Second Australian COVID-19 BI Test Case

APPEAL JUDGMENT SUMMARY
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DLA PIPER

COVID-19 ALERTS

Introduction

1. On 21 February 2022, the Full Court of the Federal Court of Australia delivered judgment on appeal in the Second Test Case: *LCA Marrickville Pty Limited v Swiss Re International SE* [2022] FCAFC 17. The appeals were heard over five days in November 2021 before Justices Moshinsky, Derrington and Colvin. The judgment relates to appeal points run by policyholders and insurers in five of the original ten proceedings which comprised the Second Test Case at first instance.

2. The Full Court substantially upheld the judgment delivered at first instance by Justice Jagot in 2021. In doing so, the Full Court affirmed findings made by her Honour:

    - in favour of insurers, including that:
        - government orders made in response to a general risk or threat posed by COVID-19 do not satisfy 'disease clauses' or 'hybrid clauses'. This is because such orders do not satisfy the necessary causal connection, requiring the order to result from a specific occurrence or outbreak of disease at, or in the vicinity of, the insured premises;
        - where a policy contains an insuring clause (e.g. a 'hybrid clause') which refers expressly to disease and an insuring clause directed to more general matters, such as "threat of damage" or "risk to life" (e.g. 'prevention of access clause'), the more general clauses do not provide cover for business interruption consequent upon disease; and
        - 'catastrophe clauses' do not provide cover for business interruption caused by COVID-19 because the phrase "conflagration or other catastrophe" refers to events capable of causing physical destruction and a disease pandemic does not meet this description; and
    - in favour of policyholders, including that:
        - to demonstrate an "outbreak" of COVID-19, evidence of transmission of the disease is not required;
        - 'prevention of access clauses' are capable of responding to business interruption caused by orders motivated by the general risk posed by the pandemic on a broad (e.g. state-wide) scale; and
        - trends clauses cannot be applied to make an adjustment for losses resulting from the same "*underlying fortuity*" which gave rise to the insured peril.

3. However, the Full Court also overturned certain findings which her Honour made in favour of insurers at first instance and decided the issues in favour of policyholders instead. These include her Honour's findings that:

    - adjustments should be made to account for certain benefits, grants and other payments received by policyholders. The Full Court determined that no adjustment should be made to reflect such payments; and
    - interest under section 57 of the Insurance Contracts Act 1984 (Cth) does not accrue given the on-going test case proceedings. The Full Court determined that the existence of test case proceedings does not necessarily mean that it was not unreasonable for the insurers to have withheld payment of claims.

4. This briefing paper addresses certain key aspects of the appeal judgment, including those areas where the Full Court has departed from findings made at first instance. However, having regard to the number of proceedings, policies and issues involved, this briefing paper is not intended to provide an exhaustive summary of all of the findings in and implications flowing from the appeal judgment.

Recap – the first instance decision

5. The first instance judgment was generally regarded as a favourable outcome for insurers, principally due to findings made about the construction and operation of insuring provisions.

6. One key finding related to 'hybrid clauses', which provide cover for business interruption consequent upon a closure order resulting from disease at, or within a specific radius of, the insured premises. Her Honour determined that the necessary causal link between the closure order and the disease would not be satisfied if an order was imposed in response to the risk posed by COVID-19 generally. In fact, her Honour reasoned there must be a causal link between the closure order and the specific outbreak or occurrence of disease at, or within the prescribed vicinity of, the insured premises. The result of this finding was that many policyholders whose businesses had been interrupted by sweeping, state-wide orders and restrictions, are unlikely to secure cover under 'hybrid clauses'.

7. Another key finding made by her Honour at first instance related to the interplay between insuring provisions referring specifically to interruption caused by disease and insuring provisions directed to more general subject matters, such as a risk to life or threat of injury to persons (including so-called 'prevention of access clauses'). Her Honour determined that policies containing both types of insuring provision should be construed such that the broader insuring clause does not provide cover for interruption caused by disease.

8. In nine of the ten proceedings adjudicated at first instance, her Honour declared that the policies did not provide cover because the requirements of their insuring clauses were not satisfied.

9. Although the insurers succeeded at first instance on a number of significant issues, they did not succeed on all issues. By way of example, policyholders' arguments were accepted as to the meaning of "outbreak", which her Honour determined did not require transmission of COVID-19 and would be satisfied if there was "*a case of active (that is, infectious) COVID-19 in the community (that is, in a non-controlled setting)*". Policyholders also succeeded on the issue of trends clauses. In this regard, her Honour followed a similar line of reasoning as was applied in the UK FCA Test Case (including by rejecting the "but for" approach adopted in *Orient-Express Hotels Ltd v Assicurazioni Generali SA* [2010] Lloyd's Rep IR 531). Her Honour determined that the amount of any indemnifiable loss should not be reduced by reason of circumstances arising from the same "*underlying fortuity*" which gave rise to the insured peril.

What remains unchanged?

10. As noted at the outset, the first instance judgment was substantially upheld by the Full Court on appeal. The key findings made at first instance in relation to the relevant insuring provisions have not been disturbed. Accordingly, in many cases, these findings will continue to present significant hurdles for policyholders seeking to advance business interruption claims arising from the pandemic.

Insuring Clauses

11. With respect to 'hybrid clauses', the Full Court recognised the same distinction which Justice Jagot had recognised at first instance, being:

    "the distinction between, on the one hand, an authority preventing or restricting access to the premises as a result of a threat or risk of harm to each and every person in the State… and, on the other hand, an authority closing or evacuating the premises as a result of an outbreak of an infectious or contagious human disease occurring within a 20 kilometre radius of the premises".

12. The Full Court agreed that, while insuring clauses applying to the former may be enlivened by orders imposed in response to the general risk of the pandemic, insuring clauses (such as 'hybrid clauses') applying to the latter will not be. In reaching this conclusion, the Full Court confirmed that the 'equal proximate cause' reasoning applied in the FCA Test Case in the UK is not applicable in Australia due to the countries' differing governance systems and experiences of the pandemic.

13. With respect to 'prevention of access clauses' and other insuring provisions which are not expressly directed to disease (including so-called 'catastrophe clauses'), the Full Court affirmed Justice Jagot's determination. Thus where a policy contains another insuring clause which refers expressly to disease, the more general insuring clause does not apply to loss consequent upon disease. To construe the policy otherwise would result in "*profound incoherence or incongruence*".

14. Further, with respect to the 'catastrophe clause' under consideration in the Second Test Case, the Full Court affirmed Justice Jagot's determination that the term "catastrophe" does not include a pandemic of disease. Rather, the Full Court held that the term "*should be given a meaning which requires … a physical event of some magnitude causing widespread physical destruction or loss of life as a result of the unleashing of destructive forces*".

Exclusions

15. In November 2020, the NSW Court of Appeal delivered judgment in the First Test Case, which concerned the operation of exclusion clauses referring to diseases declared under the repealed *Quarantine Act 1908* (Cth) "and *subsequent amendments*". The Court determined that such exclusions did not apply to COVID-19. However, the First Test Case did not consider the potential operation of section 61A of the *Property Law Act 1958* (VIC), which provides:

    "*Where an Act or a provision of an Act is repealed and re-enacted (with or without modification) then, unless the contrary intention expressly appears, any reference in any deed, contract, will, order or other instrument to the repealed Act or provision shall be construed as a reference to the re-enacted Act or provision.*"

16. At first instance in the Second Test Case, Justice Jagot determined that section 61A could not be utilised so as to construe references in exclusions to the repealed *Quarantine Act 1908* (Cth) as referring to the *Biosecurity Act 2015* (Cth). The Full Court upheld Justice Jagot's finding on this issue, determining that "*the primary judge was correct to hold that the word* "Act" in s 61A *means an Act of the Parliament of Victoria and does not include a Commonwealth Act*", such as the Quarantine Act.

Adjustment

17. The Full Court affirmed the first instance decision on trends clauses and, in doing so, applied a line of reasoning consistent with the 'underlying fortuity' principle enunciated by the UK Supreme Court in the FCA Test Case. The Full Court held that "*a sensible commercial construction of a policy would not construe cover for an insured peril as being limited by the impact of loss causing events which are inherent in the occurrence of the peril itself*".

18. Giving this conclusion a practical application, where an insuring clause provides cover for orders imposed in response to a risk to life (in this case, the threat of disease), other consequences of that same threat of disease – including, for example, a trading downturn as a result of people staying at home – must be removed from, or 'stripped out' of, the relevant counterfactual for the purpose of applying the trends clause.

19. However, the Full Court agreed that, if the underlying fortuities were not the same, then an adjustment may be appropriate. For example, in one case, the Full Court held that an adjustment should be made to account for loss which a travel agency had sustained as a result of overseas travel restrictions. This was because the insured peril was "*the presence of COVID-19 in the State and the associated risk of the spread of COVID-19 throughout the State*", whereas the overseas travel bans arose from "*the presence of COVID-19 overseas and the risk that an overseas traveller coming to Australia may bring COVID-19 into any part of Australia*". Consequently, the Full Court held that "[t]*he underlying fortuities involved different subject-matter*".

What is different?

20. The Full Court's decision differs from the first instance decision in two principal respects, being

    - firstly, the treatment of third party payments (e.g. grants, subsidies and benefits) received by policyholders; and
    - secondly, the application of interest pursuant to section 57 of the *Insurance Contracts Act 1984* (Cth).

21. Both of these issues had been resolved in insurers' favour at first instance, however, in both cases, the policyholders succeeded on appeal.

Third Party Payments

22. At first instance, Justice Jagot found that adjustments should be made to account for certain types of payments received by policyholders. These payments included Commonwealth JobKeeper payments and other receipts which had the effect of reducing the policyholder's indemnifiable loss. Her Honour distinguished these payments from certain other types of government grants which should not be accounted for because they were 'acts of grace' or 'mercy payments'.

23. On appeal, the Full Court addressed two main issues. The first was whether there was a general principle of indemnity which prevented policyholders from receiving the benefit of payments from both their insurer and the third parties. The second was whether the 'savings' provisions in the policies required an adjustment to be made for third party payments received.

24. The Full Court emphasised that primacy must be given to the language of the policy, including the loss calculation methodology it prescribed, observing that: "[t]*he reasonable businessperson considering the policy from the point of view of the parties to it would understand them to have agreed upon this methodology as the basis for determining both whether there is a loss, as well as the quantum of any loss*". The Full Court therefore held that "[i]*n light of the... detailed provisions, there is simply no room for general principles applicable to contracts of indemnity to operate*".

25. As to the issue of specific 'savings' provisions, the Full Court considered a provision which required an adjustment to be made for "*such charges and expenses of the Business as may cease or be reduced in consequence of the interruption or interference*". The Full Court noted that, whereas the insured peril was the outbreak of disease in the vicinity of the insured premises, the benefits received by the policyholder – including JobKeeper benefits – were not received in consequence of that outbreak. Rather, the policyholder was entitled to JobKeeper benefits because it satisfied certain financial criteria prescribed by the Commonwealth Government, which "*did not depend on whether or not there had been an outbreak*". Accordingly, the Full Court held that the 'savings' provision did not require an adjustment to be made to reflect the JobKeeper benefits and other government grants which the policyholder had received.

Interest

26. Section 57 of the *Insurance Contracts Act 1984* (Cth) provides that an insurer is liable to pay interest on amounts payable under a policy from the date upon which it was unreasonable for the insurer to have withheld payment. At first instance, Justice Jagot determined that, to the extent any of the policyholders involved in the Second Test Case were entitled to indemnity, interest under section 57 would not apply to any such payment because it was not unreasonable for the insurers to await the outcome of the test case (including any final determination on appeal) before paying the claim.

27. The Full Court observed that the existence of a bona fide coverage dispute does not, of itself, mean that an insurer is not acting unreasonably in withholding payment. Further, the fact that the coverage dispute may have been advanced by way of test case proceedings does not change the position. The Full Court stated:

    "[i]*f it was unreasonable for an insurer to withhold payment as from the date on which it denies its insured's claim, it cannot subsequently become reasonable for it to continue to withhold such amount because the insured, amongst others, has agreed to their claim being determined as part of the test case*".

28. The Full Court, however, went on to state that, in principle, circumstances which might result in it not being unreasonable for an insurer to withhold payment included if the policyholder changed its claim to such an extent that "*the claim pursued at trial bore "little resemblance" to the claim either notified to the insurer or pleaded*" or if the policyholder failed to provide sufficient information to facilitate proper consideration of its claim by the insurer. This is because "[t]*he period of time which a reasonable insurer would require to investigate and consider a claim cannot elapse until the claim which ultimately succeeds has actually been advanced or becomes apparent*".

Conclusion

29. On the whole, the Full Court substantially upheld the first instance decision in the Second Test Case.

30. The policyholders achieved some new successes on certain issues which they had not succeeded on initially, however these issues tend to relate to the adjustment and quantification of any indemnity, rather than its availability.

31. While insurers' appeals were largely unsuccessful, they consolidated their positions on important issues which they had achieved success on at first instance, including issues which are likely to present significant obstacles to cover for many policyholders.

Appeal

32. Any application for special leave to appeal the Full Court's judgment to the High Court of Australia must be filed within 28 days of the date of judgment.

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