# NU Claims

COVERING THE BUSINESS OF LOSS



An ALM Publication
PropertyCasualty360.com
July/August 2020 // Volume 68 // Number 4


# PREPPING FOR A SURGE OF COVID-19 **BAD-FAITH ISSUES**

By Lynn Allen

**IN MARCH 2020, THE UNITED STATES** came to a screeching halt. Schools closed, businesses shut down and the national economy saw its largest decline in more than a decade.

The wave of insurance coverage litigation over COVID-19 losses was inevitable. And as policyholders seek to recoup business-related losses, business interruption claims are becoming the new normal. With insurance companies denying such claims for lack of physical damage or loss to property, bad faith lawsuits are soaring and businesses are suing their insurance companies in increasing numbers.

As the pandemic progresses and closures linger, businesses are getting more aggressive in their attempts to minimize financial loss by filing class action and multi-district suits against their insurers. Attorneys are finding creative ways to extend current case law and develop new arguments for coverage. A few examples include:

- In a federal suit filed in Chicago, Big Onion Tavern Group — a group of Chicago-based restaurants and movie theaters — sued their insurer seeking coverage for lost revenue due to forced closures following Illinois Governor J.B. Pritzker's COVID-19 shutdown order. The plaintiffs also sought damages for statutory bad faith.
- Seven shuttered San Antonio, Texas, barbershops filed claims with their insurer, State Farm, asking them to cover loss of business income. The claims were denied, so the shops responded by suing State Farm for breach of contract for wrongfully denying coverage and other claims.
- Mudpie Inc. — a San Francisco-based children's clothing boutique — filed a class-action lawsuit on behalf of California-based retail stores against Travelers, alleging the small businesses were wrongfully denied coverage for losses resulting from government-mandated public health shutdowns related to COVID-19 — despite having paid premiums for business interruption policies.

These lawsuits are just the beginning. In light of this unprecedented pandemic, insurers can expect a historic increase in business interruption and civil authority claims. As a result, insurance companies need to anticipate and prepare for such claims.

> **Attorneys are finding creative ways to extend current case law and develop new arguments for coverage.**

Despite mounting business interruption claims, evolving regulations and a surge in lawsuits, there are some proactive steps insurers can take to investigate and resolve claims fairly and minimize a spike in bad faith litigation.

## TACKLING EMERGING BAD FAITH ISSUES

Bad faith litigation hinges on an insurance company's inherent duty of good faith and fair dealing when investigating and responding to claims. While bad-faith laws vary from state to state, generally, insurers are required to conduct prompt and thorough investigations and provide a reasonable basis for their coverage decisions. It is always in the best interest of insurance companies to avoid bad faith claims, which expose them to consequential damages, general damages for emotional distress and inconvenience, attorneys' fees and punitive damages in egregious cases. With this in mind, insurers should not renege on obligations to policyholders — and be prepared to take proactive steps to handle claims fairly and consistent with state law.

In the wake of the COVID-19 pandemic, insurers – at a minimum – must have a reasonable, good faith basis for disputing coverage because the presence of the coronavirus at the insured's premises does not amount to "direct physical damage" of property. Assuming an adequate and reasonable investigation has been conducted, property insurers that deny coverage on this basis are unlikely to face bad faith liability — even if a court later disagrees with their coverage position.

Insurance carriers can curtail the risk of bad faith litigation by considering the following when evaluating claims:

***Accept responsibility.*** Taking responsibility makes the insurer appear reasonable. The degree and manner of responsibility accepted depend on each case, but the strategy must be applied in some variation. In practice, claims professionals and their defense counsel often find it difficult to embrace the strategy of accepting responsibility while also vigorously defending a case. In many cases, the defense has strong evidence it complied with the standard of care. Counsel must fight the kneejerk, typical defense reaction to deny having any responsibility! The defense must accept responsibility for *something* in every single case. Taking responsibility can be as simple as conducting a reasonable investigation before denying coverage, consistent with the duty of good faith and fair dealing.

***Facts matter.*** Address and discuss the most difficult aspect of the case. Insurers and their defense counsel are human, too. When addressing the dire impact of COVID-19, it is more than okay to acknowledge the emotional burden the defense and their client carry as a result, regardless of liability. Doing so further instills the defense cares and has compassion, helping defuse anger. It is wise to handle claims with empathy, keeping the human impact of business closures in mind.

***A reasonable investigation.*** Insurers typically offer coverage for physical damages, not the damages caused by global pandemics. As a result, in many COVID-19-related lawsuits, insureds allege their insurers denied claims based on an assumption of lack of physical damage or loss to the property. With this in mind, it is critical to carefully consider the language in the insuring agreement and determine whether any exclusions apply. The insurer should examine evidence suggesting any physical contamination of the insured property and determine if it would constitute physical damage or loss under the laws of the jurisdiction. The language of the specific emergency orders should also be consulted and addressed. The science surrounding COVID-19 is constantly evolving, so it may be necessary to consult with experts and review the specific civil authority orders under which the business closed — as some reference physical damage as a basis for business closures.

***Know the jurisdiction.*** The interpretation of "direct physical damage" varies, depending on the state. Amidst the COVID-19 pandemic, plaintiffs have sought to draw analogies to cases in which courts have found coverage involving bacterial contamination of well water, odor from a methamphetamine lab in a house, asbestos fibers in a factory and toxic gases emitted by defective

drywall. Some jurisdictions have adopted the reasonable expectations doctrine and may find coverage where the insurer or its agent has led the insured to believe there would be coverage or where the policy language may lead a reasonable insured to believe the claim would be covered.

***Disclose all applicable coverages.*** To help circumvent bad faith liability in the event of litigation, it is important to disclose and evaluate all potential coverages that may apply, even if the facts or law ultimately do not support coverage.

***Communicate the complete basis for the reservation of rights or denial.*** It is a common claims practice to utilize a reservation of rights. To avoid the potential for a waiver, the insurer should communicate all known reasons for the reservation of rights or disclaimer of coverage. This should include the facts supporting the application of a coverage exclusion to the loss. The insurer should also follow up with supplemental reservations of rights or disclaimers of coverage when additional grounds supporting disclaimers of coverage emerge.

***Defend liability claims under a reservation of rights if appropriate.*** There is minimal case law interpreting exclusions for communicable diseases and other similar exclusions. In determining whether to deny coverage, careful consideration should be given to how the particular jurisdiction construes the duty to defend. Also critical: the rules of policy interpretation, and the ability of the plaintiff and the insured to enter into a stipulated judgment and assignment agreement if the insurer does not provide a defense.

***Accurate and complete claim file documentation.*** Many jurisdictions require the production of the insurer's claim file in bad faith litigation. Accurate and comprehensive claim file documentation — including all evaluations, correspondence, and a list of payments made on the claim, receipts and invoices and more — will help explain the company's investigation and decision-making process in defending against a bad faith claim.

The impact of the COVID-19 pandemic on the insurance industry could be severe, especially if the recent onslaught of lawsuits is an indication of things to come. Insurers can prevent costly bad faith litigation by conducting reasonable investigations of coverage and the facts, anticipating the arguments policyholders may make in support of coverage, and being prepared to address those arguments – reasonably and compassionately – if coverage is denied.

---

Lynn Allen (lallen@tysonmendes.com) is a partner at insurance defense firm Tyson & Mendes LLP, representing clients in a wide variety of complex cases, including insurance coverage disputes and insurance bad faith. She is based in the firm's Phoenix, Arizona office.