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Judgment in FCA's COVID-19 Business Interruption Insurance Test Case

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The High Court of England and Wales has recently handed down judgment in the highly anticipated COVID-19 Business Interruption Test Case, *The Financial Conduct Authority v Arch and Others*.[1] The test case is significant for a number of reasons, not least because of the potential impact for the insurance coverage available to SME businesses across the U.K. for losses arising from the COVID-19 pandemic. For litigators, the case holds particular interest, as it is the first time that a case has been brought on an expedited basis by the U.K. Financial Conduct Authority ("**FCA**") under the Financial Market Test Case Scheme set out in Practice Direction 51M of the Civil Procedure Rules (the "**Scheme**"). It is also interesting to note that permission was sought, and given, for the case to be heard by two highly experienced judges sitting together, Lord Justice Flaux and Mr Justice Butcher.

Although unusual in normal circumstances, the two-week hearing was conducted remotely via Skype in accordance with the High Court's current procedures for virtual hearings during the pandemic.

Speed-read

- Many policyholders with business interruption coverage who had expected their losses arising out of the COVID-19 pandemic to be covered by insurers have faced obstacles when asserting a claim. As a result, the FCA decided to use its authority to seek the court's determination of a test case brought containing a sample of 21 pre-selected clauses used by eight insurers.
- The court found for the FCA on the majority of the issues of interpretation. The FCA has estimated that some 700 policies across 60 insurers and 370,000 policyholders could potentially be affected by the test case. Although the judgment will be welcome news for many policyholders, it does not conclude that insurers would be liable across all 21 representative wordings considered. Each policy will still need to be reviewed carefully alongside the detailed judgment in order to determine liability.
- This is the first case brought under the Scheme and it has given rise to a number of interesting procedural points that are outside the norm for High Court litigation:
  - The number and range of pre-action steps was unusual: the FCA developed a framework agreement, in conjunction with participating insurers, which would govern the scope of the proceedings which stated that the FCA and defendant insurers had a ***"mutual objective of achieving the maximum clarity possible for the maximum number of policyholders and their insurers"***.

  - The case was heard by two judges—Flaux, LJ (a Lord Justice of Appeal) and Butcher, J (a Financial List judge)—as this was a case of particular urgency and importance.
  - The FCA sought for the trial to be expedited. As a result, the claim form was issued on 9 June 2020 and trial was scheduled for eight days from 20 July 2020—a mere 6 weeks later—an incredibly short time for such a case to be brought to trial.
- Given the success of its first test case under the Scheme, it is possible that the FCA may seek to use it more frequently for issues of general public importance and impact significant numbers of businesses or individuals. If so, we may expect that a similarly open and transparent approach will be taken to future cases.

Background

Business interruption insurance generally covers loss of profits and additional expenses suffered by a business as a result of insured damage. Insured damage usually includes physical damage to premises or property, but many policies also include extensions of cover for non-physical damage. In this case, it was non-physical damage, caused by the COVID-19 pandemic, that was considered.

Business interruption policies generally contain detailed provisions that set out how any loss of profits suffered by a business is to be quantified. Quantification is usually carried out by reference to trends clauses that set out a process for analysing the counterfactual development of the business if the loss had not occurred.

It has been well documented that a number of policyholders with business interruption coverage who had expected their losses arising out of the COVID-19 pandemic to be covered by insurers have either had their claims denied or otherwise been faced with a number of obstacles when asserting a claim. These problems have resulted from the wide variety of policies in the market and the fact that, at the point of drafting, they did not contemplate the all-consuming nature of the pandemic and the widespread, interventionist government response. As a result, in many cases, the contractual wording in such policies does not sit very happily with recent events. In the meantime, many businesses faced existential threats due to unprecedented interruption to their business, consequential loss of income and unexpected costs. Insurers faced corresponding claims of daunting magnitude from thousands (and potentially hundreds of thousands) of policyholders. In the face of such huge challenges, battle lines were quickly drawn and the prospect of years of entrenched litigation seemed inevitable.

As a result, the FCA, as regulator of the defendant insurance companies, decided to use its authority to bring a test case for the first time since the Scheme was put in place, in order to seek the court's determination of issues concerning policy coverage in respect of a sample of 21 pre-selected business interruption insurance clauses that had been used by eight separate insurers.

Two consumer action groups—the 'Hiscox Action Group' and the 'Hospitality Insurance Group Action' – were given permission to intervene on behalf of certain policyholders and present additional arguments to those put forward by the FCA. With the co-operation of the insurers, an agreed protocol was devised in order for the key issues to be determined without what would otherwise have been very significant cost and delay. Broadly speaking, the FCA, representing the interests of policyholders, argued that two types of policy wordings should provide coverage for policyholders for business interruption losses arising out of the pandemic: (i) 'disease' wordings (i.e., coverage for business interruption in consequence of, or following, the occurrence of a notifiable disease within

a specified radius of the insured premises); and (ii) 'denial of access' wordings (i.e., coverage where there has been a prevention or hindrance of access to, or use of, the premises as a result of government restrictions).

The issue with 'disease' wordings is that the clauses envisioned a local occurrence of a notifiable disease, such as one instance within a mile of the premises. However, these local outbreaks were almost impossible for policyholders to distinguish from the trans-local effects of, and responses to, the pandemic.

The issue with many of the 'denial of access' wordings was whether the respective government announcements were mandatory instructions or effectively just advice. For some businesses, closure was not mandated by government direction, but instead forced upon them as a matter of viability; for example, restaurants unable to offer a take-away only service when their sit-in offering became prohibited under the government's lockdown. Businesses grappling with such economic realities faced serious hurdles to coverage claims. There were also some 'hybrid' wordings that were engaged by restrictions imposed on the premises following the occurrence of a notifiable disease. The issue with these wordings was similar to that posed by the 'denial of access' wordings; namely, whether the government announcements constituted mandatory instructions or mere advice.

The FCA also had to overcome the problematic decision of *Orient Express Hotels Ltd v Assicurazioni Generali SpA*,[2] which the insurers relied on to support their case. The *Orient* decision arose out of claims submitted by an hotel due to the damage caused by Hurricanes Katrina and Rita. The claim for physical damage to the hotel was not disputed by insurers but, when it came to the hotel's claim for business interruption losses, insurers argued that there was no coverage because, even if the hotel had been undamaged by the hurricane, it would have suffered business interruption in any event as the devastation to the local area meant there was no tourism. The High Court held (on appeal from an arbitral tribunal) that this counterfactual was the correct application of the causal test.

In the present case, insurers sought to rely on the *Orient* decision to argue that the trends clauses in their policies operated in a similar way, i.e., with the insured peril being the occurrence of the disease and the counterfactual including the government advice to 'stay at home', such that the interruption to the business would have occurred even if there had been no occurrence of the disease in the local area. If such arguments were successful, the quantum of policyholders' claims would have been reduced to a negligible amount in many instances.

Judgment

The court found for the FCA on the majority of the issues of interpretation. However, this is not to say that all 21 wordings afforded coverage in all circumstances.

The full judgment is complex and highly detailed, but the main conclusions can be summarised as follows:

The 'disease' policy wordings (eight sample wordings)

The court held as follows:

- The court agreed with the FCA that the outbreak of the disease could not be separated into local occurrences and was indivisible. The court's conclusion, therefore, avoided the anomalous results that would follow from the argument put forward by the insurers that ***"there would be no effective cover if the local occurrence were a part of a wider outbreak and where, precisely because of the wider outbreak, it would be difficult or impossible to show that the local occurrence(s) made a difference to the response of the authorities and/or public"***.

- The outbreak of the disease within the relevant radius was the threshold for coverage to apply—triggered from the point in time when there were cases in the area (the test being whether the cases were diagnosable, regardless of whether they were actually diagnosed).

- However, in relation to two of the sample wordings contained in policies taken out with QBE Insurance, the court took a different approach. These wordings provided cover for ***"Loss resulting from interruption of or interference with the business in consequence of any of the following events: any occurrence of a notifiable disease within a radius of 25 miles of the premises"*** (emphasis added). The court considered that the wordings only envisaged coverage for a specific localised event because of the use of the words ***"in consequence of"*** together with ***"events"***, which have a specific meaning in insurance contracts. In particular, the term ***"event"*** has been defined in case law as something occurring at a particular time, in a particular place and in a particular way.[3] This may be of some assistance to an insured during the present localised lockdowns but will likely be fatal to a claim arising from the countrywide lockdown.

The 'denial of access' wordings (eight sample wordings)

The court held as follows:

- Where the policy wording specified a location and nature of the emergency/incident (e.g., ***"emergency in the vicinity"***), this connoted something specific that happened at a particular time and in the local area and was consequently intended to provide narrow localised cover. Therefore, for coverage to apply, the action of the relevant authority would have to be in response to the localised occurrence of the disease.

- An action by an authority that prevents access requires steps that have the force of law. It must convey a restriction that is mandatory and not merely advisory. Accordingly, government advice (such as that issued on 23 March 2020 when lockdown was announced) would be insufficient, but once this advice was given the force of law on 26 March 2020, it would trigger coverage.

- Where ***"prevention"*** of access is required, there must have been a closure of the premises for the purposes of carrying out the business.

- ***"Interruption"*** does not mean a complete cessation of business; it includes both disruption and interference to business.

- Consequently, coverage under a 'denial of access' policy wording will turn very closely on the actual wording of the policy and the circumstances faced by each policyholder. If the business was not mandated to close, but was simply impacted by the general 'stay-at-home' requirements, it would likely struggle to obtain coverage under this form of wording.

Hybrid Wordings (five wordings)

The court held as follows:

- The court took a similar approach to the 'disease' part of the clause and rejected insurers' arguments that the coverage should only respond to local outbreaks.

- As with the 'denial of access' wordings, the court construed the 'denial of access' part of the clause restrictively, holding that ***"restrictions imposed by a public authority"*** require a mandatory restriction and ***"inability to use"*** requires something more than an impairment of normal use.

'Trends' clauses

The court held as follows:

A trends clause is included within a policy to assist the policyholder and insurer in agreeing what the relevant counterfactual would be, had the insured damage not occurred. Accordingly, the purpose of a trends clause is to ensure that the policyholder is put in the position they would have been in but for the interruption. For example, a policyholder whose business was interrupted due to a cyber-attack in April 2020 would not simply be able to rely on financial results from April 2019 as proof of its likely losses. The trends clause would dictate that the trends of the business and the wider market must be considered in light of the COVID-19 pandemic and so the losses from the cyber-attack would have less of an impact on profit than it otherwise might.

The court held that the issues of causation followed from construction of the wordings and, therefore, *Orient* could be distinguished. However, the court did analyse the *Orient* decision (given how heavily it was relied on by insurers) and, in its view, the court in *Orient* had misidentified the insured damage by treating the damage to the local area as the insured peril, rather than the hurricane itself. The court also noted that it would be an absurd result if for more serious and widespread insured events, it was permissible for insurers to include within the counterfactual some aspect of the insured event, with the consequence that less coverage was ultimately available to the policyholder.

The court held that, in order to determine the trends of the business and the wider market, the insured damage must be completely removed from the counterfactual. Therefore, the extent of the insured damage becomes a vital question. Insurers contended that the insured damage should be defined narrowly, to only the local occurrence of COVID-19. The court had little sympathy for this argument. Consequently, the occurrence of the disease and the reaction of the public authorities should not be considered as part of the counterfactual for the purposes of quantifying loss.

Comment

The eight defendant insurers all consented to participate in the test case following the agreement of a carefully developed case protocol that was devised before proceedings were issued. The FCA and insurers agreed upon 21 sample wordings as representative of the coverage available in the wider market. The FCA has estimated that, in addition to the 21 wordings opined on, some 700 policies across 60 insurers and 370,000 policyholders could potentially be affected by the test case. Although the judgment will be welcome news for many policyholders, it does not conclude that the defendant insurers would be liable across all 21 representative wordings considered by the court. Each policy will still need to be reviewed carefully alongside the detailed judgment in order to determine liability. What the judgment has achieved, however, is to resolve some key contractual uncertainties and prevent each individual policyholder from going through the same arguments with insurers, no doubt at great trouble and expense during what is already a very challenging time.

The FCA has already indicated that there remains scope for appeal by the defendant insurers and permission has been granted by the High Court for a leapfrog appeal to the Supreme Court on a number of grounds. However, it has noted that, at this stage, the parties are still in discussions to see if an appeal can be avoided.

Whilst we await a decision in this regard or on any appeal, it is worth reflecting on the fact that this is the first case brought under the Scheme and has given rise to a number of interesting procedural points that are outside the norm for High Court litigation:

- First, the number and range of pre-action steps was unusual. In overview, the FCA issued a statement setting out its intention to obtain court declarations aimed at resolving the issues of contractual interpretation that it knew many policyholders were facing in relation

to their business interruption claims. Alongside this, it approached a number of insurance companies requesting information on their business interruption cover in order to determine which policy wordings it would seek to include in its sample. The FCA then opened up the proposed sample wordings, assumed facts, a matrix of issues and questions for determination by the court to public consultation. From there, eight of the insurers that the FCA approached agreed to take part in the test case and the FCA developed a framework agreement in conjunction with those insurers that would govern the scope of the proceedings. This agreement stated that the FCA and defendant insurers had a ***"mutual objective of achieving the maximum clarity possible for the maximum number of policyholders and their insurers"***. All of this took place before service of the claim form.

- Second, and in line with the ***"mutual objective"***, the defendant insurers supported the FCA's application for the case to be heard by two judges as provided for by the Scheme, as this was a case of particular urgency and importance. As such, the case was heard by both Flaux, LJ (a Lord Justice of Appeal) and Butcher, J (a Financial List judge).

- The FCA also sought for the trial to be expedited (again supported by the defendant insurers) and this application was granted. As a result, the claim form was issued on 9 June 2020 and the trial was scheduled for eight days from 20 July 2020—a mere six weeks later. Of course, the case did not involve large-scale disclosure, or require factual or expert witness evidence, but it was nevertheless an incredibly short time for such a case to be brought to trial.

Given the success of its first test case under the Scheme, the FCA may seek to use it more frequently for those issues which are of general public importance and impact significant numbers of businesses or individuals. If the FCA does make more use of the Scheme, we may expect that a similarly open and transparent approach will be taken to future cases. The advancing of a mutual objective is not the usual object of adversarial litigation and (quite rightly) a different approach was taken in the current case to ensure that the decision obtained was sufficiently broad and inclusive to assist as many impacted policyholders as possible.

This was only achieved in such a short time frame as a result of the consultative and collaborative approach adopted by the FCA and with the co-operation of the insurers who are to be commended for the way in which they embraced the process.

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[1] [2020] EWHC 2448 (Comm).

[2] [2010] EWHC 1186 (Comm).

[3] For example see *Axa Reinsurance v Field* [1996] 1 WLR 1026.

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