Insurance Contract Law Reform - Proposed Amendments to the Duty of Good Faith

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The Law Commission continues to make great strides in proposing insurance contract law reform. Its latest offerings are two papers which consider the duty of good faith: Issues Paper 6, *Damages for Late Payment and the Insurer's Duty of Good Faith; and Issues Paper 7, The Insured's Post-Contract Duty of Good Faith*. We touched briefly on both these topics in our December 2009 issue of *Insurance and Reinsurance Review*.

Issues Paper 6 – Damages for Late Payment and the Insurer's Duty of Good Faith

This Issues Paper was published on 24 March 2010. In it, the Law Commission considers 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. Failure by insurers to provide a prompt indemnity, for example, following a fire at commercial premises, can lead to disastrous financial consequences on the part of the insured, which can include a total loss of the business. Under English law, there is no recompense, save for the discretionary award of interest which will often not reflect the policyholder's true loss.

In American jurisdictions of course, the position is very different. Under the law of most states, insurance companies owe a duty of good faith and fair dealing to the persons they insure. This duty is often referred to as the "implied covenant of good faith and fair dealing" which automatically exists by operation of law in every insurance contract. If an insurance company violates that covenant, the policyholder may sue the company on a tort claim in addition to a standard breach of contract claim. The contract-tort distinction is significant because as a matter of public policy, punitive or exemplary damages are unavailable for contract claims, but are available for tort claims. The end result is that a plaintiff in an insurance bad faith case may be able to recover an amount larger than the original face value of the policy, if the insurance company's conduct was particularly egregious.

The Problem with Sprung

Under English insurance law it is established law that a claim under an insurance policy is a claim for damages and there is no right to damages for late payment of claim/indemnity, as held in *President of India Lips Maritime Corporation (The Lips)* [1988] AC 395 and followed reluctantly by the Court of Appeal in the key case of *Sprung v Royal Insurance (UK) Limited* [1997] CLC 70.

The Law Commission considers that Sprung is out of line with the principles of ordinary contract law. The general position is that a defendant is required to compensate the claimant for any loss flowing naturally from the breach of contract or any special loss which he ought to have known would flow from the breach. Insurance law is the exception because the sums due under the insurance policy are in the form of damages for breach of the insurers' undertaking to "*hold the insured harmless*" by way of indemnity and therefore payable on the occurrence of the insured peril. As the Law Commission points out, this is a pure fiction as it means that insurers are automatically in breach of contract if the assured suffers a loss.

The Law Commission also has the following objections to the decision of *Sprung*:

- the law is unfairly weighted in favour of insurers because the assured has no remedy if insurers choose to pay late. By contrast, policy terms may impose onerous obligations on the assured with draconian remedies for the insurers if the obligations are not complied with.
- the law does not support efficient and TCF compliant insurers and as such provides no incentive for an inefficient and poorly-run insurer to change its ways.
- the law can result in unjust decisions and consequences.

Breach of Insurers' Duty to Act in Good faith

It could be argued that late payment is a breach of the insurer's utmost good faith, but there is a problem in that it is well established that the only remedy for such a breach is avoidance ab initio and return of the premium by the insurer (*Banque Financière v Westgate Insurance Co* [1991] 2 AC 249). This is unlikely to be of much use to the insured particularly if it has suffered a significant loss.

Alternative Remedies

However, an insured does have limited remedies available if it has suffered loss as a result of the late payment of a claim:

- ***Interest*** – there is the possibility of an award of interest under Section 35A of the Senior Courts Act 1981, but that is a remedy only awarded by the court following a judgment
- ***The FOS*** – The Financial Ombudsman Service (FOS) is available to help those cases falling within its jurisdiction, namely consumer and small business cases. It has proved itself willing to award damages for distress and inconvenience (although such awards are primarily for consumers and do not involve large sums) and also for financial loss flowing from business interruption.
- ***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 and in practice, policyholders instead rely upon The FOS route.

- ***The tort of deceit*** – In theory, if an insurer lies to an insured, it would be liable for any losses which result. However, this tort 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 is unlikely to help most policyholders when their valid claims are paid late or not at all.
- ***Reinstatement*** – often policies 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 proposals

The Law Commission has identified two broad approaches to reform. Firstly an amendment could be made to Section 17 of the MIA, so as to provide policyholders with damages where an insurer has acted in bad faith. Secondly the decision in *Sprung* could be reversed, so as to make an insurer liable for a failure to pay a valid claim within a reasonable time.

If these changes took place, it is clear from what the Law Commission has said that:

- the policyholder should be required to prove his loss caused by a declinature or unjustifiably delayed payment
- the consequential loss must have been foreseeable (in the mind of insurer/policyholder) when the policy was entered into
- that the policyholder has been reasonable by trying to limit the loss.

The Law Commission is therefore proposing that insurance contracts be treated in the same way as ordinary contracts. In addition it has proposed that the core duty of good faith should be non-excludable (as you would expect in a contract of *uberrimae fidei*). However, in business insurance, the parties would be free to agree to contract terms excluding liability for failure to pay within a reasonable time. It has also proposed that damages for distress, inconvenience and discomfort should be made available for delayed payments.

Industry Feedback

Responses to this Issues Paper were invited by 24 June 2010. The industry, whilst generally accepting that reform of the law is needed and that injustices such as that demonstrated in Sprung, need to be avoided, has voiced a number of concerns, namely the possible increase in costs (when there are commercial pressures not to increase premiums), and the possible increase in "satellite" disputes (for example what is a "reasonable" time for an insurer to investigate a claim? At what point does delay in payment become unjustified?).

Some commentary relates to the limitations of the Law Commission's proposals. For example, the singling out of insurers from insureds and other commercial entities for special treatment. It is not clear why any change in the law cannot apply to all debts. In addition, if breach of the duty of good faith by an insurer has a remedy in damages, this should be extended so that either party to the contract is entitled, in the event of breach by the other party, to elect either for avoidance from the date of the breach or for damages.

Other aspects which insurers feel strongly about are that they should be permitted to have a reasonable period of time to investigate the claim, that any legislation should affect insureds and insurers alike and be spelt out clearly, and that it should be permissible to exclude the duty of good faith.

A full consultation paper is planned for early 2011 and it will be interesting to see what affect these industry considerations will have on the current proposals. The Issues Paper can be viewed at http://www.lawcom.gov.uk/docs/late_payment_issues.pdf.

Issues Paper 7 - The Insured's Post-Contract Duty of Good Faith

According to figures released by the ABI, 1.4% of claims were refused for fraud in 2008, amounting to 4.2% of the value of claims. Issues Paper 7 considers the law of fraudulent claims, focusing in particular on what remedies should be available to insurers if policyholders act fraudulently.

Express Terms

The current law permits the use of express "fraud clauses" setting out the consequences of making a fraudulent claim, provided they are in clear, unambiguous terms. Public policy does not however permit a party to exclude liability for his or her own fraud. The Law Commission agrees with this position. The law is unclear, however about whether a party may exclude or limit liability for the fraud of its agents. Whilst it is unlikely that an insurer will wish to assume the risk that the insured's agent is fraudulent, the Law Commission queries whether the law should prevent an insurer from doing so if the parties so wish.

Absence of an Express Term

At present if a policyholder suffers a legitimate loss but then adds a fictitious claim to that loss, the policyholder will lose its entire claim. Whilst the Law Commission considers that this is correct, it believes the law on fraudulent claims to be unnecessarily confusing. As with Issues Paper 6, the problem lies with the fact that Section 17 of the MIA provides only one remedy, that of avoidance of the contract from the start (ie that the insurer is not on risk for that claim). In theory, this entitles an insurer to require the policyholder to repay all past claims under the policy even though all of those claims are genuine. The courts have dealt with this problem by holding that a fraudulent policyholder should forfeit the fraudulent claim, leaving the rest of the contract unaffected.

The Law Commission considers this to be the correct approach albeit that it is incompatible with what Section 17 says. As such, it has tentatively suggested that Section 17 be amended to reflect the current common law position. In addition, it has suggested that the insurer should be entitled to damages from a policyholder for the costs of investigating a fraudulent claim.

Joint and Group Insurance

Issues Paper 7 also considers fraudulent claims in joint and group insurance. With respect to joint insurance (taken out by two or more people to cover joint interests, commonly couples) the law finds that the fraud of one policyholder affects the other. The Law Commission has proposed that where two or more people act together to insure their joint interests, there should be a presumption that any fraud committed by one party is done on behalf of all the parties. However, it would be open to an innocent party to rebut this presumption and if he or she produces evidence that the fraud was not carried out on their behalf or with their knowledge, then the claim should be paid. Recovery should be limited to the innocent party's particular loss, and the guilty party should not benefit.

With respect to group insurance (typically group schemes where an employer takes out a policy for the benefit of employees), as group members are not policyholders, there is doubt as to whether they are caught by the obligations imposed on policyholders under insurance contract law. The Law Commission has queried whether there is a need to make special provision for fraudulent claims by group members to give insurers similar remedies to those available where a policyholder acts fraudulently.

The Duty of Good Faith

The Law Commission has considered whether the insured's post-contract duty of good faith has any other effects, outside the context of fraudulent claims. In many European countries, as policies tend to last for several years, policyholders are under a continuing duty to notify the insurer of factors which aggravate the risk. The Principles of European Contract Law provide the insurer with a remedy if the policyholder fails to do so, but the remedy is limited. The insurer may only refuse payment if the loss was caused by the aggravation of the risk. Even if the loss was so caused, the insurer is usually required to pay a proportion of the claim, based on the premium it would have charged had it known the full circumstances. the insured also has a right to a premium reduction if there is a material reduction in the risk.

UK law however does not recognise an on-going duty of disclosure in the absence of a specific contract term. Even if the contract does include a notification clause, the UK courts will interpret it restrictively. The Law Commission has agreed with this approach, but has questioned whether there would be advantages to following the approach set out in the Principles of European Contract law.

Codification

Lastly, the Law Commission has looked at whether any codification of the duty of good faith should be exclusive, so that it covers only specified instances, or whether it should continue to

have some general, unspecified effect. On the one hand, allowing a general duty might permit the courts to develop the law to meet new challenges, but on the other hand, it could add to confusion and uncertainty. The Law Commission has requested responses to its proposals by Monday 11 October 2010. If you would like to view the Issues Paper, please see it here: http://www.lawcom.gov.uk/docs/issues7_duty-of-good-faith.pdf.

Comment

There appears to be a general consensus that the remedies available under English law for a breach of the duty of good faith are out of step with today's commercial realities and can be unclear and confusing. The Law Commission, with these two recent Issues Papers, has attempted to strike a balance between the rights of the insured and the insurer. It remains to be seen whether or not its proposals will make it to the statute books.

We will continue to closely monitor these projects both on InsureReinsure.com and through this publication.