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CLAIMS LAW UPDATE

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BUSINESS SUSPENSIONS AND COVID-19, IS THE RESULTING LOSS OF INCOME COVERED?

[Ref. Commercial Property Coverage, Paras. 3.02, 3.03, and 3.07]

INTRODUCTION

Across the country businesses have been affected by a variety of federal, state, and local orders in response to the COVID-19 pandemic. Businesses that were deemed non-essential, those that did not provide life-sustaining services, were ordered closed or allowed to operate on a limited basis. Non-essential businesses that were allowed to remain open with reduced operations were also adversely affected by stay-at-home orders that kept many customers away. This has been economically devastating for many businesses, which in turn have submitted claims under commercial property policies and business owners policies that provide business interruption coverage. But does that coverage apply?

The majority of court decisions considering COVID insurance claims to date have addressed defense motions to dismiss for failure to state a claim. A motion to dismiss for failure to state a claim will be granted if the factual allegations in the complaint fail to state a plausible claim for relief. A plaintiff's speculation and proffered legal conclusions are insufficient to survive the motion.

BUSINESS INTERRUPTION COVERAGE

Prior to considering the issues specific to COVID cases it is useful to have a basic understanding of business interruption coverage. Policies issued to commercial entities, whether the insured is a large corporation or a mom and pop business, are intended to provide coverage against physical loss or damage to business property, real and personal, from specified causes of loss. The policies cover the repair, rebuilding, or replacement of tangible property damaged by a covered cause of loss. Policies that cover or are endorsed to cover business income provide for the recovery of loss of business income the insured sustained as a result of the necessary suspension of operations, due to a covered loss, during the period of restoration. In a standard ISO business income form, the period of restoration begins 72 hours after the date of direct physical loss or damage giving rise to the claim and ends on "the date the property at the described location should be repaired, rebuilt or replaced with reasonable speed ... or ... when business is resumed at a new permanent location," whichever occurs first. This coverage is only available when covered property at an insured location is physically harmed by a covered cause of loss.

The standard ISO business income form provides an additional coverage for loss of business income that results from an act of civil authority. This coverage applies when a civil authority denies access to an area surrounding the insured's property because of damage resulting from a covered cause of loss not to the insured's property, but to other nearby property. The damaged property must be within a mile of the insured's covered premises. As a result of the order of the civil authority the insured must be prohibited from accessing the premises described in the policy. The act of the civil authority must be in response to either dangerous physical conditions related to the property damage or the continuation of the cause of the damage, such as an ongoing fire, or the act must be to enable the civil authority access to the damaged property. Coverage is restricted to a maximum of four weeks, beginning 72 hours after the first act of civil authority that prohibits the insured's access. The one mile limitation can vary from policy to policy, with some requiring damage to adjacent property and some extending coverage when the damaged property is within a 100 mile radius of the described premises. This coverage does not apply when the income loss results from damage to covered property. It applies when the civil authority acts in response to property damage elsewhere, in the vicinity of the covered premises. Not all polices include coverage for loss due to an act of civil authority.

COVID-19 AND PHYSICAL LOSS OR DAMAGE

Direct physical loss of or direct physical damage to property is the key to triggering the potential for coverage under either business income or civil authority coverage. This is the first issue to resolve in a COVID business income claim. Does a virus, which can certainly harm people, cause harm to property? Does harm have to result in some kind of tangible change to property to satisfy the requirement of either direct physical loss of or direct physical damage to property? The majority of courts require some form of actual or tangible harm to, or an intrusion on, the covered property to qualify as direct physical loss or direct physical damage.

It is the plaintiff's duty to prove a plausible right to coverage and, if successful, the burden then shifts to the defense to prove the loss is not covered. A court will first focus on the issue of whether the plaintiff has alleged a plausible claim for physical property loss or damage that falls within the policy's scope of coverage. The factual allegations are compared to the language of the insuring agreement. The litigated COVID claims have mostly involved policies with the special causes of loss forms that provide open perils, often called all-risk, coverage. There is coverage for direct physical loss or damage unless caused by an excluded cause of loss, subject to other coverage limitations within the policy. In a claim for loss of income due to an act of civil authority the insured must prove that the act was in response to physical damage to property other than at the covered premises, by a covered cause of loss. If an insured fails to allege facts that show a plausible claim for direct physical loss of or direct physical damage to covered property, or that the civil authority's act was in response to direct physical damage elsewhere, the motion to dismiss will be granted without the need to consider any policy exclusions or limitations on coverage.

A number of plaintiffs have tried to satisfy the requirement for direct physical loss or damage by arguing that the loss of the ability to use the covered property as intended is a physical loss. Many insureds have argued that their loss was the direct result of an order of civil authority, triggering the right to business income coverage. It has also been argued that the civil authority orders limiting or shutting down operations were taken as a result of physical damage to property in the area of the insured premises.

In the vast majority of cases for business interruption (not civil authority) there were no allegations that the virus was present at the covered premises.

> In *Hillcrest Optical, Inc. v. Continental Casualty Co.*, 2020 U.S. Dist. LEXIS 195273 (S.D. Ala. 2020), the claim was for loss of income as a result of the insured's compliance with a statewide civil authority order that postponed all medical procedures indefinitely, with limited exceptions. The order remained in effect for one month, at which point medical procedures were permitted to resume and the insured reopened its business. The insured

claimed that while the order was in effect it sustained a direct physical loss because it was unable to use its property for its intended purpose. Continental denied the claim because the insured's inability to use the property was not a direct physical loss of or to the property and the insured failed to state a period of restoration, as required for business income coverage.

The insured tried to distinguish between "loss" and "damage" as used in the policy in an attempt to support its theory that it had suffered a direct physical loss of its property. The court, however, disagreed. Cases on which the plaintiff relied were factually distinguishable because they involved a "permanent dispossession" of property. This insured never lost possession of the property. The court then considered whether a temporary inability to use property is a "loss of" the property. The court, again, found the cases the plaintiff relied on to be distinguishable. For example, in one case the property had been physically contaminated by gasoline and rendered uninhabitable. In another the premises had been infiltrated with smoke from a wildfire. These cases involved events that had a tangible physical effect on the covered property. Hillcrest's claim was purely economic in nature. Its inability to use its premises "did not result from an immediate occurrence which tangibly altered its property – the order did not immediately cause some sort of tangible alteration to Plaintiff's office."

The court then turned to the policy language for loss of business income during the "period of restoration." Hillcrest argued that the period of restoration contemplates the inability to use its property as a direct physical loss of that property. It argued the property required repair because it was not useable and that the second order, allowing business to resume, was the repair that returned the premises to "a sound and healthy state." The court disagreed, citing the policy requirements. The court explained:

> It is apparent ... that a "direct physical loss of property" contemplates the tangible alteration of property which would necessitate a party's absence to fix it or require the party to begin operations elsewhere. The "period of restoration" expressly assumes repair, rebuild or replacement of property. Read in context with "direct physical loss of property," a "period of restoration" can occur only by virtue of a repairable, rebuildable, or replaceable physical alteration of covered property." This begs the question: how can a statewide order which "required" Plaintiff to shut down necessitate some sort of repair? In answer to this, Plaintiff argues a "repair" in certain contexts includes "restoring the property to a sound or healthy state." But Plaintiff claims its property was not in a sound state only because it could not use its property. Plaintiff was not dispossessed of its property due to the Order, nor was there any tangible alteration to it. Plaintiff's inability to use its property was not caused by an unsound or unhealthy condition of the property itself, which necessitated repair, rebuilding, or replacement.

The court concluded that Hillcrest's claim failed to meet the minimum procedural standards and granted Continental's motion to dismiss, with prejudice, barring it from bringing the same claim again.

In many COVID claims the insured attempts to prove a right to recover under the business income coverage and, alternatively, the civil authority coverage. The argument is that the civil authority acted in response to the presence of the virus in the geographic area of the insured premises and the act prohibited access to the insured premises. This argument too has generally been unsuccessful.

In *Michael Cetta, Inc. v. Admiral Indemnity Co.*, 2020 U.S. Dist, LEXIS 233419 (S.D. N.Y. 2020), the insured restaurant filed a claim for loss of business income as a result of a civil authority order that prohibited restaurants from serving food and beverages on their premises. The restaurant was, however, allowed to remain open to provide takeout and delivery service. Admiral denied the claim under both the business income and civil authority coverages because the restaurant did not suffer direct physical loss of or damage

to property and because the civil authority order did not result from property damage near the restaurant or prohibit access to the restaurant.

The court had no difficulty in finding that the insured failed to prove a business income claim for physical loss or damage to its covered premises. In the claim for civil authority coverage the court found the insured's arguments to be flawed. The insured made no allegation that property near the restaurant had sustained physical damage. Rather, the insured simply alleged that the civil authority order affected neighboring businesses. The insured also failed to allege that it was ever denied access to its premises or to the area surrounding its premises. It simply alleged that the civil order limited it to providing takeout and delivery. The court found that the restaurant's ability to continue operations in some capacity was fatal to its claim for civil authority coverage. The insured failed to plead that the area surrounding the restaurant suffered physical damage or that the civil authority completely barred access to its premises. The court concluded that the insured failed to state a claim under either coverage and granted Admiral's motion to dismiss, with prejudice.

In a few cases the insured alleged that it was likely the premises was contaminated because COVID is widespread and someone with the virus could have been on the premises. Typically, without knowledge that an infected person was in fact on the premises, these allegations are too speculative to prove a plausible claim. Even if it is proved that the virus was on the premises, however, did that exposure result in direct physical loss of or damage to the property?

In *Uncork & Create LLC v. The Cincinnati Insurance Co.*, 2020 U.S. Dist. LEXIS 204152 (S.D. W.Va. 2020), the insured made a claim for lost business income it sustained while its business operations were suspended as a result of a civil authority shutdown order for non-essential businesses. Cincinnati denied the claim because there was no direct physical loss at the insured premises. The insured countered that the virus itself causes direct physical loss or damage. The court found that coverage depended on whether COVID and the civil order satisfied the policy requirement of physical loss or physical damage under the policy.

The insured argued that West Virginia courts do not require a structural alteration to prove a direct physical loss for the purpose of coverage. The case the insured relied on involved houses that were deemed uninhabitable because of their proximity to an area that had been subject to rockfalls, which also impacted neighboring houses. The court distinguished that case, however, because the houses were "rendered uninhabitable by a physical threat," and it was likely that additional rockfalls would physically damage those houses. The court went on to hold that COVID has no effect on the insured's physical premises. The civil order to shut down businesses was made to prevent people from exposing one another to the virus. Citing an earlier decision, the court explained that "economic losses, such as loss of income and benefits, do not constitute property damage or physical injury to property."

The court took note of one case, *Studio 417, Inc. v. Cincinnati Ins. Co,* 2020 U.S. Dist. LEXIS 147600 (W.D. Mo. 2020), which held the insured had stated a plausible claim for relief based on allegations that COVID particles attached to their property causing damage that made the premises unsafe and unusable. The court was not persuaded by the *Studio 417* ruling because the majority of courts to address the issue have found that COVID and civil authority orders closing businesses to slow the spread of the virus do not cause physical damage or physical loss to insured property. The *Uncork* court agreed with the majority position and explained:

> The court finds those decisions concluding COVID does not cause direct physical damage or loss to property to be more persuasive. Although some courts have drawn a distinction based on whether a complaint alleged presence of the virus on the premises, the Court does not find such an allegation determinative. Firstly, while factual allegations drive the analysis of a motion to dismiss, courts are not required to set aside common sense, and neither *Studio 417*, which relied in part on the

allegation of presence of the virus, nor the instant case, involve actual allegations of employees or patrons with infections traced to the business. There is a similar risk of exposure to the virus in any public setting, regardless of artful pleading as to the likelihood of the presence of the virus. Secondly, even when present, COVID does not threaten the inanimate structures covered by property insurance policies, and its presence on surfaces can be eliminated with disinfectant. Thus, even actual presence of the virus would not be sufficient to trigger coverage for physical damage or physical loss to property. Because routine cleaning, perhaps performed with greater frequency and care, eliminates the virus on surfaces, there would be nothing for an insurer to cover, and a covered "loss" is required to invoke the additional coverage for loss of business income under the Policy.

The court concluded by holding that the pandemic impacted human health and behavior, not physical structures. The insured's economic loss was the result of changes in human behavior, including what was required by the civil order. There was no coverage for this loss and the motion to dismiss was granted.

With regard to the *Studio 417* case addressed by the *Uncork* court, it is significant that the *Studio 417* court emphasized that the plaintiffs had merely pleaded enough facts to avoid dismissal. That court did not find that the claim was covered, rather, only that the case could proceed to discovery and that the defendant insurer could, if warranted, reassert its arguments against coverage at the summary judgment stage.

EXCLUSIONS

There are several exclusions that have been raised by insurers defending against COVID claims. The most frequently argued, and the strongest, is a virus exclusion.

In 2006 ISO introduced a mandatory virus or bacteria exclusion. The exclusion applies to all policy parts, including loss of business income. The exclusion states:

B. We will not pay for loss or damage caused by or resulting from any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness or disease.

Not all insurers that have chosen to include a virus exclusion, whether in the body of the policy, the cause of loss form, or by endorsement, utilize the language of the ISO exclusion verbatim. Some insurers have developed their own exclusions. These exclusions may be subject to introductory language stating that the exclusion applies to direct or indirect damage. The policy might also use anti-concurrent causation language specifying that the exclusion applies "regardless of any other cause or event that contributes concurrently or in any sequence to the loss." Some insurers rely on an exclusion for fungus, wet rot, dry rot, bacteria, and virus. Some include virus as an excluded cause of loss in a pollution exclusion.

Although the initial coverage inquiry is traditionally whether the plaintiff has stated a plausible claim that it suffered a direct physical loss of or damage to its covered property, some courts skip that analysis and look directly to the policy exclusions to determine the validity of a motion to dismiss for failure to state a claim.

In *LJ New Haven LLC v. Amguard Insurance Co.*, 2020 U.S. Dist. LEXIS 239513 (D. Conn. 2020), the insured operated a restaurant that suffered a loss of business income as a result of a civil authority order that restricted restaurant operations to takeout and delivery service. LJ claimed a right to coverage under its business income, extra expense, and civil authority coverages. After its claim was denied it sued Amguard. Amguard moved to dismiss the

complaint based on its policy's virus exclusion, that the property did not sustain a direct physical loss, and that there was no claim of property damage that would trigger the civil authority coverage. The court agreed that the virus exclusion foreclosed all of LJ's claims and found that it was not necessary to consider the insurer's other arguments. In granting the motion for dismissal the court considered the scope of the exclusion.

The virus exclusion at issue stated:

> We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss. These exclusions apply whether or not the loss event results in widespread damage or affects a substantial area.
>
> ...
>
> j. Virus or Bacteria
>
> (1) Any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness or disease.

While the insured's amended complaint alleged the civil authority order as the immediate cause of its business income loss, it also identified the basis of that order as the emergence of and need to stop the spread of the corona virus. The order itself identified as its purpose the reduction of the spread of COVID. The court explained that although COVID might not have been a direct cause of the insured's loss, it was certainly an indirect cause. The exclusion contained valid anti-concurrent causation language that displaced the efficient proximate cause rule. As such, a literal reading of the exclusion meant that coverage was excluded if COVID was at least one causal factor in the loss. The court went on to state that even if given a more narrow reading, requiring "the virus be a 'significant,' 'substantial,' or 'near' indirect cause" the exclusion would apply. The civil authority order would never have been issued in the absence of the outbreak of COVID. The virus and the issuance of the order were intertwined.

The insured made one last argument that the exclusion did not apply because it was limited to onsite contamination and COVID was not present on its premises. This argument was based on the inclusion of other types of exclusions in the same policy subsection that involved conditions that, as per the insured, only caused damage when present on the covered premises. These excluded causes included pollution and fungi, wet rot, and dry rot. The court found that these causes of loss could in fact cause damage to covered property if, for example, they existed at an adjacent building. Further, a virus is quite different from any of these other causes. The policy's terms reinforced that the exclusions were intended to be treated differently. The court refused to "import an 'onsite' or 'contamination' restriction" into the virus exclusion.

A number of courts, after finding that the plaintiff failed to meet its initial burden of proof as to the existence of direct physical loss or damage, have nonetheless considered the effect of a policy exclusion on the plausibility of a plaintiff's claim.

In *Newchops Restaurant Comcast LLC v. Admiral Indemnity Co.*, 2020 U.S. Dist. LEXIS 238254 (E.D. Pa. 2020), the insured restaurant claimed a loss of business income after it complied with civil orders that closed all dine-in facilities, but allowed takeout, delivery, and drive-through service. Admiral denied coverage under both the business income and civil authority coverages. The court first focused on the shared coverage requirement of damage to property by a covered cause of loss. The court explained that under either coverage, the damage must be physical. Under civil authority coverage, the order prohibiting access to the insured premises must be issued in response to "a physical condition in a nearby property," and loss of a particular type of use of the property was neither physical nor structural. Likewise, the mere possibility that the virus was present in a nearby property did not satisfy

the physical damage requirement. Since there was no damage to the insured premises that required it be repaired, rebuilt, or replaced there was no coverage under the business income coverage either. Newchops failed to state a plausible claim.

In response to the insured's argument that the civil orders were a covered cause of loss, the court found that the civil orders could not constitute a covered cause of loss under either coverage. The shutdown orders were not issued in response to damage to any property. The orders were enacted in response to COVID to stop the spread of the virus, which Newchops actually asserted in its amended complaint. The court stated "the civil authority action cannot be both the cause of that damage and the response to it." The court went on to address the policy's virus exclusion, which used the standard ISO exclusionary language. The court explained that even if the insured had stated a loss under either the business income or civil authority coverage, the virus exclusion would bar coverage. The court found that the exclusion was clear and unambiguous. The court concluded:

> The insureds have not stated a claim for coverage under the civil authority or the business income provisions. They have not alleged losses caused by a "covered cause of loss." Even if the insureds had met their burden of establishing coverage under either or both of these provisions, the virus exclusion precludes coverage. Therefore, we shall grant the motions to dismiss with prejudice.

The vast majority of courts have found the virus exclusions to be clear and unambiguous. Many courts have held, regardless of the issue of physical loss or damage, COVID claims are not covered because of the virus exclusion.

CONCLUSION

Whether because of a lack of direct physical loss or direct physical damage, or the application of a virus exclusion, most courts that have considered these issues have found that COVID loss of income claims are not covered under either commercial property or business owners policies. These claims are, however, in their infancy. A handful have survived defense motions to dismiss and the outcome of those cases remains to be seen.