

What Triggers First-Party Coverage: Facts, Not Fear

Law360, New York (May 04, 2012, 1:45 PM ET) -- In late April 2012, at a rendering plant near Fresno, Calif., a routine test of a dairy cow revealed the presence of Bovine Spongiform Encephalopathy (BSE), commonly referred to as “mad cow disease”. The cow was one of 40,000 cows tested each year by the United States Department of Agriculture (USDA) for the disease and is the first discovered in the U.S. since 2006.

Fortunately, the USDA confirmed the cow “at no time presented a risk to the food supply or human health.”

The discovery of mad cow disease, however, prompts a revisit of case law addressing the issue of whether the fear of contamination of a food product is physical loss or damage for purposes of first-party property insurance.

In recent years, the embargo of Canadian beef in 2003 and the peanut butter contamination crisis of 2010, among others, gave rise to first-party claims of coverage despite the absence of actual contamination of the product. Courts consistently have held that without some alteration of the product, there is no “physical loss or damage” to trigger coverage.

The fear of mad cow disease led to an often-cited case addressing the issue of what constitutes physical damage to property to trigger coverage for first-party insurance.

The Eighth Circuit U.S. Court of Appeals in *Source Food Technology Inc. v. USF&G Co.*, 465 F.3d 834 (8th Cir. 2006) held that a food company’s loss of income due to an embargo of Canadian beef for fear of mad cow disease contamination did not constitute to direct physical loss that would trigger business interruption coverage.

The insured, Source Food, sold a beef product with the cholesterol removed. Source Food’s sole supplier was a company that manufactured and packaged beef in Canada using Source Food’s patented manufacturing process. In 2003, a cow in Canada was found to have mad cow disease, and the USDA reacted to the scare by closing the border to Canadian beef.

A truckload of Canadian beef on its way to Source Food's U.S. plant was not allowed to enter the U.S. because of the general embargo of imported beef. The beef product was owned by Source Food. As a result, Source Food's business was interrupted until it could obtain an alternate supplier, and it submitted a business interruption and extra expense claim to its Insurer.

The insurer denied the claim, asserting that Source Food suffered no direct physical loss to property because the beef product suffered no actual physical contamination.

On appeal, the Eighth Circuit initially held that since "Source Food was denied the use of its product due to circumstances beyond its control ... it has suffered a direct, physical loss of its beef." *Source Food Technology v. USF&G Co.*, 460 F.3d 995 (8th Cir. 2006).

The majority initially determined that whether the beef was actually tainted was not controlling, but rather the controlling fact was that it was treated as tainted by the U.S. government. *Id.* at 998.

The Eighth Circuit, however, granted USF&G's motion for rehearing and vacated its previous decision. The court then affirmed the insurer's coverage denial on the basis that Source Food suffered no direct physical loss to property because the beef product suffered no actual physical contamination.

The Eighth Circuit explained that Source Food had not experienced a "physical loss" merely because the beef could not be used for its intended purpose:

"Although Source Food's beef product in the truck could not be transported to the United States due to the closing of the border to Canadian beef products, the beef product on the truck was not — as Source Foods concedes — physically contaminated or damaged in any manner. To characterize Source Food's inability to transport its truckload of beef product across the border and sell the beef product in the United States as direct physical loss to property would render the word 'physical' meaningless. *Source Food*, 465 F.3d at 838."

The court distinguished cases where actual contamination was found: *Gen. Mills Inc. v. Gold Medal Ins. Co.*, 622 N.W.2d 147 (Minn. Ct. App. 2001) (sixteen million bushels of General Mill's raw oats were in violation of U.S. Food and Drug Administration regulations) and *Marshall Produce Co. v. St. Paul Fire & Marine Ins. Co.*, 98 N.W.2d 280 (Minn. 1959) (smoke from a nearby fire violated the sanitation requirements of the government contract).

The court also emphasized the importance of the specific wording in the Source Food policy, which required direct physical loss to property. The court inferred a different result might be reached if the policy required physical loss of property. *Source Food*, 465 F.3d at 835 – 836.

California courts have also addressed the issue of what constitutes physical loss where a product is stigmatized or has reputation damage only. In *Meridian Textiles Inc. v. Indem. Ins. Co.*, No. CV 06-4766 CAS, 2008 U.S. Dist. LEXIS 91371 at *18 (C.D. Cal. Mar. 20, 2008), the federal court interpreting California law held the "perception of loss by the market for plaintiff's product, is not, by itself, sufficient to trigger coverage under the policy, which covers 'all risks of physical loss or damage from any external cause.'"

The Meridian Textiles case involved yarn temporarily stored at a warehouse in California which sustained a small fire. Not all of the yarn was incinerated, water-soaked or otherwise tangibly affected by fire, smoke, water or humidity.

The insured contended, however, the undamaged yarn could not be used for finished products because its customers would not purchase the yarn once they learned of the yarn's potential exposure to fire, smoke, heat, water and mold. Because plaintiff could not sell the yarn as first-quality yarn, it sold the yarn in the secondary yarn market at a reduced price.

The insurer refused to cover the diminution in value of the yarn, contending the yarn did not sustain physical loss or damage. The court agreed and concluded in order to trigger coverage under the policy, the plaintiff must demonstrate there was some tangible change in the yarn, e.g., an odor, mold or mildew, or there was some detectable physical change in the yarn such that it was likely to develop a detectable odor, mold or mildew. Absent any alteration, mere damage to the "reputation" of the yarn does not trigger coverage.

A similar result was found in *Gerawan Farming Ptnrs. Inc. v. Westchester Surplus Lines Ins. Co.*, No. CIV F 05-1186 AWI DLB, 2008 U.S. Dist. LEXIS 4511, 35-39 (E.D. Cal. Jan. 4, 2008) involving a claim for loss of pitted nectarines, a cosmetic condition which affects the surface of the fruit with small craters.

The insured owned, grew, packed and processed nectarines and the policy covered "direct physical loss of or damage to covered property" caused by or resulting from any covered cause of loss.

The court held the pitting was physical loss or damage to the nectarines. The court noted pitting is a physical condition that caused the loss of or damage to the nectarines and the alteration in the condition of the product triggered coverage.

Likewise, in *Shade Foods Inc., v. Innovative Products Sales & Marketing Inc.*, 93 Cal. Rptr. 2d 364, 78 Cal. App. 4th 847 (2000), the court identified as property damage the wood chip contamination of almonds used in edible nut clusters.

Although *Shade Foods* involved the interpretation of a commercial general liability policy, it was relied upon by the federal court in *Gerawan*. The *Shade Foods* policy triggered liability coverage if the insured was legally liable for property damage defined as "physical injury to tangible property, including all resulting loss of use of that property."

The product at issue was cereal clusters that included almonds. Customers found wood chips in the almond mix and the court held the almond mix did sustain physical injury to tangible property.

The result is consistent with the requirement there be some distinct, demonstrable physical alteration of the property. The presence of wood splinters in the diced roasted almonds caused property damage to the nut clusters and cereal products in which the almonds were incorporated.

The cases confirm the requirement that the loss to property must be "physical," and given the ordinary definition of the term, coverage is excluded for alleged losses that are intangible or incorporeal.

It is likely that courts, at least in California, would agree there is no coverage for loss when the insured suffers only a detrimental economic impact unaccompanied by a distinct, demonstrable, physical alteration of the property.

In the case of mad cow disease, if the recent media attention causes suppliers to sustain a business income loss due solely to the fear or stigma that beef is contaminated, first-party property policies will likely not provide coverage. Absent actual alteration of the beef, there is no physical damage which could trigger coverage.

Fear — real or imaginary — will not trigger coverage.

--By William Webster and Ann F. Ketchen, Robins Kaplan Miller & Ciresi LLP

William Webster is a partner in Robins Kaplan's Los Angeles office. Ann Ketchen is an associate with the firm in the Boston office.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2012, Portfolio Media, Inc.