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January 27, 2023

Via E-Filing

Honorable Chief Justice Patricia Guerrero
and the Honorable Associate Justices
California Supreme Court
350 McAllister Street
San Francisco, California 94102-7303

Re: Letter of United Policyholders re: Request for Certification in *Another Planet Entertainment, LLC v. Vigilant Insurance Co.* Case No. S277893

To the Honorable Chief Justice and Associate Justices of the California Supreme Court:

I write on behalf of *Amicus Curiae* United Policyholders ("UP") in support of the Court accepting the question certified by the U.S. Court of Appeals for the Ninth Circuit in the above-captioned case. In regard to this issue, UP particularly opposes the statements submitted by Vigilant Insurance Company ("Vigilant"),[1] and the American Property Casualty Insurance Association ("APCIA"),[2] as both statements rely on a "distinct, demonstrable physical alteration" standard.[3] As explained below, that was not the majority rule in the country before it first was formulated in *Couch on Insurance Third* ("*Couch Third*") in the 1990s. Given the significance of this issue, UP felt it was crucial to educate the Court on the narrow issue concerning the fallacy behind the formulated standard.

[1] Jonathan Hacker, Vigilant Ins. Co. Counsel, letter to Honorable Patricia Guerrero, C.J. & Associate Justices of the California Supreme Court, Jan. 17, 2023 ("Vigilant Letter").

[2] Mark D. Plevin, APCIA Counsel, letter to Honorable Patricia Guerrero, C.J. & Associate Justices of the California Supreme Court, Jan. 17, 2023 ("APCIA Letter").

[3] Vigilant Letter, p. 2; APCIA Letter, p. 2.

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As shown in an in-depth, well-documented law review published in 2021,[4] courts adopting many of the COVID-19 insurance decisions cited by Vigilant and APCIA nonetheless adopt this reformulation of the standard applicable to "direct physical loss" as stated in *Couch Third*, and in so doing ignore the long-held majority rule which held that loss of use constitutes "direct physical loss." This issue is important for policyholders, large and small, under not just commercial property insurance policies but also under the hundreds of millions of homeowners insurance policies purchased every year by ordinary consumers across the country.

UP writes to underscore two points. First, arriving at the correct answer to the certified question is vital to the long-term health of the insurance market in California. Second, the federal courts have gotten the answer seriously wrong. In UP's view, that is due in large part to an error made by *Couch Third* in the early 1990s. That error has snowballed, now into what some courts in the COVID-19 insurance context have begun to transform a "doctrine." However, doing so is contrary both to standard-form policy language and insurer underwriting expectations; and to policyholders' reasonable expectations of coverage and the pre-COVID-19 majority rule on how to interpret the key term, "direct physical loss." This Court's intellectual prowess is sorely needed, at some point, to restore order on this issue.

Interest of the Amicus Curiae

UP is a non-profit organization based in California that has served a respected voice for the interests of consumers and policyholders across the country for 30 years. Tax-exempt under Internal Revenue Code § 501(c)(3), UP is funded by donations and grants. It does not sell insurance or accept money from insurance companies. Individual policyholders across the country routinely call upon UP for help in the wake of large-scale national disasters such as hurricanes in the Gulf and across the Eastern Seaboard; floods and windstorms in the Midwest; wildfires, floods, hurricanes, windstorms, earthquakes, and other natural disasters); *Roadmap to Preparedness* (insurance and

[4] Lewis et al., *Couch's Physical Alteration Fallacy: Its Origins and Consequences* (2021) 56 Tort Trial & Ins. Prac. L.J. 621, 624-632 ("*Physical Alteration Fallacy*").

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financial literacy education and disaster preparedness); and *Advocacy and Action* (advancing pro-consumer laws and public policy).

UP's Executive Director, Amy Bach, has served as an official consumer representative to the National Association of Insurance Commissioners ("NAIC") since 2009. In that role, UP assists state regulators in monitoring policy language and claims practices and (NAIC) contributions to the development of model laws and regulations. Since the creation of the elected position in 1988, UP has worked closely with each California Insurance Commissioner, including now Ricardo Lara. UP is also a member of the Federal Advisory Committee on Insurance to the U.S. Treasury Department, and a regular participant before the National Conference of Insurance Legislatures (XCOIL). Public officials, regulators, legislatures, academics, and journalist regularly seek UP's input on insurance related legal matters "effecting the dominant protective purpose of insurance . . . ."[5]

As part of its *Advocacy and Action* initiative, UP is committed to assisting courts in upholding the fundamental purpose of insurance, which is loss indemnification. A diverse range of policyholders throughout California regularly communicate with UP, which allows UP to provide courts with topical information through the submission of amicus briefs. This Court recently relied on UP's brief in *Association of California Insurance Companies v. Jones* (2017) 2 Cal.5th 376, 383. The U.S. Supreme Court has done the same. (E.g., *Humana Inc. v. Forsyth* (1999) 525 U.S. 299, 314.)

In connection with COVID-19 pandemic, UP has assisted business owners by maintaining a library of resources at uphelp.org/COVID. UP has also sought to counter the insurance industry's attempt to use the pandemic to realize a dramatic narrowing of the historically broad "all risks" property and business insurance. UP has filed *amicus curiae* briefs in state and federal courts around the country that push back against the insurance industry's campaign to upend decades of carefully reasoned decisions – including California state court decisions such as *Hughes v. Potomac Insurance Company of District of Columbia* (1962) 199 Cal.App.2d 239 – regarding the meaning of words "physical loss" and/or "damage" when used in property insurance policies

[5] Rest., Law of Liability Insurance, § 2, com. c.

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which are sold to businesses, small and large, and to hundreds of millions of individual policyholders across the country.

ARGUMENT

Case Law Before Reformulation of the Standard by Couch Third

Since 1985, property-insurance policies have covered "physical loss" and "physical damage." (Miller et al., *COVID-19 and Business-Income Insurance: The History of Physical Loss and What Insurers Intended It to Mean* (2023) 57 Tort Trial & Ins. Prac. L.J. 675, 682-683 ("*History of Physical Loss*").) This change in 1985 was an effort to shift away from named-peril policies and toward a true "all risk" product. (*Id.* at pp. 679-685.)[6]

That shift created significant uncertainty. "Physical damage" seems fairly straightforward, but how far does "physical loss" extend? In the courts' view, it had an extensive reach—covering injury involving some physical force, even in cases where "any alteration of the property occurred, if at all, on a molecular level." (*History of Physical Loss*, *supra*, 57 Tort Trial & Ins. Prac. L.J. at pp. 686-687 (surveying cases involving radon, smoke, vapors, vibrations, and theft).) Even before the 1985 change to "all risks" property insurance, courts had concluded that "physical loss" can include loss of use.)

Before *Couch Third* published its reformulation of the applicable standard, courts understood that, contrary to the assertions now made in their Letters to this Court by Vigilant and APCIA, and before COVID-19, the majority rule *rejected* arguments (as Vigilant put it) that loss of use of property cannot not constitute "direct physical loss." As with many modern doctrines, this standard upholding coverage for loss of use has

[6] For the most part, existing policies had covered "damage or destruction" by specified perils—fire, water, hail, lighting, and the like. (*History of Physical Loss*, *supra*, 57 Tort Trial & Ins. Prac. L.J. at pp. 679-685.) The shift to the "physical loss" also extended to policyholders protection for losses from larceny or burglary—things that do not injure the property itself, but that do impair the owner's ability to use and enjoy the property. (*Id*. at pp. 683-685.)

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deep roots in California. (*Hughes v. Potomac Ins. Co. of D.C.*, *supra*, 199 Cal.App.2d 239.) The First District confronted an insurer that had denied coverage for a house that was suddenly perched precariously on a cliff after a landslide and was too dangerous to occupy until the cliff was stabilized. (*Id.* at pp. 248-249.) The insurer noted the house itself was unscathed and argued that there was no coverage. (*Ibid*.) The Court of Appeals was unconvinced:

> To accept [the insurer's] interpretation of its policy would be to conclude that a building which has been overturned or which has been placed in such a position as to overhang a steep cliff has not been "damaged" so long as its paint remains intact and its walls still adhere to one another. Despite the fact that a "dwelling building" might be rendered completely useless to its owners, appellant would deny that any loss or damage had occurred unless some tangible injury to the physical structure itself could be detected. Common sense requires that a policy should not be so interpreted in the absence of a provision specifically limiting coverage in this manner. [Policyholders] correctly point out that a "dwelling" or "dwelling building" connotes a place fit for occupancy, a safe place in which to dwell or live. It goes without question that respondents' "dwelling building" suffered real and severe damage when the soil beneath it slid away and left it overhanging a 30-foot cliff. Until such damage was repaired and the land beneath the building stabilized, the structure could scarcely be considered a "dwelling building" in the sense that rational persons would be content to reside there.

(*Ibid*.) The court reached this conclusion, in part, based on the familiar rule that, "[i]f semantically permissible, the [insurance] contract will be given such construction as will fairly achieve its object of securing indemnity to the insured for the losses to which the insurance relates." (*Id*. at p. 248, quoting *Wildman v. Gov. Employees Ins. Co.* (1957) 48 Cal.2d 31, 35.)

Hughes's logic became the North Star for property insurance coverage, both before and long after the 1985 revisions. It demarcated a crucial, outer limit of coverage: there must be a physical hazard at or near the property that made it substantially unsafe or unsuitable for human use. This was the standard in *Couch*'s first and second editions.

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Even the lead author of *Couch Third* recognized this as the correct standard multiple times: in a textbook he writes, which most recently was updated in 2021; and in articles published almost a decade ago and never retracted. (See *Physical Alteration Fallacy, supra*, 56 Tort Trial & Ins. Prac. L.J. at pp. 624-632.)[7]

At the same time, "physical loss" had its limits, which *Hughes* helped shape. (*Physical Alteration Fallacy*, 56 Tort Trial & Ins. Prac. L.J. at p. 633 & fn. 66.) A homeowner ejected by a superior claim of title might construe that as a "physical loss"—after all, they had lost their home, a physical thing. However, courts were not willing to extend the policy that far, which would cause property insurance to swallow title insurance. (See, e.g., *Com. Union Ins. Co. v. Sponholz* (9th Cir. 1989) 866 F.2d 1162, 1163; *HRG Development Co. v. Graphic Arts Mutual Ins. Co.* (Mass.Ct.App. 1988) 527 N.E.2d 1179, 1181.) Similarly, a merchant staring at a warehouse of very physical goods rendered unsalable by a rescinded warranty might see a "physical loss" to his business. Courts again refused, being careful not to warp the commercial code's allocation of risk and liability amongst buyers and sellers. (See *Glens Falls Ins. Co. v. Covert* (Tex.Ct.App. 1975) 526 S.W.2d 222, 223.) Without *Hughes*, someone whose house was unsalable because it was "widely reputed to be possessed by poltergeists" might try to foist the loss on their property insurer. (*Physical Alteration Fallacy*, *supra*, 56 Tort Trial & Ins. Prac. L.J. at p. 637 & fn. 82, discussing *Stambovsky v. Ackley* (N.Y.App.Div. 1991) 169 A.D.2d 254, 255-256.)

[7] *See* DiMugno et al., Catastrophe Claims: Insurance Coverage for Natural Disasters and Man-Made Disasters (2014 updated 2021) § 8.6 (contrary to statements in *Couch Third,* "it is difficult to distill a general rule" from relevant cases); see also Plitt, *All-Risk Coverage for Stigma Claims Involving Real Property* (2013) vol. 35 Ins. Litig. Rep., No. 9 (2013) ("It is well recognized by courts that physical loss exists without destruction to tangible property," such as serious impairment of a building's function that "may render the property useless."); Plitt, *Direct Physical Loss in All-Risk Policies*: *The Modern Trend Does Not Require Specific Physical Damage, Alteration,* Claims J. (Apr. 15, 2013), at <https://amp.claimsjournal.com/magazines/ideaexchange/2013/04/15/226666.htm> [as of Jan. 27, 2023].) The title of the second article states the point succinctly.

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Hughes's boundary between coverage and noncoverage makes eminent sense. (*Physical Alteration Fallacy*, *supra*, 56 Tort Trial & Ins. Prac. L.J. at pp. 635-639.) It "has a firm basis in the risk-based nature of insurance, in basic principles of insurance law, and in insurance-industry intent." (*Id.* at p. 637.) "Actuaries can predict the likelihood of physical phenomena that might affect property, even if those perils do not structurally injure property, and even if the peril strikes the entire risk pool at the same time." (*Ibid.*) Things on the other side of that line are either covered by other risk arrangements or are so erratic that they defy actuarial prediction.

Couch Third's Reformulation, Rejecting the Majority Rule

Couch Third upset this balance in the early 1990s for no discernable reason. It stated, contrary to the then-existing majority rule, that the term "physical" was "widely held" to "preclude any claim against the property insurer" when the injury was "unaccompanied by a distinct, demonstrable, physical alteration of the property." (*Physical Alteration Fallacy*, *supra*, 56 Tort Trial & Ins. Prac. L.J. at p. 625.) As support, it cited a handful of title-impairment and rescinded-warranty cases and old cases addressing named – perils (not all-risks) policies whose policy language that were inherently limited to physical perils. (*Id.* at pp. 624-625, 633.) None of these cases used *Couch Third*'s "distinct, demonstrable, physical alteration" standard. (*Ibid.*) The only case that came close was from a federal court in Oregon (*Great Northern Insurance Co. v. Benjamin Franklin Federal Savings & Loan Association* (D. Or. 1990) 793 F.Supp. 259) and involved nonfriable asbestos in a building. (*Id.* at p. 625.) To deny coverage, *Benjamin Franklin* fashioned a "physical alteration" test out of liability-insurance principles designed to separate liability for injury to the *policyholder*'s work (not covered) and injury to *third parties*' work (covered). (*Id.* at p. 625 & fn. 24.) Even in its incorrect analysis, *Benjamin Franklin* only noted that the property was "intact and undamaged." (*Id.* at pp. 625-626.) The modifiers "distinct," "demonstrable," and "alteration" are all original to *Couch Third.* (*Ibid.*) They were not used in decisions handed down before *Couch Third* was published.

Couch Third did not offer any substantial, analytical justification for the "distinct, demonstrable, physical alteration" concept. (*Physical Alteration Fallacy*, *supra*, 56 Tort Trial & Ins. Prac. L.J. at pp. 635-636.) It presented that formulation as merely a product of the case law, as treatises often do. (*Id.* at p. 625.) Unlike many other treatises in

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existence at the time (such as those by Appleman and Windt), *Couch Third* also has never, in all of its updates and revisions since the 1990s, grappled with the reasoning of *Hughes* and its numerous progeny. (*Id.* at pp. 626-627, 630-632.) However, *Couch Third* had earned a following over years of faithful, insightful reporting by George Couch and his successors. (*Id.* at p. 622.) So some courts—especially federal courts—have taken *Couch Third* at its word. (*Id.* at pp. 632-633.)

Couch Third's "physical alteration" formulation eventually made inroads in California. In a case that has been widely cited by insurers in the COVID-19 litigation, the Second District held that an MRI machine's failure to "boot up" was not covered by property insurance. (*MRI Healthcare Center of Glendale, Inc. v. State Farm Gen. Ins. Co.* (2010) 187 Cal.App.4th 766, 777-779.) The reason? There was no "distinct, demonstrable, physical alteration" to the machine. (*Id.* at p. 779.) However, the result in *MRI Healthcare* is obviously correct; even under *Hughes*—a machine's internal defect or malfunction is a warranty issue, not a "physical" property risk. *MRI*'s use of the *Couch Third* formulation was dictum.

Yet that dictum, and others like it, have caused tremendous harm. Like most dicta, it was not the product of a carefully considered progression from the facts presented to the judgment necessary to resolve the dispute before the court. It was drawn from *Couch Third* alone, which the Second District (justifiably) assumed was thorough and correct. Yet the *Couch Third* analysis caught on for intermediate appellate courts looking for a way to dismiss claims like the early title and warranty cases—like those involving canceled contracts or counterfeit wine. (*Simon Marketing, Inc. v. Gulf Ins. Co* (2007) 149 Cal.App.4th 616, 622-624; *Doyle v. Fireman's Fund Ins. Co.* (2018) 21 Cal.App.5th 33, 38-39.)

Then came COVID-19. Rather than question whether *Couch Third's* and *MRI's* dicta-upon-dicta made sense, was analytically sound, or conformed to the policy language, courts have largely treated it as inviolable precedent and invoked it as a talisman to dismiss hundreds of coverage claims. (*Physical Alteration Fallacy*, *supra*, 56 Tort Trial & Ins. Prac. L.J. at pp. 634-635.) However, the soundness of the test matters in this context, in which a microscopic, deadly virus forced people out of their property for much of the same reason as the landslide in *Hughes*—if they stayed, they could die. (*Id.* at pp. 635-639.)

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Importance of a Decision by This Court on This Crucial Issue

This is why the Court's review of the certified question is so important. Why is an "alteration" necessary? Why must it be "distinct" or "demonstrable"? Why is the presence of a deadly, under standard-form all-risks policies microscopic physical hazard not enough to satisfy the word "physical?" How does this square with the policy language—which says only "physical loss" and which is something only insurers can change? And most importantly, what other things (besides SARS-CoV-2) will suddenly be "not covered" if *Couch Third*'s test controls? (*Physical Alteration Fallacy*, *supra*, 56 Tort Trial & Ins. Prac. L.J. at pp. 635-639.)

These are not hypothetical concerns. They are not answered by *Couch Third's* revisions or by any of the COVID-19 decisions of which UP is aware. Insurers are already citing under the standard-form all-risks property insurance bought by millions of policyholders, these decisions in non-COVID cases in an effort to narrow their coverage obligations without a corresponding reduction in premium. The Court needs to intervene and correct this error before a single, stray proclamation in a treatise, contradicted by its own lead another recently and not once but several times, overrules decades of settled insurance law without respecting or grappling with the force of *stare decisis*.

It is true that the authors of the *Physical Alteration Fallacy* article cited here generally represent policyholders and thus have an interest in the Court rejecting *Couch Third's* reformulation of the test applicable to the meaning of "direct physical loss." That said, their first obligation (and UP's) is to the law and to the courts; and, of course, Vigilant and APCIA, and their lawyers here, have the same interest, from the insurance-industry side. All of us want the law to be just, coherent, and predictable. From the outset, the authors of the *Physical Alteration Fallacy* article and those at UP have been clear to colleagues on the other side of the bar that they welcome criticism and debate on the positions taken in the article, because they want the courts to get the law right. It has been more than a year since the *Physical Alteration Fallacy* article was published. In that time, while many have objected to the article, no one has offered or published a well-reasoned *merits*-based response. That silence speaks for itself.

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UP urges the Court to accept the certified question.

Sincerely yours,

Yosef Y. Itkin

cc: Counsel of Record

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