GOING VIRAL: Will Regulatory Estoppel Arguments Undermine the Virus Exclusion?

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Although the number of declaratory judgment actions seeking coverage for COVID-19 business interruption losses is now nearing 500, relatively few of these cases seek recovery under commercial property policies containing virus exclusions. It may well be that many of the law firms bringing these suits are doing so on a contingency basis given the straitened financial circumstances of restaurants and other small businesses and prefer to seek coverage under "low hanging fruit" of policies where the key coverage defense is "direct physical loss" and that lack virus exclusions.

Indeed, the virus exclusion (Form CP 01 40 07 06)[2] is a formidable obstacle to coverage for COVID-19 claims. This exclusion was promulgated by the Insurance Services Office in 2006 after the SARS pandemic raised the prospect of virus claims in the United States. It states that there is no coverage "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."

Last week, however, a Pittsburgh law firm filed a law suit in the Western District of Pennsylvania that will test the effectiveness of this exclusion. More intriguingly, this suit attempts to avoid the virus exclusion by resurrecting a legal doctrine that has been gathering dust since the pollution coverage wars abated a decade ago.

By the late 1980s, insurers had recovered from early losses involving the "sudden and accidental"-type pollution exclusion and had largely succeeded in convincing courts that this exclusion was unambiguous and that gradual or intentional sources of pollution should be excluded under CGL policies. At the same time, many insurers sought to expand the applicability of so-called "absolute" pollution exclusions that had been introduced in 1986 so that they also encompassed toxic tort claims and other suits involving exposure to hazardous substances and not just hazardous waste clean ups.

Help for policyholders arrived in 1993, however, when the New Jersey Supreme Court issued its opinion in *Morton International v. General Accident Ins. Co.,* 134 N.J. 1, 629 A.2d 831 (1993). In *Morton*, the New Jersey Supreme Court declared that "sudden," if given its literal meaning, would limit coverage to "big boom" type polluting events. However, the court ruled that statements made to insurance regulators in 1970 by the Insurance Rating Bureau (ISO's predecessor) were grossly misleading. In particular, the court focused on IRB's statement that

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[2] CP 01 40 Virus Exclusion Form

> Coverage for pollution or contamination is not provided in most cases under present policies because the damages can be said to be expected or intended and thus are excluded by the definition of occurrence. The above exclusion clarifies this situation so as to avoid any question of intent.

In light of the perceived inconsistencies between what insurer trade associations told regulators in 1970 and their present claim that gradual pollution was also intended to be excluded, the *Morton* court concluded that insurers should be estopped from taking this more expansive view of "sudden and accidental." But how to get around the fact that conventional estoppel did not apply since few policyholders had any awareness of these 1970 regulatory filings when they purchased their insurance. The New Jersey Supreme Court's novel solution was "regulatory estoppel," which the court described thusly:

> Although we have not heretofore applied the estoppel doctrine in a regulatory context, its application to these circumstances is appropriate and compelling. A basic role of the Commissioner of Insurance is "to protect the interests of policy holders" and to assure that "insurance companies provide reasonable, equitable and fair treatment to the insuring public." *See In re N.J.A.C. 11:1-20,* 208 *N.J. Super.* 182, 189, 505 *A.*2d 177 (App. Div. 1986). In misrepresenting the effect of the pollution-exclusion clause to the Department of Insurance, the IRB misled the state's insurance regulatory authority in its review of the clause, and avoided disapproval of the proposed endorsement as well as a reduction in rates. As a matter of equity and fairness, the insurance industry should be bound by the representations of the IRB, its designated agent, in presenting the pollution-exclusion clause to state regulators.

In the wake of *Morton*, policyholder counsel aggressively pursued discovery efforts with respect to the claimed drafting history of pollution exclusions and argued that insurers should not now be able to argue for a broader scope than was disclosed to state insurance regulators at the time that these exclusions were approved for use. Apart from New Jersey, however, state after state rejected "regulatory estoppel" arguments, whether because extrinsic evidence of intent is admissible where policy language is otherwise unambiguous or because the doctrine of estoppel requires that the party seeking to enforce a contract have relied to his or her detriment on a misstatement by the other contracting party.[3]

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[3] *Millipore Corp. v. Travelers Ind. Co.,* 115 F.3d 21, 30 (1st Cir. 1997)(finding conflict of law between Massachusetts and New Jersey with respect to regulatory estoppel arguments); *Federated Mut. Ins. Co. v. Botkin Grain Co.,* 64 F.3d 537 (10th Cir. 1995)(rejecting *Morton* as being contrary to Kansas law); *State of California v. Underwriters at Lloyd's,* 146 Cal. App.4th 851 (4th

After eight years in the wilderness, the "regulatory estoppel" doctrine came back to life after a fashion when it was given a half-hearted endorsement by the Pennsylvania Supreme Court in *Sunbeam Corp. v. Liberty Mutual Ins. Co.,* 781 A.2d 1189 (Pa. 2001). In *Sunbeam,* the Supreme Court ruled 3-2 (two justices having declined to participate) that lower courts had erred in granting the insurers' demurrer and dismissing a policyholder's complaint with prejudice where, in the majority's view, the insurer had properly pleaded the elements of a claim for estoppel based upon representations concerning the scope of the exclusion that the insurance industry had made to the Pennsylvania Insurance Department in 1970. While not going so far as to formerly adopt *Morton*-style regulatory estoppel, the Supreme Court remanded the question back to the trial court for further finding and further suggested that such evidence might be relevant to establish a "custom and usage" within the insurance industry that mandates an interpretation of "sudden and accidental" that is contrary to the understanding of the general public. Justices Saylor and Castille argued that the lower court's ruling should have been affirmed as the plain and ordinary meaning of "sudden and accidental" precludes coverage in a case where contamination occurred gradually over an extended period of time.

The initial promise of *Sunbeam* failed to extend beyond Pennsylvania and, indeed, has rarely been cited even by Pennsylvania courts. Nevertheless, it is the conceptual foundation of the claim for COVID-19 BI coverage that asserted last week in *1S.A.M.T. Inc. d/b/a Town and Country v. Berkshire Hathaway, Inc.*, No. 20-2025 (W.D. Pa. June 11, 2020). The insured in this case is a banquet and catering company located in New Castle, Pennsylvania. It argues that the economic damage that it has suffered due to pandemic shut-down orders resulted in "direct physical loss or damage" to its insured premises. Furthermore, the Complaint asserts that National Indemnity should be estopped from asserting that any coverage that might otherwise

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Dist. 2006), *as modified* 2007 Cal. App. LEXIS 100 (4th Dist. Jan. 25, 2007); *Buell Industries v. Greater New York Mutual Ins. Co.,* 791 A.2d 489, 259 Conn. 527 (2002)("regulatory estoppel appears to be another attempt to examine extrinsic evidence on a term that we have already concluded is clear and unambiguous"); *Continental Cas. Co. v. City of Jacksonville*, No. 3:04-CV-1170 (N.D. Fla. Aug. 6, 2009); *E.I. DuPont v. Allstate Ins. Co.,* 693 A.2d 1059 (Del. 1997)("regulatory estoppel is inapplicable where, as here, the contract language is clear and unambiguous"); *American States Ins. Co. v. Kiger,* 662 N.E.2d 945 (Ind. 1996); *Cessna Aircraft Co. v. The Hartford Acc. & Ind. Co.*, 900 F Supp. 1489 (D. Kan. 1995); *Polaroid Corp. v. The Travelers Indemnity Co.,* 414 Mass. 747, 750, 610 N.E.2d 912 (1993)(striking amicus briefs that purported to set forth the drafting and regulatory history of the pollution exclusion); *Anderson v. Minnesota Insurance Guarantee Association*, 534 N.W.2d 706 (Minn. 1995)(whatever representations the IRB may or may not have made to state insurance regulators could not create an estoppel where the wording of the exclusion itself was clear and unambiguous); *Montana Refining Co. v. National Union Fire Ins. Co. of Pittsburgh, PA*, 918 F.Supp. 1395 (D. Nev. 1996); *Wysong & Miles Co. v. Employers Ins. Co. of Wausau*, 4 F.Supp.2d 421 (M.D.N.C. 1998); *M&M Metals International v. Continental Cas. Co.*, 2008 Ohio App. LEXIS 9 73 (Ohio App. March 14, 2008); *Chickasha Cotton Oil Company v. Houston General Ins. Co.*, 2002 WL 1792467 (Tex. App. May 2, 2002) and *Sinclair Oil Corp. v. Republic Ins. Co.,* 967 F.Supp. 462 (D. Wyo. 1997).

apply is negated by an exclusion for "loss or damage caused by or resulting from any virus, bacterium or other micro-organism" (Form CP 01 40 07 06). The Complaint asserts that the exclusion is factually inapplicable “to the extent that the governmental orders, in and of themselves, constitute direct physical loss or damage to Plaintiff's Covered Property." It goes on to argue:

> 46. Further, to the extent that the coverage under the policy derives from direct physical loss or damage caused by the COVID-19 virus, either to Plaintiff’s Covered Property or to property other than Plaintiff’s Covered property, Defendant should be estopped from enforcing the Virus Exclusion, on principles of regulatory estoppel, as well as general public policy.
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> 47. In 2006, two insurance industry trade groups, Insurance Services Office, Inc. (“ISO”) and the American Association of Insurance Services (“AAIS”), represented hundreds of insurers in a national effort to seek approval from state insurance regulators for the adoption of the Virus Exclusion.
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> 48. In their filings with the various state regulators (including Pennsylvania), on behalf of the insurers, ISO and AAIS represented that the adoption of the Virus Exclusion was only meant to “clarify” that coverage for “disease-causing agents” has never been in effect, and was never intended to be included, in the property policies.
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> 49. Specifically, in its “ISO Circular” dated July 6, 2006 and entitled “New Endorsements Filed to Address Exclusion of Loss Due to Virus or Bacteria,” ISO represented to the state regulatory bodies that:
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>> While property policies have not been a source of recovery for losses involving contamination by disease-causing agents, the specter of pandemic or hitherto unorthodox transmission of infectious material raises the concern that insurers employing such policies may face claims in which there are efforts to expand coverage to create sources of recovery for such losses, contrary to policy intent.
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> 50. Similarly, AAIS, in its “Filing Memorandum” in support of the Virus Exclusion, represented:
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>> Property policies have not been, nor were they intended to be, a source of recovery for loss, cost or expense caused by disease-causing agents. With the possibility of a pandemic,

> there is concern that claims may result in efforts to expand coverage to create recovery for loss where no coverage was originally intended . . .
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> This endorsement clarifies that loss, cost, or expense caused by, resulting from, or relating to any virus, bacterium, or other microorganism that causes disease, illness, or physical distress or that is capable of causing disease, illness, or physical distress is excluded . . .

> 51. The foregoing representations made by the insurance industry were false. By 2006, the time of the state applications to approve the Virus Exclusion, courts had repeatedly found that property insurance policies covered claims involving disease-causing agents, and had held on numerous occasions that any condition making it impossible to use property for its intended use constituted "physical loss or damage to such property."
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> 52. The foregoing assertions by the insurance industry (including Defendant), made to obtain regulatory approval of the Virus Exclusion, were in fact misrepresentations and for this reason, among other public policy concerns, insurers should now be estopped from enforcing the Virus Exclusion to avoid coverage of claims related to the COVID-19 pandemic.
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> 53. In securing approval for the adoption of the Virus Exclusion by misrepresenting to the state regulators that the Virus Exclusion would not change the scope of coverage, the insurance industry effectively narrowed the scope of the insuring agreement without a commensurate reduction in premiums charged. Under the doctrine of regulatory estoppel, the Court should not permit the insurance industry to benefit from this type of duplicitous conduct before the state regulators.

It was predictable that a policyholder would attempt to resurrect the "regulatory estoppel" doctrine as a basis for subverting the virus exclusion, just as it is predictable that policyholders will seek "drafting history" discovery as a means of delaying or avoiding dispositive motion practice in these cases. For the most part, however, it appears that these efforts are a forlorn hope, notwithstanding *Sunbeam*.

To begin with, *Sunbeam* appears to have limited precedential value, particularly on the issue of regulatory estoppel. In *Hussey Copper, Ltd. v. Arrowood Indemnity Co.,* 319 Fed. App'x 507 (3rd Cir. Aug. 23, 2010), the U.S. Court of Appeals for the Third Circuit declined to find that *Sunbeam* estopped a liability insurer from contesting coverage for cleanup claims due to run-off from defective copper roofing that the insured had installed for the property owner. Despite the

insured's argument that representations made by ISO to Pennsylvania insurance regulators should estop Royal from asserting the application of an absolute pollution exclusion to these claims, the Third Circuit ruled that the underlying action fell squarely within the language of the exclusion as involving "any loss, cost or expense arising out of any request, demand or order that any insured or others in any way respond to or assess the effects of pollutants. The court declined to find that "industry custom and usage" demonstrated that insurers did not consider Section 2(a) as applying to "product-based claims" such as those asserted against Hussey Copper. Finally, the court rejected the insured's regulatory estoppel argument based upon alleged representations by ISO to the effect that this exclusion did not apply to product-based claims. While acknowledging that the Pennsylvania Supreme Court had adopted the doctrine of regulatory estoppel in *Sunbeam,* the Third Circuit found that the District Court had properly rejected the application of this doctrine to the facts in this case where the insured's claimed evidence of industry representations pertained to a different pollution exclusion in a different contract and were simply not relevant to a claim for estoppel involving the Royal language. In any event, the court found that the ISO statements, when read in context, showed that ISO consistently represented to regulators that the pollution exclusion would apply to cleanup costs like those the Building Commission incurred and were not contrary to Arrowood's position in this litigation.

Furthermore, unlike the trade association representations to regulators that were at issue in *Morton* and *Sunbeam,* there is no inconsistency between the statement of purpose in the ISO Circular that accompanied the "virus exclusion" and the positions that insurers are now taking in response to COVID-19 claims. The argument in Paragraph 51 that the insurers' representation that commercial property policies would generally not covered pandemic losses is "false" represents an interpretation of conflicting case law around the country. It was (and remains) the view of property insurers that pandemic losses were never meant to be covered. There is, therefore, no basis for arguing that the insurers are now taking an inconsistent position.

Additionally, this law suit fails to note that the ISO Circular stated that ISO had developed this new exclusion because "specific types" of "viral" contamination "warrant[ed] particular attention." ISO specifically identified SARS, which is caused by a coronavirus, as an example of viral contamination, and stated that "[t]he universe of disease-causing organisms is always in evolution." While ISO may not have anticipated the scope and devastation of COVID-19, this exclusion certainly anticipated the possibility of this or future pandemics and sought to insulate commercial property insurers from their consequences.

This is surely not the last or best argument that policyholders will make in the months to come in their efforts to persuade courts that claims due to the COVID-19 virus do not seek payment "for loss or damage caused by or resulting from any virus…" While efforts will certainly be made to liken the 2006 ISO documents to statements that were made to state regulators in the past concerning pollution exclusions, a reasoned assessment of these respective claims confirms that this virus exclusion was, in fact, adopted for the very sort of pandemic that now plagues our world.