One Court, Two Decisions: The Debate Continues As To What Constitutes "Direct Physical Loss" Under Business Interruption Insurance

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A recent pair of decisions by the U.S. Court of Appeals for the 8th Circuit provides a unique view into opposing lines of reasoning with regard to what constitutes "direct physical loss" for purposes of business interruption insurance. In *Source Food Technology, Inc. v. United States Fidelity & Guaranty Company*, the 8th Circuit Court of Appeals initially found, under Minnesota law, that a direct physical loss had occurred, but later filed a superseding opinion finding no evidence of a direct loss. 460 F. 3d 995 (8th Cir. 2006), superseded by *Source Food Technology, Inc. v. United States Fidelity & Guaranty Company*, No. 06-1166, 2006 WL 2920651 (8th Cir. Oct. 13, 2006). The result of this duo appears to confirm that, at least in Minnesota, actual physical contamination is required to establish a direct physical loss for purposes of business interruption insurance. Moreover, the *Source Foods* decision has instructive value nationwide given the relative dearth of case law nationally interpreting the meaning of direct physical loss.

The crux of the issue in *Source Foods* was whether an embargo that prevented shipment of otherwise uncontaminated beef product could constitute a "direct physical loss" under the insured's business interruption insurance. Source Foods sold cholesterol-free beef product in the US and its sole supplier was located in Ontario, Canada. In the spring of 2003, the USDA closed the Canadian border to all Canadian beef and beef products due to concerns about a Mad Cow outbreak. At the time of the closure, the supplier had loaded a truckload of beef product for Source Foods, which was lost when the truck could not cross the border into the US. The embargo caused Source Foods to shut down operations while it secured an alternate supplier and, due to the delay in operations, Source Foods lost one of its primary customers. Source Foods submitted a claim to USF&G under its business interruption insurance policy, which USF&G denied based on the lack of a "direct physical loss." Both sides agreed that the beef product in the trucks was not contaminated with Mad Cow. The trial court, applying Minnesota law under diversity jurisdiction, granted USF&G's summary judgment motion, finding that an embargo of otherwise uncontaminated product was not a loss covered under business interruption insurance. Source Foods appealed.

The 8th Circuit issued an appellate decision, written by Judge Gerald Heaney, in June 2006. Judge Heaney reversed the district court and found that direct physical loss can exist without structural damage to property. Judge Heaney relied heavily on *General Mills, Inc v. Gold Metal Ins. Co.*, 622 N.W. 2d 147, 151 (Minn. Ct. App. 2001), and *Sentinel Management Co. v. New Hampshire Insurance Co.*, 563 N.W. 2d 296 (Minn. Ct. App. 1997), interpreting them to equate physical damage with "functional impairment." In *General Mills,* oats were sprayed with an unapproved pesticide and thus barred from sale under FDA regulations, even though the pesticide was not toxic and the oats were safe for human consumption. In *Sentinel,* the insured's apartment building contained traces of released asbestos and the insured sought to recover for the cost of abatement. In both cases, the court found that there had been "direct physical loss" despite, in Judge Heaney's opinion, the lack of tangible injury or destruction. Judge Heaney found that Source Food's beef product was analogous to the oats in *General Mills* because both were safe for human consumption but rendered unusable by government regulations.

Judge Heaney distinguished Source Foods from the recent 8th Circuit opinion in *Pentair, Inc. v.*

American Guarantee & Liability Insurance Co., 400 F.3d 613 (8th Cir. 2005), where the insured was denied recovery for losses caused by a power outage that temporarily stopped manufacturing operations. Judge Heaney reasoned that in *Pentair*, there was no direct physical loss because the insured simply lost power to its manufacturing facility without any physical damage to the facility. In contrast, Source Foods actually lost the beef product when the truck was barred from crossing the border. The loss of that truckload was, in Judge Heaney's analysis, sufficient to trigger business interruption coverage for all losses caused by the embargo.

This decision stood for less than two months before USF&G's petition for rehearing was granted by the panel. Notably, Judge Heaney had retired in the interim, so the decision on rehearing was issued by the remaining two judges.[2] Judge Gruender, who had dissented in the original decision, authored the superseding opinion in favor of the defendants.[3]

The opinion by Judge Gruender applied the same case law to the same facts to reach the opposite conclusion – that Source Foods had *not* suffered a direct physical loss. Under Judge Gruender's analysis, *General Mills* and *Sentinel* both turned on actual physical contamination to the property. He emphasized that *Sentinel* found physical loss only where "a building's function may be seriously impaired or destroyed and the property rendered useless *by the presence of contaminants*." Similarly, it was the physical contamination of the oats that violated the FDA regulations and rendered them unusable in *General Mills*. Judge Gruender reasoned that the products or property at issue in both cases were rendered useless by the presence of contaminants and that functional impairment, absent physical contamination, is not sufficient to create a direct physical loss. He found support for this result under *Pentair*, concluding that neither the power outage in *Pentair* nor the embargo in *Source Foods* involved physical damage or contamination so neither could constitute a direct physical loss.

Does this rule stand for less tangible property? For example, it is easy to see how traditional commodities, such as beef, either are or are not physically contaminated. What about less tangible property, though, such as computer software? In *American Guarantee & Liability Insurance Co. v. Ingram Micro, Inc.*, No. 99-185 (D. Ariz. April, 18, 2000) WL 726789, a District Court in Arizona tackled the issue in the context of lost software configurations. In *Ingram*, although power was restored within half an hour, the insured's mainframe computers lost all programming information and were down for an hour and a half during reprogramming. The insured's networking system also lost its custom configurations, which took eight hours to reprogram. The insured filed a claim under its business interruption coverage due to its inability to conduct business during this period. Finding the circumstances constituted "physical damage," the court held that "physical damage is not restricted to the physical destruction or harm of computer circuitry, but includes loss of access, loss of use, and loss of functionality." A District Court in Tennessee recently followed this reasoning, finding a direct physical loss occurred where the insured's pharmacy computer data was corrupted due to a power outage. *Southeast Mental Health Center v. Pacific Insurance Co., Ltd.*, 439 F.Supp.2d 831 (W.D. Tenn. 2006).

Despite the court's language in *Ingram*, these cases do not necessarily state a rule different from that of *Source Foods* and *Pentair*. Loss of functionality, in both instances, was a result of power outages that left the computers with different data and programming information than before the outage. In essence, the software sustained a technological form of physical damage analogous to pesticide-tainted oats or asbestos contamination. Taken as a whole, *Source Foods* and its predecessors articulate a rule that mere functional impairment is not enough;

there must be physical damage or contamination to establish a direct physical loss under business interruption insurance.

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[2] Under 8th Circuit rules of court, Rule 47E, where a judge, who has heard an argument or taken under submission any appeal, retires while the matter is still pending, then the remaining two judges will determine the matter. US Ct. of App. 8th Cir. Rule 47E, 28 U.S.C.A. (West 2006).

[3] At the time of writing this article, a petition for rehearing by Source Foods was pending with the 8th Circuit Court of Appeals.