COVID-19 Claims May Survive Insurers' Physical Loss Defense

By **Mark Packman and Jason Rubinstein** (September 1, 2020)

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The policyholders in lawsuits by restaurants and others seeking insurance coverage for income they've lost from the coronavirus pandemic have largely relied on the business interruption provisions of their policies.

As the name implies, these provisions generally obligate insurers to reimburse policyholders for lost income due to an interruption in the policyholders' businesses. The interruption must generally result from a direct physical loss to the policyholder's property. Insurers have argued that this language means there must be either a destruction of, or at least a tangible physical alteration to, the policyholder's property.

Because COVID-19 does not destroy or tangibly alter the structure of property, the insurers have asserted there is no coverage for claims arising from the pandemic.

Initial decisions on this issue broke the insurance industry's way. But the litigation of disputes has barely begun. There is significant evidence to suggest there are many legal paths available to plaintiffs as they struggle with losses related to COVID-19. We explore the findings and implications to date.

In Gavrilides Management Co. LLC v. Michigan Insurance Co., believed to be the first ruling on the availability of business interruption insurance for a COVID-19 claim, Michigan trial court Judge Joyce Draganchuk dismissed the claims of two restaurants against their insurer.[1] The plaintiff was seeking $650,000 for losses it suffered after the state issued executive orders in March that suspended the normal business operations of the two restaurants.

Judge Draganchuk reasoned that the restaurants' policy required direct physical loss to trigger business interruption coverage and that direct physical loss means tangible physical damage to the integrity of the insured property. Here, she said, "The complaint here does not allege any physical loss of or damage to the property" or any alteration of the physical integrity of the property.

Indeed, the plaintiff denied that coronavirus ever was present on the property. In the judge's view, the allegation of lost business caused by shutdown orders constituted only a claim of lack of access to, or use of, the insured property, which, she held, did not constitute direct physical damage. Accordingly, she granted summary disposition to the insurer, without leave to amend the complaint.

Two recent decisions have reached similar results.

First, in Diesel Barbershop LLC v. State Farm Lloyds, the U.S. District Court for the Western District of Texas dismissed claims by barbershop policyholders that their policies covered income lost due to shutdown orders issued to respond to the pandemic.[2] The policies covered property damage arising from accidental direct physical loss, but excluded coverage for losses arising from a virus, even if the virus was only a partial or concurrent cause of the loss.

The policies also covered income lost by the policyholders as the result of an order by a civil authority that prevented access to the policyholders' properties, so long as the order was necessitated by direct physical loss to the property of another.

Based on this language, the barbershops contended that shutdown orders by the governor of Texas and authorities in Bexar County, Texas (where San Antonio is located), triggered coverage under the policy. The insurer denied coverage, arguing that the barbershops' losses did not result from direct physical loss and that, even if they did, the virus exclusion barred coverage.

Ruling in favor of the insurer, the court held that the barbershops had failed to plead a direct physical loss. The court acknowledged that "some courts have found physical loss even without tangible destruction" or physical damage to the covered property.[3] Nonetheless, the court found that "the line of cases requiring tangible injury to property are more persuasive here and that the other cases are distinguishable."[4]

The court went on to hold that, "even if [it] found direct, physical loss to the Properties, the Virus Exclusion applies and bars Plaintiffs' claims."[5] The court took note of the policyholders' argument that the immediate cause of the barbershops' lost income was the shutdown orders and that there was no allegation that the virus itself was present at any of the policyholders' properties.

But the court was persuaded that the shutdown orders would not have been issued but for the presence of the virus in the community and therefore the virus was at least a partial cause of the loss sufficient to trigger the exclusion.[6] The court therefore granted the insurer's motion to dismiss.

Second, in Rose's 1 LLC et al. v. Erie Insurance Exchange, the Superior Court of the District of Columbia, Civil Division granted summary judgment to insurers on business interruption claims brought by a group of restaurants that were forced to shut down because of the pandemic.[7]

The restaurants asserted that they were covered under policy provisions that insured against direct physical loss and obligated Erie to pay for loss of income stemming from partial or total interruption of business resulting directly from loss or damage to insured property. The insurers responded that no direct physical loss had occurred. The court agreed with the insurers.

The court reasoned that a physical loss had to be one that affected the material or tangible structure of the insured properties.[8] Because there was "no evidence that COVID-19 was actually present on the insured properties" and the shutdown orders did not have any effect on their structures, the court found no physical loss under the policies.[9]

The court relied on cases that had rejected business interruption coverage where there was no direct physical harm to the insured premises, i.e., material physical damage to the properties, rather than the loss of use resulting from shutdown orders.[10] Accordingly, the court concluded, there was no coverage for the restaurants.[11]

However, the insurance industry's efforts to present these rulings as a silver bullet to COVID-19 claims are likely premature. A recent federal court decision out of the U.S. District Court for the Western District of Missouri[12] illustrates the differing approaches courts will take to coverage for COVID-19 claims and demonstrates that we are only in the

opening rounds of what is sure to be an extended and evolving battle. Results will surely vary based on the specific facts of the claim, the specific policy language, and the jurisdiction where claims are decided.

In completely rejecting the insurer's motion to dismiss, the court took an approach more consistent with the policy language, Missouri law, and insurance policy rules of construction. In Studio 417 Inc. v. The Cincinnati Insurance Company, the plaintiffs were operators of hair salons and restaurants that had purchased all-risk property insurance policies.

The court correctly noted that "[a]ll-risk policies cover all risks of loss except for risks that are expressly and specifically excluded."[13] Like many property policies, the policies included a building and personal property coverage form and business income (and extra expense) coverage form.

The policies provided coverage for "direct 'loss' unless the 'loss' is excluded or limited" therein.[14] A covered cause of loss was defined as "accidental [direct] physical loss or accidental [direct] physical damage."[15] The policies failed to define "physical loss" or "physical damage." The policies also did not include any virus or communicable disease exclusion.

In general, the plaintiffs alleged that it was likely that customers, employees, and/or visitors to the insured properties were infected with COVID-19 and, consequently, the properties were infected with the virus.[16] The plaintiffs also alleged that COVID-19 "is a physical substance," that it "live[s] on" and is "active on inert physical surfaces," and is "emitted into the air."[17]

Furthermore, the plaintiffs alleged that the presence of COVID-19 "renders physical property in their vicinity unsafe and unusable," and that they "were forced to reduce business at their covered premises."[18] Finally, the court noted that, like most jurisdictions, in response to the pandemic, civil authorities in Missouri and Kansas had issued orders that required suspension of plaintiffs' businesses.

The insurer's overarching argument for denying coverage under each provision of the policy was that the policies provided coverage "only for income losses tied to physical damage to property, not for economic loss caused by governmental or other efforts to protect the public from disease."[19]

The court rejected the insurer's argument and held that plaintiffs adequately alleged a direct physical loss under the policies.[20]

First, the court found that plaintiffs' allegations that COVID-19 (1) is a physical substance that lives on and is active on inert physical surfaces, and (2) is emitted into the air and attached to and deprived plaintiffs of their property by making it unsafe and unusable alleged a direct physical loss.[21]

Second, the court found that the insurer conflated "loss" and "damage" in arguing that the policies require a tangible, physical alteration.[22]

Third, the court found support for its conclusion that plaintiffs had adequately stated a claim in the case law.

In support of its holding, the court not only relied on decisions from the U.S. Court of Appeals for the Eighth Circuit and the U.S. District Court for the Eastern District of Missouri,

but also cases out of the U.S. Court of Appeals for the Third Circuit, the U.S. District Court for the District of Oregon and U.S. District Court for the District of Minnesota.[23]

Although the Studio 417 order is only at the motion to dismiss stage, discovery will progress. This is a significant victory for policyholders and demonstrates that the coverage battle for COVID-19-related claims is only in its infancy, will depend significantly on the factual specifics of the claim and policy language, and will vary by jurisdiction based on applicable precedential case law.

For example, one of the factors that seemed important to the courts in the cases discussed above was whether the policyholders alleged that the coronavirus was physically present on their premises. In Gavrilides, Diesel and Rose's, the courts all relied in part on the fact that there was no allegation that the virus was actually found on the policyholders' properties. In Studio 417, by contrast, the policyholder alleged that the virus had likely physically infected the restaurant.

Moreover, not all property insurance policies have the same language. What type of loss the policy requires, whether it defines the terms "loss" and "damage," and whether there is a virus exclusion — and, if so, what it says — will all influence a court's ultimate determination of whether there is coverage, and if so, to what extent.

Finally, it is important to note that case law varies from state to state. There are, to be sure, decisions that have been read to require some sort of alteration to the physical structure of a property for a direct physical loss.[24] But there are numerous other cases holding that no such alteration is necessary.

To take just one example, the U.S. District Court for the District of New Jersey, in ruling for the policyholder in Gregory Packaging Inc. v. Travelers Property Casualty Co., observed that "courts considering non-structual property damage claims have found that buildings rendered uninhabitable by dangerous gases or bacteria suffered direct physical loss or damage."[25]

For this reason as well, policyholders, insurers and counsel should all think twice before assuming that any decision is dispositive of the issues of coverage for coronavirus claims.

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[1] Gavrilides Management Co. LLC v. Michigan Insurance Co., No. 20-258-CB-C30 (Mich. Cir. Ct. July 1, 2020) (available on YouTube at https://www.youtube.com/watch?v=Dsy4pA5NoPw&feature=youtu.be).

[2] Diesel Barbershop LLC v. State Farm Lloyds, No. 5:20-CV-461-DAE (W.D. Tex. Aug. 13, 2020).

[3] Id. at 12, 13.

[4] Id. at 13.

[5] Id. at 18.

[6] Id. at 15–18.

[7] Rose's 1 LLC v. Erie Insurance Exchange, No. 2020-CA-0024B, (D.C. Super. Aug. 6, 2020).

[8] Id. at 5.

[9] Id.

[10] Id. at 7–8.

[11] Id. at 10.

[12] Studio 417, Inc. v. The Cincinnati Insurance Company, Case No. 6:20-cv-03127-SRB.

[13] Id. at 2.

[14] Id.

[15] Id.

[16] This allegation is in direct contrast to the allegations in the Michigan case discussed above in which the policyholder alleged that "a[t] no time has COVID-19 entered the Soup Shop of the Bistro ... and in fact, states that it has never been present in either location." Gavrilides Mgmt. Co. LLC v. Michigan Ins. Co., Case No. 20-258-CB (Ingham County, Mich. July 1, 2020), Doc. No. 37-2, p. 21.

[17] Id. at 4.

[18] Id.

[19] Id. at 5.

[20] Id. at 8.

[21] Id.

[22] Id. at 9.

[23] Id. at 9–10.

[24] For example, the court in Gavrilides read Dickie Brennan & Co. v. Lexington Insurance Co., 636 F.3d 683, 686 (5th Cir. 2011), and United Air Lines, Inc. v. Insurance Co. of State of PA, 439 F.3d 128, 134 (2d Cir. 2006), in this manner.

[25] Gregory Packaging, Inc. v. Travelers Prop. Cas. Co., 2014 WL 6675934, at * 6 (D.N.J. Nov. 25, 2014).