QUANTUM WARS: ENDGAME

COMMENTS ON THE QUANTUM ISSUES ARISING FROM THE SUPREME COURT FCA TEST CASE JUDGMENT

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Well there it is… a mere 258 days since the FCA announced its intention to *"obtain court declarations aimed at resolving the contractual uncertainty around the validity of many BI claims"* we have managed to get through a High Court test case followed by a Supreme Court appeal to arrive at a final judgment.

While it might not have felt like it to the small businesses waiting on insurance payouts, the speed of the process has been incredibly impressive, and - as the Supreme Court acknowledged in its appeal judgment – the quality of the written and oral submissions has been exceptional throughout. It is *de rigueur* for insurance companies to get a hard time when they seek to rely on what many would see as "technicalities" to avoid making payouts – in this instance, that ire is misplaced. In arriving at its conclusion – which opens up the potential for substantial restitution for the fortunate policyholders with the right coverage – the Supreme Court had to overrule *Orient Express*, the key legal precedent for dealing with "wide area damage".

This was not an inevitability – the Supreme Court cannot just decide "ah, this time we would like insurers to pay out" – the rationale for the judgment will have lasting implications for business insurance claims (not least those in a catastrophe scenario) and was based on interpretation of fundamental legal principles. There were genuine – and legitimate – differences of opinions between the parties that have been resolved largely in favour of policyholders in this instance.

Of course, while this is the end of the test case, there remains the not inconsiderable task of applying the framework set out by the judgments to the individual circumstances of many thousands of claims in order to calculate the quantum of each claim. Inevitably this will shine a light on areas of the judgment that will require further clarification – a few of which I explore further below.

I do not intend to cover in detail the coverage aspect of the test case in this article – there are a number of excellent legal commentaries on that front – but for those brave souls who dove straight into the detail of the judgment, a very different outcome appeared to be emerging from the interpretation of the coverage aspect of the disease clauses. However, like a close-up magician, what the Supreme Court seemed to be taking away with the coverage hand, miraculously reappeared in the causation hand later on.

QUANTUM ISSUES

In a series of articles I wrote last year, I explored the potential quantum impacts of the arguments put forward by both sides – broadly, the FCA put forward a case where the calculation of damages assumes that COVID-19 never existed, while insurers put forward a multitude of positions which would require far more complex "but-for" scenarios, e.g. taking out the business closures, but not COVID-19 and the other non-closure governmental measures.

In reading the detailed judgment, the Supreme Court dismissed the FCA's arguments that the insurer's position was too complex, acknowledging that *"it is in the nature of business interruption claims that they can give rise to difficult questions of quantification, often concerning what would have happened in hypothetical circumstance"*. So it wasn't just that the Supreme Court decided to choose the simple option. Ultimately, it was the Supreme Court's view that the positions taken by insurers were uncommercial – and that in certain scenarios the cover afforded would therefore become illusory - that led it to favour the FCA's position.

TREND CLAUSES AND PRE-TRIGGER TRENDS

The outcome from the High Court's original judgment was that, where a policy had been triggered, the calculation of the loss should be compared to a scenario where there was no COVID-19. However, that judgment also included certain comments relating to pre-loss trends which it said could be considered when applying the trends clause. This, coupled with the High Court's judgement that hybrid / prevention of access clauses required business closures to be "mandatory" meant that insurers could – and in fact were – looking at the trends of businesses in the week or two prior to the mandatory closures (where the various non-mandatory statements from the government were starting to impact on customer behaviours) and seeking to apply this short-term trend (which in some cases was a significant downturn) over the whole of the two or three month closure period.

In my opinion, this was an incorrect reading of the original judgment in light of the subsequent declaration which stated that *"the downturn will only apply to the extent that as a matter of fact the downturn would have continued during the indemnity period if the insured peril had not been triggered."* As the insured peril had been held to include COVID-19, I believe in the absence of the disease those downturns would have recovered within a short period after the policy trigger.

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That argument became academic as the FCA appealed the pre-trigger trends point as part of a wider appeal as to whether any aspect of the insured peril should be brought into the "but-for" scenario under the trends clause.

On this point, the Supreme Court held that circumstances arising out of the same underlying or originating cause should not be considered under the trends clause. For claims arising from COVID-19 this means the various consequences of the disease will not impact on the "but-for" position of the policyholder, nor will any pre-trigger impacts of the disease have any consequence on the indemnity received.

So if liability is triggered, for all policies considered by the test case the indemnity received is compared to a no COVID-19, business-as-usual position. That is a huge win for policyholders.

SUPPORTING "NORMAL" TRENDS

On a practical note – the normal methods for assessing what a business would have achieved but-for an insured peril would be to either look at historic sales trends, a comparison to pre-incident budgets or a comparison to the market / competitors / other comparators. Given the ubiquitous nature of the pandemic, there are no unaffected markets or competitors – this means any quantification exercise is likely to focus on historic sales trends or budgets. Businesses that were projecting significant growth for any reason will likely come under close scrutiny, and those businesses should look to collate as much pre-pandemic support as it can to support that growth expectation.

Also, due to the prolonged effect of the pandemic, many businesses will have likely crossed over its year end and may have prepared its new budgets with the knowledge of the impact of the pandemic in mind. Now is the time to revisit those budgets but considering what the business would have realistically achieved had the pandemic not occurred – there is nothing wrong with cautious optimism, but anything which departs significantly from historic performance could potentially give rise to additional scrutiny from insurers and this is where additional documentation could assist.

INTERRUPTION PERIOD AND NUMBER OF OCCURRENCES – PREVENTION OF ACCESS / HYBRID CLAUSES

In considering the causation issues relating to the prevention of access and hybrid clauses, the Supreme Court concluded that those wordings indemnify the policyholder against the risk of all the elements of the insured peril acting in causal combination to cause business interruption loss (i.e. the disease / danger + authority action + inability to use / prevention of access). In the event that all elements are present, as discussed above, the "but-for" scenario should then exclude all impacts and consequences of COVID-19. The question arises as to what happens when the final link in the causal chain (the inability to use / prevention of access) stops.

In the same way that a business that has suffered a fire is not back to normal as soon as its building has been restored, if it is the case that the insured peril has ceased once the business is allowed to reopen, that is not to say that it is not still suffering further impacts from the closure.

On the last day where all parts of the insured peril are in place, the calculation of the loss compares a business-as-usual position (100% of normal revenue) with a closure (for some businesses this will be 0% of normal revenue). On the next day when the business is allowed to open – removing the final link in the causal chain – the factual position aligns, but the overall picture is significantly different.

If we take the example of a restaurant which was able to reopen on 4 July – in the actual scenario, the restaurant has been closed for around two and a half months and the entire population of the UK – with the exception of a limited number of key workers – has been required to stay home with very limited exceptions. By 4 July, the infection rates in the UK had shown significant improvement, but it would not be surprising to see limited custom at restaurants immediately upon reopening. Compare this to the "but-for" scenario where the restaurant has been open in a COVID-19 free world right up to 3 July – in the event that there was a sudden prevalence of COVID-19 in the UK at the levels they were on 4 July along with the new government measures, there would certainly be an impact on the business, but – I would argue – significantly less than the impact in the actual scenario. One scenario is looking at an increase from 0%, the other a reduction from 100% and they are unlikely to be the same.

For the restaurant example, this could be further complicated by the increased in trade during the period of Eat Out To Help Out, and then for all businesses, whether the second (or third) lockdowns count as separate insured events (with a new sublimit) where the policy is still in cover (those businesses which saw the lockdowns straddle the policy renewal date may have found that specific COVID-19 exclusions were added to their new policies – however, those with January renewal dates could potentially claim for three separate lockdown events).

It will be interesting to see how the valuation of this "tail" to the losses is approached as, again, there is little comparable data on which to draw conclusions. While we are currently in midst of a second spike of infections and a third lockdown, the position over the summer of 2020 was quite different when infections did remain at a low level until they started ramping up again in autumn – in the "but-for" world nobody would have any experience of the infection spikes and likewise the behavioural impacts of those spikes would also not have occurred.

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HYBRID CLAUSES – CATEGORY 3 AND 5 BUSINESSES

The Supreme Court has done an excellent job of giving clarity on a huge number of issues, but a critical issue to many Hiscox policyholders (22,000 or two thirds of them per the Hiscox press release) is whether Regulation 6 of the 26 March regulation – effectively the stay at home order -could give rise to an "inability to use" for Category 3 and 5 businesses which were not expressly required to close. On this issue, the Supreme Court choose to repeat the High Court position stating that:

> *"We do not accept that there was any such confusion. Nor do we consider, even taking into account the wider interpretation of the requirement which we consider to be appropriate, that the court was wrong to say that the cases in which regulation 6 would cause an "inability to use" premises are likely to be rare. As the court points out, it must be an inability of use rather than hindrance or disruption. It is likely that it will be difficult for Category 3 and Category 5 businesses which were allowed to remain open to demonstrate the requisite inability."*

The wording clearly leaves open the possibility that regulation 6 could give rise to an "inability to use" category 3 and 5 businesses – albeit that it would be rare - but fails to give any guidance on what those "rare" circumstances would be.

Unless clarification can be sought by way of declarations to the judgment, this issue seems destined for further legal challenge on a case-by-case basis.

It should be noted that, contrary to the High Court position, the Supreme Court found that "inability to use" the business premises may include a policyholder's inability to use either the whole or a discrete part of its premises for either the whole or a discrete part of its business activities.

This could assist a number of policyholders, where their ability to use a part of their premises was potentially stopping them from claiming losses for another part of their business which was clearly suffering from an "inability to use" – this should even include some Category 3 businesses which were technically allowed to stay open, but sometimes not for their full range of products or services (e.g. a department store that was only allowed to open its pharmacy).

OTHER PREVENTION OF ACCESS CLAUSES

In the original High Court judgment, certain prevention of access clauses were determined to only provide localised cover and so would not respond to the effects of a national pandemic. A good example of this is the Hiscox Non-Damage Denial of Access (NDDA) clause. This clause responds to:

> *"an incident occurring during the period of the insurance within a one mile radius of the insured premises which results in a denial of access or hindrance in access to the insured premises, imposed by any civil or statutory authority or by order of the government or any public authority, for more than 24 consecutive hours"*

In the High Court judgment it was noted that *"Mr Gaisman agreed that incident is to be equated with "an occurrence" and "an event""* but Mr Gaisman also submitted that *"the presence of someone within the one mile radius or in the vicinity of the premises who had COVID-19 could not possibly be described as "an incident""*

This view was supported by the High Court which made two comments on the use of the term "incident":

- *"The cause of the imposition of the restrictions was the national pandemic which cannot be described as "an incident""; and*
- *"It is no answer for the FCA to say that there is an incident if someone with COVID-19 is present within the one mile radius. As Mr Gaisman QC said, that person might or might not know that he or she had COVID-19 and, in any event, it is a misnomer to describe the presence of someone in the radius with the disease as "an incident" for the purposes of the clause."*

Given the logic of the Supreme Court in relation to causation for the policies considered by the appeal, so long as there is a case of COVID-19 within the requisite area, then this will be a concurrent cause of the national pandemic response, and cover will be provided. This would appear to remove the first obstacle to cover from the High Court judgment. As a result, the only challenge to cover would appear to be the use of the term "incident" rather than "emergency" or "danger".

In light of this, it will be interesting to see if there is a further legal challenge on whether an occurrence of the disease could potentially be considered an "incident" to trigger cover under similarly worded policies.

NUMBER OF OCCURRENCES – DISEASE CLAUSES

Although much of the coverage of the test case has focussed on the impact to small businesses, there are also a number of larger corporate policyholders whose insurance coverage will be impacted by the test case decision. For those policyholders, one issue that wasn't raised in the test case will be the number of occurrences of loss and whether this might give rise to multiple limits of loss. An example might be a retail company with multiple stores and infectious disease cover – will the infectious disease sublimit be applicable to the whole company, or each store?

In the High Court judgment, it was held that the outbreak of disease is the "occurrence" of the disease and individual outbreaks form indivisible parts. In this context, it may be argued that there was a single "occurrence" of the disease which was the cause of subsequent government intervention. The Supreme Court departed from this reason, and instead favoured the High Court's alternative

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position that each case of illness suffered by an individual is a separate occurrence, with each occurrence being a concurrent cause of the overall impact of the pandemic.

By favouring a view that there are multiple concurrent occurrences, this potentially supports an argument that the "occurrence" which (concurrently) caused the closure of a shop in Manchester was not the same "occurrence" that (concurrently) caused the closure of a shop in Newcastle.

This has been a live issue since the original High Court judgment and it will be interesting to see the legal commentary on this issue in light of the Supreme Court's judgment. There is no doubt that it could have a significant impact on quantum for policyholders with multiple premises.

GOVERNMENT ASSISTANCE

An area not touched upon by the test case, but which is likely to be material to the quantification of claims is how the policy treats the various forms of government assistance – grants, reliefs and furlough.

The Association of British Insurers previously confirmed to the Economic Secretary to the Treasury that 12 major commercial insurers had agreed not to deduct *"the Local Authority Grant, the Small Business Grant and the Leisure/Retail/Hospitality grants, or their equivalents in Scotland, Wales and Northern Ireland, from any Covid-19 claims payments."*

However, this still leaves a question over whether other forms of assistance, including the business rates relief and furlough payments should be deducted from claims.

It is a challenging issues – on one hand insurers will argue that policyholders will be overindemnified if they don't deduct such government assistance from their business interruption claims, but equally it seems unpalatable for public monies intended to provide assistance to struggling businesses to effectively reduce the exposure of insurers.

There also remain question marks over how these would be treated within the mechanics of the business interruption calculation. Business Rates Relief is probably the easier one to deal with – it will simply give rise to a reduction in the rates cost which could then be considered as saving in costs paid out of gross profit (or revenue).

However, the furlough payments are not so simple – in the accounts of businesses that took part in the furlough scheme, the wage costs will still be recorded in the accounts, but a separate "income" will be recorded in relation to the amount received from the government under the furlough scheme. The deduction of "income" only falls to be considered as part of the loss of income / gross profit section of the policy, many of which define income as being "income from the business activities of the business" and refer to the definition of business activities in the policy schedule. So the key question is whether furlough "income" is income from business activities? For a restaurateur, is that really restaurant income?

If the answer to that question is no, then – where the policy wording has a specific definition of income – it could be argued that the furlough "income" falls outside of the mechanics of calculating the business interruption claim, and therefore, ultimately, does not get "deducted" from the claim.

CONCLUSION

While we should congratulate all involved with the FCA Test Case, the Supreme Court judgment simply switches the focus from the legal arena to the adjusting arena. For months now, loss adjusters and forensic accountants have been quietly working with policyholders collating the information required to quantify and review claims, albeit with a lack of certainty as to the final methodology. The judgment allows that process to proceed with better clarity which should lead to further payments being made to policyholders. That being said, it seems inevitable that there will be further legal challenges along the way. We may have entered the endgame, but this story has a few more twists and turns to go.

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