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Solicitors

Client Briefing on the FCA Test Cases in the Supreme Court

Dear Clients and Contacts,

Introduction

The Supreme Court on 15th January 2021 provided a landmark decision on the business interruption ("BI") coverage issues arising out of COVID-19, rejecting insurers appeals and accepting the FCA's appeal with some restrictions, from the First Instance decision of Flaux LJ and Butcher J.

Key Findings

The key findings in favour of Insureds relate to:

1. broader cover under the interpretation of the disease clause;
2. reduced requirements for prevention of access cover which can include partial loss of access and BI cover for partial trading;
3. limitations on the causal link required between BI losses and the occurrence of the disease;
4. limitations on the application of the trends of the business clause in relation to the quantification of BI losses;
5. the recovery of pre-trigger losses based on the downturn in business before the imposition of trading restrictions; and
6. overturning the application of the *Orient Express Hotels* decision to limit BI recoveries based on the post occurrence general reduction in trade, the so-called Wide Area Damage theory of non-coverage.

This is a significant victory for the FCA and the Action Groups who intervened. The judgment is of considerable importance to buyers, intermediaries and sellers of insurance and reinsurance impacted by COVID-19 business interruption losses. This decision also has broader implications for insurance policy interpretation generally and BI insurance specifically as in respect of the latter, this is the first time that some of these issues have been considered by the Supreme Court. It is also a landmark decision because it makes significant new law on concurrent causation.

This decision is also likely to lead to significant s.13 Insurance Act 2015 claims for losses caused to insureds as a result of non-payment of their COVID-19 related BI claims. This is an undeveloped area of law since the new causes of action were introduced into law by an amendment to the Insurance Act 2015 through the Enterprise Act 2016.

The FCA argued for policyholders that the 'disease' and 'prevention of access' clauses in the representative sample of 21 policy types provide cover in the circumstances of the coronavirus (COVID-19) pandemic and that the trigger for cover caused policyholders' losses.

The High Court's judgment last September said that most of the disease clauses and certain prevention of access clauses (12 policy types from the sample of 21, issued by six insurers) provide cover and that the pandemic and the Government and public response caused the business interruption losses. The six insurers appealed those conclusions for 11 of the policy types, but the Supreme Court has dismissed those appeals, for different reasons from those of the High Court.

On the FCA's appeal, the Supreme Court ruled that cover may be available for partial closure of premises (as well as full closure) and for mandatory closure orders that were not legally binding; that valid claims should not be reduced because the loss would have resulted in any event from the pandemic; and that two additional policy types from insurer QBE provide cover. This will mean that more policyholders will have valid claims and some pay-outs will be higher.

Disease Clauses

Disease Clauses respond to business interruption losses resulting from cases of disease, which occur within a specified local radius. Each individual case of COVID-19 amounts to an effective proximate cause of the Government's restrictions, the result being that disease clauses respond to a broader range of losses caused by the pandemic (including losses consequential upon national restrictions).

The Supreme Court focused on the wording of the Disease Clause in a Royal & Sun Alliance policy, which they regarded as an exemplar. This clause (like many other Disease Clause wordings) covers business interruption losses resulting from any occurrence of a notifiable disease within a specified geographic radius of the insured premises.

The High Court interpreted this type of wording as covering business interruption losses stemming from the COVID-19 pandemic provided there had been an occurrence (meaning at least one case) of the disease within the specified geographical radius.

The Supreme Court took a narrower approach to identify the insured peril or trigger in disease clauses, focusing on individual occurrences, but because it found that such individual occurrences could as a matter of law satisfy the test of causation (along with all other such occurrences) the conclusion that there was cover under the disease clauses was confirmed.

Prevention of Access and Hybrid Clauses

Prevention of Access Clauses typically provide cover for business interruption losses resulting from public authority intervention preventing access to, or use of, the insured premises. Hybrid Clauses combine certain elements of Disease Clauses and Prevention of Access clauses.

These clauses were construed broadly with the Supreme Court's interpretation allowing for expansive cover. For example, terms such as "restrictions imposed" included Government instructions regardless of whether they had been incorporated into an accompanying regulation. Additionally, a policyholder will have an "inability to use" premises where they are unable to use/access a discrete part of their premises (as opposed to complete prevention).

The Court agreed that inability rather than hindrance of use of the premises must be established but found that this requirement may be satisfied where a policyholder is unable to use the premises for a particular activity or is unable to use a part of the business premises. While the Court acknowledged that all cases would be fact-specific, they gave the example of a department store, which had to close all parts of the store except its pharmacy as one involving the inability to use a discrete part of the premises. The Court interpreted clauses requiring "prevention of access" in a similar manner i.e. it could cover prevention of access to a discrete part of the premises or for the purpose of carrying out a discrete part of the business activities.

The Supreme Court confirmed that prevention of access/hybrid clauses will be triggered more readily than at first instance – there is no requirement for an actual legislative step ordering closure, and equally losing access for the purposes of a part of a business or access to a part of premises may suffice. On causation, the “source” event (i.e. the COVID-19 pandemic) will not be a competing cause when assessing if the insured has established causation and hence Insurers’ arguments as to the competing causes of loss were rejected.

Causation /“But for” Test

It was the insurers' position that a policyholder was required to evidence that a loss would not have resulted *but for* the occurrence of the insured peril. Because the effects of the pandemic were so pervasive across society, insurers contended that policyholders would have suffered the same loss regardless of whether they could point to an occurrence of COVID-19 or not.

In an important part of the ruling, the Supreme Court rejected the insurers' argument and explained why the "but for" test of causation is sometimes inadequate and noted, in summary, that there can be situations (such as the current pandemic) *"where a series of events all cause a result although none of them was individually either necessary or sufficient to cause the result by itself"*. Upon reaching this conclusion, the Supreme Court proceeded to dis-apply the "but for" test in relation to the clauses in dispute and instead reiterated the importance of the principle of proximate causation, which they noted was the general approach to the question of causation in both marine and non-marine insurance alike. Importantly, the Supreme Court acknowledged that the presumption of proximate causation can be expressly displaced by policy language, but it is rare for the test for causation "*to turn on such nuances*". Previously the position was that the "but for" standard could be relaxed where that was required by "fairness and reasonableness" but this ruling now goes a step further.

Concurrent Cause

When discussing the applicability of the proximate cause test, the Supreme Court turned to issues surrounding concurrent causes of loss, namely:

- Where there are two proximate causes of loss, neither of which are subject to an exclusion, but only one of which is expressly insured, insurers shall be liable for the loss (*Miss Jay Jay* [1987] 1 Lloyd's Rep 32); and
- Where there are two proximate causes of loss and one of those is an insured peril but the other is expressly excluded, the exclusion will usually take precedence (*Wayne Tank* [1974] QB 57).

Whilst this view of concurrent proximate causes has usually been limited to circumstances where there are two competing interdependent causes of the loss (i.e. in circumstances where the losses would not have occurred had one of those causes not been present), the Supreme Court considered that there was no reason why such an analysis cannot be applied to multiple causes which act in combination to bring about a loss.

Applying this to the pandemic, the Supreme Court considered that whilst any individual case of illness resulting from COVID-19 could on its own have caused the Government to introduce restrictions, it was the case that the restrictions came about in response to information about all the cases of COVID-19 in the country as a whole. They agreed with the High Court in noting that *"it is realistic to analyse this situation as one in which all the cases were equal causes of the imposition of national measures"*. So, each case of COVID-19 (of which there were potentially hundreds of thousands in the UK) was a separate cause, subject to vicinity provisions.

The Supreme Court did, however, accept that questions around causation become more difficult when the number of separate events that combine to bring about loss is multiplied many times over. Notwithstanding this observation, the Supreme Court could find nothing in principle which precludes an insured peril, in combination with many other similar uninsured events, being seen to bring about a proximate cause of a loss, even where the insured peril is neither necessary nor sufficient to bring about the loss by itself. However, in making a final determination as to whether the required causal connection has been satisfied, the ultimate determination needs to be made by reference to the policy wording and what has been agreed by the parties (which shall be a matter of contractual interpretation).

Trends Clauses

Trends Clauses are intended to address losses wholly outside the insured peril; matters inextricably linked to the insured peril or the source of the insured peril are not trends and do not fall to be taken into account.

Most of the policies considered in the test case included "trends clauses" which provide for business interruption losses to be calculated by adjusting the results of the business in the previous year to take account of trends or other circumstances affecting the business, in order to estimate the results that would have been achieved if the insured peril had not occurred.

The Supreme Court determined that these clauses are part of the machinery included in the policy for the purpose of quantifying loss and should not be interpreted so as to reduce the cover provided by the relevant insuring clause. It follows that the trends and circumstances upon which the adjustments are based must not include circumstances arising out of the same underlying cause as the insured peril.

This means that any factors or effects relating to or stemming from the COVID-19 pandemic should be disregarded when assessing trends or circumstances impacting the business for the purpose of calculating business losses to be indemnified by insurers.

The Supreme Court considered that the proper use of 'trends' clauses (which are designed to allow adjustment of losses to reflect what those losses would have been if the damage had not occurred) was not to alter the scope of cover, but rather to assist purely with the quantification of loss. When quantifying the loss, a trends adjustment cannot be applied to any circumstances having the same originating cause as the insured peril. As a result, no global effects of the pandemic can be factored into the machinery of quantification once cover has been triggered. This does not prevent insurers from taking into account previous circumstances that have a bearing on turnover, but which are unconnected with the insured peril and do not arise from the same underlying fortuity.

Pre-trigger Losses

At first instance, the High Court held that. if there was a measurable downturn in the turnover of a business due to COVID-19 before the insured peril was triggered, then in principle the continuation of that measurable downturn and/or increase in expenses could be taken into account as a trend or circumstance affecting the business in calculating the loss to be indemnified.

The Supreme Court disagreed with this conclusion and asserted that the above principles in relation to trends clauses apply to pre-trigger downturns in revenue. This means that only circumstances affecting the business which are unrelated to the insured peril and its underlying cause (in this case COVID-19) are permitted to be used when reducing the amount of loss. The Court gave the example of a public house suffering a downturn just prior to the UK Government's instructions in relation to COVID-19 due to public concern about the disease. The Court stated that the insurer's indemnity should be calculated by reference to what would have been earned by the business had COVID-19 not occurred, disregarding any revenue drop prior to the UK Government's instructions that resulted from COVID-19.

Consistent with its approach to causation and the appropriate application of the "trends" clauses, the Supreme Court held that the indemnity payable for business interruption loss sustained after cover was triggered should not be reduced to reflect any downturn in the turnover of the business due to COVID-19 and which would have continued even if cover had not been triggered by the insured peril. In calculating the loss, an assumption should be made that pre-trigger losses caused by the pandemic would not have continued during the operation of the insured peril.

***Orient Express Hotels v Assicurazioni General [2012]* case**

Of particular note also to the insurance industry more generally, the Supreme Court has determined that the *Orient Express* case was wrongly decided and that it should be overruled thus going further than the High Court who merely indicated that they would not have followed it if it was relevant.

The *Orient Express* case was relied on heavily by the insurers in the test case in support of its arguments on causation of loss and the effects of trends clauses.

Orient Express concerned a claim for business interruption losses arising from hurricane damage to a hotel in New Orleans. The claim was made under an all risks property damage policy which contained a trends clause which had similar wording to those considered in the test case. The case was considered by the High Court on appeal from an arbitration tribunal, the appeal being limited to questions of law arising out of the arbitral award. The case was decided by a member of the Supreme Court panel and another member of the panel served as one of the three arbitrators. Cover was confirmed for the physical damage to the hotel but, when it came to business interruption losses, the arbitration panel (and the High Court) accepted the insurers' argument that the cover did not extend to business interruption losses which would have been sustained in any event, as a result of hurricane damage to the city of New Orleans, even if the hotel itself had not been damaged.

In light of its conclusions on causation, the Supreme Court concluded that the High Court had been wrong to hold that business interruption loss was not covered by the insuring clause to the extent it did not satisfy the "but for" test. This is on the basis that the insured peril (damage to the hotel) and uninsured peril (damage to the rest of the city) operated concurrently and arose from the same underlying fortuity (the hurricane) such that loss arising from both causes operating concurrently should have been covered.

Applying their earlier conclusions regarding the effect of trends clauses, the Supreme Court concluded that the correct approach in that case would have been to interpret the trends clause so as to exclude from the assessment of what would have happened if the damage had not occurred in those circumstances which had the same underlying cause as the damage, namely the hurricanes.

The Supreme Court therefore determined that the *Orient Express* case had been wrongly decided and should be overruled. The Court conceded that this was one of those rare instances where they had to "surrender former views to a better considered opinion."

The Supreme Court overruled the *Orient Express* decision for the following two main reasons:

- Where a loss is caused concurrently by both an insured and uninsured peril, arising from the same underlying circumstance (i.e. the hurricanes), so long as the uninsured peril is not expressly excluded, the loss resulting from both concurrent causes shall be covered. (This applies *Miss Jay Jay* / *Wayne Tank* to the wide area damage scenario).
- Having regard to their analysis of the trends clauses, the correct approach to the adjustment of claims in *Orient Express* would have been to exclude the circumstances that had the same underlying cause as the relevant damage i.e. the hurricanes.

The overturning of *Orient Express* is significantly good news for policyholders as it will now be difficult for insurers to deny cover or reduce an indemnity on grounds that the relevant losses would also have resulted from uninsured perils, which share the same underlying fortuity as the triggered insured peril.

Applying this to the current pandemic, insurers will be unable to exclude losses caused concurrently by both an insured and uninsured peril, where both perils can be said to have arisen from the outbreak of COVID-19. *Orient Express* has always been much criticised by policyholders on the grounds of iniquity – the bigger the loss, the less cover is available. It could also lead to absurd windfall results on certain scenarios, for example in the hurricanes context if a hotel had been notionally the only one standing within a flattened wider area. This aspect of the Supreme Court's decision will therefore be a big relief to policyholders but also brings clarity and common sense to this area of the law. It will be welcome news, as an example, for hotel groups now considering whether to launch COVID-19 BI claims.

FCA Locus & Fast Track Appeal

The FCA exercised and performed its specified statutory powers and duties under the Financial Services and Markets Act 2000 (FSMA) with its strategic objective to ensure that the relevant markets function well and its operational objectives to protect and enhance the integrity of the UK financial system and to secure an appropriate degree of protection for consumers.

It is the first time that a case has been brought on an expedited basis by the UK **FCA** under the Financial Market Test Case Scheme set out in Practice Direction 51M of the Civil Procedure Rules (the "**Scheme**"). The FCA 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.

The Supreme Court judgment, which followed a "leapfrog" appeal from the High Court and an expedited hearing, given the urgency of the questions, brings definitive guidance on the proper operation of cover under certain non-damage business interruption insurance extensions and clarity to policyholders and insurers alike. The judgment brings long-awaited guidance for SMEs on the scope of cover for COVID-19 related business interruption losses. The Supreme Court appear to be in high praise of the FCA's approach and the "leapfrog" appeal process and the Fast Track Appeal.

Commercial Issues

The Supreme Court judgment has brought clarity and certainty for all parties. It has addressed the issue that insurers often get lawyers on board early on in coverage disputes, but that the objective view of the reasonable man with all the facts is the relevant one not the subjective view of a pedantic lawyer or the subjective intention of the insurers who wrote the policy. It has also reminded insurers to be transparent and provide clarity in their drafting of policies, particularly for exclusions, as below:

> "77….. *In any event, the overriding question is how the words of the contract would be understood by a reasonable person…the person to whom the document should be taken to be addressed is not a pedantic lawyer who will subject the entire policy wording to a minute textual analysis…It is the ordinary policyholder who, on entering into the contract, is taken to have read through the policy conscientiously in order to understand what cover they are getting….*
>
> *78…..The reasonable reader would naturally assume that, if the intention had been to put a further substantive limit on the risk of business interruption….this would have been done transparently…and not buried away in the middle of a general exclusion…at the back of the policy*"

The judgment emphasises that the test is what a reasonable person, with all the background knowledge which would reasonably have been available to the parties when they entered into the contract, would have understood the wording of the contract to mean. What either party thinks about how the contract should work is irrelevant to the exercise of interpretation. Although the above also emphasises that the Court will have expected the policyholder to have read the policy before entering into it.

The judgment improves the position of the policyholders significantly beyond that which was already established by the High Court judgment. Although the Supreme Court construed the disease clauses more narrowly than the High Court, it gave broader interpretations to key coverage words in the prevention of access/hybrid wordings (especially as to partial closure of a business). Most significantly, its findings on causation mean that it will be very challenging for insurers to deny cover, or reduce an indemnity otherwise due to an insured, on the basis that losses that would otherwise be covered under the policy would have resulted in any event from uninsured perils whose underlying cause is the COVID-19 pandemic. This will have significant implications in real terms for the indemnities received by policyholders.

The judgment will be binding on those insurers who were party to the proceedings and provides guidance to insurers and policyholders with similar policy wordings. In addition to favourable findings for policyholders on issues relating to causation and the proper application of trends clauses, the Supreme Court took a more flexible approach to Denial of Access/Hybrid Clauses, concluding that cover may be available for partial (as well as full) closure of premises and as a consequence of mandatory orders which are not legally binding. Policyholders should consider revisiting such clauses to assess whether their coverage position is more favourable as a consequence of the Supreme Court judgment.

The FCA is to be commended for using their special powers so effectively and also the Supreme Court for clearly illustrating in their judgment that they do not welcome the fact coverage interpretation by lawyers and for reminding the insurers that the contract means what a reasonable man would think and not what insurers think it means or what the insurers intended the contract to mean. The Supreme Court decision is important for policyholders in respect of BI claims arising out of natural catastrophes and future non-reliance on "trends clauses" and the *Orient Express Hotels* wide area damage arguments. In circumstances where "trends clauses" form part of a policy's quantification machinery, the overturning of the *Orient Express* has removed a significant hurdle for policyholders in establishing cover for losses arising from a fortuity giving rise to both insured and uninsured perils, including in cases of so-called wide area damage. The FCA test case, which involved 7 insurance law firms and 31 Counsels, would have cost a lot of money and possibly constituted one of the most expensive insurance-related cases.

Since the Supreme Court judgment, the FCA has written a Dear CEO letter to all insurers setting out what it expects to happen now following the Supreme Court decision. Our further Client Briefing will deal with this guidance which is again pro policyholder.

Kind regards,

Wordley Partnership.

UK Partners' Contact Details:

Paul Wordley	+44 (0)20 3874 2994 paul.wordley@wordleylaw.com
Graham Denny	+44 (0)20 3874 2993 graham.denny@wordleylaw.com
Alison Proctor	+44 (0)20 3874 2992 alison.proctor@wordleylaw.com
Nick Foster	+44 (0)20 3874 2998 nick.foster@wordleylaw.com