



FOIL UPDATE

June 2010

Damages for Late Payment and the Insurer's Duty of Good Faith

The Law Commission has published an issues paper looking at remedies available to a policyholder when an insurer either fails to pay a valid claim, or only pays after considerable delay. Obviously the general rule when one party breaches a contract is that the other party can claim damages for actual, foreseeable loss suffered. The English courts have held that insurance is an exception to this rule, and an insured cannot recover damages for losses caused by a failure to pay, or delay in paying a valid policyholder claim. The new proposals are aimed at policyholder rather than third party claims but there is one potential impact on third party actions mentioned in the conclusion, below.

The Current Position

The lead case in this area is *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111. Mr Sprung had an insurance policy to protect his factory against "sudden and unforeseen damage". When vandals damaged his factory his insurers rejected the claim. Ultimately, four years later, he was awarded an indemnity for his damaged property with interest and costs, but, in difficult trading conditions, in the meantime his business had been lost. A claim for damages of £75,000 for the lost opportunity to sell his business was rejected.

The claim for the loss of the business was rejected because a contract of insurance is based on the fiction that the insurer's obligation under the contract is to "hold the insured harmless" i.e. the insurer is said to have promised that the act causing the loss will not occur. If it does occur then the insurer is immediately in breach of contract and obliged to pay the insured a sum in damages as set out in the policy. The money received from an insurer is therefore not a contractual obligation but damages, and the principle under English law is that no damages are payable for a failure to pay damages. The position in Scotland (and many other jurisdictions) is different. In Scotland an insurer is under an implied obligation to pay a valid claim after a reasonable time for investigation. If an insurer is judged to be in breach of contract through not paying, usual contract principles will be applied in assessing damages for any loss incurred.

In the view of the Law Commission the approach in England and Wales is wrong: the law lacks principle, it appears biased against the insured, it may reward inefficient or dishonest insurers and may lead to injustice.

The Duty of Good Faith

The consultation considers the special nature of insurance contracts: that they are based on mutual "good faith". The courts have recognised that a refusal to pay or an

The proposals in brief:

- The current law in England and Wales prevents policyholders claiming damages for refused and delayed claims.
- The position is different in Scotland.
- The Law Commission takes the view that the approach in England and Wales is wrong and should be changed
- One proposal would introduce statutory guidelines on the insurer's duty of good faith and introduce damages as a remedy for breach of the duty, not available at present.
- A further proposal would reverse the seminal case of *Sprung v Royal Insurance* to bring insurance in line with normal contract law.
- Damages could be introduced for distress and inconvenience, in line with normal contract principles.
- The proposals will not affect third party claims in general although there is potential for claims under the Third Parties (Rights against Insurers) Act to be affected.

unreasonable delay in meeting a claim may be a breach of the insurer's duty of good faith but have held that damages are not payable for that breach (the precedent case being *Banque Financiere v Westgate Insurance Co*). This is due in part to the wording of Section 17 of the Marine Insurance Act 1906 (which, despite its name, has general application to all types of insurance). The Section states that if the obligation of "utmost good faith" which applies to a contract of insurance is not observed by either party "the contract may be avoided by the other party". The courts have interpreted this to mean that avoidance is the only remedy available in the event of a breach. The contract is therefore declared void and the premium is refunded. This is generally helpful to insurers but most consumers would prefer their claims to be paid rather than getting the premium back.

The view of the Law Commission is that the duty of good faith will only become "a truly mutual obligation if it were possible for policyholders to claim damages for losses which result from the insurer's bad faith".

Other remedies available to the insured

Complaints about delayed payment and bad claims handling regularly come before the Financial Ombudsman Service (FSO), although it can only deal with complaints brought by consumers and small businesses. The consultation paper sets out that the FSO will generally compensate for the effects of late payment in three ways: through the payment of interest, through awards for distress and inconvenience, and occasionally, through the award of damages for financial loss.

The paper also looks at other remedies which may be available to an insured who has suffered loss as the result of late payment of a claim:

- **The payment of interest** – in its research in 2004 the Law Commission found a wide variety in approaches to setting interest rates, although the judgment rate, 8%, is the most common. The main provision allowing for interest is Section 35A of the Supreme Court Act 1981 which is limited as under that provision interest is only available as a result of court action and there is no provision allowing for compound interest.
- **The Late Payment of Commercial Debts (Interest) Act 1998** – the Act applies to all commercial creditors. It awards interest at a rate to penalise late payers, 8% above the base rate. The consultation states that it is not clear how the Act applies to the late payment of insurance claims. They are not expressly excluded from the Act but the Directive underlying the Act does appear to exclude insurance claims. The classification of payment under a policy as damages in England and Wales would also seem to exclude a claim, although that would not affect claims in Scotland.
- **Breach of Statutory Duty** – the FSA imposes responsibilities on insurers in handling and paying insurance claims. Detailed rules are set out in the Insurance Conduct of Business Sourcebook (ICOBS). Under Rule 8.1.1 an insurer must handle claims properly and fairly, must provide reasonable guidance to an insured in making a claim, must not unreasonably reject a claim and must settle claims promptly once terms are agreed. An insurer which fails to abide by the rules may be subject to disciplinary action by the FSA but there is little assistance for consumers.
- **The tort of fraud** – in theory this remedy may be available but as it requires a representation of fact which the insurer knows to be false it is only likely to be applicable to a small number of cases.

- **Criminal fraud** – this is unlikely to assist in most of the circumstances the Law Commission is exploring.
- **Reinstatement** – an insurance policy may allow an insurer to choose between payment of money or reinstatement. If reinstatement is chosen the policy will become a contract for services and the Sale of Goods Act 1979 and the Supply of Goods and Services Act 1982 will apply. Where an insurer has agreed to reinstatement, damages for distress and inconvenience may be available if the insurer fails to complete the reinstatement within a reasonable time.
- **Damages for distress and inconvenience** – there are two circumstances in contract law where these damages may be available: where an important object of the contract is to give pleasure, relaxation or peace of mind; or where some physical inconvenience and discomfort has been caused by the breach. As set out above, where the insurer has elected to reinstate, these damages may be awarded for bad or slow workmanship. However, where the insurer has failed to pay the claim the courts have been unwilling to award this type of damages.

The Case for Reform

In the consultation paper the Law Commission criticises the decisions in *Sprung v Royal Insurance (UK) Ltd* and *Banque Financiere v Westgate Insurance Co*. The Law Commission concludes:

"The combined effect of these decisions is that policyholders have little recourse, even when insurers act in bad faith by wrongfully refusing to investigate claims, delaying payment, or rejecting claims for irrelevant reasons"

The paper indicates that the fact that policyholders may not sue for foreseeable loss has proved controversial and it summarises the judicial and academic criticism of the current position. The Law Commission itself makes four criticisms of the principle:

- The law lacks principle. It is based on a fiction and cannot be justified on normal contract principles. It is out of line with the law in Scotland, Australia, Canada and the United States.
- The law appears unfair – it gives the impression of being biased against the interests of policyholders. The Law Commission believes that this undermines confidence in insurance law and in the insurance industry.
- The law appears to reward inefficiency and dishonesty. Most insurers do pay claims fairly and within a reasonable period because there are strong commercial pressures to do so. However, an insurer in run off, for example, may not feel under the same pressure. Individual claims handlers may also lose perspective and act unfairly.
- It may, on occasion, lead to injustice – although consumers can take their complaints to the FOS it is not able to help everyone, particularly where the business complaining is medium sized and above the FOS jurisdiction level, or where the case involves disputed oral evidence, making it unsuitable for the FOS procedure. The Law Commission thinks that the actual number of cases of injustice is likely to be small.

A Note of Caution

As the Law Commission explains, "the limited evidence of actual policyholder detriment suggests that it may be wise to proceed cautiously". It mentions a number of issues to be taken into account, including:

- Insurance contracts are for specific risks: an insurer should not be exposed to uncertain and additional risk
- Remedies need to be proportionate: it would be unfair if an insurer faced a very large claim for consequential loss on a relatively small policy.
- An insured can buy business interruption cover – an insurer should not have to provide this without payment.
- An overly generous right to compensate may increase premiums for everyone.

Proposals for Reform

The Law Commission has reached the conclusion that the law in England and Wales is in need of reform. It has identified two approaches, the first of which would provide damages where the insurer breaches its duty of good faith and the second of which would reverse the decision in *Sprung*, so as to make an insurer liable for a failure to pay a valid claim within a reasonable period, (which the Commission calls the 'strict liability' approach). The duty to act in good faith would be non-excludable under the contract. The 'strict liability' approach would be read subject to the express terms of the contract, which would allow the liability to be excluded in business contracts, although in consumer contracts exclusion would be likely to be considered unfair under the Unfair Terms in Consumer Contracts Regulations 1999.

Breach of the Duty of Good Faith

The Law Commission suggests that it may be helpful to provide guidelines within legislation on how an insurer is required to behave. Fraud or dishonesty would clearly be a breach. Continuing to avoid a policy or to repudiate a claim relying upon allegations that have been shown to be incorrect would be a breach. A mistake in handling a claim may not be a breach unless it involved serious incompetence. Breach of regulations such as ICOBS "may well" constitute a breach of good faith. The Law Commission has distilled the obligations into three main areas:

- To investigate a claim fairly
- To decide a claim fairly
- To pay a claim within a reasonable time once a settlement is agreed.

Delay of itself would not be a breach, nor would an incorrect refusal to pay if the insurer genuinely and reasonably thought that the claim was invalid. The legislation would set out the appropriate remedies for breach which would include damages for foreseeable loss. A limited and controlled liability is anticipated: actual losses would need to be proven. The Law Commission does not believe that the commencement of litigation should affect the obligation to act in good faith: proceedings should not absolve the insurer of responsibility for any consequences of delay. The Law Commission thinks that the number of cases would be low, with only a handful of claims succeeding each year. It believes that the insurance industry already settles some of these claims to avoid bad publicity and the possibility of an unfavourable decision before the appeal court.

Reversing the Decision in Sprung

The Law Commission believes that *Sprung* was wrongly decided and out of line with general contract principles. It states:

"We accept that insurers need to be able to refuse valid claims. Every so often, an insurer will act unreasonably in deciding a claim is invalid, but later be found to be wrong. In these circumstances, should the loss lie with the insurer or the insured? We think that in commercial insurance, this question is best left to the parties themselves. The default position should be that the insurer bears the risk, following its failure to perform the contractual obligation. However, the parties should be free to exclude this liability through a contract term....."

In consumer insurance, the parties' right to exclude liability is restricted by the Unfair Terms in Consumer Contracts Regulations 1999. An exclusion clause which was not properly brought to the consumer's attention would be considered unfair."

The paper considers how *Sprung* should be overturned. It thinks that it would be open to the Supreme Court to overturn the decision but a suitable case may not come along and the Court may feel constrained by previous precedents. If new legislation were introduced "*the industry is likely to react by automatically excluding liability in all commercial contracts. This would effectively render the reform nugatory.*" There is also a danger that a new statute may set a particular approach in stone, which would separate insurance law from general contract law, preventing it from developing with other changes in the common law.

The Law Commission does not think that reversing *Sprung* would have a significant practical effect. It does not anticipate many successful cases. It notes that the impact will be reduced as many insurers will exclude liability in commercial contracts. It acknowledges that the change may discourage insurers from refusing claims if they potentially face a large liability if they get it wrong. This may, in turn, encourage policyholders to submit invalid claims.

Damages for consumers' distress, inconvenience or discomfort

It is not clear that damages of this type are available where there is delay or a refusal to meet a claim. The Law Commission believes that normal contract principles should apply which would mean that where a consumer policy has been sold to provide peace of mind, damages of this type should be available where appropriate. Views are sought on whether the courts can reach this result through a development of case law or whether there is a need for statutory guidelines.

Conclusion

The Law Commission is convinced that reform is required in this area but states that it has an open mind on the method to be used – on the extent of the duty to be imposed on insurers and the best mechanism to use to achieve change. The proposals are put forward on the basis that the practical effect will be limited: that the number of cases in which the new principles are applied will be very small. The Law Commission view is that there will only be "a handful of cases for breach of good faith" and if a 'strict liability' approach were adopted, the Commission would "not anticipate many successful cases". The impact assessment within the paper is very brief and it is clear that no research or investigation has been conducted in this area. The Law Commission itself notes the "limited evidence of actual policyholder detriment" and suggests that it may be wise to proceed cautiously. These are issues which must be taken seriously.

As with all reforms it is important to guard against the introduction of unforeseen consequences. In this case, the Law Commission is focussing on the rights of remedies available to policyholders and it is clear that no changes are envisaged to third party claims. FOIL will be raising with the Law Commission the issue of claims under the Third Party (Claims against Insurers) Act 2010. Under that statute:

"The rights of the relevant person [the policyholder] under the contract against the insurer in respect of the liability are transferred to and vest in the person to whom the liability is or was incurred (the "third party").

It would appear that in this situation there is the potential for new rights aimed at policyholders to be used by third parties – a considerable extension beyond the stated objectives of the paper. Whilst the practical implications of this may be quite small it is an issue that should be thought through in detail before any reform is introduced.

The consultation questions are listed below. The full consultation paper can be accessed on the Law Commission website:

http://www.lawcom.gov.uk/docs/late_payment_issues.pdf

FOIL will be preparing a response. Please forward your comments and views on the proposals to Shirley Denyer on shirley.denyer@foil.org.uk by **21 June** please.

The consultation closes on 24 June 2010

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LIST OF CONSULTATION QUESTIONS

The Commission asks for comments on and responses to the following questions:

THE LAW ON DAMAGES FOR LATE PAYMENT

10.1 Do consultees agree that the law on damages for late payment in England and Wales is unsatisfactory and in need of reform? (Paragraph 8.33)

10.2 Do consultees agree that the law on damages for late payment in Scotland is generally satisfactory? (Paragraph 8.36)

10.3 Do consultees agree that Scots law on the insurer's duty of good faith could usefully be clarified? (Paragraph 8.37)

LEGISLATIVE REFORM OF THE INSURER'S DUTY TO ACT IN GOOD FAITH

10.4 Should legislation include guidelines for the content of the insurer's duty to act in good faith? (Paragraph 9.23)

10.5 If so, should it specify that:

- (1) An insurer should investigate claims fairly;
- (2) 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;
- (3) If an insurer considers a claim to be invalid, it should give the insured reasons for its decisions;
- (4) If the insurer considers the claim to be valid, it should pay it within a reasonable time? (Paragraph 9.24)

10.6 Do consultees agree that this should be a non-exhaustive list? (Paragraph 9.25)

Damages for breach of good faith

10.7 Do consultees agree that damages should be available to a policyholder who has suffered foreseeable loss as a result of the insurer's breach of its duty of good faith? (Paragraph 9.29)

10.8 Do consultees agree that damages should be limited to losses within the contemplation of the parties at the time of the contract, and that damages in tort or delict should not be available? (Paragraph 9.30)

Delay during litigation

10.9 Do consultees agree that where damages would otherwise be available, they should not be precluded because they were caused by delay while litigation progressed? (Paragraph 9.33)

A non-excludable duty

10.10 Do consultees agree that an insurer should not be permitted to exclude its statutory duty of good faith? (Paragraph 9.35)

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

10.11 We welcome information about the cost and benefits of reforming section 17 to provide for a remedy of damages. (Paragraph 9.40)

10.12 Do consultees agree that the number of successful claims against insurers for breach of the duty of good faith is likely to be low? (Paragraph 9.41)

THE "STRICT LIABILITY" APPROACH: REVERSING THE DECISION IN *SPRUNG*

10.13 Do consultees agree that:

- (1) it is wrong to characterise the insurer's obligation under an insurance contract as a duty to prevent the harm from occurring?
- (2) insurers should have a contractual obligation to pay valid claims within a reasonable time – and that an insurer who fails to meet this obligation should be liable for the foreseeable losses which result?
- (3) the parties to a business insurance contract should be able to exclude this liability through the express terms of the contract? (Paragraph 9.46)

10.14 If *Sprung* is to be reversed, should this be left to the courts, or is legislative reform desirable? (Paragraph 9.53)

Impact of reversing *Sprung*

10.15 We welcome comments on the costs and benefits of making insurers liable for the foreseeable losses which result from a failure to pay a valid claim within a reasonable time. (Paragraph 9.58)

DAMAGES FOR CONSUMERS' DISTRESS, INCONVENIENCE OR DISCOMFORT

10.16 Do consultees agree that in consumer insurance contracts, the Financial Ombudsman Service approach to the award of damages for distress, inconvenience and discomfort is correct as a matter of policy? (Paragraph 9.64)

10.17 Do consultees think that there is a need for statutory reform in this area, or can the matter be left to the courts? (Paragraph 9.65)

10.18 Is there a need for guidelines on the amount of such damages? (Paragraph 9.66)