Policyholders Win a Covid Case! North Carolina Supreme Court Rules Government Closure Order Can Result In "Direct Physical Damage"

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I have a vision of Amy Bach, the Executive Director of United Policyholders, jumping for joy as she read the North Carolina Supreme Court opinion, which the insurance industry must think of as a Friday the 13th ruling. The court noted its conclusion early in the opinion:

> Because a reasonable policyholder in the restaurants' shoes could expect 'direct physical loss' to property, as used in this policy, to include the results of COVID-19-era government orders which affected the restaurants' use of and access to their physical property, and because the policy otherwise contains no exclusion for viruses, we construe the ambiguity here in favor of coverage. Accordingly, we hold that this policy does cover the restaurants' alleged losses and that the restaurants are entitled to their motion for partial summary judgment. We therefore reverse the judgment of the Court of Appeals and remand to the Court of Appeals for further remand to the trial court for further proceedings consistent with this opinion.

From the policyholders' view, the United Policyholders *amicus* brief [1] stated what had been the longstanding law regarding physical loss before Covid struck:

An ‘all risks’ insurance policy, like the one Cincinnati sold North State Deli, provides coverage for all risks that are not otherwise excluded. See *Avis v. Hartford Fire Ins. Co.*, 283 N.C. 142, 146, 195 S.E.2d 545, 547 (1973) (‘Recovery will be allowed under a policy affording ‘all risks’ coverage for all losses of a fortuitous nature not resulting from misconduct or fraud, unless the policy contains a specific provision expressly excluding the loss from coverage.’).

Policyholders, courts, and insurers – including Cincinnati – have for decades understood all risks policies to provide expansive coverage, including in situations where property was rendered unfit or unsafe for its intended use, regardless of whether there was physical alteration to property. When a policyholder cannot use property as intended due to an external physical peril, that is the type of ‘physical loss’ or ‘physical damage’ to property that all risks insurance policies were purchased to address. It is only now that Cincinnati seeks to narrow the broad nature of all risks policies, like the one it sold North State Deli, to protect policyholders for physical loss or damage to property only when the insured property suffers visible or structural damage.

…

…It is true that insurers including Cincinnati have expanded the scope of property insurance coverage over the years. For instance, when the Insurance Services Office (‘ISO’) – an industry trade group that drafts widely used form policies that many insurers use as the basis for their policies – began drafting policies decades ago, coverage was triggered only if the property was ‘damaged or destroyed.’ See *Frank S. Glendening, Business Interruption Insurance: What Is Covered* 100 (1980). However, the ISO form property policies – like the Cincinnati policies at issue here – now include the broader trigger of physical ‘loss’ or ‘damage’ to property.

Thus, by their plain text, property insurance policies now cover a broad range of physical perils that rob property of its intended use even if they do not cause visible, structural damage in the way that fires and hurricanes do (though even those perils often cause damage that is not apparent to the naked eye). Indeed, Insurance Industry *Amici* concede that ‘theft’ is covered and often theft does not damage property in the same way that a fire

might. APCIA Br. 9-10. Rather, theft is covered because if property is stolen, the policyholder cannot use that property for its intended use due to an external force beyond the policyholder's control. See, e.g., *Intermetal Mexicana, S.A. v. Ins. Co. of N. Am.*, 866 F.2d 71, 76 (3d Cir. 1989); *Great N. Ins. Co. v. Dayco Corp.*, 620 F. Supp. 346, 351 (S.D.N.Y. 1985).

Therefore, for decades, consistent with North Carolina law requiring broad construction of all risks policies, courts across the country interpreting property policies have found coverage when a property is deemed unfit or unsafe for its intended use:

• **Threat of collapse** that required abandonment of property. *Hampton Foods, Inc. v. Aetna Cas. & Sur. Co.*, 787 F.2d 349, 352 (8th Cir. 1986); *Hughes v. Potomac Ins. Co.*, 199 Cal.App.2d 239, 248-49 (1962) (holding that policyholder's home, which became perched on the edge of a cliff after a sudden landslide, was damaged because it became unsafe to live in and thus useless).

• **Threat of falling rocks**, regardless of whether rocks ever made contact with property. *Murray v. State Farm Fire & Cas. Co.*, 203 W.Va. 477, 493, 509 S.E.2d 1, 17 (1998).

• **A ransomware attack** that prevented the insured from 'accessing' 'data contained on the server, and all of its software' and therefore caused 'loss of use, loss of reliability, or impaired functionality.' *Nat'l Ink & Stitch, LLC v. State Auto Prop. & Cas. Ins. Co.*, 435 F. Supp. 3d 679, 686 (D. Md. 2020).

• **Asbestos** fibers that were 'released into the air' and remained 'airborne' for long periods of time. *U.S. Fid. & Guar. Co. v. Wilkin Insulation Co.*, 144 Ill.2d 64, 74-75, 578 N.E.2d 926, 931 (1991); see also *Port Auth. of N.Y. & N.J. v. Affiliated FM Ins. Co.*, 311 F.3d 226, 236 (3d Cir. 2002) ('physical loss' occurred when 'the presence of large quantities of asbestos in the air of a building' made 'the structure uninhabitable and unusable').

• **Sulfuric gas** that rendered a property 'uninhabitable,' even though drywall was 'physically intact, functional and has no visible damage.' *TRAVCO Ins. Co. v. Ward*, 715 F. Supp. 2d 699, 708 (E.D. Va. 2010), aff'd, 504 F. App'x 251 (4th Cir. 2013).

• **Urine odor**, because the term 'physical loss' includes 'changes' that 'exist in the absence of structural damage.' *Mellin v. N. Sec. Ins. Co.*, 167 N.H. 544, 550, 115 A.3d 799, 805 (2015); see also *7 *Essex Ins. Co. v. BloomSouth Flooring Corp.*, 562 F.3d 399, 405-06 (1st Cir. 2009) (odor that affected air and 'permeated the building' constituted 'physical injury to property').**Gasoline vapor** that rendered rooms of insured building 'uninhabitable' and 'dangerous' to use. *W. Fire Ins. Co. v. First Presbyterian Church*, 165 Colo. 34, 36-37, 437 P.2d 52, 55 (1968) (en banc).

• **Methamphetamine vapor and odor.** *Farmers Ins. Co. of Or. v. Trutanich*, 123 Or.App. 6, 11, 858 P.2d 1332, 1336 (1993); see also *Graff v. Allstate Ins. Co.*, 113 Wash.App. 799, 806, 54 P.3d 1266, 1270 (2002) (finding coverage under vandalism policy when 'methamphetamine lab released hazardous vapors into the house'; 'visibility' of damage not required).

• **Ammonia gas** that 'physically transformed the air within [the] facility' and made it 'unfit for occupancy until the ammonia could be dissipated.' *Gregory Packaging, Inc. v. Travelers Prop. Cas. Co. of Am.*, 2014 WL 6675934, at *6 (D.N.J. Nov. 25, 2014).

• **Carbon monoxide.** *Matzner v. Seaco Ins. Co.*, 1998 WL 566658, at *4 (Mass. Super. Aug. 12, 1998).

The urine odor is my favorite example, as noted in *Cat Urine That Smells Bad is Covered But Not Covid, Which Can Kill You*.

The North Carolina Supreme Court decision is a critical victory for policyholders in North Carolina and a notable development in the national discourse on insurance coverage disputes arising from the pandemic. At the heart of the case was the interpretation of the phrase "direct physical loss" in the restaurants' insurance policies. The policies insured against losses resulting from "direct physical loss or direct physical damage to property" caused by a covered peril. Notably, the policies at issue did not exclude virus-related losses.

The restaurants argued that the government-mandated COVID-19 shutdowns resulted in a “direct physical loss” of their property, as they were unable to physically use their premises for their intended purposes. Cincinnati Insurance, on the other hand, contended that “direct physical loss” required tangible, structural alteration to the property—a position that many insurers have taken across the country.

The North Carolina Supreme Court sided with the policyholders, emphasizing the well-established rules of insurance contract interpretation in North Carolina:

1. **Plain Language Controls:** Undefined terms in an insurance policy are given their ordinary meanings. The court found that “loss” could reasonably mean deprivation of use, and that the conjunction “or” between “physical loss” and “physical damage” indicated distinct concepts. Thus, “physical loss” need not entail structural damage.
2. **Ambiguities Resolved Against the Insurer:** If a policy term is susceptible to more than one reasonable interpretation, courts must construe it in favor of the insured. Here, the court determined that a reasonable policyholder could interpret “physical loss” to include loss of use due to government orders.
3. **Coverage Provisions Are Interpreted Broadly:** Provisions granting coverage are to be read expansively, while exclusions are interpreted narrowly. The absence of a virus exclusion in the policies strongly supported the court’s decision to interpret ‘direct physical loss broadly.’

North Carolina’s rules of insurance contract interpretation played a pivotal role in this decision. As the court highlighted, insurance contracts are unique due to the disparity in bargaining power between insurers and insureds. Policyholders typically have no input in drafting the terms and must rely on the insurer’s chosen language. Recognizing this imbalance, North Carolina courts have long held that ambiguities must be construed in favor of the insured to reflect the reasonable expectations of a policyholder.

In *North State Deli*, these principles ensured that the restaurants received the benefit of the coverage they reasonably believed they had purchased. The court’s insistence on enforcing policy language as understood by a reasonable insured—rather than adopting strained interpretations favoring the insurer—is a crucial safeguard for policyholders.

Source:
https://uphelp.org/policyholders-win-a-covid-case-north-carolina-supreme-court-rules-government-closure-order-can-result-in-direct-physical-damage/ Date: January 22, 2025

This decision has significant implications for both policyholders and insurers going forward. For policyholders and public adjusters, the ruling highlights the importance of carefully reviewing insurance policies and advocating for coverage consistent with the policy's plain language and reasonable interpretations. It also highlights the critical role of state-specific rules of interpretation in resolving coverage disputes.

For insurers, the decision is a cautionary tale about the risks of relying on ambiguous policy language to deny claims. Insurers must draft clear and precise terms if they wish to exclude specific risks. It also serves as a reminder that traditional state law interpretation rules have not been thrown out because of the multitude of Covid-related decisions paying lip service to the impact of these rules.

The court's ruling diverges from decisions in many other jurisdictions, where courts have generally required physical alteration to trigger coverage for "direct physical loss." However, the North Carolina Supreme Court's adherence to state-specific principles of contract interpretation—and its focus on the reasonable expectations of policyholders—sets an important precedent for other states grappling with similar issues.

Finally, while the coverage case has been decided, the case is not finished. The damages aspects of the case still must be proven by the policyholder. Most Covid cases never made it this far. The amount of damages and the policy language applying to the damages portion of the case still make these cases complex and difficult.

My view is that this North State Deli decision reaffirms North Carolina's commitment to protecting policyholders through fair and reasonable interpretation of insurance policies. It is a win not only for the restaurants involved but also for all North Carolinians who rely on insurance coverage to safeguard their businesses against unexpected risks. As the landscape of the few remaining COVID-19 insurance litigation continues to evolve, this case will undoubtedly be a touchstone for future disputes and a hope for policyholders.

I can still envision Amy Bach and the rest of the United Policyholders (UP) staff smiling as if all their efforts were not a waste of time. They held weekly meetings for two years, coordinating the *amicus* efforts of policyholders across the country. While small in comparison to the insurance

industry and its legions of attorneys and propagandists, UP is very relevant and a force for policyholder rights. It is much harder to lose when you never give up.

Thought For The Day

"Words are, of course, the most powerful drug used by mankind."
—Rudyard Kipling