COVID-19: CONSIDERING THE WIDER IMPLICATIONS OF THE FCA'S TEST CASE

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Insurance Alert

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The Financial Conduct Authority v Arch Insurance and Others [2020] EWHC 2448 (Comm)

BACKGROUND TO THE TEST CASE

In June 2020, the FCA issued proceedings against a group of insurers in a test case designed to clarify the interpretation and application of commonly-used insurance coverage extensions under Business Interruption insurance policy wordings, in the context of losses arising from the COVID-19 pandemic. We have written previously about the anticipated scope and potential effect of this important test case.[1]

The Test Case proceedings recognised that, generally speaking, most Business Interruption insurance policies are predicated on the occurrence of physical damage and, therefore, losses arising from COVID-19 were unlikely to trigger cover. However, many policyholders purchase extensions of cover which do not require damage (non-damage extensions) which formed the focus of the FCA's test case, specifically those which provide cover for business interruption resulting from an outbreak of disease (disease cover), or from an inability to use or access insured premises (denial of access cover).

Following an eight-day trial conducted in early August, Lord Justice Flaux and Mr. Justice Butcher handed down their eagerly anticipated judgment on 15 September 2020.[2] The decision, which runs to over 160 pages, and considers 21 different policy wordings, underwritten by eight different insurers, found in favour of policyholders on many of the key issues, in particular in respect of coverage triggers under most disease covers and hybrid disease/denial of access clauses as well as in relation to causation issues and so called “trends clauses”. The judgment has been widely reported as a promising decision for policyholders, many of whose claims for COVID-19 losses had initially been rejected by insurers. Much has been written, and will be written, in coming weeks and months, about the specific implications of the case in relation to claims under disease cover and denial of access extensions arising from COVID-19. In this alert, we consider the potentially wider repercussions of the decision for corporate buyers of insurance, which are likely to be felt beyond the immediate scope of COVID-19 claims.

Naturally, each insurance claim depends on the specific policy wording and relevant underlying facts, but nonetheless this decision will have significance for many different policyholders.

Larger, or International Policyholders

First and foremost, when the FCA commenced the Test Case, it was stated to be limited in scope to insurance policies purchased by small- and medium-sized enterprises (SMEs), whose business operations were based in the United Kingdom. Further, the Test Case was concerned only with claims for loss of revenue, loss of profits and increased costs of working (at the exclusion of claims for, for example, loss of rent).

Despite this apparently limited scope, it has been recognised that the judgment may impact other policyholders regardless of size, location or sector. Many of the arguments and principles adopted by the Court may prove to be more wide-ranging in their effect.

As a result, larger corporate policyholders should consider whether their coverage position is made more favourable by the Commercial Court's decision. Similarly, insureds that have premises outside of the UK but which are insured in the London market should consider the facts and circumstances affecting each of their premises. Regardless of location, the decision may provide clarity on the evidential and contractual thresholds necessary to trigger cover.

Policy Interpretation

The decision provides a helpful summary of the generally applicable principles of policy interpretation. While this summary does not materially change well-established principles applicable to policy interpretation, insureds will find it helpful to have a clear précis of those principles. Often, in contentious coverage claims, insurers have been known to adopt a literal approach to policy interpretation that can be unfavourable to the insured. This often conflicts with the insured's expectations about the scope and levels of coverage purchased.

The principles outlined in this judgment serve to highlight the fact that the literal approach often adopted by insurers does not always provide the complete answer. Policyholders should feel emboldened to argue for more pragmatic and commercially reasonable interpretation of their policy wordings. Insureds may well wish to question denials of cover more widely.

Application of General Exclusions

One insurer sought to rely on a General Exclusion for “Contamination or Pollution,” which was incorporated into one of its standard policy wordings. In particular, the insurer argued that this General Exclusion had the effect of excluding cover explicitly provided for under a disease-related extension to the same policy wording. The Court concluded that this General Exclusion was one which had been “included without detailed consideration.” The Court determined that it was unreasonable to interpret the policy wording in a way which suggests the insurance “to be expressly giving cover with one hand and taking it away by the other.”

This is a good example of the Court being unwilling to adopt the insurer's literal interpretation of the policy wording, particularly where this creates an obvious inconsistency. The finding may be of relevance to other types of insurance dispute, where insurers contend that express coverage is excluded by general exclusion clauses, particularly those which cover a range of matters. The Court has signaled its disapproval of “the absurdity, and potential unfairness, of an express grant of cover being eliminated by a General Exclusion.”

Proof of Loss and Evidential Requirements

Many disease-related extensions of cover are expressed to require an occurrence of a notifiable or specified disease within a specific radius of an insured premises. Some insurers have argued that such a provision places an obligation on the insured to prove that there has been an actual, diagnosed case of COVID-19 within the specified radius. This is a challenging burden, and one which could be difficult to meet due to practical and scientific limitations.

The Court adopted a more pragmatic and policyholder-friendly approach which largely rejects the restrictive and literal approach to proving the availability of cover promoted by the insurers. It held that for there to have been an “occurrence” of a disease, it was not necessary for the case to have been diagnosed. Instead, a disease “occurs”

when the illness is “sustained” by a person, “which we consider means, in simple terms, that they are suffering from it, not that they have been diagnosed with it.” This is crucial for policyholders claiming in the context of COVID-19, in circumstances where testing was limited and hospital attendance discouraged.

The Court did not make any findings of fact as to where COVID-19 had occurred or manifested. This has to be proven on a case by case basis, but it is worth noting that the insurers conceded that the categories of evidence put forward by the FCA (including specific evidence, reported cases and medical data) are in principle capable of demonstrating the presence of COVID-19 within a particular area. The Court supported a variety of techniques designed to counterbalance any suggestion that relevant data is incomplete. For example, the judgment endorses the use of averages, and establishing an “undercounting ratio” (i.e. the assumption that the disease may have occurred more frequently or widely than the data collection methods were capable of accounting for). This practical approach by the judges is to be welcomed not least because it could assist policyholders in other contexts. The Court has shown itself willing to take a pragmatic approach to evidence which may assist insured's going through other crisis scenarios.

TRENDS CLAUSES

Trends clauses are commonly incorporated in Business Interruption policies to adjust the amount of cover available to the insured depending on prevailing factual circumstances. In practice, a trends clause typically requires the imagining of a hypothetical counterfactual in which the insured peril had not occurred. In crude terms, the difference between the insured's hypothetical revenue or profits, and actual revenue or profits equals the value of the insured's losses and thus the amount that can be recovered under the policy.

In the context of the FCA test case, the insurers argued that, even if coverage is triggered under notifiable disease (or denial of access) clauses, the application of so-called “trends clauses” means that adjustments must be made for the wider effects of the pandemic and/or other government actions such as social distancing and the general lockdown. The net result of the insurers' argument was that the trends clause would negate the benefit of any cover available under the relevant insuring clause.

The Court concluded that trends clauses in general provide the quantification machinery for a claim, so that it is not part of the delineation of cover, but part of the machinery for calculating the business interruption loss on the basis that there is a qualifying insured peril. The object of the quantification machinery (including any trends clause) is to put the insured in the same position it would have been in if the insured peril had not occurred. The Court found it would “seem contrary to principle” for that loss to be limited by the inclusion of any part of the insured peril in the assessment of what the position would have been if the insured peril had not occurred. Given the purpose of the trends clause is to put the insured in the position it would have been if the insured peril had not occurred, this meant stripping out of the counterfactual those elements found to be included within the insuring clause.

CAUSATION: THE LEGACY OF ORIENT-EXPRESS HOTELS

A crucial aspect of the Court's decision relates to its findings about causation, which is of particular relevance in the context of Business Interruption insurance. Insurers placed significant reliance on one leading case, *Orient-Express Hotels v Assicurazioni General*[3] in support of their arguments on causation and trends clauses. Ultimately, the Court found that issues of causation were sufficiently addressed by their construction of the policy

wordings and that the Orient-Express could be distinguished on the facts. Nevertheless, the, Court felt obliged to consider the case given the reliance placed on it by the insurers.

Policyholders have long faced challenges in their Business Interruption claims due to the precedent set in Orient-Express, albeit that the case has been the subject of widespread criticism. In that case, the policyholder was the owner of a luxury hotel in New Orleans. In anticipation of a hurricane in September 2005, New Orleans was subjected to a curfew and the city was evacuated. When the hurricane struck, the hotel, along with much of the city, was badly damaged and the hotel was forced to close for several months, incurring business interruption losses.

Insurers argued that the policy should only the put the hotel owner in the financial position it would have been in had the insured peril not occurred. They construed the insured peril narrowly, to just mean damage to the hotel itself, disregarding the hurricane and its wider effects. Thus, insurers argued, the counterfactual should imagine what position the policyholder would have been in had it owned an undamaged hotel, in an otherwise hurricane-damaged and evacuated city. The practical effect of this decision was that, in the hypothetical scenario, it was assumed that the hotelier would nevertheless have suffered a drastic reduction in business, and thus the Business Interruption losses caused specifically by the insured peril were zero.

Ten years since the decision in Orient-Express, Flaux LJ and Butcher J have identified “several problems with the reasoning” and stated that, had they considered the case to be relevant, they would have declined to follow it. They recognised that a narrow approach to identifying the insured peril is unrealistic and leads to the bizarre outcome in which “the worse the fortuity which befalls the insured and the vicinity of the insured's premises, the less the insurance responds, [which] cannot have been intended.”

CONCLUSION

Every claim for Business Interruption losses, whether or not arising as a result of COVID-19, will turn on the specific policy wording and the relevant facts. Policyholders will need to assess the impact of the judgement with reference to their own policy cover and specific loss scenario. Nevertheless, the decision of Flaux LJ and Butcher J in the FCA's Test Case is a pragmatic and comprehensive one. It provides some helpful guidance for policyholders seeking to navigate crisis scenarios and addresses some historic imbalances in the way that Business Interruption claims are assessed and quantified.

The judgment is likely to be subject to an appeal to the UK Supreme Court, and further details about the scope of issues to be appealed are expected in the coming weeks.

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FOOTNOTES

[1] COVID-19: FCA Files Business Interruption Insurance Test Case

[2] England and Wales High Court (Commercial Court) Decisions

[3] *Orient-Express Hotels Limited v Assicurazioni General S.p.A. (UK Branch) t/a Generali Global Risk* [2010]

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