**The Law Commission**
**and**
**The Scottish Law Commission**

# INSURANCE CONTRACT LAW

Issues Paper 6

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

# THE LAW COMMISSIONS – HOW WE CONSULT

**About the Law Commissions**: The Law Commission and the Scottish Law Commission were set up by the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

The Law Commissioners are: The Rt Hon Lord Justice Munby (*Chairman*), Professor Elizabeth Cooke, David Hertzell, Professor Jeremy Horder and Frances Patterson QC. The Chief Executive is Mark Ormerod CB.

The Scottish Law Commissioners are: The Hon Lord Drummond Young (*Chairman*), Laura J Dunlop QC, Professor George L Gretton, Patrick Layden QC, TD and Professor Hector L MacQueen. The Chief Executive is Malcolm McMillan.

**Topic**: We ask whether a policyholder should be able to claim damages from their insurer for the late or non-payment of an insurance claim. We consider whether this might be achieved by reform of the insurer's post-contract duty of good faith. We welcome views on our provisional recommendations.

**Geographical scope**: England and Wales, Scotland.

**Duration of the consultation**: from 24 March 2010 to **24 June 2010**.

**How to respond**

Please send your responses either –

**By email to**: commercialandcommonlaw@lawcommission.gsi.gov.uk or

**By post to**: Martyn Naylor, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ

Tel: 020 3334 0286 / Fax: 020 3334 0201

If you send your comments by post, it would be helpful if, where possible, you also send them to us electronically (in any commonly used format).

**After the consultation**: In the light of the responses, we will work towards a full Consultation Paper, which we hope to publish in early 2011.

**Freedom of information**: We will treat all responses as public documents in accordance with the Freedom of Information Act. We may attribute comments and include a list of all respondents' names in each of our publications. If you wish to submit a confidential response, you should contact us before sending it.

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THE LAW COMMISSION
THE SCOTTISH LAW COMMISSION

# Joint Review of Insurance Contract Law
# Issues Paper 6

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

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# 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 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.

# LIST OF TERMS USED IN THIS PAPER

| | |
|---|---|
| 1906 Act | Marine Insurance Act 1906. |
| ABI | Association of British Insurers. |
| BILA | British Insurance Law Association. |
| Claimant | The party bringing, or who has brought, a civil action in England and Wales. |
| Defendant | The party against whom a civil action has been brought in England and Wales. |
| Defender | The party against whom a civil action has been raised in Scotland. |
| FOS | Financial Ombudsman Service. |
| FSA | Financial Services Authority. |
| ICOBS | Insurance Conduct of Business Sourcebook. |
| LIBOR | London Inter-Bank Offered Rate. |
| *Obiter* | A remark or observation made by a judge which does not form a necessary part of the court's decision. It may be persuasive but does not have to be followed as precedent by other courts. |
| *Per incuriam* | A judgment of a court decided without reference to a statutory provision or earlier judgment which would have been relevant. It does not then have to be followed as precedent by other courts. |
| PEICL | Principles of European Insurance Contract Law. |
| Pursuer | The party raising, or who has raised, a civil action in Scotland. |
| Reinstatement | Repair or replacement of property by an insurer. |

# PART 1
# INTRODUCTION

1.1 This Issues Paper is part of a joint review of insurance contract law by the Law Commission and Scottish Law Commission. It looks at whether an insured should be entitled to damages where the insurer has refused to pay a valid insurance claim, or has paid only after considerable delay.

1.2 This is an area where the law of England and Wales differs from the law of Scotland. In England, 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. This has proved to be a controversial rule. By contrast, in Scotland, damages may be payable, provided that the loss is considered foreseeable at the time the contract is made.[1]

1.3 In this paper, we focus on the insurer's obligations, rather than those of the insured. We have already considered the insured's duty to provide information before entering into an insurance contract.[2] Later this year we intend to publish a further Issues Paper dealing with a policyholder's duty to act in good faith after the contract has been formed.

1.4 This paper sets out our preliminary thinking. Its purpose is to promote discussion before the formal consultation process begins. The contents should not be quoted as representing the views of either Commission.

1.5 Our tentative proposals and questions are listed in Part 10. We seek views on these issues by **Thursday 24 June 2010**, and would be grateful if responses could be sent:

> by email to commercialandcommon@lawcommission.gsi.gov.uk;
>
> by post to Martyn Naylor, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ (tel: 020 3334 0286); or
>
> by fax to 020 3334 0201, marked for the attention of Martyn Naylor.

[1] Part 2 discusses the law in England and Wales, while Part 3 considers the law in Scotland.

[2] See Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured, Joint Consultation Paper LCCP 182/SLCDP 134, July 2007. We made recommendations to reform the law as it affects consumers in Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation, Law Com No 319/Scot Law Com No 219, December 2009.

**THE CASE OF MR SPRUNG**

1.6 The English case of *Sprung v Royal Insurance (UK) Ltd*[3] illustrates the problems. Mr Sprung was a small businessman who owned a factory that processed animal waste. He bought two insurance policies to protect his business against unforeseen loss. The first provided protection against theft. The second provided cover for Mr Sprung's plant and machinery against "sudden and unforeseen damage that necessitates immediate repair of the plant before it can resume normal working". Condition 6 of the second policy permitted Mr Sprung to carry out minor repairs "without prejudice to the liability of insurers" provided they were given notice and a schedule of the work Mr Sprung intended to do. Major repairs in contrast required the prior sanction of the insurers.

1.7 Unfortunately for Mr Sprung trading conditions became difficult. In April 1986 vandals broke into his premises and badly damaged both the factory and the plant. Mr Sprung submitted a claim to his insurers. His claim was rejected.

1.8 Mr Sprung's insurers contended that the first policy did not apply as no theft had occurred. As for the second policy the insurers claimed that there was no cover for "wilful damage". Mr Sprung found himself in an unenviable position. Trading continued to be difficult. He lacked the financial resources to carry out the repairs himself and he was not able to raise a loan. Six months later Mr Sprung was out of business.

1.9 Mr Sprung started proceedings against his insurers. Four years later, in March 1990, the insurers abandoned their defence under the second policy. Mr Sprung was awarded an indemnity for his lost plant and machinery, plus simple interest and costs. The judge then went on to find that the claim should have been paid by October 31, 1986. As it had not, Mr Sprung suffered an uninsured loss of £75,000 calculated by reference to the value of the lost opportunity to sell his business. However, Mr Sprung was not entitled to claim this further loss, as it was not a claim recognised in law.

1.10 Mr Sprung pressed on as a litigant in person to the Court of Appeal. He argued that the insurer had committed two breaches of contract: first by paying late and secondly by failing to accept liability. As the case proceeded, Mr Sprung also claimed that the insurers were in breach of their obligations to deal with his claim properly by refusing to give consent to repairs.

1.11 Mr Sprung was unsuccessful. The Court of Appeal considered itself bound by earlier authorities that held that an insurer was in breach of contract the moment the insured loss occurred. The insurer was liable for unliquidated damages as a result of that breach. The court also decided that it was bound by the principle that there could be no award of damages for the late payment of damages. Mr Sprung had been compensated by an award of interest for the delay in payment. He was not entitled to damages as well.

[3] [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70.

1.12 As for Mr Sprung's case that the insurers had not dealt with his claim properly, the court decided that any breach of the policy by the insurer would have entitled Mr Sprung to undertake the repairs himself without their consent. The loss arose because he could not afford to do so. That broke the chain of causation. The insurer was not liable for Mr Sprung's lack of money. Lord Justice Evans concluded:

> What has to be said, however hard it may seem to say it, is that in such circumstances the cause of the loss which the plaintiff suffered must be regarded as the consequences of his own decision not to proceed with repair or reinstatement, whether that decision was voluntary or not. In other words, if, unfortunately, through his own financial circumstances he is unable to do so without assistance from the defendants, he cannot allege that the defendants were in breach of contract by failing to accept liability at that stage.[4]

1.13 Lord Justice Evans came to his decision with "undisguised reluctance". Lord Justice Beldam called for reform of the law:

> There will be many who share Mr Sprung's view that in cases such as this such an award [Mr Sprung's indemnity for the loss of his plant and machinery 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 of the law in similar cases.[5]

1.14 Had Mr Sprung been based in Scotland the outcome of his case might have been different. As we discuss in Part 3, Scots law does not consider an insurer to be in breach of contract the moment an insured loss occurs. Instead, the court would have asked whether his insurers were in breach of contract by refusing to pay his claim. If so, then the court would have asked whether any of Mr Sprung's losses were caused by that breach and whether such losses were reasonably foreseeable when the insurance contract was agreed.[6] A similar position would apply in other Commonwealth countries. As we discuss in Part 6, Mr Sprung might also have achieved a different outcome today if his claim had been considered by the Financial Ombudsman Service.

1.15 In this paper we compare the position taken by English law with the law in Scotland and elsewhere. We consider how far the law needs to be reformed.

## STRUCTURE OF THIS PAPER

1.16 The structure of this Issues Paper is as follows:

(1) In Part 2 we describe the current law on delayed payment by insurers in England.

[4] Above, at p 79.

[5] Above, at p 80.

[6] Though whether it was foreseeable that Mr Sprung's business would collapse within 6 months of the loss remains an open question.

(2) In Part 3 we discuss the position in Scotland.

(3) In Part 4 we consider an insurer's duty to act in good faith.

(4) In Part 5 we consider other remedies available, including statutory interest; a possible breach of Financial Services Authority Rules; the different rules applied where an insurer is responsible for delays in reinstatement (that is, replacing and repairing property); and the law on damages for distress and inconvenience.

(5) In Part 6 we consider how the Financial Ombudsman Service deals with delayed payment.

(6) In Part 7 we provide a brief overview of the law in other jurisdictions.

(7) In Part 8 we consider the case for reform.

(8) In Part 9 we review the options for reform.

(9) In Part 10 we list our tentative proposals and questions.

(10) In Appendix A we discuss in more detail the law relating to late payment of insurance claims in other jurisdictions, including Australia, Canada and the United States.

# PART 2
# DAMAGES FOR LATE PAYMENT IN ENGLISH LAW

## INTRODUCTION

2.1 As we saw in Part 1, where an insured has suffered loss through the failure of an insurer to pay a claim within a reasonable time, English law does not allow the insured to claim damages. This rule was set out by the Court of Appeal in *Sprung v Royal Insurance (UK) Ltd*,[1] and has been applied in several subsequent cases.

2.2 As we shall see, it appears this rule has not been followed in Scotland.[2] Under Scots law, late payment of a claim may be considered as a breach of contract, giving rise to damages under the rule in *Hadley v Baxendale*.[3] Nor has the English rule been followed in other common law jurisdictions.[4]

2.3 In this Part we start by considering how the rule preventing damages for late payment of an insurance claim compares with general principles of English contract law. We argue that the rule appears increasingly anomalous. Recent developments in general contract law emphasise that the law should reflect the commercial context. Furthermore, it is now clear that payment obligations have no special status, and may give rise to damages in the same way as other breaches. Finally, the House of Lords has held that damages are available for losses caused by the financial inability of the wronged party to mitigate a loss.

2.4 We then go on to examine the reasoning behind the rule in *Sprung.* We suggest that characterising an insurance payment as damages for the insurer's failure to prevent the loss rests on a fiction, which fails to address the reality of the insurance bargain. At a time when the courts increasingly stress that the rules on damages should take account of the commercial setting and expectations of the market in question, it is difficult to justify basing the law on a fiction in this way.

## RECOVERABLE LOSS IN GENERAL CONTRACT LAW

2.5 The general rule in England is that if one party breaks a contract, the other party may claim damages. Essentially, the wronged party is entitled to compensation for losses which were foreseeable at the time the contract was made, subject to three main limitations:

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

[2] See Part 3 below.

[3] (1854) 9 Exch 341. We describe this rule in paras 2.6 to 2.15, below.

[4] See Part 7 and Appendix A below.

(1) The victim of the breach of contact must prove actual, financial loss. Damages are not generally recoverable for distress or inconvenience unless a major or important object of the contract was to provide pleasure, relaxation or peace of mind.[5] We discuss the law on damages for distress and inconvenience in more detail in Part 4.

(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. The contract may, for example, exclude certain types of losses, or set a monetary limit on the damages which the contract breaker is liable to pay.

**Foreseeable loss and the rule in *Hadley v Baxendale***

2.6 The principles of "foreseeable loss" in contract law were set out in 1854, in the case of *Hadley v Baxendale*.[6] Losses may be recovered if they may "reasonably be supposed to be in the contemplation of both parties, at the time they made the contract". They are of two kinds:

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

(2) those arising from any special circumstances which were communicated at the time the contract was made (the "second limb"). [7]

2.7 In *Hadley v Baxendale*, millers brought a claim against a firm of "common carriers". The millers had arranged for the carriers to take their broken mill shaft to Greenwich. The carriers delayed delivery, in breach of contract. As a result, the manufacturers in Greenwich delayed making a replacement shaft, and all work at the mill stopped. The millers claimed for loss of profit.

2.8 The millers' claim was rejected. The court held that the carriers had no reason to know that that the mill could not operate without the shaft. The loss of profits did not arise naturally from the delay, and the special circumstances (namely that the mill could not operate without the shaft) were not communicated to the carriers.

2.9 These rules have been considered many times since. A loss has been said to "arise naturally" if it is reasonably foreseeable, "a serious possibility" or "not unlikely".[8] However, this test has been applied cautiously. As Lord Reid pointed out, the test is more restricted than "reasonably foreseeable" loss in tort law:[9] if one party wishes to protect itself against a risk which the other party would regard as unusual, that party should have mentioned it before the contract is made.[10]

[5] *Farley v Skinner (No 2)* [2001] UKHL 49; [2002] 2 AC 732.

[6] (1854) 9 Exch 341.

[7] Above, by Alderson B at p 354.

[8] See, for example, *Victoria Laundry (Windsor) Ltd v Newman Industries Ltd* [1949] 2 KB 528 and *C Czarnikow v Koufos (The Heron II)* [1969] 1 AC 350.

[9] *The Heron II* (above) [1969] 1 AC 350, at p 385.

[10] Above, at p 386.

2.10 In 2008, the House of Lords returned to the issue in a case concerning the charter of a ship called *The Achilleas*.[11] The charterers had redelivered the ship late. As a result, the owners were unable to meet the terms of a follow-on charter, at a high rate of hire, and could only retain the second charter at a reduced rate of hire. The owners claimed the difference between the second charter's original rate and the reduced rate over the whole period of the second charter. The charterers argued that they were only liable for the owner's loss during the time of the overrun. In rejecting the owner's claim, the House of Lords held the owner's damages were limited to losses during the overrun, as that was the general understanding in the market.

2.11 In reaching this conclusion, Lord Hoffmann described the rule that foreseeable losses may be claimed as "a prima facie assumption about what the parties may be taken to have intended, no doubt applicable in the great majority of cases". However, the assumption may be rebutted if:

> the context, surrounding circumstances or general understanding in the relevant market shows that a party would not reasonably have been regarded as assuming responsibility for such losses.[12]

2.12 It is therefore important to interpret the contract as a whole within its commercial setting, to look at what the parties may reasonably be expected to have assumed and paid for. Lord Walker observed that some types of contract (such as charterparties and construction contracts) "have inevitably become specialised subjects".[13] Here the parties may have a specialist shared knowledge about the damages which would be payable if the contract were broken.

2.13 In *The Achilleas*, there was a general understanding in the shipping market that where charterers returned a ship late, damages would be restricted to the difference between the market rate and the charter rate for the overrun period. The House of Lords held that this understanding should be respected.

2.14 *The Achilleas* is a timely reminder that the losses for which a contract breaker is liable must be considered by looking at the commercial context of the contract, bearing in mind what reasonable people in the position of the parties thought they were paying for. Thus the application of the rule in *Hadley v Baxendale* may differ from market to market.

2.15 In an insurance context, there may be substantial differences between policies. A consumer may buy a travel policy for "peace of mind". A small business may buy property insurance because it could not otherwise afford to replace property vital to its profits. Alternatively, a large business policy may wish to allocate a precisely defined element of risk at the lowest possible premium. The rule in *Hadley v Baxendale* may lead to different results in different contexts.

[11] *Transfield Shipping Inc v Mercator Shipping Inc (The Achilleas)* [2008] UKHL 48; [2009] 1 AC 61.

[12] Above, at para 9. Lord Hoffmann expounds his thinking further in "*The Achilleas*: Custom and Practice or Foreseeability" (2010) 14 *Edinburgh Law Review* 47.

[13] Above, at para 70.

**Damages for breach of payment obligations**

2.16 Some nineteenth century cases suggest that the general rules on damages do not apply where one party has failed to pay money owed. In 1829 *Page v Newman* held that, in the absence of a specific agreement or trade usage, no interest was payable for money owed under common law.[14] In 1893, Lord Herschell commented that he was not "altogether satisfied" with the reasoning in this case. However, the rule was so well-established that it was not possible to re-open the matter.[15]

2.17 Since 1893, the courts have searched for ways to confine the rule that interest may not be awarded at common law as damages on a debt. It was held that the rule only applied to the first limb of *Hadley v Baxendale*: although interest was not payable "in the usual course of things", it may be payable where special circumstances were in the contemplation of the parties.[16]

2.18 In 2007 the House of Lords re-examined this area in *Sempra Metals v Inland Revenue*.[17] A tax payer had substantially overpaid money to the Inland Revenue. The Revenue was required to repay the money, and the court was asked to decide whether the Revenue should also pay compound interest on the returned amounts. Technically, the case concerned the appropriate restitutionary remedy. However, the House of Lords took the opportunity to review the whole question of damages for breach of contract to pay a debt.

2.19 Lord Nicholls started with "the broad proposition of English law" that a claimant can recover damages for losses caused by a breach of contract which satisfy the usual remoteness tests. In the past, this principle was thought to be subject to "an anomalous, that is, unprincipled, exception" regarding "claims for interest losses by way of damages for breach of contract to pay a debt".[18] Having undertaken an extensive review of the case law, Lord Nicholls concluded that this exception was wrong.

2.20 Lord Nicholls took the opportunity to declare that "those who default on a contractual obligation to pay money are not possessed of some special immunity in respect of loss caused thereby". Instead

> it is always open to a claimant to prove his actual interest loss caused by late payment of a debt. These losses will be recoverable, subject to the principles governing all claims for damages for breach of contract, such as remoteness, failure to mitigate and so forth.[19]

[14] (1829) 9 B & C 378. This rule was not followed in Scots law, which has allowed interest as damages on a debt. See Part 3 below.

[15] *London, Chatham and Dover Railway Co v South Eastern Railway Co* [1893] AC 429.

[16] See *Wadsworth v Lydall* [1981] 1 WLR 598; *President of India v La Pintada Compania Navigacion SA* [1985] AC 104.

[17] *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v Inland Revenue Commissioners* [2007] UKHL 34; [2008] 1 AC 561.

[18] Above, at para 74.

[19] Above, at para 94.

Possible losses might include the cost of borrowing money, or the loss of an opportunity to invest. However, Lord Nicholls did not confine his remarks to interest. He specifically stated that "the loss flowing from the late payment may take some other form".[20] Lord Nicholls stressed that any claim for loss must be particularised and proven:

> The common law does not *assume* that delay in payment of a debt will of itself cause damage. Loss must be proved.[21]

2.21 We do not think that *Sempra* should be taken as having a direct effect on the Court of Appeal's decision in *Sprung*. *Sempra* did not concern insurance. Nor were Lord Nicholls' remarks central to the decision in the case, which means they are not necessarily binding on other courts. However, the principles stated in *Sempra* leave the rule in *Sprung* looking increasingly isolated and anomalous.

**The duty to mitigate and financial inability**

2.22 The amount recoverable by a claimant is limited by the claimant's duty to mitigate its loss. The law expects the victim of a breach of contract to act as if there is no one from whom to claim compensation. This means that the victim must take all reasonable steps to reduce the scale of the loss.

2.23 The difficult question is what happens when a party cannot afford to take the steps necessary to mitigate the loss. In 1933, the House of Lords took a harsh line on this issue, in the case of the *Liesbosch Dredger.*[22] Lord Wright commented that "the law cannot take account of everything that follows a wrongful act". He thought that where a victim is unable to mitigate a loss because of a lack of money to do so, the law should not compensate the victim for impecuniosity, which may be regarded as "a separate and concurrent cause".[23]

2.24 Today, however, the *Liesbosch Dredger* can no longer be regarded as good law. In *Lagden v O'Connor,*[24] the House of Lords said that Lord Wright's observations had been overtaken by subsequent developments in the law. As Lord Walker put it, impecuniosity should not be regarded as some "extraneous" factor, although in both claims for contract and tort, some loss attributable to impecuniosity "may on examination prove to be too remote".[25] Lord Hope said that the law

> requires the wrongdoer to bear the consequences if it was reasonably foreseeable that the injured party would have to borrow money or incur some other kind of expenditure to mitigate his damages.[26]

[20] Above, at para 95.

[21] Above, at para 96.

[22] *The Liesbosch Dredger (Owners of) v Owners of SS Edison (The Liesbosch)* [1933] AC 449.

[23] Above, at p 460.

[24] [2003] UKHL 64; [2004] 1 AC 1067.

[25] Above, at para 102.

[26] Above, at para 61.

2.25 In *Sprung*, Lord Justice Evans mentions that Mr Sprung could not proceed with repair or reinstatement because he was not able to raise the necessary finance. Following *Lagden*, Mr Sprung's strained financial circumstances should not be regarded as breaking the chain of causation. In other words, if the insurers would otherwise be liable for a foreseeable loss, the loss does not cease to be recoverable even if some other, well-resourced insured could have prevented it.

2.26 We do not think that the decision in *Lagden v O'Connor* overrules the decision in *Sprung*. As we discuss below, the main reasons for the decision in *Sprung* remain unaffected. Again, however, a recent House of Lords ruling leaves the rules applicable to late payment of insurance claims looking anomalous and out of line with general principles of contract law.

## DAMAGES FOR LATE PAYMENT OF INSURANCE CLAIMS

2.27 The principles outlined above apply to "non-indemnity" or "contingency" insurance, such as life insurance. Claims under life policies have been treated as contract debts,[27] and the usual rules of contract law apply.

2.28 However, these rules of contract law do not apply to indemnity insurance, such as property and liability insurance. Under *Sprung*, indemnity insurance is treated differently. The decision rest on three propositions:

(1) An insurer's primary obligation in indemnity insurance is not to pay a claim, but to prevent a loss from occurring;

(2) If an insurance payment represents damages rather than a debt, there can be no further liability for "damages on damages"; and

(3) There is no implied term within an insurance contract to pay within a reasonable time.

2.29 Below we examine each of these propositions in turn.

### An insurer's primary obligation is to prevent a loss occurring

2.30 This rule has a long history.[28] In 1990, the House of Lords confirmed it in the joint cases of *The Fanti and The Padre Island*.[29] Lord Goff put it in the following terms:

> a promise of indemnity is simply a promise to hold the indemnified person harmless against a specified loss or expense. On this basis, no debt can arise before the loss is suffered or the expense incurred; however, once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense.[30]

[27] *Blackley v National Mutual Life Assn Ltd (No 2)* [1973] NZLR 668

[28] *Irving v Manning* (1847) 1 HL Cas 287.

[29] *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti); Secony Mobil Oil Inc v West of England Shipowners Mutual Insurance Association (The Padre Island)* [1991] 2 AC 1.

[30] Above, at pp 35 and 36.

2.31 On this basis, an insurer's primary obligation is not to pay claims but to prevent the loss occurring in the first place. This is a surprising view. As the judge put it in *Transthene v Royal Insurance*, property insurers may be surprised to discover that on this argument

> they are, collectively, in breach of contract hundreds or thousands of times every day, whenever a fire, a flood, a road accident or other such event occurs.[31]

2.32 Here we look at how the "hold harmless" doctrine was applied in *The Fanti and The Padre Island*, where third parties attempted to use it to impose greater obligations on insurers. We then look at *The Italia Express,* where this analysis was used by the insurer to prevent the payment of damages for rejecting claims.

***The Fanti and The Padre Island*: *specific performance to prevent a loss?***

2.33 *The Fanti and The Padre Island* involved two appeals with similar facts. In both cases, ship owners were responsible for lost cargo. The cargo owners sued and obtained judgment against the ship owners, who then became insolvent. The cargo owners attempted to obtain payment directly from the ship owners' liability insurers under the Third Parties (Rights against Insurers) Act 1930. The liability insurers were Protection and Indemnity (P and I) Clubs who had included "pay to be paid" clauses in their contracts. In other words, the contracts specifically stated that the insurers were only liable to indemnify the insured if the insured had in fact paid the third party. The P and I Clubs said that as the insured had not paid the third party, no claim could arise under the contract.

2.34 Before 1990 there had been some debate on whether a "pay to be paid" clause could defeat the apparent purpose of the 1930 Act in this way.[32] The House of Lords decided that such clauses were effective to defeat third party claims, as the 1930 Act did not grant the third party any greater rights than it granted the insured. Much of the litigation concerned the construction of the 1930 Act. However, the cargo owners also argued that the "pay to be paid" clause could be defeated by a principle of equity. One of the many arguments made concerned the "hold harmless" analysis.

2.35 Clearly, in property insurance there is little an insurer can be expected to do to prevent a fire or a flood. However, liability insurance is different. Here the obligation is not to prevent the loss of the cargo, but to protect the insured against the expense of paying the third party's claim. The insurer *can* prevent this loss by paying the third party first. The cargo owners argued that equity could and should order specific performance: the insurer should be obliged to carry out its contractual obligation and prevent the loss to the insured from arising in the first place, by paying the third party.

[31] *Transthene Packaging Co Ltd v Royal Insurance (UK) Ltd* [1996] Lloyd's Reinsurance Law Reports 32, at p 40.

[32] See Lord Goff's discussion on this point at p 30 in *The Fanti and The Padre Island* [1991] 2 AC 1.

2.36 The Law Lords accepted that in some cases a liability insurer could be obliged to pay a third party to prevent a loss from arising. However, this had to be consistent with the terms of the contract.[33] As Lord Brandon put it, equity could not "disregard or override" the express provisions of the contract.[34] Thus an insurer could not be obliged to prevent a loss if the contract specifically stated that the insurer was obliged to pay only once the loss had occurred.

2.37 This analysis involves some mental gymnastics. The law considers that the insurer's primary obligation is to prevent the insured from incurring the expense of compensating the third party – even though the contract specifically states that the insurer should *not* act to prevent the expense in this way.

### *The Italia Express*

2.38 In 1992, the Commercial Court considered what effect the "hold harmless" doctrine had on a claim for damages for late payment of an insurance claim.[35] The owner had insured a ship, *The Italia Express*, against war risks for $4 million under a valued policy. The ship was sunk by explosives while it was undergoing repairs near Piraeus harbour. The insurers suspected the owner of sinking it, and pursued these allegations "fairly but persistently" for three and a half years. The insurers' case depended on surreptitious tape recordings. When these tapes were declared inadmissible, the insurers withdrew the allegations, and judgment was entered for $4 million.

2.39 The owner then claimed a variety of damages caused by the delay in payment. These included the loss of income which would have been earned by a replacement vessel; the increase in the capital value of a replacement vessel; and distress and inconvenience.

2.40 This raised issues about the nature of the insurers' primary obligation under the contract. The claimant argued that the obligation was to make good the loss when called on to do so (that is, once a demand had been received). The insurers had failed to do so, and were liable for damages for breach of this obligation. By contrast, the defendant argued that the insurers' obligation was to prevent the loss from occurring in the first place. The remedy for this breach was to pay the liquidated damages agreed under the contract, namely $4 million. The insurers had done this, and no further damages were payable.

2.41 Relying on *The Fanti and The Padre Island,* Mr Justice Hirst agreed with the defendant. He held that the "hold harmless" doctrine applied equally to both liability and property insurance.

[33] See, for example, above, by Lord Goff at p 36.

[34] Above, at p 28.

[35] *Apostolos Konstantine Ventouris v Trevor Rex Mountain (The Italia Express (No 3))* [1992] 2 Lloyd's Rep 281.

> Once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense; this phraseology is entirely appropriate to cover both the *loss* against which the insured is indemnified under property insurance, and the *expense* against which he is indemnified under liability insurance.[36]

2.42 The claimant had argued that it was "absurd" to suggest that insurers promised that vessels would not sink, as "the insurer would be entering into a contract which he knew from the outset he could not perform".[37] Mr Justice Hirst disagreed. He countered that it was also "commercially inconceivable" to require an insurer to pay a large complex claim immediately, without investigation. If this was correct, "generations of distinguished Counsel in innumerable marine insurance cases must have overlooked potentially a very valuable head of damages". The judge concluded that the lack of recorded cases of damages for failure to pay insurance claims "appeared to bear out the soundness" of his conclusion.

2.43 On this basis, the insurers were in breach of contract as soon as the explosives were detonated. The insurers were liable to pay damages for this breach, but only to the extent that had been agreed in the contract (that is, up to the value of $4 million). Mr Justice Hirst then applied the principle set out by the House of Lords in *The Lips,*[38] that "there is no such thing as a cause of action in damages for late payment of damages". Thus the claim for damages must fail. We discuss the *Lips* case below.

**No damages on damages**

2.44 In *The Lips*[39] the House of Lords rejected a claim for late payment of damages. As Lord Brandon put it:

> There is no such thing as a cause of action in damages for late payment of damages. The only remedy which the law affords for delay in paying damages is the discretionary award of interest pursuant to statute.[40]

2.45 *The Lips* was a dispute between the owner and the charterers of a ship. The charterers had agreed to unload the cargo within a certain number of "lay days". If these were exceeded, the charterers agreed to pay "demurrage". This was a specified payment of US$6,000 a day. The contract specified that it was to be in sterling, set at the exchange rate on the date of the bill of lading.

[36] Above, at p 292.

[37] Above, at p 289.

[38] *The President of India v Lips Maritime Corporation (The Lips)* [1988] AC 395.

[39] Above.

[40] Above, at p 425.

2.46 The vessel took more than the agreed lay days to unload, which led to a dispute about the period of time for which demurrage was payable. By the time the issue was eventually resolved at arbitration, sterling had depreciated. The arbitrator awarded £10,230 for outstanding demurrage, plus around £5,515 for damages for the late payment of this outstanding sum, caused by the depreciation in sterling.

2.47 The House of Lords held that the charterer was in breach of contract as soon as the ship was detained beyond the stipulated lay days. Demurrage was not a debt due under the contract. Instead, it was an agreed form of liquidated damages. No additional damages were available for a failure to pay damages. As Lord Brandon put it:

> Most, if not all, voyage charters contain a demurrage clause, which prescribes a daily rate at which the damages for such detention are to be quantified. The effect of such a clause is to liquidate the damages payable.[41]

2.48 *The Lips* can therefore be seen as part of the more general reasoning put forward in *The Achilleas*, discussed above:[42] the agreement must be considered against its commercial setting, looking at how the parties allocated risks between them. Demurrage is a commonly used method to allocate the risk of exceeding lay days, by prescribing a rate of payment. Furthermore, the charterparty in this case specifically allocated the risks of currency fluctuations, by stating that the value of sterling was set on the date of the bill of lading. The allocations of risk made specifically by experienced business people in a specialist contract should be respected, and no further damages are available because these payments were made following arbitration rather than immediately.

2.49 In *Sprung*, Mr Sprung argued that his case did not involve a claim for demurrage, and different considerations arose. Lord Justice Evans commented:

> Mr Sprung is entirely correct to say that this is not a claim for demurrage and the same considerations with regard to the claim accruing do not arise. But the more general statement, "There is no such thing as a cause of action in damages for late payment of damages" has to be accepted, as Hirst J later found, as applying also to a claim for payment under an insurance policy, such as this one.[43]

[41] Above, at p 422.

[42] *Transfield Shipping Inc v Mercator Shipping Inc (The Achilleas)* [2008] UKHL 48; [2009] 1 AC 61.

[43] *Sprung v Royal Insurance (UK) Ltd* [1999] Lloyds Rep IR 111; [1997] CLC 70, at p 75.

2.50 The Court of Appeal took Lord Brandon's statement out of its context and applied it to another type of contract, based on different understandings and allocations of risk. We think this is an unduly technical approach. As *The Achilleas* states, it is important to bear in mind "the context, surrounding circumstances or general understanding in the relevant market" about how the parties should be taken to assume responsibility for risks.[44] The fact that the parties to a charterparty agree that damages for exceeding lay days will be limited to a fixed amount does not necessarily mean that Mr Sprung agreed to assume the risk that his insurers would refuse to pay him for almost four years.

**No implied term to pay within a reasonable time**

2.51 In *Sprung*, the Court of Appeal left open the possibility that a breach of a separate obligation could allow a claim for damages. Lord Justice Evans said:

> If as a matter of law the plaintiff is able to show that the defendants have committed some other and separate breach of contract, and if specifically he can show that the defendants were in breach by failing to accept liability or to approve of the reinstatement at an early stage, then the recovery of damages would not be restricted to the discretionary award of interest which exists in the other case.[45]

2.52 This opens the possibility that if an insurance policy contains a specific term that the insurer should consider or pay a claim within a reasonable time, then damages may be available for breach of that specific term.

2.53 In *Insurance Corporation of the Channel Islands Ltd v McHugh*,[46] the policyholders owned a hotel which suffered three arson attacks. The insurers refused to pay the policyholders' claims under the fire and business interruption policies, alleging various frauds. Among other issues in the litigation, the policyholders argued that the insurers had breached an implied term in each policy to conduct the negotiations, assess the claim and/or pay the sum due with reasonable diligence and due expedition. As a result, they said, the hotel was unable to recommence business within the three years covered by the business interruption policy, and had suffered further loss.

2.54 Although the case was decided on the basis that the policyholder had committed some of the alleged frauds, Mr Justice Mance specifically rejected the argument that such a term should be implied:

> The law will not… imply a term unless it is necessary to give the contract business efficacy or represents the obvious, although unexpressed, intention of the parties. Mere reasonableness or convenience is not sufficient.[47]

[44] *Transfield Shipping Inc v Mercator Shipping Inc (The Achilleas)* [2008] UKHL 48; [2009] 1 AC 61, by Lord Hoffman at para 9.

[45] *Sprung v Royal Insurance (UK) Ltd* [1999] Lloyds Rep IR 111; [1997] CLC 70, at p.76.

[46] [1997] 1 Lloyd's Reinsurance Law Reports 94.

[47] Above, at p 136.

2.55 He said that the prerequisites of an implied term were not present. Furthermore, when the loss occurred then, subject to the conditions precedent, the insurers became liable to pay damages. The policyholders were arguing for an implied contractual obligation to assess, negotiate and pay damages for which the insurers were already liable. This "would appear to be a further reason why [such a term] cannot be regarded as either necessary or obvious".[48]

2.56 The courts have steered away from imposing a contractual obligation on insurers to act quickly, even where the policy appears to include a term to that effect. In *Tonkin v UK Insurance Ltd,*[49] a consumer buildings policy contained the following provision.

> Caring for You
>
> We will always try to be fair and reasonable whenever you have need of the protection of this Policy. We will also act quickly to provide that protection.

2.57 Following a fire, the insurers and the householders became embroiled in a lengthy dispute over the reinstatement scheme. Three and a half years later the property had not been rebuilt. The householders argued that the insurers had not acted quickly to provide protection and as a result they had suffered further loss.

2.58 The judge rejected this claim. Although the provision in the policy was agreed to be an express obligation on the insurer to act "quickly" when dealing with the claim, the judge held that it could not give rise to a separate claim for damages. Citing *Sprung* and *The Italia Express*, the judge held that the "delay" claim was effectively a claim for damages for the failure to pay damages, "which is just the sort of claim which the authorities noted above hold to be invalid".[50]

2.59 Accepting that the issue was not entirely clear-cut, the judge then proceeded to consider the claim on its merits. He found that most of the delay was caused by the policyholders. Any criticisms of the insurer were not such as to amount to a breach of contract, and even if they did, they did not lead to an identified loss.

2.60 The English courts appear extremely reluctant to find that insurance policies contain terms requiring insurers to assess and pay claims expeditiously. As we discuss later, this contrasts with the position in Scotland and other common law jurisdictions.[51]

[48] Above, at p 137.

[49] [2006] EWHC 1120 (TCC); [2006] 2 All ER (Comm) 550.

[50] Above, at para 38.

[51] Discussed in Parts 3 and 7 below.

## DECISIONS SINCE *SPRUNG*

2.61 Since 1996, *Sprung* has been cited in at least six High Court decisions. Five cases were claims against insurers and in all five, *Sprung* was applied to defeat the possibility of damages for late payment. In the sixth case, *Sprung* was held not to apply to a claim against an insurance broker. The claimant was awarded substantial damages for the loss to their business, which was considered to be the foreseeable consequence of not receiving the expected insurance payment.[52]

### Cases where the claim was defeated

2.62 We have already discussed two cases: *Insurance Corporation of the Channel Islands Ltd v McHugh*[53] and *Tonkin v UK Insurance Ltd*.[54] The remaining three are described below.

2.63 In *England v Guardian Insurance*,[55] Mr and Mrs England suffered damage to their house, caused by piling at an adjacent site. They claimed under their buildings insurance, but the insurers denied liability. The couple then issued proceedings against both the insurers and several parties whom they considered responsible for the piling (including the engineers and the site owner). The insurers eventually paid £102,000; and the engineers were ordered to pay £126,000. However, the Englands were left to meet £40,000 in costs to the site owner. The insurers claimed subrogation rights against the payment from the engineers.

2.64 One issue in the case was whether the insurers' payment just covered the damage to the house, or whether it also included damages for distress and inconvenience and other irrecoverable costs. The judge applied *The Italia Express* and *Sprung* to hold that the full amount of the insurers' payment must have been for the damage to the house, as no other heads of damage were recognised at law. He explained:

> Non-payment gives rise to a claim for the debt and to an entitlement to interest but not to an additional claim for damages. In the context of a house and home policy, this approach may appear unduly technical but it is based on a long line of authority.[56]

2.65 This rule is difficult to explain to consumers. As we have seen, *Sprung* did not hold that non-payment gives rise to a claim for debt: rather the loss to the house puts the insurer in breach and gives rise to a claim for damages. This is so counter-intuitive that few consumers or small businesses would understand or accept it.

[52] *Arbory Group Ltd v West Craven Insurance Services* [2007] PNLR 23, discussed below at paras 2.70 to 2.74.

[53] [1997] 1 Lloyd's Reinsurance Law Reports 94.

[54] [2006] EWHC 1120 (TCC); [2006] 2 All ER (Comm) 550.

[55] [1999] 2 All ER (Comm) 481.

[56] Above, at para 73.

2.66 In *Normhurst Ltd v Dornoch Ltd*,[57] the claimants traded from a property damaged in a fire. When the insurers purported to avoid liability for non-disclosure, the claimants brought an action: among other things, they sought damages for the insurers' refusal to pay. The insurers made an application to strike out this part of the claim, and the issue was eventually determined in a preliminary hearing. The judge applied *Sprung*, which he described as "considered, unanimous, and entirely in point".[58] The claimants said the "hold harmless" analysis was inconsistent with the specific wording of the insurance policy. This imposed various conditions on the insured, which were described, in clause 4, as:

> a condition precedent to any liability of the underwriters to make a payment.

2.67 The judge held that despite references to the underwriters' liability to make a payment, he had to look at "substance not form". In other words, the substance of the contract was that the insurers undertook to prevent the fire, even if they had not said so in their contract.

2.68 *Mandrake v Countrywide Assured Group*[59] also concerned an application to strike out a claim for damages for late payment. In the Court of Appeal, the claimant's counsel accepted that both the High Court and Court of Appeal were bound by *Sprung*. However, the whole area of law was controversial and "ripe for review" by the House of Lords.

2.69 Lord Justice Rix thought that the controversial issue "may well interest their Lordships' House and, if it does, may well lead to some clarification and amendment to the law".[60] He was keen to provide a suitable procedure to allow the claimants "the opportunity to revisit this area of law" if the insurers were found liable on the main claim. However, the Court of Appeal did not go as far as granting permission to appeal to the House of Lords. They thought that that should be an issue for the House of Lords itself. In the event, the House of Lords refused leave to appeal.[61]

[57] [2004] EWHC 567 (Comm); [2005] Lloyd's Rep IR 27.

[58] Above, at para 8.

[59] [2005] EWCA Civ 840.

[60] Above, at para 25.

[61] On 10 November 2005.

### Foreseeable loss in a claim against insurance brokers

2.70 The case of *Arbory Group v West Craven Insurance Services*[62] is somewhat different. The claimant business had asked the defendant brokers to arrange business interruption insurance. However, the brokers acted negligently in failing to advise the business about how to assess their gross profit for insurance purposes. The result was that the business was significantly underinsured. When its premises suffered a major fire, the claimant did not receive the expected business interruption payments. It was unable to resume trading and its profitability was further reduced. The High Court was asked to decide how much the brokers should pay. Should damage be limited to the payments the claimant would have received if they had not been underinsured, or should the brokers pay for the further loss?

2.71 The judge found that the brokers should pay for the further loss. He rejected the defendant's argument that this was "tantamount to awarding damages for the non-payment of damages", and therefore not permitted following *The Lips* and *Sprung*. Instead he agreed with the claimant that it was reasonably foreseeable that failure to pay under the policy would adversely affect the company's ability to trade successfully. He commented that business interruption cover is designed to inject additional funds into a going concern at a vulnerable time. The broker either was or should have been aware that the claimant would need the funds to sustain it through any temporary disruption.[63]

2.72 The case shows that were the rule in *Sprung* to be reversed, the loss of profitability in a business might be considered a foreseeable loss in some circumstances.

2.73 In this context it is interesting to note the advice given by the Association of British Insurers (ABI). In April 2008, the ABI published guidance to small businesses buying insurance.[64] It described business interruption insurance in the following terms:

> Business Interruption Insurance will cover you for any periods when you cannot do business as normal because of any event resulting in damage to property on your premises, such as an essential machine breaking down or flooding. Research suggests that 80% of businesses that suffer such a major incident fail within 18 months.[65]

2.74 This suggests that the parties to a contract for business interruption insurance would often contemplate business failure as a foreseeable consequence of the non-payment of a claim.

[62] [2007] PNLR 23.

[63] Above, para 52.

[64] ABI, *Insurance for Small Businesses: a guide to protecting your business*, 10 April 2008.

[65] Above, at pp 10 to 11.

## CONCLUSION

2.75 As we have seen, English law characterises an insurance contract as a contract to prevent a loss. It is treated as analogous to a contract with a security firm, in which the security firm undertakes to prevent a break-in. Of course, 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.

2.76 This 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. No-one would seriously think that by buying insurance, they are making a fire, flood or theft less likely. Instead, what policyholders believe they are buying is the promise that if something does go wrong, the insurer will provide the payment specified in the contract. And they generally trust that this will happen. 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 along the lines of a demurrage clause.

2.77 The idea that insurers are primarily there to prevent loss is a fiction. It is a fiction which contravenes common sense and the normal understanding of the parties. As we saw in the *Normhurst case*,[66] it is also at odds with the way in which insurance policies are normally written. Policies are typically structured around the idea that the insurer will be liable to make a payment calculated in accordance with the policy, in the circumstances specified in the policy, after the insured has met the necessary conditions.

2.78 We have discussed how the fiction is out of line with general contract principles. As we shall see, it is also out of line with other common law jurisdictions.

2.79 On the other hand, it is one thing to say that *Sprung* is wrong, and another to say exactly what should be put in its place. In *The Italia Express*, when the claimant argued that it was "absurd" to suggest that insurers promised that vessels would not sink, the judge countered that it was "commercially inconceivable" to require an insurer to pay a large complex claim immediately, without investigation. We are not suggesting that an insurer should be held liable to make a payment immediately on demand. Clearly, the exact nature of an insurer's obligation in indemnity insurance requires careful thought and discussion, and we return to this issue in Part 9.

[66] [2004] EWHC 567 (Comm); [2005] Lloyd's Rep IR 27.

2.80 There are two basic approaches. The first, which we describe as the "strict liability" approach, is to say that an insurer must make the payment required by the contract within a reasonable time. The other, based on good faith, suggests that an insurer's primary obligation is to investigate and assess the claim fairly. On this characterisation, an insurer would be allowed some leeway to pursue a reasonable defence "fairly but persistently", even if (as in *The Italia Express*) a court later finds that the defence is mistaken. Part 3 describes the Scots law, which follows what might be termed a strict liability approach. Part 4 discusses the obligation on the parties to an insurance contract to act in good faith.

# PART 3
# DAMAGES FOR LATE PAYMENT IN SCOTS LAW

3.1 The law of Scotland in relation to damages for unjustifiable delay in payment of insurance claims is different from the law of England and Wales. It is a contractual claim whose quantification is based upon common law rules of foreseeable loss, as set out in *Hadley v Baxendale*.[1] In principle, these rules permit an insured to claim damages for losses caused by non-payment or delayed payment. The default remedy for late payment, namely judicial interest, is also available.

## A CONTRACTUAL OBLIGATION TO PAY VALID CLAIMS

3.2 The starting point of the Scots law analysis is that payment of a claim made under an insurance policy is classified as a contractual obligation to pay a sum of money equivalent to the insured's loss.[2] Unlike in English law, an insurance payment is not considered to be damages for breach of the obligation to hold harmless.[3] In *Scott Lithgow Ltd v Secretary of State for Defence*[4] Lord Keith noted that:

> It is observed in passing that Scots law has not adopted the English view that the right of action in the event of non-payment under a policy of insurance is one for unliquidated damages. Scott Lithgow's right of action is here a contractual one, not one in reparation.[5]

3.3 In this case, Scott Lithgow had entered into a contract with the Secretary of State for Defence to construct two submarines. In the course of construction, Scott Lithgow contracted with a third party for the supply of cables which turned out to be defective and caused loss. Scott Lithgow claimed damages for breach of contract against the third party but the award was insufficient to compensate fully for the loss suffered. Scott Lithgow then claimed under a clause in the contract with the Secretary of State for Defence, which stated that the Secretary of State for Defence would indemnify Scott Lithgow against loss, damage and liability incurred by them. The claim for indemnity was not fulfilled timeously, causing further loss.

[1] (1854) 9 Exch 341. This case is described in paras 2.6 to 2.8 above

[2] *Carrick Furniture House Ltd v General Accident Fire Life Assurance Corp Ltd* 1977 SC 308; *Scott Lithgow Ltd v Secretary of State for Defence* 1989 SC (HL) 9; *Anderson v Commercial Union Assurance Co. PLC* 1998 SLT 826; *Strachan v The Scottish Boatowners' Mutual Insurance Association,* Outer House, Court of Session, 31 May 2001 (unreported), see summary at 2001 GWD 19-754.

[3] As is the position in England: see para 2.30 above.

[4] 1989 SC (HL) 9; see also *Strachan v The Scottish Boatowners' Mutual Insurance Association,* Outer House, Court of Session, 31 May 2001 (unreported), by Lord Eassie at para 14.

[5] 1989 SC (HL) 9 by Lord Keith at p 20.

3.4 As the demand for payment of indemnity was categorised as a contractual claim for implement and not as one for payment of damages for breach of contract, damages were potentially available for the losses caused by late payment. As Lord Keith's observation makes clear, the decision confirmed rather than created the Scottish approach to payment under a contract of indemnity insurance. Scottish cases have consistently treated payment under a contract of insurance as a matter of implementation of contractual obligations.[6] Where insurers are in breach of their obligation to pay the sum assured they may therefore be liable for damages caused by the breach.

**THE TIME AT WHICH THE BREACH OCCURS**

3.5 Whereas under English law the insurer is in breach of contract as soon as the loss occurs,[7] under Scots law the insurer is not obliged to pay the insured until a claim is made. Even then, the insurer is not required to pay immediately. Instead, authority suggests that the insurer must first have an opportunity to investigate a claim.[8]

3.6 In *Strachan v The Scottish Boatowners' Mutual Insurance Association*,[9] a fishing boat was damaged at sea and brought back to port by salvors. The insurer refused to indemnify the owners for the cost of repairs on the ground that the vessel had put to sea in an unseaworthy condition. For three years, the damaged vessel remained arrested by the salvors and during this time its condition deteriorated beyond repair. In relation to the time at which payment became due, Lord Eassie accepted the insurer's argument that:

> It was clear under Scots law that that point in time [when the insurer came under obligation to make payment] could not be said to be the moment of the casualty. Before an obligation to pay could crystallise there had to be first the making of the claim. The insurer then had to have an opportunity to investigate its soundness, the insurer's obligation being only to pay upon a valid claim.[10]

3.7 The insurer's obligation to pay therefore only arises once loss has occurred, the insured has made a valid claim and the insurer has had an opportunity to investigate its soundness. There are two ways in which the insurer may be in breach of its contractual obligation: by unjustifiable delay of payment or by wrongful repudiation of the claim.

[6] *Westminster Fire Office v Glasgow Provident Investment Society* (1888) LR 13 App Cas 699; *Carrick Furniture House Ltd v General Accident Fire Life Assurance Corp Ltd* 1977 SC 308; *Anderson v Commercial Union Assurance Co Plc* 1998 SLT 826; but cf *Toremar v CGU Bonus Ltd* [2009] CSOH 78, discussed at para 3.13 below.

[7] See paras 2.30 to 2.43 above.

[8] *Strachan v The Scottish Boatowners' Mutual Insurance Association* Outer House, Court of Session, 31 May 2001 (unreported), by Lord Eassie at para 36.

[9] Outer House, Court of Session, 31 May 2001 (unreported), see summary 2001 GWD 19-754.

[10] Above, by Lord Eassie at para 36.

3.8 The time period within which payment must be made may be specified in the insurance policy. If there are no express terms regarding payment it is necessary to examine whether there are terms implied by law as to when payment becomes due.

3.9 In the English case of *Insurance Corporation of the Channel Islands Ltd v McHugh*,[11] discussed earlier,[12] the judge refused to imply any term regarding the reasonable negotiation or assessment of payment of a claim. However, in *Alonvale Ltd v J M Ing*,[13] the claim for breach of contract was advanced on the basis that there was an implied term that the claim would be dealt with reasonably and without delay, and that indemnification would be granted promptly. The pursuer's business premises had burned down and he had made a claim to the defender under a policy of indemnity insurance. When the defender failed to pay, the pursuer claimed for lost profits from the time when the building should have been reinstated. It was accepted that there was an implied term to pay timeously. The insurer had breached this obligation, raising the question of potential liability for loss caused by the breach.

3.10 In *Strachan,*[14] Lord Eassie distinguished *Alonvale Ltd v J M Ing* on the ground that it was concerned with delay in making payment, whereas in *Strachan* the insurers had communicated their refusal to pay the claim promptly. The insured's argument was that an outright refusal which turned out to be wrong was a breach of contract giving rise to an entitlement to damages for losses sustained from the time of the refusal.

3.11 Lord Eassie held that, in the absence of proper grounds, an insurer's refusal to perform its obligation would amount to at least an anticipatory breach of contract. Therefore, on repudiating liability, the insurer must be assumed to have committed a breach of the contract at the date of the repudiation.[15] Lord Eassie further specified that, where refusal of indemnity is unjustified, the insurer's "honest belief" that a claim is not valid is not a defence to liability.[16] Thus he allowed the insured's claim for damages for breach of contract to proceed to proof along with the question of the insurer's liability.

[11] [1997] Lloyd's Reinsurance Law Reports 94. Cited by the insurer in *Strachan v The Scottish Boatowners' Mutual Insurance Association* Outer House, Court of Session, 31 May 2001 (unreported), at para 37.

[12] See paras 2.53 to 2.55 above.

[13] 14 Oct 1993 GWD 36-2345.

[14] Outer House, Court of Session, 31 May 2001 (unreported), at para 38.

[15] *Strachan v The Scottish Boatowners' Mutual Insurance Association* Outer House, Court of Session, 31 May 2001 (unreported), at para 40.

[16] Above, at para 38.

3.12 In *Hawkins v Scottish Mutual Assurance plc*,[17] the temporary judge, RF Macdonald QC, accepted that in Scotland the unjustified refusal to pay the sum assured may amount to a breach of contract. This case concerned critical illness and disability insurance. Payment became due once the defenders had received an expert doctor's report on the policyholder's health, which confirmed that conditions for the claim were met. The judge accepted that there had been a breach of contract due to the wrongful repudiation and then examined whether the losses suffered were recoverable as damages.

3.13 One further Scottish case requires to be mentioned. In *Toremar v CGU Bonus Ltd*,[18] a public house was extensively damaged by fire. The judge, Lord Brodie, decided that the fire had been started by the insured and accordingly that the insurer was entitled to avoid the fire insurance policy. Lord Brodie went on, obiter, to consider how he would have assessed damages and stated,[19] under reference to a passage in MacGillivray[20] that "as conventionally analysed", the claim under the policy was one for damages for breach of contract: in other words, he adopted the English analysis. As has already been noted, this is not a correct analysis of the position under Scots law. Neither the dictum of Lord Keith in the House of Lords in *Scott Lithgow Ltd v Secretary of State for Defence* to the contrary, nor the line of case law discussed above, had been cited to the judge.[21] His conclusion[22] (following MacGillivray) that there is no cause of action in Scots law for damages for late payment of damages must therefore be regarded as having been reached *per incuriam*.

## THE RULE IN *HADLEY V BAXENDALE* APPLIED TO LATE PAYMENT

3.14 The normal remedy for late payment under a contract is interest on the sum from the date that it became due; however, there is no rule that interest will be the only redress for consequential loss suffered as a result of the late payment of money.[23] Wider recovery of damages will be open to a pursuer who can show that the loss was reasonably foreseeable within the rules in *Hadley v Baxendale.*[24]

[17] [2005] CSOH 101.

[18] [2009] CSOH 78.

[19] Above, at para 105.

[20] Now at MacGillivray, *Insurance Law* (11th ed 2008) para 19-073.

[21] The pursuer was a party litigant. The defenders' counsel had advised the court that there was no Scottish authority to the contrary.

[22] *Toremar v CGU Bonus Ltd* [2009] CSOH 78, at para 108.

[23] *Strachan v The Scottish Boatowners' Mutual Insurance Association,* Outer House, Court of Session, 31 May 2001 (unreported), by Lord Eassie at para 34.

[24] (1854) 9 Exch 341, as now explained by the House of Lords in *Transfield Shipping Inc v Mercator Shipping Inc (The Achilleas)* [2008] UKHL 48; [2009] 1 AC 61, which has been cited on a number of occasions in Outer House cases, for example *Donoghue v Greater Glasgow Health Board* [2009] CSOH 115, *Beaghmor Property Limited v Station Properties Limited* [2009] CSOH 133 and *Upton Park Homes Ltd v MacDonalds Solicitors* [2009] CSOH 159; [2010] PNLR 12.

3.15 The test of reasonable foreseeability was confirmed as the Scottish approach in relation to loss caused by late payment of money in *Margrie Holdings Ltd v City of Edinburgh District Council (No 1).*[25] This case concerned the late payment of an improvement grant by a local authority and the consequential loss incurred as a result of having to make alternative financing arrangements when the grant was not paid on time. The losses were held to be too remote and no damages were awarded. This demonstrates that the question whether the damage falls into either branch of *Hadley v Baxendale* is one of fact in each case.[26] The second branch (that is, losses arising through special circumstances) is the one more usually invoked in relation to damages for late payment of insurance.[27] This means that for losses to be recoverable, it is usually necessary to show that the defender had special knowledge of the pursuer's circumstances at the time of contracting.[28]

3.16 In a series of cases, the rule in *Hadley v Baxendale* has been applied to claims for damages for late payment or non-payment by an insurer. The court has taken a cautious approach. In *Alonvale Ltd v J M Ing*,[29] it was held that the pursuer's loss of profits caused by late payment of the insurance claim was not within the insurer's reasonable contemplation.[30] The fact that the insurer knew that the pursuer had insured against loss of profits and was financed by loans did not indicate that the parties had contemplated the pursuer's financial vulnerability. The loan financing, for example, might be "a matter of policy rather than necessity". However, the court considered that in principle an insured claiming payment under a policy of assurance could recover damages beyond loss of interest on one or other branch of the rule in *Hadley v Baxendale.*[31]

[25] 1994 SC 1, by Lord President Hope at p 11.

[26] See, for example, *Plews v Plaistead* 1997 SLT 804, by TG Coutts QC at p 807.

[27] The restricted scope of the first branch in this context was illustrated by *Margrie Holdings Ltd v City of Edinburgh District Council* 1994 SC 1, by Lord President Hope at p 12; to fall within the first branch the court seemed to require that loss be applicable in *all* cases: "but we do not think that it can be fairly and reasonably asserted, as a proposition which is applicable to all cases".

[28] But for cases allowing recovery under the first branch of *Hadley v Baxendale* see *Caledonian Property Group Ltd v Queensferry Property Group Ltd* 1992 SLT 738, *Nelson Cladding Ltd v Murray Williamson (Builders) Ltd* 1995 SLT (Sh Ct) 86 and *Ogilvie Builders Ltd v City of Glasgow District Council* 1995 SLT 15.

[29] 14 Oct 1993 GWD 36-2345.

[30] 14 Oct 1993 GWD 36-2345.

[31] (1854) 9 Exch 341, by Alderson B at p 342.

3.17 In *Plews v Plaistead*[32] the pursuer operated a video rental shop. He made a claim under a policy of indemnity insurance after video tapes were accidentally damaged. The insurers refused to pay and the pursuer claimed for damages for loss of profits due to his financial inability to replace damaged stock. Temporary Judge TG Coutts QC considered that the normal remedy for late or non-payment was judicial interest. He referred to the approach in *Margrie Holdings Ltd v City of Edinburgh District Council*[33] and to the requirement that any loss suffered must have been within the parties' contemplation in order to be recoverable. He observed that insurers are entitled to investigate and dispute liability and expressed the view, obiter, that it would be going too far to say that, where an insurer disputed liability and was then found liable, it would in every case be subject to a claim for damages for breach of contract beyond judicial interest.[34]

3.18 An approach based upon the second branch of *Hadley v Baxendale* was also adopted in *Hawkins v Scottish Mutual Assurance plc*[35] where damages were claimed for the loss in value of the pursuer's business caused by his inability to manage it effectively because of his illness. It was averred that, had the insurance company paid promptly, the business would have been sold as a going concern. Instead, in an attempt to support his family, the pursuer continued to run his business inefficiently so that it lost significant value. In relation to foreseeability of losses, Temporary Judge RF MacDonald QC stated:

> it seems to me that on no conceivable view can it be said that the losses claimed… were such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it so as to fall within the second branch of the test in *Hadley v Baxendale*.[36]

**CONCLUSION**

3.19 The Scots law approach to damages for late payment of insurance claims has followed ordinary contract principles. An insurer is under an implied obligation to pay a valid claim after a reasonable time for investigation. An insurer who unjustifiably delays payment or wrongfully repudiates a claim is considered to be in breach of contract. This opens the possibility that the insurer may be liable for losses which the insured has suffered and which fall within one or other branch of the rule in *Hadley v Baxendale*.

[32] 1997 SLT 804.

[33] 1994 SLT 994.

[34] 1997 SLT 804, at p 807.

[35] [2005] CSOH 101, at para 22.

[36] Above, at para 29.

3.20 None of the contracts considered by the Scottish courts has contained an exclusion clause designed to exclude the insurer's liability for delay in payment or wrongful repudiation. In a consumer contract, such an exclusion clause would be likely to be considered unfair under the Unfair Terms in Consumer Contracts Regulations 1999. If a business insurance contract contained a clause excluding liability for late payment, the courts would construe it narrowly.[37] However, if its meaning was clear, it would probably be held to be valid.[38]

3.21 As far as we can tell, it is rare for insurers to attempt to exclude liability for late payment in their contracts. This may be because UK insurers do not necessarily write their contracts with Scots law in mind.[39] Furthermore, it may be that the courts' reluctance to award damages in practice leads insurers to think that they have little to fear from this form of liability. On the other hand, if the Scottish approach to this issue were to be extended to the UK as a whole, insurers might react by placing standard exclusion clauses in all their small business contracts. We return to this issue in Part 9.

[37] See *Canada Steamship Lines Ltd v The King* [1952] AC 192.

[38] See *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827.

[39] We have recently reviewed 14 UK small business contracts. Of these 13 were specifically written under English law, and one was said to be subject to the relevant law of the insured's address, as shown in the schedule. This contract did not include any attempt to exclude liability for late payment.

# PART 4
# GOOD FAITH IN INSURANCE CONTRACTS

4.1 Unlike most contracts, insurance contracts are based on mutual "good faith". This opens the possibility that an insurer's unjustified delay or unreasonable refusal to pay a claim may be a breach of its duty of good faith. The courts recognise that this may be so, but until now have refused to grant the insured damages for the insurer's breach. In this area, English and Scots law are similar. This Part therefore discusses the law in both jurisdictions.

4.2 Here we start by outlining the history of the doctrine of good faith in insurance contracts, first in England and then in Scotland. We then describe how good faith operates both before a contract is formed, and during the life of the contract. The content of the duty varies according to its context.

4.3 The main problem with the duty of good faith in insurance contracts is that the only remedy available for breach is avoidance. This is a one-sided remedy, of far more use to the insurer than to the insured. The next section examines the case of *Banque Financiere v Westgate Insurance Co,* which held that breach of the duty of good faith does not give rise to damages.[1] This is a controversial decision, and we summarise the main criticisms made of it. We conclude, however, that it would be followed in both England and Scotland. We tentatively suggest that there is a need for statutory reform, to provide policyholders with appropriate remedies should an insurer act in bad faith, including a right to claim damages.

4.4 The fourth section examines the developing case law regarding the insurer's duties to act in good faith when a claim has been made. Although the law in this area is uncertain, there are tentative suggestions that insurers should make enquiries, not act arbitrarily and not take into account circumstances wholly extraneous to the merits of the claim.

## THE HISTORY OF THE DOCTRINE OF GOOD FAITH

### England and Wales

4.5 The ethos normally applicable in contract law is "buyer beware". However, English contract law treats insurance differently. The parties are obliged to act in good faith. This doctrine has a long history. Howard Bennett suggests that its origins lie in the middle ages with the law merchant. This was a "body of transnational commercial law generated by the largely autonomous mercantile community and administered by specialist tribunals".[2]

1 [1991] 2 AC 249, affirming the judgment of the Court of Appeal [1990] 1 QB 665.

2 H Bennett, "Mapping the doctrine of utmost good faith in insurance contract law" [1999] *Lloyd's Maritime and Commercial Law Quarterly* 165, at p 186.

4.6 The modern law on good faith in insurance contracts developed from Lord Mansfield's seminal decision in 1766, *Carter v Boehm.*[3] This concerned the policyholder's duty not to mislead the underwriter. However Lord Mansfield was in no doubt that the duty was mutual:

> The policy would equally be void, against the underwriter, if he concealed; as, if he insured a ship on her voyage, which he privately knew to be arrived; and an action would lie to recover the premium.[4]

4.7 In *Carter v Boehm,* and in subsequent decisions, Lord Mansfield was attempting to introduce a general principle of good faith into the whole of English commercial law. As Lord Hobhouse observed in *The Star Sea*, this failed.[5] It did however survive "for a limited class of transactions, one of which was insurance".[6]

4.8 The Marine Insurance Act 1906 codifies the English common law relating to marine insurance. Section 17 imposes a mutual duty of good faith on the parties to an insurance contract. It states:

> A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party.

Despite its title, the Marine Insurance Act is regarded as having general application to insurance.[7]

4.9 John Lowry has observed that the introduction of "utmost" into the concept of good faith was a nineteenth century development.[8] Lord Mansfield referred only to duties of "good faith". In a series of cases, the courts increased the duties on the insured. For example, they held that, contrary to Lord Mansfield's original views, the underwriter was under no duty to make enquiries. If the insured failed to disclose a material fact this gave the insurer a remedy even if the insured had acted honestly:

> Hence, without fraudulent intent, and even *in bona fide*, the insured may fail in the duty of disclosure.[9]

[3] (1766) 3 Burr 1905. In *Stewart v Morison* (1779) Mor 7080, the Lord Ordinary (Gardenston) appears to have accepted the statement of the law as expressed by Lord Mansfield in *Carter v Boehm* as representing the law of Scotland.

[4] Above, at p 1909. On the mutuality of the duty, see also *Life Association of Scotland v Foster* (1873) 11 M 351, at p 359 where Lord President Inglis stated that both parties to an insurance contract are bound to act with the utmost good faith.

[5] *Manifest Shipping v Uni-Polaris Insurance Co ("The Star Sea")* [2001] UKHL 1; [2003] 1 AC 469.

[6] Above, at para 42.

[7] See, for example, the statement by Lord Mustill in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* that "the common law relating to the two types of insurance is the same, and that the Act embodies a partial codification of the common law": [1995] 1 AC 501 at p 518.

[8] J P Lowry, "Redrawing the parameters of good faith in insurance contracts" [2007] *Current Legal Problems* 338.

[9] *Life Association of Scotland v Foster* (1873) 11 M 351, by Lord President Inglis at p 359.

4.10 In other words the insured, however honest, could still be in breach of duty. “Utmost” stretched the parties’ mutual duties beyond reasonable honesty and integrity.

**Scotland**

4.11 Scots law has long recognised the Roman law notion of *bona fides* (good faith) in relation to specific contracts such as sale, hire, and partnership. By the eighteenth and early nineteenth centuries some writers and judges were prepared to extend this to make good faith a principle of general contract law.[10] In this context, the Scottish courts began in effect to follow *Carter v Boehm* in holding for a positive pre-contract duty of disclosure resting upon the insured in insurance law. Thus the influential nineteenth-century text-writer Bell and his editors described insurance as "a contract of good faith".[11] But it was not until 1873 that this was expressed in terms of “utmost” good faith (“*uberrimae fidei”*).[12]

4.12 However, any nascent general doctrine of good faith in contracts has not developed into an explicit principle of Scots law. Partly this was due to the growing influence of English law (and in particular the impact of the application of the Sale of Goods Act 1893 to Scotland). Partly also, it was because at this period Scots law had a wide concept of fraud which encompassed much bad faith conduct.[13] In modern times, the existence of a “broad principle in the field of contract law of fair dealing in good faith” has been judicially recognised by both the First Division of the Court of Session and the House of Lords.[14] But the concept is actually a limited one. In the most recent judicial statement, Lord Hope observed:

> Good faith in Scottish contract law… is generally an underlying principle of an explanatory and legitimating rather than an active or creative nature.[15]

[10] See the citations in ADM Forte (ed), *Good Faith in Contract and Property* (1999), at p 13, n 32, and pp 77 to 79.

[11] Bell, *Principles* (10th ed 1899), s 474.

[12] The phrase is used by Lord President Inglis in *Life Association of Scotland v Foster* (1873) 11 M 351 at p 360. Contrast Lords Deas and Ardmillan, who speak of insurance as "a contract of good faith" (at pp 364 and 370). See further Forte, "Insurance", in K Reid and R Zimmermann (eds), *History of Private Law in Scotland*, vol 2 (2000), at pp 346 to 50.

[13] McBryde, *Contract* (3rd ed 2007), at para 17.30. The Scots law definition of fraud was however considerably narrowed after the decision of the House of Lords in *Derry v Peek* (1889) LR 14 App Cas 337.

[14] *Trade Development Bank v David W Haig (Bellshill) Ltd* 1983 SLT 510, by Lord President Emslie at p 517; *Smith v Bank of Scotland* 1997 SC (HL) 111, by Lord Clyde at p121.

[15] *R v Immigration Officer at Prague Airport, ex parte European Roma Rights Centre* [2004] UKHL 55; [2005] 2 AC 1, at p 51, para 60.

4.13 It has accordingly been suggested by one text-writer that, while Scots law "had a concept of bad faith [which] would affect rights which otherwise would be acquired", "there is no single principle of good faith". Instead, only "certain nominate contracts" have "special rules on good faith, such as insurance".[16]

## PRE AND POST CONTRACT DUTIES OF GOOD FAITH

4.14 Much of the case law on good faith concerns the policyholder's duties to provide the insurer with information before entering into an insurance contract. These are set out in sections 18 and 20 of the 1906 Act, and are said to be specific examples of the more general duty. However, section 17 is not limited to pre-contract matters. It is a mutual duty which may also govern the way the parties behave towards each other after the contract has been formed.

### England and Wales

4.15 In *The Star Sea,* the House of Lords reviewed the parties' post-contract duties in some depth.[17] The case shows that the post-contract duty is flexible and varies according to context. As Lord Clyde put it:

> The idea of good faith in the context of insurance contracts reflects the degrees of openness required of the parties in the various stages of their relationship. It is not an absolute. The substance of the obligation which is entailed can vary according to the context in which the matter comes to be judged.[18]

4.16 Lord Hobhouse agreed. Although the pre-contract duty of good faith was relatively clear, "when it comes to post-contract disclosure the criterion becomes more elusive".[19] It is not necessary, for example, for the parties to disclose facts occurring after the risk was accepted. Furthermore, the parties' duties ceased once litigation commenced, at least with regard to obligations to disclose information.

4.17 Post-contract duties are more restricted than pre-contract duties. The duty is one of "good faith" rather than "utmost good faith". Before a contract is formed, the duty of "utmost good faith" includes a duty not to misrepresent. Every material representation the insured makes must be true. If it is not true, the insurer may avoid the contract and it makes no difference that the insured may have made a genuine mistake.[20] However, if the insurer makes a mistake after the contract has been formed, and innocently says something to the insured which is not true, this is not a breach of the duty of "good faith".

[16] McBryde, *Contract* (3rd edn, 2007), at paras 17.29 to 17.30 (note the use of the past tense in relation to the concept of bad faith, related to the wider concept of fraud in Scots law before *Derry v Peek*).

[17] *Manifest Shipping v Uni-Polaris Insurance Co ("The Star Sea")* [2001] UKHL 1; [2003] 1 AC 469.

[18] Above, at para 7.

[19] Above, at para 54.

[20] The two Law Commissions have recommended reforms to the duty of disclosure in consumer insurance: see "Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation" (2009) Law Com No 319/Scot Law Com No 219.

4.18 This is illustrated by *The Ainikolas.*[21] Here the claimant sought to argue that a mistaken claim by the insurers for payment of interest was a breach of the insurer's duty of good faith such that the policy could be avoided. The claim failed on the ground that mere mistake was insufficient to permit avoidance, at least where the mistake had been made after the conclusion of the contract.

**Scotland**

4.19 Scottish case law and writing on good faith in insurance is almost entirely concerned with the insured's obligations of disclosure before entering the contract. However, it is clear that the obligation of good faith is a mutual one, which carries the implication that it extends to the post-contract relationship, since a mere duty of pre-contract disclosure for the insurer is almost meaningless.[22]

4.20 There is one Scottish case which discusses the post-contract duty of good faith. This is the Outer House decision of *Fargnoli v GA Bonus plc*.[23] The case concerned the insured's duty, and we will consider it in greater depth in our forthcoming paper on the insured's post-contract duties. Briefly, the pursuer, a restaurateur, made a claim in respect of a fire at his premises. The defender insurers resisted on the ground that the pursuer had caused or connived at a second, later fire at the same premises. The insurers argued that the pursuer had therefore forfeited all benefits under the policy, including the claim for the first fire. Lord Penrose rejected the insurers' argument. He suggested that "a claim tainted by fraud would be cut down as a whole".[24] He held, however, that the pursuer's first claim was a valid one made under a valid contract, and his subsequent involvement in the further fire had no effect on that position.

4.21 Lord Penrose accepted the existence of both post as well as pre-contract good faith duties in insurance contracts.[25] He appeared, however, to view utmost good faith as a factor which would "colour" the material obligations, express and implied, owed by both parties, rather than as a stand-alone duty.[26] Of particular relevance to this paper is his statement that it:

[21] *The Standard Steamship Owners' Protection and Indemnity Association (Bermuda) Ltd v Oceanfast Shipping Ltd ("The Ainikolas")*, unreported, 7 March 1996, by Mance J. The case is referred to in A Naidoo & D Oughton, "The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?" (2005) *Journal of Business Law* 346, at p 359.

[22] *Life Association of Scotland v Foster* (1873) 11 M 351 by Lord Deas at p 364; JJ Gow, *Mercantile Law* (1964), at p 339; Gloag & Henderson, *Law of Scotland* (12th ed 2007), at para 21.05; *Laws of Scotland: Stair Memorial Encyclopaedia*, vol 12, at para 858, note 5.

[23] [1997] CLC 653, also reported at 1997 SCLR 12.

[24] Above, at p 670 (rejecting an earlier obiter view to the contrary by Lord Trayner in *Reid & Co v Employers' Accident & Live Stock Insurance Co* (1899) 1 F 1031, at p 1037).

[25] In particular, see above at p 663 and pp 670 to 671.

[26] Above, at p 670.

> must be open to question whether an insurer would be in good faith in delaying an admission of liability, or in advancing spurious defences to a claim, or to put the insured to proof of what the insurer knows is true, or in delaying settlement of claims which he would, objectively, be obliged to admit before a court to be valid.[27]

In such circumstances, Lord Penrose considered that the insurer would be held to be in repudiatory breach.[28]

### SECTION 17 AND THE REMEDY OF AVOIDANCE

4.22 The main problem with the mutual duty of good faith set out in section 17 of the Marine Insurance Act 1906 is that the provision only mentions one remedy for breach: avoidance. As we explain below, the courts have interpreted this to mean that avoidance is the only remedy available. This means that the contract is declared to be void from the start: the insurer may refuse all claims and simply return the premium. This greatly assists insurers but, as Lord Hobhouse pointed out in *The Star Sea*, the remedy is "wholly one-sided".[29] By contrast, most policyholders want their claims paid. They are unlikely to argue that the insurance never existed because their recovery would then be limited to return of the premium and nothing more. Unsurprisingly, therefore, more cases on the issue of good faith are brought by insurers than by policyholders. The case law on the insurer's obligations is relatively undeveloped.

4.23 In our view, the duty of good faith would 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. In 1988, the English Court of Appeal found that there was no such right to damages. This case is called *Banque Financiere v Westgate Insurance Co*, though somewhat confusingly it is also referred to by its previous name, *Banque Keyser v Skandia*.[30] This is a particularly complex piece of litigation, which we look at in more detail below. We then consider whether the Scottish courts would be likely to reach a similar decision. Finally we summarise the main criticisms made of the case and offer a tentative view that statutory reform is needed.

[27] Above, at pp 670 to 671.

[28] Above, at p 671.

[29] *Manifest Shipping v Uni-Polaris Insurance Co ("The Star Sea")* [2001] UKHL 1; [2003] 1 AC 469 at p 497, para 57.

[30] *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665. This was later approved by the House of Lords in *Banque Financiere de la Cite SA v Westgate Insurance Co Ltd* [1991] 2 AC 249.

### The *Banque Financiere* case

#### *The facts*

4.24 The claimants were a syndicate of banks who lent substantial sums to a businessman, who defaulted on the loans. As the judge put it, “the story is one of fraud on a massive scale”.[31] The banks’ main security was a series of credit insurance policies, guaranteeing repayment. The banks’ brokers placed the insurance, and the banks were co-insured under the policies. The problem, however, was that the policies contained fraud exclusion clauses. In the event, they proved to be useless. The banks were left with large losses.

4.25 On further investigation, the banks discovered that one of their own broker’s employees, L, had also been dishonest. In one of the early loans, L had issued cover notes stating that credit insurance was in place when it was not. The insurers’ agent, D, had discovered this, but had failed to mention it to the banks. The banks argued that at the time they were in pre-contract negotiations with the insurers over further policies. The fact that a fraud had been committed was highly relevant to them. If they had known, they would not have made further loans. The failure to disclose, the banks said, was a breach of the insurers’ duty of good faith, and the insurers should compensate them for the losses that had resulted.

#### *The progress of the litigation*

4.26 In the High Court,[32] Mr Justice Steyn held that, as a matter of principle, an insured can claim damages from an insurer for loss suffered as a result of the insurer’s lack of good faith. He made this ruling on the basis of “justice and policy considerations”: where there is a right, there should be a remedy.[33] He observed that “occasionally judges have to apply an existing remedy to a new situation when a right already recognised by the law is not adequately protected”.[34]

4.27 The Court of Appeal reversed this decision, and held that damages were not available. When the case proceeded to the House of Lords on a different point, the House of Lords approved the Court of Appeal’s reasoning on this issue.[35]

[31] Above, by Steyn J at p 681.

[32] *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665; [1987] 2 WLR 1300 (QBD).

[33] Above, at p 706.

[34] Above.

[35] *Banque Financiere de la Cite SA v Westgate Insurance Co Ltd* [1991] 2 AC 249 (HL).

### *The Court of Appeal's reasoning*

4.28 Lord Justice Slade gave judgment for the court.[36] While not denying that the insurers owed a duty to the banks, he unequivocally denied that damages were available for breach of that duty. This is despite admitting that, where the breach occurs after the insured event, avoidance and return of the premiums "may be quite inadequate".[37]

4.29 The court reasoned that in order to decide whether the remedy of damages is available, one has to start by analysing the nature of the right:

> If the banks' right to full disclosure of material facts is founded neither on tort nor on contract nor on the existence of a fiduciary duty nor on statute, we find it difficult to see how as a matter of legal analysis it can be said to found a claim for damages.[38]

4.30 Here, there were only two possibilities: contract or tort. After considering both, the court decided that the banks did not have an enforceable right in either.

4.31 As to whether there was a breach of contract, the court concluded that the duty of disclosure was not based on an implied term in the insurance contract. A survey of the authorities revealed a consensus that the duty of disclosure arises outside the contract, and is not incorporated within it.[39] It should be remembered, however, that this case dealt with a pre-contract non-disclosure. Of a post-contract duty to disclose, Lord Justice Slade admitted that "on the particular facts of some cases" such a duty could be said to arise under the terms of the contract.[40]

4.32 As to whether a breach of good faith could constitute a tort, the Court of Appeal could find "no authority whatever to support the existence of such a tort".[41] Furthermore, they offered four reasons why a novel tort should not be created:

(1) Relief for non-disclosure shares an origin in the courts of equity with duress and undue influence. These do not give rise to a claim for damages.

(2) When an underwriter (or possibly an insured) is seeking avoidance of a policy for non-disclosure, the effect of the non-disclosure on the underwriter in question is not considered – merely the effect on a notional prudent underwriter. This approach would not translate easily to a scenario where damages were sought.

[36] *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665.

[37] Above, at p 775.

[38] Above, at p 776.

[39] See *Merchants and Manufacturers Insurance Co Ltd v Hunt* [1941] 1 KB 295; *Bell v Lever Brothers Ltd* [1932] AC 161; *March Cabaret Club & Casino Ltd v London Assurance* [1975] 1 Lloyd's Rep 169.

[40] *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665 (CA), by Slade LJ at p 777.

[41] Above, by Slade LJ at p 780.

(3) Section 17 of the 1906 Act does not refer to damages being available for a breach of the duty of good faith, merely avoidance.

(4) The obligation to disclose is an absolute one, not being dependent on fault at all. Given its reciprocal nature, the availability of a damages remedy could cause hardship – for example if an insurer sought damages from an insured for an innocent non-disclosure.

**Subsequent case law in England and Wales**

4.33 The reasoning in *Banque Financiere* that damages are not available for breach of the good faith duty appears to have become entrenched in subsequent case law.

4.34 As to the finding that breach of good faith was not a tort, the Court of Appeal later adopted similar reasoning in reaching its decision in *HIH v Chase Manhattan*.[42] Lord Justice Rix held that it was not fair and reasonable to impose on insurer and insured a duty of care to each other when a proposal is put. In giving his reasons (with which other members of the Court agreed) he said that the theme running through the *Banque Financiere* case:

> is that the duty of good faith which the law has developed especially for contracts of insurance provides a remedy only in avoidance and not in damages. It seems to me to follow that if *the established remedy in this context grants no remedy in damages*… then it ought to require very special factors to make it just and reasonable to superimpose an additional remedy for the narrower case of a negligent misrepresentation [emphasis added].[43]

**Damages for breach of good faith in Scots law**

4.35 It is difficult to tell whether the outcome of *Banque Financiere* would be different under Scots law. In the *Fargnoli* case, Lord Penrose rejected the argument that avoidance was always the appropriate remedy for a breach of good faith, and was prepared to look at the reality of the situation.[44] This might suggest a more flexible approach.

[42] *HIH Casualty and General Insurance Ltd and others v Chase Manhattan Bank and others* [2001] EWCA Civ 1250; [2001] 2 Lloyd's Rep 483.

[43] Above, at para 68.

[44] *Fargnoli v G A Bonus plc* [1997] CLC 653, at p 670. Lord Penrose distinguished between bad faith at the outset, which entirely vitiates the contract, and bad faith during the currency of the contract, where retrospective invalidity would "defeat the reality" that a binding contract had existed until that action.

4.36 Furthermore, Scots law takes a different view of how delictual liability may apply to new situations. The approach is a more generalised one, and development is not dependent upon the creation of “new delicts”. The question is rather one of whether a party has inflicted harm on another through intentional or faulty conduct. This might suggest that if a duty of good faith exists, there is no reason in principle why there should not be a delictual claim in respect of breach of it.[45] It is possible that other grounds for the avoidance of contracts, such as force and fear (duress), may also give rise to delictual liability though the issue is not clear cut. Professor du Plessis has observed that:

> There is no modern case law which deals with force and fear… as a delict. Neither do textbooks display much enthusiasm for doing so …However, this does not mean that [a] delictual claim cannot lie.[46]

4.37 There are, however, contrary arguments. Professor Thomson notes that:

> while the concept of fraud as a factor vitiating consent in voluntary obligations is wide enough to include conduct which can be characterised as merely contrary to good faith, it does not follow that such conduct will be grounds for an action of reparation.[47]

Professor McBryde argues further that “good faith is usually a shield and not a sword – it is a defence to an action and not the foundation of an action”.[48]

4.38 Against this background, and given the very limited content Scots law has so far given to the principle of good faith, it seems highly unlikely that a claim in delict couched simply on the basis of breach of good faith would be successful.[49]

**Criticisms made of the *Banque Financiere* case**

4.39 The *Banque Financiere* case has attracted academic criticism. It has been argued that the court was overly cautious in not creating a new tort. Professor Birds, for example, found the Court of Appeal’s reasoning to be “unsatisfactory”.[50] He pointed out that in other areas of law the courts have been prepared to create new torts.[51] He offered the following criticisms of the four reasons against the creation of a new tort:

[45] A possible example is so-called “Melville Monument” liability, for which see MacQueen & Thomson, *Contract Law in Scotland* (2nd ed 2007), paras 2.92 to 2.96. It is not clear whether this liability is to be regarded as contractual, delictual or *sui generis*. Some doubt has been cast on its continued existence by obiter dicta in *Khaliq v Londis (Holdings) Ltd* [2010] CSIH 13.

[46] JE du Plessis, *Compulsion and Restitution*, at para 4.4. See also above, para 3.3.1(iii)(a).

[47] JM Thomson, “Fraud”, 11 *Stair Memorial Encyclopaedia*, para 720.

[48] McBryde, *Contract* (3rd ed 2007), at para 17.29.

[49] Of course, where the conduct amounted to delictual fraud, that would be the basis of the delictual claim.

[50] J Birds, *Birds’ Modern Insurance Law* (7th ed 2007), at p 142.

[51] For example, breach of confidence: *Fraser v Thames Television* [1984] QB 44; [1983] 2 All ER 101.

(1) The duty of disclosure stems from the common law courts of Lord Mansfield, rather than equity as suggested by the Court of Appeal.

(2) While the court suggested the effect on the actual underwriter in question was irrelevant, *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co*[52] means this point no longer stands.

(3) The absence of a reference to damages in section 17 should not be decisive as the 1906 Act was a codification of common law. In other circumstances the courts have been content to read words into the Act.[53]

(4) The fact that fault is not needed for a breach should also not be decisive – a party in breach of contract, for example, can be liable without fault or blameworthiness.

4.40 Peter Macdonald Eggers also argued that the Court of Appeal's reasons "do not stand up to scrutiny".[54] He did not accept that a duty must be classified as contractual, tortious, fiduciary or statutory in order for a breach to give rise to a remedy in damages. He pointed out that misrepresentation may give rise to the remedies of both rescission and damages.

4.41 Meanwhile, Andre Naidoo and David Oughton argued that the Court of Appeal did not adequately consider the possibility that a duty of good faith may take effect as an implied term.[55] While it is true that an obligation to act in good faith before the formation of the contract cannot arise from the contract itself, this does not apply to the post-contract duty. In *The Litsion Pride*,[56] Mr Justice Hirst suggested that once a contract was made, section 17 might operate as an implied term of an insurance contract:

> The duty not to make fraudulent claims and not to make claims in breach of utmost good faith is an implied term of the policy.[57]

4.42 Some support for this view can also be found in remarks by Lord Hobhouse in *The Star Sea*. He noted that both counsel accepted that *Banque Financiere* was good law, and there was no remedy in damages for want of good faith. He commented:

> It follows from this that the principle relied on by the defendants is not an implied term but is a principle of law which is sufficient to support a right to avoid the contract of insurance retrospectively.[58]

[52] [1995] 1 AC 501.

[53] See, for example, *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co* [1995] 1 AC 501, where the House of Lords held that inducement was an implied requirement in ss 18 and 20.

[54] P Macdonald Eggers, "Remedies for the failure to observe the utmost good faith" [2003] *Lloyd's Maritime and Commercial Law Quarterly* 249, at p 275.

[55] A Naidoo & D Oughton, "The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?" [2005] *Journal of Business Law* 346 to 371.

[56] *Black King Shipping Corp v Massie ("The Litsion Pride")* [1985] 1 Lloyds Rep 437.

[57] Above, at p 518.

4.43 This made sense where the insured had failed to disclose information. Lord Hobhouse thought, however, that where the want of good faith occurs later, avoidance becomes anomalous and disproportionate: "the result is effectively penal". Lord Hobhouse was clearly constrained in saying that *Banque Financiere* was wrongly decided when both counsel before him argued that it was good law. Nevertheless, he went on to set out his best attempt to make sense of section 17:

> A coherent scheme can be achieved by distinguishing a lack of good faith which is material to the making of the contract itself (or some variation of it) and a lack of good faith during the performance of the contract which may prejudice the other party or cause him loss or destroy the continuing contractual relationship. The former derives from requirements of the law which pre-exist the contract and are not created by it although they only become material because a contract has been entered into…. The latter can derive from express or implied terms of the contract; it would be a contractual obligation arising from the contract and the remedies are the contractual remedies provided by the law of contract.[59]

**Our view**

4.44 The insurer's duty to act in good faith underpins the insurance contract. Where an insurer acts in bad faith it is right that the law should provide the insured with an appropriate remedy. In this paper, we are considering cases in which an insurer deliberately refuses to investigate, or advances spurious defences, or deliberately delays payment on a claim it knows to be valid. This may cause foreseeable loss to the insured, and we think the law should provide compensation for this loss.

4.45 As we discuss below, however, it is less easy to characterise the duty of good faith. We do not think it is right to see it as either an implied term or as giving rise to an action in tort or delict. We think it is best seen as a separate, non-excludable duty, giving rise to specific remedies as set out in statute.

[58] *Manifest Shipping v Uni-Polaris Insurance Co ("The Star Sea")* [2001] UKHL 1; [2003] 1 AC 469, at para 49.

[59] Above, at para 52.

### *A new tort/delict?*

4.46 We can see two policy arguments for not creating a general tortious or delictual liability for bad faith in insurance contracts. The first is that this liability could operate harshly against the policyholder. Where a policyholder has failed to disclose a relevant matter, or made a misrepresentation, we think the insurer's remedies should be limited to avoiding the policy or refusing all or some of the claim, and we have set out recommendations to this effect.[60] We do not wish to see insurers also suing policyholders for damages.

4.47 The second is that tortious or delictual damages are more generous than those for breach of contract.[61] For example, while contract damages are restricted to losses within the contemplation of the parties at the time of the contract, under tort law, the victim is entitled to any loss foreseeable at the time of the tort (that is when the insurer acts in bad faith). At this point, the insurer is likely to have much greater knowledge of the insured's specific circumstances. In the USA, the courts of several states have been prepared to provide high levels of tort damages against insurers. Although British courts would be unlikely to award damages on such a scale, we can understand concern about potentially unrestricted increases in an insurer's liability.

### *An implied contract term?*

4.48 We have also considered whether it would be right to see the post-contract duty of good faith operating as an implied term of the contract.

4.49 If the post-contract duty of good faith is categorised as a contract term, breach would then give rise to a claim for damages under normal contract principles. There are clear attractions to this idea. We think that contract damages would be an appropriate remedy: they are flexible and principled, while not being as open-ended as damages in tort or delict. Loss must be foreseeable at the time the contract was made.

[60] Our recommendations are set out in our 2009 Report, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* ((2009) Law Com No 319/Scot Law Com No 219). With consumer insurance, for example, an insurer would be entitled to avoid the policy for a deliberate or reckless misrepresentation. Where a misrepresentation is careless, the outcome would depend on what the insurer would have done had it known the information. Our draft Bill on misrepresentation in consumer contracts removes the possibility that an insurer could claim damages against a consumer for a misrepresentation under the Misrepresentation Act 1967 or under Scots law. For the Scots law on remedies for misrepresentation see Issues Paper 1: Misrepresentation and Non-Disclosure, Appendix A, at paras A.29 to A.33.

[61] See for example Lord Reid's comment that the contract test is more restricted than "reasonably foreseeable" loss in tort law: *The Heron II* [1969] 1 AC 350, at p 385.

4.50 We have concluded, however, that it would not be right to categorise a general duty to act in good faith as an implied contract term. First, we think that without further elaboration, such a term would be too uncertain. Express contract terms requiring parties to act in good faith have been held unenforceable for uncertainty in both the English and the Scottish courts.[62] The same must apply to an implied term.

4.51 Secondly, and most importantly, the parties are always free to exclude implied terms by express agreement.[63] Yet insurance contracts depend fundamentally on the duty of good faith that each party owes to the other. The idea that parties to an insurance contract can agree that they will not act in good faith therefore seems wholly self-contradictory. Accordingly, we think that the basic duty to act in good faith should not be excludable by a contract term. It is like fraud, liability for which cannot be excluded between contracting parties.[64] This is reinforced, at least for standard form consumer insurance contracts, by the Unfair Terms in Consumer Contracts Regulations 1999 in which terms must not be contrary to good faith or cause a significant imbalance between the parties' obligations to the detriment of the consumer.[65] We think that a clause which excludes an obligation to act in good faith must by its nature be contrary to good faith.

***A statutory duty?***

4.52 We have therefore come to the conclusion that damages should be available for the insurer's bad faith. However, where an insurer acts in bad faith, this should not be seen as either a tort, or delict, or as breach of an implied contract term. Rather it is breach of a stand alone duty. We think it should give rise to specific remedies as set out in statute.[66]

4.53 Our tentative conclusion therefore is that statutory reform is needed to reverse the effect of the *Banque Financiere* case. This would need to repeal the words in section 17 to the effect that “if utmost good faith is not observed by either party, the contract may be avoided by the other party”. Instead, the courts would be provided with a range of remedies.

[62] *Petromec Inc v Petroleo Brasileiro SA Petrobas* [2004] EWHC 127 (Comm), at paras 85-92 (Moore-Bick J); *Beaghmor Property Ltd v Station Properties Ltd* [2009] CSOH 133 (Lord Hodge); both following *Walford v Miles* [1992] 2 AC 128. See also *R & D Construction Group Ltd v Hallam Land Management Ltd* [2009] CSOH 128, by Lord Hodge at para 55.

[63] English law permits the parties to exclude liability for both deliberate acts and negligence: see *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827. However, such clauses would be construed narrowly. In the case of exclusions for negligence, the clause must pass the exacting standards set out in *Canada Steamship Lines Ltd v The King* [1952] AC 192. Scots law has reached a similar conclusion: *North of Scotland Hydro Electric Board v D & R Taylor* 1956 SC 1; *Smith v UMB Chrysler (Scotland) Ltd* 1978 SC (HL) 1. See further McBryde, *Contract* (3rd ed 2007), at paras 8.69 to 8.73.

[64] *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2003] UKHL 6. Again Scots law is similar. JM Thomson, “Fraud”, 11 *Stair Memorial Encyclopaedia*, para 720, and McBryde, *Contract* (3rd ed 2007), at paras 14.43 and 14.67, cite the main Scottish cases on this point.

[65] Reg 5(1).

[66] See paras 9.9 to 9.41 below.

4.54 Sections 18, 19 and 20 are all specific examples of the duty of good faith. However, they relate only to pre-contract duties, and only to the duties of the insured or the insured's agents. There is a case for adding further examples of the mutual duty of good faith, relating to the duty of the insurer to investigate, assess and pay claims in good faith. We think that where the insurer breaches these duties the insurer should be liable to compensate the insured for actual loss resulting from the breach, providing such loss was foreseeable at the time the contract was made.

***The European approach***

4.55 The *Principles of European Insurance Contract Law* (PEICL) are worth noting in this connection. The *Principles* incorporate good faith in a general way,[67] and lay down that in its interpretation "regard should be had to the need to promote good faith and fair dealing in the insurance sector".[68] However, they do not otherwise make much use of the good faith concept.[69] Post-contract duties are discussed in its sixth chapter (headed "Insured Event"). This sets out specific post-contract obligations on the parties, and then specifies the remedy for breach of each obligation.

4.56 Thus the policyholder is required to notify the insurer without undue delay of the occurrence of an insured event and must co-operate with the insurer's investigation of the event. The chapter specifies that an insurer who is prejudiced by the breach may reduce the payout to the extent of the prejudice.[70]

4.57 Chapter 6 then requires the insurer:

(1) to take all reasonable steps to settle a claim promptly (Art 6:103); and

(2) to pay accepted claims without undue delay (Art 6:104).

The *Principles* clarify that late performance by the insurer entitles the claimant to interest plus damages for any additional loss (Art 6:105).

4.58 We do not think that all failures to pay promptly will necessarily involve a breach of good faith. The insurer may, for example, have a genuine but mistaken view that the claim is fraudulent. However, where an insurer knows that a claim is genuine, but nevertheless delays payment, we think that it is right to specify remedies of this sort.

4.59 We return to these issues in Part 9.

[67] PEICL Art 1:105(2) incorporates the general obligation of good faith set out in the companion work, Principles of European Contract Law.

[68] PEICL Art 1:104.

[69] The only other reference to good faith is in PEICL Art 2:304 (Abusive Clauses) which rewrites the Unfair Terms Directive 1993 to make it more directly related to insurance contracts.

[70] See Art 6:101 and Art 6:102. Art 6.102 also provides if the policyholder fails to co-operate with the insurer's investigation with intent to cause prejudice or recklessly and with knowledge that prejudice would probably result, the insurer is not obliged to pay the insurance money at all.

## ARE INSURERS OBLIGED TO EXERCISE THEIR RIGHTS IN GOOD FAITH?

4.60 The non-availability of damages means that issues concerning insurers' obligations of good faith tend to reach the courts as a defence rather than as a primary cause of action.[71] In several cases the policyholder has argued that the insurer should not be entitled to exercise an apparent right because the right was not exercised in good faith. In the following paragraphs, we consider cases in which the insurer has purported to avoid the contract. We then consider cases regarding the way in which insurers exercise their contractual rights in relation to claims handling. We are interested to see how far these cases clarify the scope of the insurer's duty.

### Avoidance and good faith

#### *The Grecia Express*

4.61 In *The Grecia Express*,[72] the defendant insurers sought to avoid a ship policy on the ground that there had been non-disclosure of material facts at the time of renewal. The facts relied on as material were other claims for losses arising in suspicious circumstances.[73] These would have influenced the insurer at the time. However, Mr Justice Colman in the High Court held that the previous losses were not in fact suspicious, and were thus not material. Consequently, he held that the insurer could not rely on those facts to avoid the policy. This would be "contrary to their duty of the utmost good faith and therefore unconscionable and therefore impermissible".[74]

4.62 He cited Lord Justice Staughton in *Kausar v Eagle Star Insurance*[75] that "avoidance for non-disclosure is a drastic remedy" and "there should be some restraint in the operation of the doctrine". He said that if the allegations were untrue, the underwriters:

> would be seeking to avoid liability in respect of a risk which, had they been in possession of the true facts, as distinct from the allegation of suggested facts, they would have written without hesitation.[76]

4.63 To persist with a defence of non-disclosure in such circumstances "in the face of evidence before the Court" would "be quite contrary to their duty of the utmost good faith".[77]

[71] See the discussion on non-availability of damages for breach of the duty of good faith at paras 4.22 to 4.34 above.

[72] *Strive Shipping Corporation and another v Hellenic Mutual War Risks Association ("The Grecia Express")* [2002] EWHC 203 (Comm); [2002] 2 Lloyd's Rep 88.

[73] Including the loss of *The Italia Express*, mentioned at paras 2.38 to 2.43 above.

[74] *Strive Shipping Corporation and another v Hellenic Mutual War Risks Association ("The Grecia Express")* [2002] EWHC 203 (Comm); [2002] 2 Lloyd's Rep 88, by Colman J at p 154.

[75] *Kausar v Eagle Star Insurance Co Ltd* [2000] Lloyd's Rep IR 154. by Staughton LJ at p 157.

[76] *Strive Shipping Corporation and another v Hellenic Mutual War Risks Association ("The Grecia Express")* [2002] EWHC 203 (Comm); [2002] 2 Lloyd's Rep 88, by Colman J at p 133.

### *Brotherton*

4.64 However, the Court of Appeal in *Brotherton v Aseguradora Colseguros SA (No 2)*[78] took a different approach. Here the claimant reinsured certain aspects of professional indemnity insurance written in favour of a Colombian bank. The claimants alleged that the defendant insurers had been aware of allegations of serious impropriety by senior officials of the bank, but had failed to disclose them. They brought an action seeking a declaration to the effect that they were entitled to avoid the policies. The defendants argued (much as in *The Grecia Express*) that whether such allegations were material depended upon their correctness, which should be ascertained at trial.

4.65 Lord Justice Mance rejected the defendants' argument and Mr Justice Colman's reasoning in *The Grecia Express*. He said that "rescission under English law is not generally subject to any requirement of good faith or conscionability" and that "the mere fact that a right to rescind has an equitable origin does not mean that its exercise is only possible if that is consistent with good faith".[79]

4.66 Lord Justice Mance agreed that there was a post-contract duty of good faith, but held that authority had limited it to "circumstances of repudiatory breach or fraudulent intent".[80] That said, he conceded that there was some support for the idea that the insurer's good faith could be taken into account where allegations that a prudent insurer would have wanted to know about have been proven to be untrue by the time the insurer sought to avoid (although this had not been the case either in *Brotherton* or *The Grecia Express*).[81]

### *Drake v Provident*

4.67 A differently constituted Court of Appeal in *Drake v Provident*[82] did, however, consider that the duty of good faith placed constraints on the ability of the insurer to avoid a policy. The dispute was between two insurers, both of whom had insured the same driver. When the driver had an accident, the claimant insurer sought a contribution from the defendant insurer towards the driver's claim. The defendant argued that it was entitled to avoid its policy for non-disclosure. The driver had failed to mention two facts: one increased the risk, and the other diminished it. If the defendant had made a full enquiry and discovered both facts, the overall risk assessment would have been the same.

4.68 Among other issues, the court considered whether, if the defendant had had a right to avoid, that right was constrained by good faith. Lord Justice Rix suggested that:

[77] Above, by Colman J at 133.

[78] *Brotherton & others v Aseguradora Colseguros SA & another (No 2)* [2003] EWCA Civ 705; [2003] 2 CLC 629.

[79] Above, at pp 656 to 657.

[80] Above, at p 657. He cited *The Star Sea*, above; *Merc-Scandia XXXXII (K/S) v Lloyd's Underwriters ("The Mercandian Continent")* [2001] EWCA Civ 1275; [2001] 2 lloyd's Rep 563 and *Agapitos v Agnew ("The Aegeon")* [2002] EWCA Civ 247; [2003] QB 556.

[81] *Brotherton*, see above, at p 653.

[82] *Drake Insurance plc v Provident Insurance plc* [2003] EWCA Civ 1834; [2004] QB 601.

> the doctrine of good faith should be capable of limiting the insurer's right to avoid in circumstances where that remedy, which has been described in recent years as draconian, would operate unfairly.[83]

4.69 He also referred to the fact that "not all insurance contracts nowadays are made by those who engage in commerce" and that further consideration of the doctrine of good faith "may demand that ultimately regard must be had to a concept of proportionality implicit in fair dealing".[84]

4.70 Lord Justice Rix admitted that once an insured was found not to have acted in good faith, it might be hard to conclude that the same doctrine would itself constrain the insurer's rights. He suggested, however, that "knowledge or shut-eye knowledge" of the true facts in this case would have made it a matter of bad faith to avoid the policy. The other members of the court agreed with this conclusion.[85]

4.71 Indeed Lord Justice Pill notably went slightly further, basing his decision on the duty of good faith, saying:

> A failure to make any inquiry of the insured before taking the drastic step of avoiding the policy was, in my judgment, a breach by the insurer of the duty of good faith.[86]

**The claims handling process and good faith**

4.72 The courts have also found that the post-contract duty of good faith can be applied to a variety of other situations. Naidoo and Oughton describe it as "an emerging principle of good faith in the way in which insurers handle claims".[87]

4.73 In *Gan Insurance v Tai Ping Insurance (No 2),*[88] Tai Ping reinsured third party liability risks with Gan. The reinsurance policy contained a claims co-operation clause, which stated that "no settlement and/or compromise shall be made and liability admitted without the prior approval of reinsurers". Among other things, the reinsurers alleged that the insurers had agreed a settlement and admitted liability without their approval.

4.74 Lord Justice Mance held that the reinsurer's right of approval under the claims co-operation clause was not unqualified. He said that it was:

[83] Above, by Rix LJ at p 628, para 87.

[84] Above, by Rix LJ at p 629, para 89.

[85] Above, by Rix LJ at p 629, para 91.

[86] Above, by Pill LJ at p 649, para 177. Clarke LJ also raised this point but declined to decide it.

[87] A Naidoo & D Oughton, "The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination" [2005] *Journal of Business Law* 346 to 371, at p 364.

[88] *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* [2001] EWCA Civ 104; [2001] CLC 1103.

> A right to be exercised in good faith after consideration of and on the basis of the facts giving rise to the particular claim, and not with reference to considerations wholly extraneous to the subject-matter of the particular reinsurance or arbitrarily.[89]

4.75 He also gave examples of when an insurer's behaviour might amount to bad faith. This might include deliberate delay:

> Another example might be that of a reinsurer who withheld approval because it had decided, for reasons unrelated to the particular claim, that it wished as reinsurer to prolong payment of any claims for as long as possible.[90]

4.76 In *Eagle Star Insurance Co Ltd v Cresswell*,[91] the Court of Appeal again found that the insurer was obliged to exercise its contractual rights in good faith. The claimant obtained reinsurance from the defendant reinsurers. The insurers received and compromised claims, but the reinsurers refused to indemnify them, relying on a claims control clause. This said that the reinsurers "shall control the negotiations and settlements of any claims under this Policy".

4.77 The Court of Appeal held that the clause gave the reinsurers discretion to take control of any negotiation or settlement. This discretion was, however, tempered by the doctrine of good faith. Lord Justice Rix held that this duty arose from an implied term, saying:

> If, while exercising or refusing to exercise control, the reinsurers act in bad faith, capriciously or arbitrarily, then there is the implied term found by Mance LJ and Latham LJ in *Tai Ping* to protect the reinsured….[92] But this protection may not depend only on a term to be implied 'for business efficacy', but may be inherent as a matter of law in the very essence of the reinsurers' mutual obligation of good faith.[93]

4.78 More recently, it has also been suggested that where a policy term gives an insurer discretion to waive compliance with certain terms, the insurer must consider any request for such a waiver in good faith.[94]

**Four types of avoidance**

4.79 The preceding discussion suggests that an insurer may avoid a contract in four ways:

[89] Above, at p 1136, para 76.

[90] Above, at p 1134, para 68.

[91] [2004] EWCA Civ 602; [2004] 1 CLC 926.

[92] In *Tai Ping*, Sir Christopher Staughton disagreed in the respect that the duty arose from an implied term.

[93] *Eagle Star Insurance Co Ltd v Cresswell & others* [2004] EWCA Civ 602; [2004] 1 CLC 926, by Rix LJ at p 960.

[94] *Anders & Kern UK Ltd (T/A Anders & Kern Presentation Systems) v CGU Insurance plc (T/A Norwich Union Insurance)* [2007] EWCA Civ 1481*; Diab v Regent Insurance Co Ltd* [2006] UKPC 29; [2007] 1 WLR 797.

(1) *An avoidance may be legally correct and in good faith*. Clearly, insurers are fully entitled to act in this way, and there is no question of giving the policyholder a remedy in these circumstances.

(2) *An avoidance may be legally correct, but not in good faith*. There is conflicting case law on how far the courts will recognise this form of avoidance. However, it is not an issue we address directly in this paper. Instead, in our 2009 Report,[95] we proposed reforms to the law on avoidance for non-disclosure to close the gap between what is legally correct and what is fair.

(3) *An avoidance may not be legally correct, but nevertheless made in good faith*. An example would be *The Italia Express*,[96] where the insurers suspected the owner of deliberately sinking the vessel, and pursued these allegations "fairly but persistently" for three and a half years. The insurers' view was formed honestly and reasonably, but in the event, the insurers were unable to prove it. If the *Sprung* decision were to be reversed, the insurers would be considered to be in breach of contract, and liable for the foreseeable consequences of their delay. However, for business insurance, this liability could be excluded by a contract term.

(4) *An avoidance may not be legally correct, and not made in good faith*. An example would be where an insurer quite wrongly turned down a claim simply to improve its cash flow. If *Sprung* were to be reversed, and a new damages remedy provided for bad faith behaviour, the insurer would be liable on two separate (but concurrent) bases: first for refusing a claim wrongly and secondly for refusing a claim in bad faith. The difference would be that the second liability could not be excluded by a contract term. The parties may agree to slow payment, but may not agree to claims being considered in bad faith.

**Cases on the insurer's obligations: conclusion**

4.80 The development of the concept of good faith as a post-contract duty of the insurer has been described as "embryonic".[97] The extent of an insurer's duty remains uncertain. For example, it is difficult to reconcile the conflicting approaches of *Brotherton* and *Drake*. However, developments suggest that in some cases an insurer may be required to exercise its rights in good faith. This may, for example, require an insurer to make enquiries, not to act arbitrarily, and not to take into account wholly extraneous circumstances. Deliberate delay to help the insurer's cash flow, for reasons wholly unconnected with the merits of the claim, may also be a breach of good faith.

[95] *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* ((2009) Law Com No 319/Scot Law Com No 219)

[96] *Apostolos Konstantine Ventouris v Trevor Rex Mountain ("The Italia Express (No 3)")* [1992] 2 Lloyd's Rep 281.

[97] R Merkin, "Reforming insurance law: is there a case for reverse transportation?" Report for the English and Scottish Law Commissions, at p 12.

## THE NEED FOR REFORM

4.81 Contracts of insurance are ultimately contracts based on trust. One party pays money to another not in return for goods or services but against a promise to pay should an agreed event occur. The insurer has to be confident that the policyholder has provided a fair presentation of the risk. The policyholder has to be confident that the insurer will investigate and consider its claim fairly, free from bias and prejudice. Mutual duties of good faith reinforce the parties' contractual arrangements.

4.82 Many cases define the insured's duties, but far fewer cases consider the insurer's duties. However, there are suggestions in the case law that the insurer should make enquiries, not act arbitrarily, and not take into account wholly extraneous circumstances. Deliberate delay to help the insurer's cash flow, for reasons wholly unconnected with the merits of the claim, may also be a breach of good faith.

4.83 In our view, the law should provide the parties with appropriate remedies if these obligations are breached. It is wrong that the only remedy available to an insured whose insurer has acted in bad faith is to avoid the contract. Given that most policyholders want their claims paid, the remedy of avoidance is of no practical value to the insured in these circumstances.[98] Instead, an insured who has suffered foreseeable loss from the insurer's bad faith actions should be entitled to damages.

4.84 The law on good faith has been codified in sections 17 to 20 of the Marine Insurance Act 1906. This means that the courts are constrained in how far they can develop the law in this area. We tentatively conclude that statutory reform is needed. In Part 9 we therefore make tentative proposals for reform.

[98] See paras 4.22 and 4.23 above.

# PART 5
# OTHER REMEDIES

5.1 In this Part, we discuss four other possible remedies which may be available to a policyholder who has suffered loss as a result of the late payment of a claim. We start by considering the rules on interest. We then outline the possibility of a claim for breach of statutory duty for failing to comply with Financial Services Authority rules. Thirdly, we briefly discuss the tort of deceit (or, in Scots law, the delict of fraud), which may be available to policyholders in particular cases. Finally, we consider the very different way in which the law treats a failure to reinstate (that is, to repair or replace property) to a satisfactory standard within a reasonable time. For example, where an insurer has agreed to reinstate but fails to do so, the courts are prepared to award damages for distress and inconvenience.

## INTEREST

5.2 The main compensation for late payment is statutory interest. The provisions under which interest may be awarded differ between England (and Wales) and Scotland. Here we give a brief summary of each.

### Statutory interest in England and Wales

5.3 The Law Commission described the various ways in which pre-judgment interest may be awarded in its 2004 report, Pre-Judgment Interest on Debts and Damages.[1] The main provision is section 35A of the Supreme Court Act 1981 and its county court equivalent.[2] The section provides that the interest must be simple, not compound. Other than that, it gives the court a wide discretion. The discretion extends to whether to award interest at all; to the rate of interest; and to the period for which interest should be awarded.

5.4 In 2004 the Law Commission found a wide variety of approaches to setting interest rates. The most common approach was to follow the judgment rate, which was set at 8% in 1993 and has not been changed since. A survey of general county court work found that 8% was still the rate most commonly claimed, although at a time of low interest rates it was clearly too high. In the Commercial Court it was more common to set a rate of 1% above the base rate or the interest rate at which banks lend to each other, known as LIBOR (London Inter-Bank Offered Rate). However the 1% above base figure was described as "no more than a presumption".[3] It could be displaced by evidence of the rates applying to borrowers with the general attributes of the claimant. For example, in *Jaura v Ahmed*, the Court of Appeal allowed a rate of 3% above base, on the grounds that this was a more realistic assessment of the rate at which small businesses borrowed.[4]

1 (2004) Law Com No 287.

2 County Courts Act 1984, s 69.

3 (2004) Law Com No 287, at para 3.13.

4 [2002] EWCA Civ 210.

5.5 In indemnity insurance a strict legal analysis suggests that interest should run from the date of the loss. In practice the courts have used their statutory discretion to decide that interest should run from a later point: either from the time at which a claim is notified; or even from the time at which a reasonable investigation of the claim ought to have been completed.[5]

5.6 As a compensatory remedy, an award of interest under section 35A is limited. First such interest is only available as the result of court proceedings. Second the interest awarded must be simple. In its 2004 Report the Law Commission recommended that the courts be granted a power to award compound interest, but acceptance of these proposals is still pending.

**Interest in Scotland**

5.7 Under Scots law, entitlement to interest differs according to whether the principal sum claimed consists of a contractual debt on the one hand or damages on the other. Since, according to the Scottish analysis, the right to payment of a policyholder is contractual, entitlement to interest depends upon the rules for contractual debt. In the absence of any express entitlement under the terms of the policy, interest is payable at common law but does not begin to run until payment is "wrongfully withheld" by the insurer. This phrase has been interpreted to mean that interest does not run until a judicial demand has been made, i.e. until an action for payment has been raised.[6] There is probably no judicial discretion to award interest on debt from any earlier date.[7] From the date when the action is raised, interest runs at the judicial rate, that is, the rate prescribed for post-decree interest.[8]

5.8 Compound interest is only payable in exceptional circumstances, such as breach of trust, or where there is an established commercial usage. None of these exceptions is likely to be relevant to a claim for payment under an insurance policy, and accordingly any interest awarded will be simple interest only.

5.9 In its 2006 Report on Interest on Debt and Damages,[9] the Scottish Law Commission recommended the creation of a general statutory entitlement to (simple) interest on contractual debts. In the case of interest on a sum payable under a contract of insurance, it was recommended that interest should begin to run from whichever is the later of:

[5] *Rhesa Shipping Co SA v Edmunds* [1984] 2 Lloyd's Rep 555.

[6] *Carmichael v Caledonian Railway Co* (1870) 8M (HL) 119, by Lord Westbury at p 131; *Blair's Trs v Payne* (1884) 12R 104. For a discussion of the current law regarding interest on contractual debt, see the Scottish Law Commission Discussion Paper No 127 on *Interest on Debt and Damages* (2005), at paras 2.10 to 2.23 and the Scottish Law Commission Report on *Interest on Debt and Damages* ((2006) Scot Law Com No 203).

[7] *Dean Warwick Ltd v Borthwick* 1983 SLT 533, by Lord Cameron at 535; *Elliot v Combustion Engineering Ltd* 1997 SC 126. This may be contrasted with the position regarding interest on damages, which may be awarded for any period since the date when the right of action arose: Interest on Damages (Scotland) Act 1958, s 1(1) (as substituted by the Interest on Damages (Scotland) Act 1971, s 1).

[8] Rules of the Court of Session 1994, rule 7.7. As in England and Wales, the rate has been 8% per annum since 1993.

[9] (2006) Scot Law Com No 203.

(1) the date 30 days after the date when a claim in respect of the occurrence of the event insured against is intimated to the insurer and vouched in accordance with the conditions of the contract; or

(2) where the insured has sustained a loss as a consequence of the occurrence of the event insured against, the date when the loss was sustained.[10]

5.10 These recommendations have not yet been implemented.

**The Late Payment of Commercial Debts (Interest) Act 1998**

5.11 The Late Payment of Commercial Debts (Interest) Act 1998 covers the UK. It was introduced to protect small businesses against the late payment of commercial debts. Since 2002, however, it applies to all commercial creditors – both large and small businesses – who are owed money by other commercial organisations. The 1998 Act is intended to be penal. Interest is awarded to penalise late payers, and encourage prompt payment of debts. The rate is therefore set at 8% above the base rate.

5.12 The 1998 Act grants interest as of right, rather than as a matter of discretion. It applies to contracts "for the supply of goods or services where the purchaser and the supplier are each acting in the course of a business".[11] Interest starts to run on the day after the agreed date for payment,[12] and is available irrespective of whether court proceedings have been issued.

5.13 It is not clear how far the Act applies to the late payment of insurance claims. While insurance contracts are not one of the types of contracts specifically excluded from the 1998 Act, it is doubtful that it would apply where an insured is seeking a remedy for late payment of a claim. The Directive underlying the 1998 Act appears to exclude insurance claims in Recital 13 of the Preamble.[13] Furthermore, the characterisation of an indemnity insurance claim as one for damages, rather than a debt, would seem to exclude such a claim from being one which might be subject to an award of interest under the 1998 Act. This, however, would not be an issue under Scots law.

[10] Above, paras 3.24 to 3.29.

[11] Section 2(1). The definition specifically excludes consumer credit agreements and mortgages (section 2(5)).

[12] Section 4(4).

[13] Directive 2000/35/EC on combating late payment in commercial transactions.

### Interest as damages

5.14 In Part 2 we discussed the decision in *Sempra*.[14] Here the House of Lords confirmed that a creditor may recover damages for the wrongful detention, non-payment or late payment of a debt. This means that it is open to a creditor to plead and prove the interest they have actually paid. If the need to borrow at this rate was foreseeable at the time the contract was made, and if the creditor has acted reasonably in mitigating the loss, then this interest may be recovered as damages. The main advantage is that interest may be compound rather than simple.

5.15 It is clear that this form of damages is open to policyholders under Scots law.[15] However, it is still unlikely that a claim would be successful in England and Wales, at least at first instance. As discussed in Part 2, insurance claims are categorised as damages rather than debts, and *Sempra* did not apply to claims for damages.[16]

## BREACH OF STATUTORY DUTY

5.16 The Financial Services Authority (FSA) has an important influence on the approach taken by insurers to handling and paying claims. Detailed rules are contained in the Insurance Conduct of Business Sourcebook (ICOBS). In particular, Rule 8.1.1 states that an insurer must:

(1) handle claims properly and fairly;

(2) provide reasonable guidance to help a policyholder make a claim and appropriate information on its progress;

(3) not unreasonably reject a claim (including by terminating or avoiding a policy); and

(4) settle claims promptly once settlement terms are agreed.

5.17 Breaches of the FSA Rules have two consequences. First, the FSA may take disciplinary action against the insurer and may, for example, impose a fine.[17] However, this may be of little comfort to a policyholder seeking compensation.

[14] *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v Inland Revenue Commissioners* [2007] UKHL 34; [2008] 1 AC 561.

[15] See, for example, *Caledonian Property Group Ltd v Queensferry Property Group Ltd* 1992 SLT 738, applying the first branch of *Hadley v Baxendale*.

[16] For a discussion on why *Sempra* should apply to insurance claims, see M Clarke, "Compensation for failure to pay money due: a 'blot on English common law jurisprudence' partly removed" [2008] *Journal of Business Law* 291.

[17] Financial Services and Markets Act 2000, s 66.

5.18 Second, in principle, consumer policyholders may bring a claim for damages against a regulated firm for breach of statutory duty under section 150 of the Financial Services and Markets Act 2000. This provision is little used, however, and there are very few reported cases where it has been applied since coming into force.[18] It would appear that most consumers would find it easier to bring a complaint to the Financial Ombudsman Service (described in Part 6) than attempt a complex and novel action for breach of statutory duty before the courts.

5.19 These claims are not open to businesses: potential claimants must be private persons, and must not suffer the loss in question in the course of carrying on business of any kind.[19]

### THE TORT OF DECEIT OR THE DELICT OF FRAUD

5.20 The tort of deceit provides that a party will be liable to another if they knowingly make a false statement of existing fact, intending that the other should rely on it, with the result that the other acts on the statement to their detriment.[20]

5.21 A similar action is available in Scots law, where the delict of fraud provides a ground for the recovery of damages when a person fraudulently induces another to act to their economic detriment. In relation to a fraudulent misrepresentation, it "may be a false statement of fact or law, but it can take the form of positive conduct, active concealment or failure to disclose where there is duty to disclose."[21]

5.22 The English tort of deceit takes its modern form from the decision of the House of Lords in *Derry v Peek*, where Lord Herschell set out the test for proving fraud:

> Fraud consists in "a false representation made by the defendant knowingly, or without belief in its truth, or recklessly, careless whether it be true or false, with the intention that the plaintiff should act in reliance upon the representation, which causes damage to the plaintiff in consequence of his reliance upon it."[22]

The same test has also been adopted in Scots law.[23]

[18] See, for example, *Spreadex Ltd v Sekhon* [2008] EWHC 1136 (Ch). The claimant spread-betting company brought a claim against a private individual seeking payment for sums owed. The private individual defending the claim counter-claimed under s 150 of FSMA 2000 for breach of the Conduct of Business Rules r 7.10.5. Morgan J held that the defendant was entitled to damages, but his contributory liability was set at 85%.

[19] Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001, SI 2001/2256, Reg 3.

[20] S Deakin, A Johnston & B Markesinis, *Markesinis and Deakin's Tort Law* (6th ed 2007), at p 565.

[21] 11 *Stair Memorial Encyclopaedia*, para 723.

[22] *Derry v Peek* (1889) 14 App Cas 337, by Lord Herschell LC at p 374.

[23] *Boyd & Forrest v Glasgow & South Western Railway Company* 1912 SC (HL) 93; *Robinson v National Bank of Scotland* 1916 SC (HL) 154.

5.23 In theory, this tort or delict might be available to a policyholder whose claim is improperly dealt with by their insurer. If, for example, the insurer tells the policyholder that property is worth less than it really is (while knowing or not caring about its true value) and, in reliance on that representation, the policyholder accepts a lower payment than they are entitled to, the insurer may be liable. Similarly, if the insurer states that it is not going to pay a valid claim because of some invented allegation, and the policyholder relies on this misrepresentation in arranging alternative compensation (such as raising a high-interest loan in order to replace damaged property), the insurer may be liable for that cost.

5.24 In cases where the tort or delict may be relied upon, the policyholder will be entitled to be put into the position in which he would have been had the fraudulent statement not been made. As an intentional wrongdoer, the insurer would not be entitled to the benefit of the reasonable foreseeability test usually applicable in tort and delict or the remoteness tests used in contract law (from *Hadley v Baxendale*[24]). Instead, the insurer would have to pay for all actual losses directly flowing from the action it induced.[25] The limitations of *Sprung* would therefore not apply.

5.25 However, this tort or delict is unlikely to be available in the vast majority of cases. The insurer must make a representation of fact which it knows to be false (or does not care whether it is false). Inaction will not suffice; nor would a mere statement of opinion that a claim is invalid. Further, the policyholder must rely on the representation to their detriment. In most cases involving late or non-payment, the policyholder is unlikely to have acted on an insurer's false statement in this way. For these reasons, the tort or delict is unlikely to help most policyholders when their valid claims are paid late or not at all.

**Criminal fraud**

5.26 In England and Wales, a new Fraud Act was passed in 2006, which simplified the criminal law on fraud into a number of broad offences. These offences are wider than the piecemeal law which they replaced. For example, under section 2 of the new Act, a person is guilty of fraud if they dishonestly make a false representation intending either to make a gain or to cause a loss to another (or expose another to a risk of loss). Alternatively, section 3 makes it an offence for a person to fail to disclose to another person information which they are under a legal duty to disclose, intending thereby to make a gain or cause loss to another.

[24] (1854) 9 Exch 341.

[25] S Deakin, A Johnston & B Markesinis, *Markesinis and Deakin's Tort Law* (6th ed 2007), at p 569. See 11 *Stair Memorial Encyclopaedia*, para 731.

5.27 The concepts of “gain” and “loss” in both fraud offences are broadly defined as including “a gain by keeping what one has” and “a loss by not getting what one might get”.[26] This would cover an insurer’s intended gain by keeping money it would otherwise have to pay out and the policyholder’s loss by not having their claim paid. Therefore, if an insurer makes a false representation to the policyholder, it might be guilty of fraud.

5.28 This opens the possibility that the victim of the fraud might be entitled to a compensation order.[27] However, this is unlikely to help in most of the circumstances considered in this paper.

## REINSTATEMENT

5.29 As a matter of practice, insurance policies often allow insurers to choose between paying a sum of money or reinstating the property damaged. Reinstatement generally means replacing property which has been destroyed or repairing property which has been damaged.[28] If an insurer does elect to reinstate rather than pay, it acquires obligations in relation to the quality of that reinstatement, breach of which can give rise to a claim in damages.

### Nature of the agreement

5.30 If the insurance contract allows the insurer to choose between payment of money and reinstatement, this choice is subject to the doctrine of election. That is, it must be made within a reasonable time, be unequivocal and be communicated to the person affected. The effect of a failure to elect in a reasonable time will depend on the wording of the policy, although generally the result will be that the insured simply can insist on one option or the other.[29]

[26] Fraud Act 2006, s 5. In Scots law, fraud at common law is the bringing about of some practical result by means of a false pretence. A large number of statutes create specific offences akin to common law fraud. See 7 *Stair Memorial Encyclopaedia*, paras 365 and 378.

[27] See Powers of Criminal Courts (Sentencing) Act 2000, s 130(1). In magistrates’ courts, compensation orders are limited to £5,000.

[28] *Anderson v Commercial Union Assurance Corp* (1885) 55 LJQB 146, at p 149.

[29] R Colinvaux & R Merkin, *Insurance Contract Law*, C-0452. For Scots law to the same effect in this area see 12 *Stair Memorial Encyclopaedia*, para 890.

5.31 The effect of election is that the insurer "is in the same position as if he had originally contracted to do the act which he has elected to do".[30] In other words, once the insurer has elected to reinstate, the insurance contract ceases to be a contract of indemnity and becomes a contract to reinstate. As such, the insurance policy effectively becomes a building contract or a repair contract.[31] The insurer must replace property destroyed "by other things which are equivalent to the property destroyed",[32] even if the cost of reinstatement proves to be greater than the sum insured[33] or than the amount of the loss measured on the basis of depreciation.[34]

5.32 Following an insurer's election to reinstate, the policyholder becomes obliged to allow the insurer to enter their land to carry out the repair or replacement work and the court will not grant the policyholder an injunction or interdict to restrain them.[35] A policyholder who refuses the insurer entry and does the reinstatement work personally will be left without a remedy under the policy.[36]

**Quality of reinstatement and statutory controls**

5.33 If the insurer elects to reinstate, the insurance policy is treated as if it had always been a contract for reinstatement. This rule is long-established in case law dating back to at least the middle of the nineteenth century.[37] As the policy effectively becomes a building contract or a contract for services, the Sale of Goods Act 1979 or the Supply of Goods and Services Act 1982 will apply to it.[38] This means that if the insurer replaces the lost subject matter with other goods, those goods would be expected, for example, to be fit for their purpose and of satisfactory quality. If not, the insured is entitled to reject them,[39] or to accept them and claim damages.

[30] *Brown v Royal Ins Co* (1859) 1 El & El 853, by Lord Campbell CJ at pp 858 to 859. Statement applied in *Maher v Lumbermen's Mutual Casualty Co* [1932] 2 DLR 593.

[31] N Legh-Jones, J Birds & D Owen (eds), *MacGillivray on Insurance Law* (11th ed 2008), at para 21-006.

[32] *Anderson*, see above, by Lord Esher MR at p 148.

[33] *Brown v Royal Ins Co*, see above; *Argy Trading Development Co Ltd v Lapid Developments Ltd* [1977] 1 Lloyd's Rep 67, by Croom-Johnson J at p 74. The FOS also takes this approach.

[34] *Swift v New Zealand Ins Co Ltd* [1927] VLR 249.

[35] *Bisset v Royal Exchange Assurance* (1821) 1 S 174.

[36] *Beals v Home Insurance* (1867) 36 NY 522.

[37] See, for example, *Brown v Royal Ins Co*, above, and *Home District Mutual Insurance Co v Thompson* (1847) 1 UC Er & App 247.

[38] See, for example: M Clarke, *The Law of Insurance Contracts* (5th ed 2006), 29-2D; CJ Miller & B Harvey, *Consumer Trading Law* (1985), Ch 3. For Scotland see Part 1A of the 1982 Act, added by the Sale and Supply of Goods Act 1994, Sch 1.

[39] *Braithwaite v Employers' Liability Assurance Corp* [1964] 1 Lloyd's Rep 94.

5.34 In addition, a contract of reinstatement would be subject to the Unfair Contract Terms Act 1977.[40] Although this Act does not apply to insurance contracts, it would apply to exemption clauses in a reinstatement contract for goods and services.

5.35 For the purposes of this discussion, the important point is that insurers may face liability in damages for any loss of profit or other consequential loss caused to the policyholder by failing to reinstate within a reasonable time.[41] The breach will be dealt with under normal contractual principles, and will not be subject to the type of arguments put forward in *Sprung*.[42]

## DAMAGES FOR DISTRESS AND INCONVENIENCE

5.36 Another contrast is that 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. However, if the insurer simply fails to respond to the claim at all, such damages may not be awarded.

5.37 For consumers this is an important distinction, which we examine in more detail below.

### Damages for distress and inconvenience in English law

5.38 The general principle is that compensation is only awarded for financial loss, and for pain, suffering and loss of amenity. There are, however, two exceptions to this general rule. The first, following the House of Lords decision in *Farley v Skinner*,[43] is where a major or important object of the contract was to give pleasure, relaxation or peace of mind. The other is where some physical inconvenience and discomfort have been caused by the breach.[44]

5.39 In *Farley v Skinner*, the claimant, who was considering buying a house, asked the defendant surveyor to investigate whether the property would be affected by aircraft noise. The surveyor reported that it was unlikely it would. When the claimant bought the house and moved in, he found that the surveyor had been incorrect. The House of Lords held that the claimant was entitled to £10,000 for the distress and disappointment which had resulted – although this was described as being "at the very top end of what could possibly be regarded as appropriate damages".[45]

[40] R Colinvaux & R Merkin, see above, C-0457. As far as consumer contracts are concerned, the Unfair Terms in Consumer Contracts Regulations 1999 will apply to both insurance and reinstatement contracts.

[41] Supply of Goods and Services Act 1982, s 14. See Colinvaux & Merkin, above, at C-0455, who refer to *Ferruzzi France SA v Oceania Maritime Inc* ("*The Palmea*") [1988] 2 Lloyd's Rep 261.

[42] *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70.

[43] [2001] UKHL 49; [2002] 2 AC 732.

[44] *Watts v Morrow* [1991] 1 WLR 1421, by Bingham LJ, cited with approval (in this respect) by the House of Lords in *Farley v Skinner* [2001] UKHL 49; [2002] 2 AC 732.

[45] *Farley v Skinner*, see above, by Lord Steyn at p 751.

5.40 An example of compensation for distress following property damage is *Glen Haysman v Mrs Rogers Films Ltd*.[46] Here, the defendant film company had contracted to use the claimant's house as a film location. The agreement included a term indemnifying the claimant for loss and damage to the property. In using the house, damage was caused and the claimant sued for that damage, and for the distress and inconvenience he had suffered in seeing his home damaged. The Deputy High Court Judge held that an important object of the contract had been to provide the claimant with peace of mind – the indemnity clause was a significant feature of the bargain, and had the clear purpose of giving the claimant reassurance. He therefore awarded £1,000 for the claimant's inconvenience and upset. There are several similar cases allowing payments for distress and inconvenience for breach of construction contracts.[47]

**Damages for distress and inconvenience in Scots law**

5.41 Under Scots law, damages may be awarded for trouble and inconvenience resulting from a breach of contract.[48] Such a claim is not categorised as a claim for personal injury and may be awarded to a company as well as to an individual.[49] It extends beyond physical inconvenience and discomfort and includes, for example, protracted correspondence resulting from the breach.

5.42 As regards claims for distress or anxiety, the position under Scots law is similar to that in England and Wales. Recovery for "inconvenience" does not generally extend to emotional reaction, such as grief or distress, falling short of a recognised psychiatric illness.[50] However, it appears that Scots law does recognise the exception identified by Bingham LJ in *Watts v Morrow*[51] where the object of the contract is to provide pleasure, relaxation or peace of mind.[52] In *Mack v Glasgow City Council*,[53] the court drew a distinction between:

[46] [2008] EWHC 2492 (QB).

[47] *Eiles v Southwark Borough Council* [2006] EWHC 1411 (TCC); *Iggleden v Fairview New Homes (Shooters Hill) Ltd* [2007] EWHC 1573 (TCC).

[48] *Webster & Co v Cramond Iron Co* (1875) 2R 752; *Wilkie v Brown* 2003 SC 573; *Mack v Glasgow City Council* 2006 SC 543.

[49] For example, *Webster & Co v Cramond Iron Co* (above); *Aarons & Co Ltd v Fraser* 1934 SC 137.

[50] *Simpson v Imperial Chemical Industries Ltd* 1983 SLT 601; *Simmons v British Steel plc* 2004 SC (HL) 94, by Lord Hope of Craighead at para 24.

[51] See para 5.38 above.

[52] See Scottish Law Commission Report No 174 on Breach of Contract (1999), para 3.3; McBryde, *Contract*, at paras 22.104 to 22.105. Examples include *Diesen v Samson* 1971 SLT (Sh Ct) 49; *Colston v Marshall* 1993 SCLR 43.

[53] 2006 SC 543, Extra Division at para 10.

> …an emotional reaction to the mere fact of breach of contract, which does not sound in damages at all (save in the exceptional category of case identified by Bingham LJ) and 'inconvenience' (to use Lord Clyde's terminology)[54] or 'physical inconvenience and discomfort' (to use the language used by the other judges quoted), caused by circumstances brought about by the breach of contract, which will sound in damages.

**Distress and inconvenience in insurance contracts**

5.43 It appears that an award may be made where the insurer has elected to reinstate the insured's property and then caused distress or inconvenience through bad or slow workmanship. In *AXA Insurance UK v Cunningham Lindsey UK*[55] the claimant insurer sued its loss adjuster for professional negligence in the way it handled the process of reinstating the insured's property. As part of the claim that the insurer had settled with its insured, £92,000 had been included for distress and inconvenience. Mr Justice Akenhead held that this was too much, and could therefore not all be passed on to the loss adjusters. He did decide that an award would have been payable, however – albeit one that probably would have been no more than £1,800 per person per year. He noted that the authorities suggested a maximum of around £2,000 per person per year for inconvenience and distress.

5.44 However, where a claim has been made for distress or inconvenience as a result of an insurer's failure to pay a claim at all, the courts have not granted redress. In *The Italia Express*,[56] Mr Justice Hirst put the point as follows:

> Such damages in contract are only recoverable where the contract which has been broken was itself a contract to provide peace of mind or freedom from distress… [Counsel] submitted that I should "make the leap" and hold that a contract for marine insurance is a contract of this character. I find this suggestion impossible to accede to, not only because of the very nature of the contract itself (to provide financial indemnity for commercial loss damage liability and expense), but also because, as has been pointed out in other cases, in the vast majority of marine insurance contracts the assured is not an individual but a company, which could never invoke the "peace of mind" test.[57]

5.45 In *England v Guardian Insurance Ltd*,[58] the court came to the same conclusion in a consumer case, concerning a home policy. Judge Thornton QC said:

[54] See *Farley v Skinner* above.

[55] [2007] EWHC 3023 (TCC).

[56] *Ventouris v Mountain ("The Italia Express") (No 3)* [1992] 2 Lloyd's Rep 281.

[57] Above, at p 293.

[58] [1999] 2 All ER (Comm) 481.

> Distress and inconvenience damages are only awarded as damages for breach of contract where the contract is one to provide personal service or enjoyment to the plaintiff, such as are provided by professionals or holiday companies. Such damages are not awarded for breach of commercial contracts such as policies of insurance. Insurance policies only provide cover for such a loss where the cover expressly extends to provision of peace of mind or freedom from distress of the insured.[59]

**Distress and inconvenience: conclusion**

5.46 We agree with the courts that damages for distress and inconvenience are not appropriate for commercial insurance. However, they may well be appropriate where a consumer is left for a prolonged time with the distress and inconvenience of a damaged home. As noted above, this would probably go further than the present recovery for "inconvenience" available in Scots law.

5.47 Where an insurer has agreed to reinstate a consumer's home, but has not carried out the required work, the courts may be prepared to award damages for distress and inconvenience. The amounts are small. A guiding principle appears to be that such awards should be "restrained and modest".[60] By contrast, where the insurer wrongly rejects the claim, or fails to respond to it at all, such damages do not appear to be available.

5.48 It is difficult to justify this distinction in policy terms. As we see in Part 6, the Financial Ombudsman Service does not follow this distinction. Instead, it is prepared to award restrained, modest damages in both types of case.

**CONCLUSION**

5.49 The four alternative remedies discussed in this Part may sometimes assist policyholders who have suffered loss as a result of their insurer's late payment. For example, the court's discretion to award interest on the sum claimed might be exercised so that a policyholder receives more than they would otherwise be entitled to. This would compensate them for extra expenditure incurred while the insurer refused to pay out. Or a policyholder might be able to insist on reinstatement, which would entitle them to damages in the event that their property was not reinstated within a reasonable time.

5.50 However, we think that these remedies will only apply in very specific circumstances and only to a limited range of claimants. A claim for breach of statutory duty, for example, is only open to consumers and not to businesses. Similarly, the tort of deceit or the delict of fraud would only be available to policyholders in very particular (and unusual) situations. We think that in the vast majority of cases, policyholders who have suffered loss due to a late or non-payment will have no effective remedy under English law, while their remedies in Scots law are less extensive than may be appropriate.

[59] Above, at para 74.

[60] *Farley v Skinner*, see above, by Lord Steyn at p 751.

# PART 6
# THE FINANCIAL OMBUDSMAN SERVICE

6.1 Complaints about delayed payment and bad claims handling form a regular part of the work of the Financial Ombudsman Service (FOS). The FOS estimates that around one in ten complaints contains a claim for a loss that would not have arisen had an insurer paid a claim within a reasonable time. The sums claimed for further losses range from no specified amount to thousands of pounds.

6.2 The FOS has a jurisdiction to hear complaints from both consumers and from small businesses. Previously businesses with a turnover of less than £1 million could have their claims heard by the FOS. On 1 November 2009 this changed to businesses with an annual turnover of less than €2 million and less than ten employees.[1] Under the Financial Services and Markets Act 2000, it is required to decide disputes "by reference to what is in the opinion of the ombudsman, fair and reasonable in all the circumstances of the case".[2] This means that although the FOS will have regard to the law, where the legal result would be at odds with what it considers to be fair and reasonable, then the law will not be applied. We were therefore interested to see how far the FOS departs from the strict case law in deciding cases about loss caused by insurers' late payment in consumer and small business disputes.

6.3 Our discussions with the FOS, together with a reading of FOS documents and six sample cases, have suggested that the FOS will compensate for the effects of late payment in three ways: through interest; through awards for distress and inconvenience; and, occasionally, through the award of damages to compensate for financial loss. Below we look at each in turn.

### INTEREST PAYMENTS

6.4 When a claim has been wrongly refused the FOS will generally order interest to compensate the consumer for being out of funds. The FOS generally follows the courts by awarding 8% from the date that the claim should have been paid until the date of the award.[3] However, it may award a different rate where this would more accurately reflect the consumer's loss. An example would be where the insurance was partly an investment.

[1] FSA Handbook, DISP 2.7.3.

[2] Section 228 (2). The FOS will first attempt to resolve disputes by mediation. If that fails, an adjudicator investigates the disputes. If either party remains dissatisfied, then disputes can be referred to an ombudsman. At all three stages, the FOS will attempt to find a solution that is fair and reasonable in the circumstances.

[3] In Ombudsman News Issue 33, it says "we would award the value of the claim, plus simple interest at 8% per year ….from the date of the incident to the date when the firm settles the claim".

## DISTRESS AND INCONVENIENCE

6.5 Where the insurer has caused distress and inconvenience by mishandling a claim, the FOS will order the insurer to make some kind of reparation. The FOS considers the degree of distress caused to the policyholder that is attributable to that failing, and may make a monetary award. These awards are compensatory rather than penal, and tend to be low. The reparation can range from an order to send flowers, to a significant award of between £300 and £999, to an award of a sum exceeding £1,000 in exceptional cases. Examples of "significant" and "exceptional" cases are given below.[4]

> Example: Case 1 - *significant compensation (£300 to £999)*
>
> A woman required emergency surgery while abroad. Her insurer failed to give approval for the cost of an operation within a reasonable time. As the condition was life threatening, she had the operation at her own expense. The insurer eventually paid for the cost of the operation.
>
> The FOS awarded "significant compensation" of £300 to £999.

> Example: Case 2 - *significant compensation (£300 to £999)*
>
> A man became seriously ill while on holiday. His treating physician said to the man's travel insurers that there was an urgent need for repatriation. The insurers insisted that a formal medical report would have to be produced in line with the policy wording. The insured had to pay for his flights back himself.
>
> The FOS considered that the insurer's insistence was in the circumstances unreasonable. In addition to an award to reimburse the travel expenses, a significant award was made for distress and inconvenience.[5]
>
> The FOS awarded "significant compensation" of £300 to £999.

> Example: Case 3 - *exceptional compensation (£1,000 or more)*
>
> An elderly couple whose home had suffered subsidence had to wait 5 years for their home to be repaired. Despite knowing of the consumers' particular circumstances, the insurers failed to provide them with alternative accommodation.
>
> The FOS awarded "exceptional compensation" of at least £1,000.

[4] For further examples, see http://www.financial-ombudsman.org.uk/publications/technical_notes/distress-and-inconvenience.htm .

[5] Further details of this case are in http://www.financial-ombudsman-news/56/56-travel-insurance.htm56/4 .

6.6 In Part 5, we discussed the distinction made by the courts between the insurer's failure to carry out the agreed reinstatement and the insurer's failure to meet the claim at all. Where an insurer has agreed to reinstate, but has done so inadequately, damages for inconvenience are available - though they tend to be low. The FOS follows the law in this area, and awards damages on a similar scale.

6.7 However, the courts have, until now, refused to award damages for distress and inconvenience where the insurer fails to pay a sum of money, or fails to respond to the claim at all. It is difficult to justify this distinction in policy terms, and the FOS does not follow it. The FOS considers that it is important for financial service providers to provide a reasonable service. Where the service falls short of that which ought to have been delivered, it is the practice of good suppliers to make voluntary payments to cover distress and inconvenience. The FOS awards such payments because they represent good industry practice. Under its statutory jurisdiction it may do this where it is fair and reasonable in the circumstances.

**COMPENSATION FOR FINANCIAL LOSS**

6.8 The FOS will also consider awarding compensation for further financial losses caused by delayed payment, non-payment, poor claims handling or poor repair. The FOS considers that insurers should provide a proper service, and where the insurer has failed to do so, the insured may be compensated for the consequences. Where the complainant can prove actual loss, the award may be substantial. 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. The FOS thought that the insured's losses were probably more than £100,000, and it recommended that the insurer pay the balance on a voluntary basis.

6.9 The FOS attributes liability on two bases.

(1) The FOS considers that insurers should pay claims within a reasonable time. Thus it is prepared to order compensation for further losses flowing from a failure to pay within a reasonable time. Unlike the Court of Appeal in the *Sprung* case,[6] the FOS would consider that it is the insurer, rather than the insured, that is responsible for the consequences of unreasonable delay.

(2) It is now common under consumer insurance policies, such as property insurance, for the insurer to carry out repairs or reinstatement itself. Where an insurer undertakes or is otherwise obliged to put right a loss by repair or reinstatement, the FOS expects that to be done expeditiously and to a reasonable standard. Again, the insurer may be required to compensate an insured for a failure to provide the required service.

[6] *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70.

6.10 Whichever basis is applied, the FOS takes account of the duty of policyholders to mitigate their loss, as far as they are able to do so. However, the FOS accepts that one reason for taking out insurance is that families do not have the money available to meet the costs of expensive repairs or medical bills unless the claim is paid. The FOS will therefore not require policyholders to mitigate when they cannot do so because they do not have the resources. This could be seen as consistent with developments in the common law since *Sprung*, to the effect that the obligation to mitigate a loss is limited to the actual financial ability of the victim of a breach.[7]

6.11 In some cases, the FOS is prepared to cover the cost the insured has incurred in borrowing money at high rates. For example, the FOS told us that where a travel insurer failed to pay the emergency medical costs incurred abroad within a reasonable time, the insurer may be required to pay the consumer's additional costs. These might include the insured's high credit card charges, if these were incurred necessarily.

**Foreseeable loss**

6.12 As we discuss in Part 2, an important principle of contract law is that the parties may only be compensated for a loss arising as a result of a breach of contract if that loss was foreseeable at the time the contract was made.

6.13 We were interested to explore how far the FOS would be prepared to compensate consumers for additional losses arising out of unusual circumstances which were communicated to the insurer at the time of the claim, but which were not foreseeable at the time the contract was made.

6.14 A hypothetical example would be where a policy provides for immediate repatriation in the event of medical emergency. A medical emergency occurs in a place with one reasonably accessible airport. An insured, when making a claim, reports to the insurer that it must act quickly to avoid the effects of an airport staff strike that may happen in a week's time. What would happen if the insurer fails to act within a reasonable time and the consumer is required to incur the expense of a long land journey to an alternative airport, again having to borrow money at high rates?

6.15 We were told that in appropriate circumstances, the FOS would be prepared to compensate the insured for the additional losses, even though this series of events was not foreseeable at the time the policy was entered into. The fact that the insurer did not act within a reasonable time in any event, and that the possibility for further loss was made known to the insurer at the time of the claim, may be sufficient to make the insurer liable for the loss.

[7] *Lagden v O'Connor* [2003] UKHL 64; [2004] 1 AC 1067, discussed at paras 2.24 to 2.26 above.

6.16 Another hypothetical example would be where the insurer was responsible for delays in repairing a property following flood damage. A family might be particularly vulnerable to damp because their child was asthmatic. If the insurer was told that the child's asthma made it particularly important for the house to be repaired within a reasonable time, the FOS would be prepared to provide compensation, even though the insurer was unaware of the asthma at the time the insurance was taken out. This would be another example of a failure to reinstate, which the law considers to be a separate contract. Thus the law would look to what was foreseeable at the time the insurer agreed to the reinstatement.

**The effect of exclusions or limitations**

6.17 Two types of exclusions are relevant:

(1) Where a policy covers a loss of type x, but excludes a loss of type y; and

(2) Where there is a maximum sum capable of being claimed under the policy.

6.18 An example of the first sort of exclusion is to be found in a policy that guaranteed the standard of build of residential properties.

> Example: Case 4
>
> This case concerned an owner of three newly built apartments that were bought with the benefit of insurance that would cover structural defects. The policy covered the cost of repair, but stated that the insurer "will not be liable for…loss of enjoyment, use, income or business opportunity or any other consequential loss affecting [the owner] or any loss to [the owner's] home".
>
> There were defects found within the policy period. The insurers undertook to put them right. However, there were significant delays in the course of effecting the repairs and the workmanship was said to be bad. The owner claimed, among other things, that he had lost profit by being unable to sell the properties at the market value that he could have obtained had the work been done well and within a reasonable time.
>
> On the facts, the FOS was not persuaded that the loss of profit was established, but did consider the evidence submitted in support of that part of the claim. An award in the sum of £500 was made for inconvenience, miscellaneous additional costs and annoyance.

6.19 Case 4 suggests that, had there been clear proof of loss of profit or rental income, the FOS may have been prepared to award substantial compensation.

6.20 In a similar kind of policy (found in Case 5) the words, "will not be liable for any cost or expense greater than that necessary to effect a workmanlike repair of the relevant defect or major damage…", did not prevent the FOS from awarding the sum of £2,500 for distress and inconvenience caused to a complainant. The Ombudsman found that poor claims handling had caused serious illness to the insured, which was not precluded by the exclusion.

Example: Case 6

A taxi driver's insurers undertook to repair his car following an accident. The initial repairs that were carried out were deficient and the car had to be taken away a second time for further work. The taxi driver claimed, among other things, that he had lost income as a result of the deficient repairs. There was an exclusion clause in the policy that said, "not covered … loss of use of the car or any consequential loss".

Although on the facts the Ombudsman did not uphold a claim for loss of earnings, the Ombudsman noted: "Of course, this should not allow a firm to simply ignore the plight of a policyholder when unacceptable and avoidable delays that are directly its responsibility have caused proven lost earnings."

6.21 The FOS also told us that where there had been significant delays in repairing homes following the 2007 floods, the cost of alternative accommodation may in some cases have exceeded the limits set out in the relevant policies. The FOS would not allow the insurer to cease paying for alternative accommodation simply because the limit had been reached, if the excessive cost was due to the insurer's own delay. We understand the insurance industry has generally accepted this approach, and would not impose maximum limits in cases of serious delay.

# PART 7
# OVERVIEW OF COMPARATIVE LAW

7.1 In Appendix A, we discuss the laws applicable to the late payment of claims in Australia, Canada and the United States. We also provide a brief outline of the position in China, Germany, Italy and Spain. All these jurisdictions offer greater protection to policyholders than English law. In this Part we extract the main themes arising from a comparison between the laws of these jurisdictions and English law.[1]

**No other jurisdiction follows *Sprung***

7.2 The decision in *Sprung*[2] has not been applied, or cited with approval, in any case in Australia, Canada or the United States. Nor have the principles underlying that decision been followed in any of those jurisdictions. In Australia, Canada and the US, the primary obligation of insurers is characterised as a duty to pay valid claims, rather than as a promise to hold the policyholder harmless against the risk insured. In Australia, the courts have recognised, as a term implied in a contract of insurance, an obligation requiring the insurer to pay within a reasonable time.[3] Furthermore, the High Court of Australia[4] has disapproved Lord Brandon's dictum in *The Lips* that "there is no such thing as a cause of action in damages for late payment of damages"[5] – the principle which has proved fatal to the availability of damages for the late payment of claims in English cases.

**Contractual remedies are generally available for late payment of claims**

7.3 In Australia, Canada and some states of the United States, a policyholder may have recourse to general contractual remedies in the event of the delayed payment of an insurance claim. In particular, policyholders can seek damages for breach of contract which may, in appropriate circumstances, include damages for consequential loss. Whether damages are recoverable is usually assessed with reference to the principles expounded in *Hadley v Baxendale*[6] and subject to the requirements of causation and mitigation. The courts in Australia, Canada and the US have, for example, awarded damages for loss of a business;[7] for money paid out servicing loans;[8] and for mental distress and inconvenience.[9]

[1] As discussed in Part 3 above, Scots law differs from English law in the approach taken to redress for the delayed payment of claims; that is to say, Scots law offers greater protection to policyholders. Scots law will not, therefore, be discussed in this Part.

[2] *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70.

[3] See, for example, *Tropicus Orchids Flowers and Foliage Pty Ltd v Territory Insurance Office* [1997] NTSC 46.

[4] *Hungerfords v Walker* [1989] 171 CLR 125, by Mason CJ and Wilson J.

[5] *President of India v Lips Maritime ("The Lips")* [1988] AC 395 at p 425.

[6] (1854) 9 Exch 341.

[7] Eg in the United States, *Reichert v General Insurance Co* 428 P 2d 860 (Cal 1967).

[8] Eg in Australia, *Moss v Sun Alliance Australia Ltd* (1990) 55 SASR 145; (1990) 6 ANZ Ins Cas 60-967.

[9] Eg in Canada, *Warrington v Great-West Life Assurance Co* (1996) 24 BCLR (3d) 1 (CA).

7.4 China, Germany, Italy and Spain also allow some form of compensation where there has been late or non-payment of a claim. Indeed, all of the jurisdictions which we have examined provide remedies which are more generous to policyholders than those which are available under English law.[10]

**A mutual duty of good faith**

7.5 Australia, Canada and the United States all recognise that both parties to a contract of insurance are bound by a duty of good faith, both before and after the formation of the contract. It has been held that the insurer's post-contract duty of good faith includes obligations to pay valid claims promptly and to act in good faith throughout the claims-handling process.

7.6 In Australia, for example, "prompt admission of liability to meet a sound claim for indemnity and prompt payment"[11] is said to be part of the insurer's duty of good faith. In Canada, the courts have characterised an insurer's duty of good faith as including an obligation both "to act with reasonable promptness during each step of the claims process" (including paying "in a timely manner") and "to deal with its insured's claim fairly".[12] In the United States, an influential judgment declared that:

> … the implied obligation of good faith contemplates, at the very least, that the insurer will diligently investigate the facts to enable it to determine whether a claim is valid, will fairly evaluate the claim, and will thereafter act promptly and reasonably in rejecting or settling the claim.[13]

7.7 Good faith is also a pervasive doctrine of contract law in civil law jurisdictions, including Germany, Italy and Spain.

[10] For further details, see Appendix A.

[11] *Moss v Sun Alliance Australia Ltd* (1990) 55 SASR 145; (1990) 6 ANZ Ins Cas 60-967, by Bollen J.

[12] *Ontario Inc v Non-Marine Underwriters, Lloyd's of London* [2000] OJ No 866 (Ont CA), by O'Connor JA at paras 28 to 29.

[13] *Beck v Farmers Insurance Exchange* (1985) 701 P 2d 795 at 801 (Utah).

**Remedies are generally available for breach of the duty of good faith**

7.8 In the common law jurisdictions we considered, damages are available in the event an insurer breaches its duty of good faith. The law governing the duty of good faith in Australia was originally similar to English law. Australian insurance law was based on a version of the 1906 Act, which meant that the only remedy available for a breach of the duty of good faith was avoidance. As a result of the Insurance Contract Act 1984, however, the obligation to act in good faith was made an implied term of the contract.[14] This means that normal contractual remedies are available in the event of breach.[15] As a principle this is also relatively new to Canada, but long-established in the United States.

**The remedies available for breach of the duty of good faith take different forms**

7.9 The appropriate cause of action for a policyholder seeking compensation for losses incurred as a result of an insurer's bad faith conduct varies between each of the jurisdictions we have examined. In Australia, it is clear that the appropriate cause of action is to sue for breach of contract; the argument that insurers incur liability in tort for failure to pay promptly has been rejected.[16] In Canada, however, if an insurer's conduct falls short of the requirements of good faith, its liability may not be limited to damages for breach of contract. Bad faith conduct is considered to be a "separate or independent wrong" capable of giving rise to an award of aggravated damages. This is irrespective of whether breach of the duty also amounts to an independent tort.[17]

7.10 In the United States, the appropriate cause of action for breach of the duty of good faith differs from state to state. Breach of the duty, however, is most commonly found to sound in contract, in tort, or in both.[18] Where the appropriate action is in tort, the damages awarded tend to be more generous; this is partly because the test for remoteness is broader, and therefore more favourable to the claimant, in tort than in contract. Recognition of the breach as a tort also circumvents the prevailing view in some states that the quantum of contractual damages for failure to pay a debt is limited to the value of the debt plus interest.

[14] Insurance Contracts Act 1984, s 13.

[15] See R Merkin, "Reforming insurance law: is there a case for reverse transportation?" Report for the English and Scottish Law Commissions, at para 8.14 and footnotes 437 to 438.

[16] *Lomsargis v National Mutual Life Association of Australasia Ltd* [2005] QSC 199.

[17] *Whiten v Pilot Insurance Co* [2002] 1 SCR 595.

[18] Some states, notably Kansas, have found breach of the duty of good faith to give rise to an action for breach of fiduciary duty. This is of limited utility, however, as such an action may only be brought when the dispute relates to a third-party situation under a liability policy; *Spencer v Aetna Life & Casualty Insurance Co* (1980) 227 Kan 914, by Herd J at 920. A hybrid action, referred to as "contort" has also been adopted in some states. For further discussion of "contort" see J Lowry and P Rawlings, "Insurers, claims and the boundaries of good faith" [2005] 68 *Modern Law Review* 82, at p 101.

### Some jurisdictions allow punitive as well as consequential damages

7.11 In Canada and the United States, allegations of bad faith claims-handling by insurers may be accompanied by a claim for punitive damages. Punitive damages seek to ensure that insurers do not abuse their economic power, by punishing them beyond the level of simple compensation when their behaviour is particularly reprehensible.

7.12 In Canada, punitive damages are available where the behaviour complained of is found to be malicious, high-handed or oppressive in addition to being a breach of the insurer's duty of good faith. In *Whiten v Pilot Insurance Company*,[19] the Supreme Court of Canada upheld an award of C$1 million in punitive damages in addition to the main claim amount for an insurer's bad faith refusal of a claim. It is clear, however, that such awards should be available only in the minority of cases.[20]

7.13 In the United States, punitive damages are generally unavailable for breach of a contractual obligation. Unless the contrary is provided for by statute, the availability of punitive damages is dependent on breach of the duty of good faith sounding in tort. The degree of conduct required to justify an award of punitive damages varies between states, but it appears that all states require more than bad faith simpliciter. That said, awards for an insurer's bad faith are relatively common, and the sums involved are often substantial. It should be noted, however, that the availability of punitive damages reflects a particular economic and legal context which does not exist to the same extent in the UK. Insurers in the UK do sometimes provide protection that would otherwise have to be provided by the welfare state (with social housing, for example), but this is much less widespread than in the US.

7.14 With a limited welfare state, the courts in the United States have long recognised that insurers provide a service affecting the interests of the public and have imposed obligations which go beyond those imposed upon parties to private commercial contracts. To protect the public interest, the courts have used, and continue to use, the doctrine of good faith and punitive damages to regulate the behaviour of insurers.

7.15 It is interesting to note that the Australian courts have not followed the United States in this regard. They have shown themselves to be reluctant to award punitive damages, and have never done so in connection with an insurance dispute.

[19] *Whiten v Pilot Insurance Co* [2002] 1 SCR 595.

[20] Above, by Binnie J at para 94.

# PART 8
# THE CASE FOR REFORM

## PROBLEMS WITH THE LAW IN ENGLAND AND WALES

8.1 In Part 2 we criticised the decision in *Sprung v Royal Insurance (UK) Ltd*,[1] that English law did not recognise an action for damages following an insurer's refusal to pay a valid claim, or for their delay in paying it. In Part 4 we criticised the decision in *Banque Financiere v Westgate Insurance Co*[2] that a policyholder was not entitled to damages where the insurer breached its duty of good faith. 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 policyholder may sue for the claim, plus interest, but has no right to be compensated for any additional foreseeable losses caused by the failure to pay.

8.2 In England and Wales, the fact that policyholders may not sue for foreseeable loss has proved controversial. Here we start by summarising the judicial and academic criticisms of the law, before setting out the main four reasons why we think reform is needed.

### Judicial criticism

8.3 Judicial criticism began in the judgment in *Sprung* itself. Holding "with reluctance" that Mr Sprung's appeal must fail, Lord Justice Beldam said:

> To compensate a plaintiff in such circumstances Parliament has provided that the court should be able to award interest on the damages which the court eventually assesses. There will be many who share Mr Sprung's view that in cases such as this such an award is inadequate to compensate him or any other assured who may have had to abandon his business as a result of insurers' failure to pay, and that early consideration should be given to reform of the law in similar cases.[3]

8.4 Reaching the same conclusion "with undisguised reluctance", Lord Justice Evans also said:

> I do not find the defendants' submissions at all attractive, either from a commercial or from a moral point of view.[4]

8.5 In March 2001, Lord Justice Longmore gave the Pat Saxton Memorial Lecture[5] in which he set out a number of areas of insurance law which he believed should be reviewed by the Law Commission. He said:

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

[2] [1991] 2 AC 249, affirming the judgment of the Court of Appeal [1990] 1 QB 665.

[3] *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70, at p 80.

[4] Above, at p 79.

> The question of delay in paying valid claims is a newer topic, which, it seems to me, does merit consideration. The courts have set their face against there being an implied term of an insurance contract that valid claims will be met and thus do not award damages against an insurer even if his delay in negotiating the claim means that the insured goes out of business. In a sense this is part of a wider point, viz whether interest is truly compensation for delayed payment of claims for damages. But it has always been an oddity that a claim under an insurance policy is treated by the law as a claim for damages, rather than a straight debt. This is a doctrine that could usefully be considered, I suggest, by the Law Commission.

8.6 More recently, the law as applied in *Sprung* and subsequent cases has attracted criticism from Lord Justice Rix. In *Mandrake*,[6] the Court of Appeal applied *Sprung* and dismissed an appeal against a refusal to allow the claimants to amend their particulars of claim to include further losses. Although bound by the authorities not to allow the amendment, Lord Justice Rix considered the possibility that the House of Lords may be interested in the principles of law raised and said:

> It seems to me that, in these circumstances, the opportunity to revisit this area of law should be granted.

**Academic criticism**

8.7 Academic criticism of *Sprung* also began soon after the decision. Professor Birds said of the case in 1997:[7]

> With no Insurance Ombudsman for the small businessman like Mr Sprung… to complain to, and with none of the other protection that the current law and practice does afford non-commercial insurance consumers, the decision illustrates quite starkly that something needs to be done to remedy insurance law when the insured has no bargaining strength or resources to compete with an insurer.

8.8 He went on to say that although as a matter of strict law the decision of the Court of Appeal seemed "unimpeachable":

> It does seem clear that there should be such a remedy [damages] where an insurer repudiates or refuses to admit liability without reasonable grounds, and the Court of Appeal thought so also. The only solution, perhaps, is to make this another area of insurance law where statutory reform is needed.

[5] Sir Andrew Longmore, "An Insurance Contracts Act for a new century?", delivered on 5 March 2001 at the invitation of the British Insurance Law Association Trust.

[6] *Mandrake Holdings Ltd v Countrywide Assured Group plc* [2005] EWCA Civ 840, at para 25.

[7] J R Birds, "Case Comment: No damages remedy when insurers unjustifiably repudiate liability" [1997] *Journal of Business Law* 368.

8.9 Lowry and Rawlings have struck a similar note. Discussing Lord Justice Longmore's calls for wide-ranging reforms of insurance contract law, they have said:

> It is evident that the law relating to the claims process should be added to this growing list. The decision in *Sprung* provides a clear example of the proclivity of insurance to favouring the interests of insurers.[8]

8.10 Professor Clarke has also been critical:

> … as a matter of precedent, it is clear that, unless the case comes before the IOB,[9] a claimant cannot recover damages for late payment of insurance money.[10]

8.11 But of the line of authority from *The Lips* to *Sprung* via *The Italia Express*, he has said:

> As a matter of principle, however, the thinking of the English courts is far from clear. The decisions are doubtless in line with the wishes of insurers but out of line with the reasonable contemplation of businessmen and with the law in other common law jurisdictions.[11]

8.12 More recently, he has noted that the House of Lords case of *Sempra* (discussed in Part 2)[12] may apply to non-indemnity or "contingency" insurance, with the result that an action for damages for delayed payment may be possible for those types of insurance. He further suggested that:

> Surely this should apply to the promise of indemnity insurers as it does to others. It must at least be open to argue that *Sprung* should now be disregarded, that another "blot on English common law jurisprudence" can be erased, and that English law can be restored to the wider common law fold.[13]

8.13 Al-Asady in a 2006 article[14] compared the approaches of US and Canadian law to English law on the subject of late payment and indemnity insurance. Noting that the former jurisdictions are far more protective of insureds than in England, she said:

8 J Lowry & P Rawlings, "Insurers, claims and the boundaries of good faith" (2005) 68 *Modern Law Review* 82 to 110.

9 Insurance Ombudsman Bureau – forerunner of the Financial Ombudsman Service.

10 M Clarke, *The Law of Insurance Contracts* (5th ed 2006), at para 30-9B1.

11 Above.

12 *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v Inland Revenue Commissioners* [2007] UKHL 34; [2008] 1 AC 561.

13 M Clarke, "Compensation for failure to pay money due: a 'blot on English common law jurisprudence' partly removed" [2008] *Journal of Business Law* 291.

14 J Al-Asady, "Damages, late payment and indemnity insurance" [2006] *Journal of Business Law* 396 to 407.

> The purpose of insurance is to provide peace of mind and it ought to be reasonably expected that the insurer is aware of the detrimental effect of delayed payment to the insured. This should be implied into indemnity policies at the time of contract in the interests of equity and common sense…
>
> It is common sense and practical commercial reality that, in the event of a delayed payment, the insurer should be sued for failing to provide peace of mind and compensating for the insured loss.

8.14 In reaching her conclusions, Al-Asady also argued that the regulatory framework in place outside of insurance contract law does not go far enough in mitigating the situation:

> Although the FSA seeks to provide a framework for insureds to be treated fairly, more needs to be done through statutory provision. The Financial Services and Markets Act (FSMA) 2000 does not provide adequate remedies to insureds other than under s.150, which permits an action for damages in the event of contravention of a "rule". Furthermore, the Association of British Insurers (ABI) statements of practice and general insurance claims code merely provide minimal guidance to insurers, not all of which are members.

8.15 Ultimately, Al-Asady concluded that the law should encourage good faith practice and efficient claims-handling, and deter the inefficient and unreasonable insurer. This would involve awarding not only damages for further loss but also damages for inconvenience and distress. She said:

> The Canadian approach to damages should be adopted.[15] Reform is overdue…

8.16 In an article which compared the Australian approach to late payment of claims with English law, Ying has also said:[16]

> The time is ripe for reconsideration of the principles that deny an insured any entitlement to claim damages for an insurer's failure to pay the insured sum within a reasonable time after the lodging of a valid claim and investigation by the insurer. A property-owner insures his property to avoid shouldering the risk of loss from unwelcome events and for peace of mind because of the assurance of an indemnity if that risk eventuates. If loss occurs, he could reasonably expect that a valid claim on the insurance policy should be followed by prompt payment from the insurer. If there is no payment or delayed payment, he may suffer financially. It is submitted that subject to questions of proof and causation, he should be entitled to recover for his consequential losses from the insurer.

[15] For further details on Canadian law in this area, see Appendix A below.

[16] C Ying, "Damages for late payment of insurance claims" [2006] 122 *Law Quarterly Review* 205.

8.17 Ying offers three justifications for reversing *Sprung*. First, *Sprung* rests on the incorrect premise that an indemnity insurer promises to prevent the event insured. Second, an obligation to perform carries with it the implication on business efficacy grounds that performance must take place within a reasonable time. Third, *Sprung* is both the result and an extension of an old principle of English law – that a claim for damages based on a mere failure to pay money is not possible – which has been said to be "contrary to principle and commercial reality" in Australia.[17]

**Comment**

8.18 In *First Energy (UK) Ltd*[18] Lord Steyn remarked that:

> A theme that runs through our law of contract is that the reasonable expectations of honest men must be protected.[19]

8.19 We think that the combined effect of the decisions in *Sprung* and *Banque Financiere* undermines this principle. We have four main criticisms of the current law in England and Wales.

***The law lacks principle***

8.20 It is difficult to justify the decision in *Sprung* on normal contract principles. The idea that the insurer's primary obligation is to prevent a loss from occurring is a fiction. It ignores the commercial reality of the situation. Both insurers and insureds would regard the insurer's primary obligation as being the obligation to pay a valid claim after the expiry of a reasonable period for investigation (whether or not any investigation actually takes place). Thus under contract law one would expect the insurer to be liable to pay damages for foreseeable losses which flow directly from a breach of this obligation (subject to the terms of the contract). If the law is to depart from this principle, it needs a clear justification.

8.21 The decision in *Banque Financiere* that the insured may not claim damages for the insurer's failure to perform contractual obligations in good faith also appears anomalous. It undermines the principle, established by Lord Mansfield in the eighteenth century, that insurance contracts require *mutual* obligations to act in good faith. If an insurer clearly acts in bad faith (for example, by unreasonably refusing to investigate or pay a valid claim) we think that the insurer should be liable for foreseeable losses which flow directly from a breach of this obligation.

8.22 It is noticeable that the law in England is out of line with the law in Scotland, Australia, Canada and the United States.

[17] *Hungerfords v Walker* (1989) 171 CLR 125, by Brennan and Deane JJ at p 152. For further details on Australian law in this area, see Appendix A below

[18] *First Energy (UK) Ltd v Hungarian International Bank Ltd* [1993] 2 Lloyd's Rep 194.

[19] Above, at p 196.

8.23 In Part 5 we noted that damages (including damages for distress and inconvenience) are available to consumers where the insurer agrees to reinstate the property, but delays in doing so. However, no such damages are available where the insurer unreasonably refuses to consider or pay a claim at all. There is little practical logic to this distinction. Nor can we see any logic to the distinction between life insurance and indemnity insurance. Damages are available where an insurer fails to pay a life insurance claim, and should also be available for a failure to pay an indemnity insurance claim

***The law appears unfair***

8.24 The law in England and Wales gives the impression of being biased against the interests of policyholders. We think this undermines confidence in insurance law and in the insurance industry.

8.25 We doubt that policyholders buy insurance on the understanding that if their insurer fails to pay their claim they have no remedy other than interest to compensate for any losses caused by the delay or non-payment. Most policyholders would take the same view as Mr Sprung in thinking that their case should be decided on its merits, rather than automatically rejected. The explanation of the law given to Mr and Mrs England when their insurer refused to underpin their home, for example, must have appeared baffling.[20]

8.26 As we noted in Part 6, the Financial Ombudsman Service does not consider the strict legal approach to be fair and reasonable. The Financial Services Authority requires that insurers must handle claims properly and fairly,[21] yet the civil law fails to provide compensation if the insurer does not do so.

***The law appears to reward inefficiency and dishonesty***

8.27 Most insurers do pay claims fairly and within a reasonable time because there are strong commercial pressures to do so. Above all, insurers wish to preserve their reputations.

8.28 However, where an insurer is in run off, for example, it may no longer feel the need to preserve its reputation.[22] Here a rogue insurer may decide that the profits to be made from withholding money may be greater than the consequences of delay in paying claims (such as being required to pay interest). Alternatively, claims handlers may lose perspective on the merits of a case and refuse the claim in a biased and unjustified way.

8.29 These rare cases damage the reputation of the industry as a whole. It is in the interest of all insurers that the law should provide suitable disincentives to deter behaviour of this sort.

[20] See the discussion in paras 2.63 to 2.65 above.

[21] ICOBS Rule 8.1.1.

[22] This is where an insurer has taken the decision (or has been forced) to stop writing new insurance policies but may still be liable for future claims on past business (that is, old policies under which claims may continue to arise). A reserve is usually established for the payment of such claims.

### *The law may, on occasion, lead to injustice*

8.30 In practice, the injustice caused by the law is mitigated by the fact that consumers and small businesses[23] may take their complaints to the Financial Ombudsman Service. As we have seen, the FOS is prepared to award damages for distress and inconvenience and for actual, foreseeable loss caused by the insurer's breach.

8.31 However, the FOS is not able to help everyone. In particular, it cannot help cases which involve

(1) medium sized businesses, which exceed the FOS jurisdiction limit;

(2) damages over £100,000 where the insurer is not prepared to abide by a voluntary recommendation; or

(3) cases involving disputed oral evidence, which are not suited to the FOS procedure.

Nor does the FOS help those who, for whatever reason, exercise their constitutional right to take their claim to court.

8.32 We think the actual number of cases of injustice is likely to be small. Experience in Scotland shows that it is relatively rare for an insured to prove that foreseeable losses were the direct result of the insurer's breach. However, this does not excuse unfair law.

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

### THE LAW IN SCOTLAND

8.34 As discussed in Part 3, Scots law has not adopted the reasoning set out in *Sprung*. Instead, the courts have followed ordinary contract principles. An insurer is under an implied duty to pay a valid claim after a reasonable time for investigation. We think this is the correct approach.

8.35 That said, the law in Scotland is not always well-known or well-understood, as the case of *Toremar v CGU Bonus Ltd*[24] illustrates. There is also some uncertainty over the insurer's duty of good faith in Scots law, and the remedies available if it is breached. We think it would be helpful to clarify the law in Scotland on these issues.

8.36 **Do consultees agree that the law on damages for late payment in Scotland is generally satisfactory**?

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

[23] Previously businesses with a turnover of less than £1 million could have their claims heard by the FOS. On 1 November 2009 this changed to businesses with an annual turnover of less than €2 million and fewer than ten employees.

[24] [2009] CSOH 78. For discussion of this case, see para 3.13 above.

### A NOTE OF CAUTION

8.38 The limited evidence of actual policyholder detriment suggests that it may be wise to proceed cautiously. We think the following factors should be taken into account:

(1) Insurance contracts are for specific risks. An insurer should not be exposed to uncertain and additional risk (which it may not be able to re-insure) simply because it disputes liability.

(2) Remedies should be proportionate. It would be unfair if an insurer as a result of delay on a relatively small policy faced a very large claim for consequential loss.

(3) An insured can purchase business interruption insurance. An insurer should not have to provide this without payment.

(4) In the United States the issue is often dealt with by the concept of a tort of "bad faith". There are legitimate concerns about this development.

(5) An overly generous right to compensation for late or non-payment of valid claims may result in higher premiums for all.

(6) Insurers' reputations are not assisted by a rule that rewards inefficiency or dishonesty and which is perceived to be unfair.

# PART 9
# PROPOSALS FOR REFORM

## INTRODUCTION

9.1 We have reached the conclusion that the law in England and Wales is in need of reform. At present, policyholders have no right under English law to be compensated for foreseeable losses suffered when an insurer refuses a valid claim, or pays only after unreasonable delay. We think this is wrong, for the reasons given in Part 8. The law in this area lacks principle; it appears biased against the insured; it may reward inefficient or dishonest insurers; and it may lead to injustice.

9.2 In this Part we look at different ways in which the law could be rendered fairer and more principled. We stress that the Law Commissions have not reached a conclusion about which is the best way forward. We wish to hear from insurers, intermediaries and policyholders before formulating our proposals.

## TWO BROAD APPROACHES

9.3 We have identified two main approaches to reforming the law in this area. The first would provide damages where an insurer breaches its duty of good faith. It would reverse the rule discussed in Part 4 and set out in the case of *Banque Financiere*, namely that the only remedy for breach of good faith is avoidance of the contract. Instead, we think that where an insurer has acted in bad faith in refusing a claim or delaying payment, the policyholder should have a right to damages for foreseeable losses caused by the insurer's breach. In Part 4 we argued that the duty of good faith should be non-excludable. In other words, a contract term could not exclude the duty or limit liability for its breach.

9.4 The second approach would reverse the decision in *Sprung,* so as to make an insurer liable for a failure to pay a valid claim within a reasonable time. We refer to this as the "strict liability" approach. As discussed in Part 2, we do not think that a claim under an indemnity insurance policy is correctly characterised as a claim for damages for breach of an obligation to hold the insured harmless. We prefer the approach of the law in Scotland and in most other common law jurisdictions, which considers the insurer to be under a primary contractual obligation to pay valid claims. If the insurer fails in this primary obligation, then under normal contract principles, the insurer should be liable for any foreseeable losses which result. The test is an objective one. If the insurer refused a claim later held to be valid, the insurer would be liable, even if it had reasonable grounds for its original refusal.

9.5 However, unlike the duty of good faith, we think this "strict liability" should be read subject to the express terms of the contract. It would therefore be open to the parties to exclude or restrict this liability. In business contracts, a well-drafted exclusion clause would be considered valid – though in consumer contracts such a term might be considered unfair under the Unfair Terms in Consumer Contracts Regulations 1999.

9.6 The following examples illustrate the difference between the "bad faith" and the "strict liability" approach:

**Example 1**

Policyholder P brings a claim under its property policy for flooding. Insurer A reviews the policy wording, takes legal advice and forms the view that this particular loss falls outside the terms of cover. A promptly notifies P. The parties are unable to settle the dispute which eventually proceeds to litigation. A is successful at first instance, but eventually loses on appeal.

The process has taken several years. Over that period P's business has failed, resulting in further heavy losses. Yet if the insurance money had been paid earlier, P's business would have continued successfully. A had a genuine and reasonable belief that the claim was invalid, and no judge criticised A's actions. It is just that the decision to refuse the claim proved to be wrong.

In this example, P would not have a claim for damages for breach of the duty of good faith. However, P might have a claim under a strict liability approach, on the ground that the insurer failed to fulfil its primary contractual obligation to pay a valid claim within a reasonable time.

**Example 2**

P presents a claim to Insurer B, whose claims department benefits from a generous performance incentive scheme. P's claim would prevent B's claims department earning a bonus in a particular year. B's claims manager knows that the claim is valid but nevertheless seeks to delay payment of P's claim in the hope that settlement can be deferred until the next bonus year. B therefore refuses to admit liability for P's claim and requests information on a piecemeal basis, before eventually making a payment 12 months later.

P's business runs into financial difficulties as a result of the delay in payment. Eventually P's business fails, having incurred further heavy losses.

Here P would have a claim under both approaches. The insurer has acted in bad faith *and* has failed to fulfil its primary contractual obligation.

9.7 Below, we consider whether the law should be reformed to recognise a non-excludable liability for breach of "good faith". We then ask whether the law should also recognise an excludable "strict liability" to pay valid claims within a reasonable time.

9.8 Finally we consider whether consumers should be entitled to damages for distress, inconvenience and discomfort. We think the Financial Ombudsman Service (FOS) is right to follow general contract principles in this area, rather than apply special rules to insurance contracts. We ask whether statutory reform is needed to embed this approach within the law.

## DAMAGES FOR THE INSURER'S BREACH OF THE DUTY OF GOOD FAITH

9.9 For many years UK contract law has treated insurance differently from other contracts, by imposing an obligation on the parties to act in good faith. As discussed in Part 4, the parties have mutual obligations both before and after the contract is formed, which are independent of the terms of the contract.

9.10 We think the law is right to recognise mutual duties to act in good faith in insurance contracts. The nature of the insurance bargain makes good faith a commercial necessity. One party pays money to another not in return for goods or services but against a promise to pay should an agreed event occur. The insurer has to be confident that the policyholder has provided a fair presentation of the risk. The policyholder has to be confident that its claims will be considered on their merits, in a fair and unbiased way. Mutual duties of good faith reinforce the parties' contractual arrangements.

9.11 The principle is set out in section 17 of the Marine Insurance Act 1906 in relation to marine insurance, though the principle has been applied to all insurance contracts. It states that:

> A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party.

9.12 We think it is right to say that an insurance contract "is a contract based upon good faith". We think that the addition of the word "utmost" may be confusing, especially in the context of the parties' post-contract obligations.

9.13 The main problem with section 17, however, is that the courts have held that avoidance is the only remedy under the section. This is wholly unequal. Avoidance is a powerful remedy for the insurer, but it is of little practical use to an insured. An insured with a valid claim wants the claim paid, not a declaration that the insurance never existed and their premium returned.

9.14 Below we discuss our tentative proposals for reform. We start by looking at what actions or omissions might constitute a breach of the insurer's duty of good faith in considering a claim. We then consider whether the insured should have a claim for damages if the insurer breaches this duty.

### The content of the duty of good faith

9.15 The law cannot provide an exhaustive list of circumstances to define a breach of good faith by an insurer. What is or is not good faith must depend upon the specific circumstances and the type of policy. Changing commercial expectations may present new issues and new problems, and the courts should be free to adapt to them.

9.16 However, it may be helpful to provide guidelines about how an insurer is required to act. Clearly fraud or dishonesty by an insurer would constitute a breach of good faith. 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, although seriously incompetent claims handling would be. Breach of regulatory obligations such as those in ICOBS 8 may well constitute breach of good faith, particularly if done deliberately and persistently.

9.17 In Part 4 we explained that under current case law, on receiving a claim an insurer is expected to make enquiries, not act arbitrarily, and not take into account wholly extraneous circumstances. This is similar to the requirements on insurers imposed by the Financial Services Authority to handle claims fairly, to provide reasonable guidance to policyholders; not to reject claims unreasonably and to settle claims promptly once settlement terms are agreed.[1]

9.18 This suggests that an insurer's post-contract obligations exist in three main areas:

(1) *To investigate a claim* fairly.

(2) *To decide a claim* fairly. This might, for example, include assessing claims in a way which is free from bias, taking into account relevant circumstances, and not taking into account irrelevant ones. Given the emphasis the FSA places on giving appropriate information to policyholders, we think it may also be helpful to specify that insurers should give reasons for refusing claims.

(3) *To pay a claim* within a reasonable time, once settlement is agreed.

9.19 We do not consider that delay by itself would constitute a breach of duty. Insurers owe obligations to the wider group of insureds to take care that only valid claims are paid. In many cases, the insurer may legitimately need more time to investigate or assess a claim. Nor would an incorrect refusal constitute a breach of good faith, if the insurer genuinely and reasonably thought that the claim was invalid. However, if the insurer had good reasons for believing that the claim was valid, but nevertheless refused it, we think this would destroy the basis of trust on which insurance is founded.

9.20 The insurer's obligation to act in good faith should also apply to express policy terms. If the contract grants a power to the insurer such as a claims control or co-operation clause then the insurer must act within the terms of the clause in good faith and not capriciously or in its own specific interest to the detriment of the insured.

[1] ICOBS Rule 8.1.1.

9.21 As currently drafted, the 1906 Act sets out a general duty of good faith in section 17, and then specifies two examples of the insured's duties. The duty to disclose is set out in section 18, and the duty not to misrepresent in section 20. We think it would also be helpful for the legislation to provide guidelines on the content of the insurer's duties. However, any list would need to be non-exhaustive thereby enabling the courts to continue to develop the concept of good faith in response to a changing market.

9.22 We welcome views on these issues generally, and we set out specific questions below.

9.23 **Should legislation include guidelines for the content of the insurer's duty to act in good faith**?

9.24 **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**?

9.25 **Do consultees agree that this should be a non-exhaustive list**?

### Damages for breach of good faith

9.26 We think that legislation should set out appropriate remedies for the insurer's breach of the duty of good faith. This should include damages for foreseeable losses.

9.27 We are proposing a limited and controlled liability. The first prerequisite to liability would be that the claim was valid. A policyholder would not be entitled to damages because an insurer turned down an invalid claim for the wrong reasons. The policyholder would then need to prove actual losses, and that these were foreseeable within the general principles of *Hadley v Baxendale*. In other words, the policyholder would need to show that the losses claimed were in the contemplation of both parties at the time they made the contract, because either

(1) they may fairly and reasonably be considered as arising naturally; or

(2) they arose from special circumstances communicated at the time the contract was made.[2]

[2] *Hadley v Baxendale* (1854) 9 Exch 341, by Alderson B at p 354. For a fuller discussion, see Part 2, above.

The policyholder would also need to show that the breach caused the loss, and that it had done all it reasonably could to mitigate the loss.

9.28 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 much more extended and unpredictable liability, which could add to the cost of premiums.

9.29 **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**?

9.30 **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**?

### Delay during litigation

9.31 The most common form of bad faith would be a biased and unreasonable rejection of the claim, perhaps motivated by the insurer's own commercial targets rather than the merits of the claim. This would force the policyholder to litigate, perhaps facing many years of delay as the claim progressed through the court system. In *The Star Sea*[3] it was suggested that once litigation had commenced, the relationship between the parties changed and they could no longer be held to duties of good faith. Could it be argued that this absolves the insurer from responsibility for the consequences of any delay caused by litigation?

9.32 We think not. The discussion in *The Star Sea* focused specifically on the duties of disclosure during litigation, where the rules of court provide for specific actions and for the remedies if those actions are not taken. It was not intended to extend further. The litigation process inevitably takes time. If any insurer breached its duty of good faith by forcing the policyholder into litigation, we see no reason why the insurer should automatically be absolved from responsibility for those delays, if the consequences were the foreseeable result of the breach.

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

### A non-excludable duty

9.34 We do not consider that an insurer should be permitted to exclude its obligation to act in good faith. We think this would be inimical to the nature of an insurance contract. Nor do we think such a clause would represent a genuinely negotiated bargain. No policyholder who properly considered the matter would agree that the insurer could refuse a claim in a biased or unfair way, or without properly investigating the claim. We note too that in Australia the duty of good faith cannot be excluded.

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

[3] *Manifest Shipping v Uni-Polaris Insurance Co ("The Star Sea")* [2001] UKHL 1; [2003] 1 AC 469.

### Impact assessment

9.36 Our proposal to reform section 17 of the 1906 Act would impose liability on an insurer who had acted in bad faith. In practice this will usually occur where the insurer is dishonest or guilty of maladministration beyond everyday error when dealing with the insured's claim. The insured would be able to recover losses for breach of contract where such losses were foreseeable on the normal *Hadley v Baxendale* principles.

#### *Benefits*

9.37 We think that the main benefit of reforming section 17 is that it will improve customer confidence. We think that statutory guidance on the insurer's duties will act as a useful training aid for insurers, reminding claims staff of their duty to act in a fair and unbiased manner. The possibility of damages will ensure that these duties are taken seriously. Reform will therefore complement the FSA's initiative to treat customers fairly, and will encourage trust in the insurance industry.

#### *Number of claims*

9.38 We think the number of claims is likely to be low. Claims will only succeed if the policyholder establishes all of the following:

(1) The claim was valid.

(2) The insurer breached its duty of good faith (for example, by refusing to investigate, or taking into account irrelevant circumstances). This will not be easy to prove.

(3) The policyholder suffered actual loss. Again, this must be proved, and cannot be assumed.

(4) The loss was of a type which was foreseeable at the time the contract was entered into. The Scottish case law suggests that this may be a difficult hurdle to overcome.

(5) The breach caused the loss. This will also be difficult to show. For example, if a business fails immediately, then the insurer would be able to argue that the failure was not caused by the delay in payment. It would have failed even if the claim had been paid within a reasonable time.

(6) The policyholder had done all that was reasonably required to mitigate its loss.

9.39 We estimate that only a handful of claims would succeed each year, though there might be settlements which never come to court. We suspect that insurers already settle claims where policyholders have suffered loss as a result of bad faith rather than risk the effects of unwanted publicity, and the possibility of an unfavourable decision before the appeal courts. The insurance industry already bears the cost of these cases, and reform will not add to the costs of such settlements. Reform might however protect some policyholders where the insurer is in run-off (that is, no longer open for new business) and therefore insensitive to the effects of bad publicity.

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

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

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

9.42 In Part 2, we set out the reasons why we think that *Sprung* was wrongly decided, and is now out of line with general contract principles. We preferred the approach of the Court of Session in *Strachan v The Scottish Boatowners' Mutual Insurance Association.*[4] In other words, the insurer's primary obligation is not to prevent a loss from occurring, but to pay valid claims, after the opportunity for a reasonable investigation. If an insurer fails to carry out this obligation, it should be liable for damages for actual loss caused by the breach provided that loss was foreseeable; that the policyholder acted reasonably to mitigate their loss; and that the loss was not excluded by a contract term.

9.43 We accept that insurers need to be able to refuse invalid claims. Every so often, an insurer will act reasonably 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 in contract law should be that the insurer bears the risk, following its failure to perform its contractual obligation. However, the parties should be free to exclude this liability through a contract term. This gives the policyholder a choice: more certain cover at greater cost; or cheaper cover which may be paid late if the insurer takes a mistaken defence. This must, of course, be read subject to our proposals on the duty of good faith. If the parties have a non-excludable duty to act in good faith, the parties could only exclude liability for late payment where the delay did not result from bad faith.

9.44 For many insurers, it is important to know the maximum amount of liability in advance. We therefore accept that insurers will commonly seek to exclude this liability. However, as the industry develops more experience in assessing and pricing the liability, insurers may seek to obtain a commercial advantage in offering more certain, prompter payments, with appropriate compensation for undue delay.

9.45 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. As discussed in Part 6, the Financial Ombudsman Service already accepts insurers should compensate consumers where their failure to pay has caused loss, and the industry generally accepts this. Reversing the decision in *Sprung* would bring the courts in line with what the FOS already does.

9.46 **Do consultees agree that:**

[4] Outer House, Court of Session 31 May 2001 (unreported), see summary 2001 GWD 19-754.

(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**?

**Court reform or legislative reform?**

9.47 If it is agreed that *Sprung* is wrongly decided, and that the law should be changed, the next question is how this should be done. Should the matter be left to the courts, or is legislative reform desirable?

9.48 We think it would be open to the Supreme Court to overturn the Court of Appeal decision in *Sprung*. In Part 2 we argued that the reasoning in *Sprung* was out of line with recent developments in contract law. We considered the "hold harmless" doctrine to be a fiction, which could be removed without affecting other areas of insurance law. The case usually seen as authority for the proposition that an insurer has a duty to prevent a loss is *The Fanti and The Padre Island*.[5] Yet the decision in this case would be more easily explained by saying that the insurer was not required to prevent the loss but only to make a payment in the circumstances specified in the contract.

9.49 Alternatively, it would be open to the Law Commissions to draft legislation to the effect that an insurer's primary obligation under the contract was not to "hold the insured harmless". Rather it is to make a payment (or perform services) in the circumstances specified in the contract. If no time for payment is specified, the insurer should make a payment after allowing a reasonable time to investigate and assess the claim.

9.50 The argument for legislative reform is that a suitable case might not come before the Supreme Court. And if it did, the Court might feel constrained by previous precedents. Legislative reform would make the law clearer, fairer and more principled.

9.51 The main argument against legislative reform is that the industry is likely to react to new legislation by automatically excluding liability in all commercial contracts. This would effectively render the reform nugatory.

9.52 There is a further danger that statutory intervention might set a particular approach in stone. Insurance law would become separated from general contract principles, and would fail to develop with other changes to the common law. Judicial reform will allow the courts to take into account a range of factors and to develop the law as circumstances change.

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

[5] [1991] 2 AC 1. For further discussion, see paras 2.30 to 2.37.

### Impact assessment

9.54 We do not think that reversing the decision in *Sprung* would have a significant practical effect. The Scottish experience suggests that the courts will be restrained in the way they award damages. We do not anticipate many successful cases. In paragraph 9.38 above, we set out six steps a policyholder would need to prove to found a claim for bad faith damages. For strict liability damages, the policyholder would still need to prove five out of the six steps: namely, that the claim was valid; that they suffered loss; that the loss was foreseeable; that the breach caused the loss; and that the policyholder took reasonable steps to mitigate the loss. The only change is that the policyholder would not need to prove that the insurer acted in bad faith.

9.55 Furthermore, in business contracts, many insurers may re-write their contracts to exclude damages claims. And in consumer and micro-business contracts, the FOS is already able to award damages to cover foreseeable losses caused by the wrongful late payment of claims.

9.56 Reversing the decision in *Sprung* would have the following advantages:

(1) An unjustified anomaly would be removed.

(2) Insurance law would be aligned with general contract principles.

(3) Consumers would be able to obtain the same justice from the courts as from the FOS, protecting those with claims over £100,000 and those who need to rely on disputed oral evidence.

(4) Commercial parties would be free to reach their own decisions within their contracts over whether insurers should pay for the consequences of a wrongful refusal made in good faith.

(5) The law would be the same in England, Wales and Scotland.

9.57 On the other hand, we need to consider the effect of any change in liability on the behaviour of the parties. If insurers are to incur a potentially large liability for refusing valid claims, insurers can be expected to react by being less likely to refuse claims which are probably invalid, but where there is some uncertainty over whether the issue can be proved to the satisfaction of a court. This may in turn encourage policyholders to submit invalid claims. We do not think this is a huge risk, because it would always be possible for commercial parties to exclude the liability. Nevertheless, we would be interested in hearing views on the possible effect of any change on the behaviour of the parties.

9.58 **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**.

## DAMAGES FOR CONSUMERS' DISTRESS, INCONVENIENCE OR DISCOMFORT

9.59 In Part 5 we explained that where an insurer opts to reinstate property the insurer is considered to be party to a contract of sale, or work and materials. If an insurer fails to carry out the agreed reinstatement, and leaves a consumer's home in a poor state of repair, the consumer may be entitled to damages. These damages are said to be for distress and inconvenience, and will be "restrained and modest".[6] By way of illustration, the courts have suggested that the inconvenience of living in a damaged home or caravan should be no more than £2,000 per person per year.[7]

9.60 However, it is not clear that damages of this type are available where the insurer fails to respond promptly to a claim or at all. It is difficult to justify this distinction in policy terms. The FOS is prepared to provide damages for distress, inconvenience and discomfort in both scenarios, albeit providing modest awards.

9.61 We think that the FOS is correct in its approach. 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.[8] 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.

9.62 We are interested in hearing views on whether the courts can reach this result through a development of the case law, or whether statutory reform is needed. We would also be interested in views on whether there is a need for guidelines about the amount of such damages.

9.63 Again, we think that the practical effect of any change in the law is likely to be limited. The change would only apply to consumer insurance, where the FOS already awards damages for distress, inconvenience and discomfort. Those awards are modest in amount, and have already been accepted by the industry. We would welcome any information that insurers are able to provide to indicate how often such damages are paid.

9.64 **Do consultees agree that in consumer insurance contracts, the FOS approach to the award of damages for distress, inconvenience and discomfort is correct as a matter of policy**?

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

9.66 **Is there a need for guidelines on the amount of such damages**?

[6] *Farley v Skinner (No 2)* [2001] UKHL 49; [2002] 2 AC 732, by Lord Steyn at para 28.

[7] See *AXA Insurance UK v Cunningham Lindsey UK* [2007] EWHC 3023 (TCC) and the discussion in Part 5.

[8] See *Watts v Morrow* [1991] 4 All ER 937 for the current law on cases where the object of the contract is to provide pleasure, relaxation or peace of mind.

# PART 10
# LIST OF CONSULTATION QUESTIONS

We ask 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)

# APPENDIX A
# COMPARATIVE LAW

A.1 In this Appendix we discuss the law relating to late payment of claims in Australia, the United States, Canada; and refer briefly to China, Germany, Italy and Spain. In Part 7 we summarise the conclusions arising from the survey, and the main points that could be made in a comparison with English law. Here we examine the law in each jurisdiction in some detail – looking not just at late payment itself but also in some cases the related law on good faith, reinstatement and interest. Australia is tackled first – as until the 1980s much of Australian insurance law was very similar to English and Scots law, but since then significant reforms have taken place. Some of these reforms have influenced our thinking in other areas. Next we look at the US – as while it is an extremely large insurance market, it takes a relatively protective approach to policyholder rights. Our third detailed examination is of Canada, which sits somewhere between the US and Australia in the protection it offers. Finally we take a brief look at the law in some civil law jurisdictions.

## AUSTRALIA

A.2 Until 1984, Australian insurance law was to a large extent modelled on English insurance law.[1] However, in 1982 the Australian Law Reform Commission (ALRC) produced a Report, *Insurance Contracts* (the 1982 Report),[2] which gave rise to the Insurance Contracts Act 1984 (the 1984 Act).[3] In the context of late payment of claims, the 1984 Act was significant for two reasons: first, because, although the point is not finally resolved, there is now authority for the proposition that late payment of a claim can amount to a breach of the implied term of good faith in section 13; and second, because section 57 imposes an obligation on an insurer to pay interest from the date on which a claim should reasonably have been paid.

A.3 More recently, the Supreme Court of New South Wales has suggested that a refusal to pay may also give rise to an action for damages for breach of the insurance contract without the insurer having breached section 13 of the 1984 Act.[4]

A.4 We will consider each of these strands in turn: good faith, the possible common law cause of action for breach of contract and interest. Finally, we consider the law on reinstatement.

1 For example, the Marine Insurance Act 1906 was adopted almost word for word in the Australian Marine Insurance Act 1909.

2 Australian Law Reform Commission, *Insurance Contracts* (1982) ALRC 20.

3 The 1984 Act covers insurance generally, but does not apply to marine insurance (to which the 1909 Act still applies), reinsurance (common law), workers' compensation, export credits and compulsory third party motor insurance: 1984 Act, s 9.

4 *Brescia Furniture Pty Ltd v QBE Insurance (Australia) Ltd* [2007] NSWSC 598.

A.5 There is some risk in drawing general conclusions from Australian cases, as to a great extent they come from separate state jurisdictions. However the effect of this is mitigated by the practice of judges to treat other states' decisions as persuasive. Furthermore, in the insurance field, even where the High Court of Australia has not heard a matter, there is nevertheless a high degree of uniformity across Australia where state appellate courts have decided the law.

**Good faith**

A.6 While the mutual requirement of good faith existed prior to the 1984 Act in Australian insurance law, before the passage of the Act there was no reported case in which the duty operated to the benefit of the insured. As in England, the only remedy available to the insured for the insurer's breach of good faith was avoidance of the contract – unlikely to be of benefit to the insured.[5]

A.7 However, section 13 of the 1984 Act sets out an insurer's continuing duty of good faith in the following terms:

> 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.

A.8 Section 14 also augments the duty, by stating that where reliance by a party on a provision of the contract would be to fail to act with the utmost good faith, the party may not rely on that provision. Neither section 13 nor section 14 can be excluded, restricted or modified, as section 52 prohibits contracting out of the 1984 Act.

A.9 The expression "utmost good faith" is not defined by the 1984 Act. However, Professor Merkin[6] has suggested actions requiring good faith which are relevant in the context of damages for late payment of claims:

(1) Insurers should not plead policy defences other than with the utmost good faith.

(2) Insurers are under a duty to reach a timely decision on a claim.

(3) Insurers must act with the utmost good faith in deciding whether the insured has established a claim under the policy.

A.10 On the other hand insurers are not in breach of any implied duty of good faith simply by asserting a defence which is ultimately shown to be unfounded.

[5] Kelly and Ball, *Principles of Insurance Law in Australia and New Zealand* (1991) pp 156 to 159, as cited in *CGU Insurance Ltd v AMP Financial Planning Ltd* [2007] HCA 36.

[6] R Merkin, "Reforming insurance law: is there a case for reverse transportation?" Report for the English and Scottish Law Commissions, at paras 5.8 to 5.10. Available at: http://www.lawcom.gov.uk/docs/merkin_report.pdf .

A.11 Insurers which delay in the payment of a claim may face liability for damages for breach of duty in respect of consequential loss, as well as interest on the sum (in the latter case under section 57 of the 1984 Act).

A.12 In *Moss v Sun Alliance Australia Ltd*,[7] a case in which the facts were similar to those in *Sprung*, the plaintiffs had insured their general store against the risk of fire with the defendant insurers. A fire destroyed the building and virtually all of its contents. The plaintiffs promptly reported the fire. The defendant insurers never denied their obligation to indemnify – but took 11 months to admit liability, and continued to dispute quantum.

A.13 Bollen J in the Supreme Court of South Australia addressed the insurer's failure to make a prompt decision about whether it would not, or could not, provide indemnity, saying:

> [Counsel] says that prompt admission of liability to meet a sound claim for indemnity and prompt payment is required on an insurer by virtue of its obligation to act with the utmost good faith towards its insured. I agree. The defendant here, says [counsel], did not so behave. It is, therefore, in breach of its contract, of its obligation to act with the utmost good faith, of a term in its contract with the plaintiffs. It delayed for an unreasonably long time in admitting liability and in withholding, even until now, payment.[8]

A.14 The judge found on the facts that the insurer should have investigated and paid the claim within four months of the fire. He held that the insurer was to compensate the plaintiff by way of damages for interest charged on loans which the plaintiffs would have been able to pay off had they received the money within four months – to be calculated from four months after the fire to the date of judgment.

[7] (1990) 55 SASR 145; (1990) 6 ANZ Ins Cas 60-967.

[8] *Moss*, see above, by Bollen J.

A.15 In *Gutteridge v Commonwealth of Australia*,[9] after a period of delay in investigation and determination of a claim under a fire policy, the claimant insureds sought mandatory orders from the court that the insurer forthwith admit or reject the claim. Four days before the hearing, the insurer formally rejected the claim. The insureds conceded no order was needed, but arguments as to costs were still made. Ambrose J in the Supreme Court of Queensland adopted a similar approach to that in *Moss*, stating:

> Failure to make a timely decision to accept or reject an insured's claim for indemnity under a policy can amount to a failure to act towards the insured with the utmost good faith as required by s 13 of the Act, even if the failure results not from an attempt to achieve an ulterior purpose, but results merely from a failure to proceed reasonably promptly when all relevant material is, or ought to be, at hand sufficient to enable a decision on the claim to be made and communicated to the insured.[10]

A.16 The judge found that it was arguable that the insurer had breached its obligation under section 13 by failing to accept or reject the claim in the 2 months between the fire and the institution of proceedings. Consequently he found that the claimants had an arguable case to claim the relief they had sought, and awarded them costs.

A.17 The High Court of Australia tackled these issues in *CGU Insurance Ltd v AMP Financial Planning Ltd*.[11] While the case did not involve a claim in relation to late payment, there was detailed discussion of the scope and nature of the duty of good faith imposed by section 13. It is clear from the judgments in the High Court of Australia that the duty imposed on an insurer by section 13 extends to the manner in which the insurer handles claims made by its insureds; including the time taken to consider and respond to such claims. Kirby J, in particular, (albeit in a dissenting judgment on the issues) cited both of the above passages with approval.[12] Callinan and Heydon JJ, in a joint judgment, concurred that the duty extended to claims handling, and noted that a delay by an insurer can be just as damaging to an insured as an outright rejection of a claim.

[9] Unreported, Supreme Court of Queensland, 25 June 1993.

[10] *Gutteridge*, see above, at pp 12 to 13.

[11] [2007] HCA 36.

[12] Above, by Kirby J at paras 133 and 135, citing Bollen and Ambrose JJ as set out in paras A.13 and A.15 above.

A.18 However some residual uncertainty remains as to whether damages can be awarded for a breach of section 13 of the 1984 Act where there is delay by the insurer. It could be argued that it was not the intention of the Australian legislators that section 13 should provide such a remedy, as it was not suggested in the 1982 Report. Also, the Australian Treasury's 2004 Review[13] of the 1984 Act left the question open. It stated that claims for damages under section 13 may be possible, and simply noted the uncertainty in the case law.[14] In *Re Zurich Australian Insurance Ltd*,[15] for example, it was suggested that damages could only be awarded if there was breach of an implied term requiring payment on a given date. The weight of authority, however, is in favour of damages for late payment where there has been a breach of section 13.[16] Indeed the ALRC in its 2001 Report on the Marine Insurance Act 1909 said that "it is quite clear that, as utmost good faith is an implied term of contracts of insurance covered by [the 1984 Act], damages are available for breach".[17]

A.19 Although good faith is increasingly established as a concept relevant to damages for late or non-payment of claims in Australia, there is no suggestion as yet of the courts establishing a separate tort of bad faith or of awarding punitive damages in such cases.

A.20 The argument that there is liability in tort for failing to pay promptly was rejected in *Lomsargis v National Mutual Life Association of Australasia Ltd*.[18] In that case, McMurdo J, in the Supreme Court of Queensland, noted that no such tort existed in England, Canada or New Zealand and, exhibiting a clear reluctance to establish a new tort, said:

> As to principle, the plaintiff advanced no argument as to how the imposition of such a tortious liability would represent an extension of an established principle to a particular context. As to policy, it is significant that the Australian Law Reform Commission,[19] after its consultations and consideration, saw fit to recommend an introduction of a contractual obligation but to reject the imposition of a tort of bad faith and there was no argument to the effect that any changing commercial or social conditions now present different policy considerations.[20]

[13] Australian Treasury, *Review of the Insurance Contracts Act 1984: Final Report on Second Stage* (2004).

[14] Above, at para 6.20.

[15] (1999) 10 ANZ Ins Cas 61-249.

[16] See R Merkin, above, at para 8.14 and footnotes 437 to 438.

[17] Australian Law Reform Commission, *Review of the Marine Insurance Act 1909* (2001) ALRC 91, at para 10.144.

[18] [2005] QSC 199.

[19] This is a reference to the 1982 Report, cited earlier in the judgment. The Report had concluded that a tort of bad faith would not add substantially to the remedies available to an insured.

[20] [2005] QSC 199, by McMurdo J at para 58.

A.21 The attitude of Australian courts towards punitive or exemplary damages is generally less restrictive than that of the English and Scottish courts. In the companion cases of *Uren v John Fairfax & Sons Pty Ltd*[21] and *Australian Consolidated Press Ltd v Uren*,[22] the High Court of Australia declined to adopt the restrictions on punitive damages awards set out in *Rookes v Barnard*.[23] Punitive damages are available for "conscious wrongdoing in contumelious disregard of another's rights".[24] Punitive damages have been awarded in particularly egregious cases of trespass to chattels, trespass to land, trespass to the person, deceit, reckless negligence and defamation.[25] However, such damages are not normally available in breach of contract claims, and so have not been awarded in insurance disputes.

**Common law**

A.22 There is recent authority for the proposition that (in contrast to English law) the insurer has a primary obligation under the insurance contract to pay, and furthermore that it is an implied term that payment is made within a reasonable time. Arguably this has expanded an insurer's liability for late payment to the consequences of any delay beyond a "reasonable time", rather than arising only from delay in bad faith. Losses caused by the failure of an insurer to comply with its contractual obligations are recoverable as damages if they fall within the ambit of *Hadley v Baxendale*.[26]

A.23 The principle that an insurer has a primary obligation to pay (rather than hold the insured harmless, as in England) appears to be long established in Australian law. However, an insured's ability to claim damages for further losses arising from a failure to pay has, until recently, been hamstrung by a principle that has undergone recent judicial reconsideration. Previously the Australian courts had decided that in order for an insured to be able to claim damages when an insurer did not pay a claim, it had to treat the contract as terminated.[27] The insured could not demand money under a policy, thus treating it as continuing, and at the same time claim damages for the consequences of the insurer's failure to pay.

A.24 In *Tropicus Orchids Flowers and Foliage Pty Ltd v Territory Insurance Office*,[28] however, this view was rejected. Mildren J in the Supreme Court of the Northern Territory discussed the possible bases on which a departure could be made from the earlier principle. He concluded:

[21] (1966) 117 CLR 118.

[22] (1966) 117 CLR 185.

[23] [1964] AC 1129.

[24] *Whitfield v De Lauret & Co Ltd* (1920) 29 CLR 71, at p 77.

[25] *Gray v Motor Accident Commission* (1998) 196 CLR 1.

[26] (1854) 9 Exch 341.

[27] *Russell Young Abalone Pty Ltd v Traders Prudent Insurance Company Ltd* (1993) 7 ANZ Ins Cas 61-182.

[28] [1997] NTSC 46.

> Where, as here, a contract does not stipulate a time for performance by the insurer, the insurer must perform its obligations under the contract within a reasonable time. This obligation is an implied term of the contract. This is the general rule in contract law, and it is in insurance contracts unless there are indications to the contrary in the policy… if the insurer fails to pay within a reasonable time, the insurer is in breach and the insured may sue for the indemnity under the policy, and for damages for breach of contract. In order to sue for damages, it is not essential that the insurer has repudiated the contract.[29]

A.25 Furthermore, the availability of damages for breach of an implied contract term to pay within a reasonable time has arguably[30] been confirmed by the Supreme Court of New South Wales in *Brescia Furniture Pty Ltd v QBE Insurance (Australia) Ltd*;[31] the facts of which were similar to *Sprung*. The case arose from a fire at the warehouse of a family business. The defendant insurer had provided cover for loss by fire and for business interruption up to a maximum period of 12 months. The insurer refused to pay.

A.26 The claimant sued for the loss to its property and clear-up costs, business interruption for a period that exceeded 12 months, and for a lost opportunity to make a profitable purchase of new business premises. The court held that the insurer had no defence to the indemnity claim itself and awarded compensation for loss of property and for 12 months of business interruption.

A.27 The insurer, however, contested liability for the remaining further loss claims, and made three assertions: first, that as a matter of principle further loss damages were not available where the insured has not terminated the contract of insurance for breach; secondly, that the further losses could not reasonably be supposed to have been in the contemplation of the parties at the time the contract was entered into (the losses were outwith the ambit of the second branch of *Hadley v Baxendale*); and thirdly, the claimant incurred the further losses by its own failure to act.

A.28 The court did not agree. Hammerschlag J said:

> It is settled law that the failure within a reasonable time by an insurer to pay, or an unreasonable delay in payment or admission of liability without payment, is a breach of the contract of insurance: *Stuart v Guardian Royal Exchange Assurance of New Zealand Ltd* (No 2) (1988) 5 ANZ Insurance Cases 60-844*; Moss v Sun Alliance Australia Ltd* (1990) 55 SASR 145.[32]

[29] Above, at 7.4. Good faith and section 13 of the 1984 Act were not relied upon as the case involved a state insurer and so the Act did not apply.

[30] *Brescia* could also be said to be based on section 13, as the judge cites *Moss*. That said, neither section 13 nor good faith is discussed explicitly in the judgment.

[31] [2007] NSWSC 598.

[32] *Brescia*, see above, at para 88.

A.29 Although this statement in its references may have mixed the separate principles of damages resulting from breach of good faith and damages as a result of breaching an implied term to pay within a reasonable time, Hammerschlag J went on to say:

> The breach by an insurer to meet its obligations to indemnify is no different to a breach by any other citizen of a contract. The general principle remains that when assessing damages for breach of contract the plaintiff should be put in the position that he or she would have been in but for the breach, that is, the position if the contract had been performed.[33]

A.30 Dismissing the argument that further losses were not available where the insured had not terminated the contract, the judge said:

> Whether the contract is on foot or not plays no role in whether or not *Hadley v Baxendale* applies to a particular breach.[34]

A.31 With regard to the remoteness argument, the court noted that the very existence of a business interruption provision showed that a loss of that type was clearly foreseeable by the insurer. The court therefore awarded damages for the period beyond 12 months during which the business was interrupted. That said, the court did not find that the intended purchase of new premises could have been within the reasonable contemplation of the insurer at the time the policy was agreed, and so that loss was not recovered.

A.32 In respect of the causation argument, the court found that the insured had the financial means to effect reinstatement of the premises itself. Nevertheless, the court decided that it was reasonable for the insured not to have done so given the refusal of payment by the insurer.

**Interest**

A.33 In Australian law it appears to be possible to claim interest both on a statutory basis and on a common law basis as damages for late payment. In both instances Australian claimants are at a slight advantage compared to English claimants.

[33] *Brescia*, see above, at para 510.

[34] *Brescia*, see above, at para 514.

A.34 In respect of the former, the 1984 Act requires interest to be paid for all insurance claims, and not simply in those cases in which the insurer is sued for indemnity and loses. That said, the obligation to pay interest begins not at the time of loss, but after the insurer has had a reasonable opportunity to investigate, assess and decide to pay. Sections 57(1) and (2) of the 1984 Act state:

> Interest on claims
>
> (1) Where an insurer is liable to pay to a person an amount under a contract of insurance or under this Act in relation to a contract of insurance, the insurer is also liable to pay interest on the amount to that person in accordance with this section.
>
> (2) The period in respect of which interest is payable is the period commencing on the day as from which it was unreasonable for the insurer to have withheld payment of the amount and ending on whichever is the earlier of the following days:
>
> > (a) the day on which the payment is made;
> >
> > (b) the day on which the payment is sent by post to the person to whom it is payable.

A.35 The case law suggests that section 57 does not preclude an award of damages in addition to interest – or at least interest as damages rather than pursuant to section 57. In *Walker v FAI Insurance Ltd (No 2)*,[35] on facts again similar to *Sprung*, the claimant insureds' shop and stock was damaged by fire. In order to re-stock the shop the claimants expended money extended to them on credit at a rate of 17% compounded monthly. At first instance, the court awarded the claimants statutory interest of 11% on the indemnity sum (pursuant to section 57). The Supreme Court of Tasmania, however, held that there was evidence upon which the jury might have awarded additional damages, by way of interest, for the additional debt-servicing costs arising from the non-payment of the claim. A re-trial on that issue was ordered.

A.36 In reaching their decision, the Supreme Court of Tasmania relied on the decision of the High Court of Australia in *Hungerfords v Walker*,[36] the leading case on interest in Australian law. Although this was not an insurance case, the High Court held that interest claimed as damages for the loss of use of money was a "plainly foreseeable loss" within the first branch of *Hadley v Baxendale* and further that interest should be calculated on a compound basis. Lord Brandon's dictum in *The Lips* (discussed in Part 2) was expressly rejected. It is thought that this decision combined with section 13 of the 1984 Act would at least allow for compound interest to be claimed as damages for a breach of that provision.[37]

[35] [1992] TASSC 15.

[36] [1989] 171 CLR 125.

[37] Australian Treasury, *Review of the Insurance Contracts Act 1984: Final Report on Second Stage*, see above, at para 6.31.

### Reinstatement

A.37 Australian law treats the obligation to reinstate as a primary one. The High Court of Australia described the obligation in the following terms:

> The decided cases contain numerous examples of the situation where a contractual right to elect in favour of reinstatement as the mode of discharge of the obligation of the insurer has been conferred upon the insurer. There will be a term implied that the insurer will effect reinstatement within a reasonable time. A right to opt for reinstatement may also be conferred on the insured.[38]

A.38 In *Smith v Colonial Mutual Fire Insurance*[39] an insurer had elected to reinstate premises that were destroyed by fire. Before the reinstatement was complete, a second fire caused further damage and destroyed the previous efforts of the insurer. The insurer argued that it should be credited in a sum representing the first set of repairs it had carried out. The Court rejected this contention.[40] In a subsequent case, *Government Insurance Office of NSW v Atkinson-Leighton Joint Venture*,[41] Barwick CJ said, relying on the *Smith* case:

> It would be no answer for him [the insurer] to say that the added cost was due to an uninsured risk. The true analysis is that the obligation to reinstate having attached during the currency of the policy, its performance is required whatever it costs and however the cost is increased by events which could not in themselves have given rise to a claim under the policy.[42]

A.39 Barwick CJ was in the minority on the main issue that decided the case and what he said above was said in passing. It is arguable, nevertheless, that Australian law would treat a second uninsured incident, occurring in the course of reinstatement and during the currency of the policy, as a risk that the insurer continues to bear.

A.40 In Australia, reinstatement is considered as performance of the insurance contract itself. Having said that, from the dictum of Barwick CJ, it can be inferred that the obligation to reinstate is not necessarily subject to the terms of the policy. The court will consider a new set of circumstances has arisen, and the duty to reinstate to be a distinct obligation. The insurer is taken to have adopted any risks incidental to the reinstatement.

[38] *CIC Insurance Ltd v Bankstown Football Club Ltd* [1997] HCA 2, at p 8.

[39] (1880) 6 VLR 200.

[40] The subsequent case of *CIC Insurance v Bankstown Football Club Ltd* [1997] HCA 2 suggests that the *Smith* case would have had a different outcome had the second event been one that was not covered under the policy.

[41] [1981] HCA 9.

[42] *Government Insurance Office of NSW v Atkinson-Leighton Joint Venture*, see above, at para 35.

## UNITED STATES

A.41 The law in the United States of America, or more correctly the law of each of the individual states within the union, has had a significant impact on the international insurance market. Before considering the specific legal issues, it is helpful to look at the landscape in which insurance law operates in the United States, including the political and economic characteristics of the insurance market. We then examine the nature of the insurer's contractual obligation; the insurer's duty to act in good faith; the availability of punitive damages; and the availability of interest.

### Background

A.42 In spite of a shared legal heritage, regulators, legislators and (most notably) the courts in the United States have adopted a more interventionist approach to insurance law than their counterparts in either England or Scotland. It is arguable that this is attributable, at least in part, to the limited state provision of welfare services in the United States.[43] In the US, for example, the private sector provides a far greater proportion of healthcare services than in the United Kingdom or Europe.[44] It follows that, due to the limitations of the state-provided safety net, the courts in the United States may be more willing to view the insurance industry as providers of a public service. This is exemplified by the statement in *Continental Life & Accident Co v Songer*[45] that insurers:

> … are part of an industry which is affected by the public interest… As a result they can and should be held to a broader legal responsibility than are parties to purely private contracts.

A.43 Furthermore, judges and regulators have focussed on the perceived inequality of bargaining power, the complexity of policies particularly for consumers and the fact that policies are drafted on insurers' standard terms which makes it hard to negotiate more favourable terms.[46]

[43] Reuben Hasson, *The Special Nature of the Insurance Contract: A Comparison of the American and English Law of Insurance* [1984] 47 *Modern Law Review* 505, at pp 521 to 522.

[44] In 2006, the UK spent 8.4% of its gross domestic product on health care, whereas the US spent 15.3%. However, the UK's spending was much more from the public sector, with 87.3% of expenditure on health being from the public sector, compared to 45.8% by the US in 2008: http://www.oecd.org/document/16/0,3343,en_2649_34631_2085200_1_1_1_37407,00.html.

[45] *Continental Life & Accident v Songer* (1979) 603 P 2d 921 (Ariz).

[46] See J Lowry and P Rawlings, *Insurers, Claims and the Boundaries of Good Faith* (2005) 68 *Modern Law Review* 82, at p 91.

A.44 In keeping with this perception, all states have enacted legislation to regulate unfair insurance practices in the settlement of claims. Typically these statutes provide that an insurer must: investigate a claim promptly; keep the insured informed about the investigation; admit or deny liability in a reasonable time; and pay promptly once liability is established.[47]

**The insurer's contractual obligation**

A.45 The laws of the United States, like the law of Scotland, do not categorise a contract of insurance as a promise by the insurer to hold the policyholder harmless against the risks insured. The California Insurance Code, for example, defines a contract of insurance in the following terms:

> … a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event.[48]

An insurer's primary contractual duty is, therefore, an obligation to make a payment under the terms of the policy to compensate the policyholder for the loss suffered. Failure to make such a payment may render an insurer liable in damages for breach of contract.

A.46 The quantum of damages for breach of a contract of insurance may be limited by the general rule of contract that, in an action to claim money due under contract, only the debt, with interest as compensatory damages, is recoverable.[49] In many states, this would have the effect of restricting an insurer's liability for breach of contract to the policy limit, with appropriate interest thereon.[50]

A.47 It appears, however, that the courts of some jurisdictions are willing to take a liberal approach to recovery in excess of policy limits for breach of a contract of insurance. In *Lawton v Great Southwest Fire Insurance Company*,[51] the Supreme Court of New Hampshire noted that while the policy limit may be apt to restrict the sum the insurer would have to pay out in performance of the contract, it would not have the effect of restricting the insurer's "liability for damages resulting from its own breach of contract".[52]

[47] J Lowry and P Rawlings, *Insurers, Claims and the Boundaries of Good Faith* (2005) 68 *Modern Law Review* 82, at pp 91 to 92. The authors also note that the legislation of most states is based upon the model Unfair Claims Settlement Process Act promulgated by the National Association of Insurance Commissioners.

[48] California Insurance Code, § 22.

[49] See, for example, *Restatement of the Law (Second) Contract*, § 354; *California Civil Code*, § 3302; *Insurance Company v Piaggio* 83 US 378 (1872); *Smith v Wetherell* 89 NH 106 (1937).

[50] *Samovar of Russia Jewelry Antique Corp v Generali* (1984) 102 AD 2d 279 (NY), at p 281.

[51] (1978) 118 NH 607.

[52] *Lawton*, see above, at p 611.

A.48 Similarly, in *Reichert v General Insurance Co*,[53] the Supreme Court of California rejected the argument that an insurance company's liability for breach of contract was confined to the policy limit. The case involved a policyholder who was forced into involuntary bankruptcy when his insurer refused to indemnify him for a fire loss. The court held that the policyholder's consequential losses, the costs of his bankruptcy and the loss of his business, were foreseeable and could be recovered. Addressing the issue of foreseeability, the court opined:

> Insurers are… chargeable with knowledge of the basic reasons why fire insurance is purchased, and of the likelihood that an improper delay in payment may result in the very injuries for which the insured sought protection by purchasing the policies.[54]

It should be noted that, at a subsequent rehearing of the case, the Supreme Court of California vacated this decision on the ground that the entitlement to bring a claim against the insurer had passed to the plaintiff's trustee in bankruptcy.[55] It seems clear, however, that in both hearings of the case, the justices were of the opinion that an action for consequential loss sounded in contract, provided that the loss was foreseeable.

A.49 In *Royal College Shop Inc v Northern Insurance Co of New York*,[56] on facts similar to *Reichert*, the United States Court of Appeal for the Tenth Circuit confirmed that the rules expounded in *Hadley v Baxendale*[57] should be applied consistently across all contractual claims, including insurance. The court affirmed the decision of the district court in which the jury allowed damages for loss of a business which was attributable to the insurer's refusal to indemnify the policyholder.[58]

A.50 Commentators have listed numerous other such cases in which the courts have granted policyholders consequential damages for breach of contract, distinct from any separate bad faith recovery, and without regard to policy limits. [59]

A.51 In order to mitigate the problems associated with, for example, the payment of unmeritorious claims, higher premiums and under-supply of coverage, Jerry[60] notes that some US states have statutorily defined the limits of consequential damages for breaches of insurance contracts.

[53] (1967) 428 P 2d 860 (Cal).

[54] *Reichert v General Insurance Co* (1967) 428 P 2d 860 (Cal), at p 864.

[55] See *Reichert v General Insurance Co* (1968) 68 Cal 2d 822.

[56] (1990) 895 F 2d 670 (10th Cir).

[57] (1854) 9 Ex 341.

[58] (1990) 895 F 2d 670 (10th Cir), at p 679.

[59] E R Anderson, J S Stanzler & L S Masters, *Insurance Coverage Litigation* (3rd ed 2000), footnote 391 (runs for four pages).

[60] R H Jerry II, *Understanding Insurance Law* (3rd ed 2002), at p 769.

**Good faith**

A.52 Insureds in the United States may be assisted in establishing breach of contract by their insurers by the covenant of good faith implied in all contracts, including insurance. The *Restatement of the Law (Second) Contracts* states:

> Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.[61]

A.53 In *Beck v Farmers Insurance Exchange*,[62] the insured alleged that the insurer had acted in bad faith in refusing to investigate, negotiate or settle his claim under a motor insurance policy. In addition to damages for breach of contract within the limits of the policy, the insured sought compensatory damages in excess of policy limits for additional injury, including mental anguish.[63] The Supreme Court of Utah held that the implied duty of good faith and fair dealing implied in all contracts was not limited, in the case of insurance contracts, to a duty to bargain and settle in good faith, and confirmed that breach of the duty gave rise to a claim for breach of contract.[64] Zimmerman J, delivering the judgment of the court, posited that:

> … the implied obligation of good faith performance contemplates, at the very least, that the insurer will diligently investigate the facts to enable it to determine whether a claim is valid, will fairly evaluate the claim, and will thereafter act promptly and reasonably in rejecting or settling the claim.[65]

A.54 In arriving at its decision, the court rejected the argument that the damages for breach of the duty of good faith should be constrained by the limits of the policy. Zimmerman J stated:

> In an action for breach of a duty to bargain in good faith, a broad range of damages is conceivable, particularly given the unique nature and purpose of an insurance contract.[66]

In particular, he stated that, in the event that an insurer was in violation of the duty of good faith and fair dealing, damages, in addition to general damages, could be awarded for consequential losses which were foreseeable under *Hadley v Baxendale* and, in "unusual cases", for mental anguish.

[61] *Restatement of the Law (Second) Contracts*, § 205.

[62] (1985) 701 P 2d 795 (Utah).

[63] The insured's claim for punitive damages was struck from the prayer on the ground that punitive damages may not be awarded for breach of contract.

[64] *Beck*, see above, at p 798.

[65] *Beck*, see above, at p 801.

[66] *Beck*, see above, at p 802.

A.55 Whilst the doctrine of good faith and fair dealing is mutual the courts have noted that:

> … the scope of the insured's duty of good faith and fair dealing, and the remedies available to the insurer for a breach of that duty, are fundamentally and conceptually distinct from the insurer's reciprocal duty, and the remedies available to the insured for breach of that duty, under the insurance policy.[67]

**Liability of insurers in tort**

A.56 The recognition of an implied obligation to act in good faith binding on insurers has not only affected the way in which the courts have assessed insurers' obligations within the framework of contract law, but has also rendered insurers liable in tort for bad faith conduct. In delivering two of the seminal judgments on the concept, *Crisci v Security Insurance* Co[68] and *Gruenberg v Aetna Insurance Co*,[69] the Supreme Court of California appears to have been instrumental in the development of the independent tort of bad faith.

A.57 The development of the tort of bad faith, in California, began in relation to the settlement of third party claims. In *Communale v Traders and General Insurance Co*,[70] for example, a precursor to the cases cited above, it was held that:

> … an insurer, who wrongfully declines to defend and who refuses to accept a reasonable settlement within the policy limits in violation of its duty to consider in good faith the interest of the insured in the settlement, is liable for the entire judgment against the insured even if it exceeds the policy limits.[71]

A.58 The duty of an insurer to accept a reasonable settlement in satisfaction of a third party claim was further explored in *Crisci v Security Insurance Co*.[72] In this case, the court held that:

> Liability is imposed not for a bad faith breach of contract but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing.[73]

[67] *Kransco v American Empire Surplus Lines Insurance Co* (2000) 97 Cal Rptr 2d 151, at p 160.

[68] (1967) 66 Cal 2d 425.

[69] (1973) 9 Cal 3d 566.

[70] (1958) 50 Cal 2d 654.

[71] *Communale*, see above, at p 661.

[72] (1967) 66 Cal 2d 425.

[73] *Crisci*, see above, at p 430.

That is to say, *Crisci* expressly confirmed that a violation of the duty of good faith and fair dealing sounded in tort irrespective of whether the conduct complained of could also constitute a breach of contract.[74] The test to be employed, in determining whether an insurer has violated the duty, is whether a "prudent insurer without policy limits" would have accepted the offer to settle.[75]

A.59 If an insurer is found to have violated the aforementioned duty, it will be liable to compensate the insured for all losses proximately caused by the breach, whether anticipated or not. In addition, such liability may include damages for mental distress.[76]

A.60 The landmark decision in *Gruenberg v Aetna Insurance Co*[77] provided a fundamental leap in the development of the tort of bad faith. In this case, the Supreme Court of California held that:

> The duty to so act [in good faith] is immanent in the contract whether the company is attending to the claims of third persons against the insured or the claims of the insured itself. Accordingly, when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort.[78]

That is to say, the court held that the tort of bad faith not only applied to third party insurance claims, but also to first party claims. The court went on to state that the insurer's duty was unconditional and independent of the contract.[79]

A.61 For an insurer to prevent itself becoming liable in tort, it must give at least as much consideration to the interests of its insured as it does to its own when assessing whether to accept or decline liability.[80] When coverage is denied, the test to be applied in assessing whether the conduct complained of is tortious, is one of reasonableness.[81]

[74] *Crisci*, see above, at pp 432 to 434.

[75] *Crisci*, see above, at p 429.

[76] *Crisci*, see above, at p 433. See also California Civil Code, § 3333.

[77] (1973) 9 Cal 3d 566.

[78] *Gruenberg*, see above, at p 575.

[79] *Gruenberg*, see above, at p 578.

[80] *Egan v Mutual of Omaha Insurance Co* (1979) 24 Cal 3d 809, at p 818. See also *McCormick v Sentinel Life Insurance Co* (1984) 200 Cal Rptr 732.

[81] *Congleton v National union Fire Insurance Company of Pittsburgh* (1987) 189 Cal App 3d 51, at p 62.

A.62 It should be noted, however, that not all states which recognise the tort of bad faith do so in relation to both first and third party claims. In *Beck v Farmers Insurance Exchange*,[82] for example, the Supreme Court of Utah acknowledged that while there was precedent for recognition of the tort in the third party context, the breach of the duty of good faith in the first party context sounded solely in contract.[83]

A.63 In addition to consequential damages, liability in tort opens the door to an award of exemplary or punitive damages, which are not generally available for breach of contract.[84]

A.64 Of the fifty states in the union and the District of Columbia, 47 appear to allow punitive damages to be awarded for bad faith conduct.[85] Given the potential for substantial jury awards for punitive damages,[86] it is unsurprising that thirteen of that number place a statutory cap on the amount which may be awarded.[87] In addition, the United States Supreme Court has held that compensation for bad faith is unavailable if insurance policies are covered by the Employee Retirement and Income Security Act 1974, on the ground that the terms of the federal statute should not be supplemented or supplanted by varying state laws.[88]

A.65 What constitutes sufficiently reprehensible behaviour to merit an award of punitive damages varies between states. For example, in California, proof of "oppression, fraud, or malice" is required to justify an award of punitive damages.[89] In Oklahoma, such damages may be awarded where "there is such recklessness and wanton disregard of another's right that malice and evil intent may be inferred."[90] It is clear, however, that mere bad faith is not sufficient to justify an award of punitive damages.

**Interest**

A.66 As noted above, the compensatory damages recoverable for failure to pay money are often limited to interest on the debt. It is important, therefore, to consider the period over which interest is calculable.

[82] (1985) 701 P 2d 795 (Utah).

[83] *Beck*, see above, at pp 799 to 800. The basis of the distinction appears to be that, in the third party context, the insurer is charged with a fiduciary duty.

[84] See, for example, *Restatement of the Law (Second)*, § 355; *California Civil Code*, § 3294; *Beck v Farmers Insurance Exchange* (1985) 701 P 2d 795 (Utah).

[85] From http://www.badfaithinsurance.org/statelaws.html.

[86] See, for example, *Mitchell v Fortis Insurance Company*, Supreme Court of South Carolina, Opinion No 26718 (2009). In this case the plaintiff was awarded, at first instance, $150,000 as compensatory damages and $15 million as punitive damages. The latter award was reduced to $10 million by the Supreme Court.

[87] http://www.badfaithinsurance.org/statelaws.html.

[88] *Pilot Life Insurance Co v Dedeaux* (1987) 481 US 41.

[89] *California Civil Code*, § 3294 (a).

[90] *Sunray DX Oil Company v Brown* (1970) 477 P 23d 67, at p 70.

A.67 When an insurer undertakes to pay the policy proceeds to the insured and then fails to do so, "pre-judgment interest" is generally recoverable.[91] In addition, consistent with the general rules common to all judgments, "judgment interest" is recoverable.

A.68 There is, however, a general rule that pre-judgment interest may not be recovered on claims which are not liquidated. A growing number of courts, though, have awarded policyholders pre-judgment interest in cases where the damages were unliquidated for the avowed purpose of giving the insured full and fair compensation.[92]

A.69 Considerable differences exist in the cases regarding the time from which pre-judgment interest is calculated.[93] If payment is due at the time of loss, according to the terms of the policy, interest may be calculated from that date.[94] There are also cases in which interest has been allowed from the date of the insurer's wrongful denial of coverage.[95] Other courts have held that the time for computing interest runs from the date of the filing of the proof of loss, the date the insured files suit against the insurer, or the date of the verdict in third-party litigation against the insured.[96]

## CANADA

A.70 Like the United States, Canada shares a common heritage with England. The Canadian courts, however, have not adopted the English approach to damages in insurance contract law. In particular, the two jurisdictions differ markedly in the way in which aggravated and punitive damages have developed. Furthermore, the Canadian courts have imposed a contractual duty of good faith on insurers when handling claims. which plays an important role in the availability of both aggravated and punitive damages.

### Good faith

A.71 The development of a contractual duty placed on insurers to act in good faith in the settlement of insurance claims appears to have been relatively recent; that is, in the last twenty years. In *Frederickson v Insurance Corporation of British Columbia*,[97] the British Columbia Supreme Court declined to follow *Dillon v Guardian Insurance*[98] which purported to import the American concept of damages for bad faith refusal to settle. Esson CJSC, delivering the judgment of the court, noted that:

[91] R H Jerry II, *Understanding Insurance Law* (3rd ed 2002), at p 697.

[92] See, for example, *Casey Enterprises Inc v American Hardware Mutual Insurance Co* (1981) 655 F 2d 598 (5th Cir), at p 604.

[93] R H Jerry II, *Understanding Insurance Law* (3rd ed 2002), at p 698.

[94] See, for example, *California Civil Code*, § 3287.

[95] See, for example, *Rogers v Aetna Casualty & Surety* Co (1979) 601 F 2d 840 (5th Cir), at pp 845 to 846.

[96] R H Jerry II, *Understanding Insurance Law* (3rd ed 2002), at p 699

[97] (1990) 69 DLR (4th) 399.

[98] (1983) 2 CCLI 227.

the US cases rest on the rule that an obligation of good faith and fair dealing is implied in every contract, a rule of law not generally accepted in this country.[99]

A.72 Nevertheless, he did suggest that a post-contract duty of good faith could apply to insurers when deciding to settle claims, as this would reflect the dominant position of the insurer and the vulnerability of the insured.[100] Unfortunately, the circumstances of the case did not warrant an investigation of the nature of the duty. By 1991, however, the courts in British Columbia had expanded the post-contract duty of good faith beyond this embryonic stage. In *Shea v Manitoba Public Insurance Corporation*,[101] the Supreme Court of British Columbia expressly held that the insurer owes the insured a duty "of good faith and fair dealing… [and must] give at least as much consideration to the insureds' interests as it does to its own interests ".[102]

A.73 In *Ontario Inc v Non Marine Underwriters, Lloyds of London*,[103] the Ontario Court of Appeal made the following observations on the nature of the insurer's duty of good faith:[104]

(1) The duty of good faith obliged "the insurer to act with reasonable promptness during each step of the claims process. Included in this duty is the obligation to pay a claim in a timely manner when there is no reasonable basis to contest coverage or withhold payment".

(2) "The duty of good faith also requires the insurer to deal with its insured's claim fairly. The duty to act fairly applies both to the manner in which the insurer investigates and assesses the claim and to the decision whether or not to pay the claim".[105]

A.74 The test is one of reasonableness; a denial of coverage must be based on an insurer's reasonable interpretation of its rights and obligations under the policy and the existence of a "genuine issue" pertaining to coverage.[106]

99 Above, at p 425.

100 He drew a parallel with the imposition of a duty of good faith on insureds in the pre-contract period to reflect their dominant position.

101 (1991) 1 CCLI (2d).

102 Above.

103 [2000] 184 DLR 687 (Ont CA).

104 Above, by O'Connor JA at p 694, para 28.

105 Above, by O'Connor JA at p 694, para 29.

106 C Brown, J Neyers, & S Pitel for the Insurance Bureau of Canada, "The Impact of Recent Legal Developments on Liability Insurance" (2005), at p 20.

A.75 The duty of good faith appears to be continuous from the moment the claim is lodged. An insurer has an obligation to continually evaluate the evidence and has a duty to pay or settle the claim should its position (of refusal) no longer be viable on the evidence.[107]

A.76 In summary, the law in Canada obliges insurers to act promptly and fairly in the investigation, assessment and settlement of a claim. Nevertheless, if an insurer decides to refuse a claim it will not be in breach of any duty of good faith provided that the refusal is made on reasonable grounds, even if that refusal is ultimately found to be wrong. If, however, the insurer's conduct is deemed to have breached the duty of good faith and fair dealing, the court may award aggravated and, in some cases, punitive damages.

**Aggravated damages**

A.77 As explained by the Supreme Court of Canada in *Fidler v Sun Life Assurance Co of Canada*,[108] the term "aggravated damages" is frequently used to describe two different categories of damages, damages for mental distress and "true" aggravated damages, both of which are compensatory in nature.

***Damages for mental distress***

A.78 Damages for mental distress are awarded under the principles of *Hadley v Baxendale*[109] and, unlike for an award of true aggravated damages,[110] the requirement for a separate cause of action is not a prerequisite; an award of mental distress damages is solely dependent on the parties' expectations at the formation of the contract.[111] In the majority of commercial contracts, it is unlikely to be in the reasonable contemplation of either party that a breach of contract would result in the infliction of mental distress upon the innocent party. However, this rule does not apply to all insurance contracts. In *Fidler*, it was explained that an insurance policy providing long term benefits in the event of disability was not merely a contract providing tangible benefits (payments), but also providing intangible benefits (knowledge of income security in the event of disability).[112] It could, therefore, be reasonably foreseen that the breach of such a contract by the insurer, by wrongly terminating payments, would cause the insured to suffer mental distress.

[107] *Khazzaka (cob ESM Auto Body) v Commercial Union Assurance Co of Canada* [2002] OJ No 3110 (Ont CA).

[108] [2006] 2 SCR 3, by McLachlin CJ and Abella J at para 51.

[109] (1854) 9 Ex 341.

[110] See paras A.80 to A.81 below.

[111] *Fidler v Sun Life Assurance Co of Canada* [2006] 2 SCR 3, by McLachlin CJ and Abella J at para 53.

[112] Above, by McLachlin CJ and Abella J at para 56.

A.79 Where it is established that mental distress was a reasonably foreseeable consequence of the breach of contract, it does not appear that the intention or reasonable belief of the party breaching the contract need be considered. In *Warrington v Great-West Life Assurance Co*,[113] which also related to the payment of disability benefits, the Court of Appeal for British Columbia held that it was the delay in payment itself which resulted in the insured suffering mental distress and that the distress suffered would have remained irrespective of the insurer's motivation.[114]

***True aggravated damages***

A.80 True aggravated damages arise from aggravating circumstances which are independent of the principles expounded in *Hadley v Baxendale*.[115] The award of such damages is, however, dependent upon the existence of a separate cause of action. In *Fidler*, the court mentioned fraudulent or defamatory conduct as examples which would constitute a separate cause of action. Both would amount to an actionable wrong under the law of tort.[116] It is apparent from a previous related judgment, however, that the actionable wrong need not be an independent tort.

A.81 In *Whiten v Pilot Insurance Company*,[117] the Supreme Court of Canada held that a breach of the contractual duty of good faith is independent of the breach of the contractual duty to pay for the loss. Binnie J, delivering the judgment of the court, reasoned that such a breach would, therefore, constitute a separate actionable wrong. Although this judgment related to punitive damages, there is no reason that it should not be seen to be equally applicable to aggravated damages because, like punitive damages, the requirement is simply for the existence of a separate actionable wrong. Furthermore, it is accepted that "aggravated damages will frequently cover conduct which could also be the subject of punitive damages".[118]

**Punitive damages**

A.82 Punitive damages may only be awarded where there has been a "finding of the commission of an actionable wrong which caused the injury complained of by the plaintiff".[119] In addition, the defendant's misconduct must be "so malicious, oppressive and high-handed that it offends the court's sense of decency".[120]

[113] (1996) 24 BCLR (3d) 1 (CA).

[114] Above, by Newbury J at para 22.

[115] (1854) 9 Ex 341.

[116] *Fidler v Sun Life Assurance Co of Canada* [2006] 2 SCR 3, by McLachlin CJ and Abella J at para 52.

[117] [2002] 1 SCR 595.

[118] *Vorvis v Insurance Corporation of British Columbia* [1989] 1 SCR 1085, by McIntyre J.

[119] *Vorvis v Insurance Corporation of British Columbia* [1989] 1 SCR 1085, by McIntyre J.

[120] *Hill v Church of Scientology of Toronto* [1995] 2 SCR 1130, by Cory J at para 196.

A.83 *Whiten v Pilot Insurance Company*[121] is the leading Canadian case on punitive damages in the context of insurance. In restoring the jury's award of C$1m for punitive damages, the Supreme Court of Canada authoritatively pronounced that a breach of the insurers' duty of good faith is a separate actionable wrong such that insurers could be liable for punitive damages in appropriate circumstances.[122] In considering whether punitive damages should be awarded, Binnie J provided guidance for trial judges to give to the jury, in the form of the following numbered list:[123]

(1) Punitive damages are very much the exception rather than the rule,

(2) imposed *only* if there has been high-handed, malicious, arbitrary or highly reprehensible misconduct that departs to a marked degree from ordinary standards of decent behaviour.

(3) Where they are awarded, punitive damages should be assessed in an amount reasonably proportionate to such factors as the harm caused, the degree of the misconduct, the relative vulnerability of the plaintiff and any advantage or profit gained by the defendant,

(4) having regard to any other fines or penalties suffered by the defendant for the misconduct in question.

(5) Punitive damages are generally given only where the misconduct would otherwise be unpunished or where other penalties are or are likely to be inadequate to achieve the objectives of retribution, deterrence and denunciation.

(6) Their purpose is not to compensate the plaintiff, but

(7) to give a defendant his or her just desert (retribution), to deter the defendant and others from similar misconduct in the future (deterrence), and to mark the community's collective condemnation (denunciation) of what has happened.

(8) Punitive damages are awarded only where compensatory damages, which to some extent are punitive, are insufficient to accomplish these objectives, and

(9) they are given in amount that is no greater than necessary to rationally accomplish their purpose.

(10) While normally the state would be the recipient of any fine or penalty for misconduct, the plaintiff will keep punitive damages as a "windfall" in addition to compensatory damages.

[121] [2002] 1 SCR 595.

[122] See para A.81 above.

[123] *Whiten v Pilot Insurance Company* [2002] 1 SCR 595, at para 94.

(11) Judges and juries in our system have usually found that moderate awards of punitive damages, which inevitably carry a stigma in the broader community, are generally sufficient.

A.84 The separate goals of aggravated and punitive damages mean that the court may award both. Aggravated damages are available to compensate the insured for loss not included in an award of general damages and, where the court considers the insurer's conduct is so serious that it justifies a penal rather than merely compensatory award, punitive damages are available.

### Interest

A.85 In *Bank of America Canada v Mutual Trust Company*,[124] the Supreme Court of Canada considered the competency of the courts to award pre-judgment and post-judgment compound interest on damages for breach of contract. In a clear analysis the Court concluded that it had the power to award compound interest pre and post-judgment where appropriate. Major J reasoned that simple interest artificially distinguished between money owed and interest owed whereas compound interest more precisely reflected the benefit gained by possessing money for a period of time as:[125]

> Compound interest compensates… for the decrease in value of all money which is due but as yet unpaid because unpaid interest is treated as principal.

A.86 Therefore, where the contractual obligation is to pay money, and the obligation is breached by non-payment, an award of compound interest will fully compensate the claimant. By accurately reflecting the "time-value" of money, it awards the claimant the value he or she would have received had the contract been performed. It appears, however, that not every breach of a contractual obligation to pay money will merit an award of compound pre- and post-judgment interest:

> An award of compound pre- and post-judgment interest will generally be limited to breach of contract cases where there is evidence the parties agreed, knew, or should have known, that the money which is the subject of the dispute would bear compound interest as damages. It may be awarded as consequential damages in other cases but there would be the usual requirement of proving that damage component.[126]

## OTHER JURISDICTIONS

A.87 A number of countries that do not share a common legal tradition based on English law have tackled the issue of late payment of insurance claims, and the consequential losses which may result therefrom. We summarise a few examples below.

[124] [2002] 2 SCR 601.

[125] Above, at para 23.

[126] Above, at para 55.

### China

A.88 China produced its first piece of comprehensive insurance legislation in 1995, the Insurance Law. A number of amendments have been made since then, including a new Act in 2009, but provisions on claims handling and payment of claims have remained essentially unchanged.

A.89 Chinese law remains a blend of legal cultures, with Chinese, Soviet and Western (particularly German civil law and more recently US) influences. Contract and insurance laws, in particular, reflect this latter influence; principles of good faith and fairness govern contractual relationships in general (according to articles 5, 6 and 20 of the Contract Law 1999) and contracts of insurance in particular (articles 5, 13 and 20 of the Insurance Law 2009).

A.90 The 2009 Act tackles the problem of insurers delaying the claims process by piecemeal requests for information and refusing to inform the insured of the decision on liability. The Act requires the insurer to notify the insured, in one comprehensive list, of all the documents and evidence it needs to assess a claim, and to make a decision on liability promptly. If the claim is complicated, the insurer has 30 days from receiving notice of the claim to make a decision on liability; by implication, the period is less for simple claims. Payment must be made within 10 days of the insured's agreement to the settlement proposed. If the settlement amount cannot be determined within 60 days of notification the insurer must make a payment on account of the sums that can be agreed.

A.91 Article 24 of the 2009 Act specifically provides that:

> An insurer who fails to fulfil the obligation as prescribed in the preceding paragraph [described above] shall compensate the policyholder or beneficiary for losses incurred therefrom, in addition to paying the insurance amount or claim.

### Spain

A.92 Spanish insurance law is more interventionist than either English or Scots law. The law in Spain provides for proportionate payments in the event of a misrepresentation or non-disclosure by the insured; thereby making it less likely that the insurer will avoid a claim. If nevertheless the insurer and insured cannot agree a claim, Spanish regulation stipulates that both parties must appoint loss adjusters within 40 days. If the adjusters cannot agree the loss, they must appoint a third adjuster, or the court will appoint one. The assessment of the majority is binding. The process takes place against the backdrop of a punitive interest regime.

A.93 The Insurance Contract Act 1980 (Ley de Contrato de Seguro) provides both that insurers have an obligation to pay claims, and sets out the remedies available should they not fulfil that obligation. Article 20 requires the following:

(1) An insurer must within 40 days of notification of a loss pay the minimum that it reasonably considers falls due to the insured.

(2) An insurer must pay the full amount owed within 3 months.

(3) From the date of loss and for up to a period of 2 years any amount due and not paid to the insured shall attract interest at one and a half times the ordinary rate.

(4) Beyond the period of 2 years stated above any amount continuing to be owed shall attract an interest rate of not less than 20%.[127]

**Italy**

A.94 In the Italian legal system, the rules on insurance contract interpretation and enforcement are contained in the Civil Code; in particular, the provisions are contained in Section XX of Title III of Book IV of Obligations. Within Title III of Book IV there is also a section dealing with general contracts, which also applies.

A.95 The two relevant provisions are: Article 1375, which states that a contract must be performed according to good faith; and Article 1175 which says that debtors and creditors are required to abide by the principle of fair dealing.

A.96 It appears that in several cases Italian courts have applied both of these principles to allow a policyholder to seek redress from an insurer – including for consequential economic loss in excess of policy limits.[128]

**Germany**

A.97 In the recent Insurance Contracts Act of 2007 (*Versicherungvertragsgesetz*) a provision exists in the section on accident insurance (*Annerkentnis*) which tackles non-performance by the insurer. In general terms, Article 187 of the 2007 Act states that following a request by the insured the insurer must explain its decision on liability and any settlement proposals within one month of receiving the information necessary to make such a decision. If the claim is acknowledged and an agreement is reached, payment of the claim must be made within two weeks.

[127] Spain's Supreme Court (Tribunal Supremo) in 2007 resolved some ambiguity in this provision, holding that the 20% punitive rate started from the beginning of the third year, rather than operating retroactively: STS (Pleno) 1-3-2007 (RC 2302/2001). It should be noted that under the Spanish system such a decision is not technically binding on lower courts and many have held that the 20% minimum applies from the date of loss.

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