

Damages for Late Payment Under English Law: An Opportunity Missed

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Abstract

Under English law policyholders cannot recover damages from an insurer who fails to pay a valid claim within a reasonable time (or at all). This paper considers the rationale behind the so-called 'hold harmless' principle, the recent proposals by the English and Scottish Law Commissions for reform of this area of the law and the decision ultimately to remove the proposed reforms from the Insurance Act 2015.

Introduction

Under English law, policyholders cannot recover damages from an insurer who fails to pay a valid claim within a reasonable time (or at all) and can only recover the value of the claim plus interest. This position is inconsistent with the ordinary principles of English contract law and arises from the archaic legal fiction that an insurer's primary obligation is to prevent its insured from suffering a loss in the first place. The current position under English law is out of line with commercial reality and distinct from the position in most other common and civil law jurisdictions. As such, the position is potentially damaging to the reputation of the London market in the eyes of international policyholders.

The Law Commission of England and Wales and the Scottish Law Commission (the 'Law Commissions') embarked upon a review of English insurance law in 2006, culminating in the passing of the Insurance Act 2015, which will come into force in August 2016. Unfortunately, proposals put forward by the Law Commissions for reform of the law regarding late payment of valid claims were not included in the new Act, having been considered too controversial to go through the special procedure for uncontroversial Law Commission Bills.

English law on damages for late payment

Damages under English contract law

In accordance with the ordinary principles of English contract law, breach of a valid and enforceable contract gives the innocent party a right to recover damages for the loss it has suffered as a result of the breach. The innocent party must take reasonable steps to mitigate its loss and can only recover damages where the loss was not too 'remote' a consequence of the defendant's breach of contract. Generally, loss is not too remote where it was within the reasonable contemplation of both parties at the time of entry into the contract.¹

Sprung v Royal Insurance (UK) Limited²

In 1986 Mr Sprung was running a small, family-owned business collecting and processing animal waste products. He purchased insurance to protect his factory against theft and 'sudden and unforeseen damage'. When thieves broke into the factory, wrecking the machinery inside, Mr Sprung submitted a claim to his insurer for the cost of making good the damage.

Mr Sprung's insurer denied liability for the claim, initially asserting that the policy did not provide cover for 'wilful damage'. Mr Sprung was unable to finance the repair of the machinery himself and could not obtain credit to do so. In difficult market conditions, his business began to decline and within a few months it was forced to close.

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¹ *Hadley v Baxendale* (1854) 156 ER 145.

² [1999] 1 Lloyd's Rep 111.

Mr Sprung issued proceedings against the insurer, who raised no substantive defence to the claim. After four years, the insurer eventually agreed to settle Mr Sprung's claim for £30,000 plus interest of £10,937.50, as well as Mr Sprung's costs of the action to date. That resolved Mr Sprung's primary claim for an indemnity in respect of the covered loss, but Mr Sprung was also seeking damages for consequential losses suffered 'by reason of the Defendant's breach of contract'. At first instance, the judge found that the claim should have been paid by 31 October 1986 at the latest. As a result of the delay in receiving payment, the judge held that Mr Sprung had suffered a further loss of £75,000, which was the value of Mr Sprung's lost opportunity to sell his business to another firm, Prosper De Mulder, which it was said would have been interested in purchasing Mr Sprung's business but for the loss. Ultimately, however, it was held that Mr Sprung was not entitled to recover his further loss from the insurer, because his claim was not recognised under English law.

The 'hold harmless' principle

The result in *Sprung* arose because of the historic rule in English law that an insurer's fundamental obligation is to 'hold the insured harmless', in other words, to prevent the insured from suffering a loss in the first place. As a consequence of this rule, as soon as a covered loss occurs, the insurer's primary obligation is considered broken, giving rise to a secondary obligation to pay damages. Money which is then paid under the indemnity policy is in the nature of liquidated damages and because, under English law, failure to pay damages does not itself give rise to an action for damages, failure to pay a valid claim under an indemnity policy is not actionable in damages.

The case for reform

Sprung is out of line with parties' expectations

The rule in *Sprung* is a legal fiction which does not reflect the expectations of parties to a commercial insurance contract. An insurer has no intention, at the inception of a policy, to sit outside the insured's premises and prevent a break-in or a fire from occurring, nor does an insured expect their insurer to. Equally, such an insurer would not regard itself as in breach of contract when a break-in or a fire does occur at its insured's premises. It is nonsensical for the law to operate in a way which neither party to the contract expects or intends.

Sprung is unfair and does not promote good claims handling

Very often the payment of interest and costs where a claim has not been paid in a timely manner (or at all) is insufficient to compensate an insured for its loss. Where a business has been damaged by fire or flood, for example, timely payment can be crucial to its survival (as was the case in *Sprung*). As the Association of Insurance Risk Managers in Industry and Commerce (AIRMIC) explained in its response to the Law Commissions' consultation:

'Effective indemnity depends as much on the timing of payments as the adequacy of the final settlement if a business is to survive the post loss recovery period. In the event of unreasonable delays in the settlement process, there is currently inadequate opportunity for legal redress. This fact does nothing to encourage reasonable behaviour on the part of the insurer.'³

The problem has become heightened in recent years in the UK as a result of the economic crisis and the fact that many businesses are now more financially dependent on insurance than ever before.

In 2013, the British Insurance Brokers' Association (BIBA) suggested that 77% of insurers had become stricter on paying claims, also as a result of the economic climate⁴, with most believing that this trend is here to stay. One broker gave the following example:

'An insurance company and their appointed loss adjuster repudiated liability for a claim relating to loss of metered water. We challenged their decision as we did not accept their reason for repudiation. The claim was again repudiated by the local insurer manager but the decision was overturned when we took the matter higher. It also took almost a whole year of fighting to get the result we did.'⁵

³ The Law Commission and The Scottish Law Commission report 'Insurance Contract Law: Business Disclosure; Warranties; Insurers' Remedies for Fraudulent Claims; and Late Payment' July 2014, p 262.

⁴ 'Insurance brokers adding value in the claims process' BIBA member research (January 2013).

⁵ Ibid.

That is not to say that this stricter approach to paying claims is always unjustified, but the fact of the matter is that English law does little to prevent insurers from unreasonably delaying payment of a claim and provides no remedy for an insured who, as a result of such delay, finds itself out of business. The law currently permits an insurer, as Lord Mance has put it, to 'delay dealing with a claim to his own financial benefit, at least in cash-flow terms, and to the detriment of the insured, potentially putting him under financial pressure to settle, and possibly even out of business.'⁶ So long as there is no remedy for late payment of a valid claim, insurers will theoretically be able to benefit from the time value of money by holding onto funds for as long as possible. It is equally conceivable that individual underwriters may attempt to push payment of a valid claim into the next financial year in order to benefit in terms of bonus and salary payments. In this way, the rule in *Sprung* does nothing to encourage good claims handling by insurers.

Sprung is inconsistent with the law in other major jurisdictions

The position under English law differs from that in other common and civil law jurisdictions making England one of the least favourable venues for policyholders in the world in terms of being properly compensated where an insurer has unreasonably delayed paying a claim.

Scotland

Scottish law does not adopt the 'hold harmless' analysis of an insurer's obligations. An insurer's primary obligation under Scottish law is to pay a sum equivalent to the insured's loss. Consequently, when an insurer unjustifiably delays payment or refuses to pay a valid claim, a policyholder has a contractual right to damages.

The USA

In the USA, the law views an insurance contract not as a promise to hold the insured harmless, but as a promise by the insurer to pay the insured for a loss which is covered by the policy. As such, failure by the insurer to make payment in accordance with the terms of the policy entitles the insured to seek damages for breach of contract, subject to the usual rules regarding mitigation, foreseeability and causation.⁷

In addition, the Restatement of the Law (Second) Contracts provides that:

'Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.'

The recognition of a general duty of good faith in US contract law has led, in some States, to the development of a separate tort of bad faith. This, in turn, has led to tortious claims being brought against insurers who fail to pay valid claims on time or at all⁸, paving the way for a number of substantial jury awards of exemplary and punitive damages, which would not otherwise be available in a simple breach of contract claim.

One frequently cited case is *Campbell v State Farm*. The case arose from a road traffic accident in which one person was killed and another was seriously injured. Mr Campbell, who caused the accident, had an auto policy with State Farm, which provided a \$25,000 liability limit for each person injured and a maximum aggregate limit of \$50,000. State Farm refused to settle the injured plaintiffs' claims for \$50,000 (the policy limit). At trial, the two plaintiffs were awarded \$135,000 and \$50,000 respectively, resulting in a \$135,000 excess exposure to Mr Campbell.

Mr Campbell sued State Farm for bad faith. The jury awarded Mr Campbell and his wife \$2.6 million in damages for emotional distress (later reduced by the trial court to \$1 million) and \$145 million in punitive damages. After a series of appeals, including to the US Supreme Court, the Supreme Court of Utah finally set the punitive damages award at \$9 million.⁹

⁶ 'The 1906 Act, common law and contract clauses – all in harmony?' [2011] Lloyd's Maritime and Commercial Law Quarterly, p 346 at pp 349 to 350.

⁷ See, for example, *Royal College Shop Inc v Northern Insurance Co of New York*, (1990) 895 F 2d 670 (10th Cir).

⁸ See, for example, *Gruenberg v Aetna Insurance Co*, (1973) 9 Cal 3d 566 in which the Supreme Court of California held that where an insurer unreasonably withholds payment of a valid claim it is subject to liability in tort.

⁹ *State Farm Mut. Automobile Ins. Co v Campbell* 538 U.S. 408 (2003)

Australia

Australian law regards the insurer's primary obligation as to pay rather than to hold its insured harmless. Although there are some contradictory decisions, there is also authority for the proposition that damages are available where an insurer has failed to pay a valid claim in a reasonable time or at all. The basis for such a claim is section 13 of the Insurance Act 1984, which provides that:

'A contract of insurance is a contract based on the utmost good faith and there is implied in such a contract a provision requiring each party to it to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith'.

Arguably, an insurer who fails to pay a valid claim would be acting other than with the utmost good faith.¹⁰ Unlike in the US, however, the Australian courts have rejected the suggestion that there is liability in tort for failing to make a timely payment.

Civil law jurisdictions

The Italian Civil Code provides that parties to a contract must abide by principles of good faith and fair dealing and the Italian courts have applied these principles to permit a policyholder to obtain consequential damages from an insurer.¹¹ In Spain, an insurer must pay the minimum amount that it reasonably considers due to the insured within 40 days of notification of a loss, and the full amount within 3 months. Any amounts due and not paid attract interest from the date of the loss at a rate of one and a half times the ordinary rate for the first two years, and not less than 20% thereafter.¹² In Argentina, insurers must make a decision regarding a claim within 30 days of receiving relevant information from the insured - failure to respond is treated as acceptance of the claim. Insurers must also pay claims within 15 days from the date on which the amount of the claim is established or from the acceptance of a settlement offer.

Sprung is potentially bad for business

The results of a 2014 study conducted by the London Market Group ('LMG') and the Boston Consulting Group ('BCG') stated that the London market's reputation for paying claims was a key factor underpinning its historic perceived competitiveness. It also found, however, that £13.9bn (33%) and £7.1bn (16%) of London market premiums originate from North America and Europe respectively¹³. As explained above, both North America and Europe, and indeed most other major jurisdictions around the world, offer some form of protection to policyholders whose claims are paid late or not at all. The failure of English law to provide a remedy in such circumstances has the potential to discourage these international policyholders from seeking coverage in the London market (although it is of course possible for London market insurers to offer coverage which is subject to the substantive law of another jurisdiction).

It may well be that the vast majority of London market insurers act reasonably when considering and paying claims made by their insureds, but the fact remains that English law does not currently prevent insurers from behaving unreasonably, nor does it protect insureds whose valid claims are left unpaid. Where just one insurer fails to act reasonably, this can undermine general confidence in the industry as a whole, which should be of concern for all insurers. Those insurers who are confident that they do pay claims in a timely and efficient manner should have little to fear from reform of the rule in Sprung. Indeed, the vast majority of insurers who provided feedback on the Law Commissions' consultation were supportive of the proposed reform with 11 of 14 insurers and insurance organisations agreeing that insurers should be under a contractual obligation to pay claims within a reasonable time.¹⁴

¹⁰ R Merkin 'Reforming insurance law: is there a case for reverse transportation?' Report for the English and Scottish Law Commissions, at paras 8.12 – 8.15.

¹¹ See, for example, *Lca Sanremo c. Velotto*, Supreme Court of Cassation, III, 18 April 1997, no 3353.

¹² The Insurance Contract Act 1980, Article 20.

¹³ London Matters, The competitive position of the London Insurance Market, Joint study of the London Market Group representing its London market insurance members and the Boston Consulting Group London, November 2014.

¹⁴ The Law Commission and The Scottish Law Commission report 'Insurance Contract Law: Business Disclosure; Warranties; Insurers' Remedies for Fraudulent Claims; and Late Payment' July 2014, p 265.

Proposals for reform

Payment within a 'reasonable time'

The Law Commissions proposed that English law should be reformed such that there would be an implied term in every contract of insurance that, if an insured makes a claim under the policy, the insurer must pay any sums due in respect of the claim within a reasonable time. The Commissions' proposals made clear that a reasonable time would include time to investigate and assess the claim and would depend on all the relevant circumstances of the case including the type of insurance in question, the size and complexity of the claim, compliance with statutory and regulatory rules and factors outside the insurer's control.

Reasonable grounds for disputing a claim

The proposals also included the specific caveat that if an insurer could show reasonable grounds for disputing a claim (whether as to the amount payable or whether anything is payable at all) the insurer would not be in breach of the implied term while that dispute was continuing, although its conduct in handling the claim might be relevant in deciding whether the implied term had been breached. As the Law Commissions explained, the proposals were intended to catch bad claims handling processes, not prevent legitimate investigations by insurers.

Contracting out

The Law Commissions recommended that in non-consumer contracts, the parties should be free to disapply the default regime with insurers being entitled to exclude or limit their liability for breach of the implied term (save where the insurer's breach could be shown to be deliberate or reckless).

The case against reform

Reform would not change the outcome for policyholders like Mr Sprung

Some commentators initially argued that reform of the rule in *Sprung* would not alter the position for policyholders, like Mr Sprung, whose businesses fail due to late payment of a valid claim because those policyholders' own impecuniosity would break the 'chain of causation' between the insurer's late or non-payment and the policyholder's loss. This is incorrect in light of the House of Lords decision in *Lagden v O'Connor*¹⁵ which confirmed that, under English law, an innocent party's lack of funds does not break the chain of causation.

The question of whether or not Mr Sprung's impecuniosity would have been in the reasonable contemplation of the parties at the time of the policy's inception is a separate matter, but it is common place in the current economic climate for businesses to rely heavily on insurance and arguably insurers should reasonably foresee that a failure to pay a valid claim on time or at all might result in the failure of the insured's business. In many cases it will be clear that a delay in payment will cause the business to fail – consider a manufacturer whose only warehouse is completely destroyed by fire, it would be undeniable in such a case that delay in paying a valid claim would halt production and put in danger the financial viability of the company.

Reform would open the door to US-style bad faith actions

As already noted above, the position in the USA is very different with many American States permitting policyholders to seek damages for late or non-payment of a valid claim in contract and in tort as well. When the Law Commissions put forward their proposals for reform, both the Lloyd's Market Association and the International Underwriting Association expressed concern that reform of the English law position would open the floodgates to bad faith claims similar to those which have developed in the US.

This concern is understandable in light of judgments like that in *Campbell v State Farm*. The Law Commissions too were persuaded by such misgivings, and revised their initial reform proposal - that damages should be available for the insurer's breach of the duty of good faith - replacing it with the proposed duty to pay valid

¹⁵ [2003] UKHL 64.

claims within a reasonable time. The Law Commissions were also clear, however, that any cause of action based on an insurer's bad faith would be a step too far.

It is highly unlikely that, had the reforms proposed by the Law Commissions been adopted, the English courts would have gone on to develop a US-style tort of bad faith, enabling Campbell-esque claims to be brought against insurance companies in England and Wales. Bad faith litigation against insurance companies is an entirely US phenomenon and is not seen anywhere else in the world. When the Australian Law Reform Commission drafted the Insurance Contracts Act 1984, it considered and specifically declined to introduce a tort of insurance bad faith and, since then, the Australian courts have consistently refused to judicially impose what the Australian Parliament had declined to introduce¹⁶. There is no reason to suspect that the English courts would behave any differently if faced with the same situation.

Reform would increase the cost of insurance for policyholders

Another alleged disadvantage to the proposed reforms was that the potential additional exposure to consequential damages claims could lead to increased premiums for all insureds. This concern does not withstand scrutiny, however, and is based on the flawed premise that insurers should be entitled to pass on the cost of failing to pay valid claims on time to their insureds.

As noted above, the Law Commissions' proposals included a specific defence to damages claims where the insurer had a genuine reason for disputing the claim. In other words, insurers would only be liable to pay damages to their insureds where they had no genuine reason to delay payment. It would be highly peculiar for an insurer who wrongfully delays payment of a valid claim to fund the potential cost consequences of that wrongful act by charging the innocent party to its potential breach of contract a higher fee.

In any event, those insurers who responded to the Law Commissions' consultation felt that it would be rare for an insurer to unjustifiably delay payment of a valid claim due to a combination of regulatory and reputational pressure meaning that claims are not often unpaid without good reason. Assuming that this is correct then, even if it were acceptable for insurers to pass on the cost of their own breach in this way, there would be little justification for a significant increase in premiums.

The Law Commissions also felt that policyholders would be willing to absorb a small increase in premiums if it meant greater confidence that their claims would be paid on time.

Some industry players also highlighted the possibility of spurious claims during the Law Commissions' consultation, which might cause insurers to increase premiums. The Law Commissions noted in response that there have been very few cases in Scotland over the past 20 years where the Scottish courts have taken a hard line in respect of such claims.

Reform would cause difficulty for insurers when assessing their reinsurance and capital adequacy requirements

In its response to the Law Commissions' consultation, the International Underwriting Association expressed concern about potentially 'unlimited damages' and the possibility that an insurer's overall exposure could greatly exceed the policy limits, which could also lead to difficulties for insurers when assessing their reinsurance and capital holding requirements under Solvency II.

The objective of the Solvency II minimum capital requirements is to ensure that insurers hold minimum amounts of financial resources to cover the risks to which they are exposed under the policies they underwrite. The purpose is not to ensure that sufficient reserves are held to cover the cost of fines and damages which the insurer incurs as a result of its own failings and/or breaches of contract. The same can be said of insurers' reinsurance arrangements, which are not put in place to cover damages awarded to a policyholder due to the insurer's breach of contract.

In any event, the Law Commissions' research into the matter revealed that 90% of insurance brokers estimated the average financial loss resulting from an unreasonable delay in paying a valid claim as being less than

¹⁶ See, for example, *CGU Workers Compensation (NSW) Limited v Garcia* [2007] NSWCA 193, in which the New South Wales Court of Appeal declined to recognise a tortious duty of good faith.

£5,000¹⁷. The Law Commissions' proposals also included the ability for insurers to limit their liability for such consequential damages.

Reform would force insurers to pay unmeritorious claims

A further concern raised was that insurers might be compelled to pay unmeritorious claims for fear of being exposed to large consequential damages awards. It is true that faced with a policyholder whose business looks likely to fold in the event that its losses are considered to be uninsured, an insurer might decide to pay that insured's claim rather than risk a subsequent order of consequential damages. It is also true, however, that under the current law an insurer might equally decide to not pay a valid claim for cash-flow or financial reasons, or other reasons entirely unconnected with the merits of its insured's claim, or quite simply to force a settlement at a significant discount.

The question in these circumstances, therefore, is which party should the law protect? It is generally accepted that, even in the case of large corporate policyholders, it is the insurer who has the better bargaining position both when it comes to negotiating the terms of coverage and at the point when a claim is made. The Law Commissions' proposals, in particular the provision of a specific defence where the insurer had genuine reason to dispute the claim, would have provided sufficient comfort to insurers to ensure that they were not compelled to pay unmeritorious claims. That is not to say that it would never happen, but the current position is far from ideal and the proposed reforms would have resulted in a more balanced playing field.

What next?

It is theoretically possible that the Supreme Court could reverse the Court of Appeal's decision in Sprung if the right case came along. Many senior judges, notably Lord Justice Rix and Lord Mance, have expressed their dissatisfaction with the present law. It is highly likely, however, that insurers would seek to settle any claims alleging consequential losses to avoid the potential repercussions of a reversal of Sprung by the courts. In particular, if reversal was effected by the courts, many of the detailed elements of the Law Commissions' proposals, including the specific defence where an insurer has reasonable grounds for disputing the claim, would likely be lost.

In the meantime, the Law Commissions continue to consult on the issue of 'insurable interest' and it is possible that reform of the rule in Sprung will be revisited as part of any further reforms which are required following that consultation.

Given that many insurers were supportive of the Law Commissions' proposals, some policyholders may even seek to negotiate contractual provisions regarding payment of claims in a timely and efficient manner.

Conclusions

It is unfortunate for policyholders and insurers alike that the Law Commissions' proposals for reform of the rule in Sprung were not included in the Insurance Act 2015. The position under English law remains out of line with the expectations of parties to commercial insurance and has the potential to cause unjustifiable damage to insureds.

To remain competitive in an increasingly aggressive, global market, London must proactively persuade both domestic and international insureds that it can meet all of their needs and properly protect their interests. It is in the interests of all participants in the London market, therefore, that the English law on damages for late payment of valid claims is brought in line with other major common law and civil law jurisdictions.

¹⁷ Broking Now! In association with BIBA by FWD Research, *Research on Damages for Late Payment* (September 2011).