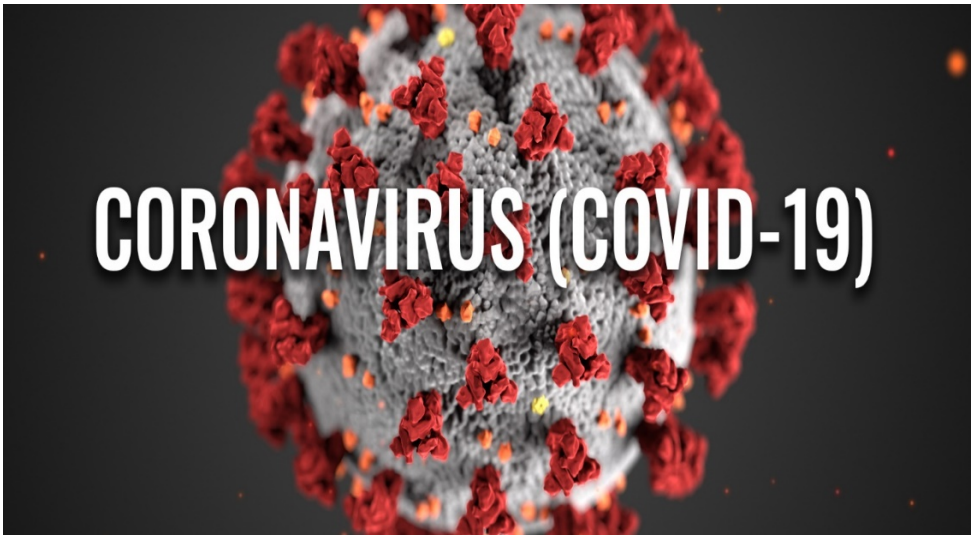


# 2.0 – COVID-19: CONTRACT DEFAULTS AND INSURANCE FOR LOST INCOME

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## I. INTRODUCTION

The arrival of a new coronavirus (2019-nCoV) in Wuhan, China created a sense of déjà vu with the severe acute respiratory syndrome coronavirus (SARS-CoV) epidemic that started in China back in 2003. Coronaviruses are characterized as enveloped, positive-stranded RNA viruses of mammals and birds. These types of viruses have high mutation and gene recombination rates, making them ideal for pathogen evolution. Genetic analysis suggests that COVID-19 began as an initial single-locus (genetic marker) zoonotic spillover event in November, 2019, and subsequently spread through human-to-human transmission.

In the human population, coronavirus usually presents with common cold symptoms. Earlier novel coronaviruses, such as SARS-CoV and Middle East respiratory syndrome coronavirus (MERS-CoV), which began in the Middle East in 2012, were characterized as severe and sometimes fatal. COVID-19 appears closely related to SARS-CoV and other bat coronaviruses, thus the early rumor that the Chinese practice of eating bats was the cause. COVID-19 is another virus in the pipeline that originated from contact with animals, in this case a seafood and animal market in Wuhan, China. COVID-19 has spread world-wide and was declared a pandemic by the World Health Organization on March 11, 2020. On March 13, 2020, the President of the United States declared the COVID-19 outbreak a national emergency.

Most of us first heard of COVID-19 in early February 2020, with media reports of the fast-spreading disease coming from Wuhan in the Hubei province of China. The infection was spreading at such an alarming rate, the Chinese government attempted to contain the virus by "locking down" the city of Wuhan and restricting travel in and out of the city and also ordering its

citizens to stay home. China also began construction of two hospitals in Wuhan to treat those afflicted with the disease. By mid-February, most of China was on "lock down."

Unfortunately, one of the characteristics of COVID-19 is that it is easily transmitted by human-to-human contact and that it can live on surfaces for days. South Korea was the next country hit with numerous COVID-19 cases. Korea set up drive-through test stations, an approach only now being launched in the United States. Korean health officials initially focused their efforts on members of a secretive megachurch in Daegu with a branch in Wuhan, but they then broadened their reach to Seoul and other major cities. Presently, South Korea had tested more than 248,000 people and identified 8,236 cases. So far, 75 have died, or 0.9% of those infected. If compared to the Chinese province of Hubei where the coronavirus first emerged, the fatality rate for the province currently stands at about 4.5%.

Italy, a member of the European Union and a popular tourist destination, joined the list of COVID-19 affected countries on January 30, 2020 when two COVID-19 positive cases were reported in Chinese tourists. Italy's COVID-19 cases reached 24,747 on March 15, 2020, marking the biggest coronavirus outbreak outside Asia. Italy also replaced South Korea as the second most affected coronavirus country in the world with the cases increasing at a higher rate than in Korea. The COVID-19 death toll in Italy reached 1,809, with a significant increase in the last few days. Vatican City, home to the Pope and headquarters of the Roman Catholic Church, reported its first coronavirus case on March 6th. The Italian COVID-19 cases surged from hundreds to thousands within two weeks, from a few hundred in the third week of February to more than 3,000 in the first week of March and crossed 10,000 on March 10, 2020. The high number of coronavirus infection cases in Italy might be explained by the expanding air travel with China. Italy is the European

nation with the highest number of air connections with China after the air connections between the two countries tripled earlier this year.

To curb infection rates, the Italian government took measures such as screening and suspending major community events during early times of the coronavirus outbreak, and has eventually announced closure of educational institutes and hygiene/disinfection measures at airports. The Italian National Institute of Health recommended "social distancing" and acknowledged that the country's larger aged population poses a challenge.

The United States has adopted Italy's approach to containing the spread of COVID-19 by suspending entry into the US for most foreign nationals who have been in certain European countries. State and local governments have closed schools, restricted public gatherings and encouraged "social distancing" while increasing testing capabilities nation-wide. Many businesses have been forced to close entirely.

The coronavirus is about to cause contract disputes in ways that we cannot fully imagine. Parties will call their attorneys asking if they can send default letters or if they have defenses for missed contractual deadlines. Terms such as "force majeure," "acts of God," "impossibility of performance," and "Oh my gosh, the contract is silent on this," will become staples of our legal diet. Calls asking, "Does this fall under my business interruption insurance?" will become common. Unfortunately, there is no one answer to all of these questions because the nature of the contract disputes will vary widely depending on the industry, facts, locations and laws involved in the particular dispute.

Companies will be faced with contractual defaults caused by workforce unavailability, supply claim issues, and an inability to access properties that have been shut down. These events will disrupt contracts and loan closings, cases of non-payment of rents and loss of business income

as a result of property closures. The issue is whether the law offers any relief to the party that is in default or has lost business income.

This white paper sets out to provide general guidance and focuses on four areas: federal common law, New York law, Delaware law and Texas law. These were selected as many bank loan and international contracts are under New York law, a disproportionate number of equity and entity documents are governed by Delaware law and, finally, we are a Texas law firm so, obviously, many of our clients' transactions are governed by Texas law.

The legal battleground regarding contractual rights will center around two areas: (1) the applicability of force majeure provisions in contracts; and (2) the applicability of the doctrine of impossibility or impracticability of performance and frustration of purpose. Generally, if the contract at issue has a force majeure clause, the language of the force majeure provision will be of critical importance. If it lists specific events that will relieve a party of its contractual obligations, but does not include either specific language regarding pandemics or general language that might be interpreted to encompass a pandemic, epidemic or outbreak, a court might interpret that it was the parties' intent to exclude such events. While that would seem to be an absurd result, the courts will not construe force majeure to alter the intent of the parties if it appears they intended to exclude viral outbreaks from the clause.

If the contract does not include a force majeure provision, the defaulting party will have to rely on the common law doctrines of impossibility of performance and/or frustration of purpose. The essence of the doctrines is if something is a basic assumption to a contract and due to completely unforeseen circumstances that assumption later proves incorrect, a party will be relieved of performance. Classic examples are the death of a person necessary for performance,

the destruction of a thing necessary for performance or a governmental regulation preventing performance. However, generally, any event that prevents actual performance will relieve the obligor, with a couple of notable exceptions. First, circumstances which are specific to the obligor, such as dire financial condition, as opposed to an event which makes performance impossible for everyone will not relieve the performance by the obligor. Second, many may try to argue that the unavailability of a particular source of parts, funds, etc. makes performance "impossible." Even if one party anticipated a particular source, and the other party knew that source would be utilized, an absence of that source does not relieve performance. The obligor must attempt to "cover" with a substitute source and must utilize that source if it is at all commercially reasonable.

Many businesses will lose income due to (1) closures, or (2) tenants' inability to pay rent and will look to insurance to cover those losses. Unfortunately, while standard commercial property policies cover business interruption, such coverage is usually available only as an off shoot to some "property damage." However, policies must be reviewed closely to confirm that the prerequisite of property damage is required. Some policies may not utilize standard forms. Moreover, some policies also afford loss of ingress/egress coverage and/or action of "civil authorities" coverage. Property damage insurance as a source of funds should not be ignored without a close policy review.

## II. FORCE MAJEURE

The primary analysis involving any contract-based inability to perform will involve the need to understand that specific agreement, and whether the applicable contract contains a "force majeure" provision. According to Black's Law Dictionary, force majeure, which means "superior force" in French, is "an event or effect that can be neither anticipated nor controlled." *FORCE*

*MAJEURE, Black's Law Dictionary (11th ed. 2019).* In the context of contracts, a force majeure is an unexpected event that prevents a party from doing something it had agreed or officially planned to do. *Id.*

A force majeure clause relieves parties from their contractual obligations where performance is prevented due to causes beyond the parties' control, such as large-scale disasters, acts of God, and similar excuses for performance, but it is critical to understand the literal language contained in the force majeure contract provision, taken in light of the subject matter of that particular agreement. The underlying premise of force majeure provisions is similar to common law doctrines like impossibility of performance, impracticability and frustration of performance. Indeed, if a contract does not include a force majeure clause, a party to a contract will be forced to rely on such common law defenses if it wishes to excuse its performance under the contract, and the ability to do so will solely be governed by the applicable law set forth in the underlying agreement.

It is always advisable to include a force majeure provision in order to avoid the uncertainty of what may happen when unexpected circumstances arise. However, courts in most states interpret force majeure clauses narrowly, meaning that only events identified in the contract will be excused as a "force majeure."

***Texas.*** In Texas, as in most jurisdictions, the ability to avoid performance under a contract is narrowly construed, and accordingly "an act of God does not relieve the parties of their obligations unless the parties expressly provide otherwise." *GT & MC, Inc. v. Texas City Ref. Inc.*, 822 S.W.2d 252, 259 (Tex. App.—Houston [1st Dist.] 1991, writ denied). For that reason, contracts in Texas frequently include force majeure clauses, which are enforceable under Texas law. *See id.* However, "[t]he scope and effect of a 'force majeure' clause depends on the specific

contract language, and not on any traditional definition of the term." *Virginia Power Energy Mktg., Inc., et al. v. Apache Corp.*, 297 S.W.3d 397, 402 (Tex. App.—Houston [14th Dist.] 2009, pet. denied). Texas courts will look at the language of the force majeure provisions within the contract to determine the parties' intent. *See id.* Thus, if the parties define the "contours" of force majeure in their contract, "those contours dictate the application, effect, and scope of force majeure,' and reviewing courts 'are not at liberty to rewrite the contract or interpret it in a manner which the parties never intended.'" *Allegiance Hillview, L.P. v. Range Texas, Prod., LLC*, 347 S.W.3d 855, 865 (Tex. App.—Fort Worth 2011, no pet.) (quoting *Sun Operating Ltd. P'ship v. Holt*, 984 S.W.2d 277, 283 (Tex. App.—Amarillo 1998, pet. denied)). Further, a force majeure provision's "scope and application…is utterly dependent upon the terms of the contract in which it appears." *Sun Operating Ltd.*, 984 S.W.2d at 283. In sum, if a particular event or set of facts is not listed in the force majeure clause as expressly excusing performance for the claimed event, the occurrence of such an event likely will not relieve a party of its obligations under the contract.

Where a force majeure provision exists, the burden of showing that the provision applies rests with the party seeking to excuse its performance under the contract. *See Hydrocarbon Mgmt. Inc. v. Tracker Exploration, Inc.*, 861 S.W.2d 427, 436 (Tex. App.—Amarillo 1993, no writ). However, Texas law does not require the party to exercise reasonable diligence to avoid the effects of a force majeure event unless such a requirement is expressly set forth in the contract. *See Sun Operating Ltd.*, 984 S.W.2d at 283-84; *El Paso Field Servs., L.P. v. Mastec N. Am. Inc.*, 389 S.W.3d 802, 808 (Tex. 2012). For a party to successfully invoke a force majeure clause, the party must be able to show that the event in question was unforeseeable at the time the parties made the contract, and that the party lacked reasonable control over the occurrence of the event. *Valero Transmission Co. v. Mitchell Energy Corp.*, 743 S.W.2d 658, 663 (Tex. App.—Houston [1st Dist.]

1987, no writ). It is not sufficient for a party to argue that its performance should be excused just because the cost of its performance became greater than initially anticipated. *Id.* at 663-64.

A party could easily argue that the emergence of COVID-19, its growth to pandemic status, and the widespread cancellation of events and services worldwide was unforeseeable at the time a contract was executed. A party seeking to invoke a force majeure provision to excuse performance would be required to demonstrate that the language was intended to include such unforeseen events as an epidemic, pandemic, or other disease-related event similar to COVID-19 to excuse their obligations. Otherwise, a Texas court would likely find that it is not at liberty to expand the scope of a relevant provision to include epidemics, pandemics, outbreaks, etc. The inclusion of epidemics, pandemics, quarantine regulations, or other disease-related events in the contract would obviously cover the COVID-19 crisis. Further, subsequent government actions (e.g. government restrictions on gatherings, travel restrictions, etc.) could themselves constitute force majeure events if contemplated by the contract, as would a governmental agency not issuing building permits and certificates of occupancy, as a result of such a health-related crisis as COVID-19.

***New York.*** According to New York courts, the purpose of a force majeure provision is to relieve a party of liability and/or limit its damages when the contracting parties' expectations are frustrated by unforeseeable circumstances beyond the parties' control and not due to their fault or negligence. *Constellation Energy Servs. of N. Y., Inc. v. New Water St. Corp.*, 146 A.D.3d 557, 558, 46 N.Y.S.3d 25 (1st Dept. 2017); *Team Mktg. USA Corp. v. Power Pact, LLC*, 41 A.D.3d 939, 942, 839 N.Y.S. 242 (3rd Dpt. 2007). As in Texas, force majeure clauses in New York are to be narrowly construed, and a party's performance will be excused only if the force majeure clause specifically identifies the event that prevents the party's performance. *Reade v. Stoneybrook Realty, LLC*, 63 A.D. 433, 434, 882 N.Y.S.2d 8 (1st Dept. 2009). In other words, the force majeure

clause must include the specific event that is claimed to have prevented performance. *Philbro Energy, Inc. v. Empresa De Polimeros De Sines Sarl,* 720 F.Supp. 312, 318 (S.D.N.Y. Aug. 28, 1989) (citing *Kel Kim Corp. v. Central Markets, Inc.,* 70 N.Y.2d 900, 902–03, 524 N.Y.S.2d 384, 385, 519 N.E.2d 295, 296 (1987)).

In some instances, a force majeure clause may include a broad catchall phrase in addition to specific events. In such instances, New York law is clear that words constituting general catchall language should not be given the most expansive meaning possible. *Team Mktg. USA Corp.,* 41 A.D.3d at 942-43 (citing *Kel Kim Corp.,* 70 N.Y.2d at 903). Rather, such language applies only to the same general kind or class of events and circumstances as those specifically mentioned. *Team Mktg. USA Corp.,* 41 A.D.3d at 942-43 (quoting *Kel Kim Corp.,* 70 N.Y.2d at 903).

The party seeking to excuse its performance by invoking a force majeure clause has the burden of demonstrating a force majeure event. *Phillips Puerto Rico Core, Inc. v. Tradax Petroleum Ltd.,* 782 F.2d 314, 319 (2d Cir. 1985). Further, the party must demonstrate that it tried to perform its contractual duties despite the claimed force majeure event. *Id.*

Unanticipated difficultly in performing one's obligations under a contract is not sufficient to excuse performance. *Philbro Energy,* 720 F.Supp. at 318. Further, adverse economic conditions do not constitute a force majeure event sufficient to excuse a party's performance. *Route 6 Outparcels, LLC v. Ruby Tuesday, Inc.,* 88 A.D.3d 1224, 931 N.Y.S.2d 436 (3rd Dept. 2011).

In New York, a business seeking to invoke a force majeure clause due to the outbreak of COVID-19 will likely have to show that the clause specifically contemplated epidemics and/or pandemics that might frustrate the parties' reasonable expectations regarding the contract. While such a clause may include broad catchall language in an effort to include other non-enumerated events, such language will only apply to the same general kind or class of events and circumstances

as those specifically mentioned. Thus, it is not likely that the COVID-19 outbreak would be considered a force majeure unless an epidemic, pandemic, quarantine regulation, or other disease-related event is included on the list of force majeure events within the contract. However, it is possible that the consequences related to a pandemic like COVID-19 (e.g. government restrictions on gatherings, travel restrictions, etc.) could themselves constitute force majeure events if contemplated by the contract. Thus, in the current situation, an "act of government" may be sufficient to excuse performance.

***Delaware*.** Under Delaware law, a force majeure clause, "defines an area of events that might excuse nonperformance within the contract period." *VICI Racing, LLC v. T-Mobile USA, Inc.*, 763 F.3d 273, 287 (3rd Cir. 2014) (citations omitted). Force majeure provisions are intended to protect the parties to the contract from the consequences of negative events and circumstances beyond the parties' control. *Id.* However, as in other jurisdictions, Delaware courts will look to the language of the force majeure provision to determine the intent of the parties. *Id.* (citing *Stroud v. Forest Gate Dev. Corp.*, Case No. Civ. A. 20464-N C, 2004 WL 1087373, at *5, n. 25 (Del. Ch. May 5, 2004). A reasonable, unextreme hardship does not itself constitute a force majeure. *Id.* at 288.

It is unclear if Delaware law requires that a particular event be unforeseeable for it to constitute a force majeure. In *Stroud*, the Chancery Court examined a force majeure provision in a real estate development contract and, although the parties did not explicitly so state, determined that the parties intended that an event did not have to be reasonably foreseeable for it to constitute a force majeure. *See Stroud*, 2004 WL 1087373, at *5. The 3rd Circuit Court of Appeals in *VICI Racing* reasoned that the *Stroud* court did not hold that all force majeure clauses require a lack of foreseeability; rather, the *Stroud* court simply applied a standard contractual analysis to determine

the parties' intent. *VICI Racing*, 763 F.3d at 289. The 3rd Circuit also reasoned that the *Stroud* court took into account the nature of the real estate industry in reaching its conclusion about the foreseeability requirement. *Id.*

There is significantly less case law providing guidance on the law governing force majeure clauses in Delaware. As in Texas and New York, Delaware courts will look to the language of the force majeure provision to determine whether a particular event was intended by the parties to excuse performance. However, the limited case law we have suggests that Delaware courts may be willing to infer the meaning and scope of a force majeure clause based on outside factors, such as the parties' industry. Thus it is possible that a Delaware court may look to factors other than just the contractual language to determine the parties' intent when determining whether COVID-19 and the actions taken by government in response constitute a force majeure.

## III. IMPRACTICABILTY OF PERFORMANCE AND FRUSTRATION OF PURPOSE

### A. Impossibility

The common law doctrine of impossibility or impracticality of performance will apply to situations where the contract does not contain a force majeure clause and such situations do not involve the sale of goods.[1] The doctrine has been developed by the courts to address situations where unforeseen circumstances prevent one party's performance of its contractual obligations. Whether the doctrine offers any relief will be largely dependent upon: (1) whether circumstances "objectively" or only "subjectively" prevented performance, and (2) whether the parties allocated the risk of the bad event to the party who cannot perform. Generally, the doctrine will not apply

[1] Contracts involving the sale of goods will be governed by each State's version of the Uniform Commercial Code, which contains provisions similar to the common law doctrine of impossibility.

if the inability to perform is only subjective to the party or where the contract allocates risks to that party. *See Janak v. FDIC*, 586 S.W.2d 902, 906 (Tex.App.-Houston [1st Dist.] 1979, no writ).

### B. Contracts Not Involving the Sale of Goods

Texas, Delaware and New York each follow Restatement (Second) of Contracts § 261 regarding impossibility. *Centex Corp. v. Dalton*, 840 S.W.2d 952, 954 (Tex. 1992); *Tractebel Energy Marketing v. E.I. DuPont De Nemours and Co.*, 118 S.W.3d 60 (Tex. App. – Houston (14th Dist.), 203); *Trilegiant Corp. v. Orbitz, LLC*, 125 A.D.3d 504, 5 N.Y.S. 3d 366 (2015); *In re Bicoastal Corp.*, 600 A.2d 343 (Del. Sup. 1991) (citing with approval to § 261). That section provides:

> § 261 Discharge by Supervening Impracticability
>
> Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.
>
> § 261 is explained as follows:
>
> In order for a supervening event to discharge a duty under this Section, the non-occurrence of that event must have been a "basic assumption" on which both parties made the contract. Its application is simple enough in the cases of the death of a person or destruction of a specific thing necessary for performance. The continued existence of the person or thing (the non-occurrence of the death or destruction) is ordinarily a basic assumption of which the contract was made, so that death or destruction effects a discharge. Its application is also simple enough in the cases of market shifts or the financial inability of one of the parties***. The continuation of existing market conditions and of the financial situation of the parties are ordinarily not such assumptions, so that mere market shifts or financial inability do not usually effect discharge under the rule stated in this Section.*** In borderline cases this criterion is sufficiently flexible to take account of factors that bear on a just allocation of the risk. The fact that the event was foreseeable, or even foreseen, does not necessarily compel a conclusion that its non-occurrence was not a basic assumption.

Restatement (Second) of Contract § 261, Comment B. (emphasis added).

The Restatement requires non-occurrence of a "basic assumption." § 261 gives examples of three basic assumptions: (1) a key person remaining alive, (2) the existence of a "thing" that is necessary to perform the contract, or (3) the legality of the transaction. However, this list is not exhaustive. In the context of the coronavirus, "basic assumptions" may be the availability of a work force, the ability to use a certain venue, or the customary availability of supplies. The absence of any of these things may result in a justified plea of commercial impracticability, so long as that impracticability is not unique to the party (mere subjective impracticability) and the party has not expressly or implicitly assumed the risk of such untoward events under the contract.

It is important to note that the defense of impracticability does not apply to the unavailability of a specific source of supply even when both of the parties intended that source ***if*** it is not a basic assumption of both parties that there will be no contract if that source fails. *Tractebel,* 118 S.W.3d at 67. "One party's assumption about the source of supply – and the other party's knowledge of that assumption – is not enough to excuse performance if alternative sources of supply are still available to fulfill the contract." *Id.* at 68. "A party is expected to use reasonable efforts to surmount obstacles to performance… and a performance is impractical only if it is so in spite of such efforts." Restatement (Second) of Contracts § 261, Comment D.

The Restatement also offers several examples of when the doctrine does or does not apply:

> On June 1, A agrees to sell and B to buy goods to be delivered in October at a designated port. The port is subsequently closed by quarantine regulations during the entire month of October, no commercially reasonable substitute performance is available (see Uniform Commercial Code § 2-614 (1)), and A fails to deliver the goods. A's duty to deliver the goods is discharged and A is not liable to B for breach of contract.

In this example, the inability to perform is "objective." Nobody could have performed because the port was closed due to quarantine. Moreover, it assumes the risk of port closure was

not allocated in the contract. The doctrine of impossibility applied and the party was relieved of performance.

> A contracts to produce a movie for B. As B knows, A's only source of funds is a $100,000 deposit in C Bank. C Bank fails, and A does not produce the movie. A's duty to produce the movie is not discharged, and A is liable to B for breach of contract.

In this example, the inability to perform is "subjective." The lack of funds is specific to A. Financial woes are subjective, not objective. The doctrine therefore does not apply.

> A and B make a contract under which B is to work for A for two years at a salary of $50,000 a year. At the end of one year, A discontinues his business because governmental regulations have made it unprofitable and A fires B. A's duty to employee B is not discharged, and A is liable to B for breach of contract.

Unprofitability is not the same thing as impossibility or impracticability. The contract simply became a bad deal for A. A could still perform, but not at a profit. The doctrine therefore does not apply.

Given these examples, the boundaries of the doctrine are somewhat clear. Mere financial hardship caused by coronavirus closures will not relieve performance because, theoretically, such financial hardship is only subjective to the party.

Each contract must be carefully analyzed to determine whether the risk of the unforeseen event has been allocated to one of the parties. Remember, the purpose of the doctrine is to provide a fair resolution of unforeseen circumstances. If the parties allocated the risk of such unforeseen circumstances, the courts will honor the allocation.

As noted in Comment C to § 261:

> A party may, by appropriate language, agree to perform in spite of impracticability that would otherwise justify his non-performance under the rule stated in this

> Section. He can then be held liable for damages although he cannot perform. Even absent an express agreement, a court may decide, after considering all the circumstances, that a party impliedly assumed such a greater obligation.

As noted, the allocation does not need to be express. A court may find from all the circumstances that one party assumed the risk of the unforeseen event. The Restatement gives the following example:

> A, who has had many years of experience in the field of salvage, contracts to raise and float B's boat, which has run aground. The contract, prepared by A, contains no clause limiting A's duty in the case of unfavorable weather, unforeseen circumstances, or otherwise. The boat then slips into deep water and fills with mud, making it impracticable for A to raise it. If the court concludes, on the basis of such circumstances as A's experience and the absence of any limitation in the contract that A prepared, that A assumed an absolute duty, it will decide that A's duty to raise and float the boat is not discharged and that A is liable to B for breach of contract.

Extreme weather is a risk one would expect a marine salvage company to reasonably anticipate. The marine salvage company therefore should have included in its contract provisions for relief of its obligations in the event of bad weather. Barring such a provision, the salvage company has assumed the risk of bad weather and cannot escape its obligation when that risk comes to fruition.

As a corollary to § 261, § 264 provides that a governmental regulation or order that makes performance impracticable will presumptively relieve that party of its contractual obligations.

> § 264 Prevention by Governmental Regulation or Order
>
> If the performance of a duty is made impracticable by having to comply with a domestic or foreign governmental regulation or order, that regulation or order is an event the non-occurrence of which was a basic assumption on which the contract was made.

Unforeseen shutdowns mandated by the government of particular buildings, the operation of which are a "basic assumption" of the contract can therefore invoke scrutiny under § 261.

However, remember the caveats to that rule. First, mere financial hardship caused by the shutdown should not invoke § 261's protection because, theoretically, the obligor could perform if it had other funds and performing the contract is therefore not objectively impossible. Second, the shutdown of a specific source (of parts, funds, etc.) should not relieve the obligor if other commercially available sources are available. "Impossibility" is therefore not automatically available just because of mandated shutdowns – further analysis is required.

Particularly applicable to coronavirus cases, ***temporary*** impracticability does not completely relieve a party of performance. It only suspends performance during the period of impracticability.

> § 269 Temporary Impracticability or Frustration
>
> Impracticability of performance or frustration of purpose that is only temporary suspends the obligor's duty to perform while the impracticability or frustration exists, but does not discharge his duty or prevent it from arising unless his performance after the cessation of the impracticability or frustration would be materially more burdensome than had there been no impracticability or frustration.

This provision may be applied to situations where contract performance is delayed due to temporary shutdowns caused by the virus. Performance will be suspended only until such time as performance becomes commercially reasonable.

### C. Frustration of Purpose

Another defense that may be available to a party in the midst of the COVID-19 pandemic is frustration of purpose. Frustration of purpose arises when, after entering into a contract, a change in circumstances makes performance under the contract virtually worthless to the other. Under these circumstances, the party's principal purpose in entering into the contract is

substantially frustrated by a supervening event that both parties assumed would not occur, and the party's remaining duty to perform under the contract is discharged.

To establish this defense, the asserting party must first show that the frustrated purpose was a principal purpose for which the party entered into the contract. It is not sufficient for the asserting party to show that it had a certain purpose in mind when it entered into the contract. Both parties must understand that the purpose is the basis of the contract to such an extent that, without it, the transaction between the parties would make no sense.

Second, the asserting party must show that the nonoccurrence of the intervening event was a basic assumption of the contract. Generally, the fact that an event was foreseeable does not necessarily mean that its nonoccurrence was not a basic assumption. Rather, the foreseeability of the event is one factor in assessing this element of the defense. However, as will be shown herein, some courts give great weight to the foreseeability of an event in determining whether the asserting party should have provided for the event's occurrence in the contract.

Third, the frustration from the intervening event must be so substantial that it cannot fairly be regarded as being within the risks the party assumed under the contract. A minor inconvenience or decrease in profitability for the affected party is not sufficient. The frustration of purpose must essentially be absolute for the court to find that the frustration was substantial.

Finally—and perhaps most obviously—the frustrating event must not have been the fault of the party asserting the frustration defense.

Frustration of purpose is sometimes confused with the defense of impracticability, with which it is closely related. Impracticability occurs where the intervening events makes performance of the contract obligations infeasible (i.e. impracticable or impossible). On the other

hand, frustration of purpose occurs where the event makes performance no longer desirable (i.e. worthless) to the party asserting the defense.

To illustrate frustration of purpose, imagine a scenario where Party A and Party B make a contract whereby B pays A $1,000 to use A's window to view a parade from the window scheduled for a particular day. However, the parade is cancelled due to the illness of an important parade official. B therefore refuses to use the window or pay the $1,000 agreed to under the contract and asserts the frustration of purpose defense. B is not liable for breach of contract because its principal purpose for entering into the contract (i.e. watching the parade from the window) has been substantially frustrated.

It should be noted that courts frequently view a party's purpose in broad terms, meaning that a court may look to purposes other than the asserted primary purpose of the contract for determining whether the frustration of the purpose of the contract was absolute. For example, consider a situation where an individual enters into a contract to purchase a travel package to Miami to attend the Super Bowl. At the last moment, however, the venue for the Super Bowl is changed to Boston. The individual would seem to have a good case when he argues that his purpose for entering into the travel package contract has been frustrated. However, it is entirely possible (if not likely) that the Court would find that a travel package to Miami serves a larger purpose than just attending the Super Bowl, since Miami is a tourist destination and offers year-round attractions for travelers other than just the Super Bowl. The court likely would not find frustration of purpose if the individual argues that the package is now less valuable because it could still find that the individual retains some benefits from the contract. That being said, the court could potentially look to whether the seller of the ticket package knew at the time of the purchase that the purchaser's principal purpose was to attend the Super Bowl.

Courts asked to determine whether a tenant may terminate a lease due to an allegedly frustrating event typically look to whether the intervening event actually substantially frustrates the purpose of the lease, or whether it merely makes it less profitable for the tenant to continue operating under the lease. In *Gander Mountain Co. v. Islip U-Slip LLC,* 923 F.Supp. 351 (N.D.N.Y. 2013), a commercial retail tenant sued its landlord seeking a declaration that the lease was terminated due to a severe flooding event and the tenant's inability to secure all-risk insurance to conduct business operations on the leased premises. *Id.* at 359. The Court reasoned that the doctrine of frustration of purpose was a narrow one, which only applies where the frustration is "substantial." *Id.* (citation omitted). The Court further explained that New York law holds that frustration of purpose applies to discharge a party's duties only where an unforeseen event occurs, which "destroys the underlying reasons for performing the contract, even though performance is possible." *Id* (quoting *Sage Realty Corp. v. Jugobanka, D.D.*, 1997 WL 370786, at *1-2 (S.D.N.Y. 1997)). Indeed, the event must render the contract "valueless" to the party asserting the frustration defense. *Id.* (citing *U.S. Gen. Douglas MacArthur v. Senior Vill.*, 508 F.2d 377, 381 (2d Cir. 1974)). Performance is not excused where the frustrating event makes performance financially difficult or unprofitable, even to the point of insolvency or bankruptcy. *Id.* at 359-60 (citing *Bank of New York v. Tri Polyta Fin. B. V.*, 2003 WL 1960587, at *4 (S.D.N.Y. 2003). Further, if the party could reasonably have foreseen an event that would destroy the purpose of the contract and did not work to guard against it, then the party is deemed to have assumed the risk, and the commercial frustration defense does not apply. *Id.* at 360 (citing *Sage Realty*, 1998 WL 702272, at *3-*4.

The Court in *Gander Mountain Co.* found that the retail tenant was not entitled to termination of the lease based on frustration of purpose because the fact that it might be financially

difficult or unprofitable to operate the retail store did not excuse the tenant's obligation to perform. *Id.* at 359-62. Further, the facts suggested that flood and inability to obtain all-risk insurance were foreseeable, and therefore the frustration of purpose defense did not excuse the tenant's performance. *Id.*

In summary, the doctrine of frustration of purpose is narrowly construed by courts and will not apply in all situations where an intervening event has made performance under the contract difficult. Parties seeking to excuse performance due to the COVID-19 pandemic and related events will need to show more than the fact that the intervening event has made performance difficult and/or less profitable. They will need to show that the principal purpose of the original contract has been substantially frustrated to the point that the contract is essentially worthless to them, and that the frustrating event was so severe that it would not have been fair to regard the event as within the risks assumed under the contract. Some states, such as New York, may even look to the foreseeability of the frustrating event and whether the party should have anticipated it and provided for its occurrence in the contract.

## IV. INSURANCE COVERAGE FOR BUSINESS INTERRUPTION

### A. Was There "Direct Physical Loss or Damage to Property?"

The focal point of the majority of business interruption claims related to COVID-19 is the "physical damage" trigger found in most policies. A sample of the requirement in a typical policy is below:

> **A. Coverage**
>
> **1. Business Income**
>
> *****
>
> We will pay for the actual loss of Business Income you sustain due to the necessary

"suspension" of your "operations" during the "period of restoration." The "suspension" ***must be caused by direct physical loss of or damage to property at premises which are described in the Declarations and for which a Business Income Limit of Insurance is shown in the Declarations***. The loss or damage must be caused by or result from a Covered Cause of Loss. With respect to loss of or damage to personal property in the open or personal property in a vehicle, the described premises include the area within 100 feet of the site at which the described premises are located.

**2. Extra Expenses**

*****

b. Extra Expense means necessary expenses you incur during the "period of restoration" that you would not have incurred if there had been ***no direct physical loss or damage to property*** caused by or resulting from a Covered Cause of Loss.

Owners whose businesses are shuttered as a result of governmental orders will certainly turn towards insurance to provide some solace. The problem is that business interruption coverage is typically only a component of property damage insurance. Policies are composed primarily of standardized forms promulgated by the Insurance Service Office (ISO), and such forms routinely require that the lost income be as a result of "direct physical loss of or damage to property."[2] However, some policies deviate from standard language, and therefore only a policy review by a professional can confirm whether the policy affords such coverage.

[2] All references to standardized forms herein are specific to ISO form CP 00 30 04 02.

In most cases of business interruption caused by COVID-19, there will be no physical damage to property that initiated the interruption. Under most circumstances, this will not trigger the business interruption coverage. Courts have routinely enforced the requirement that the lost income must be caused by some adverse event that causes physical compromise to the property. A leading case is *Nat'l Children's Expositions Corp. v. Anchor Ins. Co.*, 279 F.2d 428 (2nd Cir. 1960). In that case, the insured had a policy covering the use of Grand Central Palace for an exposition during the Christmas season. The policy covered the "use and occupancy value" of the premises and insured against events that might prevent holding the exposition. There was an unforeseen snowstorm, which substantially reduced the attendance at the exposition. The Court found that because there was no physical damage to Grand Central Palace, and there was nothing concerning the physical condition of the premises that prevented the exposition from being open at all times, there was no business interruption coverage under the policy. The Court stated:

> Had the snowstorm here rendered any portion of the building unusable and prevented the holding or continuance thereof part of the exposition, the policy would cover any partial loss resulting therefrom. But here, no part of the building was made unusable by the snowstorm. The loss did not result from inability to hold the exposition in any part of the insured premises, but solely from a reduction in attendance…We hold that there was no partial loss within the terms of the policy because no part of the insured premises was rendered unusable and appellant was not prevented from holding or continuing the exposition in any part of the premises.

279 F.2d at 430. While the Court refused to hold that ***actual physical damage*** was required, the Court did hold that there must be some physical condition of the property that prevented its use before the business interruption coverage would be triggered.

Given the requirement in the standard ISO form, it is unlikely that an insured will be able to recover business interruption coverage or loss of business caused by (1) shutdowns initiated by

employers for the health of employees or (2) shutdowns ordered by civil authorities to create "social distancing."

### B. Coverage for "Loss of Access"

Historically, policies did not cover business interruption caused by "loss of access," as opposed to damage to the insured property by a covered peril. Policies now often provide coverage for "loss of ingress or egress." Some coverage forms require that denial of access be caused by damage to property, other than the insured property, which creates a physical impediment that prevents ingress and egress to the insured location. For example, a fire at an office building that causes streets to be blocked for a period of time, resulting in other businesses being closed may trigger lost income coverage for those other businesses.

Some policies may not include a specific property damage requirement for this coverage and courts will not read that requirement into the policy. The primary case on point is *Fountain Power Boat Industries v. Reliance Ins. Co.*, 19 F.Supp.2d 552 (E.D.NC. 2000). In *Fountain Power Boat*, the insured had a manufacturing and headquarters location that had only one road as its sole means of access. In 1999, Hurricane Floyd struck North Carolina dumping heavy, record-setting rains. The only road leading to the Fountain facility was flooded for days.

The policy had the following provision regarding loss of ingress and egress:

> 6. Loss of Ingress or Egress: This policy covers loss sustained during the period of time when, as a direct result of a peril not excluded, ingress to or egress from real and personal property not excluded hereunder, is thereby prevented.

The "Perils Excluded" section of the policy did not exclude hurricanes or natural disasters.

Reliance argued that physical damage was required in order to invoke this coverage. The Court refused to read such a requirement into the policy. So long as the lack of access was caused

by a covered cause of loss, the insured could recover for lost income, even in the absence of physical damage to the insured premises. *See also Houston Cas. Co. v. Lexington Ins. Co.,* 2006 WL 7348102 (E.D. La. June 15, 2005) (holding that it was reasonable to conclude that civil authorities and ingress/egress provision did not require physical damage).

The problem with the *Fountain Power Boat* decision is that it is based on specific policy language. Today, the vast majority of policies that include ingress or egress coverage will require actual physical damage to property ***other than*** the insured's property in order to trigger such coverage. Each policy must be carefully reviewed regarding the "trigger" for potential loss of ingress and egress coverage.

### C. Coverage for Actions of Civil Authorities

The civil authorities coverage contained in the standard ISO Commercial Property Coverage form also includes a property damage requirement:

> **5. Additional Coverages.**
>
> **a. Civil Authority**
>
> We will pay for the actual loss of Business Income you sustain and necessary Extra Expense 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.

Even if civil authorities act to close businesses as a result of COVID-19, unless that is also coupled with some physical damage to property (which is obviously unlikely), that will not be sufficient to trigger the business interruption coverage.

The civil authorities coverage was closely examined as a result of a proliferation of claims made after 9/11 and a rash of hurricanes in 2004. *See "Understanding Civil Authority and*

*Ingress/Egress Insurance Coverage, be (pre-pared),"* Issue 3, Sept. 2009. Numerous airlines brought suit against insurers, arguing the ground stop by the FAA after 9/11 was the result of damage to the World Trade Center Towers and the Pentagon. Courts instead held that the civil authorities provision was not triggered because the ground stops that prevented the airlines from flying were not the result of property damage. Rather, the ground stop was designed to prevent future terroristic attacks. *United Air Lines, Inc. v. Ins. Co. of the State of Pennsylvania*, 439 F. 3d 128 (2nd Cir. 2006); *City of Chicago v. Factory Mut. Ins. Co.*, 2004 WL 549447 (N.D. Ill., March 18, 2004); *U.S. Airways v. Commonwealth Ins. Co*., 2004 WL 1637139 (Va. Cir. Ct. 2007).

Similarly, hotels tried to claim lost rental income under their business interruption policies, claiming that the ground stop prevented access by guests. Likewise, these courts held that the loss of use of the property was not the result of property damage but rather was caused by efforts to stop terrorism. *730 Bienville Ptnrs. Ltd. v. Assur. Co. of America*, 2002 WL 31996014 (E.D. La., Sept. 30, 2002); *Southern Hospitality v. Zurich Am. Ins. Co.*, 393 F.3d 1137 (10th Cir. 2004).[3]

One of the leading cases after September 11, 2001 was *United Air Lines, Inc. v. Ins. Co. of State of Pa.*, 439 F.3d 128 (2d Cir. 2006). There, United sought to recover business losses resulting from the FAA's closure of Reagan National Airport. While United's ticket office in the World Trade Center was destroyed, its facilities at the airport suffered no significant physical damage as a result of the attack on the nearby Pentagon. The "civil authority" provision on which United relied to recover its business loss damages provided as follows:

C. BUSINESS INTERRUPTION

[3] As a result of these attempts at coverage for damage to property far removed from the insured property, many policies now limit coverage to situations involving damage to adjacent property or property within a specified distance away from the insured location.

1. GROSS EARNINGS

> This policy insures against loss resulting directly from the necessary interruption of business caused by damage to or destruction of the Insured Locations resulting from Terrorism, Sabotage, Mutiny, Insurrection, Rebellion, or Coup d'Etat.
>
> This section is specifically extended to cover a situation when access to the Insured Locations is prohibited by order of civil authority as a direct result of damage to adjacent premises, not exceeding, however, two (2) consecutive weeks.

*Id*. at 131. The Second Circuit Court of Appeals focused on the requirement of physical damage in holding that coverage was not triggered under the Policy. Specifically, the Court held that the airport was not shutdown "as a direct result of damage" to the Pentagon but that the shutdown was "caused by fears of future attacks." Therefore, no coverage was triggered because the civil authority order was not a "direct result" of property damage. In other words, there was no causal link between "prior [property] damage" and the action by the civil authority.

Courts around the country have also analyzed this issue in relation to evacuation orders in advance of hurricanes making landfall and other instances. For example, a mandatory evacuation of New Orleans was ordered before Hurricane Gustav made landfall, resulting in the closure of an insured's restaurants. *See Dickie Brennan & Co., Inc. v. Lexington Ins. Co.*, 636 F.3d 683 (5th Cir. 2011) (La. Law). The plaintiff argued that the "property damage" requirement was satisfied based on the damage in the Caribbean, but the Court rejected this contention, noting that the evacuation order did not reference earlier property damage as a reason for the order. The Court concluded that coverage was not triggered in the absence of physical injury to property.

More recently, in another hurricane evacuation case, a South Carolina Federal District Court rejected the plaintiff's argument that the terms "because of" following "order of civil authority" in the policy provision was ambiguous. *See Kelaher, Connell & Conner, PC v. Auto-*

*Owners Ins. Co.*, No. 4:19-cv-00693-SAL, 2020 WL 886120 (D.S.C. Feb. 24, 2020). The Court explained, "[n]aturally, if a civil authority order preventing access to the property for some reason other than 'because of' damage or destruction of an adjacent property is insufficient." *Id*. The Court concluded that the policy unambiguously required a link between the issuance of a civil authority order and the property damage in order to trigger coverage for business interruption losses. *Id*. at *6. Other cases have also required such a causal nexus before coverage is triggered. For instance, a California Federal District Court found that the requisite causal link was not present in a coverage suit brought by a business after a curfew was imposed to quell street violence and looting after the Rodney King verdict. *See Syufy Enter. v. Home Ins. Co. of Ind.*, No. 94-0756-FMS, 1995 WL 129229 (N.D. Ca. Mar. 21, 1995). In so ruling, the Court held that the term "adjacent" for purposes of property damage was not ambiguous; that the order did not "specifically" deny access to the insured's building; and that the causal link between damage to adjacent property and denial of access to the insured's business was absent. *Id*.

*United Airlines* was cited with the approval in *S. Tex. Med. Clinics, PA v. CNA Fin. Corp.*, 2008 WL 450012, at *8-9 (S.D. Tex. Feb. 15, 2008). There, a civil authority order required evacuation of Wharton County because Hurricane Rita was projected to land in the area. The insured owned and operated several medical clinics that closed pursuant to the order. However, the storm took a different path, and Wharton County suffered no storm damage. The insured sought coverage for its business interruption losses, but the insurer denied coverage, and the Court agreed:

> When, as here, the only relevance of prior damage to other property in deciding whether to issue a civil authority order that would preclude access to the insured's property is to provide a basis for fearing future damage to the area where the insured property is located, the causal link between the prior damage and the civil authority order is missing. Requiring such a causal link between the prior damage and the action by a civil authority does not rewrite the parties' policy, but rather gives effect to the language it contains.

*Id*. at *10 (internal citations omitted).

Cases since *S. Tex. Med. Clinics* have followed suit, albeit somewhat reluctantly. For instance, the Federal Eastern District of Texas described the Court's interpretation as "unrealistic and harsh" in the abstract but nonetheless agreed with its ultimate finding. In *Not Home Alone, Inc. v. Philadelphia Indem. Ins. Co.*, the Court held that the policy "clearly states" the requirement of physical damage to property. It also explained that the civil authority provision "contemplates a sequence of events where direct physical loss or damage to property occurs and then an order prohibiting access *because of that damage* issues." 2011 WL 13214381, at *6 (E. D. Tex. Mar. 30, 2011) (emphasis in original). Thus, when Texas courts construe the civil authority and business interruption provisions of standard property insurance policies, they require "physical injury" to property in order to trigger coverage.

**D. Can COVID-19 Cause Direct Physical Loss or Damage to Property?**

Insureds have and will continue to argue that COVID-19 is different than the 9/11 cases and the hurricane cases because COVID-19 can invade premises and make them unsafe. The argument has some facial appeal, because due to the ethereal nature of a virus, it is more difficult to say that it has not invaded and become part of the building. It was easy for insurers to say that the damage in 9/11 was far away in New York and Washington and therefore did not impede access to the insured premises many miles away. The same with hurricanes. The spacial distance between the event and the insured property makes those arguments easy for the insurer. COVID-19 is different. COVID-19 ***can*** be deposited on the surface of buildings and that may directly cause some loss of use. But insureds have two huge problems in making the argument that mandated closures were caused by COVID-19.

Courts consistently agree that "physical loss" requires some physical invasion. For example, in the *Phoenix Ins. Co. v. Infogroup, Inc.,* 147 F. Supp. 3d 815 (S.D. Iowa, 2015), the Court recognized "physical loss" means a loss that is "material or perceptible at some level" and thus required "some sort of physical invasion, however minor." 147 F. Supp. 3d at 824. The Court therefore rejected an insured's claim that ***threatened*** flooding from the Mississippi River was "physical loss." Likewise in *Newman Myers Kreines Gross Harris, PC v. Great Northern Ins. Co.*, 17 F.Supp.3d 323 (S.D.N.Y 2014), a utility provider preemptively shut off power to certain service networks, which left the plaintiff without power for several days. In ruling on the coverage issue, the Court held that "direct physical loss or damage" is unambiguous and that it requires "some form of actual, physical damage to the insured premises to trigger loss of business income and extra expenses coverage." *Id*. at 331.

Courts have, however, wrestled with the concept of whether ***actual structural damage*** is required or whether ***some physical compromise*** that results in loss of use of the building is sufficient.

Two cases serve as examples to frame this issue. The first is *Universal Image Prod., Inc. v. Chubb Corp.*, 703 F. Supp. 2d 705 (E.D. Mich. 2010) *aff'd* 475 Fed. Appx. 569 (6th Cir. 2012), where the insured argued that a pervasive odor, mold and bacterial contamination caused direct physical loss. The Court held that "direct" signaled intermediate or proximate cause and "physical" is defined by Merriam-Webster's Dictionary as having a "material existence; perceptible especially through the senses and subject to the laws of nature." The Court held that odors, mold and bacterial contamination were not "direct, physical loss" because there was no "***structural or tangible damage*** to the insured's property." 703 F. Supp 2d at 710. (emphasis added). Following the

reasoning of *Universal*, even if the insured can demonstrate that a shutdown was caused by exposure to a COVID-19 positive individual, that will not be direct physical loss because no ***structural or tangible injury*** has occurred to the property.

In stark contrast to *Universal* is *Mellin v. Northern Sec. Ins. Co., Inc.,* 115 A.3d 799 (N.H. 2015). In *Mellin,* the insured argued that cat urine emanating from a neighboring condominium unit caused "physical loss" of property. The Court held that the cat urine smell caused physical loss to the premises. In doing so, the Court relied upon a line of cases where courts held that exposure to adverse conditions that render the premises unusable was sufficient to be "physical damage" *See Gregory Packaging, Inc. v. Travelers Prop. Cas. Co. of America,* Civ. No. 2:12-cv-04418 (WHW), 2014 WL 6675934 at *2, *3, *8 (D.N.J. Nov. 25, 2014) (ammonia smell); *Western Fire Ins. Co. v. First Presbyterian Church,* 165 Colo. 34, 437 P.2d 52, 54, 55 (1968) (gasoline vapors); *TRAV. CO. Ins. Co. v. Ward* 715 F. Supp. 2d 699, 709-10 (E.D. Va. 2010) (gases from drywall) *aff'd* 504 Fed. Appx. 251 (4th Cir. 2013); *Farmers Ins. Co. v. Trutanich,* 123 Or. App. 6, 858 P.2d 1332, 1335 (1993) (meth lab odor). The *Mellin* Court concluded "these cases stand for the proposition that an insured may suffer 'physical loss' from a contaminant or condition that causes changes to the property that cannot be seen or touched." 115 A.3d at 804. But even the *Mellin* Court agreed that "physical loss" should not be interpreted overly broadly to encompass every situation where the property cannot be used.

Texas would appear to follow the rule in *Universal. U.S. Metals, Inc. v. Liberty Mutual Group, Inc.*, 490 S.W.3d 20 (Tex. 2015). There, the Court specifically addressed whether "[a] thing whose use or function is diminished by the incorporation of a faulty component can fairly be said to be injured, even if the injury is intangible, latent, or inchoate." *Id.* at 24. In doing so, it agreed

"with most courts to have considered the matter that the best reading of the standard-form CGL policy text is that **physical injury requires tangible, manifest harm** and does not result merely upon the installation of a defective component in a product or system." *Id*. at 27 (emphasis added). The Court relied, in part, upon an Illinois opinion, which explained:

> [W]ithout a harmful change in appearance, shape, composition, or some other physical dimension to the claimants' property, the insurance coverage is not triggered.

*Id*. (quoting *Travelers Ins. Co. v. Eljer Mfg'ing, Inc.*, 757 N.E.2d 481, 497 (Ill. 2001)).

The problem with applying *U.S. Metals* to COVID-19 contamination is that the Court was not dealing with something as ethereal as a virus. While the specific language the Court employed would seem to require some change in the tangible form of the property (which would not be the case with COVID-19 contamination) the Court did so only to distinguish "physical injury" from the "incorporation theory" of injury followed by some courts. The general ***theory*** employed by the Court, that some change in form is required, could be argued to encompass a change in "condition," even though that is not specifically mentioned in the *U.S. Metals* opinion. A change in condition might encompass contamination by COVID-19. The Courts will likely have to decide this issue.

In states following the *Universal* and *US Metals* line of cases, contamination of a building by a COVID-19 infected person would probably not result in physical loss. If the state follows *Mullin*, shutdowns directly linked to COVID-19 exposure from an infected person would be physical loss.

But even if it is physical loss, what is the claim? The bottom line is that most business shutdowns were not caused by potential contamination by a given person who had COVID-19. The true reason for shutdowns is "social distancing." Social distancing has nothing to do with

whether the building has a ***physical loss***. And even if a shutdown was caused by exposure to a given person, the period of restoration would only be the time it takes to disinfect the premises or, at the most, the time it takes for the virus to die. That is the only direct ***physical*** loss.

**E. Exclusions**

In the rare instance where COVID-19 does cause physical loss which would otherwise be covered, the physical loss must nonetheless be caused by a covered cause of loss. Insurers may rely on two exclusions: the virus exclusion and the pollution exclusion.

The virus exclusion in the standard ISO Form provides:

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

EXCLUSION OF LOSS DUE TO VIRUS OR BACTERIA.

*****

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.

If the policy contains such an exclusion, that is pretty much the end of the story, no coverage.

Insurers may also rely on the pollution exclusion in *Meyer Nat. Foods, LLC v. Liberty Mut. Fire Ins. Co.*, 218 F.Supp.3d 1034 (D. Neb. 2016) that involved a meat company that provided beef contaminated with E. coli to the insured. As a result of the contamination, the insured disposed of the beef, incurring damages of about $1.4 million. The plaintiff sought a declaration from the Court that it was entitled to coverage, but the Court ruled against it on the grounds of the "contamination" exclusion contained within the policy. That exclusion provided as follows:

> We will not pay for loss or damage caused by or resulting from any of the following:
>
> * * * *
>
> (7) Loss attributable to:

> * * * *
>
> h. Contamination, shrinkage, change in test, texture, finish or color.

Because the Court found that this exclusion barred coverage, it did not reach the alternative argument that the pollution exclusion negated coverage.

The pollution exclusion in the subject policy provided:

> We will not pay for loss or damage caused by or resulting from any of the following, regardless of any other cause or event, including a peril insured against, that contribute to the loss at the same time or in any other sequence:
>
> * * * *
>
> 4. Fungus, bacteria, wet or dry rot, decay.
>
> * * * *
>
> 5. Pollution.
>
> * * * *
>
> 10. The actual or suspected presence or threat of any virus, organism or like substance that is capable of inducing disease, illness, physical distress or death, whether infectious or otherwise, including but not limited to any epidemic, pandemic, influenza, plague, SARS, or Avian Flu.

Even though the Court did not reach this exclusion, it is important to note that it includes references to "epidemic, pandemic, influenza, plague, SARS, or Avian Flu." In light of current circumstances, and in the event of a claim against a commercial general liability policy, application of the above exclusion may work to bar coverage for losses as a result of COVID-19.