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## **Pandemic of Coverage Litigation for Business Income Losses Due to Coronavirus Plagues Insurance Industry**

Charles S. LiMandri, Milan L. Brandon, and Noel J. Meza

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## Pandemic of Coverage Litigation for Business Income Losses Due to Coronavirus Plagues Insurance Industry

Charles S. LiMandri, Milan L. Brandon, and Noel J. Meza

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### Introduction

As businesses across the nation scramble to find ways to survive this COVID-19 pandemic, many are realizing that their lost business income should be covered under their business insurance policies and are filing claims seeking the coverage to which they are entitled. These policies generally provide for "Business Interruption" coverage. In fact, a California restaurant owner—renowned chef Thomas Keller—did precisely that. On March 25, 2020, he filed a lawsuit in Napa County Superior Court.<sup>1</sup> The complaint seeks declaratory relief from the court that his insurance policy provides: (1) civil authority coverage for closures of restaurants in Napa County due to physical loss or damage from the coronavirus; and (2) business income coverage in the event that the coronavirus has caused loss or damage to the insured premises or the immediate area of the insured

premises.<sup>2</sup> Mr. Keller argues that "the order has caused a shutdown of [his] business operations, and access to [his] property has been specifically prohibited."<sup>3</sup> An increasing number of other businesses across the U.S. have followed suit.<sup>4</sup> Nationally, the American Property Casualty Insurance Association estimates business income losses for small businesses with 100 or fewer employees to be \$225–431 billion per month.<sup>5</sup>

Business owners reading this article should consider and determine whether they, too, have coverage for lost business income. This article argues that business owners who have business interruption insurance coverage have strong arguments for such coverage and should be entitled to compensation for their lost business income. Although this article focuses primarily on California law, the legal principles discussed are generally applicable across the nation.

1. See Complaint at 6, *French Laundry Partners LP et al. v. Hartford Fire Insurance Co.* (Cal. Super. Ct., Napa Cty. Mar. 25, 2020).

2. *Id.*; see also Jason Schossler, *Famed Restaurateur Sues Insurer for Coronavirus Coverage*, 30 No. 27 WESTLAW J. INS. COVERAGE 04 (2020).

3. *Business Interruption Insurance—Cal. Super.: Restaurant Files Suit to Recover Business Losses Due to COVID-19 Shutdown*, Ins. L. Rep. (CCH), 2020 WL 1847839.

Part 1 provides a summary of the nature of business interruption coverage and civil authority coverage, in addition to discussing what must be established by business owners for each coverage to apply. Part 2 argues that California business owners should be able to satisfy the “physical loss” requirement in order to trigger coverage because such business owners have suffered a “loss of use” of their business. In particular, this part analyzes how courts define and interpret policy language in business interruption and civil authority coverage provisions—such as the definition applicable to the “physical loss or damage” requirement. This part also distinguishes unfavorable California cases that insurers are likely to cite in support of their anticipated arguments that such coverages do not apply. Part 3 argues how California business owners can satisfy the “physical damage” requirement for coverage to apply. This part also discusses how the definition of “*property* damage” can be used to define and give meaning to and inform the interpretation of the “*physical* damage” definition so that coverage can be obtained. Part 4 explains why and how “virus exclusions” may be unenforceable and invalid under certain circumstances, and, as such, cannot preclude coverage for coronavirus-caused losses. Part 5 examines additional potential legal theories that business owners should consider and study carefully, including estoppel by omission, broker-agent liability, and “illusory coverage” claims against insurance companies.

## I. What is “Business Interruption” and “Civil Authority” Insurance Coverage?

The following section provides a summary and explanation of the nature of two distinct insurance coverage provisions under which insureds may seek recovery for coronavirus-related business losses: business interruption and civil authority. Sections (1) and (2) summarize, respectively, what business interruption coverage and civil authority coverage are, as well as what conditions must be met in order for these coverages to trigger and apply. Section (3) additionally discusses important considerations about these coverages that attorneys and business owners need to confront, specifically regarding issues surrounding the “period of restoration,” limits on loss amounts, and the duration of coverage.

### 1. Business Interruption Coverage<sup>6</sup>

“Business Interruption” coverage—also called “Loss of Business Income” coverage—generally covers “losses from ‘loss of business income’ resulting from damage to or destruction of the insured property from a covered peril (sometimes worded as ‘suspension of operations’ at the insured premises).”<sup>7</sup>

Business interruption policy language is not always standardized.<sup>8</sup> For example, almost all policies require that there be a “suspension” or “interruption” to the insured’s business operations<sup>9</sup>. However, policies differ on how “suspension” or “interruption” are defined. Some policies require a complete suspension of business operations—not merely a

4. See, e.g., *Caribe Rest. & Nightclub, Inc. v. Topa Ins. Co.*, No. 20-CV-03570, 2020 WL 1902927 (C.D. Cal. Apr. 17, 2020) (class action suit in California); *El Novillo Restaurant et al. v. Certain Underwriters at Lloyd’s London*, No. 20-CV-21525, 2020 WL 1845908 (S.D. Fla. Apr. 9, 2020) (class action suit in Florida federal court); *Chickasaw Nation Dep’t of Commerce v. Lexington Ins. Co.*, No. CV-20-35, 2020 WL 1684037 (Okla. Dist. Ct., Pontotoc Cty. Mar. 24, 2020) (Native American Tribe’s suit against insurers in Oklahoma state court in connection with the closure of their casinos); *Choctaw Nation of Okla. v. Lexington Ins. Co.*, 2020 WL 1683947 (Okla. Dist. Ct., Bryan Cty. Mar. 24, 2020) (same); *Cajun Conti LLC v. Certain Underwriters at Lloyd’s, London*, No. 2020-02558, 2020 WL 1298797 (La. Dist. Ct., Orleans Parish Mar. 16, 2020) (New Orleans restaurant lawsuit); *Complaint, Big Onion Tavern Grp. LLC v. Soc’y Ins., Inc.*, No. 20-CV-2005, 2020 WL 1502819 (N.D. Ill. Mar. 27, 2020) (lawsuit by group of Chicago-based movie theaters and restaurants alleging that “the continuous presence of the coronavirus on or around Plaintiffs’ premises has rendered the premises unsafe and unfit for their intended use and therefore caused *physical property damage or loss* under the Policies” and arguing that the Illinois Governor’s executive order closing all non-essential businesses, including restaurants and movie theaters “prohibited the public from accessing Plaintiffs’ restaurants, thereby causing the necessary suspension of their operations and triggering the *Civil Authority* coverage under the Policies”) (emphasis added).

5. See Eileen Gilligan, *APCIA Releases New Business Interruption Analysis*, AM. PROP. CAS. INS. ASS’N (Apr. 6, 2020), <http://www.pciaa.net/pciwebsite/cms/content/viewpage?sitePageId=60052>.

slowdown or reduction in operations. On the other hand, other policies may define “suspension” to include a slowdown of business activities.<sup>10</sup> Similarly, some policies “may also provide coverage for ‘extra expense’ (e.g., relocation costs, increased labor costs) incurred by the insured in an effort to mitigate the business interruption and continue its operations” whereas other policies will not.<sup>11</sup>

However, in spite of these differences, business interruption coverage generally has certain basic “uniform” requirements that need to be met in order for coverage to apply.<sup>12</sup> Most business interruption coverage provisions generally at least require business owners to establish six elements: (1) physical loss or damage; (2) to covered property; (3) caused by a covered peril during the policy period; (4) resulting in an actual loss of income; (5) due to “necessary suspension of operations”; and (6) during the period of restoration.<sup>13</sup>

The first element promises to be the subject of much litigation, and thus this article carefully examines the physical loss or damage requirement. In other words, we will ask what a California business owner needs to establish in order to meet the “physical loss or damage” requirement so that business

interruption coverage will apply. As a threshold matter, it is important to note, as explained above, that policy language will vary as to the “physical loss or damage” requirement. Some policies may require “physical loss or damage,” others require only “physical loss,” and, yet, others only require that a “covered loss” occur. Parts 2 and 3 of this article will argue that, regardless of how this element is phrased by a given policy, this element can be met and that such an argument is supported by case law and rules of policy interpretation.

## 2. Civil Authority Coverage

Many business interruption policies provide for “Civil Authority” coverage. “Civil Authority” coverage protects “against income losses suffered when access to the insured’s property is cut off.”<sup>14</sup> The language of civil authority coverage provisions is much less standardized than general “Business Interruption” coverage provisions. Because of this lack of standardization, business owners must closely, critically, and carefully read their policies to determine what conditions are required for civil authority coverage to trigger and apply.

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6. “Business interruption” coverage should not be confused with “contingent business interruption” coverage (also called “dependent property” coverage). Contingent business interruption covers lost business income caused by “physical loss or damage” to the property of a business owner’s supplier or customer. See JOHN K. DIMUGNO & PAUL E.B. GLAD, CALIFORNIA INSURANCE LAW HANDBOOK (2020) § 65A:3. On the other hand, business interruption coverage generally covers physical loss or damage to the *business owner’s* insured business property. The difference, therefore, is “in the identity of the property that suffers physical damage.” *Id.* Contingent business interruption insurance coverage is for business owners who have lost income because their suppliers are unable to provide them with products, goods, or materials due to coronavirus-caused physical loss or damage to the supplier’s building. For example, after the coronavirus outbreak, China’s exports to the United States dropped by 27.7% in January and February 2020. See Simina Mistreanu, *COVID-19 To Further Dampen U.S.-China Trade*, FORBES (Mar. 13, 2020, 1:46 a.m.), <https://www.forbes.com/sites/siminamistreanu/2020/03/13/covid-19-to-further-dampen-us-china-trade>. U.S. businesses whose operations were “contingent” and “depending” on these Chinese suppliers and who have lost business income may have a valid “contingent business interruption” coverage claim. However, insureds should carefully review their policies to make sure that their claim meets the requirements for such coverage to apply. Furthermore, for manufacturers depending on receiving parts manufactured in China and who have a valid “contingent business interruption” coverage claim, their restoration period may be longer because they had to shut down sooner. Such longer restoration periods may potentially increase their recoverable amount.

7. 1 H. WALTER CROSKEY ET AL., CALIFORNIA PRACTICE GUIDE: INSURANCE LITIGATION ¶ 6:258 (The Rutter Group 2019).

8. See JOHN K. DIMUGNO & PAUL E.B. GLAD, CALIFORNIA INSURANCE LAW HANDBOOK (2020) § 65A:3.

9. See *id.*

10. See 1 CROSKEY ET AL., *supra* note 7, ¶¶ 6:266–267.

11. 1 *id.* ¶ 6:270.

12. See DIMUGNO, *supra* note 8, § 65A:3 (“The language of the policy’s insuring agreement also varies although elements of coverage are relatively uniform.”).

13. See DIMUGNO, *supra* note 8, § 65A:3 (noting that business interruption provisions “uniformly require” these six elements).

14. DIMUGNO, *supra* note 8, § 65A:12 (“Civil Authority coverage requires an order of civil authority to trigger coverage.”)

Civil authority provisions often have different requirements and conditions for coverage to trigger and apply. For example, some policies require that access to the insured's property be "prevented or prohibited by an order of civil authority issued as a direct result of *physical damage*," while other policies require that the order be issued as a result of *physical loss or damage*.<sup>15</sup> Furthermore, [s]ome policies require that [the] civil order prohibit access to insured property due to *damage to 'adjacent properties'* while other policies require only that the physical damage occur to property other than the insured premises."<sup>16</sup>

However, although the language in these provisions varies from policy to policy, civil authority coverage provisions do have some common and basic requirements that must be met in order for coverage to generally trigger: (1) the lost business income must be caused by an order of civil authority that prohibits access to the described property; and (2) the order of civil authority must be issued as a result of physical loss or damage to property other than the insured property.<sup>17</sup>

Furthermore, for civil authority coverage to typically apply, the business owner's business operations must generally be suspended. However, as explained above, "suspension of operations" can have different meanings. Just like business interruption provisions, some civil authority provisions expressly require that there be a "*temporary, but complete, cessation*

*of activity*."<sup>18</sup> Where such language is present, if there is merely a slowdown or reduction in operations, there is no coverage.<sup>19</sup> Similarly, there is no coverage for a suspension or interruption of a particular project if the business as a whole continues.<sup>20</sup>

Other policies do not require a complete cessation, interruption, or suspension of operations. Under these civil authority provisions, coverage should be found even if business owners merely cut their operations and do not completely shut down. Such language would apply to restaurants who allow customers to order food for "take-out" but were forced to close their dining rooms. Yet other policies may define "suspension" to include both a complete interruption *and* a slowdown of business operations.<sup>21</sup>

### 3. Period of Restoration and Limits on Loss Amounts and Duration of Coverage

California business owners need to pay close attention to the limitations, conditions, and exclusions applicable to their business interruption and civil authority coverage provisions. Some policies specify or limit in advance the recoverable *loss amount* to a certain sum per day or as an agreed upon minimum, "requiring the insured to prove any greater loss."<sup>22</sup> Additionally, insurance policies generally will have a sublimit for these coverages, and there will usually be a deductible, likely measured by a certain number of days of lost income.

15. See, e.g., *Penton Media, Inc. v. Affiliated FM Ins. Co.*, No. 1:03-CV-2111, 2006 WL 2504907, at \*1 (N.D. Ohio Aug. 29, 2006), *aff'd*, 245 F. App'x 495 (6th Cir. 2007) (analyzing a civil authority provision that stated: "This order must be given as a direct result of physical loss or damage from a peril of the type insured by this policy").

16. DiMUGNO, *supra* note 8, § 65A:12 (emphasis added) (citing *United Air Lines, Inc. v. Insurance Co. of State of PA*, 439 F.3d 128 (2d Cir. 2006) (holding that the Pentagon is not "adjacent" to Reagan International Airport for purposes of United Airlines' claim for losses resulting from the FAA's closure of the airport in the wake of the September 11 terrorist attacks)); see also Clark Schirle, *Civil Authority and Ingress/Egress Coverage*, 37 GPSolo Magazine 55 (2020) (noting that civil authority coverage applies when the civil authority order when physical loss or damage occurs "to *other premises* in the proximity of the insured's property") (emphasis added).

17. As a general rule, civil authority coverage does not require physical damage to the insured property, but it does require physical damage somewhere that triggers the government's action. See *supra* note 16. Although less common, there are "Civil Authority" provisions that do not require a nexus between existing property damage and the order of civil authority. For example, a policy form currently in use requires only that the order of civil authority result from "loss, damage or an event" not otherwise excluded. The COVID-19 pandemic arguably qualifies as an "event"—a term the policy does not define.

18. 1 CROSEY ET AL., *supra* note 7, ¶ 6:266.

19. See *id.*

20. See *id.*; see also *Buxbaum v. Aetna Life & Cas. Co.*, 103 Cal. App. 4th 434, 448–49 (2002).

21. See *id.* ¶ 6:267.

22. *Id.* ¶ 6:264.1.

Further, some policies may also limit coverage based on geographic considerations, “providing that the physical damage which triggered the civil authority order has to be to property within a certain number of miles or feet from the insured location.”<sup>23</sup> Similarly, some policies specify or limit the *duration* of coverage, where it is agreed upon in advance that coverage will apply only for a “maximum period of time (e.g., 12 months) during which business interruption losses are covered.”<sup>24</sup> The specific limits for *duration* of coverage may differ for general business interruption coverage and civil authority coverage. For example, many policies specify the duration of general business interruption coverage to be 12 months, whereas these same policies generally limit the duration of civil authority coverage to be a mere 30 days.

The policy’s determination of what constitutes the applicable “period of restoration” may also limit recovery. As discussed above, this definition will vary from policy to policy. Some business interruption provisions limit coverage to the “period of restoration.” The “period of restoration” is generally defined as either the period during which “(1) the property actually has been repaired, rebuilt or replaced, or (2) a reasonable insured exercising due diligence and dispatch should have been able to repair, rebuild or replace the property.”<sup>25</sup>

What constitutes the “period of restoration” in a specific policy can be significant when addressing the differences between business interruption and civil authority coverage. Depending on the language of the policy, under a general business interruption coverage provision, business owners may not have a very long period of restoration. If business owners can convince courts that the coronavirus is a triggering event—as will be discussed and analyzed in the following

sections—their recovery amount may be significantly limited by a very short period of restoration.

Policies also generally incorporate language that requires business owners to undertake “reasonable means” to restore their business to operating condition. Similar to a duty to mitigate, business owners would most likely be obligated to hire a cleaning service to remove the coronavirus from their property in order to restore their operations. The problem is that the period of restoration would be very short because of the ease of cleaning a business property to remove the coronavirus. The cleaning service would most likely not require more than a few days to complete its work even in the largest of facilities. To avoid this dilemma, insureds can and probably should argue that just cleaning the property once would not be sufficient to end the period of restoration. This is because of the highly contagious nature of the coronavirus and the very real risk of recontamination whenever potentially infected people come back in contact with it.

Under civil authority coverage, the period of restoration could last for a much longer period. Assuming that the business owner can prove the governmental order was due to physical damage,<sup>26</sup> the period of restoration would begin when the business was closed by order of civil authorities and end when the order is lifted. Here, the business owner cannot simply hire a cleaning service to clean all the surfaces and remove the coronavirus because doing so would not be sufficient to “restore” business operations—they would still be closed by government decree.

Notwithstanding, the period will likely be limited to the shorter defined period (often 30 days) discussed above. As with all such provisions, a practitioner would be wise to assert that the reasonable

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23. Schirle, *supra* note 16.

24. 1 CROSKY ET AL., *supra* note 7, ¶ 6:264.2.

25. *Id.* ¶ 6:269.5.

26. Proving a causal nexus between the order and existing physical damage should not be difficult. Most shelter in place orders have anticipated this issue and included specific findings that the presence of the COVID-19 virus in buildings physically damages the buildings. For example, the Sonoma County Shelter-in-Place Order No. C19-05 (March 31, 2020) states, “the [COVID-19] virus physically is causing property loss or damage due to its proclivity to stay airborne and to attach to surfaces for prolonged periods of time.” Similarly, the March 19, 2020 (Revised April 1, 2020) “Safer at Home Order issued by the Office of the Mayor, City of Los Angeles, included a “finding” that the order was necessary “because, among other reasons, the COVID-19 virus can spread easily from person to person and it is physically causing property loss or damage due to its tendency to attach to surfaces for prolonged periods of time.”

expectations of the insured must be considered. Further, as noted above, many policies have specific limits for *duration of coverage* that are more favorable for general business interruption coverage and less favorable for civil authority coverage.<sup>27</sup> So, although the *period of restoration* may be more favorable for civil authority coverage, the *duration of coverage* for losses may be more favorable for general business interruption coverage to apply.

In conclusion, distinctions about periods of restoration are important to the amount of the claim and what is recoverable by the business owner. As explained above, the period of restoration for civil authority coverage is much more favorable than the period of restoration for basic business interruption coverage. Furthermore, for civil authority coverage, business owners might not even need to prove the presence of the coronavirus at the insured property—the civil authority order’s findings regarding the prevalent presence of coronavirus in the community may be sufficient. In any event, it is important to note that even if business owners do not need to prove the actual presence of the coronavirus in or at the subject property, business owners still have the burden to prove their “lost profits” with non-speculative evidence of what “the performance of the business would have been had the catastrophe not occurred.”<sup>28</sup> Generally, this requires “specialized accounting and forensic expertise to prove.”<sup>29</sup>

## II. “Physical Loss”: Business Owners Can Satisfy the “Physical Loss” Requirement Because They Have Sustained a Loss of Use of Their Business Property

As discussed above, both business interruption and civil authority coverage generally require that the

business owner’s lost business income result from “direct physical loss or damage.” Although such a term of art is determinative, insurance policies do not normally define “direct physical loss or damage.”<sup>30</sup>

Insurers will argue that “physical loss or damage” requires physical injury or structural alteration to the insured property, as is generally found after fires, earthquakes, floods, and hurricanes or due to a contamination or pollutants.<sup>31</sup> But as we will explain below, California and other jurisdictions have found “physical loss” without finding actual physical damage to the insured property in its popular sense. Instead, courts in California and across the country have held that loss of use of the business property constitutes “physical loss or damage.” Moreover, in addition to loss of use, these same courts have also found “physical loss” where there is loss of access, loss of functionality, loss of value, or un-inhabitability of the insured property. These cases support the argument that business owners who have lost their right to use (i.e., “loss of use”) their business properties because of the coronavirus or the civil authority-ordered business closures is covered by business interruption and civil authority insurance coverage provision.

### 1. Cases That Support a Finding of “Physical Loss” for the Coronavirus

California courts have held that a finding of “physical loss” does not require structural damage or physical alteration to the covered property. In *Cooper v. Travelers Indemnity Company of Illinois*, a health department forced a tavern to close because of water contaminated with *E. coli*.<sup>32</sup> The insured sought business income coverage, but the claim was denied and coverage litigation ensued. The policy required that the suspension of operations “must be caused by

27. For example, many policies specify the duration of general business interruption coverage to 12 months, whereas these same policies generally limit the duration of civil authority coverage to 30 days.

28. DiMUGNO, *supra* note 8, ¶ 65A:1; 1 CROSKY ET AL., *supra* note 7, ¶ 6:269 (citing *Pyramid Technologies, Inc. v. Hartford Cas. Ins. Co.*, 752 F. 3d 807, 822 (9th Cir. 2014) (applying California law)).

29. DiMUGNO, *supra* note 8, ¶ 65A:1.

30. 1 CROSKY ET AL., *supra* note 7, ¶ 6:276.

31. See *infra* Part III, section 4.

32. *Cooper v. Travelers Indem. Co. of Ill.*, No. C-01-2400-VRW, 2002 WL 32775680, at \*1 (N.D. Cal. Nov. 4, 2002), *aff’d*, 113 F. App’x 198 (9th Cir. 2004).



direct physical loss or damage to property at the premises.”<sup>33</sup> The U.S. District Court for the Northern District of California held that E. coli constituted direct physical damage to the property, which triggered the business income coverage. The court also determined that damage to “covered property” was “not required by the terms of the policy to trigger coverage of loss of business income.”<sup>34</sup> In other words, structural or compensable property damage was not required to trigger business interruption coverage. California business owners should make a similar argument: that the coronavirus—like E. coli—constitutes “direct physical loss or damage” to property *even if* it does not cause actual structural alteration or damage to the business owner’s business property. Other California courts are in accord.<sup>35</sup>

California courts have also held that *loss of use* constitutes “physical loss.” For example, in *Total Intermodal Servs. Inc. v. Travelers Prop. Cas. Co. of Am.*, the U.S. District Court for the Central District of California interpreted “direct physical loss of or damage to” as encompassing “loss of use.”<sup>36</sup> There, the insured’s property was lost during shipment but was not physically damaged. The relevant policy language provided coverage for the “direct physical loss of or damage to Covered Property caused by or resulting from a Covered Cause of Loss.”<sup>37</sup> The court analyzed “whether the coverage for ‘direct physical loss’ applies when property is merely lost, or whether it also—or instead—requires that the property be physically damaged.”<sup>38</sup>

The court held that property that was lost but not physically damaged constituted physical loss of insured property. The court ruled that “the phrase ‘loss of’ includes the permanent dispossession of something”<sup>39</sup> and that:

[u]nder an “ordinary and popular meaning,” the “loss of” property contemplates that the property is misplaced and unrecoverable, without regard to whether it was damaged. Furthermore, to interpret “physical loss of” as requiring “damage to” would render meaningless the “or damage to” portion of the same clause, thereby violating a black-letter canon of contract interpretation—that every word be given a meaning. See Cal. Civ. Code § 1641 (“The whole of a contract is to be taken together, so as to give effect to every part, if reasonably practicable, each clause helping to interpret the other.”); *Lyons v. Fire Ins. Exch.*, 161 Cal.App.4th 880, 886 (2008) (insurance policy must be read so “that all words in a contract are to be given meaning”).<sup>40</sup>

California business owners can make the same argument: they have incurred a loss of use and access to their business property and therefore have suffered a physical loss of property, “without regard to whether it was damaged.”

The definition of “property damage” in policies’ liability coverage provisions may also help to establish

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33. *Id.* at \*2.

34. *Id.* at \*5.

35. See, e.g., *Strickland v. Federal Ins. Co.*, 200 Cal. App. 3d 792 (1988) (finding that the insured was entitled to insurance coverage for loss to home other than tangible physical damage caused by landslide, although home had not collapsed or become uninhabitable); *Hughes v. Potomac Ins. Co. of D.C.*, 199 Cal. App. 2d 239 (1962) (Insurance company denied insurance coverage because the “building was not ‘damaged’ so long as its paint remained intact and its walls still adhered to one another.” The court rejected the insurer’s interpretation, noting that a dwelling might be rendered completely useless to its owners even in the absence of physical destruction. The court reasoned that, even though a mudslide did not essentially damage the home, no “rational person” would be “content” to reside in the house after a mudslide.).

36. *Total Intermodal Servs. Inc. v. Travelers Prop. Cas. Co. of Am.*, No. CV 17-04908 AB (KSX), 2018 WL 3829767 (C.D. Cal. July 11, 2018).

37. *Id.* at \*3.

38. *Total Intermodal Servs. Inc. v. Travelers Prop. Cas. Co. of Am.*, No. CV 17-04908 AB (KSX), 2018 WL 3829767, at \*3 (C.D. Cal. July 11, 2018) (applying California law).

39. *Id.* at \*4 (citation omitted).

40. *Id.* at \*3.

a finding of “physical loss”—a term the policy does not define.<sup>41</sup> In *Thee Sombrero, Inc. v. Scottsdale Insurance Co.*, a California appellate court defined “property damage” as a loss of use of tangible property that is “not” physically injured.<sup>42</sup> There, the court wrote: “If your leased apartment was rendered uninhabitable by some noxious stench, you would conclude that you had lost the use of tangible property; and if the lawyer said no, actually you had merely lost the use of your intangible lease, you would goggle in disbelief.”<sup>43</sup> Analogously, many California business owners have “lost the use of tangible property” because their business establishments have been “rendered uninhabitable” by a “physical” coronavirus and a loss of use caused by government-mandated business closures.

Non-California federal appellate decisions provide persuasive arguments for California courts to consider, and these arguments should be made by California business owners.<sup>44</sup> For example, the First, Third, Fourth, and Eighth Circuits have affirmed

decisions by federal district courts finding “direct physical loss” to property without any actual physical structural damage or physical alteration to the insured property.<sup>45</sup> Federal district court cases also support the argument that structural damage is not required.<sup>46</sup> California business owners should cite to these significant federal cases and can argue that the loss of use and loss of access to their business property constitutes “physical loss,” as is required for business interruption coverage to trigger.

Similarly, state supreme courts have found “physical loss” where the building becomes temporarily or permanently unusable or uninhabitable<sup>47</sup> or where the building loses its function, value, or usefulness.<sup>48</sup> California business owners should cite to the state supreme court decisions as persuasive authority to support their arguments. In one particular case, *US Airways, Inc. v. Commonwealth Ins. Co.*, the court held that the government’s order to close airports and halt all flights after the September 11 terrorist attacks triggered civil authority coverage for US Airways’

41. Property damage is more extensively discussed in section (2) below.

42. *See Thee Sombrero, Inc. v. Scottsdale Ins. Co.*, 28 Cal. App. 5th 729, 733 (2018).

43. *Id.* at 738.

44. *See, e.g., Matzner v. Seaco Ins. Co.*, No. CIV. A. 96-0498-B, 1998 WL 566658 (Mass. Super. Aug. 12, 1998) (holding that carbon monoxide levels in an apartment building sufficient to render a building uninhabitable were a “direct, physical loss” and therefore were covered by the policy).

45. *See Essex v. BloomSouth Flooring Corp.*, 562 F.3d 399, 406 (1st Cir. 2009); *Port Authority of N.Y. and N.J. v. Affiliated FM Ins. Co.*, 311 F.3d 226, 235–36 (3d Cir. 2002); *TRAVCO Ins. Co. v. Ward*, 715 F. Supp. 2d 699, 709 (E.D. Va. 2010), *aff’d*, 504 F. App’x 251 (4th Cir. 2013); *In By Dev., Inc. v. United Fire & Cas. Co.*, No. CIV. 04-5116, 2006 WL 694991 (D.S.D. Mar. 14, 2006), *aff’d sub nom. BY Dev., Inc. v. United Fire & Cas. Co.*, 206 F. App’x 609 (8th Cir. 2006).

46. *See, e.g., Oregon Shakespeare Festival Ass’n v. Great Am. Ins. Co.*, No. 1:15-CV-01932-CL, 2016 WL 3267247, at \*9 (D. Or. June 7, 2016), *vacated for other reasons*, No. 1:15-CV-01932-CL, 2017 WL 1034203 (D. Or. Mar. 6, 2017) (holding that structural damage was not required for there to be a loss, and it was a stretch on the part of the insurer to impute that requirement where it was not in the policy and finding coverage for loss of business income because the insured property had to be cleaned, the air filters replaced repeatedly before business could resume, and the air quality had to improve).

47. *See, e.g., Mellin v. N. Sec. Ins. Co., Inc.*, 167 N.H. 544, 546 (2015) (New Hampshire Supreme Court found that the smell of cat urine from neighboring apartment caused direct physical loss and that insureds were not required to demonstrate or prove a “tangible physical alteration” to the insured business property or that the building was rendered permanently uninhabitable; rather, evidence that a change rendered the insured property temporarily or permanently unusable or uninhabitable was sufficient to support a finding that the loss was a covered physical loss to the insured property); *Murray v. State Farm Fire & Cas. Co.*, 203 W. Va. 477, 492–93 (1998) (West Virginia Supreme Court held that “physical loss” occurs when real property becomes “uninhabitable” or substantially “unusable.” The court established that policyholders suffered a “direct physical loss” when their homes were rendered uninhabitable due to the threat of rock fall); *W. Fire Ins. Co. v. First Presbyterian Church*, 165 Colo. 34, 37 (1968) (Colorado Supreme Court held that gasoline vapors in a church building constituted a “direct physical loss” because the building could no longer be occupied or used); *accord Widder v. Louisiana Citizens Prop. Ins. Corp.*, No. 2011-CA-0196, 82 So. 3d 294, 296 (La. Ct. App. Aug. 10, 2011) (“[W]hen a home has been rendered unusable or uninhabitable, physical damage is not necessary. . . In this case, we find the intrusion of the lead to be a direct physical loss that has rendered the home unusable and uninhabitable.”); *Matzner v. Seaco Ins. Co.*, No. CIV. A. 96-0498-B, 1998 WL 566658 (Mass. Super. Aug. 12, 1998) (holding that carbon monoxide levels in an apartment building sufficient to render a building uninhabitable were a “direct, physical loss”).

losses.<sup>49</sup> There, the airport authority (civil authority) ordered Reagan National Airport to close down, and the Federal Aviation Administration (FAA) ordered all airspace to be closed. US Airways filed an insurance claim for business income loss as a result of business interruption caused by the FAA's nationwide ground stop orders and closure of the Reagan National Airport. The court rejected the insurer's argument that the business-interruption policies did not cover the losses.<sup>50</sup>

## 2. Unfavorable Cases Regarding "Physical Loss" Are Distinguishable

### A. Ward General Insurance Services, Inc.

In *Ward General Insurance Services, Inc. v. Employers Fire Insurance Co.*, a California appellate court held that loss of an insured's electronically stored data that occurred when human error caused the database system to "crash" did not constitute physical loss or damage.<sup>51</sup> There, an insured was in the process of updating its computer database when human error caused the database system to "crash," resulting in the loss of the insured's electronically-stored data. The insured claimed losses consisting of data restoration

costs and lost business income resulting from the crash of its database. The insurer made a small payment of \$5,000 but denied the rest of the insured's claim, arguing that none of the other loss or damage was a "direct physical loss." The court considered whether the loss of stored computer data was a "direct physical loss."

The court concluded that "the loss of the database, with its consequent economic loss, but with no loss of or damage to tangible property, was not a 'direct physical loss of or damage to' covered property under the terms of the subject insurance policy, and, therefore, the loss is not covered."<sup>52</sup> The court interpreted the words "direct physical loss" in their ordinary and popular sense because no party had proposed any special or technical meaning, and concluded that because data had no corporeal or tangible presence, the loss of the data did not constitute a direct physical loss triggering coverage under the policy.<sup>53</sup>

In its reasoning, the court noted the word "physical" was defined in the dictionary to mean "having material existence" and "perceptible esp[ecially] through the senses and subject to the laws of nature." The court also noted that "material"

48. See e.g., *Dundee Mut. Ins. Co. v. Marifjeren*, 1998 ND 222, ¶¶ 11–15, 587 N.W.2d 191, 194–95 (1998) (South Dakota Supreme Court held that "Damage" includes loss of function or value. "When the electrical power was interrupted for three days during the storm, the storage facilities were 'damaged' in the sense they no longer performed the function for which they were designed. In other words, the interruption of electrical power 'damaged' the storage facilities by impairing their value or usefulness."); accord *Wakefern Food Corp. v. Liberty Mut. Fire Ins. Co.*, 406 N.J. Super. 524, 540–41 (App. Div. 2009); *Pepsico, Inc. v. Winterthur Int'l Am. Ins. Co.*, 24 A.D.3d 743, 744 (2005) (rejecting insurer's argument "that to prove 'physical damages' the plaintiff must prove that 'there has been a distinct demonstrable alteration of [the] physical structure . . . by an external force'" and finding it was enough "that the product's function and value have been seriously impaired"); *Gen. Mills, Inc. v. Gold Medal Ins. Co.*, 622 N.W.2d 147, 151–52 (Minn. Ct. App. 2001) (holding that "direct physical loss can exist without actual destruction of property or structural damage to property" and find that the insured had suffered "physical damage" when there was "an impairment of function and value").

49. *US Airways, Inc. v. Commonwealth Ins. Co.*, 64 Va. Cir. 408 (Va. Cir. Ct. 2004).

50. Similarly, in *Sloan v. Phoenix of Hartford Insurance Co.*, 207 N.W. 2d 434, 436–37 (Mich. Ct. App. 1973), the court interpreted a civil authority provision as not requiring physical damage to property in order to trigger business interruption coverage. There, the provision read:

This policy is extended to include the actual loss as covered hereunder, during the period of time, not exceeding 2 consecutive weeks, when as a direct result of the peril(s) insured against, access to the premises described is prohibited by order of civil authority.

The court held that the insured was entitled to coverage under this provision "irrespective of any physical damage to the insured property." The court reasoned that:

[N]o mention is made of the necessity for physical damage to the premises before [the civil authority provision] can become operative. Such an omission is conspicuous by its absence. Had the insurer sought to embody into [the civil authority provision] a condition of physical damage to the insured property, it would have been a simple matter to insert such a clause as was done [in other sections].

51. *Ward Gen. Ins. Servs., Inc. v. Emp'rs Fire Ins. Co.*, 114 Cal. App. 4th 548 (2003).

52. *Id.* at 556–57.

53. *Ward*, 114 Cal. App. 4th at 556–57.

implies “formation out of tangible matter” and that “tangible” means “capable of being perceived esp[ecially] by the sense of touch.” Accordingly, the court ruled that the loss must be to tangible matter, but the insured had sustained a “loss of information”—an intangible matter. The court stated that it “fail[ed] to see how *information, qua* information, can be said to have a material existence, be formed out of tangible matter, or be perceptible to the sense of touch.”

However, this case is distinguishable for several reasons. First, *Ward* ignores basic laws of physics. The rearrangement of magnetic charges of electronically-stored data has *physical* instantiation. Courts across the country are in accord.<sup>54</sup> Second, the losses at stake in *Ward* and from COVID-19 are distinguishable. In *Ward*, the insured sustained a “loss of information.” The court recognized “information” as an *intangible* matter. In contrast, a business is a *tangible matter*. A California business owner’s loss of *physically* using his business is distinguishable from merely losing *intangible* information.

Business owners have suffered a *physical* closure of their businesses because of a *physical* coronavirus and a government order mandating that their businesses be *physically* shut down. As a result, business owners have suffered a loss of *something physical*. These losses, therefore, are to tangible matter, as is required by

*Ward*. Third, California businesses have a “material existence” and the loss of their business is “perceptible to the sense of touch,” as is required by *Ward*. Fourth, the actual cause of the loss—the coronavirus—is also physical. Unlike the “intangible data” in *Ward*, the coronavirus has a “material existence,” is “formed out of tangible matter.” It is the unwanted presence of the coronavirus itself—and not some non-physical intangible force—that constitutes direct physical damage. Therefore, because businesses are physically closed and the cause of such closure is a physical virus, business owners have a strong argument that *Ward* does not apply to bar coverage.

### III. “Physical Damage”: Arguments to Support a Finding that Insured Business Properties Have Suffered “Physical Damage”

For some policies, “loss of use” may not be sufficient to establish “physical loss or damage.” These policies may instead require a finding of physical alteration or structural damage to the covered property to satisfy the “physical loss or damage” requirement for business interruption coverage to trigger. Indeed, the Northern District of California has noted: “Courts have interpreted the words ‘direct physical loss’ and similar provisions in insurance contracts to mean damage to tangible, material objects.”<sup>55</sup> As such, a determination that “physical

54. See, e.g., *NMS Servs. Inc. v. The Hartford*, 62 F. App’x. 511, 512 (4th Cir. 2003) (finding insurance coverage to exist for “erasure of vital computer files and databases necessary for the operation of the company’s manufacturing, sales, and administrative systems” and that such damage constituted physical loss to the insured’s property; specifically, the physical loss was found to be damage to the computers owned by the insured); *Southeast Mental Health Ctr., Inc. v. Pac. Ins. Co.*, 439 F. Supp. 2d 831, 838 (W.D. Tenn. 2006) (concluding “that ‘physical damage’ could include loss of ‘functionality’ even if the affected machinery remained intact” and that “loss of access, loss of use, and loss of functionality” falls within the definition of direct “physical damage”); *Landmark Am. Ins. Co. v. Gulf Coast Analytical Labs., Inc.*, No. CIV.A. 10-809, 2012 WL 1094761, at \*3 (M.D. La. Mar. 30, 2012) (holding that electronic data is “physical” for purposes of satisfying the “direct, physical loss or damage” requirement in an insurance policy); *Lambrech & Assocs., Inc. v. State Farm Lloyds*, 119 S.W.3d 16, 25 (Tex. App. 2003) (holding that loss of computer data (and electronic media and records) constituted a physical loss because it was stored in a “hard drive or ‘disc’ which could no longer be used for ‘electronic data processing, recording, or storage. The data that [plaintiff] lost as a result of data is also covered because it was the ‘data stored on such media’” which was expressly covered by the policy); see also *Nat’l Ink & Stitch, LLC v. State Auto Prop. & Cas. Ins. Co.*, No. CV SAG-18-2138, 2020 WL 374460, at \*3 (D. Md. Jan. 23, 2020) (holding that “loss of use, loss of reliability, or impaired functionality demonstrate the required damage to a computer system, consistent with the ‘physical loss or damage to’ language in the Policy”); *Ashland Hospital Corp. v. Affiliated FM Ins. Co.*, 2013 WL 4400516, at \*1 (E.D. Ky Aug. 14, 2013) (holding that the “loss of reliability” of electronic equipment constituted physical loss or damage); *American Guarantee & Liab. Ins. Co. v. Ingram Micro, Inc.*, Civ. No. 99-185-TUC ACM, 2000 WL 726789, at \*1 (D. Ariz. April 18, 2000) (holding that “physical damage is not restricted to the physical destruction or harm of computer circuitry but includes loss of access, loss of use, and loss of functionality”).

55. *Patel v. Am. Econ. Ins. Co.*, No. 12-CV-04719-WHO, 2014 WL 1862211, at \*5 (N.D. Cal., May 8, 2014).

damage” occurred to covered property may be more difficult to prove than a determination that “physical loss” occurred.

In light of this, insurers will most likely argue that “physical loss or damage” requires physical damage to occur to the covered property. More particularly, insurers are likely to argue: (1) that the coronavirus does not pose a health hazard to building occupants; (2) the mere presence of the coronavirus is not necessarily injurious; (3) that even if the coronavirus is present in a building, the coronavirus can be cleaned and removed quickly and easily by a cleaning service or even by normal air filtration circulation; and (4) that the presence of coronavirus results only in economic losses—not in “physical damage.” But these arguments fail for the reasons that follow.

### 1. The Mere Threat of Potential Future Harm at Covered Property Satisfies the “Physical Damage” Requirement

Assuming that business owners have to prove structural alteration or damage to satisfy “physical loss or damage,” California courts have held that the mere presence of a dangerous substance, such as a virus, chemical, or gas—particularly when such substances are not supposed to be there—is enough to constitute “physical damage.” As such, California business owners should argue that the mere potential threat of future bodily harm constitutes physical damage. California cases support this argument.

For example, in *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co.*, a California appellate court held that the mere presence of asbestos in an insured’s building constituted “property damage” that amounted to “physical injury”—even though the insured’s building

was not structurally altered—because the asbestos was a “health hazard” with the potential threat to cause *future* harm.<sup>56</sup> The *Armstrong* court ruled not only that the mere presence of asbestos constitutes physical injury but also that the *mere potential threat of future harm* constituted “physical” injury to the insured’s covered properties.<sup>57</sup>

Based upon this reasoning, California business owners should make a similar argument. The mere presence of the coronavirus in buildings is a “health hazard because of the potential for future” infections of business patrons, employees, and those that enter the business establishment. Because *Armstrong* found that the mere potential threat of future harm constituted “physical” injury to the insured’s buildings, the presence of the coronavirus at the insured’s property should also constitute physical damage and thus satisfy the “physical loss or damage” requirement.

Additionally, California business owners can and should use the reasoning in *Armstrong* to support a finding of “physical damage” in a civil authority coverage claim. The *Armstrong* court reasoned that:

the term “physical injury” covers “a loss that results from physical contact, physical linkage, as when a potentially dangerous product is incorporated into another and, because it is incorporated and not merely contained (as a piece of furniture is contained in a house but can be removed without damage to the house), must be removed, at some cost, in order to prevent the danger from materializing.”<sup>58</sup>

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56. *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co.*, 45 Cal. App. 4th 1, 90 (1996) (“[T]he mere presence of [asbestos] in buildings is a health hazard because of the potential for *future* releases of asbestos fibers.”). Although the language at issue was not “physical loss or damage” but rather “property damage” as defined in a commercial general liability policy, the facts in *Armstrong* are analogous and the reasoning and logic used is directly on point. *Id.*

57. *Armstrong*, 45 Cal. App. 4th at 90–92 (noting that even though the asbestos might not be in the air but instead contained inside of the building walls, “common daily activities may cause asbestos fibers to be released . . . and thus the [asbestos] poses a *threat* of harm”) (emphasis added). Similarly, the common daily activities of patrons and employees going in and out of the business establishment is very likely to cause the coronavirus to be “released” into the air. In accordance with *Armstrong*, thus the coronavirus “poses a *threat* of harm.” *Id.*

58. *Id.* at 91–92 (citing *Eljer Mfg., Inc. v. Liberty Mut. Ins. Co.*, 972 F.2d 805, 810 (7th Cir.1992), *cert. den.* 507 U.S. 1005 (1993)).

“[B]ecause the potentially hazardous material is physically touching and linked with the building . . . the injury is physical even without a release of toxic substances into the building’s air supply.”<sup>59</sup> The *Armstrong* court rejected the insurer’s argument that property damage requires “physical harm to the whole.”<sup>60</sup>

Here, California business owners should make a similar argument. First, the government-mandated business closures by civil authorities are evidence in and of themselves that the coronavirus is “physically touching and linked with” buildings and people inside of these business establishments, and therefore the coronavirus physically affects the insured’s business property. Second, the coronavirus is not merely contained (as a piece of furniture is contained in a house) in the business property. Rather, the coronavirus is unpredictable, and the potential risk of infection and death cannot be controlled, easily detected, or contained by business owners without undue burden and expense—much like the asbestos in *Armstrong*. In fact, there appears to be no guaranteed method for completely removing the coronavirus from covered property or for preventing it from infecting patrons or employees. If there was, then there should be no need for government-mandated business closures.

Third, the seriousness of the potential threat of bodily harm is substantially present, much like the threat of future harm was present in *Armstrong*, and which led the court to find there was “physical” injury. But, unlike asbestos, the coronavirus is a highly infectious virus that acts relatively quickly. Asbestos-related diseases are usually caused by workplace exposure over months, years, and even decades. The coronavirus can infect, seriously injure, and even kill someone within a week or two. Lastly, even if California business owners could somehow take steps to decrease the potential risk of the coronavirus’s

deadly effects at their businesses, many of them would still not be able to open up their business without violating the government-mandated business closure orders.

In summary, the coronavirus—just like the asbestos in *Armstrong*—is not where it is supposed to be: both of these substances do not belong inside of business properties where patrons and employees can be exposed to the risk of getting sick and dying. As explained above, the primary reason the *Armstrong* court found that asbestos caused “physical damage”—even though the insured’s building was not structurally altered—was because it is a “health hazard” with the potential threat to cause *future* harm. Analogously, the coronavirus constitutes “physical damage” because it, too, is a health hazard and poses a serious health risk. As such, the mere potential threat of future harm caused by the coronavirus is “physical damage” that should be covered by the business interruption and civil authority coverage provisions.

## 2. The Mere Presence of the Coronavirus at Covered Property Constitutes “Physical Damage”

California business owners should also argue that the mere presence of the coronavirus constitutes “physical damage” to covered property because the coronavirus attaches to surfaces and is capable of causing potentially fatal infection upon contact and prevents business owners from using and enjoying their property. In fact, scientific research confirms that the coronavirus can linger on surfaces for days and that it can be transmitted through “fomites” (objects or materials likely to carry infection, such as furniture).<sup>61</sup> This makes the physical damage both “direct and tangible.”

Furthermore, the insurance industry itself has recognized that viruses may cause physical injury or

59. *Armstrong*, 45 Cal. App. 4th at 92.

60. *Id.*

61. See Neeltje van Dormalen et al., *Aerosol and Surface Stability of SARS-CoV-2 as Compared with SARS-CoV-1*, 382 NEW ENG. J. MED. 1564 (2020); see also Molly Walker, *COVID-19 Transmission ‘Plausible’ on Surfaces, in the Air*, MEDPAGE TODAY (Mar. 17, 2020), <https://www.medpagetoday.com/infectiousdisease/covid19/85466>; Shanley Pierce, *Coronavirus Can Live on Surfaces for Days*, TEX. MED. CTR. (Mar. 23, 2020), <https://www.tmc.edu/news/2020/03/coronavirus-can-live-on-surfaces-for-days>.

damage to properties since at least 2006. When preparing so-called “virus” exclusions to be placed in some policies, the insurance industry’s drafting arm, Insurance Services Office, Inc. (ISO), circulated a statement to state insurance regulators that stated, in relevant part:

Disease-causing agents may render a product impure (change its quality or substance), or enable the spread of disease by their presence on interior building surfaces or the surfaces of personal property. When disease-causing viral or bacterial contamination occurs, potential claims involve the cost of replacement of property (for example, the milk), cost of decontamination (for example, interior building surfaces), and business interruption (time element) losses. Although building and personal property could arguably become contaminated (often temporarily) by such viruses and bacteria, the nature of the property itself would have a bearing on whether there is actual property damage. An allegation of property damage may be a point of disagreement in a particular case.<sup>62</sup>

Experts will likely need to be hired to establish and determine the extent of such damages. Additionally, a strong argument can be advanced that “there was a physical deposit of hazardous biological material (coronavirus particles) upon property, such that disinfection was reasonably required before the property could be used again.”<sup>63</sup>

Evidence of quantifiable costs to contain, control, and remediate the presence of coronavirus at insured properties, in addition to ISO’s comments, weigh in favor of finding that the coronavirus causes property damage—that is, physical injury to the insured property. Furthermore, the ISO quote above makes it clear that physical loss due to a virus is foreseeable and should be covered unless there is a clear and conspicuous exclusion for losses caused by viruses.

### 3. The Loss or Damage to Business Properties Is Not Only Economic—It Is Physical

Some insurers may argue that the mere presence of the coronavirus results only in economic losses—e.g., diminished property value, abatement costs, or costs of responding to the presence of asbestos—and not in “physical damage.”<sup>64</sup> However, the California appellate court in *Armstrong* rejected this argument, ruling that the damages suffered by business owners from the presence of asbestos—even without any structural alteration to the insured’s building—“cannot be considered solely economic losses.”<sup>65</sup>

Diminished market value or abatement costs or costs of inspecting, assessing, and maintaining the in-place [asbestos] are not the “property damage.” They are “damages because of property damage.” That is, they are the alternative measures of the physical injury to the building. . . . The fact that the measure of damages is economic does not preclude a physical injury.<sup>66</sup>

62. INS. SERVS. OFFICE, AMENDATORY ENDORSEMENT – EXCLUSION OF LOSS DUE TO VIRUS OR BACTERIA, at 1 (2006), <https://www.propertyinsurancecoveragelaw.com/files/2020/03/ISO-Circular-LI-CF-2006-175-Virus.pdf>.

63. Nick Bond & Mark Maclean, *Is Coronavirus Contamination Considered Property Damage in the Context of Business Interruption Insurance?*, KENNEDYS LAW (Mar. 26, 2020), <https://www.kennedyslaw.com/thought-leadership/article/is-coronavirus-contamination-considered-property-damage-in-the-context-of-business-interruption-insurance>.

64. *Armstrong*, 45 Cal. App. 4th at 93 (the insurer argued that “the mere presence of [asbestos] results only in economic losses—e.g., diminished property value, abatement costs, or costs of responding to the presence of asbestos—and not in a physical injury”); *see also* *Great N. Ins. Co. v. Benjamin Franklin Fed. Sav. & Loan Ass’n*, 953 F.2d 1387 (9th Cir. 1992) (holding that when a property remains physically intact and undamaged, there is no physical loss but only an economic loss).

65. *Armstrong*, 45 Cal. App. 4th at 93.

66. *Id.* (citing *Maryland Cas. Co. v. W.R. Grace & Co.*, 23 F.3d 617, 627 (2d Cir.1993), *cert. den.* 513 U.S. 1052 (1994); *Geddes & Smith, Inc. v. St. Paul Mercury-Indemnity Co.*, 51 Cal. 2d 558, 565 (1959); *Geddes & Smith, Inc. v. St. Paul Mercury Indem. Co.*, 63 Cal. 2d 602, 609 (1965); *Mozzetti v. City of Brisbane*, 67 Cal. App. 3d 565, 576 (1977)).



#### 4. Unfavorable Cases Requiring “Physical Damage” Are Distinguishable

Based on the following cases, insurers will argue that “physical loss or damage” means that the business structure itself must physically suffer damage. However, these cases are distinguishable.

##### A. *MRI Healthcare Ctr. of Glendale, Inc.*

To support their position that structural damage is required for a finding of “physical loss or damage,” insurers will likely cite to *MRI Healthcare Center of Glendale, Inc. v. State Farm General Insurance Co.*<sup>67</sup> There, a California appellate court held that the phrase “direct physical loss” contemplates an actual change in the insured property “occasioned by accident or other fortuitous event directly upon the property causing it to become unsatisfactory for future use or requiring that repairs be made to make it so.”<sup>68</sup>

In that case, a healthcare landlord repaired the roof of a building that was damaged after severe storms in 2005. In repairing the roof, an MRI machine in the building had to be “ramped down,” whereby the magnetic field of the scanner is removed. The landlord caused damages through the ramp-down and ramp-up procedure of the MRI machine. The landlord filed an insurance claim for property damage, and the insurer denied it. Litigation ensued.

The court ruled that any damage suffered by the MRI machine in 2006 was not directly attributable to the 2005 storms and, therefore, not covered by the insurance policy. Rather, the decision to ramp down the MRI was the insured’s deliberate decision and was not contemplated by the policy. Thus, the landlord, and not the storms, caused the MRI damage. Additionally, there was no “distinct, demonstrable [or] physical alteration” of the machine and no external force acted upon the insured property. The failure of the MRI machine to ramp up was caused by the inherent nature of the machine.

This case is distinguishable for the various reasons. First, the insurance dispute in *MRI Health Care* was regarding business property insurance

coverage to replace business *equipment*—not business interruption coverage for lost business *income*. California business owners have sustained losses of business income and are not seeking replacement of business property, such as machinery, equipment, inventory, or accessories. This loss of business income is not related to or caused in any way by a loss of their business equipment effectuated by some decision of the insured.

Second, in *MRI Health Care*, the court found that there was no physical alteration to the MRI machine. In contrast, here, there is “distinct, demonstrable [or] physical alteration” to California business owners’ property because it is *physically* closed, they are unable to physically use, access, or operate the property, and its purpose, function, and operations have been distinctly and demonstrably suspended due to the physical presence of the virus. Business operations have been physically altered because no patrons are allowed inside of the business.

Third, the losses in *MRI Health Care* were caused by the negligence of the insured. Conversely, California business owners have not caused losses by their own negligence. Rather, policyholders have been forced to close their restaurants because of the risk of the coronavirus—a physical virus—infecting their business properties, patrons, and employees. Additionally, business owners have been forced to close their businesses to comply with California’s executive order to shut down all non-essential businesses.

Fourth, in *MRI Health Care*, an external force *did not* act upon the insured property. Here, however, an external force—the coronavirus and the government’s orders—*did act* upon the policyholders’ businesses, causing them to shut down their businesses and suffer substantial losses of business income.

Lastly, in *MRI Health Care*, the insured freely and deliberately decided to ramp down the MRI machine, which caused damage to the machine. On the other hand, California business owners have not deliberately decided to close down their businesses and suspend

67. *MRI Healthcare Ctr. of Glendale, Inc. v. State Farm Gen. Ins. Co.*, 187 Cal. App. 4th 766 (2010).

68. *Id.* at 779.



all of their business activities: that decision was made for them.

In the alternative, even if a loss of use is not found, there is still direct physical loss because people continue moving in and around the insured business property even after it is sanitized, which will continue to re-contaminate the insured property.

### 5. A Business Insurance Policy's Definition of "Property Damage" Can Help to Define and Satisfy the Policy's "Physical Loss or Damage" Requirement

As mentioned above, both business interruption and civil authority coverage generally require that the business owner's lost business income results from "direct physical loss or damage." Where a policy requires that lost business income result from "physical loss or damage," some courts may reject that the presence of the coronavirus or a government mandated business closure constitutes "physical loss" to the insured property. In such a case, business owners should argue that their businesses have suffered "physical . . . damage" rather than "physical loss." However, many policies do not define "physical loss or damage." Accordingly, business owners should inspect their policies to see if there are any definitions that help to define "physical loss or damage."

Although "physical damage" may not be defined, some business insurance policies do define "*property damage*." California courts have recognized that property damage includes not only physical injury of property but also the *loss of use* of tangible property.<sup>69</sup> California courts note that "property damage" is commonly defined in the liability section of insurance policies as:

(1) physical injury to or destruction of tangible property which occurs during the policy period, including the loss of use thereof at any time resulting therefrom,<sup>70</sup> or

(2) *loss of use of tangible property* which has not been physically injured or destroyed provided such loss of use is caused by an occurrence during the policy period.<sup>71</sup>

California business owners should argue that a court should interpret and apply their policy's "property damage" definition to give meaning to the "physical loss or damage" definition that is otherwise missing from the policy. In other words, where there is no definition for "physical loss or damage" but there is a definition for "property damage," courts are bound to use the definition and meaning of "property damage" to define "physical loss or damage." Indeed, in defining terms, California requires insurance policies to be interpreted so that the "whole of [an insurance] contract is to be taken together, so as to give effect to every part, if reasonably practicable, each clause helping to interpret the other."<sup>72</sup> California courts must interpret the contract as a whole, with each clause lending meaning to the other.<sup>73</sup>

Under these rules of policy interpretation, the court should find a business owner's "loss of use" of his insured property as a type of "property damage" that constitutes a covered "physical loss or damage." California business owners have incurred "property damage" because they have sustained a "loss of use" of their "tangible," business property due to the presence of the coronavirus at their property and/or the government-mandated business closures. As such,

69. See *Thee Sombrero, Inc. v. Scottsdale Ins. Co.*, 28 Cal. App. 5th 729, 733 (2018); *Property Damage*, CALIFORNIA INSURANCE LAW DICTIONARY & DESK REFERENCE § P107:1 (2019) (citing *Devin v. United Servs. Auto. Ass'n*, 6 Cal. App. 4th 1149, 1158 (1992)).

70. See e.g., *F & H Constr. v. ITT Hartford Ins. Co.*, 118 Cal. App. 4th 364, 371–72 (2004) ("The policy defines property damage as '[p]hysical injury to tangible property.' This definition is the *standard definition currently used by the insurance industry nationwide*." (citations omitted) (emphasis added)).

71. See, e.g., *Collin v. Am. Empire Ins. Co.*, 21 Cal. App. 4th 787, 795 (1994) (emphasis added).

72. See Cal. Civ. Code § 1641.

73. See *Bank of the W. v. Superior Court*, 2 Cal. 4th 1254, 1265 (1992) (holding that "language in a contract must be construed in the context of that instrument as a whole, and in the circumstances of that case, and cannot be found to be ambiguous in the abstract") (italics in original) (citation omitted); *S. Kornreich & Sons, Inc. v. Genesis Ins. Co.*, 56 Cal. App. 4th 407 (1997).

lost business income caused by the property damage (loss of use) would be a covered loss and business interruption insurance coverage would apply.

Outside of California, other courts have defined property damage using similar terms. For example, a Louisiana federal court acknowledged that “insurance policies all define ‘property damage’ to include loss of use of tangible property” and that:

The court is required to *interpret each provision in a contract in light of the other provisions, so that each is given the meaning suggested by the contract as a whole*. Accordingly, the Court finds that the inclusion of “loss of use” as a type of property damage in the policies suggests that the damage caused by the Chinese-manufactured drywall in Plaintiffs’ homes constitutes a covered physical loss since the drywall prevents the Plaintiffs from fully using and enjoying their homes . . . . The Court finds, based upon the foregoing analysis, that the alleged damages to Plaintiffs’ homes caused by Chinese drywall constitute a covered “physical loss” for purposes of their homeowners’ policies.<sup>74</sup>

Notably, in that case, even though plaintiffs were making a first-party property claim, they were relying on a definition of “property damage” for third party claims. Similarly, in the current situation, some policies may also define “property damage” in the third-party liability section. Many, if not most, business owners will not look to definitions for third party claims. However, if the “property damage” definition is the only one that can help to define “physical loss or damage,” courts should interpret the policy as a whole, as explained above, and use the “property damage” definition to lend meaning to the “physical

loss or damage” definition in business interruption section of the policy.<sup>75</sup> As such, insurers would be bound by this definition in their third party liability section.

#### **IV. Virus Exclusions: Why These Exclusions May Be Unenforceable and Invalid**

##### **1. Virus Exclusions May Not Be Sufficiently Conspicuous, Plain, or Clear to Provide Adequate Notice to Policyholders**

Insurance companies may seek to deny business interruption coverage if a policy contains an exclusion which bars coverage for losses due to viruses. However, a virus exclusion may not be sufficiently conspicuous, plain, or clear to be effective, or may have been added at a later date and in a way that did not provide adequate notice to the policyholder of its addition.

Quite often, insurance companies will modify the original business insurance policy through “endorsements,” where provisions, contractual obligations, terms, conditions, exclusions, and limitations are added, removed, or changed. “Unquestionably, insurers may rely on endorsements to modify the printed terms of a form policy.”<sup>76</sup> According to insurance companies, these modifications are usually tailored and designed to match the unique circumstances and insurance needs for each type of business. These changes are usually contained in a letter sent to the policyholder, oftentimes consisting of numerous pages.

However, an insurer has the burden of “notifying insureds of reductions in otherwise reasonably expected coverage.”<sup>77</sup> Under California law, to the extent that coverage is reduced when a policy is renewed by an insured, the insurer must provide adequate notice of the new exclusion, limitation, or

74. *In re Chinese Manufactured Drywall Products Liab. Litig.*, 759 F. Supp. 2d 822, 832 (E.D. La. 2010) (emphasis added & citations omitted); *see also* Dupuy v. USAA Cas. Ins. Co., No. CIV.A. 11-336-JJB, 2012 WL 832291 (M.D. La. Mar. 9, 2012).

75. *See* S. Kornreich & Sons, Inc. v. Genesis Ins. Co., 56 Cal. App. 4th 407 (1997) (holding that the court must interpret the insurance policy as a whole, with each clause lending meaning to the other).

76. *Haynes v. Farmers Ins. Exch.*, 32 Cal. 4th 1198, 1208 (2004).

77. *Id.* (citing *Tomaselli v. Transamerica Ins. Co.*, 25 Cal. App. 4th 1269, 1281–82 (1994)).

reduction in coverage.<sup>78</sup> The law is clear that “no change may be made in the terms of the renewal policy without notice to the insured.”<sup>79</sup> If an insurer “deals with the public upon a mass basis, the notice of noncoverage of the policy, in a situation in which the public may reasonably expect coverage, must be *conspicuous, plain and clear.*”<sup>80</sup>

In that regard, burying a virus exclusion deep within a voluminous policy, made up of a hodgepodge of hundreds of pages of standard forms, endorsements, and special provisions, may not satisfy the insurer’s obligation to provide adequate notice that is sufficiently conspicuous, plain, and clear. On these grounds, such an exclusion may be unenforceable, especially if it is added to an existing policy upon renewal.

In order to satisfy notice requirements, California law requires that reductions in coverage be “placed and printed so that [they] will attract the reader’s attention.”<sup>81</sup> Language appearing on a policy’s tenth page was held to not have been sufficiently conspicuous, plain, or clear because there was nothing in the heading to alert a reader that it limited permissive user coverage, nor was there anything in the section to attract the reader’s attention to the limiting language. If burying an exclusion on the tenth page of a *policy* is not sufficiently “plain, clear and conspicuous,” then inserting a virus exclusion in the middle of a voluminous document consisting of standard policy forms, dozens of endorsements, and other provisions may similarly fail.

To be conspicuous, the notice must be “displayed or presented in a way that it would be ‘noticed’ by a reasonable person.”<sup>82</sup> Courts have applied California’s Uniform Commercial Code section 1201(a)(10) for guidance in defining what “conspicuous” means for the purposes of contract interpretation. The operative provision provides:

“Conspicuous”, with reference to a term, means so written, displayed, or presented that a reasonable person against which it is to operate ought to have noticed it. . . . Conspicuous terms include the following:

(A) a heading in capitals equal to or greater in size than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same or lesser size; and

(B) language in the body of a record or display in larger type than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same size, or set off from surrounding text of the same size by symbols or other marks that call attention to the language.<sup>83</sup>

In short, burying or hiding a new virus exclusion in the middle of an enormous document may not satisfy California law governing the conspicuousness of changes, reductions, or limits on coverage. Similarly, if the font size is small, it may not provide adequate notice because it might not sufficiently attract a reader’s attention to the additional exclusion. Lastly, if the document does not have a cover page letter summarizing any new major changes or exclusions, notice may also be inadequate. California business owners should review their policies carefully to see if any of these issues are present and pay particular attention to the policy that first included the virus exclusion and the accompanying cover letter, if any.

78. See *Everett v. State Farm Gen. Ins. Co.*, 162 Cal. App. 4th 649, 663 (2008) (holding that insurers are required to provide notice “on renewal of changes in coverage or limits . . . in a ‘plain, clear and conspicuous writing’”) (citation omitted).

79. *Indus. Indem. Co. v. Indus. Accident Comm’n*, 34 Cal. 2d 500, 506 (1949).

80. *Haynes*, 32 Cal. 4th at 1208 (emphasis added).

81. *Id.* at 1204.

82. *Broberg v. Guardian Life Ins. Co. of Am.*, 171 Cal. App. 4th 912, 922–23 (2009).

83. CAL. U.C.C. § 1201(a)(10).

## 2. Virus Exclusions May Be Unenforceable Because of the Insurance Industry's Misrepresentations About Virus Exclusions Made to State Insurance Regulators

Virus exclusions may potentially be unenforceable because the approval for insurers to use this exclusion was obtained through the use of false and misleading information in 2006. If this turns out to be true, courts should “prevent insurers from enforcing those exclusions in order to avoid paying for COVID-19 claims.”<sup>84</sup>

One way to establish whether a virus exclusion provision was based on misrepresentations is to examine the provision's drafting history.<sup>85</sup> Because the virus exclusion is generally a standard form policy provision, the primary source for this exclusion's drafting history is “information maintained by the insurance industry organizations that took the lead in drafting, soliciting comment on, and gaining regulatory approval of policy provisions.”<sup>86</sup> California courts have used drafting history to assist them in

determining coverage issues for standardized industry provision<sup>87</sup>s.

If there are misrepresentations made for states to adopt the virus exclusion, the drafting history can be used to “preclude the insurer from disputing the meaning advanced when approval for the clause was sought from the relevant regulatory authorities.”<sup>88</sup> This is called “regulatory estoppel.” Business owners must be able to show that the “insurer participated in, or at least benefited from, the drafting and dissemination of that language by the relevant industry association.”<sup>89</sup>

Regulatory estoppel arguments—to invalidate exclusions based on misrepresentations to state regulators—have been successful in the past.<sup>90</sup> For example, in *Morton International, Inc. v. General Accident Ins. Co.*, the New Jersey Supreme Court held that insurers were estopped from using a standardized absolute pollution exclusion to deny coverage because they made misrepresentations to state regulators.<sup>91</sup> There, the court found that the insurance industry

84. Richard P. Lewis, John N. Ellison, & Luke E. Debevec, *Here We Go Again: Virus Exclusion for COVID-19 and Insurers*, PROP. CASUALTY 360 (Apr. 07, 2020, 12:00 AM), <https://www.propertycasualty360.com/2020/04/07/here-we-go-again-virus-exclusion-for-covid-19-and-insurers>.

85. See *Montrose Chemical Corp. v. Admiral Ins. Co.*, 10 Cal. 4th 645 (1995) (examining the drafting history of liability policy provisions and definitions to interpret occurrence definition); *Maryland Casualty Co. v. Reeder*, 221 Cal. App. 3d 961, 968 (1990) (relying on ISO publications in drafting history to interpret the “work performed” exclusion); 1 Barbara O'Donnell, *Law & Prac. Ins. Coverage Litig.* § 1:15 (2019). The Ninth Circuit has also given weight to drafting history evidence. See *Fireguard Sprinkler Systems, Inc. v. Scottsdale Ins. Co.*, 864 F.2d 648, 652 (9th Cir. 1988) (relying on information in documents published by ISO and the National Underwriters Association about the intended scope of a standard form completed operations exclusion).

86. See 1 O'Donnell, *supra* note 89, § 1:15. These industry organization include the Insurance Services Office (“ISO”) and its preceding organizations, such as the Insurance Rating Board (“IRB”), Mutual Insurance Rating Bureau (“MIRB”), and the National Bureau of Casualty Underwriters (“NBCU”). See *id.* “After proposed language is prepared and approved by drafting committees for these organizations, the language is circulated to members and later filed with state regulatory authorities for approval.” *Id.* Counsel should also “examine historical information at the state regulatory agencies.” *Id.*

87. See *Montrose*, 10 Cal. 4th at 670–71 (“Such interpretative materials have been widely cited and relied on in the relevant case law and authorities construing standardized insurance policy language. . . . In this case, we find the drafting history relevant in evaluating [the insurer's] argument that, from a public policy standpoint, the insurance industry will be harmed by the adoption of a continuous injury trigger that the industry assertedly never anticipated would be applied to these policies.”); see also *Maryland Casualty Co.*, 221 Cal. App. 3d at 968 (“[T]he ISO's standard provisions are also the subject of interpretation and comment by other insurance industry organizations and publications. The presence of the standard provisions in the Maryland policy and the concomitant availability of interpretative literature is of considerable assistance in determining precisely what risks the Maryland policies cover.”).

88. 1 O'Donnell, *supra* note 85, § 1:15. Counsel should consider the cost of obtaining the drafting history and for what purpose the drafting history will be used. The drafting history can also be used to prove that an insurance provision is ambiguous or to interpret the insurance provision at issue. See *id.*

89. See *id.*

90. See, e.g., *Morton Int'l Inc. v. Gen. Accident Ins. Co.*, 629 A.2d 831 (N.J. 1993); *St. Paul Fire Ins. Co. v. McCormick & Baxter Creosoting Co.*, 923 P.2d 1200 (Or. 1996); see also Lewis et al., *supra* note 84 (noting that in the 1970s and 1980s, the insurance industry made misrepresentations to obtain pollution exclusions).

gained regulatory approval for their standardized pollution exclusion “by misrepresenting that the exclusion merely clarified the coverage afforded under the existing occurrence provisions.”<sup>92</sup> More particularly, the court found that the insurance industry’s statements made to state insurance regulators to adopt pollution exclusions as standardized provisions were “untrue,” “paradigms of understatement,” “inaccurate,” “misleading,” “simply . . . indefensible,” and “perilously close to deception.”<sup>93</sup> The court held that the insurer’s misrepresentations and non-disclosures to state regulators that the pollution exclusion was a mere “clarification” would violate public policy and wrongly reward them for their misconduct.<sup>94</sup>

In the current situation, the insurance industry, in seeking to have the virus exclusion adopted and approved, falsely informed state insurance regulators that losses caused by viruses were historically excluded from coverage. In 2006, the Insurance Services Office, Inc. (ISO) and the American Association of Insurance Services (AAIS) submitted standardized policy forms containing virus exclusions to state insurance regulators and sought their adoption and approval. In these submissions, ISO and AAIS made statements that policies “have not been, nor were they intended to be, a source of recovery for loss, cost, or expense caused by disease-causing agents.” In other words, the insurance industry tried to argue that these exclusions for losses caused by disease-causing agents were already excluded and that the proposed “virus exclusion” was merely a “clarification” and nothing new. But these represen-

tations were arguably false.<sup>95</sup>

Up until 2006, many courts across the United States had found that losses arising from “disease-causing agents” were covered by insurance policies.<sup>96</sup> For instance, in 2002, the U.S. District Court for the Northern District of California held that *E. coli* constituted direct physical damage to property, which triggered business income coverage.<sup>97</sup> And, in 2005, the Third Circuit found that bacterial contamination of a home’s water supply constituted “direct physical loss” to property because it rendered the home uninhabitable, despite lack of physical damage.<sup>98</sup> Further, in 1999, the U.S. District Court for the District of Oregon found that mildew exposure qualified as direct physical loss sufficient to trigger business interruption coverage.<sup>99</sup> Lastly, in 1998, a Massachusetts court found that the presence of carbon monoxide which rendered a building uninhabitable constituted a “direct, physical loss.”<sup>100</sup>

Business owners and attorneys should argue that insurers should be estopped from denying coverage based on the virus exclusions because of their misrepresentations to state insurance regulators leading up to 2006. These virus exclusions are unenforceable because of these misrepresentations.

### 3. Virus Exclusions May Violate the California “Efficient Proximate Cause” Doctrine

A virus exclusion that excludes coverage where the excluded peril “contributes in any way” to the loss may be deemed illusory because it “suggests [that] the

91. See *Morton*, 629 A.2d at 831; see also *Lewis et al.*, *supra* note 84.

92. 1 O’Donnell, *supra* note 85, § 1:16.

93. *Morton*, 629 A.2d at *passim*.

94. *Id.*

95. *Lewis et al.*, *supra* note 84.

96. Before 2006, coverage had been found for “*E. coli* bacteria, radioactive dust, noxious air particles, lead, asbestos, mold, mildew, ‘health-threatening organisms,’ vaporized agricultural chemicals, and pesticides.” *Id.*

97. *Cooper v. Travelers Indem. Co. of Ill.*, No. C-01-2400-VRW, 2002 WL 32775680, at \*1 (N.D. Cal. Nov. 4, 2002), *aff’d*, 113 F. App’x 198 (9th Cir. 2004).

98. *Motorists Mutual Ins. Co. v. Hardinger*, 131 Fed. Appx. 823, 825–27 (3d Cir. 2005); see also *Port Authority of N.Y. and N.J. v. Affiliated FM Ins. Co.*, 311 F.3d 226, 235–36 (3d Cir. 2002) (ruling that if “the presence of large quantities of asbestos in the air of a building is such as to make the structure uninhabitable and unusable, then there has been a distinct loss to its owner which would constitute ‘physical loss.’”).

99. *Columbiaknit, Inc. v. Affiliated FM Ins. Co.*, No. Civ. 98-434-HU, 1999 WL 619100, at \*6 (D. Or. Aug. 4, 1999).

100. *Matzner v. Seaco Ins. Co.*, 9 Mass. L. Rptr. 41, 1998 WL 566658 (1998).

insurer could deny coverage for a loss caused by 1% of an excluded peril and 99% by a covered peril.”<sup>101</sup> The California Supreme Court addressed this issue in *Julian v. Hartford Underwriters Ins. Co.*, noting that such an interpretation “would raise troubling questions regarding the clause’s consistency with the efficient proximate cause doctrine. Denial of coverage for such a loss would suggest the provision of *illusory insurance*. . . .”<sup>102</sup>

As a closely related matter, virus exclusions that attempt to limit or exclude an otherwise covered peril may violate the California “efficient proximate cause” doctrine, the California Insurance Code, and California case law. Pursuant to these authorities, insurance companies cannot contractually exclude or limit coverage when a covered peril is the “efficient proximate cause” of a given loss regardless of the presence of other contributing causes.<sup>103</sup> “Where the policy provides coverage for a specified peril, if the specified peril is the predominant cause of the loss, the loss is covered regardless of whether there were excluded contributing causes.”<sup>104</sup>

In *State Farm Fire & Casualty Co. v. Von Der Lieth*, rising groundwater levels and earth movement cracked, tilted, and damaged the insured’s property.<sup>105</sup> The rising groundwater levels and earth movement were excluded perils. However, the court found that the “efficient proximate cause” of the loss was the negligent failure of certain public entities and private parties to take proper measures to preserve the area—which was a covered peril. The court held that the covered peril—and not the excluded peril—was the

“efficient proximate cause” of the insured’s loss.

Under the “efficient proximate cause” doctrine, business owners can and should argue that the virus and civil authority order are two *separate* and *distinct* causes of loss, with the government order being the efficient proximate (i.e., predominant) cause of the loss. Additionally, the government-mandated business closures are an *independent causal agent* that effectuated business owners’ suspensions of business operations and resulted in lost business income. The civil authority orders are not dependent on actual “loss or damage caused by or resulting from any virus.” In fact, in some cases, loss or damage caused by the coronavirus has not occurred independently of the civil authority order, especially in areas where the coronavirus may not be present at all (e.g., areas where there are no recorded cases of coronavirus infections). However, regardless of whether the virus was present or not, the claimant nevertheless suffered loss of use of the insured property due to a covered cause: the government order.

In summary, a policyholder may argue that insurance coverage is illusory where (1) the policyholder had a reasonable expectation that there would be coverage for lost business income due to a business interruption or government-mandated business closure; and (2) there is evidence that the policy covers lost business income due to government-mandated business closures. Under certain circumstances, denying coverage on the basis of a virus exclusion may render such coverage improperly illusory. Moreover, virus exclusions may

101. 1 CROSKY ET AL., *supra* note 7, ¶ 6:142.18.

102. *Julian*, 35 Cal. 4th at 759 (emphasis added); *see also* *De Bruyn v. Superior Court*, 158 Cal. App. 4th 1213, 1223 (2008) (noting that “application of such broad language in an exclusion might render illusory provisions that purport to cover other perils”); 1 CROSKY ET AL., *supra* note 7, ¶ 6:142.18.

103. *See* Cal. Ins. Code § 530; *Julian v. Hartford Underwriters Ins. Co.*, 35 Cal. 4th 747, 751 (2005); *see also* *De Bruyn*, 158 Cal. App. 4th at 1223; 1 CROSKY ET AL., *supra* note 7, ¶ 6:142 (“Many property insurance policies contain exclusionary language that appears to limit coverage to a greater extent than would be the case under the efficient proximate cause analysis. For example, some policies deny coverage for loss ‘caused directly or indirectly’ by excluded perils ‘regardless of any other cause or event contributing concurrently or in any sequence to the loss.’ If applied literally, this language would allow an insurer to deny coverage for a loss caused in part by an excluded peril, even though the efficient proximate cause of the loss was a covered peril. Such provisions are unenforceable to the extent that they conflict with [Insurance Code section] 530 and the efficient proximate cause doctrine: “[R]easonable insureds consider themselves insured against losses proximately caused by perils covered under a first party insurance policy, regardless of contrary language employed in connection with excluded perils.”).

104. 1 CROSKY ET AL., *supra* note 7, ¶ 6:142.16 (citing *Vardanyan v. AMCO Ins. Co.* 243 Cal. App. 4th 779, 792 (2015)).

105. *See* *State Farm Fire & Cas. Co. v. Von Der Lieth*, 54 Cal. 3d 1123, 1133 (1991); *see also* 1 CROSKY ET AL., *supra* note 7, ¶ 6:137.4.

also violate the California “efficient proximate cause” doctrine if they attempt to exclude or limit coverage when a covered peril is the “efficient proximate cause” of a loss regardless of whether other contributing causes were present.

#### **4. “Pathogenic Organisms Exclusions” Should Apply Only to Third Party Liability**

Although not too common, some policies may contain a “Pandemic Organisms Exclusion.” An example of such a provision includes the following policy language:

This insurance does not apply to: (1) “Bodily Injury,” “Property Damage,” “Personal Injury,” or “Advertising Injury” arising out of any “pathogenic organisms”, regardless of any other cause or event that contributed concurrently or in any sequence to that injury or damage.

“Pathogenic organisms” means any bacteria, yeasts, mildew, virus, fungi, mold, or their spores, mycotoxins, or other metabolic products.

The coverages identified in the first quoted paragraph of the exclusion typically only apply to the third party liability side of the policy, and not to the first party property damage side. Unlike the broader ISO virus exclusion, this pathogenic exclusion does not even mention the coverages for loss of business income or any of the other coverages typically associated with the first party property side of the policy. This could at the very least create an ambiguity that would operate in favor of coverage for the insured. Then again, if the broad definition of “property damage” is used to work in favor of the insured on the first party side of the policy to establish “direct physical loss”, it could potentially also be used against the insured in upholding this exclusion for

those same claims.

Notwithstanding the above, insurers are likely to have a hard time persuading courts that the “Pandemic Organisms Exclusion”, applicable to third-party liability coverage, somehow unambiguously limits first-party business interruption coverage. As the drafter of the policy, the insurer runs the risk that any ambiguity in the policy will be construed against it. Thus, if the first party liability section does not expressly exclude the risk of virus-caused losses, courts are likely to contextually interpret the attempted application of such an exclusion to first-party property loss to be ambiguous and, as such, the “pathogenic organisms exclusion” should not apply to limit or exclude that coverage.

### **V. Additional Causes of Action to Consider**

#### **1. Estoppel by Omission: Insurers Could and Should Have Expressly Excluded Losses Caused by Viruses But Have Failed to Do So in Many Policies**

As explained above, insurance companies are well aware of the risk of virus-caused losses, especially in light of past virus outbreaks, including Ebola virus, H1N1 (swine flu and bird flu), severe acute respiratory syndrome (SARS), and Middle East respiratory syndrome (MERS). Because of these legitimate, real risks, virus exclusions and other similar provisions exist to preclude coverage for virus-caused losses.

Many business insurance policies are “all risk” (or “open peril”) policies “covering all losses not expressly excluded in the policy.”<sup>106</sup> In an “all risk” business insurance policy, “the limits of coverage are defined by the *exclusions*.”<sup>107</sup> A virus that causes damage or loss to the insured property is a “risk of physical loss” and thus covered under an “all risk” policy unless specifically excluded. As such, many business insurance policies specifically *exclude* viruses as a cause of loss.

106. 1 CROSKEY ET AL., *supra* note 7, ¶ 6:250.

107. *Id.* ¶ 6:251 (emphasis in original) (citing *Garvey v. State Farm Fire & Cas. Co.*, 48 Cal. 3d 395, 406 (1989); *Nissel v. Certain Underwriters at Lloyd's of London*, 62 Cal. App. 4th 1103, 1114 (1998)).

However, many “all risk” business insurance policies omit these exclusions—they contain no provision that expressly precludes coverage for virus-caused losses. In such policies, because viruses are not specifically excluded, business interruption coverage should apply. Insurers could, and should, have expressly excluded viruses-caused losses but have intentionally failed to do so, despite having knowledge and actual notice of a real risk for virus-caused losses. Because insurers have not excluded risks for virus-caused losses in these policies, they have accepted the risk and should bear the loss. Business owners should argue that insurers are estopped from denying coverage for virus-caused losses under “all risk” policies because insurers have omitted express and explicit exclusions for risks of losses caused by viruses.

Additionally, the current property damage that California business owners have sustained is the result of a pandemic, which is a “natural disaster”—a type of major casualty event that is supposed to trigger coverage for damage. In fact, recently, the Pennsylvania Supreme Court in *Friends of DeVito v. Wolf* concluded that business losses caused by the COVID-19 pandemic are *indistinguishable* from those caused by other *natural disasters* like earthquakes, hurricanes and fires.<sup>108</sup> This is important because these are all major casualty events for which property-based insurance is intended to provide coverage. Thus, where an insurer has omitted a virus exclusion, California business owners have an objectively reasonable expectation that lost business income caused by the coronavirus constitutes a covered loss under an “all-risk” policy.

## 2. Brokers and Agents May Be Liable for Professional Negligence for Breach of Their Duty of Reasonable Care to the Insured and Insurance Companies May Be Vicariously Liable for the Conduct of Brokers and Agents

In addition to asserting various claims directly against insurance carriers, policyholders should also consider potential claims for professional negligence against their insurance agents and brokers. Depending on those brokers’ representations as to their own expertise, the scope of coverage available, and the scope of coverage ultimately procured, a broker may be found personally liable. Insurance for business losses due to pandemics was available before the Coronavirus struck.<sup>109</sup>

Licensed insurance agents and brokers can be expected to carry errors and omissions policies to cover themselves for claims of professional negligence. Moreover, as discussed in more detail below, if an insurance broker has an “appointed agent” status with a carrier, the insurer itself may be held vicariously liable for the professional negligence of the broker.

### A. Professional Negligence of Broker

In California, an “insurance broker” is defined by statute as a “person who, for compensation and on behalf of another person, transacts insurance other than life insurance with, but not on behalf of, an insurer.”<sup>110</sup> The function of a broker is to represent the proposed insured in negotiating with insurance companies on rates, premiums, and terms of coverage.<sup>111</sup> For many insureds, the friendly and helpful face of their insurance broker represents their only personal contact with their insurance companies. Brokers typically act at the buyer’s instructions as to what sort of coverage they need and often work with multiple insurance companies to place coverage for

108. See *Friends of DeVito v. Wolf*, No. 68 MM 2020, 2020 WL 1847100 (Pa. Apr. 13, 2020) (emphasis added).

109. SEE RUSS BANHAM, *THIS INSURANCE WOULD HAVE HELPED IN CORONAVIRUS CRISIS BUT NOBODY BOUGHT IT*, INS. J. (APR. 3, 2020), [HTTPS://WWW.INSURANCEJOURNAL.COM/NEWS/NATIONAL/2020/04/03/563224.HTM](https://www.insurancejournal.com/news/national/2020/04/03/563224.htm).

110. CAL. INS. CODE §§ 33, 1623.

111. See *Krumme v. Mercury Ins. Co.*, 123 Cal. App. 4th 924, 929 (2004).



their clients.

When seeking to establish themselves as more than a customer's "personal shopper," many insurance brokers expressly hold themselves out as *experts* in obtaining insurance for certain industries (like restaurants or hotels) and in the procurement of various kinds of insurance, including business income and interruption coverage. For example, one prominent broker publicly professes an ability to "Make the Complex Simple" in relation to helping clients procure business interruption insurance:

When you have an operation that is spread across the country or is very large in size, you need a business interruption policy. Chances are you have critical operations in different regions, and when catastrophes or other events occur that hinder or stop smooth operations, they affect your entire business process. . . . Business insurance is one way to protect your revenue. Examine your unique risks with an IOA advisor to determine your coverage needs.<sup>112</sup>

The broker that made these sweeping representations—IOA Insurance Services—represented its unique expertise in procuring business income and interruption insurance in order to sell a policy issued by Sentinel Insurance Company (a wholly owned subsidiary of The Hartford Financial Services) to its client. The subject policy included business income coverage, extra expense coverage, and "limited fungi,

bacteria, or virus coverage." When the carrier denied the business income claim due to the current pandemic, the insured sued for coverage and bad faith. If the court upholds the denial of coverage, there is an alternative claim against IOA for professional negligence.<sup>113</sup>

The negligent representations and omissions of the subject broker are not uncharacteristic. Indeed, business owners routinely rely on such instances of a broker's professed expertise in obtaining insurance policies. As such, an insurance broker owes a duty of reasonable care in procuring the specific type of insurance that a buyer requests. Thus, an insurance broker may be personally liable for losses suffered by an insured as a result of a broker's breach of duty to the insured arising from (1) negligent misrepresentations regarding the nature, extent, or scope of coverage<sup>114</sup> or (2) a broker's negligent failure to obtain coverage specifically requested by the insured.<sup>115</sup>

Moreover, brokers who hold themselves out as experts in a particular field of insurance sought by a prospective insured may be personally liable for losses suffered by the insured in reliance on the broker's negligent advice.<sup>116</sup> In addition, liability will also be found where a broker reduces coverage limits without the consent of the insured.<sup>117</sup> Significantly, a broker can also be liable for certain misrepresentations even if those misrepresentations contradict the written terms of the policy and the insured did not read the policy before relying on the broker's misrepresentations.<sup>118</sup> Where liability is found against an insurance broker, liability will extend to any proximately caused

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112. *Business Interruption*, IOA INS. SERVS. INC., <https://www.ioausa.com/business-insurance/business-interruption> (last visited on April 28, 2020).

113. *See* Complaint, *Mostre Exhibits LLC v. Sentinel Ins. Co., Ltd.*, [https://www.limandri.com/pdf/mostre\\_complaint.pdf](https://www.limandri.com/pdf/mostre_complaint.pdf) (last visited on May 5, 2020).

114. *See, e.g.*, *Free v. Republic Ins. Co.*, 8 Cal. App. 4th 1726, 1730 (1992); *Clement v. Smith*, 16 Cal. App. 4th 39 (1993).

115. *See, e.g.*, *Westrick v. State Farm Ins.*, 137 Cal. App. 3d 685, 691 (1982); *Greenfield v. Insurance, Inc.*, 19 Cal. App. 3d 803, 811 (1971) (finding that the broker was personally liable for failure to obtain business interruption insurance requested by insured).

116. *See* *Pac. Rim Mech. Contractors Inc. v. Aon Risk Ins. Servs. West, Inc.*, 203 Cal. App. 4th 1278, 1283 (2012); *Kurtz, Richards, Wilson & Co. v. Ins. Communicators Mktg. Corp.*, 12 Cal. App. 4th 1249, 1257 (1993).

117. *Saunders v. Cariss*, 224 Cal. App. 3d 905, 909 (1999).

118. *Clement*, 16 Cal. App. 4th at 45 ("[A]n insured should be able to rely on an agent's representations of coverage without independently verifying the accuracy of those representations by examining the relevant policy provisions. This is particularly true in view of the understandable reluctance of an insured to commence a study of the policy terms where even the courts have recognized that few if any terms of an insurance policy can be clearly and completely understood by persons untrained in insurance law.") (citations omitted).

loss resulting from the breach of the broker's duty to the insured.<sup>119</sup>

Whether a broker will be liable for the failure to procure adequate coverage will undoubtedly turn on the representations that each individual broker made as to their expertise and the specific facts surrounding each transaction. Moreover, in this instance, liability will also undoubtedly turn on the standard of practice in the community with respect to brokers advising their clients on the potential for purchasing coverage for business interruptions caused by viruses or pandemics. However, if the risk of viruses and pandemics was foreseeable enough for insurance carriers to exclude them from coverage, especially after the SARS and Ebola epidemics, then it should have been foreseeable enough for brokers to inform their clients that they could seek to endorse around those exclusions. The situation is quite similar to what happened after the September 11, 2001 terrorist attacks. Although many policies subsequently contained terrorism risk exclusions, many insureds have taken advantage of the opportunity to obtain endorsements to still cover the risk of terrorism.

### **B. Vicarious Liability of Insurer for Professional Negligence of Insurance Agent Where the Agent Is the Insurer's "Appointed" or "Captive" Agent**

Under the California Insurance Code, an insurance agent is "a person authorized, by and on behalf of an insurer, to transact all classes of insurance other than life, disability, or health insurance, on behalf of an admitted insurance company."<sup>120</sup> An insurance broker is "a person who, for compensation and on behalf of another person, transacts insurance other than life, disability, or health with, but not on behalf of, an insurer."<sup>121</sup> California defines "trans-

acts" as: "(A) Solicitation; (B) Negotiations preliminary to execution; (C) Execution of a contract of insurance; or (D) Transaction of matters subsequent to execution of the contract and arising out of it."<sup>122</sup> The main difference between an "agent" and a "broker" is that an agent generally has the authority to bind an insurance company to coverage whereas a broker generally does not.<sup>123</sup>

Although an agent is often perceived to as representing the buyer, an agent's role often changes during the insurance transaction and over the course of the agent's relationship with their clients. For example, many agents sometimes act as an agent of the insurer, such as when handling premium payments or accepting claims from a client. Determining whether an agent is transacting business on behalf of the insured or insurer is not always a clear-cut proposition. An intermediary conducting insurance "transactions" might be called a "broker" but actually represent the insurance company in a particular transaction. In such situations, the broker is actually *and* legally considered the company's agent rather than the customer's.<sup>124</sup>

Insurance companies may be held vicariously liable for a brokers' liability for professional negligence where an insurance broker serves as the insurance company's "appointed" agent. Insurance brokers often serve as "appointed agents" of the insurance companies with which they place buyers' business. "In addition to possessing a license, an insurance agent must be authorized by an insurance carrier to transact insurance business on the carrier's behalf. This authorization must be evidenced by a notice of agency appointment on file with the Department of Insurance."<sup>125</sup> In California, "[a] person licensed as a broker-agent shall be deemed to

119. *Valentine v. Membrilla Ins. Servs., Inc.*, 118 Cal. App. 4th 462 (2004).

120. CAL. INS. CODE §§ 31, 1621 (2020).

121. *Id.* §§ 33, 1623.

122. *Id.* § 35; see also *Glossary*, CAL. DEP'T. INS., <http://www.insurance.ca.gov/0200-industry/0090-faq/glossary.cfm> (last visited on May 3, 2020).

123. See *Marsh McLennan of Calif., Inc. v. City of Los Angeles*, 62 Cal. App. 3d 108 117–18 (1976).

124. See World Fed'n of Ins. Intermediaries, *The Role of Insurance Intermediaries*, COUNCIL OF INS. AGENTS & BROKERS, <https://www.ciab.com/wp-content/uploads/2017/04/RoleOfInsInt.pdf> (last visited on April 29, 2020).

125. *Chicago Title Ins. Co. v. AMZ Ins. Servs., Inc.*, 188 Cal. App. 4th 401, 425 (2010).

be acting as the insurer's agent in the transaction of insurance placed with those insurers for whom a notice of appointment has been filed with the Insurance Commissioner."<sup>126</sup> Business owners can quickly determine whether insurance brokers are "appointed agents" of insurance companies by searching for a broker's license page on the state insurance commissioner's website. For example, IOA Insurance Services, which is the subject of a complaint for professional negligence, serves as an "appointed agent" for both of its co-defendant insurance companies.<sup>127</sup>

Similarly, an insurance company may be vicariously liable for an agent's professional negligence where the agent is a "captive agent" for the insurance company. A "captive" agents (also known as "exclusive" agent) has an agency relationship with and represents only one insurance company, and is "contractually obligated to sell and service policies written only by that company"<sup>128</sup> and to "submit business only to that company, or at the very minimum, give that company first refusal rights on a sale."<sup>129</sup> Captive agents "may be full-time employees of the insurer or independent contractor"<sup>130</sup>s."

Under the law governing an insurer's liability for its appointed agents, insurance companies, as

principals, may be vicariously liable for the professional negligence of their appointed agent if the insurance company "directed or authorized the agent to perform the tortious acts, or if it ratifies acts it did not originally authorize."<sup>131</sup> For example, an insurance company may be vicariously liable for an agent's failure to procure the type of insurance sought by the insured if the insurer ratified the agent's act or if the agent had "apparent" authority.<sup>132</sup> Additionally, an insurer may be vicariously liable for its agent's negligent misrepresentations as to the existence or scope of coverage.<sup>133</sup> In such a situation, an agent's representations to business owners regarding coverage when selling a policy may have the effect of expanding the coverage beyond that actually provided by the policy even when there is no ambiguity.<sup>134</sup> For example, in *Desai v. Farmers Insurance Exchange*, a California appellate court held that a "failure to deliver the agreed-upon coverage is actionable."<sup>135</sup> The court found that an insurance company's agent negligently represented to an insured that an insurance policy provided the full 100% replacement cost coverage that the insured specifically requested before he purchased his policy.<sup>136</sup> The court recognized that the insurance company's agent failed "to deliver the agreed-upon coverage."<sup>137</sup>

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126. CAL. INS. CODE § 1731.

127. See Complaint, *supra* note 113.

128. 1 CROSKY ET AL., *supra* note 7, ¶¶ 2:1.2, 2:5.5.

129. *Finding an Agent or Broker*, CAL. DEP'T. INS., <http://www.insurance.ca.gov/01-consumers/105-type/findagtbrk.cfm> (last visited on May 3, 2020); see also *Fairbanks v. Farmers New World Life Ins. Co.*, 197 Cal. App. 4th 544, 567 n.8 (noting that "captive" agents "could not place insurance with any other company"); *Desimone v. Allstate Ins. Co.*, No. C 96-03606 CW, 2000 WL 1811385, at \*14 (N.D. Cal. Nov. 7, 2000) (noting that a captive agent "may not sell insurance for competing companies without Defendant's approval").

130. 1 CROSKY ET AL., *supra* note 7, ¶¶ 2:1.2, 2:5.5.

131. See *Am. Way Cellular, Inc. v. Travelers Prop. Cas. Co. of Am.*, 216 Cal. App. 4th 1040, 1051 (2013) ("An insurer, as a principal, may be vicariously liable for the torts of its agent if the insurer directed or authorized the agent to perform the tortious acts, or if it ratifies acts it did not originally authorize.") (citing *Desai v. Farmers Ins. Exch.*, 47 Cal. App. 4th 1110, 1118 (1996)) (citations omitted); see also *Jackson v. Aetna Life & Casualty Co.*, 93 Cal. App. 3d 838, 840, 848 (1979) (finding that an insurance company may be held vicariously liable where an insurance agent negligently failed to add an "additional insured" to a policy and failed to fulfill its basic obligation to provide the insurance required by the policy's intended beneficiary and demanded from the agent).

132. See *R&B Auto Ctr., Inc. v. Farmers Grp., Inc.*, 140 Cal. App. 4th 327, 337 (2006).

133. See *Paper Savers, Inc. v. Nacka*, 51 Cal. App. 4th 1090, 1099 (1996).

134. See *Hartford Fire Ins. Co. v. Spartan Realty Int'l, Inc.*, 196 Cal. App. 3d 1320, 1325 (1987) ("[F]raud or misrepresentation as to coverage under a policy or issuance of a policy different from that represented to the insured estops the insurer from reliance on the coverage as stated in the issued policy."); *R&B Auto Ctr.*, 140 Cal. App. 4th at 339 n.11 (2006) (finding that an agent's misrepresentation may be grounds for reformation of the policy to provide the coverage promised).

135. *Desai v. Farmers Ins. Exch.*, 47 Cal. App. 4th 1110, 1119 (1996) (internal quotations omitted).

136. *Id.*

Significantly, under California law, litigants seeking to recover damages for professional negligence from an agent or broker may also potentially recover their attorney's fees. "[I]t is a well-established principle that attorney fees incurred through instituting . . . an action as a direct result of the tort of another are recoverable damages."<sup>138</sup>

### 3. Illusory Coverage Arguments

Although it is less common, business interruption coverage may also be found if a policy contains language or provisions that make coverage "illusory." The Illusory Coverage Doctrine "is implicated when an insurance policy is written in such a way that could give the policy holder the 'illusion' that the policy covers risks that are not actually covered."<sup>139</sup> In other words, the policy purports to cover a loss that is contemplated and reasonably expected by the insured, but the policy does not actually cover that loss. The policy gives the "illusion" that it would normally cover such loss by the very nature, name, and type of the insurance policy. "Insurance coverage is deemed illusory when the insured receives no benefit under the policy."<sup>140</sup> "An interpretation that would render the objectively reasonable expectations of the insured for coverage under the policy 'meaningless' is an example of illusory coverage. Factors that may be considered in determining the existence of 'illusory coverage' are: (1) the business of the insured; and (2) the procedures of the insured in carrying on its

business."<sup>141</sup>

A court will generally refuse to apply an exclusion if the exclusion completely eliminates all potential coverage under a policy.<sup>142</sup> However, most exclusions do not preclude *all* potential coverage. They generally preclude coverage under limited extensions of coverage. For example, in *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*,<sup>143</sup> a California court held that it would not interpret an exclusion, as urged by the insurer, "in a manner that would defeat the objectively reasonable expectations of the insured, where to do so would render the coverage described in the policy's definitions illusory."<sup>144</sup> Similarly, a court in the Southern District of California refused to read the definition of "damages" narrowly—even if it could be read narrowly to exclude attorneys' fees—where the policy expressly provided coverage for derivative actions, and the main liability at issue in derivative actions are the plaintiff's attorneys' fees.<sup>145</sup>

Although most business interruption policies are unlikely to be found illusory, business owners should carefully review their policies to determine if there was a reasonable expectation of coverage, whether there was an illusion that coverage would be provided for the claimed loss, or whether the policy contains an exclusion, condition, or limitation that makes it nearly impossible for coverage apply. Coverage may be illusory under certain circumstances, including (1) where a policy provides for limited virus coverage but concurrently contains a virus exclusion or requires impracticable conditions to be satisfied for coverage

137. *Id.*

138. *Third Eye Blind, Inc. v. Near N. Entm't Ins. Servs., LLC*, 127 Cal. App. 4th 1311, 1324 (2005).

139. Ian Weiss, Comment, *The Illusory Coverage Doctrine: A Critical Review*, 166 U. PA. L. REV. 1545, 1546 (2018).

140. *Jeff Tracy, Inc. v. U.S. Specialty Ins. Co.*, 636 F. Supp. 2d 995, 1007 (C.D. Cal. 2009) (citing *Md. Cas. Co. v. Reeder*, 221 Cal. App. 3d 961, 978 (1990)).

141. *Illusory*, CALIFORNIA INSURANCE LAW DICTIONARY & DESK REFERENCE § 12:2 (2019) (citing *Shade Foods, Inc. v. Innovative Prod. Sales & Mktg., Inc.*, 78 Cal. App. 4th 847, 874, *modified on denial of reh'g* (Mar. 29, 2000)).

142. See *Pasadena Area Cmty. Coll. Dist. v. Philadelphia Indem. Ins. Co.*, No. LA 17-CV-08569 VAP (FFMx), 2018 WL 6265078, at \*8 (C.D. Cal. July 27, 2018) (citing *Evanston Ins. Co. v. Atain Specialty Ins. Co.*, 254 F. Supp. 3d 1150, 1166 (N.D. Cal. 2017)); *Century Sur. Co. v. Gene Pira, Inc.*, No. CV 13-07289 DDP (AGRx), 2014 WL 6474987, at \*3 (C.D. Cal. Nov. 19, 2014) ("Insurance policies may not provide illusory coverage.").

143. *Shade Foods, Inc. v. Innovative Prod. Sales & Mktg., Inc.*, 78 Cal. App. 4th 847, *modified on denial of reh'g* (Mar. 29, 2000).

144. *Id.* at 874.

145. See *United States Liab. Ins. Co. v. A&B Mkt. Plus, Inc.*, No. 3:19-CV-0172-GPC-AGS, 2019 WL 2107808, at \*6 (S.D. Cal. May 14, 2019); see also <https://www.limandri.com/failure-of-insurance-carrier-to-pay-1-15-million-attorneys-fees-award-was-breach-of-contract-federal-court-says/>.



to trigger; or (2) where civil authority coverage is denied by an “acts or decisions” exclusion.

#### A. Limited Virus Coverage Provisions

Some business policies have a specific endorsement that provides at least some limited coverage for viruses through what is known as a Limited Virus Coverage provision. Despite this provision, insurers may argue that the novel coronavirus’ presence and/or contamination of physical surfaces does not create a “direct physical loss” and that even such Limited Virus Coverage does not apply.

However, where such an endorsement exists, the insurer’s argument and interpretation could “render the subject coverage illusory because, if [the insurer’s] position is to be accepted, then the Limited Virus Coverage would not apply to any virus whatsoever.”<sup>146</sup> Such an interpretation effectively, actively, and improperly renders the “Limited Virus Coverage” terms meaningless and manifestly illusory because it “defeats the objectively reasonable expectations of the insured.”<sup>147</sup> Furthermore, such an interpretation defies scientific consensus. The deadly coronavirus can, in fact, remain alive and transmittable on surfaces and physical property for a prolonged period measured by days or, by some measures, even week<sup>148</sup>s. As such, taking the position that a virus is not covered under these circumstances is unreasonable (i.e., in “bad faith”) and makes coverage illusory.

Additionally, some limited virus coverage provisions may be illusory because they require unreasonable conditions that must be satisfied in order for coverage to apply. For example, a common endorsement for limited virus coverage requires that the virus be caused by a “specified cause of loss,” which is defined as meaning:

Fire; lightning; explosion, windstorm or hail; smoke; aircraft or vehicles; riot or civil commotion; vandalism; leakage from

extinguishing equipment, sinkhole collapse; volcanic action; falling objects; weight of snow, ice or sleet; water damage.<sup>149</sup>

Here, the virus coverage is illusory because it is written in such a way that it gives business owners the “illusion” that the policy covers a risk that is not actually covered. No reasonable insured would expect that a virus would be caused by any of the above specified causes of loss. Moreover, the provisions in some of these convoluted limited virus provisions—which opaquely refer to some “specified cause of loss”—are anything but “conspicuous, plain, and clear.” Indeed, the insured has to hunt elsewhere in the voluminous policy, without direction, in order to find any definition of a “specified cause of loss.” More importantly, the absurdity of thinking that any of the specified causes would result in a virus renders the promised coverage not just “limited” but virtually nonexistent.

#### B. Civil Authority Coverage Provisions

Similarly, civil authority coverage may be found illusory where such provisions do not actually provide coverage for business income loss resulting from a government lock-down order. For example, despite representing that an insured has coverage for income loss caused by the closure order of a “civil authority,” some carriers may incorrectly seek to assert an exclusion in the policy for losses caused by “acts or decisions” of a “government body” that would allegedly deny coverage. A carrier taking such an unreasonable position under these circumstances may be found to have acted in bad faith.

#### C. Pollution Exclusions

Pollution exclusions may operate to render coverage illusory where they defeat a business owner’s objectively reasonable expectation that the coronavi-

146. Complaint, *supra* n 113, at 12, *Mostre Exhibits v. Sentinel Ins. Co.*, [https://www.limandri.com/pdf/mostre\\_complaint.pdf](https://www.limandri.com/pdf/mostre_complaint.pdf) (last visited on May 5, 2020).

147. *Shade Foods*, 78 Cal. App. 4th at 874.

148. See Dormalen et al., *supra* note 61; Walker, *supra* note 61.

149. See Complaint, *supra* note 113, at 83.

rus is *not* a pollutant. For business interruption policies that contain a standard pollution exclusion, insurers are very likely to argue that the coronavirus constitutes a “contaminant” and therefore coverage does not apply. However, such an interpretation and denial on these grounds arguably makes coverage illusory because an insured is presented with the illusion (and reasonable expectation) that losses caused by the coronavirus—a microorganism rather than a pollutant—is covered by a business interruption policy. Indeed, the California Supreme Court has held that the pollution exclusion only applies to environmental pollutants, such as oil spills—not microorganisms, pathogens, or viruses.<sup>150</sup>

## VI. Possible Legislative Solutions

Several states have proposed business interrup-

tion insurance legislation.<sup>151</sup> Most of these states have proposed to rewrite existing insurance policies to cover business losses caused by government-mandated business closures. This proposed legislation has received criticism for interfering with and impairing the provisions of insurance contracts.<sup>152</sup> However, state legislatures may be justified in impairing insurance contracts because of their longstanding power to regulate insurance companies, their inherent police power to enact laws necessary for the public good, and for public policy reasons effectuated in order to achieve a significant and legitimate public purpose. In fact, courts have upheld laws that arguably impair or modify insurance contract provisions on these grounds.<sup>153</sup>

To date, California has not proposed any such legislation. However, the state legislature could follow

150. See *MacKinnon v. Truck Ins. Exch.*, 31 Cal. 4th 635, 652–54 (2003); *accord Paternostro v. Choice Hotel Int’l. Servs. Corp.*, No. 13-0662, 2014 U.S. Dist. LEXIS 161157, at \*76 (E.D. La. Nov. 14, 2014) (bacteria does not qualify as pollutant); *Keggi v. Northbrook Prop. & Cas. Ins. Co.*, 13 P.2d 785, 790 (Ariz. Ct. App. 2000) (pollution exclusion does not include bacteria); see also *Westport Ins. Corp. v. VN Hotel Grp., LLC*, 761 F. Supp. 2d 1337, 1343 (M.D. Fla. 2010), *aff’d*, 513 F. App’x 927, 931–32 (11th Cir. 2013) (holding that bacteria are not pollutants because: (1) they are not “irritants” or “contaminants” and they are not “solid, liquid, gaseous, or thermal” non-living substances, which were the only contaminants defined as “pollutants” under the policy’s pollution exclusion; and (2) “if the bacteria was considered a pollutant, the fungi/bacteria exclusion would be meaningless”); *Johnson v. Clarendon Nat. Ins. Co.*, No. G039659, 2009 WL 252619, at \*1, \*11 (Cal. Ct. App. Feb. 4, 2009) (holding that mold growth does not qualify as a “conventional environmental pollutant” and that there was no “unintended but widespread dissemination of an environmental pollutant from a place of confinement” as required by the policy at issue and by *MacKinnon*).

151. See Elizabeth Blossfield, *Despite Insurance Industry Concerns, More States Introduce COVID-19 BI Bills*, INS. J. (April 15, 2020), <https://www.insurancejournal.com/news/east/2020/04/15/564920.htm> (noting that the following states have introduced legislation: Pennsylvania, New Jersey, Ohio, New York, Louisiana, South Carolina, and Massachusetts); Tiffany Powers, Adam J. Kaiser, & Robert D. Phillips, Jr., *COVID-19: Insurance Litigation and Regulatory Responses*, ALSTON & BIRD (Apr. 26, 2020), <https://www.alston.com/en/-/media/files/insights/publications/2020/04/20200426updated-insurance-50-state-tracker.pdf>.

152. See John Sylvester, *Pa. COVID Insurance Bill Differs from Other States’ Proposals*, LAW360.COM (April 19, 2020, 3:25 PM), <https://www.law360.com/articles/1264905/pa-covid-insurance-bill-differs-from-other-states-proposals>. Generally, under the Contracts Clause of the U.S. Constitution, states may not pass laws that impairs contractual obligations. See U.S. CONST. Art. I, § 10, cl. 1.

153. See, e.g., *Campanelli v. Allstate Life Ins. Co.*, 322 F.3d 1086, 1098–99 (9th Cir. 2003) (upholding a California law that retroactively allowed property insurance claims of earthquake victims otherwise barred by contractual limitations periods because “[p]rotecting the rights of victims” was a “significant and legitimate public purpose”); *Vesta Fire Insurance Corp. v. Florida*, 141 F.3d 1427 (11th Cir. 1998) (upholding a Florida law that prohibited insurance companies from refusing to renew insurance policies after a hurricane because “protection and stabilization of the Florida economy” was a “significant and legitimate public purpose”); *State v. All Prop. & Cas. Ins. Carriers Authorized & Licensed To Do Bus. In State*, 937 So. 2d 313, 326 (La. 2006) (upholding Louisiana statute that extended prescriptive periods for property insurance claims arising from hurricanes because the law was “based upon a significant and legitimate public purpose”); *Liberty Mut. Ins. Co. v. Whitehouse*, 868 F. Supp. 425, 431 (D.R.I. 1994) (holding that a Rhode Island law requiring insurance payments to workers’ compensation recipients did not violate contract clause because “insurance is a ‘heavily regulated’ business and insurers are on notice that amounts payable to injured workers are subject to change” and the law “constituted[d] a reasonable and appropriate means of achieving a ‘significant and legitimate public interest’”); see also *Welch v. Brown*, 551 F. App’x 804, 811 (6th Cir. 2014) (collecting cases that recognize that “addressing a fiscal emergency is a legitimate public purpose”); Sylvester, *supra* note 152 (the legislative findings in the Pennsylvania proposed legislation declared the state legislature’s inherent police power to enact laws that are necessary for the public good, which includes the “impairment of contract rights when the legislature has a significant and legitimate public purpose, such as remedying a social or economic problem”).

the example of other states and propose legislation in the next few months. Shortly after California closed down businesses, 33 bipartisan members of the California congressional delegation wrote to the California Department of Insurance (CDI) Commissioner Ricardo Lara urging him to “exercise all authority to ensure that insurance companies comply with their business interruption policies.”<sup>154</sup> In response, Commissioner Lara and the CDI issued a notice requiring insurance companies to comply with their contractual, statutory, regulatory, and other legal obligations to fairly investigate all business interruption claims caused by COVID-19.<sup>155</sup> Indeed, Commissioner Lara’s notice and guidance makes clear that, in light of the COVID-19 pandemic, insurance companies need to provide a complete and fair investigation of business interruption claims and not simply deny them outright. Despite that admonition, it appears that many insurance carriers are routinely denying these business interruption claims with little or no investigation.

## VII. Conclusion

Business interruption policies are intended to provide coverage for loss of income in the face of disasters, particularly where such disasters result in government ordered business closures. Courts should soon resolve the issue in favor of insureds that the coronavirus causes “direct physical loss or damage” to covered property so as to trigger business interruption coverage. The coronavirus attaches to physical surfaces and renders them dangerous to users. Furthermore, the standard commercial property policy defines “property damage” as including “loss of use.”

Some of the exclusions that carriers are asserting to deny coverage (e.g., the pollution exclusion and the “acts or decisions” exclusion) render the promise of coverage for business losses illusory and will undoubtedly subject them to exposure for bad faith. The same can be said of carriers that unreasonably assert the requirement for a direct physical loss to covered property as a basis to deny coverage when the policy otherwise contains an endorsement that provides at least limited coverage for losses caused by a virus.

Business owners seek insurance for the same reason that any other person buys insurance: as protection for that loss, or especially a catastrophe, from which no ordinary business can hope to quickly recover. The coronavirus and its associated pandemic are a paradigmatic example of a disaster from which prudent business owners would reasonably expect to seek shelter. However, the insurance industry has failed to offer their clients and customers the protection that they purchased and expected.

Nevertheless, courts and lawmakers may yet vindicate the bargained-for benefits of policyholders across the country. The very exclusions to which insurance companies point may not be sufficiently plain, clear or conspicuous to be enforceable. Moreover, some policyholders may successfully seek recovery from the broker that promised them the protection that, ultimately, came up lacking. In the end, the democratic process may ultimately prevail to provide a more efficient form of justice. Whichever form this relief may eventually take, insureds have multiple arrows in their quiver in the fight for coverage and a good hope of victory.

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154. Paul S. White & Siobhan A. Breen, *33 Members of California Congressional Delegation Ask CA Insurance Commissioner to Ensure Access to Business Interruption Insurance*, NAT’L L. REV. (April 8, 2020), <https://www.natlawreview.com/article/33-members-california-congressional-delegation-ask-ca-insurance-commissioner-to>.

155. Press Release, Cal. Dep’t of Ins., Commissioner Lara Requires Insurance Companies to Fairly Investigate All Business Interruption Claims Caused by COVID-19 (April 14, 2020), <http://www.insurance.ca.gov/0400-news/0100-press-releases/2020/release039-2020.cfm>.

