

Interpreting contract language: Was the COVID-19 shutdown “direct physical loss” to property?

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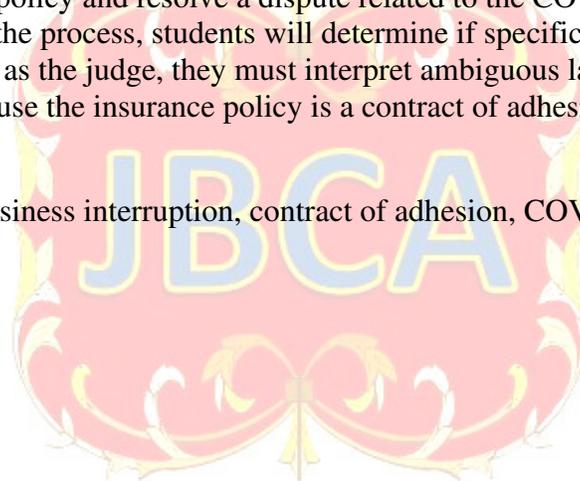
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ABSTRACT

This case study places students in the role of a trial court judge who is interpreting an insurance contract. As the judge, students will apply the Plain Meaning Rule to determine the meaning of an insurance policy and resolve a dispute related to the COVID-19 government-mandated shutdowns. In the process, students will determine if specific language in the policy is ambiguous and learn that as the judge, they must interpret ambiguous language against the insurance company, because the insurance policy is a contract of adhesion drafted exclusively by the insurance company.

Keywords: ambiguity, business interruption, contract of adhesion, COVID-19, direct physical loss, plain meaning rule



INTRODUCTION

Before March of 2020, most gyms, salons, and restaurants never thought they would be deemed “nonessential” businesses or suffer catastrophic financial losses due to government-mandated COVID-19 shutdowns (French, 2020; Knutsen & Stempel, 2020). As these businesses faced ruin from the shutdowns, many turned to their insurance companies for relief, filing claims under their business interruption coverage (French, 2020; Knutsen & Stempel, 2020). Insurance companies had marketed business interruption coverage to these businesses to protect them from lost income during the time-period between a catastrophic loss to business property and the businesses’ reopening following the repair of the property (Bell, n.d.; French, 2020; Knutsen & Stempel, 2020).

Although thousands of businesses filed claims under their business interruption coverage, insurance companies denied the claims, asserting that the government shutdowns had not caused a “direct physical loss” of property as required under the policy language (French, 2020; Knutsen & Stempel, 2020). To date, these claim denials have led to more than 1,900 lawsuits (Insurance Law Analytics, n.d.). In these lawsuits, judges have interpreted the policy language as a matter of law, and only a handful of judges have ruled in favor of the businesses, finding coverage under business interruption policies due to “direct physical loss” of property (French, 2020; Insurance Law Analytics, n.d.; Knutsen & Stempel, 2020).

The judicial opinions written in this small group of cases are excellent teaching tools for undergraduate students, because the opinions address current events and illustrate how a judge interprets a contract. This case study places students in the role of a trial court judge and helps students understand how a judge applies the Plain Meaning Rule when interpreting a contract. In addition to providing the relevant language from the insurance policy, this case study includes standard dictionary definitions and illustrates how a judge uses dictionaries when determining the ordinary meaning of a term in a contract.

This case study also demonstrates how a judge interprets a contract of adhesion, sometimes referred to as a “take it or leave it” contract – where one party drafts the language in the contract and the other party must either “take” the contract language as it is written or “leave it” and contract with someone else. Insurance policies are classic contracts of adhesion, because the insurance industry drafts the language in the policies and does not negotiate the language with insureds; insureds must either “take it or leave it” (French, 2020; Thomas, n.d., §5.01). This case study demonstrates how a judge determines whether a contract term is ambiguous and illustrates how a finding of ambiguity in a contract of adhesion results in the judge’s interpreting the contract against the party that drafted the language, i.e., the insurance company (French, 2020; Jerry & Richmond, 2018; Knutsen & Stempel, 2020).

BACKGROUND

Standard commercial insurance policies cover the cost of rebuilding, repairing or replacing business property that has been physically damaged or lost (Bell, n.d.). A business can purchase additional business interruption coverage to protect the business from lost income that might result from the business’ property being physically damaged or lost. Business interruption coverage is designed to compensate a business for the income the business would have generated if the business had been able to operate normally (Bell, n.d.; French, 2020). For example, if a restaurant’s kitchen is damaged by a fire, the standard commercial policy would pay to repair the

kitchen and the business interruption coverage would compensate the restaurant for its lost income until the kitchen was repaired and the restaurant resumed normal operations (Knutsen & Stempel, 2020).

In general, business interruption coverage requires that a business' operations be interrupted by the "direct physical loss or damage" to the business' property (Bell, n.d.). Most courts have interpreted this language to preclude compensation for business income losses that are "unaccompanied by a distinct physical alteration to property" (Bell, n.d., §46.03). In other words, the business must prove that something harmed its property in a way that interfered with the business using its property to earn income (Knutsen & Stempel, 2020). For example, if a restaurant's chef quits, the restaurant might lose business income until it hires a new chef; however, the restaurant's business interruption coverage would not compensate the restaurant for this lost income, because the chef's quitting did not harm the restaurant's property.

THE CASE

On January 1, 2020, the owner of a restaurant ("Owner") in Blackacre County in State Q purchased ABC Insurance Company's ("ABC") standardized commercial insurance policy for \$4,000. The policy covered the period from January 1, 2020 to December 31, 2020, and provided coverage for "all risks" to the restaurant, unless a risk was expressly excluded. The policy did not exclude coverage for viruses or for governmental orders, and the Owner paid an additional premium to include business interruption coverage for lost business income.

On March 3, 2020, the State Q Department of Health reported the first case of COVID-19 in State Q. Beginning on March 17, 2020, the governor of State Q mandated the shutdown of nonessential businesses, including the Owner's restaurant. During the first weeks of the shutdown, the Owner continued to pay its employees; however, the Owner soon ran out of funds and had to lay off its employees.

On April 30, 2020, the owner submitted a claim for the restaurant's lost business income under the ABC commercial property policy's business interruption coverage. On May 8, 2020, ABC notified the Owner that it would not pay the claim, because the Owner's business income insurance did not cover the restaurant's lost income, unless the Owner's property suffered physical damage or some form of physical alteration. ABC noted that the COVID-19 virus did damage or alter the Owner's property, so no coverage existed under the policy.

On June 1, 2020, the Owner closed the restaurant permanently.

On September 21, 2020, the Owner ("Plaintiff") filed a lawsuit against ABC ("Defendant") seeking a judgment that (1) the government-mandated shutdown caused a "direct 'loss' to property" under the language of the Owner's policy, and (2) ABC was responsible for paying the restaurant's lost income.

On November 1, 2020, the Owner filed a Motion for Summary Judgment seeking a judgement on the issue of whether the government-mandated shutdown was a "direct 'loss' to property." To support its motion, the Owner quoted the policy language in its Insurance Services Office ("ISO") Business Interruption Coverage Form and provided citations to standard dictionary definitions for the contractual terms not defined in the policy. In its response to the motion, ABC reiterated its argument that the Owner's business income insurance did not cover the restaurant's lost income, unless the Owner's property suffered physical damage or some form of physical alteration.

ISO Commercial Policy/Business Interruption Coverage Form:

A. Coverage

1. Business Income

...

We will pay for the actual loss of Business Income you sustain due to the necessary “suspension” of your “operations” during the “period of restoration”. The “suspension” must be caused by direct physical loss of or damage to property at premises

...

F Definitions:

...

2. “Operations” means:

a. Your business activities occurring at the described premises...

3. “Period of restoration means the period of time that:

a. Begins:

(1) 72 hours after the time of direct physical loss or damage ...

b. Ends on the earlier of:

(1) The date when the property at the described premises should be repaired, rebuilt or replaced with reasonable speed and similar quality; or

(2) The date when business is resumed at a new permanent location.

...

6. “Suspension” means:

a. The slowdown or cessation of your business activities ...
(Insurance Services Office, 2011).

Standard Dictionary Definitions of “Direct Physical Loss”:American Heritage College Dictionary

(1) “Direct” (adj.) means “proceeding without interruption in a straight course or line; not deviating or swerving ... ; having no intervening ... conditions” (n.d.,

<https://www.ahdictionary.com/word/search.html?q=direct>).

(2) “Physical” (adj.) means “of or relating to material things” (n.d.,

<https://www.ahdictionary.com/word/search.html?q=physical>).

(3) “Loss” (noun) means “the condition of being deprived or bereaved of something” (n.d.,

<https://www.ahdictionary.com/word/search.html?q=loss>).

Merriam-Webster Dictionary

(1) “Direct” (adj.) means “stemming immediately from a source ... ; marked by absence of an intervening ... influence ... ; characterized by close logical, causal, or consequential relationship” (n.d.,

<https://www.merriam-webster.com/dictionary/direct>).

- (2) “Physical” (adj.) means “having material existence: perceptible especially through the senses” (n.d., <https://www.merriam-webster.com/dictionary/physical>).
- (3) “Loss” (noun) means “destruction, ruin ... ; the act or fact of being unable to keep or maintain something ... ; failure to gain, win, obtain or utilize” (n.d., <https://www.merriam-webster.com/dictionary/loss>).

Cambridge Learner’s Dictionary

- (1) “Direct” (adj.) means “going straight from one place to another without turning or stopping ... ; with no other person or thing involved or between” (n.d., <https://dictionary.cambridge.org/dictionary/learner-english/direct>).
- (2) “Physical” (adj.) means “relating to real things that you can see and touch” (n.d., <https://dictionary.cambridge.org/dictionary/learner-english/physical>).
- (3) “Loss” (noun) means “the fact of not having ... something that you had before, or of having less of something than before” (n.d., <https://dictionary.cambridge.org/dictionary/learner-english/loss>).

THE TEACHING NOTE

This case study is based on a judicial opinion stemming from a lawsuit filed by several restaurants over the denial of their insurance claims for lost business income sustained during the government-mandated COVID-19 shutdowns. It is appropriate for use in an undergraduate legal environment of business, business law, commercial law, or insurance law course.

This case study places students in the role of a trial court judge who is interpreting an insurance policy. Students will apply the Plain Meaning Rule and determine the ordinary meaning of “direct physical loss” as it is used in the ISO Business Interruption Coverage Form. Students will also determine whether the government-mandated COVID-19 shutdown caused a “direct physical loss” of the restaurant’s property, which would require the insurance company to compensate the restaurant for its lost business income. This case study also demonstrates how a judge determines whether a contract term is ambiguous and illustrates how a finding of ambiguity in an insurance policy, which is a contract of adhesion, results in the judge’s interpreting the insurance policy against the insurance company.

CASE QUESTIONS

1. What is the legal rule if the meaning of a written contract is clear?
2. Which terms are not defined in this contract? What is the legal rule if a term is not defined in a written contract?
3. Under what circumstances will a court find that a term in a written contract is ambiguous? Is the term “direct physical loss” ambiguous?

4. If one party drafts all of the terms in a contract and the other party must “take or leave” those terms, then what legal rule will a court apply if it finds that a term is ambiguous?

DISCUSSION GUIDE

This case study is based on North State Deli v. The Cincinnati Insurance Company, No. 20-CVS-02569 (N.C. Sup.Ct. Oct. 9, 2020), wherein 16 owners of restaurants in and around Durham County, North Carolina, sued the Cincinnati Insurance Company after it denied their claims for lost business income following the governor’s mandated COVID-19 shutdown of their restaurants. Cincinnati denied the claims based on its reading of the restaurants’ commercial property insurance policy’s business interruption coverage and its finding that business interruption coverage required “direct physical loss” to property and some form of physical alteration to property.

The North State Deli court examined policy language similar to the ISO form presented in this case study. Specifically, the court examined the policy’s requirement that the restaurants’ lost income must relate to the suspension of normal operations caused by “direct physical loss” to property. This phrase was not defined in the policy, and the court consulted standard dictionary definitions of “direct,” “physical” and “loss” to determine the plain or ordinary meaning of the phrase (North State Deli v. The Cincinnati Insurance Co., 2020). After reviewing these definitions, the court held that the term was not ambiguous and that its ordinary meaning included the loss of use of the owners’ restaurants to generate business income, even if there was no structural alteration to the property. The court noted that if Cincinnati’s proffered definition of “direct physical loss” – which required some form of physical alteration to property – was also within the ordinary meaning of “direct physical loss,” then the term would be ambiguous, because the term would have more than one reasonable (ordinary) meaning. The court then noted that when interpreting an insurance policy, which is a contract of adhesion, the court must interpret an ambiguous term against the drafter of the contract, i.e., the insurance company. Based on this analysis, the court ruled in favor of the restaurant owners, finding that the shutdown caused a direct physical loss to the restaurant owners’ property resulting in lost business income (North State Deli v. The Cincinnati Insurance Co., 2020).

1. What is the legal rule if the meaning of a written contract is clear?

The Plain Meaning Rule provides that “[w]hen the language of the contract is clear, the court will presume that the parties intended what they expressed...” (Perillo, 2014, p. 136). The court must accept the language as it finds it and apply that meaning to the case at hand (The Law Dictionary, n.d.). However, in practice, “there is no lawyer’s Paradise where all words have a fixed, precisely ascertained meaning...” and some courts allow “evidence of the surrounding circumstances to aid in interpretation” (Perillo, 2014, p. 136).

2. Which important terms are not defined in this contract? What is the legal rule if a term is not defined in a written contract?

The insurance policy did not define “direct,” “physical,” “loss,” or “damage.” The court in North State Deli stated that the legal rule in North Carolina is that an undefined

contract term is to be given its plain (or ordinary) meaning and that it is appropriate for a court to consult a standard dictionary to determine that meaning (2020). The majority of courts follow this rule (French, 2020; Perillo, 2014).

After reviewing the dictionary definitions provided in the case study, the court in North State Deli found that “direct physical loss” included “the inability to utilize or possess something in the real, material, or bodily world, resulting from a given cause without the intervention of other conditions” (2020, p. 7). The court found that this definition of “direct physical loss” described the restaurant owners’ loss of their “full range of rights” to use or access their restaurants. Notably, the court found no requirement in this definition of “direct physical loss” that the property be structurally altered (North State Deli v. The Cincinnati Insurance Co., 2020, p. 6). The court then found that the COVID-19 government-mandated shutdown prevented the owners from accessing or using their restaurants to generate business income and that the shutdown caused the loss of business income. These findings led the court to hold that the insurance company must compensate the restaurant owners for their lost business income in accordance with the business interruption coverage in the restaurants’ commercial property insurance policy.

3. Under what circumstances will a court find that a term in a written contract is ambiguous? Is the term “direct physical loss” ambiguous?

In North State Deli, the court found that if a term is “reasonably susceptible to more than one interpretation,” then the term is ambiguous (2020). The majority of courts use this definition of “ambiguous” (French, 2020; Knutsen & Stempel, 2020).

In North State Deli, the court found that the plain (or ordinary) meaning of “direct physical loss,” described the restaurant owners’ loss of their use of their restaurants to generate income (2020). In so finding, the court held that “direct physical loss” was not ambiguous. However, the court acknowledged that the parties “sharply dispute[d] the meaning of the phrase ‘direct physical loss’” (North State Deli v. The Cincinnati Insurance Co., 2020, p. 8). The court then briefly examined the defendant’s argument that the definition of “direct physical loss” included “some form of physical alteration to property.” The court found that even if the defendant’s proffered definition was reasonable, then “direct physical loss” had more than one reasonable interpretation “rendering the [p]olicies at least ambiguous” (North State Deli v. The Cincinnati Insurance Co., 2020, pp. 8-9).

Note, the majority of courts that have addressed the plain meaning of “direct physical loss” have also found that the term was not ambiguous. However, those cases have found that the ordinary meaning of the term includes the requirement of some form of physical alteration (or damage) to property (Knutsen & Stempel, 2020).

4. If one party drafts all of the terms in a contract and the other party must “take or leave” those terms, then what legal rule will a court apply if it finds that a term is ambiguous?

Insurance policies are contracts of adhesion; they are “take it or leave it” contracts. The insurance industry drafts the language in insurance policies and businesses must either “take” the policy language as it is written or “leave it” (French, 2020;

Thomas, n.d., §5.01). Businesses do not negotiate the language in their commercial insurance policies. Instead, they pay a premium based on the coverages they choose to include or exclude from the policy (Knutsen & Stempel, 2020; Thomas, n.d., §5.02). In this case, the restaurant's owner did not negotiate the policy language. Instead, the owner purchased a standardized commercial insurance policy and paid an additional premium for business interruption coverage.

When interpreting a contract of adhesion, a court must interpret an ambiguous term against the drafter of the contract (French, 2020; Jerry & Richmond, 2018). In other words, if the court finds that a term in an insurance policy is ambiguous, the court must interpret the term against the insurance company, the drafter of the policy language, and in favor of the insured (North State Deli v. The Cincinnati Insurance Co., 2020).



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