Practical Guidance

# COVID-19 Business Interruption Decisions for Policyholders: State Appellate Courts (Begin to) Recognize Deviations from a Pre-Pandemic Norm

**A Practical Guidance® Article by Marshall Gilinsky and Rhonda Orin, Anderson Kill**

Marshall Gilinsky
Anderson Kill

Rhonda Orin
Anderson Kill

This article discusses how the momentum in COVID-19 business interruption litigation may be shifting toward policyholders as a state high court as well as a growing number of state appellate courts begin to recognize-finally-that many prior COVID-19 business interruption rulings deviate from the norm. Not all claims are alike and 17% of policies were sold without broad virus exclusions; policyholders with broad policy wordings and strong claims are pursuing coverage at a time when the right to coverage for such claims is pending before several other state supreme courts. The article further outlines how to best navigate an evolving landscape in which state appellate court decisions are acknowledging pre-pandemic precedent holding that losses from fumes, bacteria, and other causes of non-structural damage are covered, and allowing COVID-related business interruption claims to proceed toward trial.

Policyholder advocates reached a critical milestone at the end of September 2022 when the Vermont Supreme Court became the first state high court to adhere to pre-pandemic precedent and hold that well-pled allegations of "direct physical loss or damage" to property from COVID-19 may be sufficient to trigger coverage for business interruption losses. This state supreme court decision comes on the heels of a growing number of state appellate court decisions, including cases from California, Louisiana, and most recently Alaska, favoring policyholders on this critical issue.

The shift comes not a minute too soon for policyholders. Those who purchased first-party property insurance and business interruption policies without broad virus exclusions, and who have pursued coverage on grounds that COVID-19 caused direct physical loss or damage to property, are gathering steam just when the right to coverage for such claims is pending before several other state supreme courts.

For additional information about COVID-19 business interruption litigation, see Business Interruption Insurance: Filing a Claim, COVID-19 Business Interruption Claims Pre-Litigation, COVID-19 Business Interruption Claims Pre-Litigation Checklist, COVID-19 Business Interruption Claims Litigation, COVID-19 Business Interruption Claims Litigation Checklist, Business Interruption Insurance: Post-Pandemic Litigation Developments, COVID-19 Business Interruption Claims State Law Survey, and COVID-19 Insurance Litigation Resource Kit.

## The State of Play before the Pandemic Arose

"Back to the Future" is a good way to describe this shift in favor of coverage. Policyholder advocates take the position that the *norm*—as established by decades of decisions from both federal and state courts—is that damage is tangible and subject to coverage under such policies even when the property is not structurally altered, the principal consequence is a loss of functionality, and neither the cause of the damage nor the damage itself is visible to the naked eye. The *deviation* was the landslide of federal courts at the start of the pandemic that disregarded this well-established precedent and rejected coverage for COVID-19 losses.

How the deviation took over, to the extent that many courts perceived this deviation as the norm, is the classic story—from the policyholders' point of view—of bad cases making bad law, especially under extraordinary circumstances.

## Legal Precedent

For more than 60 years, courts across the country have held the requirement of "physical loss or damage" in property and business interruption policies is satisfied even without structural alteration of the property or damage that is visible to the naked eye.

Where property has been rendered unfit for its intended use—as by smoke from forest fires, toxic dust from nearby building collapses, or microscopic viruses that could kill inhabitants—courts have found "physical loss or damage" that establishes coverage. This was the prevailing state of the law during:

- The 1950s, see:
  - American Alliance Ins. Co. v. Keleket X-Ray Corp., 248 F.2d 920, 925 (6th Cir. 1957) (finding that the policyholder which, manufactured instruments used in measuring radioactivity, had suffered property damage from a release of radon dust and gas that made the building unsafe, and made it impossible to calibrate the instruments prior to sale because of background radiation)
- The 1960s, see:
  - Hughes v. Potomac Ins. Co., 18 Cal. Rptr. 650, 655 (Cal. Ct. App. 1962) (finding that the policyholder's home—which became perched on the edge of a cliff after a landslide deprived it of lateral support and stability—was damaged because it became unsafe to live in and was thus, useless) –and–
  - W. Fire Ins. Co. v. First Presbyterian Church, 437 P.2d 52, 54 (Colo. 1968) (en banc) (finding a "direct physical loss" where a church complied with the fire department's order to close because gasoline vapors made "use of the building dangerous")
- The 1970s, see:
  - Cyclops Corp. v. Home Ins. Co., 352 F. Supp. 931, 937 (W.D. Pa. 1973) (finding the policyholder entitled to coverage for loss of business income where vibration of motor, without apparent damage, caused the business to be shut down)
- The 1980s, see:
  - Hampton Foods, Inc. v. Aetna Cas. & Sur. Co., 787 F.2d 349, 352 (8th Cir. 1986) (finding the policyholder could claim business income coverage where risk of collapse necessitated abandonment of grocery store)
- The 1990s, see in chronological order:
  - Hetrick v. Valley Mut. Ins. Co., 15 Pa. D. & C.4th 271, 1992 Pa. Dist. & Cnty. Dec. LEXIS 236, at *3 (Pa. Commw. Pl. May 28, 1992) (finding there would be coverage for loss of use of a house if an outside oil spill made the house uninhabitable)
  - Largent v. State Farm Fire & Cas. Co., 842 P.2d 445, 446 (Or. App. 1992) (noting that insurance company conceded methamphetamine fumes could cause "accidental direct physical loss")
  - Farmers Ins. Co. v. Trutanich, 858 P.2d 1332, 1335 (Or. App. 1993) (finding costs of methamphetamine odor covered as direct physical loss or damage)
  - Azalea, Ltd. v. American States Ins. Co., 656 So. 2d 600, 602 (Fla. Dist. Ct. App. 1995) (finding damage to sewage treatment plant from chemicals that destroyed a bacteria colony necessary for the plant to operate amounted to "direct damage to the structure")
  - Arbeiter v. Cambridge Mut. Fire Ins. Co., No. 9400837, 5 Mass. L. Rep. 77, 1996 Mass. Super. LEXIS 661, at *2 (Mass. Super. Mar. 15, 1996) (finding oil fumes present in house after discovery of oil leak constituted physical damage)
  - Sentinel Mgmt. Co. v. N.H. Ins. Co., 563 N.W.2d 296, 300 (Minn. Ct. App. 1997) (finding the presence of asbestos could constitute physical loss or damage)
  - Murray v. State Farm Fire & Cas. Co., 509 S.E.2d 1, 17 (W. Va. 1998) (finding a home rendered unlivable by falling rocks had suffered a "direct physical loss to the property")
  - Shade Foods, Inc. v. Innovative Prods. Sales & Mktg., Inc., 78 Cal. App. 4th 847, 865 (2000) (holding that the intermingling of a quarter pound of wood shavings in 80,000 pounds of almonds caused physical loss or damage to the almonds even though the almonds were structurally unchanged)
  - Matzner v. Seaco Ins. Co., 96-0498-B, 1998 Mass. Super. LEXIS 407, at *4 (Mass. Super. Aug. 12, 1998) (concluding that "direct physical loss or damage was ambiguous" and could mean either "only tangible damage to the structure of insured property" or "more than tangible damage to the structure of insured property," and that "carbon monoxide contamination constitutes 'direct physical loss of or damage to property")

- o Columbiaknit, Inc. v. Affiliated FM Ins. Co., No. 98-434-HU, 1999 U.S. Dist. LEXIS 11873, at *7-8 (D. Or. Aug. 4, 1999) (finding that policyholder could bear its burden to demonstrate that clothes containing mold or mildew suffered "direct physical loss or damage" if it established "at trial a class of garments which has increased microbial counts and that will, as a result, develop either an odor, mold, or mildew")
- o Board of Educ. v. International Ins. Co., 720 N.E.2d 622, 625–26 (Ill. App. 1999) (citing liability insurance coverage cases finding that incorporation of asbestos into buildings caused "property damage," defined under liability policies to be "physical injury to or destruction of tangible property") –and–

- This precedent also controlled into the 2000s, see in chronological order:
  - o Sentinel Mgmt. Co. v. Aetna Cas. & Sur. Co., 615 N.W.2d 819, 825-26 (Minn. 2000) (holding that "[a] principal function of any living space [is] to provide a safe environment for the occupants" and "[i]f rental property is contaminated by asbestos fibers and presents a health hazard to the tenants, its function is seriously impaired")
  - o Prudential Prop. & Cas. Ins. Co. v. Lillard-Roberts, No. 01-1362, 2002 U.S. Dist. LEXIS 20387, at *8-9 (D. Or. June 18, 2002) (concluding that mold damage to house could constitute "distinct and demonstrable" damage and that inability to inhabit a building may constitute "direct, physical loss")
  - o Cooper v. Travelers Indem. Co. of Ill., No. 01-cv-2400, 2002 U.S. Dist. LEXIS 29085, at *1 (N.D. Cal. Nov. 4, 2002) (holding that the presence of coliform bacteria and E. coli could constitute physical loss or damage)
  - o Graff v. Allstate Ins. Co., 54 P.3d 1266, 1269 (Wash. Ct. App. 2002) (holding that the presence of methamphetamine vapors could constitute physical loss or damage), when insurance companies paid claims for losses caused by a novel coronavirus, SARS-CoV-1. The coverage included a $16 million payout to one hotel chain, Mandarin Oriental International. See Gavin Souter, Hotel Chain to get Payout for SARS-Related Losses, Business Insurance (Nov. 2, 2003)
  - o See also Disclosure to the Securities and Exchange Commission, dated Oct. 24, 2003. This virus is the immediate predecessor of the virus that was at the heart of the pandemic, formally known as SARS-CoV-2. If not for the magnitude of the losses that arose from the prolonged shutdowns caused by the pandemic, they would have continued to do so through today

## Insurance Industry Approach

Although this line of precedent interpreted insurance policies as providing coverage for damage that was invisible and/or did not involve structural alteration, insurers continued to issue such policies in the wake of this precedent.

Insurers draft their own insurance policies and then sell them to policyholders, after obtaining all necessary approvals from state insurance departments. The Insurance Services Office (ISO) is a trade organization that drafts policy language for insurers. ISO monitors court decisions and updates its forms and endorsements in response thereto. See Insurance Services Office (ISO) Circular dated July 6, 2006, which announces the filing of new endorsements to address exclusion of loss due to disease-causing agents such as viruses and bacteria. Insurers could have added requirements for "visible harm" or "structural alteration" to avoid providing coverage under existing policy language as interpreted by courts. However, no insurers took this approach.

Instead, many insurance companies added an exclusion to their policies, barring coverage for losses arising from viruses. According to a report published by the National Association of Insurance Commissioners (NAIC) shortly after the pandemic began, about 83% of the commercial property insurance policies sold prior to the pandemic included an exclusion for losses caused by virus, communicable disease, or pandemic. See COVID-19 Property & Casualty Insurance Business Interruption Data Call Part 1 | Premiums and policy Information June 2020.

The most common such exclusion was the ISO virus exclusion, see ISO Form CP 01 40 07 06 (2015), which was developed in response to SARS-CoV-1. See Diesel Barbershop, LLC v. State Farm Lloyds, No. 20-cv-461, 479 F. Supp. 3d 353, 2020 U.S. Dist. LEXIS 147276, at *4 (W.D. Tex. Aug. 13, 2020) (virus exclusion "was added to these Policies in response to the SARS pandemic in the early 2000s"); Christopher C. French, COVID-19 Business Interruption Insurance Losses: The Cases For and Against Coverage, 27 Conn. Ins. L. J. 1, 9 (July 1, 2020) (discussing "the 'virus' exclusion, which ISO introduced in 2006 following the SARS outbreak"); Todd C. Frankel, "Insurers knew the damage a viral pandemic could wreak on businesses. So they excluded coverage," Washington Post (April 2, 2020).

The ISO virus exclusion provides:

> We will not pay for loss or damage caused directly or indirectly by . . . [a]ny virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness, or disease" and expressly "applies to all coverage under all forms and endorsements . . . including but not limited to forms or endorsements that

> cover . . . business income, extra expense, or action of civil authority.

But the existence and widespread use of such exclusions serve to underscore the coverage provided by the basic policy form. If the policy form did not cover the inherently non-structural losses caused by invisible viruses in the first place, there would be no need to exclude such damage. The addition of the exclusion would be mere surplusage—an approach toward contract interpretation that is uniformly disavowed.

That such coverage existed in the absence of an exclusion was underscored by the Greater New York Insurance Companies (Greater NY) in 2005, when it asked the New York State Insurance Department for permission to include a virus exclusion in some, but not all, of its property policies. See Greater New York Insurance Companies' Explanatory Memorandum Response to the New York State Insurance Department's "Objection 1," dated April 30, 2020, at 1. There, Greater NY admitted that standard-form property policies using the physical loss or damage formulation cover "this type of loss ('pandemic')." In seeking permission to include a virus exclusion, it asked to make the exclusion optional, as many policyholders would want to *continue* having coverage for viruses. The memorandum further stated "our main object of this filing is to remove the carte blanch application of this exclusion and not deny coverage to the majority portion of our book" for losses stemming from virus.

Additional support that such coverage existed in the absence of an exclusion lies in court filings made by insurance companies about the coverage provided by their policies. For example, just months *before* COVID-19 struck, Factory Mutual Insurance Company (FM)—perhaps the most sophisticated property insurance company in the United States—argued to a federal court in New Mexico that "[n] umerous courts have concluded that loss of functionality or reliability . . . constitutes physical loss or damage." Factory Mutual's Mot. in Limine No. 5 re Physical Loss or Damage, filed Nov. 19, 2019, in Factory Mut. Ins. Co. v. Fed. Ins. Co., No. 1:17-cv-00760-GJF-LF (D.N.M.) (citing W. Fire Ins. Co. v. First Presbyterian Church, 437 P.2d 52 (Colo. 1968); Gregory Packaging, Inc. v. Travelers, 2014 U.S. Dist. LEXIS 165232 (D.N.J. 2014); Essex v. BloomSouth Flooring Corp., 562 F.3d 399, 406 (1st Cir. 2009); 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)). FM then asserted that "'physical loss or damage,' which is undefined, is susceptible of more than one reasonable interpretation and is therefore ambiguous and must be construed against [the drafter]."

That case involved a mold infestation in a "clean room" at a drug manufacturing plant. Factory Mut. at 3. Mold and its spores, like SARS-CoV-2 virions, exist on the surface of property and in the air. FM argued that the mold infestation constituted "physical loss or damage" under a property policy because the mold "destroyed the aseptic environment and rendered [the clean room] unfit for its intended use." FM also told the court that "physical loss or damage" as used in the policy was ambiguous and should be construed in favor of coverage. Factory Mut. at n.1.

Discovery in COVID-related coverage litigation has revealed internal FM communications acknowledging the direct connection between communicable disease and physical loss or damage. An article published in Law360.com attached materials produced by FM showing that the company specifically tracked claims involving communicable disease under "Loss Code 60"—which FM categorized as claims involving "Physical loss or damage which results from the actual presence of a communicable disease and the associated business interruption as defined in the policy." See Eli Flesch, "Vegas Hotel Says Insurer Admits Virus Can Physically Damage" (March 17, 2022).

Insurers' posting of $44 billion of reserves for the pandemic—ranking COVID-related losses as the third-largest catastrophe loss ever for the insurance and reinsurance industry—is also noteworthy. It is preceded only by the September 11 attacks and Hurricane Katrina, according to an industry outlook from Howden Broking. See "COVID losses reach $44B for the third-largest industry loss: Howden," published in Advisen (1/5/22).

## The Pandemic Turns the World on Its Head

When the pandemic turned the world on its head, these well-established legal principles were no exception.

At the start of the pandemic, many policyholders rushed to court seeking coverage under policies containing broad exclusions for losses caused directly or indirectly by bacteria or virus. This burst of often inexperienced advocacy by policyholder counsel put insurers in the catbird seat. The filing of motions to dismiss in cases with the most restrictive policy provisions and even worse facts started the avalanche that reversed decades of well-established coverage law. See Knutsen and Stempel, Infected Judgment: Problematic Rush to Conventional Wisdom and Insurance Coverage Denial in a Pandemic, *27 Conn. Ins. Law J. 185, 201–06 (2020).*

Because most policies contain broad virus exclusions, the complaints in many coverage lawsuits were drafted to allege that the losses were caused by something other than the coronavirus, in the hopes of sidestepping the policies' virus exclusions. Other complaints addressed the cause of loss head on and included allegations about how the virus survives in the air and on surfaces for days or weeks and stated that the virus caused direct physical loss or damage to property by taking property that is safe and useful and turning it into something that is unsafe, not usable for its intended purpose and possibly even deadly. Many of these detailed complaints cited to and attached scores of scientific studies supporting such allegations.

The cases generally fell into two categories:

- "Orders-only" cases where the complaints did not allege the virus causes physical loss or damage to property or was present at the insured premises. Instead, these claims were based on the assertion that government orders themselves caused a "physical loss" of the policyholder's property.
- Cases alleging that the coronavirus causes direct physical loss or damage to property, including at the insured premises, at property that led to the issuance of government closure orders, and at dependent properties that help drive the policyholders' revenue stream.

In addition to a broad public relations campaign, that commentators have characterized (with the hope that such concerns are untrue) as a "tightly packaged, insidiously executed, and albeit factually and legally incorrect adversarial position put forth in insurance media that may well have affected the initial outcomes of COVID-related coverage litigation, see Knutsen and Stempel, Infected Judgment: Problematic Rush to Conventional Wisdom and Insurance Coverage Denial in a Pandemic, *27 Conn. Ins. Law J. 185, 201-06 (2020)*, insurers hired and dispatched attorneys to file amicus briefs in scores of cases around the country arguing that rulings for policyholders would bankrupt the entire insurance industry. However, as noted in a report by Reuters, the numbers used by the insurance industry ignored that 83% of policies contained broad exclusions for viruses, communicable diseases, or pandemics. Alwyn Scott and Suzanne Barlyn, "U.S. insurers use lofty estimates to beat back coronavirus claims" Reuters Business News (June 12, 2020). Indeed additional reports about insurers' pandemic profits support the view that insurers were positioned to provide the coverage to the 17% of policyholders—especially small businesses—that purchased policies without any virus or pandemic exclusions. See Richard Holober, Progressive Insurance Hoards Covid-19 Windfall Profits, Consumer Federation of California (Aug. 13, 2020); Claire Wilkinson, Chubb reports gains in Q3 profit, net premium written, Business Insurance (Oct. 28, 2020); Angela Childers, CNA Reports Higher Net Income Despite Cat Losses, Business Insurance (Nov. 2, 2020); J. Greenwald, Berkley Reports 161% Jump in Profits, Business Insurance (Jan. 26, 2021)), largely on the back of successive premium hikes imposed every quarter despite their "no pay" stance on business interruption claims and a sharp decrease in other claims (e.g., cars were off the roads and many businesses shut down as large numbers of people worked from home). See Matthew Lerner, Most Policyholders See Rate Hikes Across Multiple Lines, Business Insurance (Oct. 26, 2020); Matthew Lerner, U.S. Commercial Property Pricing up 22% in Q2, Business Insurance (Aug. 10, 2020); Claire Wilkinson, Insurance Prices Increased Sharply in Third Quarter, Business Insurance (Nov. 5, 2020); Matthew Lerner, Global Prices Rise 22% in Q4: Marsh, Business Insurance (Feb. 4, 2021); Judy Greenwald, Continued Rate Increases Expected: Willis, Business Insurance (Nov. 19, 2020); Gavin Souter, Insurance Premium Renewal Rates Continue to Rise, Business Insurance (Dec. 7, 2021); Claire Wilkinson, Commercial property insurance rates rise again, Business Insurance (July 12, 2022).

In opposition to insurers' powerful lobby stands United Policyholders, which for the past 30 years has advocated for the interests of insured people and businesses in coverage cases nationwide in partnership with a notable group of high-profile law firms with extensive experience representing policyholders. This nonprofit organization has, worked effectively to draw attention to the rights of policyholders in the COVID-19 litigation as it progressed.

The first wave of decisions on motions to dismiss in 2020—most of which involved virus exclusions and "orders-only" cases—were significantly in favor of insurance companies. Many of those decisions specifically noted that the policyholder had not even alleged that the virus causes "physical loss or damage" and dismissed the case in the absence of such allegations. See, e.g., Diesel Barbershop, LLC v. State Farm Lloyds, No. 5:20-CV-461-DAE, 2020 U.S. Dist. LEXIS 147276 (W.D. Tex. Aug. 13, 2020) ("Plaintiffs argue that it is not COVID-19 within Plaintiffs' Properties that caused the loss directly, but rather that it was the Orders that caused the direct physical loss and thus the virus exclusion should not apply"). See also 10012 Holdings, Inc. v. Sentinel Ins. Co., Ltd., 507 F. Supp. 3d 482, 487-88 (S.D.N.Y. 2020), aff'd, 21 F.4th 216 (2d Cir. 2021) ("Plaintiff does not explain, nor does the policy's plain language support, the conclusion that insurance against loss of 'Property you own that is used in your business' encompasses business loss due to the Civil Orders limiting customer access to Plaintiff's business"); Santo's Italian Cafe LLC v. Acuity Ins. Co., 508 F. Supp. 3d 186, 199 (N.D. Ohio 2020); Mudpie, Inc. v. Travelers Cas. Ins. Co. of Am., 487 F. Supp. 3d 834, 838-39 (N.D. Cal. 2020); Geragos & Geragos Fine Arts Bldg., LLC v. Travelers Indem. Co. of Connecticut, No. 220-cv-04427, 2020 U.S. Dist. LEXIS 127427, at *1 (C.D. Cal. July 20, 2020); Oral

Surgeons, P.C. v. Cincinnati Ins. Co., 491 F. Supp. 3d 455, 456 (S.D. Iowa 2020); SA Palm Beach LLC v. Certain Underwriters at Lloyd's, London, No. 9:20-CV-80677-UU, 2020 U.S. Dist. LEXIS 251178 (S.D. Fla. Dec. 9, 2020); El Novillo Rest. v. Certain Underwriters at Lloyd's, London, 505 F. Supp. 3d 1343, 1345 (S.D. Fla. 2020); Terry Black's Barbecue, LLC v. State Auto. Mut. Ins. Co., No. 1:20-CV-665-RP, 2020 U.S. Dist. LEXIS 207636, at *1 (W.D. Tex. Nov. 5, 2020), report and recommendation adopted sub nom. Terry Black's Barbecues, LLC v. State Auto. Mut. Ins. Co., No. 1:20-CV-665-RP, 2020 U.S. Dist. LEXIS 263036 (W.D. Tex. Nov. 23, 2020). Some courts went further and accepted arguments that "physical alteration or structural degradation" is required, contrary to the vast majority of pre-pandemic precedent. See, e.g., Sandy Point Dental, PC v. Cincinnati Ins. Co., 488 F. Supp. 3d 690, 693 (N.D. Ill. 2020) ("The critical policy language here—'direct physical loss'—unambiguously requires some form of actual, physical damage to the insured premises to trigger coverage . . . Plaintiff simply cannot show any such loss because of either inability to access its own office or the presence of the virus on its physical surfaces, the latter of which Plaintiff fails to allege in its complaint. Plaintiff has not pled any facts showing physical alteration or structural degradation of the property"). See, e.g., Mark's Engine Co. No. 28 Rest., LLC v. Travelers Indem. Co. of Conn., No. 20-cv-4423, 492 F. Supp. 3d 1051, 1056, (C.D. Cal. Oct. 2, 2020); Pappy's Barber Shops, Inc. v. Farmers Grp., Inc., 491 F. Supp. 3d 738, 740 (S.D. Cal. 2020); Tralom, Inc. v. Beazley USA Servs., Inc., No. 220-cv-08344, 2020 U.S. Dist. LEXIS 249202, at *5 (C.D. Cal. Dec. 29, 2020); Mortar & Pestle Corp. v. Atain Specialty Ins. Co., 508 F. Supp. 3d 575, 581 (N.D. Cal. 2020). Michael Cetta, Inc. v. Admiral Indem. Co., 506 F. Supp. 3d 168, 176 (S.D.N.Y. 2020). Others accepted insurance industry arguments brushing away the significance of COVID-19 and its impact on the ability to safely operate during the pandemic—asserting that the risk from COVID-19 was easily resolved through simple cleaning. See, e.g., Uncork & Create LLC v. Cincinnati Ins. Co., 498 F. Supp. 3d 878, 883-84 (S.D.W. Va. 2020), ("[b]ecause routine cleaning, perhaps performed with greater frequency and care, eliminates the virus on surfaces, there would be nothing for an insurer to cover"). See Terry Black's Barbecue, LLC v. State Auto. Mut. Ins. Co., 514 F. Supp. 3d 896, 907 (W.D. Tex. 2021); Barbizon Sch. of San Francisco, Inc. v. Sentinel Ins. Co. LTD, 530 F. Supp. 3d 879, 890 (N.D. Cal. 2021); Cordish Companies, Inc. v. Affiliated FM Ins. Co., 573 F. Supp. 3d 977, 1001 (D. Md. 2021); Promotional Headwear Int'l v. Cincinnati Ins. Co., 504 F. Supp. 3d 1191, 1202 (D. Kan. 2020). Such conclusions—drawn without an evidentiary record—were inconsistent with events during the spring and summer of 2020, when the worst business interruption losses were sustained as most brick-and-mortar business screeched to a halt.

Curiously, pro-insurance company decisions were far more prevalent in federal courts compared to state courts. As of March 2021, in deciding motions on policies without a virus exclusion, federal courts ruled in favor of the insurance company about 85% of the time, whereas state courts only sided with the insurance company about 33% of the time.

But insurance law is determined by the states, see McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011-1015 (1976); Jonathan R. Macey & Geoffrey P. Miller, The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation, 68 N.Y.U.L. Rev. 13, 17 (1993), and under established precedent, federal courts must follow state law as articulated by each state's highest court. Erie R. Co. v. Tompkins, 304 U.S. 64 (1938) ("Except in matters governed by the Federal Constitution or by acts of Congress, the law to be applied in any case is the law of the state. And whether the law of the state shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern. There is no federal general common law."). In the insurance law context, past battles over common insurance coverage issues have shown that insurance law often varies from state to state. See, e.g., Lorelie S. Masters, et al., Insurance Coverage Litigation § 15.01[A] (2d ed. 2022). Thus, the most important decisions in the COVID-19 business interruption cases would come from state appellate courts.

Prior to the pandemic, only a few state supreme courts had ruled on the question of whether harm in the absence of structural alteration constitutes "physical loss or damage." See Mellin v. Northern Sec. Ins. Co., 115 A.3d 799, 803-05 (N.H. 2015) (holding that odors from cat urine could cause "physical loss" to a condominium unit); Murray v. State Farm Fire & Cas. Co., 509 S.E.2d 1, 17 (W. Va. 1998) (concluding that a home rendered dangerously unlivable by the presence of falling rocks had suffered a "direct physical loss to the property" even though the home had suffered no physical harm); W. Fire Ins. Co. v. First Presbyterian Church, 437 P.2d 52, 54 (Colo. 1968) (en banc) (finding a "direct physical loss" where a church complied with the fire department's order to close because gasoline vapors made "use of the building dangerous.") In the absence of controlling state supreme court precedent, federal courts are called upon to make an "*Erie* guess."

In ruling overwhelmingly in favor of insurers, federal courts called upon to make an "*Erie* guess" have not followed the 60 years of pre-pandemic precedent supporting the policyholders' position. These decisions were controversial among insurance law experts and were criticized for ignoring the wide majority of pre-pandemic cases holding that relatively intangible impacts to property constitute "physical loss or damage" that triggers business interruption coverage. See Knutsen and Stempel, *Infected Judgment: Problematic Rush to Conventional Wisdom and Insurance Coverage Denial in a Pandemic*, 27 Conn. Ins. Law J. 185, 241-49 (2020). The pro-insurance industry decisions also received criticism for violating fundamental tenets of civil procedure that require well-pled allegations to be accepted as true when deciding motions to dismiss. *Short form citation* 192 ("Judges granting dismissal motions without any opportunity for discovery and denying any possibility of coverage at the metaphorical starting gate, have undermined the traditional American commitment to jury trials as well as widely accepted legal principles of insurance policy construction such as interpreting ambiguous terms against the drafter and considering policyholder reasonable expectations."). Even medical organizations responded to the insurance industry arguments being accepted by courts, stating that the insurance companies' assertion SARS-CoV-2 easily can be cleaned from a property is based on "junk science." See NH Medical Society Denounces Insurers' COVID-19 Science (June 27, 2022); Amicus Brief of MedChi, the Maryland State Medical Society (July 13, 2022).

A number of state court judges broke from the herd, often making that break explicit in their decisions:

> Economists refer to this as an appeal to "herding behavior"—a process by which groupthink replaces individual decision-making . . . . Judges are not sheep, and I do not decide a case by counting noses. Further, the "herd" can be wrong.

JDS Constr. Grp., LLC, v. Cont'l Cas. Co., No. 2020 CH 5678, 2021 Ill. Cir. LEXIS 456, at *3 (Ill. Cir. Ct. Oct. 25, 2021). See also MacMiles, LLC v. Erie Ins. Exch., No. GD-20-7753, 2021 Pa. Dist. & Cnty. Dec. LEXIS 4377, at *5 (May 25, 2021) ("merely accepting the non-binding decisions of other courts 'by the purely mechanical process of searching the nations courts for conflicting decisions' amounts to an abdication of this court's judicial role"); Ungarean, DMD v. CNA, No. GD-20-006544, 2021 Pa. Dist. & Cnty. Dec. LEXIS 2, at *6 (Mar. 25, 2021) (same); Brown's Gym, Inc. v. Cincinnati Ins. Co., No. 20 CV 3113, 2021 Pa. Dist. & Cnty. Dec. LEXIS 4376, at *19 (July 13, 2021) ("State trial courts throughout the nation have agreed with the foregoing rationale articulated in the federal case law in denying insurers' attempts to dismiss business interruption insurance claims filed by insureds who assert that COVID-19 was present on their covered property"); Goodwill Indus. of Orange Cty., Cal. v. Phila. Indem. Insur. Co., No. 30-2020-01169032-CU-IC-CXC, 2021 Cal. Super. LEXIS 153025, at *3 (Jan. 28, 2021) (stating that the federal cases relied on by the insurance company "are not binding on this court and were decided under a different standard"); Snoqualmie Enter. Auth. v. Affiliated FM Ins. Co., No. 21-2-03194-0 SEA, at *6 (Wash. Super. Sept. 3, 2021) ("This court is not persuaded by [another judge's] reliance on the opinions of other federal district court opinions across the country that applied the laws of other states, nor its holding that the undefined phrase 'all-risks of physical loss or damage' cannot be reasonably interpreted by the average lay person to include the insured's inability to physically use, control, or manipulate its property as a result of the COVID-19 closure orders and Tribal resolutions"), Boardwalk Ventures CA LLC v. Century-National Ins. Co., 20STCV27359, 2021 Cal. Super. LEXIS 6040, at * 3 (Mar 18, 2021) (rejecting the "litany of unpublished federal district court cases" cited by the insurance company "in support of the proposition that courts applying California law have 'uniformly dismissed lawsuits like the instant action'"—recognizing that these cases are not binding, and the dismissal was not proper); Risinger Holdings v. Sentinel Ins. Co., 565 F. Supp. 3d 844, 2021 U.S. Dist. LEXIS 192474, at *12 (E.D. Tex. Sept. 30, 2021) (holding that the policy's use of "physical loss" is ambiguous and concluding that the policyholder "may have suffered direct physical loss due to Governor Abbott's lockdown order by being deprived of the use or full use of the physical space of its covered property, or alternately, because of the severe material losses it endured when it was forcibly excluded from its businesses").

This set the stage for the most important decisions—from state appellate courts.

## As the World Is Returning to "Normal," the Law May Be Returning to "Normal" Too

By early 2022, several lower court decisions were under review by state supreme courts. The first state high court decisions came down in favor of the insurance companies, but these generally were "orders-only" cases and many of those courts noted the absence of allegations that COVID-19 causes "physical loss or damage" or was present at the insured premises. See Wakonda Club v. Selective Ins. Co. of Am., 973 N.W.2d 545, 548-50, 552 (Iowa 2022); Cherokee Nation v. Lexington Ins. Co., 2022 Okla. LEXIS 72 (Sept. 13, 2022); Hill & Stout, PLLC v. Mut. of Enumclaw Ins. Co., 515 P.3d 525 (Wash. 2022). Thus, the merit of claims based on allegations and evidence of direct physical loss or damage caused by COVID-19 has not been tested or decided in these states. That said, there have been three state supreme courts that have affirmed the dismissal of cases without virus exclusions that alleged "direct physical loss or damage" to property caused by the virus. See Verveine Corp. v.

Strathmore Ins. Co., 184 N.E.3d 1266 (Mass. 2022); Sullivan Mgmt. v. Fireman's Fund Ins. Co., No. 28105, 2022 S.C. LEXIS 90 (Aug. 10, 2022); Colectivo Coffee Roasters, Inc. v. Soc'y Ins., 974 N.W.2d 442 (Wis. 2022).

The Vermont Supreme Court did not follow the high court decisions in Massachusetts, South Carolina, Wisconsin, or the states that had reviewed "orders-only" cases—offering a forceful statement of independence at the outset of its analysis:

> [T]here is a majority approach that has been adopted—primarily in various federal courts at the district and circuit levels but also in some state trial and appellate courts—under which courts have concluded that the presence of COVID-19 on a property is not "direct physical loss or damage to property" as a matter of law. *See, e.g.*, Mudpie, Inc. v. Travelers Cas. Ins. Co. of Am., 15 F.4th 885, 892-93 (9th Cir. 2021) (holding no coverage for COVID-related losses under policy and noting its conclusion conformed with majority approach); Verveine Corp. v. Strathmore Ins. Co., 184 N.E.3d 1266, 1275-76 (Mass. 2022) (same); see also COVID Coverage Litigation Tracker, U. Penn., https://cclt.law.upenn.edu/ [https://perma.cc/T5RX-LQGN] (tracking cases and providing statistics). Though we use the reasoning of cases across the spectrum of this jurisdictional divide to guide us, we emphasize that we are not bound by any of these decisions and that our conclusion is based on the application of settled principles of Vermont insurance law. *See* Town of Stowe v. Stowe Theater Guild, 2006 VT 79, paragraph 9 n.2, 180 Vt. 165, 908 A.2d 447 ("While we may look to the reasoning of other states as persuasive authority, ***our ultimate objective is to reach decisions that comport with Vermont law and the reasonable expectations of the parties to the contract, and not to adopt a rule simply because there is apparent strength in numbers.")***.

Huntington Ingalls Indus. v. Ace Am. Ins. Co., 2022 Vt. LEXIS 47, at *20 (Sept. 23, 2022) (emphasis added).

The court rejected the insurance industry argument that "direct physical loss or damage" requires the structural alteration of property, and instead held that there has been "direct physical damage" where there has been a "distinct, demonstrable, physical change to property"—adding that such change "need not necessarily be visible; alterations at the microscopic level may meet this threshold." Huntington at paragraph 26.

The court held that losses due to "direct physical loss" are covered in addition to losses due to "direct physical damage," and set forth a four-part standard for determining whether "direct physical loss" has occurred. Huntington at paragraph 24. In so doing, the court explained that there can be coverage "for circumstances in which property is not harmed but may not be used for some reason" (Huntington at paragraph 29), including "when property is unusable due to a health hazard" (id.) and that the loss of property "may be in whole or in part" (Huntington at paragraph 31). The court noted that the requisite "loss" of property "can be identified in specific situations based on how the property was intended to be used and why it cannot be used in that manner anymore." Huntington at paragraph 29.

Importantly, the court's decision repeatedly cited and adhered to pre-pandemic precedent that so often had been ignored by other courts. Huntington at paragraphs 28, 29, 33, 37 (citing Western Fire Insurance Co. v. First Presbyterian Church, 437 P.2d 52 (Colo. 1968) (gasoline fumes); Mellin v. N. Sec. Ins. Co., 115 A.3d 799, 805 (N.H. 2015) (cat urine odor); Sentinel Mgmt. Co. v. N.H. Ins. Co., 563 N.W.2d 296, 302 (Minn. Ct. App. 1997) (asbestos); Motorists Mut. Ins. Co. v. Hardinger, 131 F. App'x 823, 826-27 (3d Cir. 2005) (E. coli); de Laurentis v. United Servs. Auto. Ass'n, 162 S.W.3d 714, 724-25 (Tex. App. 2005) (mold); TRAVCO Ins. Co. v. Ward, 715 F. Supp. 2d 699, 707-10 (E.D. Va. 2010), aff'd, 504 F. App'x 251 (4th Cir. 2013) (toxic gas); Gregory Packaging, Inc. v. Travelers Prop. Cas. Co. of Am., No. 2:12-CV-04418, 2014 U.S. Dist. LEXIS 165232, at *2 (D.N.J. Nov. 25, 2014) (ammonia); Essex Ins. Co. v. BloomSouth Flooring Corp., 562 F.3d 399, 406 (1st Cir. 2009) (offensive odor); Farmers Ins. Co. of Or. v. Trutanich, 858 P.2d 1332, 1336 (Or. Ct. App. 1993) (methamphetamine odor).

The Vermont Supreme Court's decision aligns with recent pro-policyholder decisions from intermediate state appellate courts in several other states in cases where the policyholder purchased policies without virus or pandemic exclusions. See Cajun Conti LLC v. Certain Underwriters at Lloyd's, London, -- So. 3d --, No. 2021-CA-0343, 2022 La. App. LEXIS 939, at *7 (June 15, 2022); Marina Pac. Hotel & Suites, LLC v. Fireman's Fund Ins. Co., 81 Cal. App. 5th 96, 109, 296 Cal. Rptr. 3d 777, 788 (2022); Butter Nails and Waxing v. Underwriters at Lloyd's London, No. B311455, (Cal. Ct. App. Aug. 25, 2022 (unpublished)); Tarrar Enters., Inc. v. Associated Indem. Corp., No. A162795, 83 Cal. App. 5th 685, 2022 Cal. App. LEXIS 811, at *2 (Sept. 22, 2022); Amy's Kitchen, Inc. v. Fireman's Fund Ins. Co., No. A163767, 83 Cal. App. 5th 1062, 2022 Cal. App. LEXIS 836 (Oct. 4, 2022). These state court appellate decisions support the conclusion that these cases should be decided based on the evidence adduced regarding the disruption and loss suffered by each policyholder, analyzed under longstanding insurance law precedent.

Notably, that is what occurred in a Texas courtroom in August, during the trial over Baylor Medical Center's COVID-19 business interruption claim. The result was a $48.5 million jury verdict upholding the policyholder's right to coverage for its business interruption losses. See Jim Sams, "Jury Awards $48.5M to Baylor Medical College for COVID Business-Interruption Claim" Claims Journal, Sept 7, 2022.

How the litigation in so many different jurisdictions will shake out is still far from clear. A number of appeals are pending before the high courts in Alaska, Connecticut, Maryland, Nevada, New Hampshire, and Ohio. Others are sure to follow. But it does appear as if some jurisdictions will protect policyholders' rights, while other jurisdictions will let insurance companies off the proverbial coverage hook. Insureds must therefore continue to check their policies carefully and consult with an experienced coverage practitioner to see if their business is entitled to coverage for its pandemic-related business interruption losses.

## Back to the Future

As the world continues recovering from the pandemic, insurance coverage law may be returning to its pre-pandemic status. While the adjustment may come too late for those policyholders whose COVID-related claims may have been dismissed, it may benefit the many others who have not yet pursued their claims. But even if not, this emerging realignment with pre-pandemic precedent will help all policyholders who, in the future, seek coverage for non-structural losses that many would argue they should have always been entitled to receive.

## Related Resources

### Practice Notes

- Business Interruption Insurance: Filing a Claim
- COVID-19 Business Interruption Claims Pre-Litigation
- COVID-19 Business Interruption Claims Litigation
- Business Interruption Insurance: Post-Pandemic Litigation Developments

### Checklists

- COVID-19 Business Interruption Claims Pre-Litigation Checklist
- COVID-19 Business Interruption Claims Litigation Checklist

### State Law Surveys

- COVID-19 Business Interruption Claims State Law Survey

### Forms

- ISO Form CP 01 40 07 06 (2015) (Commercial Property, exclusion of Loss Due to Virus or Bacteria)

### Resource Kits

- COVID-19 Insurance Litigation Resource Kit
- Insurance Claims Resource Kit
- Insurance Coverage Resource Kit

**Marshall Gilinsky, Shareholder, Anderson Kill**

Marshall Gilinsky is a shareholder of Anderson Kill and practices in the firm's Insurance Recovery and Commercial Litigation Departments. Marshall is co-chair of the firm's Sexual Harassment and Abuse Insurance Recovery Group, and a member of the firm's Banking and Lending Group and Hospitality Industry Practice Group.

During his 20-year career representing policyholders, Marshall has recovered hundreds of millions of dollars for his clients, successfully litigating disputed claims under a variety of insurance products, including property and business interruption insurance, commercial general liability (CGL) insurance, errors and omissions (E&O) insurance, directors' and officers' (D&O) insurance and life insurance. Marshall has represented clients on numerous high-stakes, complex insurance claims arising out of prominent losses such as 9/11, Hurricane Katrina, Superstorm Sandy and the "Big Dig" in Boston. He also focuses extensively on assisting clients that own and manage captive insurance companies, especially with respect to resolving coverage disputes between the captive and its reinsurers.

Marshall's success in solving clients' problems stems from his ability to understand their businesses – as well as their insurance programs – in order to maximize the value of the clients' insurance assets. He frequently writes and lectures on a variety of topics of interest to professionals and practitioners in the insurance arena, and is frequently quoted in the press, including appearances in the *New York Times*, *Wall Street Journal*, *National Law Review*,*CNN.com* and *Business Insurance*, among others.

Since 2018, Marshall has been selected by his peers for inclusion in The Best Lawyers in America for insurance litigation.

**Rhonda Orin, Managing Partner (Branch), Anderson Kill**

Rhonda D. Orin is the managing partner of the firm's Washington, D.C. office. She is also co-chair of the COVID Task Group.

Rhonda represents policyholders in coverage cases nationwide, including cyber liability, third-party tort and environmental liability claims, first-party property damage and business interruption claims, directors & officers liability, errors & omissions liability, fidelity bonds and alternative risk transfer arrangements, including for employee benefit plans. She has served as lead counsel in multiple jury and bench trials, argued before the highest courts of several states, and appeared in two cases before U.S. Supreme Court. Through jury verdicts, summary judgment decisions and confidential settlements before and during litigation, she has recovered hundreds of millions of dollars for policyholders, including nine-figure recoveries.

Rhonda also represents hospitals against insurance companies with the zest and expertise of our ordinary insurance practice, even though hospitals are third parties in their insurance relationships (on the health care side) instead of traditional policyholders.