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Law reform and the damages for late payment of claims proposals: is this a good idea?

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Background

In March 2012, the Lloyd's Market Association (LMA) submitted a response to the joint consultation paper of the Law Commissions of England and Wales and of Scotland [LCCP 201], published in December 2011, containing proposals on damages for late payment of claims, insurable interest, remedies for fraudulent claims, broker liability for marine premium and other matters. Many of these proposals we believe are sensible or uncontroversial; others raise some difficult issues. A particular matter of concern for the LMA is the first mentioned - damages for late payment of claims.

The LMA's membership is comprised of all the managing agents, which manage the syndicates trading in the Lloyd's market, and also the members' agents which advise third party capital. Our views are distilled within the LMA Law Reform Committee and in consultation with members. We are very appreciative of the way in which the Law Commission of England and Wales itself consults with interested parties and engages with market practitioners.

The international nature of the business written in the Lloyd's market, much of it with English law as the applicable law, means that law reform in England is not purely a domestic matter. We must be wary of unexpected consequences.

The premium capacity of the Lloyd's market for the 2012 year of account is over £24 billion. The geographical split of the insurance business underwritten is approximately as follows:

UK	18%
EU/EEA	16%
USA	41%
Other	25%.

The percentage of premium capacity in Lloyd's, where the supporting capital originates from overseas, is approximately 50%.

The current law and the proposals

The initial thinking of the Law Commission in relation to damages for late payment, as set out in their Issues Paper 6 (published in March 2010), was to balance the mutual duty of good faith between the parties to an insurance contract: a fraudulent claim would lead to forfeiture (as proposed in Issues Paper 7 and Consultation Paper LCCP 201); bad faith by an insurer in resisting the payment of a valid claim would give rise to a statutory remedy of damages.

The reasoning behind the damages proposal is that the existing remedy of avoidance of the policy by the claiming insured, because of the insurer's breach of its duty of good faith, would not be satisfactory; and the courts in England and Wales do not award damages on damages. Since the payment of a claim under a general insurance policy (as opposed to a life policy) is in law a payment of damages, this precludes a further award of damages for late payment. [See Issues Paper 6 and Consultation Paper LCCP 201 for an exposition of the law.]

The intention was laudable and this reform would bring English law somewhat more into line with some other jurisdictions. However, the Law Commission received a heavy weight of opinion that introducing a bad faith claim for damages in this way would import into English law some of the less attractive aspects of some USA State law. Other views included that the common law in general insurance had developed as it had for sound policy reasons: the floodgates would open if consequential loss claims could be brought for losses which were not within the insurance cover purchased.

In the Consultation Paper of December 2011 [LCCP 201], to remove the bad faith litigation ogre, the proposals were re-formulated so that an insurer would be liable to pay damages for foreseeable consequential losses if in breach of a statutory obligation to pay a claim in a reasonable time. The reasonable time would include time for assessing and investigating a claim. In commercial contracts, it is proposed that the parties would be able to limit or contract out of this liability, but this would be subject to a good faith test (so "bad faith" litigation could be imported here). In consumer contracts, there would be no contracting out of the new statutory provisions.

These proposals present a significant change in the law for general insurance.

Possible problems

On the face of it, the concept of being held liable for damages for failing to pay a claim in a reasonable amount of time seems uncontroversial. Good claims' handling is after all seen as a selling point by Lloyd's managing agents and insurers in a competitive market. Bad practice is quite rightly something which would bring down the force of the Financial Services Authority (FSA) on the firm concerned. The new UK conduct of business regulator will no doubt have claims handling at the centre of its conduct of business regime, both for consumer and commercial business, when (and if) the FSA splits into two in the Spring of 2013 and the Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA) are formed.

However, if one delves deeper into the possible consequences of this reform, things begin to take on a different hue. The reasonable time for payment of a claim will introduce uncertainty and scope for litigation. If an insurer suspects fraud, how long will it have to investigate before the reasonable time runs out? How should a claims manager react when he or she is aware that a necessary investigation may nonetheless put the insured under financial strain, if payment is delayed. The trained claims manager would have in his or her mind the question as to whether the consequences of delay would have been reasonably foreseeable by his or her colleague, the underwriter, at the time of contracting. Will this pressure cause claims departments to take fewer steps in investigating fraud? This would not please the FSA, which looks to regulated firms to combat financial crime, so it can meet its own statutory objective in this respect. It would not please the general pool of policyholders if claims levels rise and premium levels follow.

In another case, a coverage dispute may arise. The claims department will have the same question in its collective mind - how long have we got before we are in breach of the contractual obligation to pay this claim in a reasonable time? Is this before we can even get the litigation to resolve the dispute under way, acting with the utmost diligence? The claimant's solicitor, doing his or her job, may put the insurer on notice of certain losses being run up by his or her client, whilst the coverage litigation is in progress. If this is a speculative device, to force a settlement, the court may take a view under the Law Commission's new statute that the claim was made in bad faith and the whole claim should be forfeit. The Commission's current proposals on the policyholder's post contractual duty of good faith would be relevant here [LCCP 201].

Proving the loss, foreseeability and mitigation

It could be that some of the losses faced by the insured during the coverage litigation would have been foreseeable by the underwriter at the time of contracting as not unlikely if a claim payment was to be delayed. The claimant would have to prove the loss was incurred and that reasonable steps had been taken to mitigate it. However, if the dispute, brought in good faith, goes against the insurer in court, then the reasonable time for payment may be found to have been before the litigation was even commenced. The Law Commission's proposals allow for investigation and assessment, in a reasonable time, but not for a reasonable time for coverage disputes.

Payment of interest would be an appropriate remedy for a late payment of a monetary claim and this could in any case be awarded by a court. If the insurer takes on the responsibility itself to repair the insured property, then damages could be claimed by the policyholder if the contract to reinstate the property is breached. The proposed law reform is not needed here.

The Law Commission's view is that its proposals, if they become statute, would not be followed by such a high level of claims for damages for consequential losses, genuine or speculative, as to affect the working of the market (claims handling load and costs, for example) and the general levels of claims and premiums. Even if there was to be an initial rise in litigation, this would drop back when the courts bring the leading case of *Hadley v Baxendale* [1854] EWHC J70 to bear. Therefore, justice would be done in hard cases (something we would all like to see), but a plethora of litigation or reduced anti-financial crime measures would not result.

Many market practitioners are not so sure this would be the case and worry about the proposals.

Drafting the policy

Another concern has been raised: how would a reasonably competent wordings specialist go about drafting a policy document, when a limitation on one aspect of cover may be seen by a court as a limitation clause on the payment of consequential losses following late payment of a claim. Clauses excluding or limiting liability to pay damages for late payment of a claim would be banned in consumer contracts and subject to a good faith test in commercial contracts under the Law Commission's proposals.

For example, take a clause in a household policy, which limits a claim for alternative accommodation, in the event of the house becoming uninhabitable, to 4% of the sum insured of the bricks and mortar (such a clause in this form or in the form of a monetary limit is common in household policies). Would this clause be banned by the new statute?

The Law Commission's view is that it would not - if there is no dispute on a claim, then the clause would operate as a policy limit in the usual way. If a policy dispute arose, the house took a long time to rebuild and the alternative accommodation limit was far exceeded, then the policyholder could bring a claim for damages for late payment, and the policy limit would not operate if the damages claim was successful.

Nonetheless, the wordings specialist may well puzzle as to whether he or she is drafting a policy in clear words with clearly defined limits (thereby offering choice, because the policy and price could be compared to other products) or drafting something through which a red line would be scratched in the event of a claims dispute. What exactly is the underwriter scratching if the policy limits are at risk of being struck out?

Practitioners are concerned that the proposals could result in disproportionate claims for damages, in the event of a late payment, compared to cover purchased. In the commercial context, will the proposals have an effect on business continuity cover?

Limitation period and reserving

There is a further concern which the Law Commission accepts is a drawback to their proposals. There would be uncertainty in the limitation period, if this runs from the date of breach of contract. Under the new statue, this would be at the reasonable time for payment of the claim. At present the limitation period runs from the date of loss (the breach of contract under common law). Whereas the date of loss is usually certain, the point of time when it is reasonable to pay the claim, after investigation and assessment, is not. This may not matter in many cases but in large or complex claims it may be a difficult question.

Added uncertainty in the limitation period would in turn affect the reserving of claims by insurers. This feeds into capital modelling, whether under the present system or under

Solvency II. Greater uncertainty leads to a greater capital requirement. Yet, if the new statute were to build in a special limitation period for insurance claims, for instance, that this runs from the date of loss (as at present), then one of the purposes of the law reform, which is to bring insurance law into line with general law, is fouled. The proposals do therefore lead to a problem in this area, which would have to be measured against the perceived benefits.

Other controls and remedies

Consumers and small businesses already have the possibility of redress through the Financial Ombudsman Service (FOS). In a case like that of Mr Sprung (see the Law Commission's papers, the facts of Sprung being at the root of the proposals), the FOS would have jurisdiction if the business falls within the small-business limit or the complainant is a consumer. Then justice could be done without a change in general insurance law, given the appropriate award is within the FOS's limit.

Further, under the Unfair Terms in Consumer Contracts Regulation 1999, the FSA and Office of Fair Trading (OFT) are able to obtain undertakings from insurers not to use particular policy terms (for example limitations or exclusions) which are perceived as unfair. Compliance Departments monitor such undertakings on the OFT website and policy wordings are amended accordingly. For example, it was thought that the use of the words "consequential loss" in general consumer insurance contracts, to exclude consequential loss, was not plain and intelligible "as it refers to an expression that has a legal meaning" [see http://www.fsa.gov.uk/pubs/other/consequential_loss.pdf]. The OFT and FSA did not think that the average consumer would understand the phrase and therefore the cover. As a result, firms have tried to find other, clearer ways of describing what is covered and what is not. It is ironic that under the Law Commission's proposals a red line could be struck through the new phrases, because these may limit of exclude liability for damages for late payment.

Importantly, the ICOBS rules of the FSA (8.1.1R) cover both commercial and retail business: these provide that an insurer must handle claims promptly and fairly; provide reasonable guidance to the policyholder in making a claim and as to its progress; not unreasonably reject a claim; and settle claims promptly once terms are agreed. Whilst ICOBS provides a remedy for the insured in person only in limited circumstances [see LCCP 201 at page 37, paragraph 3.22], it does provide a standard and a basis for supervision. Jonathan Goodliffe, in the BILA Journal of November 2011 (No 123), explores regulation and regulatory reform as an alternative to the Law Commission's proposals for law reform, including the availability of redress.

In the London market, dealing with thousands of risks from all over the world under English law, there is a danger that the Law Commission's proposals for damages for late payment, if enacted, would lead to greater litigation costs, some reserving problems, higher claims handling costs, higher claims ratios and higher premiums, with potentially some disproportionate awards of damages. The reason that the common law has developed as it has, may hold good. It may be preferable to rely on competition in the market, supervision by the FSA Conduct of Business Unit (due to become the FCA), the FOS and the OFT to minimise the occasions when an insurer handles a claim badly or in breach of good faith.

Kees van der Klugt is a solicitor and a member of the BILA committee and also of the sub-committee which has considered the Law Commission's proposals.