Dechert LLP

COVID-19
The impact of COVID-19 on insurance of real estate

31 July 2020

The COVID-19 crisis has raised questions on whether insurance will help businesses mitigate losses suffered as a result of the pandemic. This note looks at the position in the UK and the U.S., with a particular focus on business interruption insurance.

1. Business Interruption Insurance

In both the UK and the U.S., business interruption coverage is often provided in conjunction with or as an add-on to buildings insurance. It is generally designed to protect against loss of income as a result of physical damage or similar which prevents access to the property. Whether business interruption insurance policies do, or should, cover losses from COVID-19 has been hotly debated on both sides of the Atlantic.

In each case, whether or not there is cover will depend on the precise wording of the policy terms, although there are a number of common themes that will frequently arise.

Coverage: Summary of Position in the UK:

The trigger for a pay-out for business interruption under UK policies is usually limited to physical damage to the actual property (for example, from a flood or a gas explosion). Where cover is limited to these physical triggers, it is unlikely that the policy will respond to COVID-19 losses, although there may well be novel arguments raised that the presence of COVID-19 on surfaces constitutes "damage" to the property. This will raise questions on how permanent any "damage" has to be and complex issues for expert evidence on the extent of contamination, and for how long the virus remains active on different surfaces.

Where the policy contains add-ons expanding cover to include infectious diseases and/or denial of access to the property on the basis of state intervention, there will be greater scope for argument.

Already, a group of UK businesses have secured funding for a coverage dispute with a major insurer not currently paying under business interruption policies triggered by the insured's "inability to use the insured premises due to restrictions imposed by a public authority […] following an occurrence of any human infectious or human contagion disease, an outbreak of which must be notified to the local authority." Arguments in that case are likely to focus on whether businesses were "unable" to use their premises or were just advised not to (or restricted access to protect employees) and also whether the disease or infection has to specifically impact the property concerned to be covered.

Where infectious diseases add-ons are included, they tend to be tightly drafted. Disputes will arise where the relevant wording either provides for a specified list of diseases or, alternatively, excludes specific types of disease. How COVID19 is classified by the courts will be important in determining whether it falls within language such as "any mutant variant thereof" or within exclusions for SARS and mutations of it.

The UK Financial Conduct Authority ("**FCA**"), which regulates insurers, has taken certain steps to try to clarify the position for policyholders.

On 15 April 2020, it wrote to insurance chief executives making clear that, while most policies had only basic cover (i.e. no add-ons for infectious diseases) and so would not be engaged by COVID-19, there were others where there was a clear obligation to pay. The FCA impressed on insurers the need for fast payment of valid claims and indicated that, where only part of a claim was disputed, an interim payment for any undisputed amount should be made. Insurers refusing to adopt that policy were asked to send their grounds for that decision to the FCA.

The FCA also announced on 1 May 2020 its intention to bring test cases on the interpretation of a selection of sample wordings prevalent in the market. The High Court hearing of the test case ran from 20-30 July and a decision is expected by mid-September. The decision will be legally binding on the insurers that are parties to the case (notably Hiscox, Royal & Sun Alliance and Zurich) and will also provide persuasive guidance for the interpretation of similar policy wordings and claims. The FCA has issued guidance setting out its expectation that insurers should apply the judgment in (re-) assessing all outstanding or rejected claims and has also issued a statement on considerations to be taken into account on quantification of claims and the application of deductions of government support received by policyholders.

Where Business Interruption policies do not respond, there may be some scope for argument under different policy terms. For example, policyholders may try to claim the costs of frequent deep cleans, as and when restrictions ease, on the basis that the virus remaining on surfaces constitutes “damage” to the property.

We expect it unlikely that insurers will write any new policies, or extend cover under existing ones to cover COVID-19, at least for the time being, as the risk is unprecedented and still unquantifiable. In the long term, however, we are likely to see a difference in the approach to the wording of business interruption clauses; we expect a move away from identifying specific insured risks in favour of more general cover for a higher premium.

One solution for the UK market may be the introduction of a government-backed scheme to ensure future cover for pandemics. A steering group comprising several top insurance company chief executives was established in April 2020 to develop a future pandemic cover proposal which would work in a similar way to previous schemes introduced to ensure cover is available for terrorism risks (Pool Re) and flood risks (Flood Re).

Summary of Position in the U.S.:

In the U.S., there is case law where “direct physical loss or damage” has been interpreted more broadly than in UK courts. For example, in a case brought in New Jersey, an accidental release of ammonia into a packaging facility caused the facility to be shut down for one week while the ammonia dissipated. The records showed the only way to fix the issue was to “air the property” and hire an outside company to clean the property. The court noted that physical loss did not have to be structural change to the property but could be damage rendering “the facility temporarily unfit for occupancy.”

In the first substantive ruling on a COVID-19 related business interruption insurance claim, a Michigan court ruled that the insurer's denial of the claim was proper because COVID-19 did not affect the actual, tangible structure of the claimant's restaurants. Cases such as this do not bode well for policyholders and the concept that coverage requires physical damage, and that the virus does not constitute such covered physical damage, appears to be holding strong. Until the tidal wave of upcoming litigation is decided, the success or failure of such plaintiff claims remains uncertain.

The position on ‘denial of access’ cover in the U.S. is similar to the UK; some building insurance policies do provide business interruption coverage where lost earnings are the result of an order of a civil authority prohibiting access to a property of the insured.

In the context of COVID-19, a restaurant in Louisiana was the first to seek a declaratory judgement that its "all-risk" building insurance policy (a policy which covers all risk except risks specifically excluded) provides coverage for civil authority shutdowns of restaurants in the New Orleans area due to physical loss from COVID-19, and that the policy provides business interruption coverage in the event that the virus was in the insured premises. In support of its case, the restaurant alleged that COVID-19 can constitute physical loss because the virus “physically infects and stays on the surface of objects or material for up to twenty-eight days.” Other restaurateurs have followed suit and there is now fear that if such claims are successful, the stability of the insurance sector could be impacted as there is not enough surplus for the pay-outs. It is not clear at this stage whether the insurers would be entitled to a state or federal reimbursement.

This could pave the way for this argument being run in other jurisdictions, and in relation to other heads of claim, in business interruption insurance policies.

State intervention is also widespread. Various States (the first being New Jersey, followed by Ohio, New York, Massachusetts, Pennsylvania, Louisiana and South Carolina) have intervened and introduced new Bills to “protect small businesses from catastrophic losses” arising from the COVID-19 pandemic. The Bills require insurers offering business interruption insurance to retrospectively cover losses during the period of a declared COVID-19 state emergency which are attributable to viruses and pandemics, and to recognise that COVID-19 does cause physical damage. The Bills stop short of an explicit declaration that COVID-19 has caused physical damage, which therefore leaves determinations about the extent and nature of the damage to insurance providers or the courts.

No action has been taken on most of the Bills since April or May, according to a National Conference of State Legislatures database. In all states except California the Bills are still in committee. The California Bill is also the only Bill introduced that would create rebuttable presumptions that affect the burden of proof in coverage cases. The courts would be required to presume that for any business interruption caused by closure orders that:

- COVID-19 was present on the insured's property and caused physical damage.
- COVID-19 was present on any property in the geographic location covered by a civil authority's order and had caused physical damage.
- COVID-19 was present on the property of a third-party which prevented the ingress and egress to an insured's property.

This legislation would have forced insurers to pay more coronavirus business-interruption claims, but it was put on hold when state lawmakers decided not to return from their summer recess because of a resurgence of the disease.

In a blow for the insured, the Insurance Law Committee of the New York City Bar Association issued a report in June on the New York Bill, which identified deficiencies in the Bill as it stands, notably that the Bill and similar proposed legislation in other states, would alter in-force insurance policies, thus changing the legal rights and obligations of parties to an existing contract and arguably constituting an unconstitutional impairment of contract.

These and other constitutional issues have been raised in lawsuits in New York and other states and are likely to be litigated extensively over the coming months. Estimates from a major insurance trade association of business interruption losses suggest that it is untenable for the insurance industry to absorb COVID-19 losses on a categorical basis as envisaged by the Bill. Even though an insurer might be entitled to a state or federal reimbursement any single insurer might incur such severe losses under this Bill as to imperil its financial condition. According to this early estimate, on a nationwide basis, business interruption losses just for small businesses with 100 or fewer employees are approximately $255 billion to $431 billion per month. Given the breadth of the relief programs available for small businesses (such as the CARES Act's Paycheck Protection Program) and the fact that the losses experienced by U.S. businesses in connection with the pandemic may well dwarf the aggregate insurance industry's reserves, it is not clear that recovery through insurance policies that were not written to cover such perils is the best way to make businesses whole for COVID-related losses, or that doing so would lead to a socially acceptable outcome.

Insurers providing coverage mandated by the Bills can request reimbursement from the State of some of the costs incurred, which will pay the insurers' claims either by utilising “available funds” or from a "Business Interruption Insurance Fund" created by levying a charge on insurers. This is not intended to compensate the insurer fully. The Insurance Law Committee notes that the New York Bill separately states that distributions from the funds collected for this purpose are allocated "proportionately" based on an insurer's share of state-wide insurance premiums and does not include any cap on reimbursements. Since there is no reasonable way to estimate the potential claims against such funds, including the number and limit of policies affected and the unknown length of time the emergency could remain in place, the reimbursement obligations could become an industry-wide economic and solvency flashpoint.

This concept is likely to be applied on a federal level across the U.S., and on 31 March 2020, a coalition of more than 30 trade organisations submitted a proposal for the creation of a fund, backed by the federal government, to distribute government backed pay-outs to businesses through insurance contracts.

The U.S. is also looking to implement new forward-looking legislation, tentatively called the Pandemic Risk Insurance Act, which would guarantee the availability of insurance coverage arising out of circumstances similar to COVID-19.

The details of all these proposals need to be fleshed out, but the requirement that COVID-19 be retroactively considered a “covered peril” could have sweeping implications, and it will be interesting to see if any European countries try to follow suit. Even if insurers are entitled to request a reimbursement of some of the costs incurred from the state, it is likely the retrospective alteration of the terms of the parties' contracts will result in litigation being brought by insurers on constitutional grounds under the Contracts Clause. There are strong opinions on both sides of this argument, notably on the side of the insurers that it is unconstitutional to retroactively rewrite the contract to shift the burden of loss from businesses to insurers; on the other side of the argument is the view that no federal constitutional provision stands in the way of legislators' adopting regulatory measures protecting economies from devastation, including the Contracts Clause.

2. Invalidation of Existing Insurance Policies by Closure or Repurposing of Properties

Both title indemnity insurance policies and buildings insurance policies often contain a “continuing use” clause, meaning the property is only to be used for a specified use (such as a hotel), and a “keep open” clause which says that the property cannot be closed for more than a specified period (often 60 days). In these unprecedented times, it may be that properties are either re-purposed (for example, from hotels or exhibition halls to temporary hospitals), or closed in line with government guidance. The thinking in the UK insurance market is that despite the contractual terms of the policy, if an insured is acting ethically and the breach is temporary, a court would be unlikely to uphold a claim brought by an insurer that the policy has been invalidated in these circumstances.

If in doubt, the best course of action for policyholders is to tell the insurer before re-purposing or closing a property. The policy guidelines should always be followed, including taking appropriate steps to secure the building and minimise the risk of water damage/arson etc. if it is to be closed.

3. Claiming Damages under a Business Interruption Policy

If a business manages to establish a trigger to a material damage claim, it must then quantify its loss, which presents its own difficulties during the COVID-19 pandemic.

For example, in the U.S. a case concerning a business interruption claim by a hotel that was damaged as a result of Hurricane Katrina, the hotel was required to show that “but for” the damage to the hotel itself, it would not have suffered the same loss. It was unable to do so; even if the damage had not occurred, it would have suffered the same business interruption losses due to the devastation to the surrounding area. Applying this to COVID-19, a business would have to compare its actual financial position to the position that it would have been in, had it remained open while the population at large was social distancing. On this basis, the quantifiable loss could be quite limited.

In the UK it must generally be proved that the real or “proximate” cause of the loss is relevant trigger event, although this principle can be modified in the terms of the policy. Even where a trigger can be established, policyholders are likely to face significant difficulties proving that their losses were causes by damage or denial of access to their properties, given the multitude of other plausible causes linked to the wider COVID-19 impact, such as collapse of supply chains or loss of demand for the service.

Claims for consequential loss may also be viable where insurers are proved to have wrongly withheld payment of a valid claim. In both the UK and the U.S. there is precedent to support claims for damages caused by delays in payment in these circumstances. If the business fails as a result of the delay in payment, these losses could be substantial.

Authored By

Simon Fawell
Partner, Financial Litigation
London
+44 20 7184 7859
simon.fawell@dechert.com

Elizabeth Le Vay
Counsel, Real Estate
London
+44 20 7184 7892
elizabeth.levay@dechert.com

Teresa Long
Counsel, Real Estate
New York
+1 212 698 3813
teresa.long@dechert.com

Other Key Contacts – Real Estate Team

David Gervais
Counsel, Real Estate
London
+44 20 7184 7670
david.gervais@dechert.com

Edward Johnson
Counsel, Construction
London
+44 20 7184 7424
edward.johnson@dechert.com

Other Key Contacts – Insurance Team

Dorothy Cory-Wright
Partner, Litigation
London
+44 20 7184 7599
dorothy.cory-wright@dechert.com

Stephen Surgeoner
Partner, Litigation
London
+44 20 7184 7877
stephen.surgeoner@dechert.com