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PERSPECTIVE

High court declines to review COVID insurance coverage case

By Rani Gupta and David B. Goodwin

On March 10, the California Supreme Court announced that it has declined to weigh in – for now – on the biggest brewing insurance coverage dispute in the California courts and, indeed, across the country: Which policyholders can recover from their insurers for the earnings they lost as a result of the COVID-19 pandemic?

In November, Division 1 of the 4th District Court of Appeal issued the first published California state court decision on this question, *The Inns by the Sea v. California Mutual Insurance Co.*,71 Cal. App. 5th 688 (2021), answering: Policyholders with differently pleaded complaints and different COVID-19 experiences could be entitled to coverage, but not the policyholder in *Inns by the Sea*.

In so holding, *Inns* rejected the arguments that the insurance industry had pressed – that the virus that causes COVID-19 can never cause "direct physical loss" or "direct physical damage" and thereby trigger coverage under a typical property insurance policy.

Inns thus represents a significant loss for insurers. Since the onset of the pandemic, the insurance industry has taken the coordinated position that the COVID-19 virus cannot cause "direct physical loss or damage" under any circumstance because the COVID-19 virus does not cause damage to property that is visible to the naked eye. Insurers say that if your building is still standing, or if you can't at least see a demonstrable physical alteration of the property, there is no direct physical loss or damage as a matter of law, and they don't owe a thing.

Many courts have accepted this argument, especially federal courts attempting to predict what state courts would rule. But the *Inns* court did not, and for good reason. Insurance policies are read from the perspective of an ordinary layperson, and an ordinary layperson would understand that "physical loss" or "damage" can result from a wide range of physical causes that do not cause structural damage or are invisible to the naked eye or both. Those include causes (or "perils" in insurance parlance) such as asbestos, wildfire smoke, carbon monoxide, foul odors, ammonia, gasoline fumes, and radiation, which render property unsafe or unusable. Before the COVID-19 era, courts across the country agreed.

In fact, Factory Mutual Insurance Company – the world's most sophisticated property insurer – took the position in litigation months before the pandemic that "physical loss or damage" can be caused by mold and does not require a showing of "demonstrable structural damage or alteration of property."

That position – and decades of court decisions – is consistent with a key reason why businesses purchase property insurance and business interruption coverage, to insure the business' lost earnings when the business cannot use its property as intended because a physical force outside of the insured's control has rendered the property unsafe or unusable.

Policyholders with differently pleaded complaints and different COVID-19 experiences could be entitled to coverage, but not the policyholder in *Inns by the Sea*.

Policyholders buying such a policy reasonably expect that their business income losses will be covered by insurance, regardless of whether their property is made unusable by a visible or an invisible force. Indeed, many perils – such as the particulate matter in wildfire smoke or carbon monoxide – are dangerous precisely because they are microscopic and undetectable to human perception. Therefore, much as a business cannot safely operate a factory filled with carbon monoxide, many businesses could not operate safely during the early months of the pandemic: In the period before vaccinations, sophisticated air filtration systems, and other safety measures, any business open to members of the public risked the constant reintroduction of the COVID-19 virus through infected persons, creating a highly unsafe working environment and posing serious health risks to the public.

The *Inns* court recognized as much. It rejected the insurance industry's argument that the COVID-19 virus cannot cause insured physical loss or damage. Analogizing to perils such as smoke, odor and asbestos, the court held that the COVID-19 virus is a "physical force" that can impair the safe use of property and trigger insurance coverage.

The court held, however, that the short complaint at issue in *Inns* did not plead that its hotels

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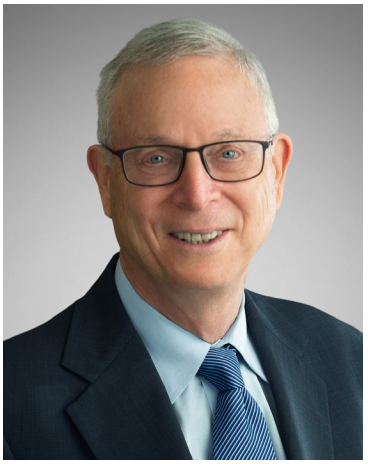

closed as a result of the presence of the COVID-19 virus on the insured properties. On that sole ground, it affirmed the judgment in favor of the insurer. In so holding, the court eliminated any doubt as to whether the insurance industry's position was the legal rule by explaining that "It could be a different story if a business – which could have otherwise been operating – had to shut down because of the presence of the virus within the facility."

Inns thus should have put an end to the insurance industry's argument that the COVID-19 virus cannot – as a matter of law – cause insured physical loss or damage. (Spoiler alert: It didn't.)

The key point going forward is that many insureds have claims that are materially different from *Inns*. If a policyholder pleads that its lost business income was caused by the COVID-19 virus on its premises, then its claim survives under *Inns*. The same is true when an insured was forced to close or limit its business operations for any period of time when a government order did not prohibit or restrict access to the insured properties.

The *Inns* court also held that the insured did not plead a claim under the separate "civil authority" coverage of insurance policy at issue because of the wording of the particular San Mateo and Monterey County orders at issue provided "no indication" that they were issued due to physical loss or damage. But where the orders are worded differently, or where discovery bears out that the orders were issued because of physical loss or damage to property, those claims too should proceed under *Inns*.

Left scrambling after *Inns* rejected their core theory of physical loss or damage, insurers have cited portions of the lengthy decision out of context, arguing that *Inns* held the opposite of what the court actually said. They have tried to turn the narrow causation-based ruling against the insured into an expansive ruling foreclosing coverage in all cases.

But their arguments do not stand up in light of the actual holding and insurance policy language in that case.

The first rule of insurance coverage litigation is that the words that the insurer used in the insurance policy matter. The insurance policy at issue in *Inns* is more favorable than many insurance policies in that it does not contain an industry-standard "Exclusion of Loss Due to Virus or Bacteria," a very broad exclusion that an industry trade group drafted in 2006 after insurers paid millions as a result of the SARS pandemic. As to a wider application of *Inns*, other property insurance policies have even broader language than the policy in *Inns*, and courts must construe that broader language accordingly.

Courts must also consider the actual facts of each case. Whether an insured has suffered "physical loss or damage" is an intensely factual question that depends on the normal way the business functions, the characteristics of the property, and the way that the COVID-19 affects the property and the business. For example, maybe a parking lot or a garden center could have operated safely throughout the pandemic, but a packed sports stadium or retail store could not.

It remains to be seen whether the insurers' aggressive and counter-textual reading of *Inns* will gain any traction in the trial courts or in the other COVID-19 insurance coverage appeals percolating through the California appellate courts. If so, a split in legal authority could develop, and the California Supreme Court may need to step in and ensure that policyholders have a fair and full chance to prove their claims on the merits.