Financial Conduct Authority Test Case

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1. The much-anticipated judgment in *The Financial Conduct Authority v Arch Insurance (UK) Ltd. and ors* [2020] EWHC 2448 (Comm) ("the Test Case") landed this week on 15th September 2020.

2. This is a brief note explaining some of the interesting features of the decision and how they will affect insurance claims. The judgment is something of a treasure trove for lawyers and no doubt will provide significant scope for argument but it is, overall, a landmark victory for claimants, most of whom are small to medium-sized businesses.

3. We are currently advising businesses of all sizes in relation to how the judgment will affect their claims, and it is important to note that despite the judgment in the Test Case much of the argument in each individual case will still relate to the specific wordings of each policy schedule, policy wording, any notice of amendment and the facts of each individual case upon which I would recommend policyholders take specific expert advice.

4. The High Court decision by Lord Justice Flaux sitting with Mr. Justice Butcher gave clarity to a number of legal questions arising in the wake of thousands of claims by businesses against insurance companies for pay-outs from their commercial insurance policies.

5. On or around 23rd March 2020 many businesses were forced to close by the government-imposed "lock-down" put in place by a series of amended and re-amended regulations made by government ministers causing those businesses to sustain enormous losses which their owners thought were covered under the terms of their business interruption insurance policies.

6. Nearly all of the claims have been met with letters of rejection from insurance companies, sometimes putting forward ludicrous arguments as reasons to decline paying out under policies obtained often with very substantial premiums.

7. Many insurers, for example, have claimed that the policies were not intended to cover outbreaks of "epidemic diseases" despite no such exclusion-terms appearing in the policy and despite there being clauses ostensibly allowing claims based on the outbreak of disease.

8. The financial regulator brought the Test Case to bring clarity to what is likely to be litigation of historic importance and value:

> *"1. This case has been brought by the Financial Conduct Authority ("the FCA"), the regulator of the defendant insurers, as a test case to determine issues of principle in relation to policy coverage under various specimen wordings underwritten by the defendants in respect of claims by policyholders to be indemnified for business interruption losses arising in the context of the COVID-19 pandemic and the advice of and restrictions imposed by the UK Government in consequence. We have been asked to determine those issues as to the correct construction of the policy terms and as to whether cover is available in principle by reference to a set of agreed facts (which we summarise in the next section of the judgment) and assumed facts (which were essentially illustrative factual scenarios as to how certain businesses have been affected)."*

9. The court summarised the procedural background as follows:

> *"3. ...the FCA made an application, supported by the defendant insurers, for (i) the expedition of the trial and (ii) the Financial Market Test Case Scheme under Practice Direction 51M to apply to the claim. That Practice Direction provides for the Scheme to apply to any Financial List claim which raises issues of general importance in relation to which immediately relevant authoritative English law guidance is needed. It also provides that in a case of particular importance or urgency the trial may, at the court's discretion, be heard by a court consisting of two Financial List judges, or a Financial List judge and a Lord or Lady Justice of Appeal. The first Case Management Conference ("CMC") on 16 June 2020 was heard by Butcher J alone. Orders were made for the expedition of the trial and for the case to be heard under the Scheme with the trial being*

> *conducted by what was in effect a Divisional Court consisting of Flaux LJ and Butcher J. The trial was fixed for 8 days from 20 July 2020."*

CAUSATION

10. One of the most common arguments put forward in the hundreds of cases dealt with us at 3PB is that if a business closed its doors when required to do so by government regulations, then it could not be argued that the closure was caused by an outbreak of disease so as to trigger disease clauses.

11. Conversely, and entirely in contradiction to that argument, insurers have also argued that closure was caused by an outbreak of disease, not by public authority intervention, in cases where businesses seek pay-outs under policies that provide cover for closure imposed by public authorities.

12. A large number of claims have until now also been rejected on the basis that "causation" is to be interpreted as strict "but for" causation. In legal terms "causation" is the often-argued issue as to whether a particular event has actually caused a particular loss. Large numbers of factual circumstances give rise to different and ingenious arguments on causation.

13. In negligence cases "but for" causation is frequently applied in the sense that there has to be a direct causal link between the event and the damage caused. In *Barnett v Chelsea and Kensington Hospital Management Committee* [1969] 1 Q.B. 428, for example, (see *Clerk and Lindsell at 2-09)* the claimant's husband was sent home from a hospital casualty department after complaining of acute stomach pains and sickness. He died later that same day of what proved to be arsenic poisoning. The hospital admitted negligence in failing to treat the man promptly. His widow's claim failed, however, because of evidence that, even had he been treated promptly, he would still have died from the poison.

14. In the context of insurance, it is argued by insurers that it could not be said that a business was closed as a result of an outbreak of disease because it was the government regulations which directly caused closure, and many businesses could have stayed open with the disease in circulation.

15. Although there is certainly legal argument as to the applicability of the "but for" test in *all* cases, even in the sphere of negligence claims, and although in contractual cases

(including insurance cases) the court has to decide based on the wording of a clause what the parties intended to be the right test for causation and the strength of the causal link intended by the parties to operate, the High Court in the Test Case side-stepped the issue and gave some over-arching guidance which will no doubt strongly support the claims of policy-holders (my emphasis added):

> *"530. Thus, in relation to prevention of access clauses, the insured peril is, for example, a composite one involving three interconnected elements: (i) prevention or hindrance of access to or use of the premises (ii) by any action of government (iii) due to an emergency which could endanger human life and for cover to be triggered that composite insured peril must have caused the interruption or interference with the business. As we said in relation to the arguments advanced by Mr Kealey QC in relation to the EIO wordings, once the true nature of the insured peril is identified, it is clear that the counterfactual requires not only the prevention or hindrance to be stripped out but the government action and the emergency, since the insured peril comprises all three elements. "But for" causation upon which the insurers, through Mr Kealey QC, placed so much emphasis and devoted so much analysis, does not dictate a different answer. The correct answer to the question it poses "but for what?" is "but for the insured peril", which is the composite one we have identified. Nothing in Orient Express dictates a different conclusion."*

16. The court thus approaches the question of causation on the assumption that *even if* the test is one of strict "but for" causation, the question can be decided with reference to the definition of the insured peril. As many policy-holders have already argued in the claims which we are currently handling, the relevant insured peril in prevention of access clauses is a composite one: i.e. "(i) prevention or hindrance of access to or use of the premises (ii) by any action of government (iii) due to an emergency which could endanger human life" and loss therefore cannot be isolated so as to only be connected to only one of those causative events.

VICINITY

17. Many clauses seek to draw some connection between the outbreak of disease, or an occurrence of an incident by using the words "within the vicinity of the Premises". Insurers, predictably, have sought to define that term narrowly.

18. The court disagreed. In interpreting a particular form of words used by Royal and Sun Alliance, it said as follows (my emphasis):

> *"140. We therefore consider that the reasonable person would have understood the parties, in using the defined term Vicinity to mean an area whose extent would depend in part on the nature of the relevant "event", but which could be very extensive, and indeed nationwide. Furthermore, if that is right, then we consider that it can properly be said that, when COVID-19 occurred, it was of such a nature that any occurrence in England and Wales would reasonably be expected to have an impact on insureds and their businesses, and therefore that all occurrences of COVID-19 were within the relevant "Vicinity"."*

19. One of the arguments pursued until now by insurers, which I have always regarded as one of the more absurd ones, is that clauses which define a spatial radius around the insured premises, limit cover to outbreaks of disease which *only* occur within that radius. Many clauses, for example, provide that cover will only result from "outbreaks of disease within 25 miles of the Premises". Extrapolation of the argument made by insurers is that if a disease also manifests 26 miles away from the premises, then cover must be denied. It is an argument so thin on inherent logic that it might well have provided the basis for a costs argument after trial.

20. The court said this (my emphasis):

> *"142. In our judgment, it is not the correct construction of the coverage provision in Clause 2.3 (viii)(d) that cover is confined to what can be shown to be the business interruption or interference resulting from the occurrence of the disease within the Vicinity and does not extend to the business interruption or interference resulting from the disease being both inside and outside the Vicinity. We do not consider that that construction is dictated by the words used. The cover is not confined to the effects of a disease occurring only within the Vicinity, nor in our view is it expressly or implicitly confined to the effects only of the cases*

of the disease within the Vicinity. Instead the words used in Clause 2.3 are consistent with there being cover for the effects of a Notifiable Disease which has come within the Vicinity.

143. That this is the correct construction is, we consider, supported by a consideration of the nature of the insurance provided. It is for business interruption resulting from the occurrence within the Vicinity of, inter alia, certain diseases including the notifiable diseases under the 2010 Regulations. The regime under those Regulations was introduced to control epidemic, endemic and infectious disease. The nature of some of those diseases is that they may very well spread over a significant, and difficult to predict, area. SARS, which is specifically included in the table in the policy, would be an example of where that would be the case. It is also of the nature of such diseases that they may well produce a response from the authorities or the public which is to the outbreak as a whole, not to those parts of it which fall within "the Vicinity". This is especially the case if, as appears to us to be the correct hypothesis for present purposes, "the Vicinity" is to be treated as a geographically proximate area which is smaller than that in which the impact of a notifiable disease may reasonably be expected to be felt. We do not consider that in agreeing Clause 2.3 (viii)(d) the parties would be reasonably understood to be restricting the cover to interference or interruption of the business which was caused only by the fact that the relevant disease was within "the Vicinity", as distinct from its also being outside "the Vicinity"

144. Consistently with this, we do not consider that it is the proper construction of the policy that cases of the notifiable disease within the relevant area are independent of, and can be regarded as a separate cause from, cases outside the area. The nature of highly infectious or contagious notifiable diseases is that cases in different areas will be related to each other, having spread from one source to multiple individuals in different places. As people move, the disease moves with them. Given the nature of notifiable diseases, which was a matter which was or is taken to be known to the parties when agreeing the insurances, we consider that the correct construction of the cover provided by Clause 2.3 and in particular by (viii)(d), is for the business interruption or interference caused by a notifiable disease, if that notifiable disease occurs within "the Vicinity". The occurrence of at least a case of the disease within the Vicinity is required for there to be cover, which is a restriction which means, on the interpretation of

> *Vicinity now under consideration, that there is no cover for diseases which are only geographically remote."*

21. The point is made very clearly and not only removes entirely a line of argument often used by insurers in their letters of declinature, but gives rise to some interesting potential arguments in favour of businesses when one considers the underlined sections above in relation to other forms of words in policies.

Contra Proferentem and Exemption Clauses

22. The principle of *contra proferentem* is applied in circumstances where two parties contract on the basis of one party's standard terms and conditions. One party might usually be a small business or consumer, and the other a large company which trades based on a set of standard terms, usually carefully considered and drafted in advance, rather than negotiated between the parties. In similar such circumstances, the court is entitled to decide that any ambiguity in the interpretation of the terms and conditions should be held against the party that drafted them.

23. Of significant importance is the extent to which the principle applies in cases of insurance contracts and its relationship with clauses which purport to exclude liability: known as "exemption clauses". It has been held previously that the principles relating to the reasonableness of exemption clauses are of limited use in relation to insurance contracts because such equivalently worded terms instead ought to be construed as *defining the scope* of cover, rather than excluding liability for specific events, and therefore their operation is inherent to the purpose of the contract as opposed to providing exceptions from it.

24. The court set out at paragraph 354 the particular clause under consideration (a prevention of access clause which *excluded* prevention of access caused by occurrence of a specified disease):

> ***"1 Prevention of access***
>
> *Access to or use of the premises being prevented or hindered by*
>
> *(a) damage to neighbouring property by any of the insured events*
>
> *(b) any action of Government Police or Local Authority due to an emergency which could endanger human life or neighbouring property*
>
> *Excluding*
>
> *(i) any restriction of use of less than four hours*
>
> *(ii) any period when access to the premises was not prevented or hindered*

> *(iii) closure or restriction in the use of the premises due to the order or advice of the competent local authority as a result of an occurrence of an infectious disease (or the discovery of an organism resulting in or likely to result in the occurrence of an infectious disease) food poisoning defective drains or other sanitary arrangements or vermin or pests*
>
> *Provided that*
>
> ***our** liability in respect of any one occurrence shall not exceed the sum insured by the items or any limit of liability shown in the schedule"*

25. At paragraph 373 the court highlighted the lack of drafting skill which has been obvious to many practitioners, and set out the proper treatment of exemption clauses:

> *"...the policy wordings are not exactly a model of clarity in terms of drafting, we agree with Mr Kealey QC that the question of the construction of the infectious disease carve-out has to be approached on the basis that it is a provision delineating the scope of cover, not in any sense an exemption clause. The applicable principles are as summarised by the judge in Crowden and there is no place for the application of the principle of contra proferentem, to the extent that principle has any application in the modern law of construction of contracts."*

26. The court appears in principle to have accepted ambiguity in the clause, but declined to apply the principle of *contra proferentem* to it and treated it as a clause defining the scope of cover rather than as an exemption clause susceptible to the challenges relating to reasonableness.

27. Nevertheless, on ordinary principles of construction, the court adopted a particularly wide definition of "local authority" (one perhaps which some practitioners might have considered somewhat strained) as "including central government" (my emphasis):

> *"375. The point can be tested by reference to the Leicester Regulations. If one assumes for the purpose of the argument that COVID-19 was a specified disease in the list, if "competent local authority" had the narrow meaning of the local district council or other*

> *local authority as defined in section 1 of the 1984 Act for which the FCA contends, then there would not be cover in relation to the restrictions on the use of premises imposed by central government in bringing into force the Leicester Regulations. However, there would be cover if the same restrictions were imposed by Leicester City Council or if the Secretary of State asked the Council to impose the restrictions. The narrow meaning for which the FCA contends leads to an artificial and illogical result. In our judgment, Mr Kealey QC is right that the phrase "competent local authority" means whichever authority is competent to impose the relevant restrictions in the locality on the use of the premises, including central government."*

28. Thus, and for other reasons, it is not at all clear that apparently restrictive terminology used within policies will be interpreted as such, and may well be given a meaning consistent with the purpose of the policy and the surrounding legislative framework.

29. As to *contra proferentem* in contexts other than exemption clauses, whilst the court has obviously expressed some doubt as to whether the modern scope of the principle is as wide as it was in previous times, it is clear from para. 118 of the judgment that although the principle did not need to be applied in relation to one particular wording under consideration, it was "one of the few cases in which it would be appropriate to apply a principle of *contra proferentem*" and the argument remains very much an open one, now assisted by other arguments based on the court's wider-than-expected interpretation of certain contractual wordings.

Proving Manifestation of COVID-19

30. Another gift for policyholders appears at paragraphs 542 onwards in the judgment. Clearly, clauses which provide coverage based on outbreaks of disease must require some proof that there has been such an outbreak, and it is far from clear how such an outbreak ought to be proven given the nature of the disease.

31. In the familiar cases of holiday claims where customers have suffered from food-poisoning, the court has adopted a fairly narrow approach as to proof, and practitioners will be familiar with the range of expert evidence from microbiologists and/or biochemists required in such claims in order to prove on the balance of probabilities the presence of some or other micro-organism.

32. The court in the Test Case has not set out a standard methodology for such proof in all cases, rather, it has opened a number of doors for policyholders seeking to prove manifestation of COVID-19. In setting out its overall conclusions at para. 547, it said:

> *"567. It is not possible for us to provide any generally applicable guidance as to what evidence may prove actual prevalence in varying factual contexts and for the purposes of different policies. For example, some policies have a relevant policy area of 3.14 square miles (in the case of a one mile radius) and others have a relevant policy area of 1,963.5 square miles (in the case of a 25 mile radius). The relevant evidence as to prevalence will also vary according to the particular timing and location of the claim. And different inferences might be drawn from a combination of underlying data in different contexts.*
>
> *568. The two questions which the Court has to consider at the general level are: (1) what types of evidence could be used in principle to discharge the burden of proof on the insured as to prevalence, and (2) whether, assuming the FCA's evidence to be the best available evidence, that would be enough to discharge the burden of proof."*

33. Specific evidence of the disease will obviously be the easiest method of proof, for example, a staff member at a pub or hotel who suffered symptoms and was then diagnosed with the disease. That, however, given the factual circumstances of the pandemic and the availability of testing, will cause problems for almost all claimants and one can easily imagine the trials of claims of this sort descending into farce were the court limited to proceeding on the basis of only such specific proof, with witnesses

no doubt describing their symptoms and the court being asked to reach the impossible decision of picking between cases of the sniffles or coronavirus based on the most subjective of evidence.

34. The High Court has, however, given guidance on alternatives, and indeed did so with the agreement of the insurers (my emphasis):

> *"579. In substance, what the FCA seeks in this case is reassurance that the types of methodologies it has suggested (in the form of averaging and undercounting) could in principle discharge the burden of proof. But that much has already been conceded. The insurers have conceded that a distribution-based analysis, or an undercounting analysis, could in principle be used to discharge the burden of proof on an insured. The insurers have accepted that insureds can seek to rely on the specific reports identified in this case. Unlike the defendants in Equitas, the insurers do not suggest that absolute precision is required and that otherwise the claims will fail. The real issues between the parties were as to the reliability of the particular methodologies introduced by the FCA. The parties were given an opportunity to pursue an additional trial in early September to deal with these matters but the FCA decided (perhaps understandably given the time- compressed nature of the July trial) to proceed with the questions as framed. The concessions which have been made by the insurers are important. It is our hope and expectation that in the light of them insurers will be able to agree on any issues of prevalence which actually arise and are relevant to particular cases. Further than that, however, we are not able to go."*

Next Steps

35. The court concluded by inviting the parties to agree a form of words for declarations to be made appropriate to the decisions made in the judgment. That ought to be a fairly uncontentious exercise in agreeing a wording of the order to be made. There may also be arguments between the parties on other matters such as permission to appeal, if the insurers seek a decision on any particular points by the Supreme Court. There may need to be a further hearing for those purposes.

36. It is not at all clear whether the insurers intend to appeal or not, but given the overall victory for policyholders, and the sums involved for insurers there may be some appetite for that, but they will need to have a specific legal basis or bases for any such appeal and no doubt we will be informed what, if any, grounds they wish to pursue fairly shortly.

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