Will Your Customers Prevail on COVID-Related Business Interruption Insurance Claims?

by
Brent C. Shaffer
Young Conaway Stargatt & Taylor, LLP

Many customers of Delaware banks have suffered unprecedented economic losses from restrictions imposed on businesses by Governor Carney related to Delaware's State of Emergency, which he declared on March 12, 2020 due to the public health threat caused by COVID-19. Good bankers always keep a close eye on their customers' financial health, and many become trusted advisors to those customers in protecting that health. A great debate arose a year ago as to whether businesses should be filing claims under their property insurance policies to cover COVID-19-related losses. The conventional wisdom was that insurers would not pay such claims. Indeed, insurance claims under various theories to recover lost business income due to COVID-19 were routinely denied, and such denials were then tested in an absolute flood of litigation throughout the country over the past year. The fact that these cases number in the thousands is no doubt a testament to the wide-spread effect of various governmental closure orders and other restrictions on businesses. Now that many courts have weighed in on COVID-19 coverage, where do businesses stand on recovering money from their insurers?

Common Threads

A survey of cases reveals many common threads, but not entirely consistent rulings. Most cases brought by businesses against their insurance companies who have denied coverage under business interruption and other related types of insurance were originally filed in various state courts, but then quickly "removed" to federal courts by the insurance company defendants (federal courts have jurisdiction due to "diversity" of the location of the insured and

the insurance companies). Regardless of whether the cases were brought in state or federal court, state law controls how these coverage cases are decided. Most of the court rulings to date have been on motions as opposed to full trial outcomes; primarily motions of the insurers to dismiss the cases up front for failure to state a valid claim. This means that the procedural posture of the court decisions requires the court to assume that the facts alleged by the insured businesses are correct; the court then determines whether the law provides the business with a sufficient legal basis to argue for insurance coverage under those facts.

All of these cases are breach of contract cases; in other words, the business sues for damages because the insurer did not pay as required under the policies, or the business seeks a ruling from the court instructing the insurer to declare coverage under the insurance policy. Even though these disputes turn on precise contract language in the policy at hand, most insurance policies are written on standard Insurance Services Office ("ISO") forms. As a result, the cases are about the interpretation of similar language and tend to be good precedent for other coverage disputes. The type of the business/nature of the COVID-related closure in each particular dispute tends not to matter much, because all of these cases deal with similar COVID concerns and similar governmental orders across the country. At most, a few court decisions have tried to make factual distinctions between essential businesses that did not have to physically close their operations and those businesses that were forced to close.

Bases for Insurance Claims

The bases for businesses to seek coverage in COVID-19 situations are primarily under business interruption insurance (more properly termed "business income" insurance), "extra expense" coverage (related to business income), and "civil authority" coverage. In a few cases, the businesses have also claimed entitlement to monies under "sue and labor," "ingress and egress," and "dependent property" coverage. Under each of these types of insurance, for an insurance company to be required to pay a claim there must be (1) a covered loss (i.e., in these cases actual loss of business income during suspension of operations); (2) a cause of loss that is a covered cause of loss (in these cases, direct physical loss or damage); and (3) no exclusion from coverage (that applies to defeat the claim even if it is a covered cause of loss).

The first of the various theories of covered loss is under business interruption insurance. Most policies contain the following business income provision: "We will pay for the actual loss of business income you sustain due to the necessary suspension of your operations during the period of restoration. The suspension must be caused by direct physical loss of or damage to property at the described premises." The second basis, "extra expense" coverage, is from a statement

(Continued on p. 20)

(continued from p. 17)

in the policy that the insurer "will pay necessary extra expense that you incur during the period of restoration that you would not have incurred if there had been no direct physical loss or damage to the property at the described premises." The third theory of recovery is the "civil authority" coverage provision, which usually states that "when a covered cause of loss causes damage to property other than property at the described premises, we will pay for the actual loss of business income you sustain and necessary extra expense caused by the action of civil authority that prohibits access to the described premises," provided that both access to the immediately surrounding area is prohibited as a result of the damage and the civil authority's action is in response to dangerous physical conditions resulting from a covered cause of loss that caused the damage.

With respect to exclusions from coverage, there are two exclusions that are typically brought up in the COVID-19-related cases: the "virus exclusion" and the "ordinance or law exclusion." The virus exclusion states that the company will not pay for loss or damage caused directly or indirectly by any virus that induces or can induce physical distress, illness or disease, regardless of whether it is otherwise a covered cause of loss. The ordinance or law exclusion denies coverage of losses as a result of the enforcement of any ordinance or law regulating the construction, use or repair of the property.

Physical Cause of Loss

As mentioned above, there must be a direct physical loss or damage for coverage to occur. This issue is at the heart of all of the COVID-19-related cases. Many of the cases involve businesses claiming that government proclamations that prohibit access or limit use cause physical loss; and in many of the cases the argument is also made that coronavirus droplets that are on the insured premises (or assumed to be on the insured premises) themselves create physical loss to the premises. The plaintiff businesses in these cases seize on the "loss or damage" policy language and seek to distinguish physical loss from physical damage as a covered cause of loss.

No Coverage in Most Cases

How have bank customers faired so far in their insurance litigation? Not well in most states. With the understanding that most of the reported decisions are currently under appeal to higher courts, the majority of these decisions have held that there is no insurance coverage under any of the theories of covered loss because there is no direct physical loss or damage to the premises. These decisions do not equate the government-mandated limits on access to a physical loss such as a fire. Moreover, most of the courts that have not found a covered cause of loss have also stated that the virus exclusion would defeat the claim, even if they had found a covered cause of loss. For example, the U.S. District Court for the Central District of California, in a case involving hotels, ruled that the virus exclusion prevents any business income or civil authority coverage because the executive orders to close were caused by a virus: the desire to halt the physical spread of COVID-19. West Coast Hotel Management, LLC v. Berkshire Hathaway Guard Insurance Companies, 2020 WL 6440037 (Oct. 27, 2020). Similarly, among many other rulings, coverage has been denied to optometrists by courts in Alabama; an online marketing firm in Florida; restaurants in Iowa; barber shops in California; restaurants in New York; a law firm in Pennsylvania; and barber shops in Texas.

Coverage Granted in Some Cases

There are a few cases with the opposite result. Courts denied insurers' motions to dismiss and permitted businesses to allege coverage under property insurance policies in cases involving restaurants in Ohio, Missouri and Washington. Also, in an additional case in Missouri, dentists were allowed to precede to trial over coverage. These cases found that there was a direct physical loss under the policies because of loss of access to the property causing the loss of a property's essential functionality or because of actual contamination by COVID-19. The policies in some of these cases did not have the virus exclusion, but in other cases the policies did and these courts found the virus exclusion not to apply because the loss of income was caused due to government shutdown orders and not COVID-19 itself. Although these cases have received much publicity and offer a glimmer of hope for businesses, they are already being called into question. More recent decisions from the same courts that allowed the cases to proceed in both Missouri and Ohio have now denied coverage in similar situations.

In 2020, legislation was introduced in 11 states and Puerto Rico, and bills were introduced in the U.S. House of Representatives, that would force insurers to retroactively pay for business interruption losses from coronavirus shutdowns. Some of these initiatives passed various assemblies, but only an Illinois bill that established a task force to study the need for changes to business interruption insurance policies became law. As of this writing, in 2021 similar legislation has been introduced in seven states.

Delaware Result

How would Delaware courts rule on this issue? There are no reported Delaware decisions on the topic as this issue goes to press. However, Delaware courts often look to case precedent from neighboring states in the Third Federal Judicial Circuit, such as Pennsylvania. There are several Pennsylvania decisions denying coverage for COVID-19 claims. Most recently, the United States District Court for the Middle District of Pennsylvania in Kahn and AARK Enterprises LLC d/b/a Mauldin's v. Pennsylvania National Mutual Casualty Insurance Company, filed February 8, 2021, granted the insurance company's motion to dismiss, finding no basis existed for

the case to proceed under business income, extra expense and civil authority coverages. Applying Pennsylvania law to the closure of a South Carolina restaurant, predictably the court based its denial on the lack of physical loss of or damage to property. The case focused on policy language requiring some issue with the physical premises that impedes business operations. Like other courts, the court in Kahn used ordinary meaning to define the otherwise undefined phrase "physical loss" in the policy as relating to or involving material things, pertaining to tangible objects; not a mere economic impact.

As of this writing, no bills have been introduced in Delaware to compel insurance companies to pay COVID-19-related claims.

Conclusion

Bankers should continue to focus on assisting their customers with paycheck protection program loans and other relief provided by the Small Business Administration, rather than encourage them to pursue insurance claims. In Delaware, it is a fairly safe bet that these businesses do not have a pot of gold on the way from their insurers, and help from the legislature is unlikely.

As counsel to parties involved in commercial real estate transactions, Brent Shaffer is known for using his experience of over 30 years to focus on the most essential elements and client goals of each transaction, and for his meticulous drafting of documentation to minimize misunderstandings and avoid litigation for each deal as well. Brent takes a practical approach, based largely on his extensive understanding of the reasoning behind common deal requirements. As commercial real estate transactions grow increasingly complex — with more mixed-use projects, more investors in the debt stack, and more regulation affecting every aspect — Brent's clients rely on him for the advocacy and documentation they need to protect their interests.