North Carolina Supreme Court Rules Covid Creates Direct Physical Loss

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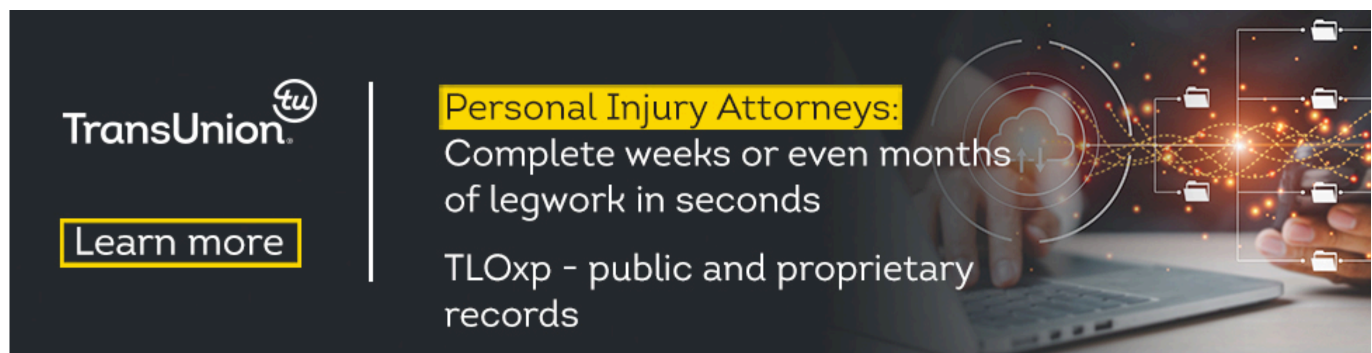
Summary

- This is the only state high court to reach this conclusion.
- In a companion case, the court upheld the insurers' enforcement of its contamination exclusion, which expressly included viruses.
- Insurers will likely characterize the "direct physical loss" decision as an outlier with little impact.

In early December 2024, the North Carolina Supreme Court in *North State Deli, LLC v. Cincinnati Ins. Co.*, No. 225PA21-2, 2024 WL 5100978, (N.C. Dec. 13, 2024) confirmed that the COVID-19 virus satisfies property insurance's triggering language: "direct physical loss." This is the only state high court to reach this conclusion. In a companion case handed down the same day, the North Carolina Supreme Court upheld the insurers' enforcement of its contamination exclusion, which expressly included viruses. *See*, *Cato Corp. v. Zurich Am. Ins. Co.*, No. 353PA23, 2024 WL 5100679, (N.C. Dec. 13, 2024).



Court Follows "Common-Sense Expectation"

In finding the virus caused "direct physical loss," the court started with dictionary definitions for each word. It concluded that "a covered cause of loss must, absent an intervening factor, result in the material deprivation, dispossession, or destruction of property." *N. State Deli*, slip op. at *14-15.

The court next addressed the parties' "reasonable arguments about whether that ordinary meaning includes closures due to government orders." *Id.* at 15-16 Ultimately, the court "fail[[ed] to see why the ordinary meaning of 'direct physical loss' is entirely insensitive to the 'use' for which a property is insured." *Id.* at 16. It explained:

> This overlap between property "use" and "loss" follows from a contextual and common-sense expectation that insurance should protect from threats to property that make it unusable for the purpose for which it is insured. Property "loss" surely occurs when it is no longer usable for its insured purpose, as a policyholder would reasonably expect. Thus when the restaurants lost physical use of their properties as restaurants due to the pandemic orders, they experienced a direct physical loss.

N. State Deli, slip op. at *16.

The court then turned to other provisions of the policy to determine whether it could harmonize those provisions with its interpretation. It noted the policy covered both "loss" and "damage" and concluded those two words must have different meanings. *N. State Deli*, slip op. at *16-17. The insurer claimed that loss meant theft or total deprivation, while the policyholder claimed loss was broader than damage "encompass[ing] dispossession, deprivation, or impairment of use or function, complete or partial." *Id.* at 17. On this, the court concluded both were reasonable positions, which fall to the policyholder.

Next, it considered the policy's "period of restoration." *N. State Deli*, slip op. at *17-18. This provision addresses the length of time the policy provides coverage. *Id.* at 17. It limits coverage to the lesser of three options. Cincinnati claimed one of the options—the date by which property was "repaired, rebuilt, or replaced"—meant there had to be damage. *Id.* at 18. That is, there had to be something to repair, rebuild, or replace.

The court rejected that position: "If a policy gives two alternatives and says the 'earlier' is operative, and one is clearly inapplicable, the 'earlier' is the only applicable one. The insured does not lose coverage because the 'loss' cannot be restored under both alternatives."

Additionally, *North State Deli* noted several other factors supporting its conclusion. First, the policy excluded some—though not all—"government zoning regulations, government ordinances, government seizures, and war and military actions, a person in the insured's shoes could reasonably expect virus-related government orders that are not an excluded cause of loss to be covered under the policy." *N. State Deli*, slip op. at *19.

Second, the policy at issue lacked a virus exclusion. The court found this important because a vast majority of policies around the country included such exclusions, and there was general knowledge surrounding risks associated with viruses.

Third, the decision observed that this is not just "property insurance" but business income insurance (issued on a separate form) reasonably expected to "'insure a capital asset—the income-earning power of their business.'" *N. State Deli*, slip op. at *20 (quoting Erik S. Knutsen & Jeffrey W. Stempel, *Infected Judgment: Problematic Rush to Conventional Wisdom and Insurance Coverage Denial in a Pandemic*, 27 Conn. Ins. L.J. 185, 199 (2021)).

Fourth, the court "decline[d] to do what other courts have done and affirmatively define the 'slippery' term Cincinnati chose to use in this manifestly ambiguous situation." *N. State Deli*, slip op. at *21 It highlighted the varying definitions other courts have constructed as evidence of the uncertainty in the phrase "direct physical loss." *Id.* at 21-22.

All of this led to the court's ultimate conclusion that the policyholder was entitled to partial summary judgment that the virus satisfied the policy's triggering language of "direct physical loss."

Virus Contamination Exclusion Bars Coverage for COVID Losses

In *Cato*—*North State Deli's* companion case—the North Carolina Supreme Court limited the scope of coverage for policyholders by enforcing the contamination exclusion. The court initially reinforced its decision in *North State Deli* on the "direct physical loss" issue. It then turned to the contamination exclusion in *Cato's* policy.

The exclusion prohibited coverage "due to **Contamination** including the inability to use or occupy property or any cost of making property safe or suitable for use or occupancy." *Cato*, slip op. at *4 (emphasis in original). It defined *contamination* "as any condition of property due to the actual presence of any . . . virus."

The policyholder disputed that this was the proper definition of contamination. It claimed that one of its "amendatory endorsements" changed the contamination definition by deleting the word "virus." *Cato*, slip op. at *4. The court disagreed.

The endorsement *Cato* relied upon was titled “Amendatory Endorsement – Louisiana.” *Cato*, slip op. at *4. *Cato* claimed this applied to its North Carolina policy and losses—not just those in Louisiana.

The court rejected this argument first noting *Cato’s* complaint failed to allege it “bargained for the Louisiana endorsement to apply to its policy covering properties not in Louisiana.” It next rejected *Cato’s* arguments that other “state-specific amendatory endorsements contain contradictions and should therefore be strictly construed in Cato’s favor.” The court noted only two of the 31 state-labeled endorsements expressly contained language stating the endorsement “**APPLIES TO THOSE RISKS IN”** that state. *Cato*, slip op. at *13. It concluded the only reasonable reading is that the state-labeled endorsements only apply to losses in that state. *Id.* at 13-14. It then buttressed this by highlighting several contradictions that would result if the state-labeled endorsements applied universally. *Id.* at 14.

Finally, the court addressed the policy’s provision that stated: “‘The titles of the various paragraphs *and endorsements* are solely for reference and shall not in any way affect the provisions to which they relate.’” *Cato*, slip op. at *15 (quoting the policy). *Cato* argued that this provision meant the title “Amendatory Endorsement – Louisiana” could not be used to affect coverage. The court rejected this argument because the titles would become superfluous, violating the court’s “obligation to give effect to each policy provision.” Furthermore, it noted the title only addressed *where* the endorsement applied; the titles did not alter the “the underlying substance of the applicable policy.”

Conclusion

The effect of these decisions is yet to be seen. There are other state high courts that have not addressed these questions. Whether the COVID-related coverage cases bear on insurance-coverage law generally is the more important question. Or will courts distinguish them given the unique circumstances surrounding them?

Policyholders are rejoicing that a state supreme court has returned to what many generally considered settled law regarding the scope of “direct physical loss.” *See generally*, Miller, C. et al., COVID-19 *and Business-Income Insurance: The History of “Physical Loss” and What Insurers Intended it to Mean*, 57 Tort Trial & Ins. Prac. L.J. 675 (2023); Lewis, R. et al., “Couch’s *“Physical Alteration” Fallacy: Its Origins and Consequences*,” 56 TORT TRIAL & INS. PRAC. L.J. 622 (2021); Steven Plitt, *All-Risk Coverage for Stigma Claims Involving Real Property*, 35:9 INS. LITIG. RPTR. 253 (Jun. 5, 2013); Steven Plitt, *Direct Physical Loss in All-Risk Policies: The Modern Trend Does Not Require Specific Physical Damage, Alteration*, CLAIMS J. (Apr. 15, 2013); 3 ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES §11:41 (6th ed. 2013) (surveying cases); 5 JOHN ALLEN APPLEMAN &

JEAN APPLEMAN, INSURANCE LAW & PRACTICE 2D §3092 (1970 & 2012 Supp.). *But see Plitt,* J. et al., 10A Couch on Ins. § 148:46 (claiming it is "widely held" that there is no coverage without "a distinct, demonstrable, physical alteration of the property.)"

Insurers, however, will likely characterize the "direct physical loss" decision as an outlier with little impact given the vast number of policies that contain "virus" in their contamination exclusions.

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