

**ARTICLE:****NO RELIEF FOR THE INN: BUSINESS INCOME LOSSES DUE TO GOVERNMENT'S COVID-19 SHUTDOWN ORDERS ARE NOT "PHYSICALLY CAUSED" BY COVID-19 SO NOT COVERED BY STANDARD COMMERCIAL PROPERTY INSURANCE**

*By Karl E. Geier\**

Addressing an issue of first impression in California, the Court of Appeal for the Second District has confirmed that businesses compelled to cease operations as a result of governmental directives issued in response to the COVID-19 pandemic cannot look to their property insurance carriers to cover the lost business income. Following the onset of the pandemic, many county health departments adopted stringent "stay at home" shutdown orders that essentially prohibited customers, guests, and most employees from entering or staying in commercial premises for a substantial period of time, often many months. In this case, *The Inns by the Sea v. California Mutual Ins. Co.*,<sup>1</sup> a hotel operator had been required to stop allowing any members of the public or non-essential employees into the premises, and essentially was ordered to cease offering overnight accommodations to overnight guests for the duration of the order. The hotel operator argued that the Business Income clause of a standard commercial property insurance policy extended to lost business income resulting from a shut-down order because the losses were attributable to a "direct physical loss of or damage to property at the premises" caused by the ubiquitous presence of the COVID-19 virus. The operator also contended that the losses caused by the shut-down order fell within the Civil Authority clause of the policy, as an action of civil authority that prohibited physical access due to direct physical loss or damage. The court of appeal sustained the trial court's grant of a demurrer on both counts, finding no basis for relief under either clause.

In the course of its opinion, the court of appeal carefully construed the terms "direct physical loss of or damage to property" and concluded that COVID-19 had not "caused" such damage. The court rejected the argument that because the insured had suffered a loss of use of the property due to the shut-down order that had been precipitated by the pandemic, the loss of use was "physically

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caused by” the virus. To the contrary, said the court, the policy language covered loss of use only where it was the result of direct physical damage to the property by an event. Here, there was no event causing physical damage. The policy did not provide coverage for a legally mandated shutdown stemming from a widespread viral pandemic, because the shutdown order was not attributable to the COVID-19 virus being specifically on the insured’s premises, it was only precautionary in case of someone infected with the virus entering the premises and spreading it to other people on the premises.

The hotel operator and various amicus curiae argued that the shutdown was “physically caused” by the virus in the same manner as other types of indirect damage that have been found covered by the standard Business Income clause. But the plaintiff’s pleadings attributed the business losses to the shutdown order, not to physical damage of the premises, and the order itself was premised on health concerns, not specific presence of contamination on the insured premises. Other types of contamination of property that trigger loss of use coverage, such as the presence of hazardous, noxious, or volatile materials, such as smoke, gasoline vapors, or ammonia fumes, all involve some physical presence and damage to the property itself. There was no indication that the COVID-19 virus had caused any physical damage to the insured property. Rather, any loss of use was attributable to a governmental decision to prohibit the hotel’s usual business operations due to a widespread health concern that could not be specifically identified or traced to the premises. In other words, as the court of appeals said (quoting from an unpublished federal district court opinion in another COVID-19 related case):

[T]he presence of COVID-19 on Plaintiff’s property did not cause damage to the property necessitating rehabilitation or restoration efforts similar to those required to abate asbestos or remove poisonous fumes which permeate property. Instead, all that is required for Plaintiff to return to full working order is for the [government orders and restrictions to be lifted].<sup>2</sup>

As an alternative to coverage under the Business Income clause, the plaintiff in the case, as well as several amicus curiae, also argued that the “Civil Authority” language of the policy was triggered by the COVID-19 shutdown order, and therefore that coverage existed under that clause even if it did not exist under the Business Income clause. The Civil Authority clause provides coverage for losses of business income “caused by action of civil authority that prohibits access to the described premises due to direct physical loss of or damage to property, other than at the described premises, caused by or resulting from any

Covered Cause of Loss.” Here, again, the problem was that there was no showing that the COVID-19 virus had caused a physical loss of or damage to other property—the shutdown order was in response to the prevalence of the coronavirus, but was not attributable to physical damage to any *property*, only to the potential for the virus to spread in the population. As the court said:

[T]he [Counties’ shutdown] Orders make clear that they were issued in an attempt to *prevent the spread* of the COVID-19 virus. The Orders give no indication that they were issued “due to direct physical loss of or damage to” any property. Therefore, the Orders did not give rise to Civil Authority coverage.<sup>3</sup>

The court of appeal in the *Inns by the Sea* decision also sustained the trial court’s grant of the insurer’s demurrer without leave to amend, rejecting the plaintiff’s claim that it could plead facts to get around the “direct physical loss of or damage” terminology. The hotel operator suggested that it could adduce scientific information to show the nature of the COVID-19 virus, and the court noted that some courts in other jurisdictions had considered that the virus may “attach to and adhere on surfaces and materials,” becoming part of those surfaces and materials, and thereby causing a “physical change in the affected surface or materials.” But this plaintiff had already pleaded that the shutdown orders caused the suspension of operations, not that some physical damage to the property had done so.

The *Inns by the Sea* decision is specifically an insurance case and involves the construction of insurance policy language, which ordinarily is construed as the insured would understand the language, and in that respect is usually considered more favorable to the insured than the insurer. However, the case is indicative of the narrow approach to contractual construction likely to be employed in any case alleging claims under or relief from contractual responsibilities as a result of the COVID-19 pandemic. The *Inns by the Sea* plaintiff argued that because the policy did not include a “virus exclusion” that is commonly included in some insurance policy forms, the coverage clauses of the policy should be construed as reflecting the insurer’s intent to provide coverage for virus losses. The court of appeal rejected the argument that the insurance policy language provided coverage on this basis, noting that California case law defines coverage in the first instance by the insuring clause, and only if that language is ambiguous does the *omission* of a specific exclusion have a bearing on its meaning.<sup>4</sup>

It is not clear from the opinion that another plaintiff insured would be precluded from arguing that the “physical damage” caused by COVID-19 or

other coronavirus strands could be considered a contaminant or potential contaminant of property, supporting a “physical damage” type of claim. Whether a party could credibly contend that it was this contamination, rather than the shutdown order, that caused the loss of income, was left unsaid by the *Inns by the Sea* court. In a footnote, however, the court of appeal observed that other courts “have concluded that contamination which is short-lived or does not prevent the use of the structure does not qualify as a direct physical loss.”<sup>5</sup>

*Inns by the Sea* may not be the last word on the insurance issues it addresses, nor does it necessarily preclude the availability of coverage for COVID-19 related losses under other insurance policy forms or other types of businesses. This is so particularly if the insured is able credibly to plead contamination by the coronavirus in the first instance, rather than being bound by an earlier pleading that attributed the losses to the shutdown order and not the physical damage caused by the virus. And the court of appeal opinion in *Inns by the Sea* may not stand if the California Supreme Court grants a hearing, which is a possibility as of the date of this writing. However, the court of appeal noted that while “no California appellate court has addressed the issue, numerous federal courts in other states have done so,” and the majority of the decisions find “no possibility of coverage under commercial property insurance policies for a business’s pandemic-related loss of income.”<sup>6</sup>

Among other cases, the Ninth Circuit Court of Appeals, applying California law, has previously reached the same result as *Inns by the Sea*. In *Mudpie, Inc. v Travelers Casualty Ins. Co. of America*,<sup>7</sup> the Ninth Circuit considered a similar lawsuit alleging coverage under the Business Income clause for losses resulting from compliance with a COVID-19 shut-down order. The appellate court in *Mudpie, Inc.*, as in *Inns by the Sea*, concluded that there were no business income losses attributable to “direct physical loss or damage” or to “loss of use” caused by such “direct physical loss or damage” as distinguished from the shutdown order itself, although the policy in *Mudpie* also included a virus exclusion that the court found also to preclude coverage, unlike the policy in *Inns by the Sea*.<sup>8</sup>

Another point that was not lost on the court of appeal in *Inns by the Sea* is the sometimes-wishful thinking of politicians and other policy makers that insurance policies should be construed broadly with respect to the COVID-19 pandemic, or even that legislation should be enacted to “clarify” that commercial property insurance policies include coverage for business income losses triggered by the COVID-19 shutdown orders. As stated by the court, however,

“[t]he principles of contractual interpretation, as applied to insurance policies, ‘do *not* include using public policy to redefine the scope of coverage.’ ”<sup>9</sup> This is likely to remain the rule regardless of whether further litigation finds coverage under some policies for some kinds of COVID-19 related injuries.

#### ENDNOTES:

<sup>1</sup>*The Inns by the Sea v. California Mutual Insurance Company*, 71 Cal. App. 5th 688, 2021 WL 5298480 (Cal. App. 4th Dist. 2021).

<sup>2</sup>*Id.*, 71 Cal. App. 5th at \_\_\_\_\_, slip op. at \*9, quoting *First and Stewart Hotel Owner, LLC v. Fireman’s Fund Insurance Company*, 2021 WL 3109724 (W.D. Wash. 2021)), at p. 4 (bracketed language is from the court of appeal opinion).

<sup>3</sup>*Id.*, 71 Cal. App. 5th at \_\_\_\_\_, slip op. at \*14 (emphasis by the court).

<sup>4</sup>*Id.*, 71 Cal. App. 5th at \_\_\_\_\_, slip op. at \*12, citing *Glavinich v. Commonwealth Land Title Ins. Co.*, 163 Cal. App. 3d 263, 270, 209 Cal. Rptr. 266 (4th Dist. 1984), and also quoting *Haering v. Topa Ins. Co.*, 244 Cal. App. 4th 725, 736, 198 Cal. Rptr. 3d 291 (2d Dist. 2016).

<sup>5</sup>*Id.*, 71 Cal. App. 5th at \_\_\_\_\_, slip op. at \*8, n.17, quoting *Kim-Chee LLC v. Philadelphia Indemnity Insurance Company*, \_\_\_ F. Supp. 3d \_\_\_, 2021 WL 1600831, at \*5 (W.D. N.Y. 2021).

<sup>6</sup>*Id.*, 71 Cal. App. 5th at \_\_\_\_\_, slip op. at \*1, n. 1, citing, *inter alia*, *Nguyen v. Travelers Casualty Insurance Company of America*, \_\_\_ F. Supp. 3d \_\_\_, 2021 WL 2184878 (W.D. Wash. 2021).

<sup>7</sup>*Mudpie, Inc. v. Travelers Casualty Insurance Company of America*, 15 F.4th 885 (9th Cir. 2021).

<sup>8</sup>*Id.*, 15 F.4th at 893-894.

<sup>9</sup>*Inns by the Sea, supra*, 71 Cal. App. 5th at \_\_\_\_\_, slip op. at \*5, quoting *Ward General Ins. Services, Inc. v. Employers Fire Ins. Co.*, 114 Cal. App. 4th 548, 553, 7 Cal. Rptr. 3d 844 (4th Dist. 2003).