ALERT MEMORANDUM

Business Interruption Claims After the UK's COVID-19 Test Case: Implications for Policyholders in the UK and US

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Following the decision of the English High Court[1] in the high profile test case brought by the UK's Financial Conduct Authority (the "FCA"), the UK insurance industry faces the prospect of being liable to cover losses relating to COVID-19 under business interruption policies.

In this alert memorandum, we review the implications of the decision and the position of policyholders in both the UK and the US.

Executive Summary

The English High Court has found that a number of representative business interruption insurance policies will cover financial losses caused by COVID-19. Insurers can now be expected to incur significant financial liabilities in meeting claims.

The Court's key findings include:

1. the "insured peril" should be broadly construed. The defendant insurers unsuccessfully argued for a narrow construction, claiming the wider effects of the pandemic were a "trend" which would have affected businesses in any event (an argument which may have substantially reduced the value of any recoveries by policyholders);
2. the majority of "Disease Clauses" (which provide cover in respect of business interruption arising from the occurrence of a notifiable disease within a specified radius of the insured premises) and "Hybrid Clauses" (which require both restrictions imposed on the insured premises and the occurrence of a notifiable disease) will cover COVID-19 related losses; and

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

3. "Prevention of Access" and similar clauses (which provide cover where there has been a prevention or hindrance of access to, or use of, the insured premises as a consequence of government or local authority action) may only provide cover for narrow, localized COVID-19 losses. The precise effects of such clauses which will be sensitive to the specific wording used and the way in which the business was affected by authorities' actions (e.g. whether the business was ordered to close and/or the degree to which it was able to remain trading).

It remains to be seen whether the judgment will be subject to an appeal, which may delay the final resolution of claims.

In the meantime, U.S. courts have been grappling with similar issues as policyholders file hundreds of insurance claims seeking coverage for business losses due to the COVID-19 pandemic and associated civil authority orders. While the great majority of the U.S. cases are still pending, recent decisions indicate that, much like the English Court's judgment, the U.S. courts will have to address whether "*prohibition of access*" provisions require total closure of premises to trigger coverage. Additionally, the outcome of a great majority of the U.S. claims will likely turn on how courts interpret a common provision, requiring "*direct physical loss or physical damage*" to trigger business interruption coverage.

Background

On 1 May 2020, the FCA (which regulates UK insurers) announced its intention to obtain a "*timely, transparent and authoritative* [Court] *judgment*" to resolve contractual uncertainty in business interruption insurance cover, due to widespread concerns about the lack of clarity and certainty for some customers making business interruption claims [2]. This stemmed from concerns that the range of wordings and types of coverage in the business interruption market made it difficult to determine the degree to which any individual customer may be able to claim.

Consequently, the FCA launched a test case in June 2020 to determine whether 21 sample insurance policies covered business interruption losses arising in the context of the COVID-19 pandemic and the consequential advice of and restrictions imposed by the UK Government (the "Test Case"). The FCA was representing the interests of the large number of policyholders who purchased the policies, many of whom are small to medium-sized enterprises. The FCA estimates that approximately 700 types of policies across over 60 different insurers and 370,000 policyholders could be affected by the Test Case.

The Test Case was heard in July 2020, with an expedited trial under the Financial Market Test Case Scheme[3] in the High Court's Financial List. This procedure is available where a claim raises issues of general importance where immediately relevant authoritative English law guidance is needed. The trial was held remotely, by two judges (Lord Justice Flaux and Mr Justice Butcher) sitting together, because of the particular importance or urgency of the Test Case.

The High Court (the "Court") decided the issues based on a set of agreed facts (which covered, amongst other things, the chronology of the pandemic and related UK government actions) as well as a set of assumed facts (illustrative factual scenarios as to how businesses have been affected by COVID-19)[4].

The Court grouped the sample clauses into three broad categories and examined each group in turn:

1. "Disease Clauses" – which largely provide coverage in respect of business interruption in consequence of or following or arising from the occurrence of a notifiable disease within a specified radius of the insured premises;

2. "Hybrid Clauses" - which refer both to restrictions imposed on the relevant premises and to the

[2] https://www.fca.org.uk/news/statements/insuring-smes-business-interruption

[3] See Practice Direction 51M of the Civil Procedure Rules for further details of the Scheme

[4] Court documents and information relating to the trial can be found on the FCA's Business Interruption Insurance webpage

occurrence or manifestation of a notifiable disease; and

3. Clauses covering the prevention of access to premises and similar perils – which provide cover where there has been a prevention or hindrance of access to or use of the premises as a consequence of government or local authority action or restriction.

Disease Clauses[5]

For Disease Clauses, the defendant insurers argued that these clauses relate only to a local occurrence of a notifiable disease, and therefore covered only the effects of the local outbreak of COVID-19 most relevant to the policyholders, and only in circumstances where such effects could be distinguished from the wider effects of the disease.

The FCA's position was that the causal test in respect of the insurance policies would be satisfied where the outbreak of COVID-19 in the relevant policy area (i.e., the geographical territory to which the policy applies) was an indivisible part of the disease. The FCA also argued, as an alternative, that there were many different effective causes, namely the occurrence of the disease in a very large number of places.

The Court accepted the FCA's position that there was one indivisible cause, namely the disease, of which all the local outbreaks formed a part, and noting the following primary factors:

- the outbreak of COVID-19 constituted the "*occurrence*" of the disease, whether or not the disease had been diagnosed in any specific individual within the policy area;
- the insured peril (this being the covered event that can cause damage or loss to the policyholder or the assets of the policyholder) is the composite peril of interruption or interference with the business of the policyholders during the relevant period following the occurrence of the notifiable disease within the defined radius of the premises; and
- cover was not limited to outbreaks wholly within the relevant policy area where the wording of the relevant clauses did not expressly indicate so.

In certain policies, the Court found that the wording used implied that cover was limited to matters occurring at a particular time, in a particular place and in a particular manner. The Court held that this was the case where the policy provided cover for an "*event*".[6] In such cases, policyholders would only be able to recover if they could demonstrate that the cases of the disease within the relevant policy area were the cause of the business interruption which such policyholders had suffered. This could be applicable, for example, to some of the local lockdowns that have been administered and/or are currently ongoing in certain parts of the UK.

Hybrid Clauses[7]

The Court reached similar conclusions on hybrid clauses. The Court therefore rejected the arguments put forward by the defendant insurers that the only cover was in respect of losses resulting from a local outbreak.

In addition, as hybrid clauses also include prevention of access and similar wording (as discussed further below), the Court took into the account the meaning of the precise wording adopted by the relevant parties in such clauses. For example, the use of language such as "*restrictions imposed by a public authority*" in relation to the causes of loss in such clauses implied that the business interruption losses had to flow from the mandatory requirements of applicable regulations.

In the case of a hybrid clause in particular, it is essential for the precise language of the clause to be examined closely in order to determine whether or not policyholders are able to recover under it.

Prevention of Access and Similar Wordings[8]

A key issue in the Test Case was whether or not the measures taken to effect social distancing following the outbreak of COVID-19 amount to "*prevention*" or "*hindrance*" of access, including in respect of

[5] *FCA v Arch Insurance,* 80-241
[6] *Ibid,* 231
[7] *Ibid,* 242-305
[8] *Ibid*, paragraphs 306-502

businesses which were permitted to remain open or partially open in some respect during the lockdown.

The position adopted by the defendant insurers in relation to certain policies focused on such matters as the distinction between such terms as "*prevention and hindrance and access and use*", noting that the implication of specific wording should in certain cases be afforded a narrow meaning whereby access to the premises was "*physically obstructed or rendered impossible*."

The Court acknowledged that this position was consistent with US decisions on business interruption insurance where access is prohibited or denied, such as *Abner, Herman & Brock, Inc v Great Northern Insurance Co.*, 308 F. Supp. 2d 331 (2004), which concerned access to insured premises following the 9/11 attacks in New York.

The Court concluded that clauses which require prevention or prohibition of access are generally to be construed in a more restrictive manner than the majority of the Disease Clauses.

The Court noted, in particular, the following important factors in determining the coverage of such wording:

- the location and nature of the emergency/incident and the causal relationship between it and the relevant authority's action. For instance, where language such as "*emergency/injury in the vicinity*" or within a specified radius was used, such language denoted something specific which happens at a particular time and in the local area, and was thus only intended to provide for narrow localized coverage;
- the nature of the authority's actions, advice and/or orders, including the advisory or mandatory nature of such the authority's instructions or announcements and whether or not such instructions or announcements have the force of the law;
- the required effect of the authority's action on access to the premises and the business of the policyholder; and
- "*interruption*" did not generally require a "*complete cessation of business*". Rather, interruption is interpreted to refer to disruption and interference with the business.

Consequently, the availability of cover under a Prevention of Access clause will depend on the precise terms of the specific policy and the application of the relevant government advice and regulations to the business of the policyholder.

Court's Treatment of Trends Clauses

A mechanism often included in insurance policy wording in respect of business interruption losses is a "Trends Clause", which allows for an adjustment to be made to the policyholder's losses to account for overarching or general trends in the business of the policyholder.

The defendant insurers argued that Trends Clauses should be interpreted to include components of the insured peril itself, which could have the effect of significantly reducing or negating the value of any insurance cover available to policyholders.

The Court accepted the FCA's position that it would be contrary to generally held principles for an established loss to be limited by the inclusion of part of the insured peril in the assessment of the policyholder's loss had the insured peril not occurred (i.e., the "Counterfactual").

In relation to each category of wording, the Court provided the following guidance as to the operation of the Trends Clauses:

- Disease Clauses: The insured peril is the interruption or interference with the business of the policyholder following the occurrence of the disease, including via the response of the public or the authorities. The wordings in issue provided cover for the effects of COVID-19 both within the specified radius and outside of it, with the result that the whole of the disease (whether inside or outside of the relevant policy area) had to be excluded in the Counterfactual.
- Hybrid Clauses: The insured peril is a composite peril involving: (i) an inability to use the insured premises; (ii) due to restrictions imposed by a public authority; and

(iii) following the occurrence of a human infectious or contagious disease. Each of these interconnected elements should be excluded from the Counterfactual.

- Prevention of access and similar wordings: The insured peril is also a composite one involving three interconnected elements: (i) prevention or hindrance of access to or use of the premises; (ii) by any action or advice of an authority; and (iii) due to an emergency which could endanger human life. All three of these elements set out above must be excluded from the Counterfactual.

A number of the Trends Clauses were drafted so as to apply to losses from "*Damage*". On their face, they did not apply to the non-damage extensions to the policy. Notwithstanding this, the Court concluded that such clauses would apply to the non-damage extensions.

What types of evidence are required for policyholders to prove the prevalence of COVID-19?

The Court made no findings of fact as to where COVID-19 had occurred or manifested, which is an issue to be considered on a case-by-case basis. The Court did, however, consider the type of evidence which may offer proof of the prevalence of COVID-19 in a given case (proof may be required, for example, where a policy requires proof of the occurrence of COVID-19 within a specific geographical area).

The Test Case identified the following:

- Categories of evidence put forward by the FCA, namely specific evidence (e.g., reports relating to a breakout in a nearby care home), publicly available NHS Deaths Data, statistics relating to deaths published by the Office of National Statistics and reported cases, were accepted by the insurers as being in principle capable of demonstrating the presence of COVID-19;
- A distribution-based analysis, or an undercounting analysis (which recognises that the number of reported cases is less than the number of actual cases), could in principle discharge the burden of proof on the policyholders; and
- The defendant insurers did not suggest that absolute precision is required.

Next steps in the Test Case

Following the Court's judgment, the FCA has issued guidance [9] to insurers stating that, upon the final resolution of the Test Case, insurers are expected to handle and assess all outstanding affected claims and complaints in line with the Court's judgment. However, the judgment is unlikely to finally resolve the matter; it appears likely the defendant insurers will appeal the High Court's decision (potentially directly to the Supreme Court without going through the Court of Appeal).

Whilst the judgment provides guidance on a number of major and nuanced issues relating to the construction of the business interruption insurance policies, it does not claim to determine every claim under such a policy. It remains for policyholders to consider how the principles established by the Court will apply to the specific circumstances and the wording contained in their business interruption insurance policies, and to calculate their loss.

Comparison with US Law

The decision in the Test Case contains several positive outcomes for policyholders with business interruption coverage who have sustained losses as a result of the COVID-19 pandemic, but U.S. claimants to date have fared less well.

Since the rise of the COVID-19 pandemic, and in the wake of governmental orders responding to that pandemic, hundreds of policyholders have filed claims across the U.S. seeking to secure coverage for losses that they attribute to the effects of the virus and associated orders, invoking business interruption and action of civil authority coverage, which were at issue in the Test Case. Reflected in the decisions emerging in

[9] https://www.fca.org.uk/publication/finalised-guidance/finalised-guidance-bi-test-case.pdf

these cases is a common theme: insurance companies contest coverage by pointing to a near-ubiquitous requirement that, for such coverage, there must be "*direct physical loss or physical damage*." This issue has so far proven to be a significant hurdle for policyholders seeking to persuade courts that the presence (or potential presence) of COVID-19 virions on the surfaces of their premises falls within that language. In addition, as seen in the Test Case, U.S. courts have grappled with the question of whether "*prohibition of access*" requires total closure of premises to trigger civil authority coverage.

At this time, the overwhelming majority of the COVID-19 insurance cases filed in the U.S. remain pending, but several decisions have now been issued; of these, only one allowed plaintiffs—restauranteurs and a barber shop—to proceed to discovery, denying defendant Cincinnati Insurance Company's motion to dismiss. In *Studio 417, Inc. v. Cincinnati Ins. Co.*, the court rejected the insurer's argument that plaintiffs' allegations about COVID-19 effects on their property failed to satisfy the "*direct physical loss or direct physical damage*" requirement. No. 20-CV-03127-SRB, 2020 WL 4692385 at *2 (W.D. Mo. Aug. 12, 2020). Importantly, the court found that "*physical loss*" and "*physical damage*," separated by a disjunctive "*or*," had to be interpreted as having distinct meaning, a basic principle of U.S. contractual interpretation. The insurer seems to have persuaded the court that contamination by the virus did not constitute "*damage*," but the court's finding that "*loss*" and "*damage*" had to mean different things meant that the same argument could not support a finding that "*loss*" was also absent. Thus, the court concluded that plaintiffs had plausibly alleged "*direct physical loss*" by showing that they had lost possession, or were deprived of their premises, albeit temporarily, due to the presence of the virus on their premises—"*a physical substance*" that was not only "*emitted into the air*" but also "*live[d] on*" surfaces—thereby making it "*unsafe and unusable*" for plaintiffs. *Id*. at *4. Further, the court found that plaintiffs had adequately alleged that their access was prohibited because the civil authority orders required businesses to "*suspend operations*." In this, *Studio 417* diverged from the approach of the Test Case, as well as *Abner*, by finding that mere restriction of access was sufficient, at least at the motion to dismiss stage, to prove prohibition or prevention as required by most civil authority provisions. The court also noted that its rationale was partly premised on the fact that the policies did not define key terms at issue: the policies failed to define "*direct physical loss*," and did not specify whether the civil authority provision was triggered by prohibition of "*all*" or "*any*" access to the premises. Thus, although it may provide U.S. plaintiffs with a glimmer of hope, *Studio 417* may also foreshadow how policy provisions may be rewritten in future to make similar claims less likely to succeed.

In sharp contrast, the recent rejection of a policyholder's motion seeking a preliminary injunction found that "*New York law is clear that this kind of business interruption needs some damage to the property to prohibit you from going*." Transcript at 15, *Social Life Magazine v. Sentinel Ins. Co., Ltd*., No. 1:20-CV-03311-VEC (S.D.N.Y. May 20, 2020), ECF No. 24. The court in this case exhibited deep skepticism that the COVID-19 pandemic was capable of causing physical loss or damage to premises, remarking that the virus "*damages lungs . . . not printing presses.*" *Id*. at 5. The court also indicated that it would be less amenable to the type of statistical evidence the Test Case envisaged, instead requiring more conclusive evidence that the virus was present at a particular property. It was not sufficient that plaintiff had himself tested positive, the court found, because he may not have contracted the virus at the insured premises. Finally, the court found that the executive order New York State passed, requiring businesses to "*reduce the[ir] in-person workforce . . . by 100 percent*" did not amount to prohibition of access. *Id*. at 13.

Overwhelmingly, the recent U.S. COVID-19 insurance decisions follow reasoning similar to that exhibited in *Social Life Magazine*, finding that the COVID-19 virus would not meet a direct physical loss or damage requirement, even where the two key phrases were deemed to have distinct meanings. *See, e.g., Mudpie v. Travelers Casualty Insurance*, Case No. 20-cv-03213-JST, 2020 WL 5525171 at *4 (Dist. Ct. N.D. Cal.)

(finding "*physical loss*" to be distinct from "*physical damage*," but denying plaintiffs' claims because plaintiffs' temporary deprivation of their storefront did not amount to permanent dispossession). Likewise, U.S. courts seem united in denying claims where plaintiffs fail to allege in relation to their physical damage claims, at a minimum, that COVID-19 was present at the insured premises.

That said, all hope is not lost. Future plaintiffs can, and should, rely on the line of insurance cases that do not require tangible alterations to property, or interpret "*physical loss or damage*" more broadly than *Social Life Magazine*, keeping in mind that courts' approaches will vary across jurisdictions. *See, e.g., Mellin v. Northern Sec. Ins. Co.*, 167 N.H. 544, 549 (N.H. 2015) (finding "*contaminant or condition that causes changes to the property that cannot be seen or touched*," like cat urine odor, sufficient to meet physical loss); *see also Gregory Packaging, Inc. v. Travelers Prop. Cas. Co. of Am.*, No. 2:12-CV-04418 (WHW)(CLW), 2014 WL 6675934 (D.N.J. Nov. 25, 2014). Given that in another recent decision the Judicial Panel on Multidistrict Litigation so far denied an industry-wide consolidation of COVID-19 business interruption coverage cases (though leaving open the possibility of future consolidation by insurer), U.S. plaintiffs can at least continue to expect diverging results across different jurisdictions. *See In re COVID-19 Bus. Interruption Prot. Ins. Litig.*, No. MDL 2942, 2020 WL 4670700, at *4 (U.S. Jud. Pan. Mult. Lit. Aug. 12, 2020).

Conclusion

The decision in the Test Case is a generally positive outcome for policyholders of business interruption insurance policies who have sustained losses as a result of the outbreak of COVID-19 and measures taken in response to the outbreak. Most of the relevant business interruption policy wordings presented before the Court were found to be triggered by the COVID-19 pandemic.

Subject to any appeal, the decision in the Test Case could be beneficial to up to 370,000 policyholders[10] in the U.K. and will likely have significant financial consequences for the relevant insurers. Policyholders will, however, need to contend with the nuances of their specific policy wordings, and the application of the decision in the Test Case to each individual scenario will need to be considered carefully against the detailed Test Case decision and factors that are individual to the policyholder (such as the actual effect on and loss to the policyholder). In some cases, further litigation may be necessary, whether to clarify particular policy wordings, resolve issues around policyholders' losses or address individual situations.

Policyholders in the U.S. will be less optimistic about their claims for business interruption losses caused by the COVID-19 pandemic. This is due to the potentially more challenging arguments required to persuade U.S. courts that the pandemic has resulted in direct physical loss or physical damage to their respective businesses. Nonetheless, U.S. plaintiffs can continue to expect diverging results across the different U.S. jurisdictions, and the approaches of the U.S. courts in some jurisdictions may be less wedded to a strict requirement for tangible alterations to property or 'physical loss or damage', and consequently more favourable to policyholders.

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[10] *FCA v Arch Insurance*, 7