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