2 Conflicting Rulings Show Hurdles In Virus Insurance Cases

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Commentary provided by Oliver Sepulveda.

The economic landscape in this country has changed dramatically since the beginning of the COVID-19 pandemic.

Nonessential businesses all over the country have been forced to suspend or limit operations to accommodate social distancing and limit the spread of the coronavirus. Understandably, businesses are losing precious revenue and are looking to their all-risk insurance policies to recoup the mounting losses.

To that end, hundreds of businesses all over the country have filed lawsuits against their insurance carriers, but the success of those lawsuits may depend on how the jurisdictions define a physical loss.

Despite the suggestive nomenclature, like most insurance policies, all-risk policies have conditions and exclusions that limit coverage under certain circumstances. One of these limitations is the requirement the insured suffer a direct physical loss.

Courts have disagreed on whether the term "direct physical loss" requires physical damage to a property. Some courts require that there be physical damage to property (i.e. a tangible, physical alteration of property) such as hurricane or hailstorm damage.[1] Other courts have found that there is a covered loss even when a nontangible substance, such as ammonia or carbon monoxide, causes the property to be uninhabitable.[2] A COVID-19 business interruption case could live or die depending on which of these two theories is applied.

The lawsuits have been piling up since March of this year, but until recently, no court had addressed the outcome-determinative direct physical loss issue. Now two courts in different jurisdictions have taken on the issue. Interestingly, these courts came to opposite conclusions, which highlights difficulty facing both plaintiffs and defendants in these cases.

The first of these cases, Studio 417 Inc. v. Cincinnati Insurance Co., involved a group of restaurants, led by Studio 417 Inc., which filed suit in federal court in Missouri to recover under various different

coverages in their all-risk policies. On Aug. 12, U.S. District Judge Stephen Bough of the U.S. District Court for the Western District of Missouri denied the insurer's motion to dismiss after rejecting the physical alteration theory of direct physical loss.[3]

The very next day, U.S. District Judge David Ezra of the U.S. District Court for the Western District of Texas, applying the same physical alteration theory that Judge Bough rejected, dismissed a lawsuit by a group of local barbershops, Diesel Barbershop LLC v. State Farm Lloyds.[4]

In Studio 417 Inc. v. The Cincinnati Insurance Co., the plaintiffs suffered losses in revenue as a result of the government-mandated closures of nonessential businesses. They sought coverage for these loses under policies that covered direct physical loss. Their insurer denied the claims and argued that the coronavirus does cause any physical damage to property and, as a result, the losses relating to the COVID-19 pandemic were not covered.

The court disagreed with the insurers. The court carefully analyzed the plain meaning of the terms "physical" and "loss" in contrast to the term "damage," essentially finding that physical loss was broader than physical damage. In doing so, the court distinguished a leading case on the issue, Source Food Technology Inc. v. U.S. Fidelity & Guaranty. Co.[5]

There, the court found that the insured had not suffered a direct physical loss to a shipment of beef because there was no evidence that the subject beef was contaminated by mad cow disease. Unlike the insured in Source Food, Judge Bough found that Studio 417 had alleged that COVID-19 was a highly contagious virus that is deposited on surfaces of its business. These allegations were sufficient to get Studio 417 past a motion to dismiss.

In stark contrast to Studio 417, in Diesel Barbershop, a group of barbershops led by Diesel Barbershop LLC had their lawsuit dismissed without an opportunity to amend, in part, because Judge Ezra was more persuaded by cases requiring physical alteration of property to constitute a physical loss.

Similar to Studio 417, Diesel Barbershop sought to recover under an all-risk policy for losses caused by government closure orders. The court briefly addressed the issue, acknowledging that some jurisdictions do not require physical alteration, but the court distinguished these cases, noting, as an example, that COVID-19 does not produce a noxious order rendering a business uninhabitable.

Then, Judge Ezra found that courts within the Fifth Circuit require "distinct, demonstrable physical alteration of the property" and that was simply not alleged by Diesel Barbershop.

Why the stark difference in opinion on two very similar claims seeking coverage under similar policies? The answer could be in the pleadings. Studio 417 alleged that it had suffered physical loss because COVID-19 was a physical substance and its presence caused an interruption in the business.

Judge Baugh, after analyzing the plain meaning of "physical" and "loss," focused on these allegations, finding that they were sufficient to state a plausible claim.

Diesel Barbershop, on the other hand, alleged generally that the presence of the virus in its county renders properties unsafe but did not allege that the virus was actually present at its premises. In granting the motion to dismiss, Judge Ezra took care to note that COVID-19 was not a substance that rendered the plaintiffs' businesses uninhabitable. This raises the question, would the outcome have been different if Diesel Barbershop alleged the physical presence of the coronavirus.

These cases are not binding authority, but they provide valuable insight into how COVID-19 business interruption lawsuits may be addressed going forward. For example, the specificity of plaintiffs' allegations with respect to these COVID-19 claims may be outcome-determinative, particularly in those jurisdictions that reject the physical alteration theory.

Plaintiffs who cannot allege the physical presence of COVID-19 in their business will have a tough time making it past the motion to dismiss stage, even in those jurisdictions that do not require physical alteration to the property. Accordingly, plaintiffs and insurers should be cognizant of the prevailing theory in their jurisdiction as that could determine whether the case makes it past dismissal.

Oliver Sepulveda is an associate at Shutts & Bowen LLP.

[1] See, e.g., Dickie Brennan & Co., Inc. v. Lexington Ins. Co. , 636 F.3d 683 (5th Cir. 2011).

[2] See. e.g., Port Auth. of New York & New Jersey v. Affiliated FM Ins. Co. , 311 F.3d 226 (3d Cir. 2002).

[3] Studio 417, Inc. v. Cincinnati Ins. Co. , 20-CV-03127-SRB, 2020 WL 4692385 (W.D. Mo. Aug. 12, 2020).

[4] Diesel Barbershop, LLC v. State Farm Lloyds , 5:20-CV-461-DAE, 2020 WL 4724305 (W.D. Tex. Aug. 13, 2020).

[5] 465 F.3d 834 (8th Cir. 2006).

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