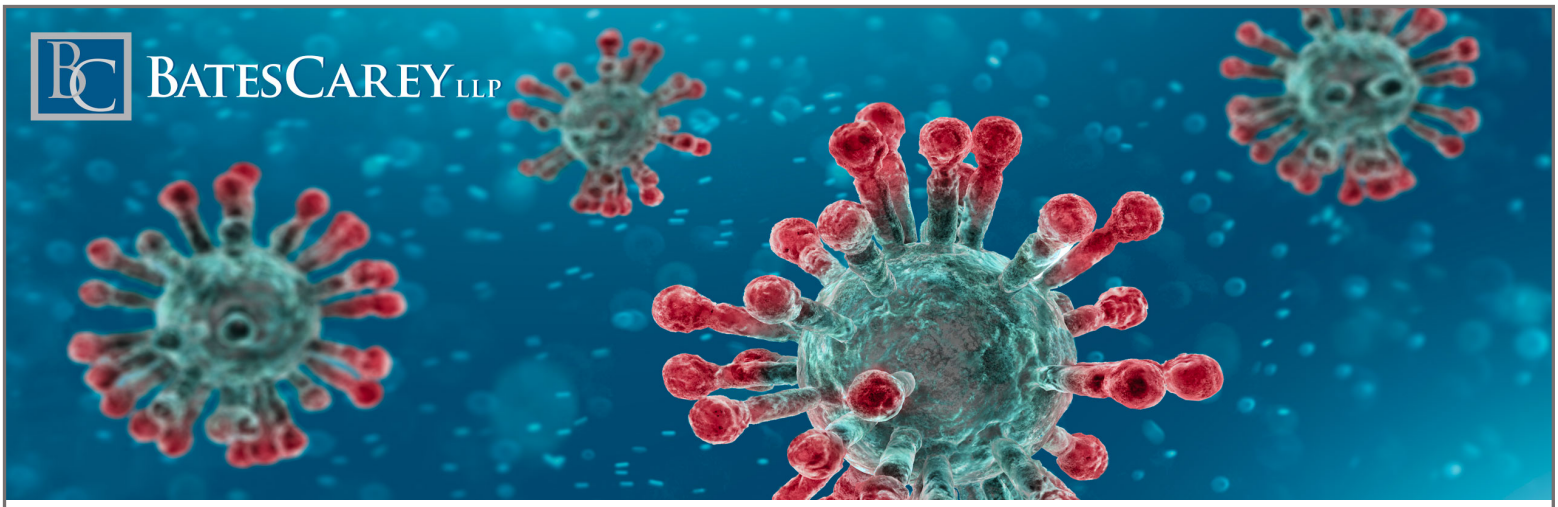

COVID-19 Team Update September 3, 2020

Recent Rulings Expose Flaws in COVID-19 Business Interruption Claims

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The coronavirus pandemic and broad government orders intended to slow its spread have been tragic for the global economy as a whole and for commercial policyholders in particular. Those policyholders have creatively turned to the insurance industry in an attempt to recoup their losses by arguing that the reason they've restricted business operations is because their commercial property has suffered direct physical loss or damage, like a flood, fire, theft or precarious structural defect. However, the insurance policies now being scrutinized by courts across the country are governed by their plain and unambiguous provisions dictating that government restrictions on use do not constitute a "direct physical loss" requiring repair or replacement of any commercial property. Courts have recognized that the world-wide health precautions causing business losses are simply not emanating from any physically or directly changed conditions within the four walls of an insured location.

The increasing volume of state and federal decisions addressing these claims have recognized that even creatively pled COVID-19 claims simply do not factually, legally or logically meet the requirements for the coverages routinely made available through commercial property policies. At the present time, there have been seven such rulings that build upon this fundamental reality.

The first such ruling, issued by the Southern District of New York in *Social Life Magazine, Inc. v. Sentinel Ins. Co., Ltd.*, Cause No. 1:20-cv-03311-VEC (S.D.N.Y. May 14, 2020), denied an insured's motion for preliminary injunction finding that it had not demonstrated a probability of success on the merits. The court acknowledged the prevalence of COVID-19 in the community and the fact that even plaintiff's principal had contracted the disease but noted that neither constituted a factual predicate that COVID-19 had actually damaged property at the premises, which then caused a suspension of operations. The court explained that "what has caused the damage is that the governor has said you need to stay home. It is not that there is any particular damage to your specific property." The court concluded:

> I feel bad for your client. I feel bad for every small business that is having difficulties during this period of time. But New York law is clear that this kind of business interruption needs some damage to the property to prohibit you from going. . . . this (pandemic) is just not what's covered under these insurance policies.

A Michigan state court was the next to weigh in, granting summary disposition for an insurer where the insured did not, and could not, allege that the insured property sustained physical damage as a result of the coronavirus. See *Gavrilides Management Co. v. Michigan Insurance Company,* Case 20-258 CB (Ingram County, Mich. July 1, 2020). The court noted that "[t]he complaint here does not allege any physical loss of or damage to the property. The complaint alleges a loss of business due to executive orders shutting down the restaurants for dining in the restaurant due to the Covid-19 threat."

The recognition that COVID-19 business restrictions are truly unrelated to any changed, altered, lost or damaged commercial property was explained clearly in *Rose's 1 v. Erie Ins. Exchange,* Case. No. 2020 CA 002424 B (Sup. Ct. D.C. Aug. 6, 2020). The Superior Court of the District of Columbia granted the insurer's motion for summary judgment, finding that direct physical loss and direct physical damage require a material alteration of the insured property. The factual predicate of true lost or damaged property at the insured premises was of course absent, given the reality that no such loss or damage was the reason for suspended operations. The court noted the obvious cause of the insured's loss was the government orders which did not have any effect on the material or tangible structure of the properties.

Similarly, in *The Inns By The Sea v. California Mutual Ins. Co.*, Case No. 20 CV 001274 (Sup. Ct. for County of Monterey, CA Aug. 6, 2020), the court noted at oral argument that "[w]hen the Governor ordered us all to shelter in place and businesses to close, it wasn't necessarily because there was COVID at your hotels. It was (due to) a fear that by having people move around the state, that that would cause us all to infect each other." The court followed by granting demurrer without leave to replead "on the grounds that the allegations fail to state facts sufficient to constitute a cause of action."

In *Diesel Barbershop, LLC v. State Farm Lloyds*, Case No. 5:20-CV-461-DAE (W.D. Tex Aug. 13, 2020), Dkt. 29, the United States District Court for the Western District of Texas granted an insurer's motion to dismiss. The court was persuaded by the majority line of cases interpreting direct physical loss or damage as requiring tangible injury to property, which of course is not the reason for any of the COVID-19 governmental orders. Moreover, the court held in the alternative that the policy's virus exclusion – preceded by anti-concurrent causation language – would preclude coverage even if the insured could adequately allege direct physical loss of or damage to covered property. See *also Martinez v. Allied Ins. Co.*, Case NO. 2:20-cv-00401 (M.D. Fla. Sept. 2, 2020) (granting insurer's motion to dismiss because cause of insured's loss was coronavirus, which was an excluded cause of

loss, and noting that "formulaic recitation of the elements of a cause of action will not do" to defeat a motion to dismiss).

Late August saw two more federal courts acknowledging that business income losses due to governmental COVID-19 restrictions simply do not constitute a claim for "direct physical loss" or property in need of repair or replacement, as is the foundation of commercial property coverage. In *Malaube, LLC v. Greenwich Ins. Co.*, Case No. 20-22615 (S.D. Fla. Aug. 26, 2020), the policyholder sought coverage for business income losses after it was forced to curtail its restaurant operations and close on-site dining in compliance with executive orders issued by the governor of Florida. The court relied upon a long line of cases holding that direct physical loss and direct physical damage require some physical alteration of insured property. Importantly, the court tied the legal analysis to the architecture of the insurance policy as a whole. Specifically, the concept of "repair" or "replacement" of lost or damaged property was referenced through the policy, including in the provision defining the measurement of the period of restoration that provides the framework for recovery for such losses. Without any factual predicate of "direct" and "physical" loss of property that caused the suspended operations, the complaint required dismissal.

On August 28, 2020, the United States District Court for the Central District of California granted another insurer's motion to dismiss in *10E, LLC v. Travelers Indemnity Co. of Connecticut*, 2:20-CV-04418 (C.D. Cal. Aug. 28, 2020), finding that the insured did not plausibly allege any factual predicate for direct physical loss or damage to any property that was the cause of any civil authority orders. The court relied upon California law, which the court understood as interpreting "direct physical loss of or damage to property" to require a "distinct, demonstrable, physical alteration." The court acknowledged that, even if permanent physical dispossession of insured property could constitute "direct physical loss of or damage to" that property, the COVID-19 orders simply did not result from or cause any permanent physical dispossession of property.

On September 2, 2020, the court issued a clarification *sua sponte*, adding that the civil authority coverage did not apply because the plaintiff alleged only generally that the physical action of the coronavirus stays on surfaces but did not "allege actual cases of direct physical loss of or damage to property at other locations. At most, the [complaint] points to a mere possibility." In dismissing the case, the court noted that the complaint simply "asserts without any relevant detail that the 'property that is damaged is in the immediate area of the Insured Property.'" The complaint, the court continued, "does not describe particular property damage or articulate any facts connecting the alleged property damage to restrictions on in-person dining. These allegations do no more than paraphrase the language of the policy without specifying facts that could support recovery under the policy."

To date, the only ruling favorable to policyholders is *Studio 417, Inc. v. Cincinnati Insurance Company*, Case No. 20-CV-03127 (W.D. Mo. Aug. 12, 2020), in which the United States District

Court for the Western District of Missouri denied an insurer's motion to dismiss. In doing so, the court took the unusual approach of finding that allegations that the virus was "likely" present in the community, including at the insured premises, could conceivably have impacted the full use of certain commercial property, which conceivably could be a "direct physical loss." The court found that, even though there was no factual predicate of actual contamination of any particular property at any location, the conclusory allegations that the coronavirus is a physical substance, that it can live and is active on surfaces and was likely present at the insured premises, was enough to survive a motion to dismiss. The court seemed unmoved by the recognition of other courts that some type of actual, physical property loss or damage is required to defeat a motion to dismiss and that the factual predicate alleged must also have been the alleged cause of the suspended operations, which simply was not the case in *Studio 417* or the other cases discussed above.

The rulings described above highlight the fundamental mismatch between the COVID-19 business interruption claims and the coverage provided by a commercial property insurance policy. The time element coverages revolve around the existence of direct physical loss or direct physical damage to property, which requires repair or replacement during a period of restoration. The actual or suspected exposure of insured property to the coronavirus does not constitute either "direct" or "physical" "loss" or "damage" to property. The artful pleading some litigants have employed – alleging likely or probable contamination of insured property by the coronavirus – draws attention to the fact that the emperor has no clothes.

Unable to allege in good faith that property has actually been infected or contaminated by the coronavirus on some certain date and that this has indeed caused the suspension of operations, litigants have couched their allegations in terms of likelihood, probability and the general prevalence of coronavirus in the community. Such allegations turn commercial property insurance policies on their head, given that there is no coverage for the likelihood or probability that maybe there was asbestos in the location in the past, or maybe there was a flood or fire, or maybe there could've been fumes within the premises that caused a shut down in the past. The motion to dismiss process is centered on prohibiting the litigation of just such factually empty claims, rather than allowing years of litigation premised upon them.

The reality is that many business income losses which would not have occurred but for the pandemic are the direct result **not** of the physical presence of the coronavirus at any particular location, but rather the government orders that have hampered economic activity in an attempt to prevent the spread of the coronavirus. The resulting business income losses are real, substantial and tragic. But this of course does not make them the result of a direct physical loss of or direct physical damage to property that is the subject of commercial property coverage.

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