Direct Physical Loss, Coverage for Construction Delay Update

October 3, 2022

Direct Physical Loss – Vermont

Huntington Ingalls Indus. Inc. v. Ace Am. Ins. Co.
--- A.3d ----, 2022 VT 45, 2022 WL 4396475 (Vt. Sept. 23, 2022)

The Vermont Supreme Court allowed a policyholder's suit seeking coverage for losses following the outbreak of COVID-19 to survive a motion for judgment on the pleadings, overturning the appellate court's holding that the policyholder had not alleged sufficient facts to overcome a motion pursuant to Fed. R. Civ. P. 12(c).

Huntington Ingalls Industries Inc. (Huntington), the largest shipbuilding company in the United States, purchased an insurance policy from its captive insurer subsidiary, Huntington Ingalls Industries Risk Management LLC (Huntington Risk Management). Huntington Risk Management, in turn, purchased policies of reinsurance to cover its obligations under the policy issued to Huntington (Huntington policy). The reinsurance policies incorporated the terms and conditions of the Huntington policy, including coverage for business interruption for "[l]oss due to the necessary interruption of business conducted by [insured], whether total or partial ... caused by physical loss or damage insured herein."

In an effort to stop the spread of COVID-19, various government entities issued orders closing non-essential operations and businesses. Huntington was designated "Essential Critical Infrastructure" by the federal government and allowed to continue operations, subject to changes to comply with guidance from the federal government to try to contain the virus. Nevertheless, employees began contracting COVID-19, requiring them to quarantine and requiring Huntington to make further changes to its operations.

Huntington and Huntington Risk Management filed a lawsuit against the reinsurers of the Huntington policy seeking a declaration that the reinsurance policies covered Huntington's damages stemming from the COVID-19 pandemic, including lost business income. The trial court granted the reinsurers' motion for judgment on the pleadings, finding that Huntington "did not experience loss of property but instead suffered an uncovered loss of income because the shipbuilding yards remained in operation despite the presence of the virus."

On appeal, the Supreme Court reversed the trial court's grant of judgment on the pleadings. The high court held that the policy's definition of physical damage included a "distinct, demonstrable, physical change to property," and direct physical loss as requiring "persistent destruction or deprivation, in whole or in part," and required "a causal nexus to a physical event or condition." Because Huntington had "adequately allege[d] that the virus physically altered property in insured's shipyards when it adhered to surfaces," the complaint alleged sufficient facts to allow the case to move beyond the pleadings stage. The Supreme Court noted that "this opinion does not state that what occurred in the insured's shipyards is a 'direct physical loss or damage to property' under the policy," but that "[w]e merely conclude that insured has alleged enough to survive a Rule 12(c) motion under our extremely liberal pleading standards."

Coverage for Construction Delay – Washington

Seattle Tunnel Partners v. Great Lakes Reinsurance (UK) PLC
--- P.3d ---, 2022 WL 4241893 (Wash. Sept. 15, 2022)

The Washington Supreme Court upheld the state court of appeals' decision affirming partial summary judgment rulings in favor of Great Lakes Reinsurance (UK) PLC and several other underwriters (Great Lakes) and against the insureds – Washington State Department of Transportation and Seattle Tunnel Partners (plaintiffs). The Supreme Court affirmed the lower court's ruling that a builder's "all-risk" insurance policy (policy) issued to the plaintiffs did not provide coverage for losses arising out of a major construction project to replace the Alaskan viaduct in Seattle.

In 2011, Seattle Tunnel Partners contracted with the Washington State Department of Transportation to construct a tunnel to replace the viaduct. The plaintiffs obtained the policy to insure against damage to both the tunneling works and the Tunnel Boring Machine (TBM). Operations began in 2013, but after excavating part of the tunnel, the TBM stopped working. The work was not completed and the tunnel was not operational again until December 2015. The plaintiffs sought coverage for losses as a result of the repairs and delay in finishing the project. Great Lakes denied coverage, and the plaintiffs filed suit alleging wrongful denial of their insurance claims.

The case turned on three issues that the trial court, the appellate court and the state's highest court were tasked with deciding: (1) whether the "machinery breakdown exclusion" excluded coverage for damage to the TBM caused by alleged design defects, (2) whether the policy afforded coverage for the losses due to project delays, and (3) whether the loss of use or functionality of the tunnel constituted "direct physical loss, damage, or destruction" that was covered by the policy. The courts ruled in favor of Great Lakes on all three issues.

The Supreme Court first ruled that the machinery breakdown exclusion precluded coverage for internal causes of damage to the machine, which included the alleged design defects. Second, it held that the "interest insured" clause in the policy did not cover losses due to the two-year project delay. Third, it held that the loss of use of the tunnel due to the failure of the TBM was not "direct physical loss, damage, or destruction" of the tunnel itself. In sum, because coverage was not afforded for any of the alleged damages, the Supreme Court affirmed and held that the plaintiffs were not entitled to coverage under the policy.

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