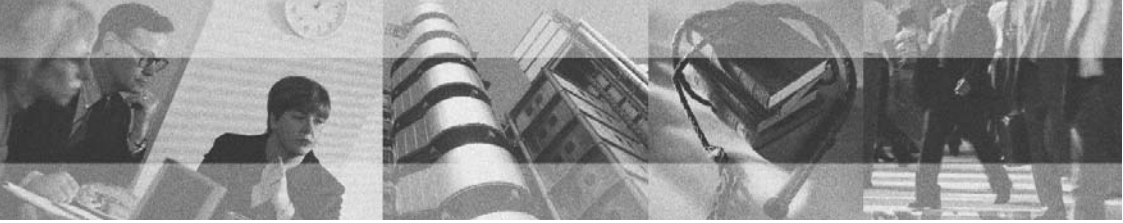

DAMAGES FOR LATE PAYMENT AND THE INSURER'S DUTY OF GOOD FAITH: BILA VIEWS

by
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Introduction

The Law Commissions of England and Wales and of Scotland are currently undertaking a full review of insurance contract law in those jurisdictions.

In their Issues Paper 6 forming part of that review, the Law Commissions have considered the law on late payment of insurance claims and the insurer's duty of good faith. Their paper reports that under the current law of England and Wales, a policyholder who has not been paid a valid claim is entitled to sue the insurer for damages representing the money owed, plus interest. However, the policyholder is not entitled to damages for any further loss suffered through the delay in receiving the money.

In the Issues Paper the Law Commissions make criticisms of this rule and put forward proposals to reform it.

The law reform sub-committee[1] of the British Insurance Law Association (BILA) has responded to the Law Commission's proposals. This article sets out the substance of that response.

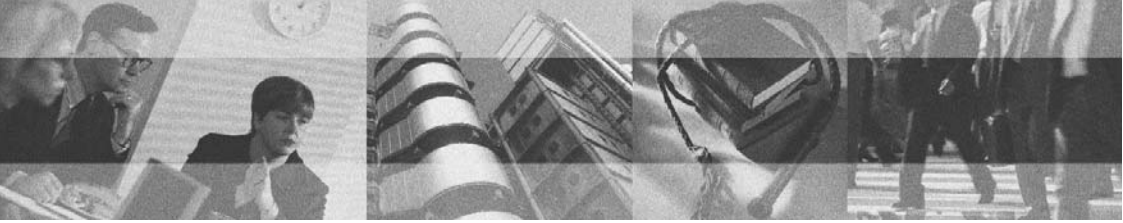
Sprung v Royal Insurance

The rule on no damages for late payment referred to above was most recently applied in the decision of the Court of Appeal in *Sprung v Royal Insurance (UK) Ltd*.[2] The case illustrates the problems which have arisen from the rule.

Facts

Mr Sprung bought an insurance policy to protect his factory against "sudden and unforeseen damage". In April 1986, vandals broke into the factory and caused considerable damage. Mr Sprung's insurers rejected his subsequent claim. In difficult trading conditions, Mr Sprung lacked the financial resources to carry out repairs himself and he was not able to raise a loan. Six months later Mr Sprung was out of business.

Mr Sprung started proceedings against his insurers. Four years later, in March 1990, the insurers abandoned their defence and Mr Sprung was awarded an indemnity for his damaged property, plus simple interest and costs. The judge found that the claim should have been paid by 31 October 1986. As it had not, Mr Sprung had suffered an uninsured loss of £75,000 for the lost opportunity to sell his business. However, the Court of Appeal held that Mr Sprung was not entitled to claim this further loss, as it was not a claim recognised in law.



Legal basis for the decision

This was mainly because the current prevailing legal analysis is that a claim under an indemnity insurance policy is to be characterised as a claim for damages for breach of an obligation to hold the insured harmless. Whilst, therefore, damages might be claimed for non payment of a debt, they cannot be claimed for non payment of a claim which itself amounts to damages ("damages on damages").

Impact on Sprung *of FSA rules*

Since *Sprung* was decided, the FSA has adopted rules on fair handling of insurance claims in its Insurance Conduct of Business Sourcebook and its Conduct of Business Sourcebook. A breach of these rules gives rise to an action in damages under section 150 of the Financial Services and Markets Act 2000 at the suit of a "private person".[3] Were the facts of *Sprung* to arise again today, therefore, the result might be different. The right of action under section 150 would not, however, arise in most claims on the wholesale insurance market.

The Law Commissions' criticisms

- The Law Commissions consider that the rule excluding claims for damages for late payment of insurance claims is unjustified for the following reasons:
- The idea that the insurer's primary obligation is to prevent a loss occurring is a fiction which ignores commercial reality.
- The law of England and Wales gives the impression of being biased against the interests of policyholders.
- The law appears to reward inefficiency and dishonesty. The law does not support efficient and well-run insurers.
- The law leads to injustice. Although the Financial Ombudsman Service (FOS) mitigates the injustice of the law for consumers and some small businesses, it cannot help medium-sized or larger businesses, award damages of over £100,000, or deal with disputed oral evidence.

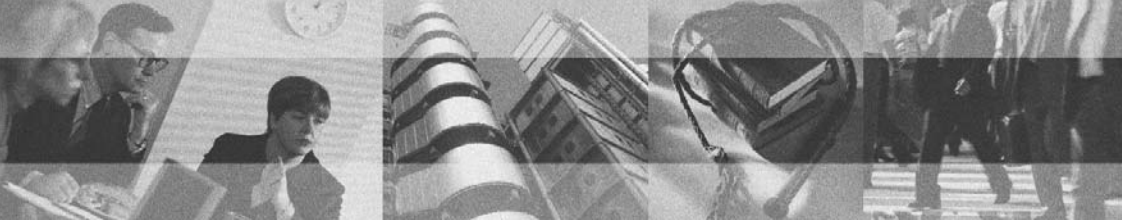
The Law Commissions' proposals

Accordingly, the Law Commissions put forward two options for reform of the rule.

- The first would be to amend section 17 of the Marine Insurance Act 1906, so as to permit policyholders to claim damages where an insurer has acted in bad faith. This might be supplemented by legislation including guidelines for the content of the insurer's duty to act in good faith.
- The second would be to reverse the decision in *Sprung*, so as to make an insurer liable for damages in the event of a failure to pay a valid claim within a reasonable time.

BILA sub-committee's views

The BILA Law reform sub-committee generally endorses everything which the authors of the Law Commissions' Issues Paper 6 have said about damages for late payment and the



insurer's duty of good faith. There is also support from at least one member of the committee for legislation covering the content of the insurer's duty.

As a practical matter, however, we believe that the Law Commissions should focus on reversing the rule underlying the decision in *Sprung,* which seems to us to be the principal defect in this part of English insurance law, requiring remediation as soon as possible. Other aspirations are perhaps less pressing and a legislative programme which sets out to achieve everything in the Issues Paper risks failure simply because it may be seen by the government of the day as over-ambitious and requiring a disproportionate use of limited resources.

The law on damages for late payment

We agree that the law on damages for late payment in England and Wales is unsatisfactory and in need of reform, at least in the field of insurance law. The House of Lords' reversal, in *Sempra Metals v IRC*,[4] of the anomalous rule that damages could not be claimed for failure to pay a debt on time, does not extend to the non-payment of claims under policies of indemnity insurance because of the even more anomalous rule that such claims are properly classified as damages and not debts. As Professor Malcolm Clarke[5] has pointed out, there is no sound basis for the latter rule and the removal of this "blot on English common law jurisprudence" is long overdue.

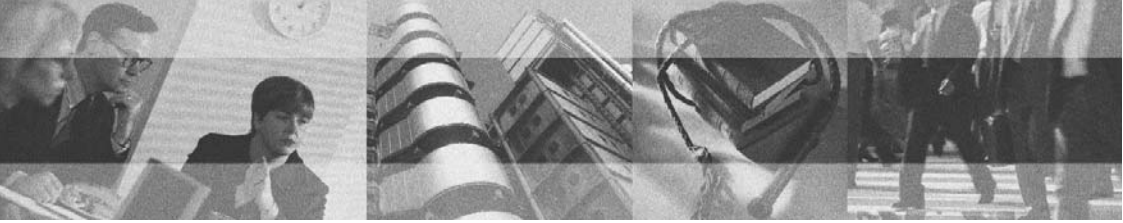
As pointed out by the Law Commissions, Scots law does provide for damages to be recoverable for non payment of insurance claims. We agree that the law on damages for late payment in Scotland is generally satisfactory. If however it is intended to align the law of England and Wales broadly with Scots law by means of legislative change then, subject to due consideration being given to the changes proposed in relation to Scots law, there may be merit in such legislation being applicable to Scotland as well as England and Wales to avoid any confusion in the future such as that which arose in *Toremar v CGU Bonus Limited*,[6] where Lord Brodie dismissed a claim for damages for late payment, having arrived at a view on Scots law which the Law Commissions consider to be incorrect. Furthermore, if the opportunity is taken to clarify Scots law on the insurer's duty of good faith, a slightly narrower focus to the question might be helpful, namely the insurer's obligations relating to the handling of claims.

Legislative reform of the insurer's duty to act in good faith

The duty of good faith

In principle, we agree that legislative guidelines on the insurer's duty of good faith would be helpful. We further agree with the list of proposed obligations set out by the Law Commissions as follows:

- an insurer should investigate claims fairly;
- an insurer should assess claims in a way which is free from bias, taking into account relevant circumstances, and not taking into account irrelevant ones;
- if an insurer considers a claim to be invalid, it should give the insured reasons for its decisions;



- if the insurer considers the claim to be valid, it should pay it within a reasonable time.

We also agree with the Law Commissions' suggestion that this should be a non-exhaustive list. Our consensus, however, is that if the Law Commissions wish to set out guidelines on the insurer's duty of good faith, they should not do so piecemeal but as part of a general review of the doctrine of good faith. The present Issues Paper is really directed at claims handling and our comments are limited to the remedy for a lack of good faith in this area.

We suggest that the issue of the remedy available to policyholders in the event of a failure by insurers or their agents to act in good faith at other times (in particular at the point of sale or renewal) be considered by the Commissions at a later stage as part of their general review. Anticipating some of the matters that such a review might encompass, practical ways to provide content to the insurer's duty might include:

- encouraging insurers to write such guidelines into their policies;
- practical application of the FSA rules on treating customers fairly; or
- FOS decisions.

Section 150(3) of the Financial Services and Markets Act 2000

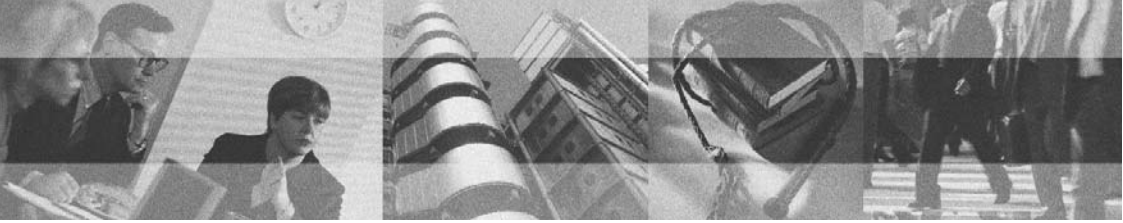
An alternative way forward with regard specifically to claims handling (which was proposed in more detail by one of our members in an independent response[7] to the Issues Paper) could be to persuade the FSA to use section 150(3) of the Financial Services and Markets Act to extend rights of action for regulatory breaches under ICOBS 8 beyond "private persons".

We note that while this approach is considered in the body of the Issues Paper (paragraphs 5.16 to 5.19), the questions for consultation focus on possible amendment of primary legislation, rather than using powers granted by existing statutes to amend secondary rules. For present purposes, if the decision in *Sprung* is reversed by legislation (a proposal which we support – see further below), the effect would be to compel insurers to investigate claims fairly and to pay valid claims within a reasonable time – which is where we believe insureds (particularly consumers) need protection as a matter of priority.

Damages for breach of good faith

We agree that damages should be available to a policyholder who has suffered foreseeable loss as the result of the insurer's failure to pay a claim when it should have been paid. (We consider further below some issues which arise in connection with the determination of the proper time for payment.) Our view on the wider issue of damages for breach of the insurer's duty of good faith (consistent with the views expressed above) is that while we agree that it would be a useful remedy for consumers, we do not think that the introduction of such a remedy should delay the reversal of *Sprung* – which might be the unintended consequence of a more ambitious legislative programme.

We agree that damages (whether for failure to pay a claim timeously or for any breach of a wider duty of good faith) should be limited to the contractual measure, i.e. losses within the



contemplation of the parties at the time that they entered into their contract, and that tortious or delictual damages, which are usually more generous, should not be available.

Delay during litigation

We agree that delay caused by litigation should not preclude the remedy of damages where that remedy would otherwise be available – not only for the reasons given by the Law Commissions, but also because this would be consistent with what is described in the Issues Paper as the "strict liability" approach which would be effected by the reversal of *Sprung*.

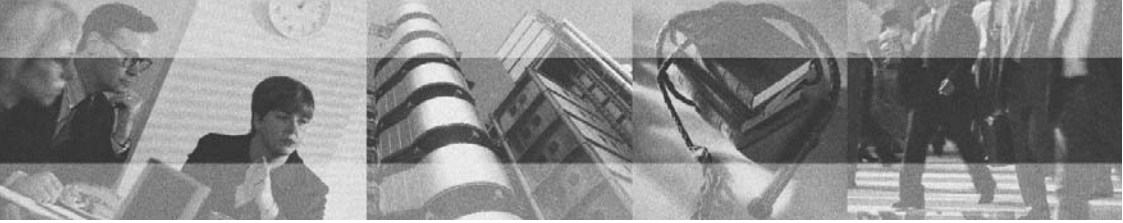
A non-excludable duty

We agree with the principle that an insurer should not be permitted to exclude its statutory duty of good faith, but there was much debate within the sub-committee over what that should mean in practice, particularly given the lingering uncertainty in English law surrounding the substantive content of that duty. It was pointed out that an insured is permitted to contract out of his duty of good faith (at least to the extent of being absolved from the duty to disclose all material facts and not to misrepresent any material facts, with an exception for fraudulent misrepresentation or non-disclosure by the insured himself).[8]

We recognise that the practical application of the duty of good faith does not produce symmetrical consequences for insureds and insurers. Absolving the insured from duties relating to disclosure of material facts simply shifts the risk of non-disclosure or misrepresentation to the insurer, who can assess whether or not to take that risk, having regard to the possibility of performing some kind of due diligence on the insured or the subject matter of the proposed insurance.

By contrast, the insured is not, in most cases, going to be in any position to make provision for the possibility that the insurer will fail to pay an indemnity properly due to the insured timeously or at all. Given that we believe the proper focus should be on late payment of claims, we have come to the provisional conclusion (and we propose to the Law Commissions) that if (as we recommend) damages for failure to pay an insurance claim should be permitted in English law, nevertheless the insurer should be allowed to limit its liability for consequential loss to some extent.

After all, if an insured has bought protection against business interruption, it does not seem unreasonable to hold an insurer liable to pay the higher cost, caused by delay, of reinstating the insured's business (even to the extent of rescuing the insured from insolvency). It is quite another thing, however, to compel the insurer in effect to provide business interruption cover if the insured has not bought such insurance in the first place. Suppose, for example, that the insured has bought a policy covering his business premises against the risk of fire, but has not bought business interruption insurance. The premises are destroyed by fire but the insurer delays payment of the indemnity properly due to the insured. The insurer should be permitted to confine damages for consequential loss to matters such as increased rebuilding costs, and to exclude a loss in turnover or profit suffered by the insured for the period during which he was unable to re-open his business.



Impact of reform on the insurer's duty of good faith

Our tentative views are that:

- the number of successful claims against insurers is likely to be low because bad faith in claims handling is the exception rather than the rule; but
- the mere possibility of bringing such claims will almost certainly lead to a number of claims being brought which would not have been brought under the existing regime.

The consequence may be increased claims handling and claims process monitoring expenses (which insurers may ultimately seek to pass on to customers by way of increased premiums), as well as more litigation and consequent legal costs. These problems are likely to be most acute in the early stages while the courts are in the process of establishing guidelines for the interpretation and effect of whatever new legislation is promulgated.

The "strict liability" approach: reversing the decision in *Sprung*

Characterisation of the insurer's duty to pay a claim

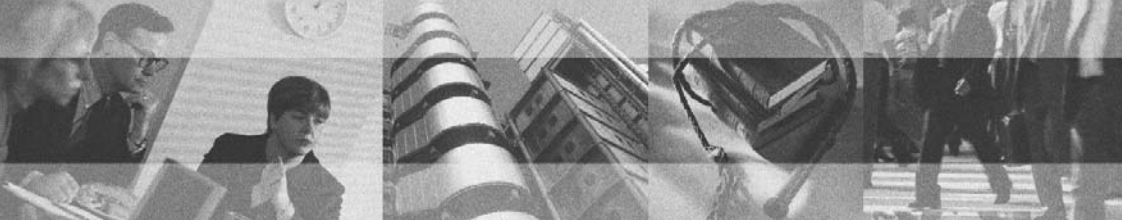
We take the view that it is wrong to characterise the insurer's obligation under an insurance contract as a duty to prevent the harm from occurring. The original rule appears to be an historical anomaly and we do not foresee any unmanageable problems following from its abrogation, although some consequential changes to the law may be necessary.

It has been pointed out that other rules are linked with the characterisation referred to above. For example, the limitation period for claims under a first party (property) policy commences to run as soon as the loss occurs. It seems to us, however, that no substantial change to the law of limitation will be necessary – at least for purposes of the basic rule which determines when an insured's cause of action against an insurer for payment of an indemnity under an insurance policy accrues. If the insurer's obligation were to be characterised either as a debt or as an obligation to pay an indemnity sounding in money (which, after all, is the normal outcome of a claim on an insurance policy) or to replace or restore the lost or damaged property or pay damages for failure to do so, that obligation would seem equally to arise at the moment of loss for purposes of the commencement of the limitation period applicable to the insured's right of action against the insurer.

A more difficult issue may be the determination of the point at which an insurer becomes liable to pay damages for consequential loss as the result of bad faith claims handling and any separate limitation issues which arise.

Implied contractual obligation

We also consider that insurers should have an implied contractual obligation to pay valid claims within a reasonable time. An insurer who fails to meet this obligation should be liable for the foreseeable losses which result, subject to the insurer's ability to limit (to some extent) damages for consequential loss by contract, for the reasons given above.



That said, we would add the comment that sympathy with the need for redress against any insurer who may appear to take advantage of the absence of an effective legal remedy against late payment (or other claims payment practices which are thought to be unreasonable) should not cause us to lose sight of the concomitant need for certainty on what "late" or "unreasonable" means in the circumstances – which is surely a pre-requisite for any amendment of the law as proposed to operate successfully.

On the one hand, a rule that the insurer is, at the instant of occurrence of an insured loss, immediately in breach either of a broad obligation to act in good faith or a narrower obligation to pay valid claims within a reasonable time, would be just as unrealistic as the present law. On the other hand, might it be necessary (or at least expedient) to sacrifice logic to some extent for the sake of simplicity, particularly if one of the motives for insurance contract law reform is consumer protection? Otherwise, there is a risk that there will be arguments in every case about how long the insurer reasonably needed to investigate, adjust and settle the loss. Of course, such arguments arise already in cases where a substantial interest claim could be made and the question has to be determined of when interest should start to run. Should, however, reform of the law lead to a multiplication of instances of such arguments and an extension of their context to disputes over whether a claim for damages for consequential loss is statute-barred?

We do not believe there are simple answers to these questions and at this stage we wish to ensure simply that the questions are included within the Law Commissions' focus at the stage of a formal Consultation Paper. On balance, we favour logic and consistency over simplicity. We therefore incline to the view that the insured's right to damages for consequential loss (where it arises) should be a separate cause of action from the right to payment of an indemnity in accordance with the terms of the policy. The former right should accrue at the date on which the insurer should, following reasonable investigation, have paid the claim. Determination of that date should be left to the courts, taking all relevant circumstances into account. We take this view notwithstanding that this solution means:

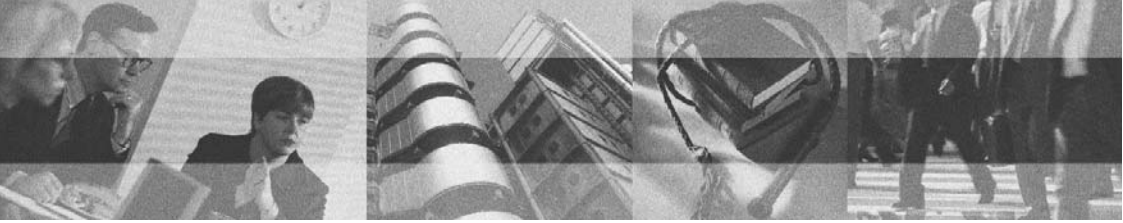
- that separate limitation periods would apply to the insurer's primary obligation to indemnify the insured and to the further obligation (where it arises) to pay damages for breach of the primary obligation;
- and that the date of such breach is potentially subject to uncertainty.

Limitation of liability for consequential loss

An insurer should be able to limit its liability for damages for consequential loss, for the reasons given above, in all cases and not merely with regard to business insurance contracts. We agree, however, that insurers issuing policies to consumers should not be allowed to exclude altogether their liability to pay valid claims within a reasonable time.

Need for legislative reform

We believe that legislative reform is desirable to reverse the effect of the *Sprung* decision. Even though the judiciary may support its reversal, law reform in this area should not wait until an appropriate case comes along. Moreover, a first instance judge (or even the Court



of Appeal) might hold that only the Supreme Court has the jurisdiction to overturn *Sprung*. A meritorious claimant should not be put to the time, trouble and expense of taking his claim to the Supreme Court.

Impact of reversing *Sprung*

The Issues Paper suggests that the impact of reversing *Sprung* will not be very significant. Moreover there are relatively few reported cases in which the issue has been addressed by the courts. We would, however, make the observation that lawyers are regularly consulted about whether there is a possibility of getting compensation in circumstances similar to *Sprung*. Once there has been reform of the law in this area, the appetite for pursuing such claims is likely to increase.

We would add a further observation in this regard. To the extent that the *Liesbosch Dredger*[9] principle (i.e. that the claimant's impecuniosity is a separate cause of the inability to mitigate a loss) may remain applicable in English law following the comments on that decision of the House of Lords in *Lagden v O'Connor*,[10] it seems to us that loss (or aggravation of it) attributable to the insured's lack of resources will in many cases not in fact be a separate factor. Alternatively, such loss may not be too remote from the contemplation of the parties, simply because the reason why insureds take out insurance in the first place is that they would not be able, without it, to weather the consequences of a major loss affecting their domestic or business property. The values insured in the relevant policy would arguably make that fact evident to the insurer.

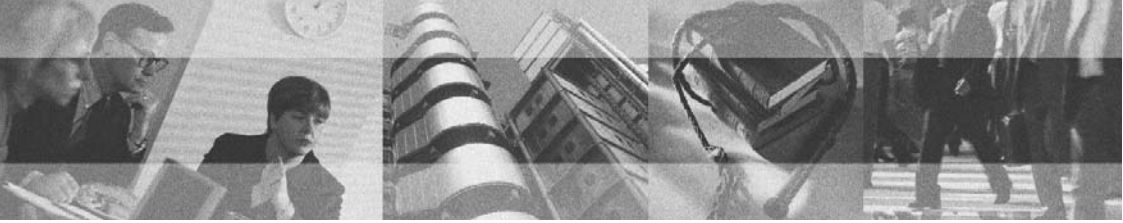
Damages for consumers' distress, inconvenience and discomfort

The Law Commission has expressed the view that:

> *"FOS is correct in its approach to awarding compensation for distress, inconvenience and discomfort. Normal contract principles should apply to this area. This means that where a consumer policy has been sold to provide peace of mind, then damages for distress, inconvenience and discomfort would be available in appropriate cases. Such damages are particularly relevant where a consumer's home has been left in serious disrepair for a prolonged period. They may also apply where a consumer has suffered delay in receiving medical treatment. If the FOS is right to award damages in such circumstances, we think that the same principles should also apply in the courts."*

Differing views were expressed on this issue by members of the sub-committee. The majority expressed themselves as follows:

- We agree that the current FOS approach to the award of damages under these heads is the correct policy.
- Our view is that the courts have coped well with the issues which have arisen and there is no need for statutory reform.
- We do not believe statutory guidelines on the amount of such damages are necessary; once again, it seems to us that the courts are well able to deal with the cases which come before them on a robust, common sense basis.



One member of the sub-committee, however, wished us to record that his experience in providing pro bono advice is that stronger protection of consumers may be desirable because damages for distress and discomfort are too low to be worth pursuing unless coupled with a more substantial award made on grounds of the wrongful denial of a claim.[11]

Acknowledgements

The sub-committee members wish to express their thanks to other members of the BILA Committee who commented on earlier drafts of their response and also to Robert Wilson of CMS Cameron McKenna, Edinburgh, for observations on Scots law.

Endnotes

1 The members of the BILA law reform sub-committee are (in alphabetical order): Jonathan Goodliffe, Freshfields Bruckhaus Deringer LLP; Alison Green, Barrister, 2 Temple Gardens; Peter Hinchliffe, Lead Ombudsman for the Insurance Sector in the Financial Ombudsman Service; Stephen Lewis, Consultant, Clyde & Co LLP; and Michael Mendelowitz, Partner, Norton Rose LLP (editor of the sub-committee's response).

2 [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70

3 This expression is defined (so as far as is relevant) as: (a) any individual, unless he suffers the loss in question in the course of carrying on: (i) any regulated activity; or (ii) any activity which would be a regulated activity apart from any exclusion made by article 72 of the Regulated Activities Order (Overseas Persons); and (b) any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind.

4 [2007] UKHL 34

5 *"Compensation for Failure to Pay Money Due: a 'Blot on English Law Jurisprudence' Partly Removed"* [2008] JBL 291

6 [2009] CSOH 78

7 http://jgoodliffe.co.uk/insurance/lawcom.pdf

8 *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2003] Lloyd's Rep IR 230 (HL)

9 *Owners of The Liesbosch Dredger v Owners of SS Edison* [1933] AC 449

10 [2004] 1 AC 1067

11 This view is more fully articulated in the separate response to the Law Commission of the BILA member concerned. See http://www.jgoodliffe.co.uk/insurance/lawcom.pdf