

The Coronavirus' Impact on Business Interruption Coverage
Is "Direct Physical Loss" Being Redefined?
By: Rick Hammond, Partner
HeplerBroom, LLC, Chicago, Illinois

Background

Recent years have witnessed pandemic outbreaks of Ebola, H1N1, Avian flu and Legionnaires' disease, and now the world is reeling from the impact of the COVID-19 ("Coronavirus disease"). Pandemics occur when new viruses emerge which are able to infect people easily and spread from person-to-person in an efficient and sustained way.

Currently, the number of people testing positive for Coronavirus is increasing in most areas of the world, at the same time that its impact on business is expanding its reach. Thus, there has been large-scale disruption of global supply chains, and possible forthcoming government-imposed closure orders. This situation is causing insurers and policyholders to closely examine whether their business insurance policies can be construed to provide coverage for the loss of business income associated with this developing pandemic.

Under that backdrop, this article will provide an overview of the underlying principles of business interruption insurance, discuss how courts may treat the business losses associated with the Coronavirus crisis, and examine whether the "direct physical loss or damage" requirement has been met when a business is impacted by this viral outbreak.

Scope of Coverage

Business interruption insurance is designed to protect the *prospective earnings* of a business. It is also designed to do for the insured, in the event of a loss, what the business would have done for itself if an interruption in the operation of the business had not occurred. Thus, business interruption insurance is designed to indemnify the policyholder for losses arising from a business's inability to continue its normal operations and functions. Coverage is generally triggered by the total or partial suspension of business operations due to the loss, loss of use, or damage to all or part of the buildings, plant, machinery, equipment, or other business personal property as the result of a covered cause of loss.

Coverage is generally provided for the "period of restoration," which is considered the period required to rebuild, repair or replace the damaged property at the described premises with

reasonable speed and similar quality. It usually commences with the date of the property's damage or destruction, and it is not generally limited by the date of the policy's expiration. Moreover, actual profits and business expenses covered by the policy are usually determined in a manner which gives due consideration for the character of the business along with the manner in which it conducts its activities.

Valuating a Business Interruption Loss

There is no prescribed or accepted formula for determining the actual loss of net profits and business expenses covered by business interruption insurance. The method employed, however, should test the insured's historical profitability, i.e., past experience and the probabilities of the future, and the loss should be determined in a practical way, having regard for the nature of the business and the methods employed in its operation.

Further, it should give practical effect to the intentions of the parties and the purpose of the insurance, as evidenced by the terms, conditions, and provisions of the policy. Thus, the insured's books and accounting system are not controlling in determining the recoverable loss under the policy of insurance. On the other hand, they are not irrelevant and should be given such weight as practical judgment dictates.

Coverage Requirements

Three separate components must be connected in order to satisfy the requirements of the typical business interruption insuring agreement:

1. A covered cause of loss must cause *direct physical loss* of or damage to the property *at the described premises*;
2. The covered loss must cause a *necessary suspension or interruption of operations*; and;
3. The *business income loss* must be caused by the suspension or interruption.

With respect to the "covered cause of loss" requirement, most commercial property policies are written on "all-risk" forms. An all-risk form covers all perils that are not specifically excluded; however, it does not cover every risk. The "causes of loss" section of an all-risk policy lists the perils that are excluded.

Because of prior pandemic outbreaks, many property policies now contain specific exclusions for property damage arising from viral or bacterial related losses. For those carriers

that have incorporated the following Insurance Services Office's (ISO) language into their commercial property policies, their exposure to Coronavirus related claims will likely be limited:

EXCLUSION OF LOSS DUE TO VIRUS OR BACTERIA

**This endorsement modifies insurance provided under the following:
COMMERCIAL PROPERTY COVERAGE PART**

STANDARD PROPERTY POLICY

A. The exclusion set forth in Paragraph B. applies to all coverage under all forms and endorsements that comprise this Coverage Part or Policy, including but not limited to forms or endorsements that cover property damage to buildings or personal property and forms or endorsements that cover business income, extra expense or action of civil authority.

B. We will not pay for loss or damage caused by or resulting from any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness or disease. However, this exclusion does not apply to loss or damage caused by or resulting from "fungus", wet rot or dry rot. Such loss or damage is addressed in a separate exclusion in this Coverage Part or Policy.

C. With respect to any loss or damage subject to the exclusion in Paragraph B., such exclusion supersedes any exclusion relating to "pollutants".

D. The following provisions in this Coverage Part or Policy are hereby amended to remove reference to bacteria:

1. Exclusion of "Fungus", Wet Rot, Dry Rot And Bacteria; and
2. Additional Coverage – Limited Coverage for "Fungus", Wet Rot, Dry Rot And Bacteria, including any endorsement increasing the scope or amount of coverage.

E. The terms of the exclusion in Paragraph B., or the inapplicability of this exclusion to a particular loss, do not serve to create coverage for any loss that would otherwise be excluded under this Coverage Part or Policy.

CP 01 40 07 06 © ISO Properties, Inc., 2006.

Those insurers that have not added the above ISO exclusionary language or something similar to their property policies are likely to experience challenges and coverage questions as to whether the Coronavirus is capable of triggering business interruption coverage under their policy forms. For those impacted carriers, one of the first threshold questions to be addressed is whether the Coronavirus can result in direct physical loss or damage to covered property. Thus, an employee who worked in and possibly infected a company's offices immediately before being tested positive for the Coronavirus seemingly leaves the insured property, i.e., the building and business personal property physically unchanged, *at least as to the naked eye*, thereby raising a coverage question regarding whether a policy's business interruption coverage has been triggered by a *direct physical loss*.

Whether a property has sustained physical loss or damage is open to question, and courts are not in complete agreement on this issue. Thus, some courts have held that the mere loss of use without physical alteration of property is not physical loss or damage *See, e.g., Newman Myers Kreines Gross Harris, P.C. v. Great Northern Ins. Co.*, 17 F.Supp.3d 323 (S.D.N.Y 2014) (holding that the policy language "direct physical loss or damage" requires some sort of actual, physical damage to the insured premises to trigger loss of business income and extra expense coverage); *Universal Image Productions, Inc. v. Chubb Corp.*, 703 F.Supp.2d 705 (E.D. Mich. 2010) (finding that intangible harms like strong odors and presence of mold/bacteria that did not alter the structural integrity of commercial property leased by the insured were not a "direct physical loss[es]").

On the other hand, other courts have found that the loss of use or uninhabitability of insured property, under certain circumstances, can constitute "physical loss or damage." *See, e.g., Gregory Packaging, Inc. v. Travelers Property Cas. Co. of America*, 2014 WL 6675934 (D. N.J. 2014). (recognizing the split of authority as to whether the phrase "physical loss or damage" can include more than tangible damage to the structure of the insured property, and finding that temporary ammonia gas contamination constitutes "direct physical loss of or damage to" property and therefore, was covered by the policy).

In either case, the mere fact that *one* employee who worked in and, possibly, infected a company's offices immediately before being tested positive tests for the Coronavirus, is probably insufficient to render a company's offices as uninhabitable. However, given the current level of unease surrounding the Coronavirus, it is easy to imagine a scenario where an entire office building is argued to be unfit for occupancy and, therefore, deemed to have suffered a direct physical loss where *multiple* employees tested positive for the virus.

Along those lines, it is interesting to note a recent announcement issued by United Airlines:

Coronavirus (COVID-19): What we're doing to keep customers and employees safe

All aircraft are cleaned at a variety of touchpoints throughout the day.

- The cleaning procedure for flights includes a thorough wipe-down of all hard surfaces touched by customers and employees — including lavatories, galleys, tray tables, window shades and armrests.
- United uses an effective, high-grade disinfectant and multi-purpose cleaner.

When we are advised by the [Centers for Disease Control and Prevention] CDC and of an employee or customer who has traveled onboard and who is potentially exhibiting Coronavirus symptoms, that aircraft is taken out of service and sent through a full decontamination process that includes our standard cleaning procedures plus washing ceilings and overhead bins and scrubbing the interior.

It is not a stretch to foresee an argument forthcoming that the steps taken by United to decontaminate its equipment evidences a direct physical loss of some type.

Cyber Losses Have Set the Stage for Courts to Redefine “Physical Loss”

Losses arising out of a cyber event, e.g., a *virus* that infects a company’s computer system and that causes a system shutdown is one of the more common type of business interruption claims being filed today. For many years, it was common for an insurer to exclude coverage for a claim of this type on the basis that electronic data was not considered a physical or tangible object that could be subject to loss or damage as defined by most policies.

However, recent decisions on this subject reflect that courts are beginning to broaden their opinion on the definition of “physical loss or damage.” In that regard, the following cases may be precursor as to how a court might construe this term as it pertains to a business interruption claim arising out of the Coronavirus crisis:

Coverage Granted

In *NMS Services Inc. v. Hartford*, 62 Fed. App’x 511 (4th Cir. 2003), a former employee of the insured’s software development company installed two hacking programs on the

insured's network systems. The hack caused the erasure of vital computer files and databases necessary for the operation of the company's manufacturing, sales, and administrative systems.

The insurer denied coverage and litigation ensued. The court upheld coverage for business interruption under policy language stating that the insurer would pay for the "actual loss of business Income" during the period of restoration. In that regard, the court noted that the suspension must be caused by "*direct physical loss of or damage to property at the described premises.*" The court further found that the insured suffered damage to its property, specifically, damage to the computers it owned, which satisfied the requirement of direct physical loss of or damage to property.

In ***Lambrecht & Associates, Inc. v. State Farm Lloyds***, 119 S.W.3d 16 (Tex. App. 2003), the insured sought coverage for a loss of computer data and the related loss of business income after a virus caused the insured's computers to malfunction and eventually become completely useless. The insured's computer system had to be taken offline and its employees were unable to use their computers until the server was restored. The insurance policy at issue committed the insurer to pay for accidental direct physical loss to business personal property, and the actual loss of business income the insured sustained due to the necessary suspension of its operations during the period of restoration.

The court disagreed with the insurer's argument that the loss of information on the computer systems was not a physical loss because the data did not exist in physical or tangible form. The court held that the plain language of the policy dictated that the personal property losses alleged by the insured were physical as a matter of law.

In ***Landmark American Insurance Co. v. Gulf Coast Analytical Laboratories, Inc.***, 2012 WL 1094761 (M.D. La. 2012), the insured provided chemical data analysis to the petrochemical industry and certain governmental agencies. Part of the insured's business involved analyzing chemical samples and storing the information as electronic data on a hard disk storage system. This system failed to read two hard disk drives, resulted in the corruption of data, and resulting in severe recovery costs to third-party vendors and losses in business income.

The insured sought coverage under its property policy. The policy covered risks of direct physical loss or damage including computer viruses, except those causes of loss and damage listed in the Exclusions. The insurer filed suit seeking a declaratory judgment from the court that electronic data is not susceptible to direct physical loss or damage. The insurer argued that electronic data is intangible in nature and thus not susceptible to "direct physical loss or damage" as a covered loss.

The court disagreed with the insurer and found that the insured's electronic data was "corporeal movable or physical in nature." The court further explained that the insured's electronic data "has physical existence, takes up space on the tape, disc, or hard drive, makes physical things happen, and can be perceived by the senses."

Coverage Denied

In *Source Food Tech., Inc. v. U.S. Fidelity & Guar. Co.*, 465 F.3d 834 (8th Cir. 2006), the insured argued that the closure of the United States/Canadian border as to its imported beef product, due to concerns of "mad cow" disease qualified as "direct physical loss" since it was unable to transport its product. The Eighth Circuit disagreed, finding that Source Food's inability to transport its beef product across the border did not constitute a product that was physically contaminated or damaged, and to hold otherwise would render the word "physical" meaningless.

In *Ward General Insurance Services, Inc. v. Employers Fire Insurance Co.*, 7 Cal.Rptr.3d 844 (Cal. Ct. App. 2003), the insured suffered a computer crash during a system update that resulted in significant losses of electronically stored data. Restoration of the data came at great expense to the company in terms of lost productivity, commissions, and profits. When presented with the insured's claim, the insurer denied coverage because the loss did not result in "direct physical loss of or damage to" property.

In the resulting lawsuit, the court agreed with the insurer. In particular, the court noted that data is stored on a tangible medium and that the information itself remains intangible. The court concluded that an electronic data loss could not provide a basis for coverage under a first-party insurance policy because electronic data does not have a "material existence."

Supply Chain and Contingent Business Interruption Coverages

One of the biggest impacts of the Coronavirus crisis is supply chain disruption and the resulting interruption in business. For businesses that are dependent on supply chain production, contingent business interruption (CBI) insurance often provides coverage when a supplier suffers a *direct physical loss* to its property that impairs its ability to provide delivery of goods or materials to its customers.

CBI insurance may also cover economic losses, including increased costs from lost or reduced operations resulting from *physical damage* on the premises of a named or unnamed supplier. CBI policies may also cover loss of services to the insured business, such as loss of utility services or loss of markets for the business's own products. That said, CBI insurance likely includes the same conditions and exclusions found in a standard commercial property policy. In other words, the same issue remains regarding whether the Coronavirus can result in direct physical loss or damage to covered property.

Civil Authority Coverage

Many property policies extend business interruption coverage for losses arising from “civil authority” orders that impair or prohibit access to an insured’s property. The scope and limitations of business interruption coverage under such endorsements vary based on whether a “direct physical loss” will be required. Note that insurers also may issue Civil Authority Coverage on a manuscript basis (custom designed for a particular insured), addressing specific needs based on expenses, geography, disease, calendar year, voluntary or mandatory orders, direct physical loss, a designated risk or other criteria.

The following cases may be instructive as to how a court might construe this term as it pertains to a business interruption claim that arises out of the Coronavirus:

Coverage Granted

In *Southlanes Bowl, Inc. v. Lumbermen's Mut. Ins. Co.*, 208 N.W.2d 569 (Mich. Ct. App. 1973) Plaintiffs were engaged in the business of operating places of amusement consisting of bowling alleys, restaurants, taverns, snack bars, cocktail lounges and motels, and these establishments were covered by business interruption insurance. In the summer of 1967 and again after the assassination of Dr. Martin Luther King, Jr., in April of 1968, widespread riots and civil commotion accompanied by burning and looting erupted in and around the City of Detroit. However, none of the plaintiffs' businesses was physically damaged. On each occasion, the Governor declared a state of emergency, imposed a curfew, and closed all places of amusement within the cities of Detroit, Highland Park, Hamtramck, Ecorse, and River Rouge. In accordance with the Governor's order, the policyholders closed their establishments and as a result suffered a \$49,687.69 net loss.

At trial, the policyholders asserted that the risk insured under the business interruption policies was the possible prohibition of access to their businesses by order of a civil authority arising from any of the enumerated perils, *e.g.*, riot, without any requirement of physical damage to the insured property. On the other hand, the insurer contended that under the terms of the business interruption policies, there is no coverage unless there has been direct physical loss and damage to the insured property; and inasmuch as no such damage was inflicted here, it was not liable to pay benefits for the policyholder’s plaintiffs' losses. The trial court concurred and found for the insurer.

On appeal, the appellate court considered whether under the language of the business interruption policy, physical damage to the insured premises is a condition precedent to the insurer's liability to pay benefits. The court concluded that where the insured businesses were closed by order of a civil authority, physical damage to the insured premises was *not* a

prerequisite to the insurer's obligation to reimburse the insured for the net losses resulting therefrom. *Sloan v. Phoenix of Hartford Ins. Co.*, 207 N.W.2d 434 (Mich. Ct. App. 1973). (*Note: Very few courts have found that access was prohibited where the order of a civil authority required the insured's premises to close, thereby invoking coverage for business losses.*)

Coverage Denied

Courts have denied coverage under a Civil Authority policy provision in the following cases where the order only had an indirect effect of restricting or hampering access to the business premises.

54th St. Ltd. Partners, L.P. v. Fid. & Guar. Ins. Co., 306 A.D.2d 67, (N.Y. App. Div. 2003). No coverage where "vehicular and pedestrian traffic in the area was diverted, [but] access to the restaurant was not denied; the restaurant was accessible to the public, plaintiff's employees and its vendors."

Syufy Enter. v. Home Ins. Co. of Indiana, 1995 WL 129229, at *2-3 (N.D. Cal. 1995) (unpublished). The policy in this case required that access to plaintiff's premises be specifically prohibited by order of civil authority, and as a direct result of damage to or destruction of property adjacent to the premises. The court rejected the insured's claim for business interruption coverage for losses sustained during curfews imposed after the Rodney King verdict because curfews were imposed to prevent *potential* looting and rioting and not as a result of adjacent property damage.

Conclusion

It is very interesting to witness the evolution of business interruption coverage and how courts seem to be broadening their interpretation of these policies as more and more "non-physical property damage" losses become prevalent, such as, pandemics and cyber-related claims. That said, as more and more businesses come to realize that these types of losses pose a serious threat to their operations and contingency planning, the insurance industry will increasingly be called upon to develop new products and/or craft exclusions in an effort to address these loss exposures. For the time being, however, courts will continue to grapple and likely offer unpredictable opinions on how these policy terms, conditions and exclusions should be construed.

About the Author

Rick Hammond is a partner with HeplerBroom, LLC, and he serves as national counsel on matters relating to property insurance coverage, fire and explosion cases, and bad faith. He also serves as an expert witness on insurance law, bad faith and coverage issues, and he is an adjunct professor on insurance law at Loyola University Law School.

Previously, Rick was the Assistant Deputy Director of the Illinois Department of Insurance's Chicago office, served as an Executive Director of a national insurance trade association, and held managerial positions in property claims and agency for two national insurance carriers.

Mr. Hammond is Past-President of the Illinois Association of Defense Trial Counsel and formerly served on the faculty and Board of Directors of the Insurance School of Chicago. He is a member of the Federation of Defense and Corporate Counsel and former Chair of their Property Insurance Law Committee. He is also the former Illinois State Representative of DRI, and he serves on the Board of Trustees of Loyola University Chicago.

Mr. Hammond was one of two attorneys in the country selected by the Lexis Nexis Insurance Law Center in 2008 to receive its "Insurance Lawyer of the Year Award." He is also a Fellow of the American College of Coverage and Extra-Contractual Counsel, an organization that includes some of the most preeminent coverage and extra-contractual attorneys in the United States and Canada.

Questions or comments can be directed to Mr. Hammond at the law firm of HeplerBroom, LLC, 30 North LaSalle, Suite 2900, Chicago, Illinois 60602, (312) 205-7743, or at the e-mail address of rick.hammond@heplerbroom.com.

*Note: The author would like to thank and acknowledge the contribution and assistance of HeplerBroom associate attorney, **Robert Hartzler**, who was instrumental in the research and preparation of this article*