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Insights

REINSURANCE IMPLICATIONS OF FCA TEST CASE

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Reinsurers, Insurers and Policyholders have all eagerly awaited the decision in the English test case brought by the Financial Conduct Authority (FCA,) which was published on 15 September.

The FCA brought the case against 8 insurers to determine whether policyholders can make non-damage business interruption (BI) claims for losses arising from disruption and closure of their businesses caused by Covid-19 and the government's response to it. The judgment has been heralded by many commentators as a victory for policyholders. In reality, many insurers will be breathing a sigh of relief. In particular, the Court's restrictive interpretation of the "Denial Of Access" wordings under review in the test case will be particularly welcomed by insurers.

Reserves will therefore in some respects be revised downwards but, with risk of wider BI damage related consequences, perhaps reserves will need to be reviewed from another perspective, on which we elaborate further below.

In the immediate aftermath of the decision, many insurers materially reduced their reserves for non-damage Covid BI claims and announced that their catastrophe reinsurance recoveries will significantly limit the net cost of BI claims for UK insurance business. Insurers therefore seem confident that reinsurers will take their share of the impact of the Court's judgment. So what are the immediate reinsurance issues arising from the decision?

Aggregation

We set out our thoughts on the anticipated issues that Covid-19 would raise in the context of aggregating BI claims at the reinsurance level in our article of March 2020. You can find that article **here**. The Court's judgment has given some useful pointers, albeit nothing definitive, as to how cedants may wish to aggregate UK BI claims to maximize their reinsurance recoveries. For example, the test case judgment repeatedly refers to Covid-19 and its impact on the UK as

amounting to a "*continuing countrywide state of affairs.*" This suggests that cedants with aggregation clauses that use a "cause" trigger, as opposed to the more restrictive "event" language, might be more confident of their prospects of successfully presenting a single claim arising from their Covid-19 losses. This is because "cause" based language generally allows greater scope for aggregation of claims than event-based language, as discussed in the test case, which itself relied on the case of *Axa v Field:*

"*In ordinary speech, an event is something which happens at a particular time, at a particular place, in a particular way … A cause to my mind is something less constricted. It can be a continuing state of affairs; it can be the absence of something happening.*"

However, many aggregation provisions that appear in Property CAT XOL contracts do not use a "cause" or "event" language. Instead, they define a Loss Occurrence as: "*all individual losses arising out of and directly occasioned by one catastrophe.*" The meaning of a "catastrophe" in the context of aggregation has never been interpreted by the English Court. This raises novel issues for the reinsurance market.

Aggregation can assist both reinsureds and reinsurers. For example, it can work to the benefit of the reinsured for the purpose of establishing it has exceeded the deductible/retention or excess required to trigger coverage. On the other hand, aggregation can of course assist reinsurers to limit their losses. Therefore, cedants and reinsurers may argue for different interpretations depending on the reinsured's Ultimate Net Loss in respect of Covid-19 BI claims. Some, for example, may seek to argue that Covid-19 on the one hand and the government's (and the public's) response to it are two distinct "catastrophes". Others will say that Covid-19 and the government's response to it amount to a single "catastrophe". A related issue is whether losses arising from "disease", "denial of access" and "hybrid" wordings (i.e. those considered in the test case) can be aggregated for the purposes of reinsurance recoveries. The Court's finding that "*the disease in the UK is one indivisible cause*" is therefore also relevant.

In addition, the majority of property reinsurance contracts (both quota share and excess of loss) contain hours clauses. Hours clauses have not been much interpreted by the English Courts previously. What we do know, however, is that hours clauses were not drafted with the aggregation of virus/disease losses in mind. We therefore anticipate that their application will be a contentious area of debate in the market, particularly in circumstances where BI losses have accrued over a period of several weeks and months.

Separately, many reinsurance contracts are structured so as to cover either "Natural" or "Non-Natural" perils. The general consensus is that Covid-19 originated naturally (although some conspiracy theorists argue it is a man-made phenomenon). Whether the government-mandated national lockdown, albeit arising in response to Covid-19, can be categorised as a "Natural" peril is open to debate.

Also, the territorial scope of many reinsurance contacts is not limited to the UK; they also cover, for example, Continental Europe and further afield. Cedants may seek to aggregate UK losses with those from other jurisdictions. Again, the scope of the aggregation provision(s) in the contract will be crucial. To make matters more complex, the Courts in other jurisdictions may reach different conclusions to those in the FCA test case judgment. For example, a broader interpretation of the scope of "denial of access" extensions or, conversely, by ruling that the Covid-19 disease is distinct from and separate to the government's response.

Time will tell how these issues play out as between cedants and reinsurers, but it appears likely that the Courts (or more likely, given the jurisdiction clauses in the majority of reinsurance contracts, arbitration tribunals) will be engaged again in the near future.

Follow the Settlements

We previously offered some insight into the 'follow' issues that may arise in the context of Covid-19 claims in our piece from April 2020, which you can find **here**. That article focussed on what is required to ascertain Covid-19 related liabilities by way of settlement. Of course, now insurers'/reinsureds' liabilities (to the extent they arise) have been ascertained/crystallised by the Court's judgment. Accordingly, this should make it more straightforward for cedants to pass on their losses to reinsurers, as the judgment provides conclusive evidence of cedants' inwards liabilities (subject to any appeal).

However, insurers and reinsurers should be alive to the need to check that the Court's judgment (which is complex and needs to be applied on a claim-by-claim basis by insurers) and has been correctly interpreted by cedants. It will be prudent of the parties to assess the validity of any BI claims settled prior to the Court's ruling and, in particular, "Denial of Access" and similar-type claims.

Orient Express

Perhaps the most damaging aspect for re/insurers arising from the first instance decision in the FCA's test case is the Court's criticism of the insurer-friendly ruling of *Orient Express Hotels v Assicurazioni Generali*. The Court concluded that there were "several problems" with the reasoning in *Orient Express*.

Property insurers had up to now routinely relied on the insurer-friendly ruling in *Orient Express,* dating back to 2010, to assess BI payments for property damage BI claims relying on the trends clause in the policies. However, the judgment in the test case casts serious doubt over insurers' ability to rely on *Orient Express* when adjusting property damage BI claims in the future. Importantly, the Court's ruling is not only relevant to the non-damage BI claims that were subject to the test case: it potentially applies to the adjustment of all property BI claims going forward. The upshot of the decision is that policyholders are potentially entitled to a higher assessment of damages when calculating their losses following an insured event. Given that insurers' exposures may increase in

the future, this will have a knock-on effect on reinsurers, particularly those participating on excess layers who did not price for these increased exposures. It is expected that the Court's ruling on *Orient Express* will be a focus for insurers in any appeal. Reinsurers will therefore also be keeping a close eye on developments.

Damages for Late Payment

Finally, insurers are legally obliged to pay claims in a reasonable time. Policyholders have been entitled to claim damages for late payment of valid insurance claims since May 2017 under the Insurance Act 2015. That change in the law was brought about with small and medium sized enterprises in mind (i.e. those businesses most affected by the policies subject to the test case), but has yet to bear its teeth. We previously discussed some of the issues raised by that change in the law in the context of Covid-19 claims in our recent article, which you can find **here**.

In the immediate aftermath of the judgment, Christopher Woolard, Interim Chief Executive of the FCA, commented: "*Insurers should reflect on the clarity provided here and, irrespective of any possible appeals, consider the steps they can take now to progress claims of the type that the judgment says should be paid.*" Subsequently, in its Dear CEO letter of 18 September, the FCA set out its expectations of insurers handling affected claims. In particular, the FCA explained that where insurers have policy wordings which were affected by the test case, and the relevant questions in the test case are the subject of an appeal, it expects insurers to continue to progress claims of the type that the judgment says should be paid so that they are as advanced as possible when any appeal judgment is handed down. Where affected policies are not subject to an appeal, insurers should reassess all potentially affected claims/complaints, unless the claim or complaint has been properly settled on a full and final settlement basis. The onus is clearly on insurers to progress claims as quickly as reasonably practicable.

However, if insurers are found liable for damages (potentially in excess of their policy limits) for failing to pay claims promptly, it is likely that they will look to pass on, as appropriate, those legal liabilities to reinsurers. Reinsurers may therefore look to relying on claims control rights (or similar) following notification of claims. Some reinsurance contracts have also been drafted so as to limit cedants' ability to pass on such losses to reinsurers. These provisions may become more common moving forward.

Conclusion

The market is still digesting the ramifications of a complex, lengthy judgment. This article raises just some of the myriad issues that cedants and reinsurers will be grappling with over the coming months. What we do know, however, is that its impact will be far-reaching for both insurers and reinsurers in the foreseeable future, notwithstanding any anticipated appeal.

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MEET THE TEAM

Jonathan Sacher

Co-Author, London

jonathan.sacher@bclplaw.com
+44 (0) 20 3400 2307

Anthony Lennox

Co-Author, London

anthony.lennox@bclplaw.com
+44 (0) 20 3400 2299