



## 2021 CLM Construction Conference

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### **Is It Safe to Get Back in the Water: COVID-19 Compliance and Claims for General Contractors in California and National Residential/Commercial Construction Projects?**

#### **A. Courts Examining Business Interruption Claims in California Arising Out of COVID-19 Have Not Found Coverage**

Many insureds with first party insurance policies with standard business interruption coverage submitted claims for business interruption arising out of government shutdown orders. In California, the State and various local municipalities began issuing shutdown orders in late March of 2020 due to the COVID-19 pandemic. Federal Courts located within California and many other states have generally not been receptive to such claims.

California courts have held that the inability to use property does not amount to "direct physical loss of or damage to property" within the ordinary and popular meaning of that phrase. Physical loss or damage occurs only when property undergoes a "distinct, demonstrable, physical alteration." MRI Healthcare Ctr. of Glendale, Inc. v. State Farm Gen. Ins. Co., 187 Cal. App. 4th 766, 779 (2010). Furthermore, "Detrimental economic impact" does not suffice for physical loss or damage. Id. (citation and quotation marks omitted); *see also* Doyle v. Fireman's Fund Ins. Co., 21 Cal. App. 5th 33, 39 (2018) ("[D]iminution in value is not a covered peril, it is a measure of loss" in property insurance). In MRI Healthcare Ctr., the court held that lost use of an MRI machine after it was powered off did not qualify as a "direct physical loss." MRI Healthcare Ctr., 187 Cal. App. 4th at 779.

Citing the MRI Healthcare Ctr. decision, the U.S. District Court for the Central District Court of California reached the same determination with respect to a claim for business interruption insurance due to government shutdown orders arising out of the COVID-19 pandemic. *See*, 10E, LLC v. Travelers Indem. Co., 483 F.Supp.3d 828 (C.D. Cal., 2020). In 10E, LLC, the insured alleged that "beginning on March 15, 2020, public health restrictions adopted by Mayor Garcetti prohibited in-person dining at Plaintiff's restaurant, limiting Plaintiff to offering takeout and delivery," and these restrictions

caused a "complete and total shutdown" of its business. The insured further alleged that it was entitled to recover under Travelers Indem. Co.'s policy because public health restrictions prohibited access to its restaurant. The restrictions caused "physical damage" by "labeling of the insured property as non-essential" and "prevent[ing] the ordinary intended use of the property." 10E, LLC, 483 F.Supp.3d at 836.

Travelers Indem. Co. filed a Motion to Dismiss the insured's First Amended Complaint on the grounds that the property insurance policy at issue here requires "direct physical loss of or damage to property" for recovery under the civil authority provision. 10E, LLC, 483 F.Supp.3d at 837. The District Court agreed with Travelers and granted the Motion to Dismiss.

A virtually identical determination was reached less than two weeks later by the U.S. District Court for the Southern District of California in Pappy's Barber Shops, Inc. v. Farmers Grp., Inc., 2020 U.S. Dist. LEXIS 166808 (S.D. Calif., September 11, 2020). In Pappy's Barber Shops, Inc., the plaintiffs made a claim under a first party business policy for business income losses they incurred as a result of the COVID-19 Civil Authority Orders issued by Mayor Falconer and Governor Newsom. Pappy's Barber Shops, Inc., 2020 U.S. Dist. LEXIS 166808 at \*3. Notably, the insuring agreements respectively restricted coverage to "caused by direct physical loss of or damage to property at the described premises," and "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."

Relying upon the MRI Healthcare Ctr. and 10E, LLC decisions, the District Court in Pappy's Barber Shops, Inc. granted the insurer's motion to dismiss, holding that "the civil authority coverage provision only provides coverage to the extent that access to Plaintiff's physical premises is prohibited, and not if Plaintiff's are simply prohibited from operating their business. The government orders alleged in the complaint prohibit the operation of Plaintiff's business; they do not prohibit access to Plaintiffs' place of business. Pappy's Barber Shops, Inc., 2020 U.S. Dist. LEXIS 166808 at \*14-15. The District Court further held as follows:

Even if the government orders alleged in the complaint could be construed as prohibiting Plaintiffs from accessing their premises, the orders were not issued due to direct physical loss of or damage to property other than at Plaintiffs' premises. Just as the complaint does not plausibly allege any direct physical loss of Plaintiff's property, it also does not allege any direct physical loss or damage to property not at Plaintiffs' places of business. Pappy's Barber Shops, Inc., 2020 U.S. Dist. LEXIS 166808 at \*15.

Other Federal District Courts in California have reached decisions like 10E, LLC and Pappy's Barber Shops, Inc. in COVID-19 business interruption claims. See, Mark's Engine Company No. 28 Restaurant, LLC v. Travelers Insurance Company of Connecticut, 492 F.Supp.3d 1051 (C.D. Cal. 2020); Selane Properties, Inc. v. Continental Casualty Co., 2020 WL 7253378 (C.D. Cal. 2020).

Some courts have applied a more expansive interpretation of the policy language “direct physical loss of or physical damage to property” in standard business interruption coverage. Nevertheless, said courts have still not found coverage. On September 14, 2020, the U.S. District Court for the Northern District of California issued a similar decision in Mudpie, Inc. v. Travelers Cas. Ins. Co. of Am., 487 F.Supp.3d 834 (N.D. Cal. 2020). The Court in Mudpie, Inc. was asked to interpret the same type of policy language for a COVID-19 that was at issue in 10E, LLC and Pappy’s Barber Shops, Inc. However, the Northern District decided not to apply the holding in MRI Healthcare Ctr. with respect to the interpretation the language “direct physical loss or damage to property,” and chose to apply a narrow interpretation of said language under Total Intermodal Servs. Inc. v. Travelers Prop. Cas. Co. of Am., No. CV 17-04908 AB (KSx), 2018 WL 3829767, at \*3-4 (C.D. Cal. July 11, 2018). In particular, the Mudpie, Inc. Court held that where a policy additionally requires “direct physical loss of or physical damage to property,” there must either be a physical change in the condition or a permanent dispossession of the property. Mudpie, Inc., 487 F.Supp.3d 834 at 839 (“finding that a more expansive interpretation of ‘direct physical loss of property’ to include dispossession of property would require a ‘permanent dispossession.’”).

The Mudpie, Inc. Court also noted that “under the Civil Authority provision, Mudpie must establish the “requisite causal link between damage to adjacent property and denial of access” to its store.” Mudpie, Inc., 487 F.Supp.3d at 843. In granting the insurer’s motion to dismiss, the Mudpie, Inc. Court held that “Mudpie’s allegations establish that the government closure orders were intended to prevent the spread of COVID-19. [Citation] (California’s Safer at Home Order was issued “to control the spread of COVID-19.”). Because the orders were preventative — and absent allegations of damage to adjacent property — the complaint does not establish the requisite causal link between prior property damage and the government’s closure order.” Mudpie, Inc., 487 F.Supp.3d at 844.

While most business interruption cases have been decided at the pleading stage through a FRCP Rule 12(b)(6) Motion to Dismiss, a Federal District Court in California recently granted a Motion for Summary Judgement under FRCP Rule 56. See, BA LAX, LLC v. Hartford Fire Insurance Company, 2021 WL 144248 (C.D. Cal. 2021). In granting the insurer’s summary judgment motion, the court held as follows:

Plaintiffs did not dispute Defendants’ characterization of their position as follows: “[t]he Complaint attributes their decrease in income to ‘Stay at Home Orders, the damage caused by COVID-19, and the transmission of COVID-19.’ SGI ¶ 2.

Here, there is no evidence – much less an allegation – of distinct, demonstrable, physical alteration, or permanent dispossession of property, at Plaintiffs’ premises, at contiguous locations, or in the immediate area. Therefore, Plaintiffs cannot establish the Business

Income, Extra Expense, Civil Authority, Ingress or Egress, or Ordinance or Law coverages. BA LAX, LLC, 2021 WL 144248 at \*3-4.

Some courts have denied business interruption claims based upon virus exclusions. See, Franklin EWC, Inc. v. Hartford Fin. Servs. Grp., 2020 U.S. Dist. LEXIS 174010 (N.D. Calif., Sept. 22, 2020). The District Court in Franklin EWC, Inc. found that there was no coverage for business interruption losses arising out of the COVID-19 pandemic shutdown orders due to a virus exclusion contained in the policy at issue and did not decide the issue of whether COVID-19 related shutdown orders were caused by “direct physical loss of or damage to property” See also, BA LAX, LLC v. Hartford Fire Insurance Company, 2021 WL 144248 (C.D. Cal. 2021).

In summary, courts in California have been unwilling, to date, to find that COVID-19 business interruption claims are covered under first party insurance policies.

## **B. TOP FIVE CONTRACT CONSIDERATIONS FOR COVID IMPACTS ON CONSTRUCTION CONTRACTS**

1. **Scope of Work Impacts Are Key Priority in Understanding Obligations**
  - A. Critical issues to include in the Scope; exclusions and how to document
    - a. Types of Construction Contracts – Make sure your contract contains the key terms of the type of contract you want.
      1. Lump sum contracts
      2. Time and materials contracts
      3. Cost-Plus contracts
      4. Unit price contracts
      5. GMP contracts
  - B. Changes in Scope and how to document.
    - b. Change Orders - Your construction contract must contain a provision that allows for changes. If there is no agreement to allow additions, adjustments, or modifications to the original contract, you may be stuck with a contract you cannot honor or fulfill.
    - c. There is not a one-size-fits-all change order, at least not one that will protect you in every situation.
    - d. An excessive number of changes may lead to “abandonment” of the original contract in California. Know ahead of time where that line may be.
    - e. Ascertain who has authority under the contract to sign the change orders, and make sure that person signs off on each order before commencing work that varies from the original contract. This may not

be easy or convenient when you are rushing to meet a deadline and alterations are needed quickly.

- f. Types of Change Orders
    - Owner Initiated – What does your contract say about continuing to work while negotiated change orders?
    - Contractor Initiated – What caused the change? Do not forget to request extension of time along with monetary compensation.
    - Circumstance Initiated – Who is responsible?
      - Differing site conditions
      - Force Majeure – See below
      - Other contractors - sequencing
- Determination of Change Orders critical in COVID setting. Force Majeure still contract interpretation still unknown, but New York early case decisions show broad interpretation of the contract terms and protection for COVID issues. See *JN Contemporary Art, LLC v. Phillips Auctioneers LLC*, (20-cv-04370), **2020**.

## 2. **Indemnity Clauses and & Risk Transfer IN COVID**

- A. Why is this critical?
  - a. Fallout from COVID:
    1. Project shut down/restart.
    2. Project schedule disruption
    3. Hazardous conditions on sites and new safety challenges
    4. Constantly changing COVID guidelines
    5. Compliance with Federal, State, and local law issues
- C. Challenges to contractors with a national presence:
  - a. COVID restrictions and regulations vary widely from jurisdiction to jurisdiction.
- D. Current Indemnity in Most States Require Fault of Indemnitor, what is the COVID impact on fault under indemnity analysis?

## 3. **Unforeseen Conditions & Delays**

- A. Unforeseen Conditions
  - a. AIA contracts have standard language to protect the contractor from unknown conditions, but it is best to quantify any possible issues in your Qualifications and Exclusions- (have a separate Exhibit to clearly outline your items wanted in the Contract)

- b. Add additional items in your “force majeure” language to cover delays in transportation, governmental shutdowns, tariffs, etc.
  - c. AIA contracts cover some delays on the Owner side, however, be sure to note that additional costs will be allowed to cover daily costs –i.e., continuing labor, site services, equipment rentals costs, etc. Often the language only allows the Contractor to have additional time, not additional costs.
  - d. Watch for specific language on weather delays and try to get specific language on what qualifies as a “weather delay”.
- B. COVID Employment Challenges

4. **Waivers/Limitation of Damages**

- A. What limitations on damages can you ask for?
- B. How do liquidated damages play in and what about waivers?
- C. Key takeaways
  - a. Trickle down to the subcontractors.
  - b. Remember – changes (like a pandemic) impact trades differently, transfer risk accordingly.
  - c. Know your jurisdiction.
- D. Preserve Remedies
  - a. Preservation of these rights and remedies, however, requires careful and timely consideration and evaluation of the contract documents and the facts and circumstances of your situation. Absent prompt and timely notice and satisfaction of any contractual conditions precedent to asserting and maintaining a claim or contractual remedy, those options may be waived, released, and lost.

5. **Dispute Resolution**

- A. To arbitrate or not to arbitrate, that is the question!
- B. Other ADR considerations: Arbitration/Judicial Reference & Trial
- C. State Court Closures and Impact on ADR Resources Delay and Limit Access