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

SUMMARY

S.1 In this Issues Paper we consider whether a policyholder should be entitled to damages where the insurer has refused to pay a valid insurance claim, or has paid only after considerable delay. In England and Wales, a policyholder who has not been paid a valid claim is entitled to sue the insurer for 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.

S.2 This has proved controversial. By contrast, in Scotland (and in most other common law jurisdictions) damages are payable, provided that the loss is considered foreseeable at the time the contract is made.

S.3 This Issues Paper sets out our preliminary thinking. Its purpose is to promote discussion before we formulate our proposals. We seek responses by **24 June 2010**, to the address on page 1 of the full paper.

S.4 Here we focus on the insurer's obligations. Later this year we plan to publish a further issues paper, looking at the insured's duty to act in good faith after an insurance contract has been formed.

THE DECISION IN *SPRUNG*

S.5 The English case of *Sprung v Royal Insurance (UK) Ltd* illustrates the problems.[1] 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.

S.6 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.

Sprung compared to ordinary contract law principles

S.7 In Part 2, we argue that the decision in *Sprung* is out of line with the principles of ordinary contract law.

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

S.8 The general rule in England is that if one party breaks a contract, the other party may claim damages for the actual loss suffered, provided that it was foreseeable at the time the contract was made. This is subject to three main limitations:

(1) The victim of the breach of contract must prove actual financial loss;

(2) The victim must take reasonable steps to mitigate the loss;

(3) The level of damages may be limited (or expanded) by the express provisions of the contract.

S.9 In 1854, in *Hadley v Baxendale*,[2] the House of Lords defined which losses are "foreseeable" in contract law. There are two kinds:

(1) Those which may fairly and reasonably be considered as arising naturally, that is "according to the normal course of things"; and

(2) Those arising from any special circumstances which were communicated at the time the contract was made.

S.10 At one stage, it was suggested that damages were not necessarily payable for breach of an obligation to pay. It was also suggested that damages were not payable to claimants who failed to mitigate their losses because (like Mr Sprung) they lacked the financial means to do so. However, the law in these areas has now changed. *Sprung* is left looking increasingly isolated and anomalous.

Why insurance is an exception

S.11 The English courts have held that insurance is an exception to the rule that the party breaking a contract should pay damages for foreseeable losses. This is based on the fiction that an insurer's primary obligation is to "hold the insured harmless". In other words, the insurer is said to promise that the loss will not occur. If it does, the insurer is then liable to pay the amount of the claim as damages. Thus an insurance payment is not a primary obligation to pay money, but a secondary obligation to pay damages. It is said that English law does not recognise an obligation to pay damages for a failure to pay damages.

S.12 An insurance contract is treated as analogous to a contract with a security firm, in which the security firm undertakes to prevent a break-in. However, if the security firm broke its promise, the courts would look at all foreseeable loss including, possibly, the effects of business interruption. Insurance law goes one step further. Insurance is treated as if the contract with the security firm had included a clause to limit any damages for breach to a specified amount. In these hypothetical circumstances, if the security firm paid the agreed damages late, the law would respect the parties' agreement to limit damages. It would not award the property owner additional damages for the loss caused by the late payment of the agreed damages.

[2] (1854) 9 Exch 341.

S.13 The English courts are also reluctant to find that insurance policies contain terms, whether express or implied, requiring insurers to assess and pay claims expeditiously. This contrasts with the position in Scotland and other common law jurisdictions.

Conclusion on *Sprung*

S.14 In Part 2 we argue that the "hold harmless" analysis is a complex and unrealistic way to characterise an insurance contract. Unlike a security firm, an insurer is in no position to prevent a loss. Buying insurance does not make a fire, flood or theft less likely. Instead, policyholders buy a promise that if something does go wrong, the insurer will provide the payment specified in the contract. There is nothing in most indemnity contracts to suggest that the parties have put their minds to what the position would be if the insurers failed to make the expected payment, or to limit damages in those circumstances.

S.15 We tentatively conclude that the insurer's primary obligation should be to pay valid claims. If the insurer fails in this obligation, then normal contract principles should apply.

DAMAGES FOR LATE PAYMENT IN SCOTS LAW

S.16 The Scottish courts do not follow the English approach. In Part 3, we explain that Scots law applies ordinary contract principles. An insurance claim is not considered to be damages for breach of the obligation to hold the insured harmless. Instead, the insurer has an obligation to pay a valid claim once it has had an opportunity to investigate its soundness. This was made clear by Lord Eassie in the case of *Strachan v The Scottish Boatowners' Mutual Insurance Association*.[3]

S.17 There are then two ways in which the insurer may breach its contractual obligation: by unjustifiable delay in payment or by wrongful repudiation of a claim. Where the insurer does breach the contract, it may be liable for losses which the insured has suffered and which fall within the rule in *Hadley v Baxendale*.

AN INSURER'S DUTY TO ACT IN GOOD FAITH

S.18 It is well-established under both English and Scots law that insurance contracts are based on mutual "good faith". In Part 4 we consider how far an insurer's unjustified delay or unreasonable refusal to pay a claim may be a breach of its duty of good faith. Although most cases on good faith are concerned with the insured's duties rather than the insurer's, there are tentative suggestions in the case law that insurers should make enquiries, not act arbitrarily and not take into account extraneous circumstances.

S.19 The problem with the duty of good faith in insurance contracts is that only one remedy is available for breach: avoidance. This means that the contract is declared void from the start. The insurer may refuse all claims and simply return the premium. It is a one-sided remedy, of far more use to the insurer than to the insured.

[3] Outer House, Court of Session, 31 May 2001 (unreported).

S.20 In the case of *Banque Financiere v Westgate Insurance Co*, the Court of Appeal confirmed that where an insurer breaches its duty of good faith, the policyholder is not entitled to damages for the loss suffered.[4] We summarise the many criticisms made of this case. However, it is a well-established precedent in English law. We think it is also likely to be followed by the Scottish courts.

S.21 Mutual duties of good faith underpin the insurance bargain. We think that the law should provide the parties with appropriate remedies if these duties are breached. If an insurer acts in bad faith in a way that causes foreseeable loss to the policyholder, damages should be available.

S.22 However, it is not easy to characterise the duty of good faith. We do not think it is an implied term or that it should give rise to an action in tort or delict. It is best seen as a separate, non-excludable duty, giving rise to specific remedies.

OTHER REMEDIES

S.23 In Part 5 we describe four other remedies available to a policyholder who has suffered loss as a result of the late payment of a claim:

(1) *Interest*. This is the main form of compensation for late payment, but does not compensate for further losses.

(2) *Breach of statutory duty*. The Financial Services Authority (FSA) requires insurers to handle claims promptly and fairly. If not, the FSA may take disciplinary action against the insurer and may impose a fine. In addition, consumer policyholders may bring a claim for damages for breach of statutory duty under section 150 of the Financial Services and Markets Act 2000. However, these claims are not open to businesses.

(3) *The tort of deceit (or, in Scotland, the delict of fraud)*. In theory, if an insurer lies to an insured, it would be liable for any losses which result. However, we do not think this would cover most examples discussed in this paper.

(4) *Reinstatement*. Insurance policies often allow insurers to choose between paying a sum of money or reinstating (that is, repairing or replacing) the property damaged. If an insurer elects to reinstate, it acquires obligations in relation to the quality of that reinstatement. Delays in reinstating property may give rise to a claim for damages, including damages for distress and inconvenience.

THE FINANCIAL OMBUDSMAN SERVICE

S.24 Consumers make take complaints against insurers to the Financial Ombudsman Service (FOS). The FOS may also resolve complaints from small businesses with a turnover of less than €2 million and fewer than ten employees. The FOS decides disputes according to what is "fair and reasonable in all the circumstances of the case". It has regard to the law, but where the legal result would be unfair, it does not apply the law.

[4] [1990] 1 QB 665.

S.25 In Part 6, we explain that the FOS departs from the strict case law on damages for late payment of insurance claims in two ways:

(1) *Distress and inconvenience*. Where an insurer has caused distress and inconvenience by mishandling a claim, the FOS will order the insurer to make some kind of reparation. These awards are compensatory rather than penal and tend to involve low monetary awards.

(2) *Compensation for financial loss*. Where claimants can prove actual loss as a result of an insurer's delayed or non-payment, the FOS may award substantial sums as compensation. For example, in one case the FOS awarded up to the maximum it is authorised to award (£100,000) for the interruption of an insured's business.

COMPARATIVE LAW

S.26 In Appendix A we discuss the law on late payment of claims in Australia, the United States and Canada, and refer briefly to the law in China, Germany, Italy and Spain. In Part 7 we summarise the results of this research.

S.27 All the jurisdictions we looked at offer greater protection to policyholders than English law. No other jurisdiction follows *Sprung*. In Australia, Canada and the United States, the primary obligation of insurers is characterised as a duty to pay valid claims, rather than as a promise to hold the insured harmless. China, Germany, Italy and Spain also allow some form of compensation where there has been late or non-payment of a claim.

S.28 In the common law jurisdictions, damages are also available for an insurer's breach of good faith. However, the cause of action differs. In Australia, good faith is considered an implied term; when breached, it gives rise to an action for breach of contract. In some states of the United States a lack of good faith may also be considered a tort, giving rise to damages on a more generous scale. Sometimes the courts award punitive damages to punish insurers who have acted in a malicious or oppressive way.

THE CASE FOR REFORM

S.29 In Part 8 we summarise the many judicial and academic criticisms made of the decision in *Sprung*. These began in the case itself. As Lord Justice Beldam put it:

> There will be many who share Mr Sprung's view that in cases such as this such an award [the indemnity plus interest] is inadequate to compensate him or any other assured who may have to abandon his business as a result of insurers' failure to pay, and that early consideration should be given to reform the law in similar cases.[5]

S.30 We make four criticisms of the current law of England and Wales:

(1) *The law lacks principle*. The idea that the insurer's primary obligation is to prevent a loss occurring is a fiction which ignores commercial reality.

[5] *Sprung*, above, at p 80.

(2) *The law appears unfair*. The law of England and Wales gives the impression of being biased against the interests of policyholders.

(3) *The law appears to reward inefficiency and dishonesty*. The law does not support efficient and well-run insurers.

(4) *The law leads to injustice*. Although the FOS mitigates the injustice of the law for consumers and some small businesses, it cannot help medium businesses; provide damages of over £100,000; or deal with disputed oral evidence.

THE OPTIONS FOR REFORM

S.31 In Part 9, we identify two broad approaches to reform. The first would be to amend section 17 of the Marine Insurance Act 1906, so as to provide policyholders with damages where an insurer has acted in bad faith. The second would be to reverse the decision in *Sprung*, so as to make an insurer liable for a failure to pay a valid claim within a reasonable time.

S.32 We think that the duty of good faith should be non-excludable. However, in business insurance, the parties would be free to agree contract terms excluding the second form of liability (for failure to pay within a reasonable time).

Damages for breach of the duty of good faith

S.33 We think that the law is right to recognise that the parties to an insurance contract have mutual duties of good faith. The nature of the insurance bargain makes this a commercial necessity. However, the law on the insured's duties is much more developed than the law on the insurer's duties.

S.34 We ask if legislation should include guidelines on the insurer's duties. Drawing on existing cases and FSA rules,[6] we suggest that an insurer should investigate claims fairly; assess claims in an unbiased way; give reasons for refusing claims; and (where an insurer considers a claim to be valid) pay it within a reasonable time.

S.35 The major flaw with the duty of good faith is that the only remedy currently available is avoidance. We tentatively propose that damages should also be available in appropriate cases.

S.36 We are proposing a limited and controlled liability. It would be a prerequisite to liability that the claim was valid. The policyholder would then need to prove actual loss, and that this was foreseeable within the general contract principles of *Hadley v Baxendale*. We do not consider that breach of the duty of good faith should form a separate tort or delict. This would leave the insurer open to a more extended and unpredictable liability, which could add to the cost of premiums, and act as a disincentive to challenge invalid claims.

S.37 We argue that the core duty of good faith should be non-excludable. It would be inimical to the nature of an insurance bargain for the parties to exclude or limit liability where a party acts in bad faith.

[6] See, in particular, ICOBS 8.

Overturning the decision in *Sprung*

S.38 We think it is wrong to characterise an insurer's obligation as a duty to prevent harm from occurring. We prefer the Scottish approach, namely that the insurer's primary obligation is to pay valid claims after the opportunity for a reasonable investigation. If an insurer breaches this obligation, it should be liable for actual loss caused by the breach, provided that the loss was foreseeable at the time the contract was made, and that the policyholder acted reasonably to mitigate the loss.

S.39 It would, however, be open to commercial parties to exclude liability for late payment through a contract term. For consumer contracts, such terms would be subject to the Unfair Terms in Consumer Contracts Regulations 1999, and would be likely to be considered unfair. However, in the case of business insurance, we see no reason why insurers should not exclude or limit their liability for damages arising from late payment.

S.40 We think that, if faced with a suitable case, it would be open to the Supreme Court to reverse the Court of Appeal's decision in *Sprung*. We ask whether the issue should be left to the courts, or whether legislative reform is desirable.

Damages for distress and inconvenience

S.41 Under normal contract law principles, where a consumer enters into a contract to provide "pleasure, relaxation and peace of mind",[7] then damages would be available where a breach of contract causes the consumer distress or discomfort. In cases where the consumer's home has been left in serious disrepair for a prolonged period, it has been suggested that it might be appropriate to award up to £2,000 per person per year.[8] The Financial Ombudsman Service follows this approach.

S.42 The courts have held that these damages are available where an insurer fails to reinstate the property, but not where it fails to make a monetary payment. We think this is an unjustified anomaly. We conclude that damages for distress, inconvenience and discomfort should also be available for delayed payments.

Questions for consultation

S.43 A full list of questions is set out in Part 10. We are particularly seeking information on the costs and benefits of the reforms.

[7] *Watts v Morrow* [1991] 4 All ER 937.

[8] *AXA Insurance UK v Cunningham Lindsey UK* [2007] EWHC 3023.