

Policyholder Playbook Episode 33: The Policy Language Details, Pt. 2—‘Direct Physical Loss’ and Coverage for COVID-19 Losses

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In Part Two of our Policy Language Details series, we discuss the North Carolina Supreme Court’s recent ruling that a group of restaurants are entitled to coverage for losses sustained in connection with government shutdown orders and threatened viral contamination stemming from the COVID-19 pandemic. The court’s decision focused on the words of the contract and the lens through which those words had to be analyzed.

By now, many have heard of the North Carolina Supreme Court’s landmark ruling that a group of restaurants are entitled to coverage for losses sustained in connection with government shutdown orders and threatened viral contamination stemming from COVID-19.¹ The ruling marks just the second state high court decision issued in the favor of policyholders, the other coming from Vermont.² Other state high court decisions have not been so friendly to policyholders.³

The keys to the policyholder’s victory in *North State Deli* were, of course, the words of the contract, and the lens through which the North Carolina Supreme Court examined those words. For the lens, the North Carolina Supreme Court leaned on two fundamental principles of insurance policy interpretation that can be leaned on in just about any insurance coverage case: (1) The contract “should be given that construction which a reasonable person in the position of the insured would have understood it to mean,” and (2) “undefined terms should be given the meaning most favorable to the insured which is consistent with the use of the term in ordinary speech.”⁴ It is often useful to remind courts that insurance policies are to be read through the lens of a reasonable insured, not through the lens of the insurer who drafted the policy. Further, when a coverage dispute hinges on an undefined term—in *North State Deli*, the key terms “direct,” “physical” and “loss” were undefined—it might be useful to examine if the applicable law discusses the treatment of undefined terms in a policyholder-friendly way.⁵

As for the words at issue, the court looked at the dictionary definitions of “direct,” “physical” and “loss,” and it held that a “covered cause of loss must, absent an intervening factor, result in the material deprivation, dispossession, or destruction of property.”⁶ The court held the government shutdown orders and threatened viral contamination stemming from the COVID-19 pandemic resulted in just that, hence its finding of coverage. The court buttressed that holding with two key observations about “the words.”

First, the court rejected the insurers’ argument that “direct physical loss” of property could not mean the “loss of physical use” of property that the policyholders’ irrefutably sustained.⁷ The court held that a reasonable reading of the policy was that “direct physical loss” indeed extended to scenarios where “threats to property . . . make it unusable for the purpose for which it is insured.”⁸ Again, the lens is important. Second, the court noted that the policyholders’ policies, which were “all risk”

policies, did not contain “exclusions for viruses in general,” despite such exclusions being widely available in the marketplace.⁹ The court stressed that “[k]nowledge of the risks of viruses, together with knowledge that other policies exclude virus risks while this one does not, underscores that a policyholder would reasonably understand the absence of such an exclusion as an affirmative grant of coverage.”¹⁰ This second point underscores how an understanding of the insurance market—and the coverages and exclusions that are available—can be leveraged to achieve a policyholder-friendly result. It’s what we wrote about in [Episode Five: Don’t Allow Your Insurer to Rewrite Your Policy](#).

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¹ See *North State Deli, LLC v. The Cincinnati Insurance Co.*, No. 225PA21-2 (N.C. Dec. 13, 2024).

² See *Huntington Ingalls Indus., Inc. v. Ace Am. Ins. Co.*, 287 A.3d 515, 529 (Vt. 2022).

³ See, e.g., *Ungarean v. CNA & Valley Forge Ins. Co.*, 323 A.3d 593, 607–08 (Pa. 2024)

⁴ No. 225PA21-2 at 12.

⁵ See, e.g., *Fireman’s Fund Ins. Companies v. Pearl*, 540 So. 2d 883, 884 (Fla. Dist. Ct. App. 1989) (concluding “that the trial court did not err in recognizing that the use of the undefined term ‘auto,’ coupled with [other] language [found in an] exclusionary clause, created an ambiguity.”)

⁶ No. 225PA21-2 at 15.

⁷ *Id.* at 16.

⁸ *Id.*

⁹ *Id.* at 19.

¹⁰ *Id.* at 20.