Published in issue 123 of the Journal of the British Insurance Lawyers Association

Late payment of insurance claims: a legal or a regulatory issue?

By Jonathan Goodliffe

Summary

In most insurance claims on the wholesale market there is no cause of action for damages for late payment of the claim, as opposed to a claim for interest. If late payment has, for instance, resulted in the claimant losing a business deal, damages might be considerably greater than interest, even interest at a commercial rate.

The Law Commissions of England and Wales and of Scotland, as part of their more general project for reforming insurance law, have recommended (subject to consultation) that this rule be reversed. The recommendation is made in their issues paper 6, "Damages for late payment and the insurer's duty of good faith". The issues paper is expected to be followed up by firmer recommendations.

This article is not primarily concerned with the merits of the Law Commissions' recommendation, which BILA[1] and I broadly support, but with the question of whether the recommendation is best achieved by primary legislation or by regulation. This question incidentally raises points on the interaction and overlap between insurance law and regulation.

In their issues paper, the Law Commissions assume that primary legislation is required to achieve their recommendation. That assumption may prove to be correct, since the outcome of the project depends more on politics than law. However, the paper did not consider what I suggest may be an alternative regulatory approach to reform. This may prove ultimately to be more politically viable, although the regulatory approach itself may have problems. These raise some interesting issues about how rulemaking powers can and should be exercised. I discuss these points below.

Sprung v Royal Insurance

In *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111, the Court of Appeal held that damages are not recoverable for late payment of an insurance claim. The reasoning was that an insurance claim is itself a claim for damages. Damages cannot be claimed upon damages. The Law Commissions' paper is primarily aimed at reversing this decision.

Since the judgment, however, The Financial Services Authority (FSA), has taken on responsibility for the supervision and regulation of insurance mediation and more generally the conduct of insurance business. It has adopted new rules relating to non-investment insurance now contained within its Insurance Conduct of Business Sourcebook (ICOBS).

ICOBS

The handling of claims otherwise than fairly and promptly in respect of non-investment insurance is now a regulatory breach under ICOBS 8.1.1R[2] which provides[3]:

> "An *insurer* must:
>
> (1) handle claims promptly and fairly;
>
> (2) provide reasonable guidance to help a *policyholder* make a claim and appropriate information on its progress;
>
> (3) not unreasonably reject a claim (including by terminating or avoiding a *policy*); and
>
> (4) settle claims promptly once settlement terms are agreed."

This is the case regardless of whether the *policyholder* is a business, a consumer, a human person or a legal person[4]. A cause of action for damages, however, in respect of a rule breach under section 150 of the Financial Services and Markets Act 2000 (FSMA) only normally accrues for the benefit of a *private person*. The meaning of this expression was required under FSMA to be "prescribed" by regulations laid before Parliament. The cause of action also accrues only to the extent that the FSA does not otherwise "specify" in its rules under section 150(2). The effect of such a "specification" is to "switch off" the right to damages in particular cases.

In the case of ICOBS 8, the right to sue under section 150 has not been switched off. For some other rules it has. An example is the FSA's Principles for Businesses, which include its "flagship" Principle 6, requiring its regulated firms to treat their *customers* fairly.

What is a "*private person*"?

The meaning applied by the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (the Rights of Action Regulations) to *private person* is highly counter-intuitive and the policy underlying it is unclear. It includes both human persons and legal persons. So a limited company can be a *private person*. In the case of human persons the loss may, among other things, be suffered in the course of a business (other than a FSMA regulated activity). In the case of legal persons (including partnerships) the loss must have been suffered otherwise than in the course of carrying on a business of any kind.

So persons entitled to sue for breach of ICOBS 8 would include, for instance:

- the plaintiff in *Sprung* (who was a human person) if his claim had arisen after ICOB came into force in 2005 (this point was not picked up by the Law Commissions in their issues paper),

- human persons operating on a solo business basis (including for example all barristers in private practice, since they invariably operate as sole practitioners),
- professional businesses in relation to their pro bono or social activities, and
- charitable corporations carrying on non-business activities.

It is thus not correct to say (as the Law Commissions do at para 5.19 of their paper) that "these claims are not open to businesses". They are open to most businesses in limited circumstances and to some businesses in all circumstances.

For non *private person*s the right to sue under section 150 may be "switched on" under section 150(3), but this can only be done in "prescribed" (rather than "specified") cases. The "prescription" must be made by regulations to be laid before Parliament.

This is a less flexible tool than the FSA rules, since the drafting of the rules is the responsibility of the FSA's sponsoring department, HM Treasury (HMT), and the rules might be blocked by Parliament. The FSA and HMT's respective policy agendas may not always coincide, as is apparent from HMT's description of the FSA's exercise of its functions as being "a tick-box approach"[5]. HMT is also very busy in its various other more mainstream functions and no doubt does not want to be regularly promoting regulations under section 150(3).

Ways of changing the law

Nonetheless regulations are themselves a less unwieldy tool for changing the law than statutes, because Parliament is also very busy. Each parliamentary bill has to compete with many others in the government or private members' agendas. Bills before Parliament are more likely to be controversial, especially if the Government does not apply a whip. Difficulties with getting proposed legislation before or through Parliament are a major reason why many previous proposals for reforming insurance law have not succeeded.

The government has recently promoted the Consumer Insurance (Disclosure and Representations) Bill to implement some of the Law Commissions' recommendations. However, that was a measure aimed at advancing the interests of consumers. It therefore had vote winning potential.

More technical changes to the law to advance the specialised interests of wholesale policyholders are another matter. A member of parliament may well ask him or herself why he should be concerned with such issues, when they are within the powers of the regulator.

Regulatory reform

A major project[6], currently taking up a large part of HMT's time and due to take up a large part of Parliament's time, involves making major reforms to the financial services

regulatory regime. It will, among other things, split the FSA's current functions between two new regulators, the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA). None of these proposals, however, will, as currently framed, affect the substance for present purposes of the power to make conduct of business rules. These will include what will be the FCA's ability to switch off the right of *private person*s to claim damages for rule breaches and the ability to switch on the rights of non-*private person*s by regulation.

Switching on the rights of non *private person*s

In fact the power to switch on the rights of action of non *private person*s has been exercised very sparingly since the FSMA came into force in 2001. The cases in which the right arises were expressed in general terms in article 6 of the Rights of Action Regulations. Most importantly they include cases where the rule that has been contravened prohibits an authorised person from seeking to make provisions excluding or restricting any duty or liability.

Since 2001 article 6 has only been amended once, to allow non *private person*s to sue for breach of ICOBS 8.2.9R. This rule requires motor insurers to pay interest at a specified rate on compensation. This rule would have been ineffective and therefore an inadequate transposition of article 22 of the Consolidated Motor Insurance Directive 2009/103/EC if the right to sue had not been switched on.

Why has the power to switch on the right to damages, say for breach of the requirement to give best execution of a market transaction under COBS 11.2, not been exercised more often? In many cases it does not need to be because businesses usually do not need to rely on FSA rules. They are more likely to rely on their contractual rights or to refuse to deal with a firm that does not give best execution. HMT and/or the FSA may also have determined as a matter of policy against a more general use of the power.

Regulatory case for the award of damages for late payment

There are, however, some persuasive reasons, aligned with the regulatory regime, arguing in favour of the use of this power more generally and specifically in relation to the late payment of insurance claims:

- the Law Commissions have noted[7] that even business policyholders, particularly small businesses (including in order of increasing size, *small businesses*, *micro-enterprises* who are eligible to make claims to the Financial Ombudsman Service and *small and medium sized enterprises* ("SME")) need protection against the market power of the insurance industry and, like consumers, are usually in no position to negotiate with an insurer over its standard policy terms,
- some protection of "consumers" or policyholders (who, within FSMA, include business policyholders and even cedants) is included in the regulatory objectives of the FSA and the proposed objectives of the PRA and FCA. In any event a

right of action for late payment of insurance claims is not something that people look out for when choosing insurance. It only becomes a problem if and when a claim arises and the insurer has poor claims management systems. So there is a case for protecting even wholesale policyholders,

- the Law Commissions' insurance law project is ambitious and extensive, yet the political momentum to give effect to it in relation to the wholesale market is questionable. It makes sense for the Law Commissions to use Parliamentary time on aspects of its programme (such as reforming the law on insurance fraud) which cannot be given effect through the regulatory regime,
- the policy that insurers should deal with claims promptly is already provided for in the regulatory regime: the focus should be on developing and enforcing that policy and not developing a parallel set of rules,
- it is pointless to have a rule requiring the prompt handling of insurance claims unless there is an effective way of enforcing it. Whilst it is often best for the regulator to take enforcement action or claim compensation for rule breaches on behalf of a class of retail policyholders (such as those within a with-profits fund), with business policyholders it is best to let them, the insured, get on with the claim,
- areas of regulation outside FSMA rules may be open to enforcement by actions for damages as well as fines or regulatory penalties. An example of this is the competition rules (which apply to insurers among others) under the Treaty for the Functioning of the European Union and the Competition Act 1998, as amended by the Enterprise Act 2002. The existence of this right of action no doubt provides additional encouragement for compliance.

It is perhaps a little surprising that there has not been more study of how the claims of people affected by rule breaches can contribute to the functioning of the regulatory regime. In my article in the December issue of the BILA Journal I suggested[8] that if the Financial Ombudsman were a little less ungenerous with its awards of compensation for distress, that might provide additional motivation for firms to avoid complaints.

At one time the FSA seemed to be touching on this subject with its "Harnessing market forces" initiative[9], but that never bore fruit. This question may merit further attention, since in the lead up to its transformation into the FCA, the FSA will be focusing more on the wholesale market than it has done previously[10]. It might benefit from using a further regulatory tool, an incidental effect of which may be to save on its own resources.

There may therefore be a case for regulations to "prescribe" in much wider terms a class of rule where a non *private person* can sue, or for the power to switch on the right to damages of non *private person*s to be exercised by the FCA through its own rules.

Contractual exclusion of the right to damages

If the Law Commissions make a final recommendation in favour of reversing *Sprung* it may well suggest that the right of action for damages for late payment should not apply in all cases. It may be unnecessary to apply it at all for specific classes of insurance or insurer. It may be appropriate that the right should be capable of being excluded where the claimant is larger than, say, an SME.

In theory the operation of an FSA rule cannot be excluded by contract. The same effect can, however, be achieved by limiting the application of the rule. So ICOBS 8.1.1R might be preceded by the following additional rule:

> "ICOBS 8.1.1R applies where the *person* making the claim is:
>
> a *private person*;
>
> a *small or medium sized enterprise*; or
>
> any other *person* to the extent that the application of ICOBS 8.1.1R has not been expressly excluded by contract."

Cutting down on ICOBS 8.1.1R in this way would not exclude the regulatory duty to treat *customers* fairly under Principle 6. In relation to that principle rights of action under section 150 have, as noted above, been and would remain excluded in their entirety.

There may be a problem here. I am not aware of any precedents of rules in the FSA Handbook which are expressed in such "adjectival" rather than "substantive" terms. Such a proposal is likely to raise eyebrows at the FSA and require a persuasive case. The way to answer the doubters may be ask how the rule is to be enforced in the wholesale market if not by civil rights of action. Should it be there at all in its application to the wholesale market unless there is a practical way of ensuring that it is respected? If it is to be respected in the wholesale market it must be expressed in workable and commercial terms.

Even if these arguments were not to find favour it should at least be possible to identity a point at which the right of action should apply on a non excludable basis. Limiting it at the SME level makes much more sense than at the *private person* level. Application of the rule more widely on an adjectival basis would then require a statute. A very long wait for this to happen can be expected.

It would be necessary for a further "prescription" by statutory instrument to add a further sub-paragraph to Regulation 6(3) of the Rights of Action Regulations, providing for another case in which rights of action would arise for the benefit of non *private persons*. It might read as follows:

> "(e) the rule that has been contravened requires an insurer to handle claims promptly and fairly and not unreasonably to reject a claim (including by terminating or avoiding a policy)"

This would switch on ICOBS 8.1.1R(1) and (3). Rights of action are probably inappropriate for (2). In relation to (4) claimants would be able to sue in contract in any event and the *Sprung* problem would cease to apply.

Which is the appropriate route to take?

If I am right in arguing that a combination of FSA rules and "prescription" under section 150(3) of FSMA can confer on non *private person*s a workable right of action for damages for late payment of insurance claims, the question nonetheless arises whether that is a better way of proceeding than by promotion of a Parliamentary bill.

Progress through regulation requires the co-operation of the FSA, which like HMT and Parliament is very busy on other matters, such as its recreation as the PRA and the FCA, with-profits insurance reform, Solvency II, and a number of other major projects in the insurance and other sectors. Reducing the late payment of wholesale insurance claims may advance regulatory objectives but may not be a major policy priority for the FSA or the FCA.

This may be partly because the FSA would doubtless be delighted for the Law Commissions to get the project through Parliament and therefore not take up its own valuable and scarce resources. Busy as the FSA and HMT no doubt are, however, the time of Parliament is surely the most valuable. A reason for moving the question up the FSA agenda is that it will save Parliamentary time, much of which is in any event going to be spent over the next few years on the government's proposed regulatory reforms.

The Law Commissions may also have missed out on the opportunity to get the FSA on board by focusing more closely on the regulatory perspective and making a case for the FSA to use its powers. Perhaps they did put the case to the FSA, since they accepted in general terms at an earlier stage of the insurance law project[11] that some reforms could be achieved through regulation. The brief and incomplete regulatory analysis in their issues paper 6, however, suggests that they probably did not, or that, if they did, it was not as persuasive as it might have been. It is not too late for them to start.

I may have to eat my words if Parliament in less than, say, 3 years does actually give effect to this reform. Nonetheless perhaps what I have said will prompt more discussion of the overlap between insurance law and regulation.

Jonathan Goodliffe is a solicitor and the honorary editor of the BILA Journal. He was also a member of the BILA sub-committee which considered and responded to the Law Commissions' issues paper 6. The views expressed in this article are his alone, however, and are not necessarily shared by other members of that sub-committee.

Endnotes

[1] See "Damages for late payment and the insurer's duty of good faith: BILA views, Michael Mendelowitz and Jonathan Goodliffe, BILA Journal issue 120, page 19.

[2] ICOBS, which was adopted in 2008, superseded the original FSA insurance conduct of business rules in ICOB, which were adopted in 2005. The differences between the two rulebooks, however, are immaterial for present purposes.

[3] In this article I follow the FSA Handbook convention of italicising defined expressions in the FSA Handbook glossary.

[4] The rule does not apply, however, to reinsurance activities (see ICOBS 1 Annex 1, part 2, para 1.1)

[5] As in, for instance, the speech by The Financial Secretary to the Treasury, Mark Hoban MP, on 26 July 2010.

[6] As described by Laura Hodgson and Simon Baker in their article at page 3 of this issue of the BILA journal

[7] "Insurance contract law: a joint scoping paper", 2006.

[8] "The price of unfair treatment" BILA Journal issue 120, page 6.

[9] Referred to in the FSA's policy document "A new regulator for the new millennium" in January 2000.

[10] "The Financial Conduct Authority: approach to regulation", para 1.10.

[11] "Insurance contract law: a joint scoping paper", 2006.