

**THE ASSURED'S REMEDY FOR LATE PAYMENT IN INDEMNITY
INSURANCE CLAIMS**

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Abstract

It is well known that in English law the indemnity insurers stand in a better position than the assureds and this is especially true when a claim is delayed: in that scenario, the insurer is neither liable for the damage caused by the late payment, nor for the compound interest.

In *Sprung v. Royal Insurance* ([1999] 1 Lloyd's Rep IR 111) this unfair situation was justified by the Court of Appeal, naturally, it brought an opportunity for the Law Commission to reconsider the law.

Recently, the new Insurance Act 2015 has been enacted and subsequently amended by the Enterprise Act 2016 in regards to the insurer's obligation to make a timely payment; however, the legal effect of the new legislation is unknown due to the lack of binding precedents.

In this work, the duty of the indemnity insurer shall be discussed in full and this work will try to make a contribution to the interpretation of the new legislation regarding to the obligation of the insurer and remedies for the assured.

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Chapter 1 Introduction

1.1 The Insurance Bill and the intentional omission

1.1.1 In July 2014, the English and Scottish Law Commissions, after over 7 years research and consultation, finally completed a draft Bill for modern insurance legislation and it was intended to be named as the Insurance Contracts Act 2014.¹ This draft Bill would make some significant amendments to the only statute which regulates indemnity insurance contracts in this country: the Marine Insurance Act 1906 (MIA 1906), which is considered too obsolete to fit the modern insurance practice today.

According to the Bill lots of issues have been changed significantly such as the duty of disclosure, the effect of a breach of a warranty, the effect of fraudulent claims and perhaps one of the most important changes among them is the insurer's obligation to make timely payment after loss and its obligation if no such payment is reasonably made.

1.1.2 However, it was surprising to find that in the final Bill, which was sent to the House of Lords for its readings, the section relating to late payment above was intentionally omitted. This meant that the only chance to add that section back to the legislation again would be in the amendment stage before the Royal Assent, or it could be done so in another legal reform in insurance law.

As time went by, the Insurance Bill was named as the Insurance Act 2015 on 12th February, when the Bill received the Royal Assent. It is now an Act of Parliament

¹ Available on < http://lawcommission.justice.gov.uk/docs/lc353_insurance-contract-law.pdf>, from p.351, accessed on 3rd Dec 2014.

and it will come into force in August 2015, which means that there will be no statutory regulation of the insurer's obligation on payment in that modern legislation on insurance, at least not in 2015 and 2016. However, the government said they would rethink on this point and this problem was finally resolved by the Enterprise Bill 2015 (now the Enterprise Act 2016); as a Government Bill rather than a Law Commission Bill it is able to contain controversial materials and the impact of the new Enterprise Bill will also be discussed in this work.

1.2 Reasons for the omission

1.2.1 For those who are not familiar with English insurance law, they may be curious about the importance of that section: because the insurer's duty on payment stated in that section has been long recognized by the majority of common law countries such as Australia, Canada and some states of the USA; and civil law countries such as most of the countries in the EU and China. More importantly, this approach is also considered a European insurance principle;² however, that obligation has never been recognized by English law and more anomalously it is generally believed that English law regards the obligation of the insurer as one to "hold the assured harmless" by preventing the loss,³ rather than to pay the indemnity under the policy. It could be imagined that before sending the revised bill to the House of Lords, there must have been a heated debate on whether the original section, s.14, should be maintained, but

² See Principles of European Insurance Contract Law (PEICL), Art 6:103.

³ For a detailed discussion see chapter 2 of this work.

regrettably it was decided by the Law Commission that a negative answer should be given.

1.2.2 This omission caused series of responses from the market and even from those consulted in the House of Lords. In the Committee Stage the representative of the Law Commission was asked by the House to give reasons.⁴

In its response, the Law Commissioner David Hertzell made several points to support the omission:

Firstly, it was accepted by the Law Commission and the English government that this section would introduce a brand new cause of action in insurance law, and there was a lack of market consensus to do so.⁵

Secondly, it was highly possible that this section could introduce uncertainty and unnecessary disputes, such as so-called “American fake litigations”, which would possibly ruin the reputation of the London market.

Thirdly, it was noticed by the Law Commission that even though most national insurers accepted the original section on the insurer’s obligation, those who did international business, such as Lloyd’s, expressed strong opposition.

To support the omission, Mr. Kees van der Klugt who represented Lloyd’s added a few points.⁶

⁴ Radio record available on <<http://www.parliamentlive.tv/Main/Player.aspx?meetingId=16698>>, accessed on 2nd Dec 2014.

⁵ *ibid*, see also *David Hertzell’s Memorandum*, available on <<http://www.parliament.uk/documents/HoL-Legislation-Office/Special-Public-Bill-Committees/Insurance-Bi-ll-%5bHL%5d/Evidence/Evidence%201-%20David%20Hertzell,%20Law%20Commissioner.pdf>>, accessed on 2nd Dec 2014, at para.15.

Firstly, Lloyd's worried about speculative damage claims and these claims would inevitably prolong any litigation which could damage the efficiency of the international insurance business.

Secondly, Lloyd's believed that there were only a small number of disputes on the issue of an insurer's obligation to make timely payment and claims for damage for late payment. This fact, as was believed by Lloyd's, suggested that insurers were doing well with the current legislation unchanged, and therefore it was redundant to change the current law.

1.3 Responses to the omission

1.3.1 Before the Committee Stage there was a call for evidence and parties representing different interests in the insurance market were asked to express their opinion on the draft Bill.

Surprisingly, most of them, both insurers and assureds, expressed their disappointment about that omission; and in the Committee Stage there were also supportive voices for reintroducing the original s.14, from parties of different interests and even from the judiciary.

Response from written evidences

1.3.2 Simon Hodgson, who speaks for Aon, expressed his concern that⁷

⁶ Radio record available on <<http://www.parliamentlive.tv/Main/Player.aspx?meetingId=16699>>, accessed on 3rd Dec 2014.

⁷ See *Written Evidence from Simon Hodgson*, all relevant written evidences and responses below are collected by Merkin and available on <<http://vle.exeter.ac.uk/mod/folder/view.php?id=393771>>, accessed on 20th Dec 2014.

“...the provision that provided for damages for late payment was both a welcome and necessary development to redress an imbalance in the current law.”

It was also a worry for Mr. Hodgson that it would be uncertain whether the new legislation would have the same effect which it was meant to have when the original s.14 was in, if the Bill passed the readings without the original s.14; and he further believed that such omission was a shame and a great opportunity was missed by it. Therefore Aon, even as an insurer, would wholeheartedly support the reintroduction of the original s.14 at a later stage.⁸

Sue Lewis from the Financial Services Consumer Panel (FSCP)⁹ expressed a more direct “catcall”. It was pointed out by FSCP that the majority of the Bill was devoted to increasing the protection for the insurer, and the only reason for the insurance industry and the Law Commission to reach the consensus that the original s.14 should be omitted was because they were unwilling to resolve the problem in the interest of assureds, especially consumer assureds. Therefore, while expressing their strong disappointment, the FSCP wished the original s.14 to be put back at a later stage.

It may have a surprising effect to find that the RSA Insurance Group (RSA)¹⁰ not only expressed its disappointment for the omission of the original s.14 but also discussed the importance of that section in detail. It was believed by the RSA that the original s.14 reflected a reasonable legal point of view and it also

⁸ See *Aon UK Limited Response to The Special Public Bill Committee on The Insurance Bill*.

⁹ See *Evidence by the Financial Services Consumer Panel on the Insurance Bill*.

¹⁰ See *The Insurance Bill – written submissions from RSA Insurance Group plc in response to the call for evidence issued by the Special Public Bill Committee of the House of Lords*.

reflected good commercial practice in the modern insurance market; and therefore that section would not harm the interest of insurers, rather, it could protect them in the long term as it would encourage assureds doing business in this market rather than elsewhere in the world. It was also of concern to the RSA that, even it was technically possible to reintroduce such clause at a later date or in another legal reform, should the section fail to be added back during the Committee Stage it would be unrealistic to believe that it could be done in a short time.

The same conclusion was also reached by brokers in the British Insurance Broker's Association (BIBA), the Financial Ombudsman Services (FOS), the legal practitioners: BLM Law Firm and the reinsurers: Reinsurance Group of America (RGA)

Discussion in the Committee Stage

1.3.3 In the Committee Stage, the Association of British Insurers (ABI) expressed the view that their members were strongly in favour that s.14 should be added again and this would bring incentives to insurers developing actions before a formal litigation, such as settlements, to the claim.

Longmore LJ, an experienced judge of the Court of Appeal, also expressed the view that s.14 should have been maintained and His Lordship was unable to understand the reasons provided by the Law Commission on why s.14 was omitted. Longmore LJ clearly stated that the law should encourage assureds to

fight for their rights and that encouragement could not happen without s.14¹¹ and only after the statutory change could the court safeguard that right through the common law approach.

However, Lord Mance, an honourable judge of the Supreme Court, believed the issue of an insurer's obligation to make timely payment with damage for late payment should not be covered by legislation, but His Lordship recommended assureds, who intended to avoid damage for late payment, to put in place business interruption policies.¹² However, this suggestion could not solve this problem completely, and in a landmark case *Sprung v. Royal Insurance*¹³ His Lordship, concluded that the English law on the obligation of the insurer was "notorious".

1.3.4 Along with these strong opposing views to the omission, there are some further points which would support legislative regulation on the insurer's obligation for timely payment and damage for the late payment.

Firstly, it was said by both Lloyd's and the Law Commission that they worried about the uncertainty brought by the new cause of action and fake litigations, however, that worry itself is a lack of confidence in the judicial system and the professionalism of the English commercial courts. It has been mentioned and

¹¹ The reason is that in English law the amount paid by the indemnity insurer is in the name of "damages" and there is no cause of action for "damage over damage", for detailed discussions on this point see chapter 2 and chapter 3 of this work.

¹² In fact, business interruption policy could neither prevent nor solve this problem, see *Pride Valley Foods Ltd v. Independent Insurance Co Ltd* [1996] Lloyd's Rep I.R. 120, this case is further discussed in chapter 2 of this work; see also *Insurance Corporation of the Channel Islands Ltd v. McHugh* [1997] LRLR 94, which is discussed in chapter 3 of this work.

¹³ [1999] 1 Lloyd's Rep IR 111.

noticed by the House that most countries around the world have adopted that approach and among them Australia is a very good lesson.¹⁴

Secondly, no one can deny the fact that the current English position on the insurer's obligation is so isolated and anomalous; and even though, it was argued by Lloyd's that this situation could maintain the "good reputation" and "international competitiveness" of London market, it is hard to believe that such a system could achieve that effect and it does not seem to comply with common sense.

Thirdly, it was admitted by Lloyd's that "clients are the heart of insurance business" but, compared with their strong opposition against the right approach to the insurer's liability, that statement becomes ironic.¹⁵ It was also stated by Lloyd's that their insurers would make timely payments in order to maintain their reputation, but this statement should be regarded as an incentive to maintain the original s.14 rather than against that.

Fourthly, it was pointed out by Lloyd's that there were fewer cases on the issue of late payment; but this situation is in fact a very dangerous signal: it is not because the insurers are doing well, but because the assureds have no way to seek for a remedy.¹⁶

¹⁴ Indeed, the Australian position is not free from problems, but at least it reflects a better understanding about insurance contracts, and more importantly, it is developing rather than remaining unchanged; for a useful comparison, Australian common law, statute and industrial self-regulation will be introduced and discussed in chapter 2, 3 and chapter 6 in this work.

¹⁵ In fact, Lloyd's statement on late payment was also doubted by the House of Lords during the hearing: <http://www.parliamentlive.tv/Main/Player.aspx?meetingId=16699>, accessed on 3rd Dec 2014.

¹⁶ There is a case line in which assureds lost each and every case on late payment, and this could deter the assured from seeking a remedy through the judicial system of this country.

1.3.5 Another point is to be read with the change in warranty: in the new legislation the obsolete rules on insurance warranty in English law have been replaced by modern ones with references from the general practice in most of the European countries. It was pointed out by Longmore LJ that it was correct to follow the European approach in this modern insurance legal reform because most of them were more reasonable. There is no doubt that this is a right understanding of how to keep the national market competitive and reputable. Accordingly, this approach should have been extended to an insurer's obligation on payment and it makes the omission more unacceptable.

1.4 Introduction to this work

1.4.1 According to the brief introduction about the background of the English legal position on the insurer's obligation of payment, several important questions have to be asked:

What is the nature of indemnity insurance in this country?

Why is the insurer's obligation in this country to prevent the loss?

Why could the assured not seek a remedy when the insurer's non-payment or late payment causes damage and is that in balance?

How could the law (common law and statute) in this country have developed in this way?

Has there been any misunderstanding during the development of the law (common law and statute) in this country which leads to the problem?

What is the available remedy for the assured?

What is the right approach?

This work is intended to answer those questions provided above by firstly, analysing the backgrounds of the leading cases about the obligation of the insurers and what have really been decided in those leading cases which lead English law to the current situation; secondly, academic opinions elaborated in journal articles and books would also be critically analysed because those opinions are of great importance as well as the opinions from Law Commission Reports when the current law is to be reformed; thirdly, it should be noted that both Australia and New Zealand used to share the same statute on insurance law with the UK, however, the modern insurance law in those country deviates from their origin and therefore a comparative law study would be focus on the development of Australian law and the law in New Zealand; additionally, the questions provided above could also find answers in non-legal solutions such as the UK's Financial Ombudsman Service and Australian General Insurance's Code of Practice. In addition to the answers to the questions provided above, this work will try to make contribution to the development of the law in insurance, especially for the justification of the original s.14 of the Bill and hopefully it could also make a contribution to the future legal reform on the insurer's obligation.

It is a piece of surprising news that before this work was submitted the government published the new Enterprise Bill¹⁷, where the original s.14 is reintroduced as s.28; additionally in s.29 of the Bill it further regulates the rule for contracting out of the implied term of late payment. No wonder it is an inspiring

¹⁷ The Enterprise Bill has become the Enterprise Act 2016 on 4th May 2016 and it will come into force on 4th May 2017.

message for assureds but it has to be remembered that a brand new cause of action would inevitably cause difficulties in practice and this work intends to make discussions and comments on the application of that section.

1.4.2 As to the structure of this work, it will, firstly, according to the general principle in contract law, introduce the insurer's primary and secondary obligation: this part is the foundation of the whole work because without a clear definition and description about the obligation of the insurer it is impossible to discuss the remedy of the assured, and by making a clear distinction between the primary and secondary of the insurer a powerful support shall be provided to the reform of the current law; accordingly, chapter 2 of this work will focus on the primary obligation of the insurer and chapter 3 will focus on the secondary obligation of the insurer.

After the discussion of the primary and secondary obligation of the insurer, it would be safe to conclude that damages should have been regarded as an appropriate remedy for the insurer and it will be an appropriate remedy for the insurer in the future. However, currently the only available remedy provided by law for the insurer is interest and the law on the issues about the interest is far from clear; therefore, chapter 4 of this work would discuss the general issues about the nature of interest while chapter 5 would discuss awarding interest in insurance claims.

In chapter 6 of this work, non-legal based remedies shall be introduced because they provide efficient remedies for the assured even when the law is silent. These remedies have different natures: they could be ADR (Alternative Disputes Resolutions) which is not bound by law or insurance industry's self-regulatory

code of conducts. Therefore, in chapter 6 the most important non-legal based ADR in the UK: FOS shall be discussed as well as the well-developed Australian industry's code: General Insurance Code of Practice.

Lastly, the new Enterprise Act 2016 will have the force of the law shortly and the effect of the new Act would be discussed throughout this work; however, the application that Act may cause future uncertainty in reinsurance area and therefore, the new impact will be discussed in chapter 7 and followed by a conclusion of the whole work.

Chapter 2 The Insurer's Primary Obligation

2.1 The current law: the "hold harmless" doctrine

2.1.1 It is common sense that the insurance contract, except the contingency insurance, is a contract of indemnity; this nature is codified in the only statutory document on insurance law: the Marine Insurance Act 1906 (MIA). Section 1 states that

"A contract of marine insurance is a contract whereby the insurer undertakes to indemnify the assured..."¹⁸

However, the detailed requirement of the obligation of the insurer is still unclear and cannot be found in the MIA. Therefore, in this chapter the primary duty of the insurer under English law will be introduced in accordance with general contract law principles and followed by a detailed discussion about its problem. Additionally, leading cases which caused the problem will be read and analysed. Lastly, a reform proposal will be provided supported by academic articles, case analyses and comparative law.

2.1.2 It needs to be noted that, unlike legislation in some other countries,¹⁹ there is no statutory definition about the primary duty of the insurer and therefore, the primary duty of the insurer has to be found in case law.

2.1.3 In *The Fanti and The Padre Island*²⁰ (*The Fanti*) the duty was described by Lord Goff as one

¹⁸ MIA 1906 s.1, notably the application of this Act extends to other types of indemnity insurance.

¹⁹ For example, see Art. 10 of Chinese Insurance Law.

²⁰ [1990] 2 Lloyd's Rep. 191.

“...to hold the indemnified person harmless against a specified loss or expense...”²¹

Although the policy in *The Fanti* was against liability, it was subsequently held by Hirst J in *The Italia Express (No.2)*²² that the doctrine of “hold harmless” given by Lord Goff would apply equally in both property and liability insurance.

After *The Fanti* the “Pandora’s Box” was open: it was legally certain after that case that the obligation of the insurer was regarded as one to hold the assured harmless by preventing the loss in indemnity insurance contracts; this makes the English position anomalous from the rest of the world.

2.1.4 In *The Italia Express (No.2)* a policy was issued by the insurer against war risks and the vessel, *The Italia Express*, was sunk by explosives. The insurers rejected the claim “fairly but persistently” for more than three years, because the insurer noticed that some tape recordings indicated that the assured might in fact have sunk the vessel himself. After these surreptitious tape recordings finally turned out to be inadmissible the insurers withdrew the defence and paid the claim according to the policy. However, the assured raised additional claims caused by the delay, according to an argument that the insurer’s primary duty was to make good the loss. This argument was rejected by Hirst J and the learned judge, relying on *The Fanti*, said that

“...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

²¹ *The Fanti* [1990] 2 Lloyd's Rep. 191, at p.202.

²² [1992] 2 Lloyd's Rep. 281.

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**.²³

2.2 The problem

2.2.1 According to the authorities above, the insurer's primary duty, under indemnity insurance, is now being described as to "hold the assured harmless" rather than to pay a valid claim; and the "hold harmless" doctrine is treated the same way as the duty of preventing the loss.

Even though the words "hold harmless" have been widely used in defining the nature of the insurer's obligation in English law, it has to be remembered that without a further explanation in detail these words could make assureds, and sometimes even insurers, to wonder the exact meaning other than the duty of preventing the loss. Accordingly, it has to be admitted that these words are unhelpful for defining or performing insurance contracts.

Additionally, it is fair to say that once the risk insured against occurs and the damage is suffered, the insurer would be automatically in the position of breach of the insurance contract. In *Transthene Packaging Co Ltd v. Royal Insurance (UK) Ltd*²⁴ the position of insurers was described by HHJ Michael Kershaw QC that

²³ *The Italia Express (No.2)* [1992] 2 Lloyd's Rep. 281 at p.292, emphasis added.

²⁴ [1996] LRLR 32.

“...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”²⁵

2.2.2 In addition to these surprising findings, another issue which is more serious would appear: namely there would be no remedy for the damage suffered by the assured which is caused by the insurer’s late payment. This problem, although first raised in *The Italia Express (No.2)*, was subsequently found in the leading case for the issue of late payment, *Sprung v. Royal Insurance (UK) Ltd.*²⁶

Introduction to Sprung v. Royal Insurance

2.2.3 In *Sprung* the assured, Mr. Sprung, a small businessman who owned a factory, bought two policies to protect his business against theft and his plant and machinery from “sudden and unforeseen damage that necessitates immediate repair of the plant before it can resume normal working”. Unfortunately, in April 1986 vandals broke into Mr. Sprung’s premises and destroyed both the insured’s plant and factory. During the year of 1986 the business conditions for Mr. Sprung were hard and therefore a timely payment made by the insurer was of fundamental importance. However, the insurer did not make the payment and six months after the accident Mr. Sprung was out of business because, without the indemnity paid by the insurer, he was unable to raise a loan.

2.2.4 In his claim against the insurer in 1990, Mr. Sprung was supported by the trial judge for the payment under the policy and it was also pointed out in the first

²⁵ *Transthene Packaging Co Ltd v. Royal Insurance (UK) Ltd* [1996] LRLR 32, at p.40.

²⁶ [1999] Lloyd's Rep IR 111.

trial that such payment of the policy should have been made some four years ago. In addition, the trial judge found that, calculated by reference to the value of the lost opportunity to sell his business, Mr. Sprung also suffered a further loss of £75,000. However, it was then held that this uninsured amount of the further damage caused by the late payment could not be awarded due to the lack of a legal basis, although the loss of plant and machinery plus simple interest was allowed. Being unsatisfied with this judgment, Mr. Sprung went on to the Court of Appeal to claim damage for late payment; however, his claim failed.

2.2.5 The Court of Appeal held that they were bound by authorities which defined the primary duty of insurers, which was to hold the assured harmless and therefore no other damage than the insured amount could be granted. However, Beldam LJ said the law should be reformed:

“There will be many who share Mr. Sprung’s view that...such an award is inadequate...as a result of insurer’s failure to pay, and the early consideration should be given to reform of the law in similar cases.”²⁷

2.2.6 It could be inferred from *Sprung* and cases introduced above that once the insured risk happens and the damage is suffered the assured has to pray for a timely payment and there would be no remedy for him if the payment is delayed, reasonably or not: because the law does not recognize that paying a valid claim is a duty of the insurer. After *Sprung*, an increasing number of doubts and criticisms about the “hold harmless” doctrine appeared due to the unjust outcome of that case.

²⁷ *Sprung v. Royal Insurance (UK) Ltd* [1999] Lloyd's Rep IR 111, at p.80.

Doubts about *Sprung*

2.2.7 It has to be noted in the first place, that in order to allow the damage for late payment two issues have to be lifted together, namely the primary obligation of the insurer and the rule for damage. In this chapter the focus is to be put on the issue of the primary obligation of the insurer, because the primary obligation of the insurer shall be understood as the precondition of the rule for damages. Moreover, it is also pointed out that without a careful review on the primary duty of the insurer cases such as *Sprung* seemed to be “unimpeachable”.²⁸

2.2.8 Historically, it was pointed out by Hasson that

“English rules of insurance are more oppressive to the insured than are the ordinary rules of contracts.”²⁹

Although the favouring of the insurer could have been justified by historical reasons,³⁰ it is

“...surprising therefore that dramatic changes in the practice of insurance, particularly in relation to the domestic market, have not led to changes in the legal principles...”³¹

²⁸ John R. Birds, ‘No damages remedy when insurers unjustifiably repudiate liability’, J.B.L (1997) 368, at p.371.

²⁹ Hasson, R. ‘The special nature of the insurance contract’, M.L.R (1984), Vol.47, No.505, at p.507.

³⁰ For example, the asymmetry of information. In old time it was very difficult for the insurer to know the exact condition about the insured vessel, therefore, for the development of navigation industry the law was in favour of the insurer at that time.

³¹ Lisa Martine Bowyer, ‘Insurance contract law and regulation and competition in the UK insurance industry: The missing link’, (2000) JFRC 8(2), 140-148, at p.140; as to the change of market practice, see International Hull Clause 2003 Cl.46.7, which requires the insurer to make a decision within 28 days.

Therefore, nowadays the “hold harmless” doctrine, as a doctrine dramatically in favour of the insurer, has to be understood as a historical product and requires careful scrutiny. However, it is more anomalous to find that the “hold harmless” doctrine itself has no historical basis, especially on the ground of property insurance.

2.2.9 It could be concluded from *Sprung* that the meaning and the function of the “hold harmless” doctrine is that the once an indemnity insurance is entered into, the insurer promises that the event insured against would not occur, nor cause loss or damage to the assured; once the loss does occur, the insurer is immediately and automatically in breach, and the payment afterwards to the assured is the damage and therefore no further damage is allowed. However, this conclusion is at least open to serious doubt.

2.2.10 It is hard to imagine that, when an insurance contract is signed, the insurer has any intention to prevent the insured risk or is willing to take any effort to prevent it; it is because the policy itself is more like a promise made by the insurer: once the loss occurs the duty to indemnify will arise and that payment of indemnity, which comes from the promise, is the very subject matter of the contract rather than damage.³² In practice, once an assured is asked what is the promise provided by the insurer, the probable answer would be “pay me money, or repair my property, if I suffer a loss”³³ rather than “to prevent the loss which I insured”. Therefore, it is difficult to interpret the “hold harmless” doctrine in light of common sense and commercial sense.

³² See also Colin Ying, ‘Damages for late payment of insurance claims’, L.Q.R (Law Quarterly Review) 2006, 122(Apr), 205-210 at p.208.

³³ Neil Campbell, ‘The nature of an insurer’s obligation’, [2000] L.M.C.L.Q. 42 at p.42.

In addition, should the doctrine be correct an absurd situation would arise, namely no insurance contract could be performed in full if an insured peril occurs because at that time the contract has already been breached by the insurer, even without fault or intention. In other words, it is common ground that the main function of the insurance contract is to indemnify the assured once the insured loss was suffered;³⁴ according to the “hold harmless” doctrine, there will be no obligation to perform the contract, but only to pay the damage for breach and no wonder this conclusion makes English insurance law anomalous and bizarre.

It has also been pointed out by Marion Egan that despite the fact that the claims for damage in *Sprung* failed, the judgment, which was given *ex tempore*, was not “quite as clear as they might be”,³⁵ therefore, it might be fairly inferred that the primary obligation of the insurer has not been decided in that case.

This uncertainty was also found by the court itself in *Pride Valley Foods Ltd v. Independent Insurance Co Ltd*.³⁶ In that case the assured raised a claim against the insurer for damages caused by the insurer’s failure to perform the primary obligation, namely to indemnify for the business interruption, while the insurer, based on the “hold harmless” doctrine and the case line before *Sprung*, applied to strike out the claim. The trial judge Parker J upheld the Master’s decision that the assured’s claim should be struck out. The Court of Appeal, expressing the view that the law had been criticized as moving in the wrong direction, granted

³⁴ MIA 1906 s.1.

³⁵ Marion Egan, ‘Insurer’s duty to pay’, *Int. I.L.R.* 1998, 6(5), 166-169 at p.168.

³⁶ [1996] *Lloyd’s Rep I.R.*120.

leave to appeal. However, due to the non-disclosure in that case,³⁷ the assured failed and the debate on the insurer's primary obligation was still left open.

The academic debate

2.2.11 It is worth stressing here again that the main discussion in this work is about the indemnity insurance and therefore, the meaning of "indemnity" itself should be discussed first.

In English the legal definitions of the word "indemnity" related to insurance could be noted as follows:

1. To keep the promise "harmless against loss", an independent obligation undertaken by the indemnifier, which does not depend upon the existence of any other obligation of any other obligor.³⁸
2. A contract of liability insurance in which the insurer undertakes to indemnify the assured against legal liabilities incurred by him within a specified range.³⁹
3. A promise to compensate the insured in the event that loss does occur.⁴⁰

Therefore, it is not difficult to find that the "hold harmless" doctrine falls within the first definition. However, it has to be noted that the first definition is found in general contract law while it is accepted by courts now that the feature of

³⁷ Unreported, Court of Appeal (Civil Division), April 22, 1999.

³⁸ This is the definition in general contract law, see *Halsbury's Laws of England* (2001), Vol 20 para 109.

³⁹ *British Cash and Parcel Conveyors Ltd v Lamson Store Service Co Ltd* [1908] 1 KB 1006 (CA).

⁴⁰ *Oxford English Dictionary*, (2nd edn, 1989).

insurance is unique⁴¹ and the general rule of contract would not apply to indemnity insurance contracts, therefore it might be improper, literally, to define indemnity insurance in terms of the first definition; in addition, it is pointed out that

“The recent English cases...have gone astray by focusing on the first meaning of indemnify, when they should have been focusing on the third.”⁴²

It is clear that in the second definition, no sign of “hold harmless” appears, although the definition came from a case of liability insurance,⁴³ while it is also pointed out that the third definition “most accurately reflects both the parties’ intentions and precedent”⁴⁴ in property insurance even though no one could read into the “hold harmless” doctrine out of that definition. Therefore, it is safe to conclude that the “hold harmless” doctrine has no literal origin from the legal definition of the word “indemnity”.

It is also appropriate to introduce the different views of academics in textbooks in order to clarify the legal definition of indemnity insurance.

In *Arnould*,⁴⁵ the object of marine insurance is described as being

⁴¹ This topic will be discussed in full in the next chapter of this work.

⁴² Neil Campbell, ‘The nature of an insurer’s obligation’, [2000] L.M.C.L.Q. 42 at p.48.

⁴³ However, it seems that the primary duty of a liability insurer could be treated as one to “hold the assured harmless” from legal liabilities in limited circumstances.

⁴⁴ *ibid.*

⁴⁵ Jonathan Gilman, QC; Professor Robert M Merkin; Claire Blanchard, QC; Mark Templeman, QC, *Arnould Law of Marine Insurance and Average* (18th edn, Sweet & Maxwell, 2013).

“...to prevent the assured from suffering loss by means of any of the perils against, and its whole spirit would be violated if he could make the occurrence of any such casualties a means of gain...”⁴⁶

In view of those who support the “hold harmless” doctrine, the definition provided above is a good resource. However, it is also stated in that distinguished book that

“...its sole and exclusive object is to procure for the assured indemnity... for any losses he may sustain through... those perils [insured against]...”⁴⁷

Therefore a better understanding of the statement in *Arnould* is to treat the duty of the insurer as to stop and/or prevent the “suffering” rather than the “loss”: what an insurer could do is not to prevent the peril which is insured against, but to provide compensation in order to stop the assured “suffering” from the loss; and accordingly that definition is, in fact, not a supportive one for the “hold harmless” doctrine.

Another clear opponent of the “hold harmless” doctrine can be found in *Chitty*,⁴⁸ in which the duty of the insurer of indemnity insurance is defined as being

“...to compensate the assured for the loss that the latter may sustain through the happening of the event upon which the insurer’s liability

⁴⁶ *ibid*, at para 1-06.

⁴⁷ *ibid*.

⁴⁸ Professor Hugh Beale, *Chitty on Contracts*, (31st edn, Sweet & Maxwell, 2012).

may arise... the insurer's obligation **does not** arise unless and until the assured has sustained a loss..."⁴⁹

The same position is also reached by Professor F.D. Rose,⁵⁰ who suggests that

"A contract of marine insurance is a contract of indemnity. Its purpose is that, when the assured suffers a loss as the result of a peril against which he is insured under the policy, the insurer will... pay him a sum of money [and the purpose]...can be **achieved by that payment.**"⁵¹

In addition, the learned professor stresses that

"To be indemnified... the assured must have **suffered** a loss..."⁵²

It is found by Neil⁵³ that a similar position is also reached by *Colinvaux*,⁵⁴ *Ivamy*,⁵⁵ and *MacGillivray*.⁵⁶

Accordingly, what constitute the most significant characteristics of indemnity insurance are **loss** and **payment**, rather than loss and the duty to prevent the loss; and should the words "hold the assured harmless" be used they have to be interpreted further by the duty of compensation. Therefore, it is a preferable argument that the primary duty of an indemnity insurer **arises with** the loss rather than be **breached by** the loss.⁵⁷

⁴⁹ *ibid*, at para 41-003, emphasis added.

⁵⁰ F. D. Rose, *Marine Insurance: Law and Practice*, (2nd edn, Informa, 2012).

⁵¹ *ibid*, at para 1.26, emphasis added.

⁵² *ibid*, at para 1.27, emphasis added.

⁵³ Neil Campbell, 'The nature of an insurer's obligation', [2000] L.M.C.L.Q. 42 at p.61.

⁵⁴ Merkin, *Colinvaux's Law of Insurance*, (7th edn, London, 1997), at pp.5-6.

⁵⁵ E.R.H.Ivamy, *General Principles of Insurance Law*, (6th edn, London, 1993), at p.11.

⁵⁶ N.Legh-Jones, *MacGillivray on Insurance Law*, (9th edn, London, 1997), at pp.1-2.

⁵⁷ However, it is also important sometimes that the loss needs to be notified to the insurer.

2.2.12 Without different contractual terms, a marine insurer's obligation is subject to the MIA 1906 and according to the structure of the legislation the title of the relevant chapter is "Measure of Indemnity" rather than "Measure of Damage", that is to say, the relevant sections within that chapter should be read as the contents of the insurer's primary obligation,⁵⁸ rather than a restriction to the remedy which the assured is entitled to when a so-called breach of the insurance contract occurs. It is supported by Neil that

"...the relevant sections of the Act measure the insured's primary right to an indemnity, and the insurer's primary obligation to indemnify."⁵⁹

In addition, no case which had held that the assured's remedy in a policy was in terms of damage caused by the breach of the "hold harmless" doctrine could be found in the *Digest of the Law Relating to Marine Insurance*,⁶⁰ from which book the statute was made.

Therefore, the avoidance of the use of "damage" and "prevent" in MIA 1906 seems to be intentional whilst the duty to indemnify, in other words, to pay a valid claim, should be regarded as the primary obligation of the insurer.

Furthermore, once the primary obligation is fulfilled the insurer is then entitled to the right of subrogation. In s.79 of MIA 1906 the words which describe the precondition are "in so far as the assured has been indemnified..."⁶¹ Therefore, it could be concluded fairly that according to the statute, the primary obligation of

⁵⁸ It is also pointed out by Lord Mance that ss.67 to 69 do not rule out the availability of damage on late payment, see Lord Mance, "The 1906 Act, Common Law and Contract Claims All in Harmony?" [2011] L.M.C.L.Q. 346 at p.351.

⁵⁹ Neil Campbell, 'The nature of an insurer's obligation', [2000] L.M.C.L.Q. 42, at p.68.

⁶⁰ M. D. Chalmers and D. Owen, *Digest of the Law Relating to Marine Insurance*, (London, 1901).

⁶¹ MIA 1906 s.79 (2).

the insurer should be the duty to indemnify rather than to “hold the assured harmless”.

2.2.13 Apart from the terminology within the statute, the common law before *Sprung*, or more accurately, before *The Italia Express (No.2)*, also seems to be against the “hold harmless” doctrine.

In *Simpson v. Thomson*⁶² and *Burnand v. Rodocanachi*⁶³ Lord Blackburn held that the meaning of the word “indemnity” was a payment made by the insurer in relation to the loss suffered by the assured, and therefore it was in fact a duty of recovery rather than a failure to prevent damage. In *Castellain v. Preston*⁶⁴ Brett LJ stated that

“The contract of insurance ... is a contract of indemnity, and of indemnity only, and . . . this contract means that the assured, **in case of a loss against which the policy has been made**, shall be fully indemnified....That is the fundamental principle of insurance.”⁶⁵

In the same case, Cotton LJ described the insurance contract as

“...a contract to indemnify the person insured for the loss which he **has sustained** in consequence of the peril insured against which **has happened**, and from that it follows, of course, that as it is only a

⁶² (1877) 3 App. Cas. 279 at pp.292-293.

⁶³ (1882) 7 App. Cas. 333 at p.333.

⁶⁴ (1883) 11 Q.B.D. 380.

⁶⁵ *ibid*, at p.386 emphasis added.

contract of indemnity, it is only to pay that loss which the assured may have sustained by reason of the fire which has occurred.”⁶⁶

Should the primary duty of the insurer be a duty of prevention, the obligation must arise at the time when the policy is issued. However, it is rightly pointed out that the tense used by Cotton LJ indicates that the obligation of the insurer arises no later than the occurrence of the insured loss,⁶⁷ and the same inference could be made from Brett LJ as well.

In *Dane v. Mortgage Insurance Co. Ltd*⁶⁸ the role played by the insurer was described as

“...a person who undertakes to pay money in a certain event...”⁶⁹

It was also held that

“The policy...is a positive contract that, if the bank does not pay a certain amount on a fixed day, the insurance company will pay that amount.”⁷⁰

According to the judgment two issues were clarified afterwards. Firstly, the primary obligation of the insurer is to make the payment “in a certain event”. Secondly, the insurer has no obligation to prevent the event: for example, if a bank does not pay a certain amount to the depositor assured, what the insurer is obliged by law to do is simply pay that amount to the depositor rather than to prevent the bank from avoiding or not paying that debt.

⁶⁶ *Castellain v. Preston* (1883) 11 Q.B.D. 380 at p.393, emphasis added.

⁶⁷ Neil Campbell, ‘The nature of an insurer’s obligation’, [2000] L.M.C.L.Q. 42 at p.59.

⁶⁸ [1893] 1 Q.B. 53.

⁶⁹ *ibid*, at p.60.

⁷⁰ *ibid*.

In *Prudential Insurance Co v. Inland Revenue Commissioners*⁷¹ Channell J defined the insurance contract as

“...a contract for the **payment of a sum of money**, or for some corresponding benefit such as the rebuilding of a house or the repairing of a ship, to become due **on the happening of an event...**”⁷²

It is clear that the judge rightly accepted the payment as the primary duty of an insurance contract. However, as to the duty of “hold harmless” the learned judge said that

“Where you insure a ship or a house you cannot insure that the ship shall not be lost or the house burnt, but what you do insure is that a sum of money shall be paid upon the happening of a certain event. That, I think, is the **first requirement** in a contract of insurance.”⁷³

According to this judgment there is limited room for the duty of “hold harmless” in the indemnity insurance contract while the primary obligation of the insurer should be the timely payment.

Subsequently, in *Jabbour v. Custodian*⁷⁴ the traditional legal position introduced above was accepted by Pearson J, who refused to interpret the duty of the insurer as a kind of damage for failure to “hold the assured harmless”. It was held that

⁷¹ [1904] 2 KB 658.

⁷² *Prudential Insurance Co v. Inland Revenue Commissioners* [1904] 2 KB 658, at p.665, emphasis added.

⁷³ *ibid*, at p.664, emphasis added.

⁷⁴ [1953] 2 Lloyd's Rep. 760.

“...the word ‘damages’ is puzzling and seems to be used in a rather unusual sense, because the right to indemnity arises, not by reason of any wrongful act or omission on the part of the insurer (who did not promise that the loss would not happen or that he would prevent it) but only under his promise to indemnify the insured in the event of a loss.”⁷⁵

The same conclusion could also be reached from the *Chandris* case.⁷⁶ In that case the assured ship-owners claimed for damage suffered from general average losses which happened some six years before. The argument provided by their insurer was that the claim was time barred and it was accepted by Megaw J (as he then was) by holding that the duty of the insurer would arise after the happening of the loss and the claim was indeed time barred.

In summary, it is fair to conclude that historical authorities do not recognize the “hold harmless” doctrine, nor impose any duty of preventing loss upon the insurer. Those cases proved that the most important feature of indemnity insurance is the promise made by the insurer to pay a valid claim when the loss occurs and damage is suffered by the assured. Therefore, the modern cases in which the “hold harmless” doctrine is developed such as *The Fanti*, *The Italia Express (No.2)* and *Sprung* have to be reviewed carefully.⁷⁷

2.2.14 As mentioned above, an insurer could not prevent the loss from happening. It is also correct to argue that to prevent a loss might not be the

⁷⁵ *Jabbour v. Custodian* [1953] 2 Lloyd's Rep. 760, at p.774.

⁷⁶ *Chandris v. Argo Insurance Co. Ltd.* [1963] 2 Lloyd's Rep. 65.

⁷⁷ This issue will be discussed in full in part 3 of this chapter.

intention of the insurer and this is especially true in property insurance cases where most practical problems could be found.

The mutual care and the cross claim

2.2.15 It is common that the assured is required either by the policy⁷⁸ or by law⁷⁹ to take reasonable care of the subject matter insured to hold himself harmless, therefore it has to be admitted that should the “hold harmless” doctrine apply to both parties in the policy both parties are obliged to prevent a loss and that is an odd position.⁸⁰ Moreover, once the loss is suffered, due to insufficient reasonable care, both parties are also in breach automatically: the insurer is in breach of preventing loss while the assured is in breach of a duty of care; should that be the case a cross-claim should would be raised frequently, which is in fact never seen in practice.

Alternatively, should the insurer’s duty be one of prevention there has to be an implied term that the insurer should prevent the loss with reasonable care, as

“...where in a written contract it appears that both parties have agreed that something shall be done, which cannot effectively be done unless both concur in doing it, the construction of the contract is that each agrees to do all that is necessary to be done on his part for the carrying out of that thing, though there may be no express words to that effect.”⁸¹

⁷⁸ For example, see IHC 2003 cl.2.2 and Institute Cargo Clauses (ICC) 2009 (A) cl.5.1.

⁷⁹ MIA 1906 s.55 (2) (a).

⁸⁰ See also Neil Campbell, ‘The nature of an insurer’s obligation’, [2000] L.M.C.L.Q. 42 at p.64.

⁸¹ *Mackay v Dick* (1881) 6 App. Cas. 251, 263.

In addition to the implied term, once the primary duty of the insurer is regarded as one of preventing the loss, such a duty seems within the scope of the Consumer Rights Act 2015, which requires the service provider to carry out the service with reasonable care and skill.⁸² Therefore, an insurer's primary obligation is not only to prevent the loss, but also to prevent the loss with reasonable care and skill. In *The Simona*⁸³ it was held that

“...when one party wrongfully refuses to perform the obligations, this will not automatically bring the contract to an end. The innocent party has an option. He may either accept the wrongful repudiation as determining the contract or sue for damages or he may ignore or reject the attempt to determine the contract and affirm its continued existence.”⁸⁴

Therefore, as there is no such intention of the insurer,⁸⁵ the assured may have an option to accept the repudiation by the insurer at the very beginning of the insurance contract rather than once the loss is suffered. However, this theory seems absurd and not aligning with commercial sense. Accordingly, to regard the primary obligation of the insurer as one of preventing loss is problematic.

Alternatively, the explanation would become more practical if the primary duty of the insurer is regarded as one of compensation and this duty will not arise until the actual loss is suffered by the assured who has complied with the condition from policy or law.

⁸² See Supply of Goods and Services Act 1982, s.13.

⁸³ [1988] 2 Lloyd's Rep 199.

⁸⁴ *ibid*, at p.203.

⁸⁵ This is especially true for property insurers.

The claim notification clause

2.2.16 It is not uncommon now for a policy to impose a duty of notification on the assured⁸⁶ which may become a condition precedent for the insurance claim. Should the duty of preventing the loss be the primary obligation, the explanation is irrational: the duty of preventing loss arises with the policy and it is breached when the loss occurs; then the innocent party shall have a right to sue. However, due to the claim notification clause, this breach cannot be sued for until a notice is given; this is illogical and complicated.

Alternatively, the better understanding is that there is no breach at all before the undue delay of the payment; the contract was valid at that time, even though the loss has occurred; subsequently the primary obligation of providing compensation should be performed, but only after the proper notice is given to the insurer by the assured. If the notice is given late, the insurer could then claim damages for loss of opportunity to investigate and defend.⁸⁷

The non-intention of the insurer and the threat of gambling

2.2.17 It needs also to be pointed out that, should the “hold harmless” doctrine become the leading principle, it would inevitably lead to the fact that in English law, insurers never indemnify assureds when the latter suffer insured losses, which should have been regarded as the fundamental purpose of the indemnity insurance because each and every payment made by the insurer is a payment

⁸⁶ For example, see IHC 2003 cl.43.2, and for a recent case see *Milton Keynes BC v Nulty and NIG* [2012] Lloyd's Rep. IR 453.

⁸⁷ See *Friends Provident Life and Pensions Ltd v Sirius International Insurance* [2005] 2 Lloyd's Rep 517, *Milton Keynes BC v Nulty and NIG* [2012] Lloyd's Rep. IR 453.

for damage. It would ruin the reputation of the insurance market and make the insurance relationship “surprising and odd”.⁸⁸

Generally speaking, the insurer should stand behind the assured, not before him.⁸⁹ In addition, to impose the duty of “hold harmless”, which could not be performed on an insurer would also make an insurance policy sound like a form of gambling. Disregarding the issue of insurable interest on the side of the assured, this doctrine could push the insurer to be a gambler: although the insurer may have an interest in preventing the loss, it is rarely seen in practice that an insurer would really take care of the subject matter insured; what an insurer actually does is to receive the premium and do nothing but pray that the loss will not occur. Although this statement seems to lead nowhere, it nevertheless draws attention to the current understanding of the primary duty of the insurer.

The problem with the election of reinstatement

2.2.18 A more difficult problem can be found in the way of reinstatement in property insurance if the primary duty of the insurer is regarded as to “hold the assured harmless”. In *Sprung* it was held by Beldam LJ that the fact that

⁸⁸ See *Transthene Packaging Co Ltd v Royal Insurance (UK) Ltd* [1996] LRLR 32, at pp.40–41 (per HHJ Kershaw, QC).

⁸⁹ This is the statement provided by Neil in ‘The nature of an insurer’s obligation’, [2000] L.M.C.L.Q. 42 at p.65, for a property insurer, and it is also appropriate to extend this statement to liability insurance with some restrictions.

“...the insurers have the option themselves to reinstate or to pay for the reinstatement of the property...does not alter the essential nature of their liability, which is to pay the sum of money as damages.”⁹⁰

From all the discussions provided above, it might be argued, with respect, that the learned judge erred by defining both payment and reinstatement by way of damage. Further problems could be caused by that statement both in practice and law when the insurer decides to reinstate the damaged property rather than to pay the money: firstly, in English law, damage is described as

“...the pecuniary compensation which the law awards to a person for the injury he has sustained by reason of the act or default of another, whether such act or default is a breach of contract or a tort; or, put more shortly, damages are the recompense given by process of law to a person for the wrong that another has done him.”⁹¹

It has to be admitted that the obligation of reinstatement is not “a pecuniary compensation” nor has the insurer done anything wrong with the assured. Whilst upholding the legal position that the primary duty of the insurer is not damage Pearson J stated that

“...the right to indemnity arises, not by reason of any wrongful act or omission on the part of the insurer (who did not promise that the loss

⁹⁰ [1999] Lloyd's Rep IR 111 at p.119.

⁹¹ *Halsbury's Laws of England*, 2nd edn, Vol. 10, at p. 82; cited with approval by Pearson J in *Jabbour v. Custodian* [1953] 2 Lloyd's Rep. 760 at p.774.

would not happen or that he would prevent it) but only under his promise to indemnify the insured in the event of a loss.”⁹²

Secondly, the duty of reinstatement is more like a method of performing a contractual duty rather than a method of compensation, because it could be rarely seen in practice that a so called wrong-doer (the insurer) rather than a victim (the assured) could be given a choice of how to compensate the breach.

Thirdly, according to a general principle, there is “no damage over damage”,⁹³ and once the damage is made good the liability for the breach will be discharged;⁹⁴ it means that if the insurer elects to pay rather than reinstate, any further defects are not the liability of the insurer. However, this is not the case in reinstatement. The insurer must bear the further obligation if the reinstatement causes further damage to the assured:

“If the insurer replaces the damaged item with something inferior, the insured is entitled either to reject it or accept it and claim damages for the difference between the two values.”⁹⁵

Accordingly, it is the reason why many insurers, who have under the policy the option to pay or to reinstate, would rather choose to pay in order to cast the risk of the defective repair upon the assured.

⁹² *ibid.*

⁹³ See *The Lips* [1987] 2 Lloyd's Rep. 311 at p.317.

⁹⁴ Although sometimes the liability of performing the original contract remains: for example, when a contract is repudiated by one party, the innocent party could claim damages while refuse to accept the repudiation.

⁹⁵ Edited by Merkin, *Insurance Law - an Introduction* (1st edn Informa, 2007), at chapter 6; see also Malcolm A Clarke, *Law of Insurance Contracts*, (4th edn), at para 29-2D and Neil Campbell, ‘The nature of an insurer’s obligation’, [2000] L.M.C.L.Q. 42 at p.67.

In *Davidson v Guardian Royal Exchange Assurance*⁹⁶ the insured car was broken and the insurer opted to repair it rather than to pay the damage; however, the repair was not fast enough and caused the car to be off the road for about 40 weeks and the assured claimed further damage. In the policy clear wording against loss of use was provided, but the court finally upheld the assured's claim for the loss of use. The rationale behind this judgment is simple: once the insurer elects to reinstate rather than to pay, the reinstatement becomes the primary contractual obligation of the insurer and the failure of the performance would lead to damage. *Prima facie* this case and the academic statement could not be reconciled with the damage rule and the "hold harmless" doctrine, and the only way of reconciling them under current legal position is to say that the reinstatement is changed from "damage" into primary obligation. However, it is clear from *Sprung* that the nature of the reinstatement could not be changed and the primary obligation is to prevent the loss; the duty of reinstatement will be put in a predicament.

In *Brown v. Royal Insurance Co*⁹⁷ the insurer elected to reinstate the fire-damaged building belonging to the assured. However, they did not do the reinstatement with care and as a result of which the remains were removed by the government. The court stated that even though the performance of the insurer's **contractual duty** was now impossible, the insurer would nevertheless be liable in damages for the non-performance. It was held by Lord Campbell that if the insurer elected to reinstate the property rather than to pay the compensation, he

⁹⁶ [1979] 1 Lloyd's Rep 406.

⁹⁷ (1859) 1 El.& El. 853.

“...is in the same position as if he had originally contracted to do the act which he has elected to do.”⁹⁸

It should be noted that Lord Campbell stressed again that the duty of reinstatement was a primary contractual duty while the duty of preventing the loss was not. Therefore, a better view is to treat the reinstatement as a method of providing compensation, namely the fulfilment of the insurer’s primary obligation, the failure of which would lead to the secondary obligation, namely, damage.

It is also pointed out that

“Nor, apart from interest, can the insured recover consequential losses arising simply from the insurers’ failure to pay, but he may be able to recover if he can show that insurers committed some other and separate breach of the insurance contract which caused his loss. Furthermore, specific heads of consequential loss arising from the occurrence of an insured peril can be and often are insured by express words in the policy.”⁹⁹

Although it is academically arguable whether an assured is entitled to consequential losses by late payment¹⁰⁰ it is obvious, from the statement above, that if there is a separate breach of the insurance contract, which causes consequential loss to the assured, damage could be awarded.¹⁰¹ Accordingly,

⁹⁸ *ibid*, at pp.858-859.

⁹⁹ Lord Mance, Iain Goldrein QC, FRSA and Professor Robert Merkin, *Insurance Disputes*, (3rd edn, Informa, 2011), at para 7.7.

¹⁰⁰ While it is legally certain that damages for late payment is inadmissible before 5th May 2017.

¹⁰¹ See *Davidson v Guardian Royal Exchange Assurance* [1979] 1 Lloyd’s Rep 406.

the duty of reinstatement has to be regarded as a contractual duty and consequential loss will follow should the duty be breached.

One step further, the duty of reinstatement and the duty to indemnify stand in the same legal position: firstly, the condition precedent of these duties is the loss insured against; secondly, both of them are the result of an election made by the insurer and once the election is made, another approach would be blocked; therefore, there should not be any reason why damage is not permitted for failure to perform the duty of payment while it is permitted once the duty of reinstatement is breached.

A different story in Australia

The contractual duty to make timely payment

2.2.19 In *Moss v. Sun Alliance Australia Ltd*¹⁰² the facts were similar to those in *Sprung*: the assured insured a store against fire and the store was destroyed by the insured risk. After a prompt report the insurer refused to admit the liability until 11 months had passed, based on an unwarranted suspicion that the assured had set fire to it himself. The delay of the payment of insurance money meant the assured was unable to repay the commercial loan and a further obligation to pay the higher interest.

It is appropriate to add here that in Australia an insurance contract is also a contract of utmost good faith but the duty is described as a contractual duty and

¹⁰² 93 ALR 592.

breach of such duty will not, at least in non-marine insurance,¹⁰³ lead to avoidance but to contractual resolutions.

Therefore, it was found by the court that the insurer in fact breached the contractual obligation to make timely payment and that he was also in breach of the duty of good faith¹⁰⁴ because the good faith in indemnity insurance contracts meant that the insurer must not delay for an unreasonably long time in admitting liability and withholding payment and it was held that the insurer was liable to pay damages.

It should be noted that, compared with the English position, the Australian understanding about the nature of indemnity insurance is more reasonable. Additionally, the Australian legal position is also well ahead in case of reinstatement, but it is true that recently there have been very few cases on this issue which have actually been to court and therefore the English common law has no chance of developing.

The obligation to “reinstatement”

2.2.20 In *Smith v The Colonial Mutual Fire Insurance Co Ltd*¹⁰⁵ there was a fire policy which stated that the insurer might elect to reinstate the insured property rather than to indemnify the assured. After a fire at the insured property the insurer elected to reinstate the damaged premises and some money was spent

¹⁰³ It should be pointed out that in the Australian MIA 1909 avoidance seems to be the only remedy when the duty of utmost good faith is breached.

¹⁰⁴ This point is arguable, but is accepted by the Australian public authority, see *Review of the Insurance Contract Act*, available on http://icareview.treasury.gov.au/content/Reports/FinalReport/03_Chapter1.asp, accessed on 24th Nov 2014, at para 1.8.

¹⁰⁵ (1880) 6 VLR (L) 200.

on such action; however, before the premises were fully reinstated a second fire occurred and destroyed the premises. The second fire was also covered by the policy¹⁰⁶ and unsurprisingly there was a total loss, but the insurer argued that the money spent in the reinstatement should be deducted from the total loss because it reflected the insurer's previous effort. The argument failed and for so many years nobody has doubted the correctness of this old authority: the insurer's obligation in respect of the second fire was to reinstate, and the fact that it had spent some money partially reinstating the premises after the first fire was simply irrelevant to the proper measurement of its obligation in respect of the second fire. It is summarised that

“During the progress of reinstatement they are their own insurers; and the happening of the subsequent fire does not concern the assured, who remains entitled to insist on the due performance by the insurers of their obligation without crediting them with what they have already expended.”¹⁰⁷

Judicially, such expression is welcomed in Australia and in *Government Insurance Office of NSW v. Atkinson-Leighton Joint Venture*¹⁰⁸ the obligation of reinstatement was further explained by Barwick CJ that during the reinstatement taken by the insurer the added cost could not be deducted because

¹⁰⁶ Once the second incident is not covered by the policy the outcome will nevertheless be the same, see *CIC v. Bankstown Football Club* [1997] HCA 2, at [50] and [71]; based on this ground it might be argued that the Law Commission made a mistake: see Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (LC Paper 6), available at <http://www.scotlawcom.gov.uk/files/5912/7981/3396/cpinsurance_issue6.pdf> , accessed on 24th Nov 2014, Appendix, at fn.40.

¹⁰⁷ Hardy Ivamy, *General Principles of Insurance Law*, (6th Edition, Butterworths, 1993), at p.487.

¹⁰⁸ (1981) 146 CLR 206.

“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.”¹⁰⁹

It is not difficult to note that the Australian insurer’s general position in reinstatement is the same as in England, but differences can be found when the insurer is willing to **reimburse the amount for reinstatement** rather than **to perform reinstatement on its own**,¹¹⁰ and that situation happened in *CIC Insurance Ltd v. Bankstown Football Club*¹¹¹.

2.2.21 In that case the building was insured against fire; the first fire occurred within the policy period while the third happened when the policy lapsed. The only dispute which was referred to the High Court was that whether the insurer was liable for the increased cost of reinstatement caused by the third fire.¹¹²

It was argued by the assured that since the first fire was covered by the policy, the insurer was liable to indemnify the assured based on the amount of reinstatement; due to the wrongful non-payment for the first fire the assured could not reinstate and the added amount of cost should be regarded as damage caused by late payment.

That argument was rejected by the High Court; it was pointed out that since in that case the reinstatement was **a measure of indemnity** rather than **an**

¹⁰⁹ *ibid*, at p.219.

¹¹⁰ *CIC Insurance Ltd v. Bankstown Football Club* [1997] HCA 2, at [45].

¹¹¹ [1997] HCA 2.

¹¹² The issue of damage for late payment was later solved by the Supreme Court.

obligation, therefore the authorities such as *Smith* were distinguished;¹¹³ and the court further held that the insurer was only liable, from the reinstatement aspect, for the cost of the first fire.¹¹⁴

Accordingly, once the word “reinstatement” appears in the policy it is crucial to identify the meaning of this word. Once it means an obligation that the insurer has undertaken to reinstate, the added risk during the reinstatement is on the insurer; while if it is a measure of indemnity the insurer is only liable to pay for the original risk and the liability of the additional risk shall be determined by other provisions of the policy and once the reinstatement is a measure of indemnity, it becomes a contractual obligation in Australian law to make that payment within reasonable time otherwise the rule of damage for late payment could still be triggered.¹¹⁵

Reinstatement with reasonable despatch

2.2.22 In *CIC v. Bankstown* the wording of the policy was that the reinstatement by the assured must be commenced with “reasonable despatch” otherwise the insurer shall not be liable for the increased amount after the happening of the damage; it was held by the High Court that even though the delay for the repair was caused by the lack of financial resources of the assured, the obligation of “reasonable despatch” was breached and the insurer was not liable for increased costs.¹¹⁶

Reinstatement and indemnity

¹¹³ *CIC Insurance Ltd v. Bankstown Football Club* [1997] HCA 2, at [71].

¹¹⁴ *ibid*, at [106].

¹¹⁵ In the first trial of *CIC v. Bankstown* Cole J quantified that the liability of the insurer was some \$0.5m.

¹¹⁶ [1997] HCA 2 at [101], see also below *TJK v. Mitsui* [2013] NZHC 298.

2.2.23 The Australian High Court provided no opinion about the definition of the money “actually incurred” in the policy from the *CIC* case which the insurer agreed to reimburse, but in the New South Wales Supreme Court Kirby P provided an *obiter* that such provision did not require the assured to actually pay out the money and an agreement should be enough.¹¹⁷

It should be noted that Kirby P expressed a reluctance to regard the “actually incurred” money paid from the assured as a pre-condition of the insurer’s liability. Additionally, should this opinion be admitted by law, it will have the effect that the assured will have a security against the payment to a third party repairer. No wonder this is a very important remedy when the assured is out of funds itself, such as was the position of the assured in the *CIC* case. This view should be encouraged and should be accepted by an English court to maximise the assured’s remedy.

It could also be argued that if the insurer wishes only to indemnify what has been actually paid already by the assured (the out of pocket money), it has to be made very clearly and with the consent of the assured.

The New Zealand development on reinstatement

2.2.24 It is also appropriate to add New Zealand cases on reinstatement in this part.

¹¹⁷ (1994) 8 ANZ Ins Cas 61-232 (CA NSW) at 75,564; see also Ian Enright, Rob Merkin and Michael Kirby, *Sutton’s Law of Insurance in Australia*, (4th edition, Thomson Reuters Australia, 2014), (*Sutton*), at para 16.44.

In New Zealand there is a recent authority¹¹⁸ which suggests that where the property is damaged by fire and the insured wishes to leave it damaged rather than to reinstate it, recovery will be allowed on the basis of the cost of reinstatement. This is subject to the proviso that there is no further requirement in the policy that the cost of reinstatement must actually have been incurred before there arises the liability of the insurer to pay.

Historically the legal position in reinstatement was unfriendly to assureds in New Zealand: in *Wright, Stephenson, and Co Ltd v Holmes*¹¹⁹ the insurer elected to repair the damaged vehicle rather than to ask for indemnity; before the repair took place the vehicle was destroyed by an earthquake. It was held by the New Zealand Court of Appeal that, by electing to repair, the obligation of the insurer changed to reinstatement, but the effect of the earthquake frustrated such obligation and the insurer was then not liable. This judgment was not welcomed; it is argued by *Sutton* that

“...the effect of frustration could surely not be to terminate the policy itself but only the repairing obligation, so the effect of the earthquake would be to revive the obligation to make payment [under the policy]...”¹²⁰

Accordingly, it seems that the frustration of the obligation to reinstate could turn back the obligation to actually reinstate to the obligation of indemnity.

¹¹⁸ *City Realities (Holdings) Ltd v. National Insurance Co of NZ Ltd* (1985) 4 ANZ Insurance Cases 60-695.

¹¹⁹ [1932] NZLR 9.

¹²⁰ See *Sutton* (4th edition, Thomson Reuters Australia, 2014) at para 16.53.

In *TJK v. Mitsui*¹²¹ there were two provisions in the policy: MD020 provided that the insurer was liable to indemnify the assured in full while MD022 provided that should the insured property be damaged by earthquake the insurer would indemnify the assured based on the reinstatement (same condition, but not better) corset (restriction), and a special condition of MD022 also provided that

“No payment of more than the indemnity value will be made under this extension:

(a) If the work of reinstatement is not commenced and carried out with reasonable despatch;

(b) Until the cost of reinstatement has been actually incurred; or

(c) If the property is damaged, but not destroyed, and the repair of the damage is not permissible by reason of any regulations or by any reason of the condition of the undamaged proportion of the property.”

Once there is a conflict between those two provisions MD022 prevails.

The effect of these clauses is clear: once the insured property suffers from any loss other than earthquake the insurer is liable for an indemnity amount based on MD020; while the loss is caused by the earthquake and the assured elects to repair, the insurer will be liable even if the amount exceeds the indemnity value, according to MD022, but if the assured refuses to repair or delays the repair the insurer is only liable for the indemnity value according to the condition of MD022. However, what is not clear from the wording is the time of the payment when the

¹²¹ [2013] NZHC 298.

property is damaged by an earthquake, but the assured does not take out the reinstatement with “reasonable dispatch”.

The insured property was damaged by an earthquake and the assured asked for immediate payment, but this was refused by the insurer who insisted that no payment should be made unless and until the actual cost by the assured had been incurred according to the condition of MD022. The dispute was referred to the High Court of New Zealand.

It was found by Miller J that a distinction should be made between “indemnity value” and “reinstatement cost” and the right to indemnity accrued immediately after the earthquake, but the insurer was not liable to pay the reinstatement cost until it was actually incurred.¹²² Miller J also pointed out that support could be found in *CIC v. Bankstown* because in that case even though the assured failed to act with reasonable despatch, the insurer was still liable for the indemnity value and the indemnity value only.

Accordingly, it should be noted that it is firmly accepted in both Australia and New Zealand that, compared with “reinstatement cost”, the duty to indemnify under the policy has the primary contractual effect. Additionally, the indemnity value could be the minimum amount for which the insurer is liable when the

¹²² See *TJK v. Mitsui* [2013] NZHC 298, at [43].

policy term on reinstatement is not fulfilled¹²³ or where reinstatement of the original property is impossible.¹²⁴

This conclusion also applies where it is impossible to reinstate, or according to the order from the local authority the damaged property could only be rebuilt rather than be reinstated.¹²⁵

2.2.25 It should be pointed out that the statement above is about the primary obligation of the insurer to indemnify the assured, and such a scheme may not, in general, affect the insurer's secondary obligation to pay damages when the primary obligation is breached. It is rightly summarized that

“...the insurer cannot rely on the failure of the assured to satisfy a condition such as carrying out reinstatement with reasonable despatch or actually incurring the costs thereof, to prevent damages...”¹²⁶

According to the comparative law discussion, it can be seen that the Australian and New Zealand's understanding about the nature of indemnity insurance is much clearer than that in England and accordingly the development of the remedies for the assured in those countries are also more advanced. Therefore, it is more crucial to review recent cases to find out the reason why the English

¹²³ See *CIC v. Bankstown* [1997] HCA 2, *TJK v. Mitsui* [2013] NZHC 298, and further *Lee v. Co-operative Insurance Co of Australia Ltd*, Unreported, 1983, SC Qld, per Kelly J, summarized by *Sutton* (4th edition, Thomson Reuters Australia, 2014) at para 16.59; for another recent New Zealand Supreme Court's example, see *Ridgecrest NZ Ltd v. IAG New Zealand Ltd* [2014] NZSC 117.

¹²⁴ See *Kypris v. MLC Fire & General Insurance Co Pty Ltd* (1981) 1 ANZ Ins Cas 60-451 (CA NSW), and see also *Sutton* (4th edition, Thomson Reuters Australia, 2014) at para 16.53.

¹²⁵ See *Colonial Mutual v. D'Aloia* [1989] VR 161 (FC), *Lumley General Insurance Ltd v. Vintix Pty Ltd* (1991) 24 NSWLR 652 CA

¹²⁶ See *Sutton* (4th edition, Thomson Reuters Australia, 2014) at para 16.45

understanding of the insurer's obligation has gone astray while the Scottish position remains the same with New Zealand and Australia.

2.3 The re-examination of recent cases

2.3.1 From the arguments above, it is now clear that the "hold harmless" doctrine is in fact incorrect if it is to be regarded as the primary duty of the indemnity insurer. It needs to be mentioned that the doctrine never appears in historical authorities nor been accepted by any other common law country. Therefore, modern cases, in which the doctrine of "hold harmless" is held to be the primary obligation of the insurer, need to be carefully re-examined. The following cases,¹²⁷ as mentioned at the very beginning of this chapter, will now be scrutinized.

The Fanti

2.3.2 In that case the ship-owner of the vessel, *The Fanti*, entered into the Newcastle Protection and Indemnity Association (also known as the P&I club). After a leakage of water appeared in some tanks of the vessel, both the vessel and the cargo on board were damaged and abandoned to the salvors. Subsequently a judgment was obtained by the cargo owner against the ship-owner, whose liability insurer was the named club. However the ship-owner became insolvent and the cargo owner, according to the Third Parties (Rights against Insurers) Act 1930, claimed damages directly against the club.

¹²⁷ Namely, *The Fanti* [1990] 2 Lloyd's Rep. 191, *The Italia Express (No.2)* [1992] 2 Lloyd's Rep. 281 and *Sprung v. Royal Insurance* [1999] Lloyd's Rep IR 111.

The main issue of the case was whether the famous “pay to be paid” clause altered the rights of parties and what right an assured had before the actual payment was made. The clause in dispute reads as

“...the Member shall be protected and indemnified against all or any of the following claims and expenses which he shall have become liable to pay and shall **in fact have paid**...”¹²⁸

The case finally reached the House of Lords and it was held that firstly, such a clause constituted a condition precedent so that unless and until the liability of the assured was discharged the club was not liable.¹²⁹ Secondly, the argument that such a clause had no effect on the ground that it purported to alter the rights of the parties was rejected; in Lord Brandon’s view that clause

“...applied throughout the lives of the contracts...imposing a condition necessary to be fulfilled before any liability of the clubs to indemnify the members could arise. ...[U]pon any member being ordered to be wound up... that member would be likely to be prevented from discharging any liability to a third party which...results rather from the member’s inability... to exercise those rights.”¹³⁰

2.3.3 It is obvious that the main issue of *The Fanti* is not on the point of the primary obligation of an indemnity insurer. However, the issue of the primary duty of the insurer was raised by the counsel for the assured, which was as follows:

¹²⁸ See *The Fanti* [1990] 2 Lloyd's Rep. 191, emphasis added.

¹²⁹ *ibid*, at p.197.

¹³⁰ *The Fanti* [1990] 2 Lloyd's Rep. 191, at p.197.

“(a) At common law, a contract of indemnity gave rise to an action of assumpsit for unliquidated damages for failing to prevent the indemnified person from suffering damage by paying the third party. A condition of prior payment was implicit in the nature of the contract.

(b) Equity, though recognizing the existence of the condition, would not allow reliance on it when the effect would be to defeat the indemnity altogether rather than to achieve the object... ”¹³¹

It could be found that the first point contained the duty of preventing the loss, which would be treated as the “hold harmless” doctrine, although it was not known according to which authority this argument arose. Counsel for the assured wished to persuade the court to accept the equity approach rather than that of common law, and this argument was rejected by Lord Goff. However, the Law Lord accepted the first submission on the common law approach by holding that

“... at common law, a contract of indemnity gives rise to an action for unliquidated damages, arising from the failure of the indemnifier to prevent the indemnified person from suffering damage, for example, **by having to pay a third party.**”¹³²

His Lordship continued by stating that

“...a promise of indemnity is simply a promise to hold the indemnified person harmless against a specified loss or expense...once the loss

¹³¹ *ibid*, at p.201.

¹³² *ibid*, at p.202, emphasis added.

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”¹³³

Accordingly, once the indemnifier, which could be an insurer, failed to pay a claim to a third party, first, a claim of damage would arise; secondly, it is the contractual duty of the indemnifier to hold the indemnified person harmless.

It is common ground that an insurance contract is a contract of indemnity, and therefore the duty of the insurer, according to the judgment, is to hold the assured harmless and what is paid to the assured sounds like the unliquidated damage.¹³⁴ However, this judgment has to be read with caution.

2.3.4 The first issue which needs to be noted is that what Lord Goff stated in that case should only be regarded as an *obiter* rather than a *ratio*: it is because what needs to be decided in that case before their Lordships was whether the “pay to be paid” clause violated the statutory regulation.¹³⁵

The judgment quoted above by Lord Goff rejected the intervention of equity¹³⁶ and therefore some special consideration of equity may have troubled the learned Law Lord, and such a judgment would only be treated as correct in very special circumstances.

Alternatively, should the judgment be regarded as a *ratio*, the special facts of *The Fanti* have to be considered and in addition, it is necessary to discuss the

¹³³ Ibid.

¹³⁴ This is the understanding of Hirst J in *The Italia Express (No.2)* [1992] 2 Lloyd's Rep. 281.

¹³⁵ This point was confirmed by Lord Goff himself, see *The Fanti* [1990] 2 Lloyd's Rep. 191, at p.199.

¹³⁶ *The Fanti* [1990] 2 Lloyd's Rep. 191, at p.201.

point of “hold harmless” and “damage” separately. Additionally, the understanding about the nature of indemnity insurance has been doubted both in English law and in Australia.¹³⁷

2.3.5 Firstly, it was held in *The Fanti* that a P&I club, as a liability insurer of the assured ship-owner, should take the responsibility to hold the assured harmless. Should there be no “pay to be paid” clause, it would be certain that the club had to make payment directly to the third party, as Lord Goff noticed that

“...clubs do on many occasions make payment direct to third parties... its payment to the third party ...discharge the member’s liability to the third party.”¹³⁸

Therefore, once statements made by Lord Goff are read together, it becomes clear that, without the “pay to be paid” clause, liability insurers such as the P&I club in *The Fanti* would assume the liability of its member and then make payment directly to the third party in order to discharge the legal liability of that member; namely, the primary duty of a liability insurer could be treated as one to hold the assured harmless.¹³⁹

However, it needs to be noted that although the liability insurer could in some circumstances prevent the loss by the payment to the third party, they cannot prevent the legal liability from occurring. For example, a motor insurer could not prevent the negligent driving of his assured driver, but what he could do is to

¹³⁷ For English example, see *Charter Reinsurance Company v. Fagan* [1997] AC 313, for a recent Australian decision, see *Lambert Leasing v. QBE Insurance (No. 2)* [2015] NSWSC 1196.

¹³⁸ *ibid.*

¹³⁹ See also Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer’s Duty of Good Faith (n.106), at para 2.35.

prevent the assured suffering the loss caused by the negligence. However, once the “pay to be paid” clause is inserted, the primary duty of the liability insurer would change; it is not a duty to hold the assured harmless, but to compensate the out of pocket money paid by the assured to the third party.

A similar conclusion was reached by Lord Brandon in the same case after a succinct historical review:

“... before the passing of the Supreme Court of Judicature Acts, 1873 and 1875, there was a difference between the remedies available to enforce an ordinary contract of indemnity (by which I mean a contract of indemnity not containing any express “pay to be paid” provision) at law on the one hand and in equity on the other. At law the party to be indemnified had to discharge the liability himself first and then sue the indemnifier for **damages for breach of contract**. In equity an ordinary contract of indemnity could be directed to be specifically performed by ordering that the indemnifier should pay the amount concerned directly to the third party to whom the liability was owed or in some cases to the party to be indemnified. There is no further doubt that since the passing of the Supreme Court of Judicature Acts, 1873 and 1875 the equitable remedy has prevailed over the remedy at law.”¹⁴⁰

Therefore, it could be said that the duty to hold the assured harmless is originally an equitable remedy, and that remedy could not prevail if a clear express term is inserted within the contract. It was held in *The Fanti* that subject to a clear “pay

¹⁴⁰ *The Fanti* [1990] 2 Lloyd's Rep. 191, at p.197.

to be paid” clause a prior payment made by the assured was regarded as a condition precedent of the duty of the insurer to indemnify.¹⁴¹

2.3.6 A conclusion could be reached that the issue of the “hold harmless” only exists in indemnity contracts where there is no clear and express contractual term which would constitute condition precedents of the liability of insurers. According to Lord Brandon, they are called “ordinary contract(s) of indemnity”.

Once a condition precedent is inserted, it would be argued that such a duty would be changed into a duty to provide indemnity for the out-of-pocket money by payment. In the latter scenario, the insurer’s primary obligation will not arise until the payment (the loss or harm) is made (suffered) by the assured, and since the assured has been “harmed” already, it is meaningless to argue that in such a situation, the primary obligation of the insurer is still to hold the assured harmless.

2.3.7 From the discussion about the judgment of *The Fanti*, it seems that the issue of damage will only arise if the contract is an “ordinary indemnity contract”. However, it is not decisive. The problem was found in another decision of the House of Lords: *Caledonia North Sea Ltd v. British Telecommunications Plc*,¹⁴² a case which relates to the “Piper Alpha Disaster”.

In that case, an indemnity clause was provided by the Contractor for liability incurred by the claimant Operator and notably the “pay to be paid” clause did not appear in the contract. Therefore, the indemnity clause would be regarded as an ordinary one and once the Operator makes a payment for its legal obligation the

¹⁴¹ *ibid*, at pp.197-199.

¹⁴² [2002] 1 Lloyd's Rep. 553.

Contractor is in breach and damage is available. However, it was refused by Lord Hoffmann, by holding that

“...this is not a claim for breach of contract. It is a claim to an indemnity for a liability incurred by the operator outside the contract.”¹⁴³

It might be argued that the contract in that case was not one of indemnity but only a clause which provided the duty of indemnity and therefore *Caledonia* is not good law for indemnity insurance. Although it seems to be a sound argument, according to Lord Hoffmann, the duty to indemnify could be a contractual obligation to perform by the indemnifier.

Therefore, even where there is an ordinary indemnity contract, whether the duty to provide indemnity is damage or merely a performance of contract, has not been decided yet.

2.3.8 Notably, the application of the decision made in *The Fanti* is of fundamental importance. Even though it was held in *Caledonia* that the duty of indemnity could be regarded as a contractual duty rather than damage it is still in dispute whether a judgment made on the basis of an “indemnity clause” could apply to a “contract of indemnity”. The problem becomes severe when property insurance is in dispute as it is seldom seen, in a property policy, that the assured would be liable to the third party.

However, once there is a condition precedent of the insurer’s liability after the loss, the same conclusion with liability insurance would be reached:

¹⁴³ *Caledonia North Sea Ltd v. British Telecommunications Plc* [2002] 1 Lloyd's Rep. 553, at p. 572.

Firstly, as mentioned above, *The Fanti* itself is a case of liability insurance and accordingly it is arguable if it was their Lordships' intention to apply the case in both liability and property insurance; should it be the case, clear words would have appeared as there are so many differences between property insurance and liability insurance.

Secondly, within the judgment several precedents were referred to in order to reach a proper decision; however, none of them was property insurance, they were non-insurance liability indemnity contracts.¹⁴⁴

Thirdly, in order to clarify the judgment, the example used by Lord Goff was an example in which an indemnifier paid directly to the third party; this could only be found in liability insurance contracts.

Accordingly, it is at least open to serious doubt that the statement made by Lord Goff in *The Fanti* would apply to another type of indemnity insurance, namely property insurance; moreover, it is also doubtful whether the statement could apply to non-ordinary liability insurance.

The Italia Express (No.2)

2.3.9 The key fact and the outcome of *The Italia Express (No.2)* have been introduced above; and what needs to be done in this part is to analyse the judgment made by Hirst J in the aspect of applying *The Fanti* in that case and the reason why the learned judge held that the duty to prevent the loss from occurring was the primary duty of property insurers.

¹⁴⁴ Leading cases which were referred to *The Fanti* were *Collinge v. Heywood* (1839) 9 Ad. & El. 633 (a case of indemnification of legal cost) and *Re Richardson* [1911] 2 K. B. 705 (a case of liability between the creditor and the debtor).

According to the re-examination of *The Fanti*, it is appropriate to argue that *The Fanti* could not apply to property insurance without qualification. This was firstly pointed out by Mr. Tomlinson (counsel for the assured) in *The Italia Express (No.2)*.

“It would... be absurd in property cases to treat the obligation to prevent the occurrence of actual loss itself, since that would amount...to a promise...that the ship would not sink... Holding harmless thus meant different things in different contexts.”¹⁴⁵

Apparently this is a very strong and elaborate argument because it reflects the threat of misplacing the rule in *The Fanti* in property insurance and the real understanding of “hold harmless”. However, this argument was rejected by Hirst J.

Although the judgment was cited at the beginning of this chapter, it is worth repeating here after the discussion about the scope of *The Fanti* and the introduction about the assured’s submission in *The Italia Express (No.2)*.

It was believed by Hirst J that

“...it would be extraordinary if different principles applied to the two classes of insurance...**as Lord Goff stated** that...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

¹⁴⁵ *The Italia Express (No.2)* [1992] 2 Lloyd's Rep. 281, at p.289.

indemnified under **property insurance**, and the **expense** against which he is indemnified under **liability insurance**.¹⁴⁶

Should the judgment be correct, it has to be admitted firstly that there is no fundamental difference between property insurance and liability insurance in nature; it must also be right to argue that, subject to the condition precedent of the insurer's liability after loss, equity would intervene in the property insurance and the court would grant specific performance, ordering property insurers to pay the assured before the loss occurs, in order to prevent the loss and suffering. Regrettably, it never happens and it is nearly axiomatic to say no such order would be given by courts in property insurance cases. Indeed, liability insurance and property insurance are not entirely different, but when it comes to practice they are not the same: liability insurance rests upon the establishment and quantification of the assured's liability, whereas property insurance rests upon the occurrence of the peril.

Secondly, the learned judge believed that different words used in Lord Goff's speech¹⁴⁷ must indicate that His Lordship's judgment should apply generally. However, in the same paragraph and in front of the quoted sentence, the word "damage" was also used by Lord Goff,¹⁴⁸ and therefore it might be true that "expense", "loss" and "damage" used by Lord Goff shared a same meaning of the consequence of the legal liability assumed by the liability assured. In addition,

¹⁴⁶ *The Italia Express (No.2)* [1992] 2 Lloyd's Rep. 281 at pp.291-292, emphasis added.

¹⁴⁷ Namely, "loss" and "expense".

¹⁴⁸ "...to prevent the indemnified person from suffering damage... by having to pay a third party.", see *The Fanti* [1990] 2 Lloyd's Rep. 191 at p.202.

should it be the intention of Lord Goff it might be a slur, as it is indeed obvious that such obligation in property insurance is

“...at odds with other precedents, with the likely intentions of the parties, and with common contractual provisions.”¹⁴⁹

Accordingly, as to the part of property insurer’s primary obligation, it has to be pointed out, with respect, that the learned judge erred in *The Italia Express (No.2)* by misunderstanding the intention of Lord Goff in *The Fanti* and misplacing the duty of the liability insurer in an ordinary contract into a property insurance contract.

Sprung v. Royal Insurance

2.3.10 Before the re-examination, it has to be stressed that what makes *Sprung* famous is not the legal rationale of that case, because the general legal principle had been decided upon in both *The Fanti* and *The Italia Express (No.2)* already, but the notorious and improper outcome imposed upon a small businessman, Mr. Sprung.

2.3.11 Once the judgment of *Sprung* is read in full it is not difficult to discover that the main issue which defeated the claim for the £75,000 damage was the causation of such loss. It was held by Evans LJ that

“...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...”¹⁵⁰

¹⁴⁹ Neil Campbell, ‘The nature of an insurer’s obligation’, [2000] L.M.C.L.Q. 42, at p.57.

¹⁵⁰ *Sprung v. Royal Insurance* [1999] Lloyd's Rep IR 111, at p.118.

As to the matter of damage for late payment Evans LJ continued:

“...I would hold that the law was correctly stated...**even if** the claim was reformulated in some such way [as a claim for damage for the late payment by the insurer] as I have stated, there would be no measurable prospects of success...”¹⁵¹

Although it was mentioned by Evans and Beldam LJJs that the damage for late payment might not be possible in that case, the better understanding would be one to regard such understanding as an *obiter*.

Therefore, it would be arguably right to infer that *The Italia Express (No.2)*, as a High Court judgment, is the first legal authority which confirms that the payment made by a **property** insurer is a payment of damage; however, such a judgment made by Hirst J has not been finally confirmed by any higher court yet.

2.3.12 Although the issue of a **property** insurer’s primary obligation was not clearly decided in *Sprung*, within the judgment some clues could be found by closer examination.

2.3.13 In *Sprung*, the policy was defined as

“In return for the premium the Company contracts to indemnify the Insured against the cost of making good [the insured damage]...”¹⁵²

It was clearly stated in the policy that the primary duty of the insurer was to make a payment in order to make good the loss, and failing to act would lead to a secondary obligation of damage. Accordingly, the duty to prevent the loss was

¹⁵¹ *ibid*, emphasis added.

¹⁵² *ibid*, at p.113.

not mentioned and, due to that fact, the only way to import such a “primary duty” would be one of implication, which will be discussed below.

Firstly, the most powerful implication, the implication by law, is understood as that

“[t]he court is... laying down a general rule of law that in all contracts of a defined type... certain terms will be implied, **unless the implication of such a term would be contrary to the express words of the agreement.** Such implications do not depend on the intentions of the parties, actual or presumed, but on more general considerations.”¹⁵³

It was then confirmed by Lord Diplock in *Photo Productions Ltd. v. Securicor Transport Ltd*¹⁵⁴ that the parties' express intention could replace the implication by law, because

“...parties to a contract are free to determine for themselves what primary obligations they will accept. They may state these in express words in the contract itself and, where they do, the statement is determinative...”¹⁵⁵

Accordingly, once there is a clear and an express clause about the primary obligation, such as the quoted clause in *Sprung*, there is no room for terms implied by law.

¹⁵³ Professor Hugh Beale, *Chitty on Contracts*, (31st edn, Sweet & Maxwell, 2012), at para 13-003, emphasis added.

¹⁵⁴ [1980] 1 Lloyd's Rep. 545.

¹⁵⁵ *ibid*, at p.552.

Alternatively, the insurer may then argue that such a primary duty is implied as an “*ad hoc* gap filler”, namely an implication by the fact or the nature of the property insurance contract; however, that argument could hardly succeed. It is well settled by law that such an implication would be tested by an “official bystander”.¹⁵⁶ Subject to this test, once a layman is asked “do you believe the insurer will prevent the loss with reasonable care and skill?” the answer would probably be in the negative. However, should the answer be one of “do you believe the insurer, by entering into this policy and receiving the premium, is bound by to making payment for a valid claim?” the answer would be different.

Therefore, it was clearly stated in *Sprung* that the primary obligation of the insurer was to make a payment for the loss; there would be no reason for the defendant insurer to argue their primary obligation was one to prevent the loss.

It was, in fact, admitted by the counsel for the insurer by stating that

“...the defendant owed no obligation to the plaintiff other than to **pay the indemnity** in question...”¹⁵⁷

The admission above is correct; no obligation other than the obligation to provide the contractual compensation shall be regarded as the primary obligation imposed on the insurer. While there is no cause of action for damage for failing to prevent the loss, there should be a cause of action for damage for non-performance of the contractual obligation to pay indemnity. What the defendant in *Sprung* did by admitting the obligation was to provide indemnity, but

¹⁵⁶ For the detail of the test, see *The Moorcock* (1889) 14 P.D.64 which has recently been reviewed by the Supreme Court in *Arnold v Britton* [2015] UKSC 36.

¹⁵⁷ *Sprung v. Royal Insurance* [1999] Lloyd's Rep IR 111, at p.117, emphasis added.

he defended Mr. Sprung's claim on the basis of preventing the loss. Therefore, Evans LJ commented on the insurer's defence, other than the part of the admission of its liability, that

"I do not find the defendants' submissions at all attractive, either from a commercial or from a moral point of view."¹⁵⁸

2.3.14 According to commercial sense, Beldam LJ expressed the view that

"The commercial object of such a policy is clearly to ensure that as soon as possible after the damage the assured will be able to restart production with his repaired plant."¹⁵⁹

It is a right approach to understanding property insurance. In most cases, the assured requires nothing but the compensation from the insurer in order to make good the loss. It should also be correct to argue that even if there is no express clause in the contract which requires the insurer to make compensation within a reasonable time, subject to the officious bystander test, the court would imply it as an *ad hoc* gap filler.

However, the learned judge still treated such payment as "damage"¹⁶⁰ and it would lead to the wrong conclusion that it is with commercial sense that there is only a primary duty which is to pay as damage but no secondary duty of damage once the primary obligation of contractual performance is breached.

The position of Evans LJ was, with respect, itself a contradiction: the learned judge held that there was no need for the assured to take out another policy

¹⁵⁸ *ibid*, at p.118.

¹⁵⁹ *Sprung v. Royal Insurance* [1999] Lloyd's Rep IR 111.

¹⁶⁰ *ibid*, at p.119.

such as a business interruption policy against the possibility that the insurer “would not **perform** the present property policy”.¹⁶¹ Should it be the case, namely the payment made by the insurer is to be regarded as the performance of the contract, the court should have allowed the appeal by awarding damages rather than to stress the rule that there is to be no damage over damage.

Even though *Sprung* is regarded as the leading case on the issue of the insurer’s late payment, it must be treated with caution, especially after the findings provided above.

Conclusion

2.3.15 According to the re-examination of all the cases above the current position of English law on the primary duty of the insurer, although illogical, can be concluded as follows:

Firstly, it has been settled in *The Fanti* that once there is an ordinary contract of indemnity the primary obligation of the insurer is one to prevent the assured from loss and suffering; such a duty could be performed by making payment to the third party directly, but that is not the only way in which that duty could be performed.

Secondly, once the contract of indemnity is modified with clear clauses, it becomes a matter of construction and it has not been settled by law. For example, the primary obligation of the club in *The Fanti*, after the modification by a “pay to be paid” clause, was to compensate the out-of-pocket money paid by the assured.

¹⁶¹ *ibid*, at p.117, emphasis added.

Thirdly, where the contract of indemnity is a property insurance contract, which needs to be treated with special care, the primary obligation of the insurer has not been settled by law either, even though it has been widely accepted that the “hold harmless” doctrine should apply. However, the primary obligation should be one of providing contractual compensation rather than of preventing the loss from happening.

Recently, *The Fanty* was firmly rejected by *Carillion Construction Ltd v AIG Australia Ltd*¹⁶² in the Supreme Court of New South Wales. In that case a “Tie Road Damage” occurred in 1999 and the claimant assured Carillion Construction Ltd (Carillion) made a claim against the insurer AIG Australia Limited (AIG) on **26th March 2010**. The claim was denied by AIG and according to the findings from the court, the date of the formal denial was **3 August 2011**.¹⁶³

It was argued by AIG that the cause of action in respect of the “Tie Road Damage” arose at the time when the damage occurred and it was therefore time-barred; while it was contended by Carillion that the cause of action only arose once AIG had a reasonable time to consider the claim, and then declined its obligation or failed to indemnify.

After reviewing conflicting opinions¹⁶⁴ the learned judge, Stevenson J, made a conclusion that

¹⁶² [2016] NSWSC 495.

¹⁶³ *ibid*, at [10].

¹⁶⁴ *ibid*, at [128-155].

“...a distinction is to be drawn between the time when an insured’s entitlement to indemnity arises and the time when its entitlement to sue for damages for breach of contract arises... It may well be that an insured under an indemnity policy would be entitled, immediately on the occurrence of the peril, to seek a declaration of its entitlement to indemnity. But its entitlement to sue for damages for breach of the promise of indemnity only arises only when the insurer has not done ‘what was required of it’ under the policy.”¹⁶⁵

Apparently, this judgment deviated from what was held in *The Fanti* and it was made under the assumption that the primary obligation of the insurer was to indemnify the assured and damages was of a secondary nature when the primary obligation was breached.

Additionally, the judge commented that

“It may be that the duty of an insurer to decide within a reasonable time whether or not to indemnify an insured carries with it a right to take reasonable time to make the decision. That duty and right may be two sides of the one coin... That is, the insurer can, within the reasonable time available to it and before that time has passed, decide what to do. In that event, as well as not being in breach of its obligation to act in a timely manner, it has waived its right to take longer. If its decision is to refuse indemnity, and that decision is not justified, it is there and then in breach of its obligations.”¹⁶⁶

¹⁶⁵ *ibid*, at [156].

¹⁶⁶ *ibid*, at [177].

Therefore it could be found out that there is a clear distinction between the primary obligation and the secondary obligation in Australian law and it this understanding is more acceptable in modern insurance development.

Chapter 3 The Insurer's Secondary Obligation

3.1 The general rule of damage

3.1.1 The primary obligation of an indemnity insurer has been discussed in full in chapter 2 and it should be remembered that the nature of that duty is not a clear-cut one in law, even though it should either be one to prevent the certain loss insured against in ordinary indemnity contracts or one to make contractual payments against certain events in other types of insurance contracts. However, it is clear that regardless of the type of indemnity insurance, the insurer's obligation to pay damages could only arise after the insured peril or liability. Therefore, in this chapter focus will be put on the scenario where the loss does occur and the secondary obligation, namely, the damage that would arise.

Firstly, the general rule of damage will be introduced followed by the current position of the law. Secondly, the application of the rules of indemnity insurance will be considered, followed by a discussion about the contractual duty of utmost good faith¹⁶⁷ during the claim handling stage.

Hadley v. Baxendale¹⁶⁸

3.1.2 It is commonly accepted that *Hadley* is the leading judgment on the principle of damage. In that case, Mr Hadley partly owned a mill and he wanted the broken crankshaft repaired in another place. Subsequently, a contract of carriage was concluded between Mr Hadley and a common carrier. However, that contract was breached by the carrier as the transportation was delayed;

¹⁶⁷ This duty is **not** the pre-contractual duty of good faith based on s.17 of MIA 1906.

¹⁶⁸ (1854) 9 Exch 341.

without the crankshaft it was impossible for the mill to finish the daily work. Mr Hadley claimed for the loss of profit resulting from the carrier's breach.

The court firstly set the principle for the recoverable loss; in other words, in order to be recovered, the losses had to be

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

(2) those arising from any special circumstances which were communicated at the time the contract was made (the second limb).”¹⁶⁹

Applying the principle to Mr. Hadley's claim, it was found by the court that the loss of profit did not arise naturally from the delay and due to the lack of communication there was no ground for the carrier to know that the mill could not work without the crankshaft. Therefore, Mr Hadley's claim failed. It was then settled by law that losses were recoverable if they were reasonably supposed to be contemplated by both parties.

***The Achilles*¹⁷⁰ and commercial sense**

3.1.3 The general principle of *Hadley* was considered recently by the House of Lords in a charterparty case: *The Achilles*. In this case the ship-owner was unable to meet the laycan (layday and cancellation day) of a subsequent time charter due to the late redelivery of the vessel by the current charterer. At the time when the subsequent charter was concluded the market price was

¹⁶⁹ *Hadley v. Baxendale* (1854) 9 Exch 341, at p. 354.

¹⁷⁰ [2008] 2 Lloyd's Rep. 275.

increasing (more than doubled); however, due to the late redelivery by the first charterer the owner had to replace the original charterparty by another time charter when the market price fell sharply. The ship-owner, then, claimed damages on the basis of the severe price difference between the original rate and the reduced rate of the whole period of the subsequent charter, while the charterer argued that it was only liable for the loss during the overrun.

It was proved by the charterer that it was the general practice of the shipping market that once the redelivery of the vessel was delayed the owner was entitled to damage, but the amount should be restricted to the difference between the market rate and the charter rate for the overrun. The House of Lords upheld the commercial practice and rejected the owner's claim. It was held by Lord Hoffmann that although the damage was foreseeable, it was a matter of law to decide whether the damage was assumed by the parties according to commercial sense and contractual terms.¹⁷¹ Furthermore, it was pointed out by Lord Hope that although it was within the parties' contemplation that late delivery may occur,¹⁷² it was not, according to commercial practice, known to the charterer that

“...there was a subsequent fixture; the owners would deal with any new charterers. This was something over which they had no control and, at the time of entering into the contract, was completely unpredictable.”¹⁷³

¹⁷¹ *The Achilles* [2008] 2 Lloyd's Rep. 275 at p.280.

¹⁷² *ibid*, at p.281.

¹⁷³ *ibid*, at p.282.

3.1.4 Therefore, it should also be remembered that the application of *Hadley* is also subject to the commercial context of the nature of a specialised contract. As for indemnity insurance, a succinct summarization is provided by the Law Commission that

“...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.”¹⁷⁴

Applying the rule in debt: *Sempre Metals v. Inland Revenue*¹⁷⁵

3.1.5 Historically, it was held by the court that the rule of *Hadley* did not apply to cases in which there was a failure or delay to make the payment owed by the debtor.¹⁷⁶ Moreover, it was once held that

“...interest is not due on money secured by a written instrument, unless it appears on the face of the instrument that interest was intended to be paid, or unless it be implied from the usage of trade, as in the case of mercantile instruments.”¹⁷⁷

¹⁷⁴ See Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer’s Duty of Good Faith (n.106), at para 2.15.

¹⁷⁵ [2007] UKHL 34.

¹⁷⁶ See *Page v. Newman* (1829) 9 B. & C. 378.

¹⁷⁷ *ibid*, per Lord Tenterden MR; notably at that time even interest was not allowed in case of a late payment, let alone damages.

Obviously, that historical position is no longer suitable for the needs of commercial development and therefore various kinds of solutions have been provided by the court. Finally, in *Sempra* the House of Lords found an opportunity to clarify the law.

In *Sempra* a tax payer asked for the restitution of the over-paid tax plus compound interest. Along with an affirmative answer, Lord Nicholls held that once the damage caused by the late payment of debt was proved, the loss would be recoverable, provided that other rules in *Hadley* such as remoteness, failure to mitigate and so forth do not apply.¹⁷⁸

Applying the rule in tort

3.1.6 In *Lagden v. O'Connor*¹⁷⁹ the victim, Mr Lagden, had his car damaged by Mrs. O'Connor. He was so poor that it was impossible for him to hire another car when the damaged one was under repair. Later on Mr Lagden had to use the service from a credit hire business service rather than an ordinary market hire one. The difference between the two services was that the credit service companies charged more and needed no advance payment from their customers. Alternatively, once they were satisfied that there would be a third party tortfeasor and an outstanding claim they would charge from that claim. The precedent was not favourable for Mr Lagden, because in *Dimond v Lovell*¹⁸⁰ it was held by the House of Lords that only ordinary market hire was recoverable

¹⁷⁸ *Sempra Metals v. Inland Revenue* [2007] UKHL 34, at [94].

¹⁷⁹ [2004] Lloyd's Rep IR 315.

¹⁸⁰ [2002] 1 AC 384.

in cases of a tort, while the additional amount charged by services such as credit hire was not.

However, the House of Lords carefully distinguished *Dimond*. In *Dimond*, although it was held that the victim acted reasonably to avail herself of the credit service; it did not mean that the full amount of the service would be recovered because once the full amount of the credit service hire was paid by the tortfeasor it would lead to a benefit for the victim. However, the situation was different in *Lagden* as it was impossible for Mr Lagden to hire another car unless the credit service was used. Therefore, it was held by Lord Nicholls that the law would be “seriously defective”¹⁸¹ if a victim like Mr Lagden could not recover the full amount. His Lordship continued:

“Common fairness requires that if an innocent plaintiff cannot afford to pay car hire charges, so that left to himself he would be unable to obtain a replacement car to meet the need created by the negligent driver, then the damages payable under this head of loss should include the reasonable costs of a credit hire company.”¹⁸²

It needs to be noted that in order to reach such a conclusion, both fairness and commercial context were considered by the House of Lords, although this judgment was delivered earlier than *The Achilles*. This decision is also important to indemnity insurance as it might provide a “back door” for the assured to claim damages for late payment.¹⁸³ More importantly, this case

¹⁸¹ See *Lagden v. O'Connor* [2004] Lloyd's Rep IR 315, at [6].

¹⁸² *Lagden v. O'Connor* [2004] Lloyd's Rep IR 315.

¹⁸³ Technically, there is no reason why the assured could not sue the insurer in tort once the late payment causes damage; this is the case in most states in the U.S but this issue is not the main point of this work.

overruled *The Liesbosch*,¹⁸⁴ in which case it was held that there were no damages in tort for a claimant whose loss was caused by the fact that he had no money to replace the damaged property.

Applying the rule in contracts of indemnity

3.1.7 The application of the rule in contracts of indemnity was considered by the Court of Appeal in *The Eurus*;¹⁸⁵ although the contract in the case was not wholly an indemnity case, the clause in dispute was a widely known “indemnity clause” in the shipping market. It provided that

“Owners shall be responsible for any time, costs, delays or loss suffered by charterers due to failure to comply fully with charterers’ voyage instructions provided such instructions are in accordance with the charterparty and custom of trade.”

In that case the price of crude oil was based on the market price when the bill of lading was issued. In order to ensure a cheaper rate the bills of lading should have been issued in February rather than January and therefore the ship-owner was notified that notice of readiness should not to be tendered before 1100 on 31st January. However, due to the misunderstanding by the master, no notice of readiness was tendered and the vessel began loading straightaway. Although on the instruction of the charterer who requested a slow loading, the job was finished at 0130 on 1 February, no February bills of lading could be issued: it was because, unbeknown to both parties of the contract, in Nigeria the loading completed before 0800 on the first day of any month should be treated as if it

¹⁸⁴ [1933] AC 449.

¹⁸⁵ [1998] 1 Lloyd's Rep. 351.

had been finished on the last day of the preceding month (the 8 o'clock rule). As a result, the charterer had to bear the cost of the price difference of 0.6 million dollars.

Two heads of claims were raised by the charterer against the ship-owner: one was based on the breach of contract and another was based on a claim for indemnity.

It was held by arbitrators that the first claim failed as it was not contemplated or foreseeable by the parties when the contract was entered into, while the second claim succeeded. The issue finally reached the Court of Appeal. It was firstly confirmed by the court that the clause provided above was one of indemnity; however, it was further held that the rule of damage was applicable and therefore the charterers' claim failed. It was held by Staughton LJ that

“...I cannot see why the parties would have wished to provide ... that the charterers' loss would be recoverable whether or not it was within the reasonable contemplation of the parties, while for all other breaches the ordinary rule as to damages in a contract case would apply.”¹⁸⁶

What is of importance from *The Eurus* is that a contract of indemnity would be interpreted with commercial sense and the reasonableness of the parties has to be considered when the rule for damage applies.

It would be correct to argue that the rule of *Hadley* has a pervasive application in different kinds of contracts, however, there is an important exception to the rule,

¹⁸⁶ *The Eurus* [1998] 1 Lloyd's Rep. 351 at p.358.

which is often referred by the court to rebut a claim for damage for late payment by the insurer: there would be no damage over damage. Even though it is at least open to serious doubt whether it is correct to regard the payment by the insurer as damage; however, it has been settled in Australian law that the obligation to make payment under the policy is not an obligation relating to damage and therefore the Australian position is of great importance for reference purposes, especially when the Enterprise Act 2016 comes into force which enables the assured to claim for damage caused by the late payment of the insurer.

The Australian position

3.1.8 Unlike the English position, indemnity insurance contracts are treated as ordinary contracts in Australia and it is common knowledge in contract law that once a repudiatory breach is made by one party, the innocent party has two possible remedies: one is to terminate the contract and claim for damage while the other is to affirm the contract and claim for damage.

In the interest of the assured, affirming the contract and then claiming damage would be the better choice, especially after the insured risk occurs, because the contractual obligation for the insurer to make the payment has to be fulfilled together with consequential damage.¹⁸⁷ It is pointed out by the Law Commission that in Australia, even though it has been well settled that it is the insurer's contractual obligation to make payment and unreasonable late payment could amount to a repudiatory breach, the assured could not claim consequential

¹⁸⁷ This understanding is correct only if the obligation of the indemnity insurer has the contractual nature rather than damage.

damage along with the policy indemnity.¹⁸⁸ This position is summarized by Professor Sutton that

“If the assured [accepts the repudiation], he or she is not bound by the terms of the policy and her or his measure of damages including consequential loss, will be governed by the rule in *Hadley v Baxendale* as to remoteness of damage.

If the assured [affirms the contract], the terms of the policy continue to apply, the insurer’s indemnity is in respect of loss of or damage **to the property insured**, together with any additional benefits provided for **in the policy**, and any consequential loss outside those benefits will not be recoverable.”¹⁸⁹

However, this conclusion has been challenged both academically and judicially.

It should be noted that Professor Sutton’s conclusion, concerning the scenario where the insurance contract is affirmed, is similar to the English position in *The Italia Express (No.2)* which held that the policy limit is “conclusive” even for consequential loss; as to this point, it has been argued in this work that damage caused by the late payment should be regarded as a separate claim and therefore it should not be limited by the policy.

¹⁸⁸ See Law Commission Paper No. 201: Insurance Contract Law: Post Contract Duties and Other Issues, available at http://www.lawcom.gov.uk/wp-content/uploads/2015/03/cp201_ICL_post_contract_duties.pdf >, accessed 20th Sep 2014, on at para A.23.

¹⁸⁹ Professor Sutton, *Insurance Law in Australia* (3rd edition, Law Book Co of Australia, 1999), at para 15.180, first emphasis as original and second emphasis added.

In order to further clarify this point it is necessary to pause here to go back to the argument in *The Italia Express (No.2)*. It has been repeated many times in this work that in English law the insurer's contractual obligation is to hold the assured harmless and once the damage occurs the contract is breached, and the reason why the assured's claim should be limited by the policy is that the amount of damage has already been written **within the contract** when it is made; but what if the assured, as the innocent party, elects to repudiate the contract? Will he or she still be bound by the contractual limit? In order to analyse this problem, it has to be assumed that it is correct to say that the insurer's obligation is to hold the assured harmless and it is a contractual term in the policy; and in order to decide the effect of breach, this term has to be classified as a breach of condition, warranty¹⁹⁰ or innominate term.

It is common ground that in a policy it is always clearly stated that the breach of the duty to "hold harmless" will lead to damage and *prima facie* it shall be regarded as a "warranty in general contract", which means that the innocent party could not repudiate the contract but only claim for damage. However, in *Hong Kong Fir Shipping Co Ltd v. Kawasaki Kisen Kaisha Ltd*¹⁹¹ it was held by the Court of Appeal that if the breach of a term deprived the innocent party substantially of the intended benefit under the contract, the court will treat that term as a condition and allow the innocent party to repudiate the contract and claim for damages. Even though it could be argued that once the effect of the breach is clearly stated in the contract there is no need to analyse other issues, it

¹⁹⁰ The word "warranty" used here is not the warranty in insurance law, but within normal contractual meaning.

¹⁹¹ [1962] EWCA Civ 7.

has to be noted that the essential benefit of the assured is the safety of the insured property, and therefore the destruction of the property will certainly deprive the assured of all the benefits of the contract; consequently the insurer, on the destruction of the insured property, commits such a repudiatory breach. However, as an innocent party the assured could not repudiate the contract as he or she is entitled to claim damages only and the amount is usually limited by the policy; it has to be pointed out that this fact makes insurance contracts even more anomalous.

Additionally, according to the Australian legal principle, where there is an affirmation after an “anticipatory breach”¹⁹² the innocent party loses all rights against the repudiation; on the other hand, where the repudiation is not regarded as an anticipatory breach, affirmation does not cause the innocent party to lose the right to recover damages for that breach. In order to support his conclusion, Professor Sutton relied on *Russell Young Abalone Pty Ltd v Traders Prudent Insurance Co Ltd*¹⁹³ where it was held that the wrongful denial of the insurance claim was a repudiatory breach but since the assured affirmed the contract the policy limit applied and therefore consequential loss was prohibited. However, the judgment in *Russell Young Abalone* is not welcomed nor followed. It was criticized by Neil Campbell on the basis that the case is “shaky” and stands no

¹⁹² In Australia, it is called “repudiation without breach”, see Carter and Harland, *Contract Law in Australia* (4th ed, Butterworths, 2002), at para 2102.

¹⁹³ (1993) 7 ANZ Ins Cas 78,037

legal ground¹⁹⁴ and in *Tropicus Orchids Flowers and Foliage Pty Ltd v. Territory Insurance Office*¹⁹⁵ it was clearly held that

“...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.**”¹⁹⁶

Therefore, despite some academic debates on the issue of damage for late payment, it could be regarded as settled in Australia that the insurer’s obligation is regarded as one to pay the claim, and any wrongful claim handling such as unreasonable late payment or denial of the policy liability could be regarded as a breach of a condition of the contract. Once the assured affirms the contract he or she is entitled to both the policy amount **within** the policy limit and **further** damage caused by the insurer.¹⁹⁷

Compared with the Australian legal position, the English rule on damage for late payment becomes more unreasonable and the following discussion is based on the current legal position that the payment made by an English indemnity insurer is a payment of damage.

¹⁹⁴ See Neil Campbell, ‘Monetary remedies for wrongful declinatures of insurance claims’, [2004] 15 Insurance Law Journal 185, at fn. 49.

¹⁹⁵ [1997] NTSC 46.

¹⁹⁶ *Tropicus Orchids Flowers and Foliage Pty Ltd v. Territory Insurance Office* [1997] NTSC 46, at [7.4], emphasis added.

¹⁹⁷ See also Kelly & Ball, *Principles of Insurance Law*, (online edition, 2003), at para 8.0170.

3.2 Damage for late payment of damage

No damage over damage

3.2.1 The rule named as “no damage over damage” was firstly decided by the House of Lords in *The Lips*.¹⁹⁸ In that case the charterer was obliged to pay demurrage, which was regarded as a kind of liquidated damage caused by delay in loading or discharging in a contract of carriage in British external sterling but accrued at a fixed rate of \$6,000 per day. The vessel was detained for some 28 days, but the charterer only admitted the liability and paid the amount for 24 days. It was held by the umpire that the period of demurrage was some 28 days and therefore there were some 4 days still to be paid. It was not in dispute that the amount should be paid was \$24,250. However, the problem appeared when that amount was to be converted into British sterling.

At the date when the demurrage should have been paid the rate of exchange was \$2.37 to £1 sterling; while at the date of the award the rate of exchange fell sharply to \$1.54 to £1 sterling. It was held by the umpire that the owner was entitled to the damage of late payment of demurrage, and in order to award such damage, the umpire calculated the amount by the latter rate of exchange and awarded the owner £10,232 (the **demurrage**) and £5,514 (the **damage** for late payment caused by the fluctuation) plus **interest**. It was also held that such damage was within the second limb of *Hadley v. Baxendale*, namely it was held by the umpire that the damage was caused by special circumstances which was communicated at the time the contract was entered into.

¹⁹⁸ *President of India v. Lips Maritime Corporation (The Lips)* [1987] 2 Lloyd's Rep. 311.

The charterer then appealed and the very question in this case was whether the owners were entitled to recover the damage of currency fluctuation caused by the late payment of demurrage (the liquidated damage).

3.2.2 The dispute finally reached the House of Lords and the charterer's appeal was allowed. The first issue which was considered by the House of Lords was the nature of demurrage; it was held by Lord Brandon that demurrage was **not**

“...money payable by a charterer as the consideration for the exercise by him of a right to detain a chartered ship beyond the stipulated lay days.”¹⁹⁹

His Lordship continued:

“It is a liability in damages to which a charterer becomes subject because, by detaining the chartered ship beyond the stipulated lay days, he is in breach of his contract... The effect of such a claim is to liquidate the damages payable: it does not alter the nature of the charterer's liability, which is and remains a liability for damages, albeit liquidated damages.”²⁰⁰

Therefore, it was well settled in law that demurrage was liquidated damage and such damage accrued as soon as the duty of the charterer was breached. It could also be inferred that what was decided in *The Lips* should be extended to unliquidated damage equally.

¹⁹⁹ *The Lips* [1987] 2 Lloyd's Rep. 311 at p.315.

²⁰⁰ *ibid.*

Subsequently, Lord Brandon delivered the famous judgment on the rule of “no damage over damage”:

“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.**”²⁰¹

Therefore, it was held by the House of Lords that there was no breach by the charterer and no damage based remedy was available to the owner while the only remedy was statutory interest.

No implied term to pay damages within a reasonable time

3.2.3 It was held by the umpire that the charterer should make the payment within two months after the completion of discharge; although it was not expressly stated in the contract, the umpire was ready to imply such a term into the contract. However, such approach was found by Lord Brandon to be wrong in law. It was then held that although it was a commercial practice that reasonable time would be required for calculating the amount and settling the dispute,

“[t]his circumstance, however, does not afford a basis for implying a term that the charterer’s liability to pay demurrage does not accrue until such a reasonable time has elapsed.”²⁰²

²⁰¹ *ibid*, at p.317.

²⁰² *The Lips* [1987] 2 Lloyd's Rep. 311, at p.316.

However, the reasonable time of two months was not completely meaningless; it was subsequently held by Lord Brandon that after the expiry of that period the interest was payable, which meant that Lord Brandon refused to regard the implied period as a period within which the payment shall be made, but a period of grace; this understanding itself is a paradox.

In addition, the refusal to accept an implied term by Lord Brandon was not conclusive. A Privy Council case²⁰³ was subsequently cited by Lord Mackay to prove that there would be some possibility for a term for the date of the payment to be implied in the contract, although His Lordship preferred the express approach.²⁰⁴

The risk allocation

3.2.4 In addition to the findings above, another issue should be noticed, namely the allocation of the risk. In *The Lips* it was clearly stated in the contract that the exchange rate on a bill of lading would also apply to demurrage. Such a statement, based on commercial sense, would be regarded as a statement made by the parties that the risk of currency fluctuations was specially allocated and should be borne by the owner because by agreeing that clause it could be predicted by the ship-owner that there might be a risk of fluctuation. Although it was not clearly ruled by the House of Lords, it was noted by Lord Brandon by stating that

²⁰³ *Loh Wai Lian v. Sea Housing Corporation Sdn. Bhd.* (unreported), Mar.3, 1987.

²⁰⁴ *The Lips* [1987] 2 Lloyd's Rep. 311, at p.320.

“The real issue in the appeal is the true construction of the provisions relating to demurrage...”²⁰⁵

Therefore, it could also be argued that the judgment of *The Lips* was also based on special commercial grounds and that this case should not have been applied universally.

3.2.5 To conclude, what was settled by *The Lips* was, in fact, that generally there would be no “damage based” remedy for late payment of damage should there be no other contractual or commercial arrangement. However, once the reasonable time to pay the damage was implied in the contract or agreed by the parties as an express term, the late payment would be regarded as a breach of contract and therefore there would be no reason to rebut the claim raised by the innocent party.

Therefore, it would also be correct to note the fact that in order to introduce the rules in *Hadley*, the nature of the claim and the rules in *The Lips* have to be viewed with care and with commercial sense and it is of fundamental importance in indemnity insurance, especially in property insurance, as it has been stated in the prior chapter, that the nature of a claim in such insurance had not been settled yet.

This point of view could also be supported once the assured places the policy through an insurance broker but the latter fails to do so, the payment which should have been claimed from the insurer is to be paid by that broker by way of

²⁰⁵ *The Lips* [1987] 2 Lloyd's Rep. 311, at p.315.

damage. Additionally, any loss caused by not having the money could also be recovered by way of damage.

In *Arbory Group Ltd v. West Craven Insurance Service*²⁰⁶ the assured TGL wished to purchase a business interruption cover for £1m through the insurance broker WCIS but due to the negligence of WCIS the actual amount was only £0.25m. After the destruction of the business by fire the assured claimed two types of losses: the first was the shortfall of the cover amounting to £0.3m and the second head was the loss of profit due to the underinsurance for another £0.3m. WCIS admitted the liability for the first type of loss, but denied the liability for the second because, according to *The Lips* and to *Sprung*, there would be “damage over damage”.

The case was referred to HHJ Grenfell and it was held that both losses could be recovered. As to the second type of loss, the judge clearly pointed out that the aim of purchasing a business interruption policy was to

“...ensure that sufficient business interruption cover was in place to enable the company to recover and to resume its pre-incident level of profitability at the earliest date.”²⁰⁷

Additionally, the judge also pointed out that once the broker was negligent in obtaining enough cover, the further loss was reasonably foreseeable²⁰⁸ and therefore WCIS would be liable for that further loss.

²⁰⁶ [2007] Lloyd's Rep IR 491.

²⁰⁷ *ibid*, at [50].

²⁰⁸ *ibid*, at [51].

As to the issue of “damage over damage”, the judge carefully distinguished *The Lips* and *Sprung* by stating that

“...had there been no underinsurance... a full payment would have been made at around the same time as payment was in fact received. I can see no good reason in this case to restrict the claim against the broker to the amount which would have been the liability of the insurer to pay had that been so.”²⁰⁹

3.3 Damage for late payment in indemnity insurance

3.3.1 It is common ground that in order to clarify the secondary obligation, the primary obligation has to be considered very carefully in the first place. Therefore, the following discussion will be divided into two approaches based on two different understandings about the indemnity insurer’s primary obligation. In this part, the discussion is based on current law, namely the primary obligation is to be regarded as one to prevent the loss and the payment made by the indemnity insurer is regarded as damage.

Current Law

3.3.2 Currently, damage for late payment in indemnity insurance is not available for the assured. The main reason is that, as previously mentioned in chapter 2 of this work, the primary obligation of the insurer is treated by law as one to prevent the loss from occurring and what is paid by the insurer is damages. However, according to the discussion about the indemnity insurer’s primary obligation, some doubts have to be cast on this conclusion. In order to find out the correct

²⁰⁹ *Arbory v. WICS* [2007] Lloyd’s Rep IR 491, at [53].

answer the damage rules have to be read in a commercial sense in the insurance market and a re-examination of the common law is also required.

The Italia Express (No.2)

3.3.3 The first case which dealt directly with the issue of damage for late payment was *The Italia Express (No.2)*, and in which case the damage for late payment was firmly rejected by Hirst J. Although this case has been discussed from the aspect of the primary obligation, the focus should be put on the secondary obligation in this part.

As to the issue about damage for late payment by the insurer the claimant in *The Italia Express (No.2)* provided two cases²¹⁰ in which damage was available to support the argument. The English case is *Grant v. Cooperative Insurance Society*.²¹¹

In that case the block insurance policy dealt with the loss of rent within specified limits. After the damage (by fire) occurred, the house was left vacant and the insurer rejected the claim. Two special claims of damage were raised by the claimant, namely cost for extra accommodation, which was above the specified limit of the policy, and damage for the cost of protection when the house was vacant. Hodgson J in that case awarded both heads.

It was firstly held that those two heads of damage were special damage and secondly, it was held, according to commercial awareness, that each head ought to have been contemplated if the insurers wrongfully refused to pay the amount

²¹⁰ Comparing with the New Zealand case, the English one is more important for this chapter.

²¹¹ Unreported, Oct. 21, 1983 Lexis.

due under the policy, thirdly, it was also held that those claims were not under the policy but were separate claims for damages which could breach the limit of the policy.

However, *Grant* was distinguished by Hirst J. The learned judge held that

“Neither the *Grant* case in England, nor the *Stuart* case in New Zealand were marine insurance cases, so they are clearly distinguishable on this ground alone; but in any event I very much doubt whether they can stand in the light of *The Fanti*...”²¹²

In the light of the discussion in chapter 2, it is doubtful whether *The Fanti* should be extended to property insurance. However, it is even more doubtful that Hirst J decided not to follow *Grant* for the reason that *Grant* was a non-marine case. It is correct to clarify that there are many important differences between marine and non-marine insurance,²¹³ however, no such difference could be found in *Grant* and *The Italia Express (No.2)*. Additionally, this uncertainty turned out to be more illogical as *The Italia Express (No.2)*, as a marine case, was applied in *Sprung* without any difficulty.

Another reason, according to which Hirst J rejected the claim by the assured, was his understanding about relevant sections of the MIA 1906. The relevant parts of these sections are cited below:

“67. (1) The sum which the assured can recover in respect of a loss on a policy by which he is insured, in the case of an unvalued policy to

²¹² *The Italia Express (No.2)* [1992] 2 Lloyd's Rep. 281, at p.292.

²¹³ See Merkin, *Marine Insurance Legislation*, (5th edn, Routledge, 2013), at p.1.

the full extent of the insurable value, or, in the case of a valued policy to the full extent of the value fixed by the policy, is called the measure of indemnity.

68. Subject to the provisions of this Act and to any express provision in the policy, where there is a total loss of the subject-matter insured—

(1) If the policy be a valued policy, the measure of indemnity is the sum fixed by the policy;”

It was understood by both the counsel for the insurer and Hirst J that these sections were to be treated as the limitation of the insurer’s liability. It was held by Hirst J that

“I consider that the starting point in this marine insurance case is s. 67 of the Act. In my judgment, this section, together with s. 68 in total loss cases, is conclusively definitive of the extent of the liability of the insurer for loss of the vessel under a valued policy.”²¹⁴

It has been argued in chapter 2 that these sections are dealing with the measure of indemnity rather than with damage; therefore, it could be argued that these sections, indeed, set a limitation on the liability of the insurer but that limitation is for the primary obligation rather than the secondary one, even though the primary obligation, under current law, has to be read as one to prevent the loss.

Therefore, ss.67-68 should not be treated as a protection to limit the secondary obligation of the insurer within the policy limit, as was held in *Grant*.

²¹⁴ See *The Italia Express (No.2)* [1992] 2 Lloyd's Rep. 281, at p.291.

ICCI v. McHugh²¹⁵

3.3.4 In *ICCI v. McHugh*, the assured entered into a business interruption policy for a hotel which suffered huge losses caused by three arson attacks. Among other issues the assured claimed that the insurers were in breach of an implied term which obliged them to conduct negotiations after the occurrence of each insured event and/or to assess the amount of the loss and/or to pay the sum due under the claim for material damage and/or the business interruption policy with reasonable diligence and due expedition. It was further argued that the assured, due to the breach, was unable to recommence business and suffered the loss due to the late payment and response by the insurers.

This claim was firmly rejected by Mance J (as he then was); it was not accepted by the learned judge that such a term could be implied into the policy in dispute:

“The law will not however 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...”²¹⁶

It could be noticed that the same approach in *The Lips* was adopted by Mance J and generally it might be correct to hold that the indemnity insurer, without express terms in the policy, is under no obligation to indemnify the assured within a reasonable time. However, the above judgment might not be the reason why the assured’s claim was finally rejected because it was found in *ICCI* that

²¹⁵ *Insurance Corporation of the Channel Islands Ltd v. McHugh (ICCI)* [1997] LRLR 94.

²¹⁶ *ibid*, at p.136.

the assured acted fraudulently by presenting forged materials in order to get profit from the loss (the fraudulent means and devices).

That issue was subsequently discussed by Mance J by stating that

“If any such term existed at all, it would, presumably, have to be mutual...**there would be a duty on the insured to present and progress the claim with reasonable speed and efficiency.** Just as **insurers would be obliged not reasonably to refuse or delay indemnity**, so, presumably, the insured would be under a duty not unreasonably to delay, misstate or overstate his case.”²¹⁷

Therefore, it is at least arguable that there could have been an implied obligation on the insurer to provide indemnity within a reasonable time if the assured also owed an obligation to co-operate with the insurer. However, in *ICCI*, the corresponding implied obligation on the assured, namely not unreasonably to delay, misstate or overstate his case, had been breached by the assured at the start by his using fraudulent means and devices; therefore, the insurer was released from such an implied obligation to handle the claim reasonably.

Tonkin v. UK Insurance Ltd²¹⁸

3.3.5 In *Tonkin* the assured insured his house and its contents by a fire policy. After a serious fire both the insured house and its contents were damaged. The insurer paid in full in respect of the contents of the house, but a dispute arose as to the payment for the reinstatement of the house.

²¹⁷ *ICCI* [1997] LRLR 94, at p.136, emphasis added.

²¹⁸ [2007] Lloyd's Rep IR 283.

In the fire policy, a clause stated as

“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.”²¹⁹

Notwithstanding this clause, the house had not been rebuilt after a period of over three years and a half; the assured claimed that such a term within the contract constituted a separate contractual obligation and it was breached by the insurer, and therefore, the assured would be entitled to damage caused by late payment and the delay in negotiation.

It was accepted by Peter Coulson QC, as a deputy judge, that such a clause was an

“...express obligation on the part of the defendant to be fair and reasonable and to act ‘quickly’ when dealing with the claim.”²²⁰

However, feeling himself bound by *Sprung* the learned judge rejected the claim:

“The claimants’ main claim here is based on the defendant’s failure to pay their claims under the policy. Thus I consider their ‘delay’ claims to be claims for damages for failure to pay damages, which is just the sort of claim which the authorities noted above hold to be invalid. It is

²¹⁹ *ibid*, at p.292.

²²⁰ *Tonkin v. UK Insurance Ltd* [2007] Lloyd's Rep IR 283, at [34].

difficult to conclude that there is here another or separate breach of contract arising out of the general obligation...”²²¹

However, in *Sprung* it was suggested that once a separate contractual obligation was breached, damage would be available for such a breach. Therefore, the learned judge seems to be wrong to reach the conclusion that even though there is a separate obligation, a breach would not lead to damage as well.

Although the learned judge might be wrong in deciding that there would be no cause of action, it was rightly found by him that in *Tonkin* the delay of in negotiation was caused by the assured. It was pointed out that

“...it seems to me that the critical delays in this story are referable to the claimants and their advisers. Whilst the defendant’s conduct is not free from criticism, for the reasons which I have stated, it is impossible to conclude that any critical delay or other identifiable loss was caused by those defaults.”²²²

Accordingly, it will be more persuasive to argue that the assured was truly defeated by their own “critical mistakes”, and even though in any event there would be no damage payable to the assured in *Tonkin*, it needs to be noted that the true reason which precluded the claim for damage is better understood as the same as in *Sprung*, namely the issue of causation.

3.3.6 Currently, to conclude the English legal position, it is open to the parties of the policy to use express terms to constitute a contractual obligation to pay a

²²¹ *ibid*, at [38].

²²² *ibid*, at [347].

claim within a reasonable time, and such a breach, if satisfying the rules of damage and causation, would lead to a claim for damage. However, where there is no express term, the answer is not a clear-cut one. It could be inferred from *ICC* that even in the claim handling (post-contractual) stage there is a mutual obligation which regulates the parties' post-contractual actions. According to the description in *ICC*, such an obligation would fall within the scope of a post-contractual duty of good faith.

The duty of good faith of insurers in claim handling stage

3.3.7 It is well known that the contract of marine insurance is a contract based on utmost good faith of both parties. The duty of utmost good faith, because of the imperfect statutory wording, has been interpreted differently case by case; the most significant difference exists in the understanding of the duty between the pre-contractual and post-contractual stage.

It is also widely accepted that the pre-contractual duty is one from statute; however, when it comes to the post-contractual duty, the situation is less clear. Therefore, in this part, the pre-contractual duty of good faith will be introduced firstly and there will be discussion on the reason why the remedy of the breach of such duty would not be suitable for the assured in the claim handling stage. Secondly, the duty of good faith in the post-contractual stage will be discussed in depth.

3.3.8 It has been mentioned above that after 12th August 2016 the new Insurance Act 2015 will come into force and according to the new legislation there will be several important amendments on the duty of good faith;

accordingly, the historical development of the duty of good faith, especially the post-contractual duty of good faith will be discussed at the beginning while the significant amendments in the Insurance Act 2015 will be discussed subsequently.

The duty of utmost good faith can be traced back to *Carter v. Boehm*²²³ and it was subsequently codified into the MIA 1906. In s.17 it originally stated 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.”

The application of this section was settled in *Pan Atlantic Insurance Co. Ltd. v. Pine Top Insurance Co. Ltd*²²⁴ that two tests have to be satisfied in order to entitle the insurer to avoid the policy. Firstly the objective test of materiality and secondly the subjective test of inducement.

It has to be noted that the duty of utmost good faith in s.17 does not state whether such duty is limited in the pre-contractual stage only, but ss.18 and 20 are explanations specifically dealing with the pre-contractual duty. Therefore, historically it is not appropriate to apply the **statutory** duty of utmost good faith in the claim handling stage, especially when the insurer unreasonably delays in making payment or in negotiation, as it has been settled in common law for a long time that the only remedy for breaching the statutory duty of utmost good faith is avoidance.

²²³ (1766) 3 Burrow 1905.

²²⁴ [1994] 2 Lloyd's Rep. 427.

In *La Banque Financiere v. Westgate*²²⁵ (the gemstone case) the broker of the insurer failed to disclose material facts to the assured banks about the fraud and according to the policy wording (the fraud exception clause) the four banks in that case suffered a huge loss but could not be recovered from the insurer. Therefore, the assured claimed damages for breach of utmost good faith at the pre-contractual stage by the insurer.

At the first trial, Styen J (as he then was) held that the assured would be entitled to damage, as

“...avoidance of a policy and a claim for return of the premium will be a wholly ineffective remedy if the breach of the duty of the utmost good faith by the insurer caused the insured to be unprotected and exposed to great loss.”²²⁶

The insurer appealed and at the Court of Appeal it was held that there was a mutual duty of pre-contractual disclosure that

“In our judgment, however, there is no doubt that the obligation to disclose material fact is a mutual one imposing reciprocal duties on insurer and insured. In the case of marine insurance contracts, s. 17 in effect so provides.”²²⁷

However, the Court of Appeal rejected to treat damage as a remedy for breach of statutory duty of utmost good faith and reversed the trial judgment; it was held that

²²⁵ [1990] 2 Lloyd's Rep. 377.

²²⁶ [1987] 1 Lloyd's Rep. 69, at p.96.

²²⁷ [1988] 2 Lloyd's Rep. 513, at p.544.

“In our judgment, however, the wording of s. 17, if anything, goes against, rather than supports, the banks’ submission, inasmuch as it explicitly confers on the other party, in a case where the utmost good faith has not been observed, the right to avoid the contract but makes no mention of damages...”²²⁸

This judgment was subsequently confirmed by the House of Lords. Therefore, historically the remedy for a breach of **statutory** duty of utmost good faith would be summarized as “all or nothing”. This position is concluded and developed as

“The remedy is all or nothing. The courts have no power to apply proportional recovery and to allow the assured to recover that proportion of his loss represented by the premium actually paid; neither may the assured make full recovery by preferring the balance of the premium that would have been charged had full disclosure been made...”²²⁹

It has to be pointed out that the “all or nothing” remedy is by no means a sufficient remedy for the assured. In the case of the gemstone case, the only remedy for the assured was to avoid the contract and claim for the premium to be returned, when the amount of premium, compared with the loss suffered by the assured, was meaningless. Furthermore, when an insurer breaches his duty of utmost good faith, pre- or post-contractual, it would be absurd for the assured to ask for the remedy of avoidance; what is required by the assured is to keep the property or liability covered and to be indemnified reasonably.

²²⁸ *ibid*, at p.548.

²²⁹ Merkin, *Colinvaux’s Law of Insurance*, (11th edn, Sweet & Maxwell, 2016), at para 6.002.

Therefore, when the problem is a claim for damage under an insurance contract, the court has tried to find some solution to balance the unfair legal situation.

In *La Banque Financiere*²³⁰ it was held that the post-contractual duty of utmost good faith existed in special circumstances:

“It may be that on the particular facts of some cases (though by no means necessarily all) the duty of post-contractual disclosure can be said to arise under the terms of the preceding contract.”²³¹

Therefore, the following discussion will be mainly based on the implied and post-contractual obligation of utmost good faith.

3.3.9 The earliest case which stated that the duty of utmost good faith existed throughout the contract could be traced back to *Britton v. Royal Insurance Co*²³².

It was held by Willes J that

“The contract of insurance is one of perfect good faith on both sides, and it is most important that such good faith be **maintained**.”²³³

Although it is believed that it will be better to regard *Britton* as the case about the rule on fraudulent claims, the existence of a continuing duty of utmost good faith has “never seriously been doubted”.²³⁴ Therefore, a conclusion could be reached that the duty of utmost good faith is not only mutual but also a

²³⁰ *La Banque Financiere v. Westgate* [1990] 2 Lloyd's Rep. 377.

²³¹ *ibid*, at p.548.

²³² (1866) 4 F.&F.905.

²³³ *ibid*, at p.909, emphasis added.

²³⁴ See Jonathan Gilman, QC; Professor Robert M Merkin; Claire Blanchard, QC; Mark Templeman, QC, *Arnould Law of Marine Insurance and Average* (18th edn, Sweet & Maxwell, 2013) (*Arnould*), at para 18-13.

continuing one,²³⁵ although there are differences between the pre- and post-contractual duty of good faith in their origins, definitions and the remedies for breach.

3.3.10 Although it should be accepted that the duty of utmost good faith is a continuing one, difficulties will arise when the definition is to be given to the post-contractual duty of utmost good faith.

The first modern case which concerns the post-contractual duty of good faith is *The Litsion Pride*.²³⁶ It was believed by Hirst J that there should be no difference both in the definition and the remedy for breach between the pre-contractual duty of good faith, which was stated in s.17 of the MIA 1906, and the post-contractual one, which had not been clearly defined. Therefore, he held that even if the contract of insurance had been concluded, the duty of utmost good faith retained its “full rigour”²³⁷, and a breach of such duty would entitle the innocent party to avoid the whole contract.

However, the judgment delivered by Hirst J was not commonly accepted both by courts and academics.²³⁸

Subsequently, the House of Lords had a chance to review the requirement of the post-contractual duty of utmost good faith and its remedy in *The Star Sea*.²³⁹ It was held by Lord Hobhouse that *The Litsion Pride* was no longer good law:

²³⁵ However, according to the House of Lords decision in *The Star Sea* [2001] 1 Lloyd's Rep. 389, the statutory duty of good faith ends when the litigation begins.

²³⁶ [1985] 1 Lloyd's Rep. 437.

²³⁷ *ibid*, at p.512.

²³⁸ For example see *Royal Boskalis v. Mountain* [1997] LRLR 523, in that case Rix J decided in favour of restricting the power of the pre-contractual duty of good faith in the post-contractual stage.

“The reasoning adopted by Mr Justice Hirst has been criticized both by academic writers and by other Judges in later cases. I consider that it should not any longer be treated as a sound statement of the law. In so far as it decouples the obligation of good faith both from s. 17 and the remedy of avoidance and from the contractual principles which would apply to a breach of contract it is clearly unsound...”²⁴⁰

Deciding not to give a precise legal definition for the post-contractual duty of good faith, Lord Hobhouse believed the problem would be solved by the implication of contractual terms and therefore a very famous judgment was then delivered that

“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 remedy is the right to elect to avoid the contract. **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.** This is no doubt why judges have on a

²³⁹ *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and La Reunion Europeene (The Star Sea)* [2001] 1 Lloyd's Rep. 389.

²⁴⁰ *ibid*, at [71].

number of occasions been led to attribute the post-contract application of the principle of good faith to an implied term.”²⁴¹

In concurring with the view of Lord Hobhouse that the post-contractual duty of utmost good faith was a contractual one and the definition was flexible, Lord Clyde held that

“...once it is recognized that in a contract of insurance, and indeed in certain other contracts, an element of good faith is to be observed, and that that element may impose certain duties particularly of disclosure between one party **and the other, duties... may vary in their content and substance according to the circumstances...**”²⁴²

Therefore, the duty of good faith in the post-contractual stage would, at least, be treated as an implied duty and the content of such duty has to be decided according to the special circumstances of each case.

3.3.11 It has been mentioned above that the rights and obligations of the parties of a contract have to be understood within a commercial context, and this rule would also apply to the understanding of the definition of the post-contractual duty of good faith subject to the judgment given by Lord Hobhouse and Lord Clyde in *The Star Sea*.

However, there are some arguments about the legal basis of the post-contractual duty of good faith, and the judgment of Lord Hobhouse has

²⁴¹ *The Star Sea* [2001] 1 Lloyd's Rep. 389 at [52], emphasis added.

²⁴² *ibid*, at [7], emphasis added.

been interpreted as an understanding which denies the existence of the post-contractual duty of good faith mentioned above,²⁴³ with respect, those doubts misunderstand the nature and the definition of the post-contractual duty of good faith and therefore should be clarified.

Firstly, in *The Star Sea* it could be clearly noted that Lord Clyde was in the same position as Lord Hobhouse. If the judgment of Lord Hobhouse is against the contractual origin of post-contractual good faith, the judgments delivered by Lord Hobhouse and Lord Clyde can hardly be reconciled, especially in light of the following speech of Lord Clyde, in which His Lordship clearly accepted the contractual origin of the duty:

“In my view 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.”²⁴⁴

Secondly, as is admitted, the contractual origin of the post-contractual duty of good faith has been widely accepted by subsequent cases,²⁴⁵ which will be introduced below.

3.3.12 In *The Mercandian Continent*²⁴⁶ it was clearly accepted by Longmore LJ that some post-contractual acts were governed by the implied and contractual duty of good faith:

²⁴³ For example, see *Arnould* (18th edn, Sweet & Maxwell), 2013 at para.18-18.

²⁴⁴ *The Star Sea* [2001] 1 Lloyd's Rep. 389, at [7], emphasis added.

²⁴⁵ See *Arnould* at para.18-18 and fn.26.

“(7) Other situations where good faith may be implied

... Interests of the insured and the insurers may not be the same but they will be required to act in good faith towards each other. If for example the limit of indemnity includes sums awarded by way of damages, interest and costs, insurers may be tempted to run up costs and exceed the policy limit to the detriment of the insured. The insured’s protection lies in the duty which the law imposes on the insurer to exercise his power to conduct the defence in good faith.”²⁴⁷

It could be clearly found that, in the judgment delivered by Longmore LJ, the insurer’s duty to make payment for a valid claim within a reasonable time would be governed by the post-contractual duty of good faith. As a matter of practice, once there is no express term such a duty would be implied, and the insurer should make the payment within a reasonable time, otherwise the post-contractual duty of good faith would be breached by the insurer. It is true that, according to the Enterprise Act 2016, the post-contractual duty of good faith could be understood as a duty implied by statute, but before the enactment of that Act the post-contractual duty of good faith in the claim handling stage could also be understood as a duty which is implied by common law.

In *Drake Insurance v. Provident Insurance*²⁴⁸ the Court of Appeal had a chance to state the law of post-contractual duty of good faith specifically in the claim handling stage. In *Drake* the assured was required to disclose previous

²⁴⁶ *K/S Merc-Scandia XXXXII v Certain Lloyd’s Underwriters (The Mercandian Continent)* [2001] Lloyd’s Rep IR 802.

²⁴⁷ *ibid*, at p.814.

²⁴⁸ [2004] Lloyd’s Rep IR 277.

speeding convictions and in the earlier policy the assured stated that there was one accident waiting for settlement and according to the term of the policy that accident was regarded as being one of contributory fault (50% of the assured and 50% of the third party). Subsequently, the assured had another speeding conviction and when the policy was to be renewed, the assured did not disclose the later speeding conviction to the insurer, however, at that time his liability in of the earlier accident was clarified and the assured turned out to be innocent.

According to the policy provisions, the premium should have remained the same due to the assured's innocence in the earlier accident, even if the later speed conviction had been disclosed and therefore the assured's non-disclosure was immaterial. However, the insurer decided to avoid the policy on the ground that the assured made a material non-disclosure which breached the **statutory** duty of utmost good faith (pre-contractual duty).

Prima facie, *Drake* did not deal with the post-contractual duty of good faith directly; however, based on the special facts of the case it was held by the court that the misuse of the right of avoidance by the insurer might become a breach of the **contractual** duty of good faith (post-contractual duty).

In reaching this conclusion, Rix LJ referred back to a statement made by Lord Lloyd in *Pan Atlantic v. Pine Top*²⁴⁹ that

“...there may be circumstances in which an insurer, by asserting a right to avoid for non-disclosure, would himself be guilty of want of good faith.”²⁵⁰

²⁴⁹ (1994) 3 Re LR 101.

However, it was then found by Rix LJ that the avoidance was made by the insurer not knowing the assured was innocent in the earlier accident, and it was then accepted by Rix LJ that the avoidance was made in good faith. However, the learned judge left a warning that

“If, however, the point were a live one, I would hazard the opinion that knowledge or shut-eye knowledge of the fact that the accident was a no fault accident would have made it a matter of bad faith to avoid the policy.”²⁵¹

A more harsh approach was taken by Pill LJ in the same case, he held that

“...a failure to make any enquiry 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.”²⁵²

Clearly there was a conflict between Rix and Pill LJJs about whether the avoidance could be justified and it was caused by different understandings on the facts of the case. However, it was not doubted that in the claim handling stage, the insurer owed a duty to act with good faith towards the assured.²⁵³

Therefore, once the insurer rejects the claim without any sound ground, or delays a valid payment arbitrarily²⁵⁴ the contractual duty of good faith will be breached and the breach of a contractual duty of good faith should be deemed as a breach of a term in the contract, although the term is an implied one.

²⁵⁰ *ibid*, at [125].

²⁵¹ See *Drake* [2004] Lloyd's Rep IR 277, at [91].

²⁵² *ibid*, at [177].

²⁵³ *ibid*, at [178].

²⁵⁴ For example, see *Sprung v. Royal Insurance* [1999] 1 Lloyd's Rep IR 111.

3.3.13 It has been argued earlier that the court is entitled to imply terms into the policy in accordance with commercial sense and good faith, it is now appropriate to introduce several examples about the successful implication of these terms.

In *Phoenix General Insurance v. Halvanon*²⁵⁵ a facultative/obligatory policy was issued for a reinsurance contract and the facultative/obligatory policy required the reinsurer to accept whatever risk was provided by the reinsured. With this commercial background Hobhouse J (as he then was) was prepared to agree that there would be an implied obligation on the reinsured to provide the risk with reasonable care of the reinsurer and follow the rule of the market. He held that

“The implication of this term or terms was not controversial before me...The facultative/obligatory nature of the transaction which imposes no restriction on the reassured’s right to choose whether to cede or not to cede, without giving the reinsurer any equivalent right, does necessitate that the reinsured should accept the obligation to conduct the business involved in the cession prudently, reasonably carefully and in accordance with the ordinary practice of the market.”²⁵⁶

When it came to the origin of the implication, Hobhouse J believed that it was based on the contractual duty of good faith and subsequently held that

“On this assumption, there is no ground for curtailing the obligation which would probably be imported anyway by the **duty of good faith** and which could also be enforced by way of discovery and inspection

²⁵⁵ [1985] 2 Lloyd's Rep. 599.

²⁵⁶ *Phoenix v. Halvanon* [1985] 2 Lloyd's Rep. 599 at p.613.

in any subsequent litigation. The relevant obligations must be regarded as continuing ones, just as is the obligation of the utmost good faith.”²⁵⁷

Another example could be found in *Goshawk v. Tyser*²⁵⁸ and the judgment of that case was made after the House of Lords decision in *The Star Sea*.

In *Goshawk* some important materials such as placing documents, claim documents and premium accounting documents were held by the brokers of the assureds. In order to reassess the risk the insurer required the brokers to disclose them again even though at that time the risk had already attached. However, some of the brokers refused to do so as their principals, the assureds, objected to this post-contractual disclosure.

The case reached the Court of Appeal and Rix LJ believed that it would be appropriate for commercial reasons to imply a term which required post-contractual disclosure; otherwise the insurer had to “work in the dark”.²⁵⁹ Although Rix LJ felt that the implied term came from a duty of good faith,²⁶⁰ he still clarified that

“...in the Lloyd’s market there has...been a term to be implied in the insurance contracts between underwriters and insureds to this effect: that placing and claims documents which have been previously shown to underwriters, and premium accounting documents which are necessary to the operation of the contract, were retained by the

²⁵⁷ *ibid*, at p.614, emphasis added.

²⁵⁸ [2006] 1 Lloyd's Rep. 566.

²⁵⁹ See *Goshawk v. Tyser* [2006] 1 Lloyd's Rep. 566, at [49].

²⁶⁰ *ibid*, at [53].

insureds' Lloyd's brokers, should be available to underwriters in case of reasonable necessity."²⁶¹

Accordingly, in order to assist the performance of the contract of insurance, the contractual duty of good faith requires implication in the contract where there is no express one.

It should be noted that in both *Phoenix* and *Goshawk* the implied obligations were imposed on the side of the assured or reinsured. As a matter of fact, it is indeed very difficult, if not impossible, to find any reported cases in which the insurer's obligation in the claim handling stage has been implied. However, this fact does not in any way mean that there should be no implied duty on the insurer. The merit behind those duties which should have been implied, namely the reasonable care and effort to assist the performance in a fair and just manner, has to be noted. Therefore, a conclusion could be reached that the behaviour of the insurer is also regulated by the duty of good faith in the claim handling stage: it requires the insurer to investigate the loss properly, to hold the negotiation with the assured fairly and to make the payment against a valid claim reasonably.

This argument finds support even from *Arnould*, in which the learned editors refused to accept the contractual origin of the post-contractual duty of good faith, however, it is admitted that the post-contractual duty of good faith

“...may inform the manner in which the parties perform their express contractual obligations to each other and the manner in which express

²⁶¹ *ibid*, at [58].

contractual liberties are exercised, including by the implication of terms...”²⁶²

It is argued by Professor Eggers²⁶³ that the damage for late payment by indemnity insurers could not be recovered and among all his powerful arguments an ingenious point was presented:

“This can be tested by assuming that the day after the loss, the assured obtains a judgment against the insurer, thus merging the insurer’s contractual liability into the liability created by the judgment. If that judgment is not honoured by the insurer, the assured should not be entitled to recover consequential damages over and above the judgment sum (other than interest).”²⁶⁴

Although it might be argued that an insurance claim made by an assured is different from a judgment because the latter is guaranteed by public authority, such an argument could not resolve the problem completely. However, once the contractual duty of good faith is imposed on the side of the insurer and requires him to act reasonably, the point raised by the learned professor could no longer be an obstacle. That is to say, once litigation begins there are two kinds of claims: one is the claim for indemnity according to the policy and the other is the claim caused by the breach of duty of good faith subject to the implied term of the policy. Although it has been decided many times that there is no damage over damage, it has not been decided yet about the remedy for a breach of

²⁶² See *Arnould* (18th edn, Sweet & Maxwell), at para.18-19.

²⁶³ Peter MacDonald Eggers, ‘Late payment of insurance claims’ [2013] L.M.C.L.Q. 341, 352.

²⁶⁴ *ibid.*, at p.352.

post-contractual duty of good faith, and once the remedy of the breach is crystallized a solution would be provided as well.

This assumption will be supported by the Enterprise Act 2016 where the implied duty of post-contractual good faith is recognized by statute and the effect of the new legislation shall be discussed in chapter 7 of this work.

3.3.14 It has been suggested that it is difficult to define the post-contractual duty of good faith; however, when it comes to the remedy for the breach it is more problematic as it is clearly stated originally in s.17 of the MIA 1906 that the only remedy for the breach is avoidance (an all-or-nothing remedy).

Therefore, different approaches have been taken by courts to bypass the one-sided and harsh remedy of avoidance when the duty of good faith is breached in the post-contractual stage.

In *Phoenix v. Halvanon*²⁶⁵ Hobhouse J held that the implied term from the post-contractual duty of good faith was innominate in nature and the consequences of breach would be subject to normal contract law:

“The term or terms are all innominate and therefore the consequences of any breach for any particular cession or any individual claim or, indeed, for the contracts as a whole, must depend on the nature and gravity of the relevant breach or breaches.”²⁶⁶

In *The Star Sea* it seemed that the same approach was taken by Lord Hobhouse as His Lordship did in *Phoenix v. Halvanon* where the Law Lord held that

²⁶⁵ [1985] 2 Lloyd's Rep. 599.

²⁶⁶ *ibid*, at p.614.

“The Courts have consistently set their face against allowing the assured’s duty of good faith to be used by the insurer as an instrument for enabling the insurer himself to act in bad faith. An inevitable consequence in the post-contract situation is that the remedy of avoidance of the contract is in practical terms wholly one-sided.”²⁶⁷

In addition, since the duty of the post-contractual good faith has a contractual nature, it could then be inferred that the remedy of the breach would be resolved by general contract law as well.

3.3.15 However, this approach was not commonly accepted and the type of the remedy remained problematic. Therefore, in *Goshawk* even though it was held by Rix LJ that there was an implied term for disclosure based on a post-contractual duty of good faith, he refused to classify the post-contractual non-disclosure as a breach of the duty of good faith, it might be inferred that it was the view of the learned judge that avoidance *ab initio* remained as the only remedy.²⁶⁸

In *The Mercandian Continent* it was held by Longmore LJ that once there was a fraudulent claim in the post-contractual stage, the insurer would be entitled, according to the post-contractual duty of good faith, to avoid the policy *ab initio*;²⁶⁹ while he left it open when there was no fraud involved.

²⁶⁷ *The Star Sea* [2001] 1 Lloyd’s Rep. 389, at [54].

²⁶⁸ See also *Arnould* (18th edn, Sweet & Maxwell) at para.18-16.

²⁶⁹ *The Mercandian Continent* Lloyd’s Rep IR 802, at [35].

The general position in Australia

3.3.16 Unlike the uncertain English position before the Insurance Act 2015, the Australian courts and legislation clearly put more favour on the existence of the post-contractual duty of good faith currently and according to the requirement of the post-contractual duty the insurer has to act honestly and reasonably; the relevant part of section 13 of the Australian Insurance Contract Act 1984 (ICA 1984) reads as

“(1) 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.”

Historically in Australia, it was argued that s.13 of ICA 1984 did not have the power to grant the innocent party damage for late payment, nor do legislators intend to do so. In *Re Zurich Australian Insurance Ltd*²⁷⁰ Cheterman J commented that

“If an insurer is liable to pay damages because it paid late, that is because there is a term or implied term of the contract that it should pay by a certain date. It is not because it was bad faith to be late...”²⁷¹

However, the Australian Law Reform Commission (ALRC) intends to regard this problem as settled, because it is clearly stated in the ALRC report that

²⁷⁰ (1999) 10 ANZ Cas 61-429.

²⁷¹ *ibid*, at [77].

“... it is quite clearly that, as utmost good faith is an implied term of contracts of insurance covered by [ICA 1984], damages are available for breach...”²⁷²

3.3.17 In *CGU Insurance Ltd v. AMP Financial Planning Ltd*²⁷³ the assured AMP Financial Planning Ltd (AMP) purchased a claim policy from CGU Insurance Ltd (CGU). In 1999 AMP notified CGU that two of their capital holders were facing potential claims from investors and AMP also sent notice to Australian Securities and Investments Commission (ASIC) about potential claims. It was believed by ASIC that the late payment to investors might have a bad influence on AMP's certificate and AMP provided settlement and sent it to CGU. CGU agreed the settlement in general, but “reserved indemnity under policy” because it was believed by CGU's solicitors that AMP would not be liable. In 2001, without further notification, AMP settled the potential claim with investors for £3m and CGU denied the payment under the policy.

In the lower court, it was held that the duty of utmost good faith was a reciprocal duty which both AMP and CGU had to follow. It was also held that the duty of utmost good faith meant something more than just acting with honesty and once the relevant material (the settlement protocol) was sent to CGU it was required by the duty of utmost good faith that CGU had to handle the claim properly and accordingly CGU failed.

The case was then referred to the High Court and the judgment was reversed. However, the focus was not put on the reason why CGU was entitled to refuse

²⁷² ALRC 91, at para 10.144.

²⁷³ [2007] HCA 36.

the claim, but the reason why AMP was not entitled to claim for indemnity and the High Court tacitly consented to the lower court about their opinion on the duty of utmost good faith.

Accordingly, it would be safe to argue that should the assured be entitled to the indemnity the insurer's refusal would be a violation of the duty of utmost good faith and according to Australian law that violation would lead to damage. Additionally, this case is a good example to illustrate that damage for late payment is the insurer's secondary obligation in an indemnity insurance contract, that is to say, once the primary obligation, namely the payment under the policy, is not breached there will be no need to trigger an insurer's liability for damage.

It is, therefore, better to reconcile Cheteman J's comment and the ALRC's statement, and this aim could be achieved by stating that in some cases the implied obligation to make payment on time could be regarded as the requirement of good faith as well. Additionally, in some of the cases discussed there is a strong point of view from the Australian courts that the duty of utmost good faith is well implied, and a breach will certainly give rise to damage and a timely payment is a good reflection. Notably, this is also the legal position in New Zealand, where it is recognized by the courts that the obligation to pay on time is well implied and a breach will lead to damage.²⁷⁴

²⁷⁴ See *Harris v. New Zealand Insurance Company Ltd* (1987) 4 ANZ Ins Cases 60-817; notably, in Canada a breach of duty of good faith could also bring damage, although on a different ground.

It is also believed by the ALRC that damage should be the only appropriate remedy and therefore it refuses to invoke the separate tort of bad faith as a remedy and such refusal shares the same approach taken by English law.²⁷⁵

Awarding damages in Australia

3.3.18 It needs, however, to be pointed out that some academics believe that even though there is an overlap between the common law approach and the statutory implication, in practice most cases are decided on a common law basis rather than by s.13 of the Insurance Contract Act 1984 (the ICA 1984); this is because the payment could be delayed even if the insurer acts in good faith²⁷⁶ or if the policy is a marine policy which is beyond the jurisdiction of the ICA,²⁷⁷ or in the situation where s.13 is not argued;²⁷⁸ but this distinction will not influence the assured's right to claim damage in any event.

It needs also to be mentioned that in Australia, following the English authority *Lagden v. O'Connor*,²⁷⁹ the assured's lack of financial resources (impecuniosity) is no longer a bar to a claim for damage.

In *Brescia v. QBE*²⁸⁰ it should be noticed that in Australia the requirement of the insurer for a timely payment is stricter than it is in Canada and the U.S.²⁸¹ when the assured's perception of the risk is raised as a defence by the insurer.²⁸²

²⁷⁵ See Law Commission Paper No. 201: Insurance Contract Law: Post Contract Duties and Other Issues (n.188), this issue is also discussed in chapter 6 of this work.

²⁷⁶ See *Sutton* (4th edition, Thomson Reuters Australia, 2014), at para 16.72.

²⁷⁷ For example, see *Tropicus Orchids Flowers v. Territory Insurance Office* (1998) 10 ANZ Ins Cas 61-412 where the ICA did not apply.

²⁷⁸ See *Maxwell v. Highway Hauliers* [2013] WASCA 115.

²⁷⁹ [2004] AC 1067.

²⁸⁰ [2007] NSWSC 598.

In that case the assured insured the family business against loss caused by negligence and business interruption for a maximum period of 12 months. The business was severely destroyed by fire and the insurer refused to pay but raised several powerful arguments: firstly, the assured failed to obtain council consent for the use of the roof level for storage and for using the spray booth system, knowing that without significant modification such consents would never be given; secondly, the assured was aware that the booth system had no filtration and flammable materials were being emitted for over 16 years; thirdly knowing the defects in the building, the assured still used the angle grinder which caused the fire. Due to the delay in payment the assured's business was interrupted for over 12 months and the assured lost a good opportunity to purchase a new building.

Prima facie the insurer's arguments were made with reasonable grounds, but the court tended more to favour the assured by using the a subjective test²⁸³ in perception of the risk by holding that in order to use perception of risk as a policy defence, the insurer had to prove that the assured not only perceived the risk, but they also deliberately took the action or inaction which caused the damage.²⁸⁴ Accordingly, the assured was awarded the policy cover for damage caused by fire and business interruption for 12 months.

²⁸¹ In Canada and the U.S the assured's perception of the risk is decided on the assured's objective knowledge.

²⁸² In England the approach taken is the same as Australia, see *The Talisman* [1989] 1 Lloyd's Rep 535 and *Fraser v BN Furman (Productions) Ltd* [1967] 2 Lloyd's Rep. 1 per Diplock LJ.

²⁸³ It has to be pointed out that in *Plasteel Windows Australia Pty Ltd v. Sun Alliance Insurance Ltd* (1989) 5 ANZ Ins Cas 60-918, Cole J expressed a view that the subjective non-perception of a risk could be rejected by a reasonable person's position.

²⁸⁴ See also Roger Walter and Melanie Cox, 'Courting the risk and the refusal of indemnity', Australian Insurance Law Bulletin Volume 23 Number 4 at p.66, available on

The insurer then contested liability for further loss claims by stating that even if the loss was caused by the insurer's breach of contractual obligation, the insurer was not liable when the contract was not terminated and it was too remote as in *Hadley v. Baxendale*; the insurer further argued that the assured's failure to purchase a new building and to get reinstatement was not caused by the insurer, as the assured had enough financial resources but had elected not to do so.

After a long and detailed analysis of the authorities, Hammerschlag J firstly confirmed that the failure to make payment within a reasonable time was a breach of the insurance contract²⁸⁵ and then held that a breach of the insurance contract was the same as the other contracts²⁸⁶ and the same principle applied and pointed out that

“Whether the contract is on foot or not plays no role in whether or not *Hadley v Baxendale* applies to a particular breach.”²⁸⁷

The judge then held that there was no difficulty in applying *Hadley v. Baxendale* , because the causation was not too remote:

“A premium was paid for consequential loss of profits insurance.

It is accordingly, not difficult to suppose that at the time of the Policy the parties had in their contemplation that if the defendants unjustifiably delayed the acknowledgement of their liability to

<http://www.carternewell.com/icms_docs/184290_Construction_Liability_Insurance_-_Read_the_Policy_Carefully.pdf>, accessed on 10th Nov 2014.

²⁸⁵ *Brescia v. QBE* [2007] NSWSC 598, at [88].

²⁸⁶ *ibid*, at [510].

²⁸⁷ *ibid*, at [514].

indemnify Brescia in respect of its losses it would inevitably suffer loss of trading profits as a consequence”²⁸⁸

As to the purchase and reinstatement, the judge found that the assured was not unreasonable to do so, as the insurer contemplated the payment of indemnity value initially and then payment to the insured for reinstatement value. The judge then held that should the policy be honoured, it was not unreasonable for the assured to proceed with its own financial resources and held that the insurer was liable for the further loss.

Accordingly, it should be noted that in Australia it is clearly recognized that an insurance contract is not as special as it is in England, and such understanding makes more commercial sense because historical reasons which made insurance law so special have no longer exist; secondly, the misconception of consequential loss has been abolished by the Australian courts by applying *Hadley v. Baxendale* to insurance contracts even if they are not terminated, while in England the long-standing authorities make it impossible for courts to award consequential damage without reforming the law; thirdly, in deciding the foreseeability the aim of the insurance policy has a great value, as the court in *Brescia* clearly stated that since the policy was against the risk of business interruption, the loss of profit and the loss of opportunity due to late payment was foreseeable.²⁸⁹

²⁸⁸ *Brescia v. QBE* [2007] NSWSC 598, at [517], emphasis added.

²⁸⁹ See also *Ferrcom Pty Ltd v. Commercial Union Assurance Co of Australia Ltd* (1993) 176 CLR 332, where it was held that the loss of profit due to the unrepaired crane was reasonably foreseeable by the insurer.

3.3.19 By contrast, in *Motor Accident Mutual Insurance Pty Ltd v. Kelly*,²⁹⁰ the assured told the insurer that he would not use the insured vehicle for business purposes but after the policy attached he did. The vehicle was stolen with business tools inside and the insurer refused to pay on the ground of misrepresentation. Judgment was given in favour of the assured plus a 2-year business loss; but at the appeal it was held that since the insurer could not have contemplated this further damage, they were not liable.

It is also predictable that the assured could suffer a consequential loss, even if the insurance payment is duly made; in this scenario the key issue is the construction of the policy wording: for example, in *Brescia* it was held that a business interruption policy covered the loss of profit and other inevitable losses. It is well summarized in *Sutton* that

“The general rule is that insurance covers physical damage resulting from an insured peril, and that consequential loss is not insured unless the policy expressly so provide.”²⁹¹

Accordingly, the damages for loss of profit could be recognized by Australian law in principle, but subject to ordinary principles of foreseeability and causation, and the existence of the foreseeability could be solved by the type of the policy and the facts and evidence in the different cases: in a business interruption policy, further damages for loss of profit and loss of chance²⁹² are more likely to be awarded than in property insurance cases in Australia. In other words, it is required by the duty of good faith that the insurer should handle the claim

²⁹⁰ (1999) 10 ANZ Ins Cas 61-420.

²⁹¹ See *Sutton* (4th edition, Thomson Reuters Australia, 2014), at para 16.60.

²⁹² See *Maxwell v. Highway Haulier Pty Ltd* [2013] WASCA 115, at [87-99].

properly and if the insurer fails to do so, whether damage should be allowed shall be determined by the rule of damage; this conclusion is based on the understanding in Australia that the primary duty of an indemnity insurer is to perform the contractual duty of payment and arguably this will be the same approach taken by English law when the Enterprise Act 2015 comes into force.

It is appropriate to add an English case here for comparison. In *Normhurst Ltd v Dornoch Ltd*²⁹³ the assured's property was also insured against business interruption and fire; the property was destroyed by fire, the insurer refused to pay and consequential loss was incurred: everything but the outcome was exactly the same as in the case of *Brescia v. QBE* in Australia. The English High Court held that the policy, property or liability, was a contract of indemnity and HHJ Chambers QC felt himself bound by *Sprung* and *The Lips* and made judgment for the insurer.

By making this comparison it can be seen in *Normhurst* that the English position lacks business sense: the insurer takes the premium and is well aware of the risk of business interruption and their inaction causing further loss but they are legally not liable. It has to be admitted that compared with Australia the English law exposes the assured to a very dangerous and unreasonable position and that is one of the reasons why the current English law should be reformed.

Limiting the misuse of the duty of good faith in Australia

3.3.20 In *Australian Associated Motor Insurers Ltd v. Ellis*²⁹⁴ the contractual duty of utmost good faith went too far for the benefit of the assured²⁹⁵ and what

²⁹³ [2005] Lloyd's Rep. I.R. 27.

²⁹⁴ (1990) 6 ANZ Insurance Cases 60-957.

should be learned from that case is that the remedy for the assured also requires some limitation.

In that case a condition was written into the policy which required that the assured should not modify the car without the insurer's written consent. After the policy was entered into the assured, without the insurer's consent, modified the car with "mag wheels". The car was subsequently damaged, but the wheel played no part in the accident. Cox J in the Supreme Court South Australia found that the insurer breached the duty of utmost good faith because the assured was not clearly notified about the consequence of the breach.

From this judgment, it might be inferred that there is a potential risk that the duty of utmost good faith on the insurer could be misused by the assured and such a threat grants the assured a very powerful weapon against their insurers even in the handling stage. Therefore, it is appropriate to add some limits to the duty of utmost good faith.

In *Zurich Australian Insurance Ltd and St Andrew's War Memorial Hospital*²⁹⁶ Chesterman J criticised the judgment made by Cox J and expressed his own opinion about the contractual duty of utmost good faith; he stated that

"This decision appears to me, with respect, wrong. A duty, the essence of which is to act honestly, is elevated to an obligation in an insurer to coddle its insured and to allow idiosyncratic judicial solicitude to replace principle."²⁹⁷

²⁹⁵ While by contrast, in England the duty goes too far towards the insurer.

²⁹⁶ (1999) 10 ANZ Ins Cas 74,828.

²⁹⁷ *ibid*, at [81].

The judge continued that

“... there is an implied limitation in any term of a policy which confers rights or powers on the insurer that they be exercised with due regard for the interests of the insured where those interests conflict with the insurers.”²⁹⁸

Even though the judgment was mainly focused on the pre-contractual duty of good faith, it nevertheless revealed the nature of the duty, namely the duty requires one party, in performing the contract in his or her part, to consider the interest of the other party and once there is a conflict between the interests of parties it is the obligation of each party to minimize the bad influence towards the other.²⁹⁹

Therefore, the assured should not, after the risk occurs, leave all the matters to the insurer and wait for the indemnity; he has to provide suitable co-operation by, for example, providing proper materials and documents. This view can be supported by Ambrose J who believes that the insurer could only be guilty for bad claim handling after obtaining all relevant materials and a reasonable period of reasonable consideration.³⁰⁰

It has been argued elsewhere in this work that a modified remedy for breach of the duty of good faith would be a resolution in English law about the assured's remedy and according to the discussion above, it could be said that in Australia

²⁹⁸ *ibid.*

²⁹⁹ See also *Wiltrading (WA) Pty Ltd v Lumley General Insurance Ltd* (2005) WASCA 106, at [67].

³⁰⁰ See *Gutteridge v. Commonwealth of Australia* (unreported, Supreme Court of Queensland, 25/6/93), at p. 13.

such a resolution, after some debate, works well and is more suitable for the modern insurance industry.

3.3.21 However, the justification of this approach is seriously doubted by Neil Campbell, who believes that the resort to good faith, not only in England, but also in Australia, is a sign of “insufficient understanding of the monetary remedies available to the insured under the general law of contract” and/or “desperation”³⁰¹ and this doubt makes it fundamentally important to have a very clear understanding about the duty of good faith not only in Australia but also in England. In order to guard his opinion, the learned academic argues that

“In my view the duty of good faith at the claims stage, if it means anything, means that obligations might be imposed on the insurer that are additional to the express and fundamental obligation to indemnify. On that view, a plea that the insurer has breached its duty of good faith is going to make a difference *only when the insurer is not otherwise in breach of contract.*”³⁰²

As a result, he stresses that the pleading should only be brought where there is a difference between the breach of contractual obligation to indemnify and the duty of good faith; the difference appears, as he says, where the remedy for the breach of the duty of good faith is better or the claim is not covered by the policy.

With respect, this argument is erring in constructing the duty of good faith too narrowly and making it isolated from the mutual contractual duty, therefore it

³⁰¹ Under current English law, it has to be admitted that “desperation” has more weight.

³⁰² Neil Campbell, Monetary remedies for wrongful declinatures of insurance claims, [2004] 15 Insurance Law Journal 185, at para 2.4, emphasis as original.

could not find legal or academic support;³⁰³ a discussion on this point will be preceded with an **explanation of the duty of good faith and its remedy in Australia.**

It has to be pointed out again very clearly that in Australia there are **two sources** for the duty of good faith: one is from **common law**, where it has been recognized for centuries that the insurance contract itself is a contract of good faith, and the other is a **statutory duty** of good faith clearly stated in s.13 of ICA 1984:

“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”

Additionally, in the Insurance Contracts Amendment Act 2013 it is further clarified that

“A failure by a party to a contract of insurance to comply with the provision implied in the contract by subsection (1) is a breach of the requirements of this Act.”

As to the common law duty of good faith, the effect of breach may not lead to a monetary remedy **directly**, but it could be found in many decided cases that it could be used as a guide to interpret the insurance contract; this point is made by McMurdo J who says that

³⁰³ Neil says he could find some support in *Re Zurich* at para 77, but in that case the policy was effected in 1977 when the ICA 1984 was not enacted.

“...the common law duty of good faith was not in itself a duty which, if breached, would give rise to a right to damages. It was effectively a rule of construction of the express terms of the insurance contract.”³⁰⁴

It might be true that should there be only a common law duty of good faith, the assured could not receive a monetary remedy **directly** from that duty, but the assured could nevertheless be awarded such remedy **indirectly**.³⁰⁵ However, since the ICA 1984 is in effect now, things have changed.

It is well understood that the duty of good faith in s.13 of the ICA 1984 is codified from common law, with some further improvements added. Firstly, s.13³⁰⁶ makes it very clear that the duty of good faith is a mutual duty, unlike English law where avoidance is the only remedy and would easily make it an insurer-favoured duty. Secondly, s.14 confirms that the duty of good faith is mandatory because it could not be excluded. Thirdly, s.13 (2) which states that the breach of the duty of good faith is a breach of law also grants justification for the intervention by the public authority, the Australian Securities and Investment Commission (ASIC)³⁰⁷, to vary, suspend or even cancel the insurer’s Australian Financial Services Licence; such intervention can be made at every stage of the insurance contract, especially the claim handling stage, to make sure the assured’s claim is fairly handled.

³⁰⁴ See Justice Philip McMurdo, An Insurer’s Breach of the Duty of Good Faith: Exemplary Damages? <https://www.aila.com.au/docs/default-source/conference-papers/06-05-25_justice_mcmurdo.pdf?sfvrsn=2>, accessed on 16th October 2014.

³⁰⁵ For example, see *Distillers Co, Bio-Chemicals (Australia) Pty Ltd v Ajax Insurance Co Ltd* (1974) 130 CLR 1.

³⁰⁶ Now s.13 (1) of the Act according to the 2013 Act.

³⁰⁷ See Explanatory Memorandum of Insurance Contracts Amendment Bill 2013, <<http://www.comlaw.gov.au/Details/C2013B00052/Explanatory%20Memorandum/Text>>, accessed on 16th October 2014, at para 1.8-1.9.

Accordingly, it can be seen that a breach of the duty of good faith will certainly give the assured monetary remedy according to the statute and it could also be argued that since most consequential damages for the assured are caused by poor claim handling by the insurer, the poor claim handling is a breach of the duty of good faith due to the lack of care for the assured.³⁰⁸ In this scenario, it could be argued that the duty of good faith and the duty to indemnify the assured could work together to give rise to a monetary remedy for the assured. Additionally, it could also be fair to say that **the duty of good faith could not be breached alone**, the breach must be represented by some behaviour: for example, in England such behaviour could be misrepresentation or non-disclosure; while in Australia such behaviour could be poor claim handling.

3.3.22 It is the opinion of the Law Commission that once the insurer is asserting a defence which is unfounded³⁰⁹ it does not break the duty of good faith; some support for this conclusion can be found in *Bankstown Football Club v CIC Insurance Ltd*³¹⁰ where the court was satisfied that the insurer's rejection was in good faith, but the court also held that the insurer was liable for consequential loss.

In summary, it can be found that in Australia, firstly a breach of the duty of good faith is a breach of a contractual term and now a breach of law; secondly, such a breach can only be triggered by some prohibited acts; thirdly, it is at least

³⁰⁸ See also *CGU v. AMP* [2007] HCA 36.

³⁰⁹ See Law Commission Paper No. 201: Insurance Contract Law: Post Contract Duties and Other Issues (n.188) at para A.10, but there is no reference from which this conclusion is reached; it might be better to understand as the insurer asserting the defence of good faith, which could be judged objectively by market practices.

³¹⁰ [1997] HCA 2.

arguable that the duty of good faith can be separated from the primary contractual duty to indemnify.

3.3.23 To conclude, according to the analysis and the comparative law discussed above, it is clear that the insurer should have an obligation arising from the post-contractual duty of good faith in the claim handling stage and such duty is a contractual one. It is further argued by Malcolm Clarke that indemnity insurance should be the same with general contracts,³¹¹ that is to say, the payment should be regarded as a kind of contractual debt rather than damages, because otherwise the rule of English insurance law would be “bizarre”.

It should also be noticed that the old law on the duty of good faith has several disadvantages:

Firstly, the statutory requirement on the duty in s. 17 of the MIA 1906 has been judicially interpreted as a pre-contractual duty and “the all-or-nothing” remedy is especially unfair to the assured.

Secondly, there is no conclusive definition of the post-contractual duty of good faith, even though it has been mentioned, *obiter*, that there has to be such a duty in insurance contracts.

Thirdly, when it comes to the question of damage for late payment there is neither a statutory remedy nor a unified guide for a common law remedy.

Even though it could be argued that once the late payment is made due to the lack of care towards the assured, the duty will be breached and the breach is to be deemed as a separate one so that it could exceed the limit of the policy: it is

³¹¹ See Malcolm Clarke, *Erasmus Law Review*, Volume 5, Issue 2 (2012).

certain that the court would be reluctant to allow avoidance as the remedy, it is understandable because once the duty of good faith is breached by the insurer, avoidance of the contract sounds like a punishment instead of a remedy; however, there are no reported cases in England in which the damage is clearly stated as an available remedy for the breach³¹² and the law on that issue remains uncertain. Therefore, it is even possible that the assured might claim damages for late payment for breach of the post-contractual duty of good faith; it is not the best option until the law on this issue is reformed. As suggested by the Law Commission and according to the amended Insurance Act 2015 this aim has been achieved.

The effect of the Insurance Act 2015

3.3.24 It was stated at the beginning of this part that the Insurance Act 2015 has made significant amendments and some of the problems have been solved.

Firstly, the new legislation abolishes the “all-or-nothing” remedy in s.17 and omits ss. 18-20 in the MIA 1906; accordingly, there is now a continuing duty of good faith which would cover the post-contractual stage; it is a statutory recognition of the common law approaches.³¹³

Secondly, the new obligation of fair presentation has replaced the pre-contractual duty of disclosure and non-misrepresentation and the remedies for the breach are also stated in the Schedule to the new legislation.

³¹² Even in *Phoenix v. Halvanon* [1985] 2 Lloyd's Rep. 599, the issue of innominate term raised by Hobhouse J should be regarded as *obiter*.

³¹³ See para 3.3.13 above, for the relevant sections of the statute, see s.14(1), s.14(3)(a) and s.21(2) of the Insurance Act 2015.

More importantly, the Insurance Act 2015 has been amended by the Enterprise Act 2016, which incorporates the duty of the insurer to make a timely payment and clarifies that damages which may exceed the policy limit is the appropriate remedy. Accordingly, the new legislation has made it clear that there is a specific duty on the insurer to make a timely payment and arguments about the post-contractual duty of good faith in late payment shall only have academic value in the future.

3.4 The assumed insurer's secondary obligation

3.4.1 It needs to be pointed out at the beginning of this part that according to the amended Insurance Act 2015, the assured could, in practice, receive damages in cases of a qualified late payment by the insurer. Moreover, the Enterprise Act 2016 has made it a contractual obligation of the insurer to make a timely payment, even though it does not express clearly whether it is the primary obligation of the insurer, which means that the "hold harmless" doctrine could be abolished, there are several reasons to assume that it should be so.

According to that assumption, issues which need to be considered by the court within a commercial context are the rules for damage in *Hadley* and issues about the causation. In addition, once the primary obligation is changed there is little need to consider the position in *The Lips*, as what is delayed by the insurer is the contractual performance rather than the damage. Therefore, if the insurer fails to pay a valid claim or rejects a claim which later turns out to be a valid one, he will be under a secondary liability to pay the claim, as foreseeable damage subject to the rules in *Hadley*, and as interest according to statute. This assumption

could also be supported by the wording of the amended s. 13A of the Insurance Act 2015 where it is clearly stated that

“It is an implied term of every contract of insurance that if the insured makes a claim under the contract, the insurer must pay any sums due in respect of the claim within a reasonable time.”

3.4.2 Another reason for the possible abolition of this doctrine is found in the rule of causation. Historically, the chain of causation would be breached by the impecuniosity of the victim himself. Therefore, in *Sprung*, it was held that the true causation which caused the loss suffered by Mr. Sprung was impecuniosity rather than the late payment by the insurer; as a consequence, it might be that even though it was held that the primary obligation of the insurer was to pay a valid claim to Mr. Sprung and the late payment was initially the cause, Mr. Sprung could nevertheless not recover damages, as the chain of causation was breached by the his own impecuniosity at that time.

Currently, the law seems to be more favourable to the assured as this is no longer the case. It has been settled in *Lagden v. O'Connor* that impecuniosity is not an obstacle for a victim to claim full damage.

In addition, in order to be indemnified, the assured needs to mitigate the loss, which is always referred as a duty to “sue and labour” in maritime policy; without express policy wording, the loss caused by failure to mitigate would be irrecoverable. In *Sprung*, the mitigation should have been done by raising a loan from the bank and selling his property, however, because of the poor market conditions and his impecuniosity, it became impossible for him to mitigate his

loss. Again, according to *Lagden v. O'Connor* in such a situation the duty to mitigate might be exonerated.

However, it has to be remembered that once an issue of fraud is involved, the assured will receive nothing as the whole claim will be forfeited. This problem was discussed by Mance J in *ICC* that although the insurer might be under an obligation to act in a reasonable manner, the fraud of the assured, in fact, exonerated the insurer from such obligation.³¹⁴

3.5 Damage for tort and emotional distress

3.5.1 It is common in tort law that in some circumstances punitive damages are available for victims with the aim of deterring outrageous behaviour, but this situation is rarely seen in contractual claims where insurance claims belong. However, in *Ruxley Electronics and Construction Ltd v Forsyth*³¹⁵ it was clearly expressed by Lord Bridge that

“There is no question of punishing the contract breaker.”³¹⁶

In Canada, punitive damage has now become available for breach of contract since the Supreme Court’s decision in *Whiten v Pilot Insurance Co*³¹⁷ where the insurer was held to be liable for the non-performance of the duty to make payment and the punitive damage awarded by the jury was \$1m and reduced to one-tenth by the court.

³¹⁴ *ICC* [1997] LRLR 94, at p.136.

³¹⁵ [1996] A.C. 344.

³¹⁶ *ibid*, at p.353.

³¹⁷ [2002] SCC 18.

However, this approach is unwelcome in England, Australia and New Zealand. It could be argued that the general damage rule would be enough to deter an insurer's delay in payment.

It is further pointed out by *Sutton* that compared to tort, insurance is

“...a contract of indemnity whereby the insurers agree to make good the assured's actual loss and no more, whereas if damage is inflicted tortuously the victim has a right of damages against the wrongdoer as a matter of law and it is no concern of the wrongdoer if and how the sum representing his liability is spent by the victim.”³¹⁸

Additionally, in Australia each state has its own power to pass laws restricting the tortious obligation of the insurer in order to prevent a crisis in the industry and such action takes into consideration the economical basis rather than the legal background and therefore it will not be discussed in depth in this work.

3.5.2 Compared with the tortious remedy, the remedy for physical inconvenience and mental distress is more ambiguous. In England it was well established by Hirst J in *The Italia Express (No.2)*³¹⁹ that both physical inconvenience and mental distress were not remedies provided by indemnity insurance, unless the policy clearly stated so;³²⁰ but this is not the conclusion in Australia and New Zealand.

³¹⁸ See *Sutton* (4th edition, Thomson Reuters Australia, 2014), at para 16.53.

³¹⁹ [1992] 2 Lloyd's Rep. 281.

³²⁰ *ibid*, at p. 293; notably in England it is common that in some indemnity policies the insurer will provide costs for alternative accommodation: *Direct Line Insurance v. Khan* [2002] Lloyd's Rep IR 364, *AXA v. Gottlieb* [2005] Lloyd's Rep IR 369, *Aviva v. Brown* [2012] Lloyd's Rep. IR 211.

In *Baltic v. Dillon*³²¹ it was held by the High Court of Australia that emotional distress was available in general contract law and not limited to non-commercial contracts³²² provided that the emotional distress came from either physical inconvenience (the first limb), or the contract itself was one of enjoyment, pleasure or free from distress (the second limb).³²³

Accordingly, one may well believe that in insurance contracts mental distress will fall within the first limb if the insurer's late payment causes physical inconvenience and in order to satisfy these limbs the assured has to be a natural person rather than a legal one. However, in Australia there is only one reported indemnity insurance case³²⁴ where mental distress was awarded.

In *Motor Accident Mutual v. Kelly*³²⁵ even though it was held by the appeal court that the insurer was not liable for loss of profit due to the remoteness, the first trial's conclusion on emotional distress was not reopened where it was held by the trial court that the insurer was liable for emotional distress valued at \$12,500³²⁶ because of the long period of time of non-payment.³²⁷ However, in that case *Baltic v. Dillon* was not referred to, and instead the Australian court used New Zealand cases for reference.³²⁸

³²¹ (1993) 176 CLR 344.

³²² *ibid*, see the judgment made by Mason CJ at pp 365-366.

³²³ The second limb of the test is the same as the English position.

³²⁴ For non-indemnity insurance, mental distress was awarded in *Johnson v. Australian Casualty Co Ltd* (1992) 7 ANZ Cas 61-109.

³²⁵ (1999) 10 ANZ Ins Cas 61-420.

³²⁶ Notably the indemnity value of the insured vehicle in that case was only \$12,750.

³²⁷ This caused a considerable sum of interest of some \$20,000.

³²⁸ In *Edwards v AA Mutual Insurance Co* (1985) 3 ANZ Ins Cas 79,160 (HCNZ) where a \$2,000 damage for mental distress was awarded from the late payment of \$42,000; *Stuart v Guardian Royal Exchange Assurance Co of NZ Ltd* (1988) 5 ANZ Ins Cas 75,274 (HCNZ) where a \$4,000 damage for mental distress was awarded from the late payment of \$80,000.

Accordingly, in Australia the door for a natural person assured to claim damages for mental distress is not completely closed even if the contract is not for relaxation or pleasure, but once the assured is a company, there is no way to possibility of satisfying the test.

This may also be true in New Zealand, but it seems to be clearer in New Zealand that a natural person assured could be awarded damages for mental distress: in *State Insurance Ltd v Cedenco Foods Ltd*³²⁹ even though it was unnecessary for the court to rule on this point, it was nevertheless pointed out by the Court of Appeal that

“...mental significance [of late payment by an insurer] may well be within the reasonable contemplation”³³⁰

By contrast, the New Zealand court firmly rejected mental distress for legal persons assured in *Infrapulse Distributors NZ Ltd v State Insurance Ltd*³³¹ holding that

“How a legal person which is but a statutory construct could suffer distress in any strict sense of the word was not explained.”³³²

However, this opinion is strongly contested by Neil Campbell, who argues that

“...the explanation is straightforward: in the same way that the law attributes the acts of individuals to a company so that it can be said,

³²⁹ (CA 216/97, 6 August 1998).

³³⁰ *ibid*, at p.7, cited and approved by Neil Campbell in ‘Monetary remedies for wrongful declinations of insurance claims’, [2004] 15 Insurance Law Journal 185, at para 3.1.2.

³³¹ [2000] DCR 170.

³³² This opinion was the same with Hirst J in *The Italia Express (No.2)* [1992] 2 Lloyd's Rep. 281.

for example, that the company breached a legal obligation, so the law can attribute the distress of individuals to the company.”³³³

It has to be admitted that such a suggestion is very avant-garde, even though there is no legal support other than jurisprudence. The better understanding has to be drawn from the nature of the insurance policy and currently the law in this area is sufficient, at least sufficient in Australia and New Zealand: for example, if the insurer provides a policy for business interruption for a legal person and subsequently, because of the insurer’s breach, that legal person suffers further damage from the business interruption which should have been prevented by a timely indemnity payment, this amount, under current law in Australia and New Zealand, could be awardable as damage for late payment, provided the rules on damage and causation are satisfied.

In chapter 2 and chapter 3 of this work, the primary and the secondary obligations of the insurer have been discussed in full, and from next chapter issues of the currently available remedies for the assured shall be dealt with.

³³³ Neil Campbell, ‘Monetary remedies for wrongful declinatures of insurance claims’, [2004] 15 Insurance Law Journal 185, at para 3.1.2.

Chapter 4 Interest in General

4.1 The historical review

4.1.1 It is now widely accepted that the most common remedy and the only legitimate remedy for the assured is interest. For example, the court refused the claim of damage to Mr. Sprung, but in addition to the contractual indemnity amount of the policy the court awarded Mr. Sprung **simple** interest.³³⁴ However, the law about interest is also, regrettably, far from clear and shows a lack of commercial sense. Therefore, in this chapter the discussion will be focused on the issue of interest.

(a) The starting point: Procedural justice

4.1.2 It has been stated repeatedly that generally in English law if a contractual party fails to perform the contractual obligation it could result in a breach of the contract and damages for such breach is available for the innocent party, provided that the remoteness tests is satisfied³³⁵. This might also be true in tort, but that will not be discussed in detail by this work. However, historically there was one “anomalous and unprincipled exception”³³⁶ that interest was not admitted by the court as a legitimate award for breach of a contract.

The first leading case on this point could be traced back to the 18th century: *Moses v. Macferlan*.³³⁷ In that case there was an agreement between Moses

³³⁴ *Sprung v. Royal Insurance (UK) Ltd* [1999] Lloyd's Rep IR 111.

³³⁵ For example, see para 3.1 and para 3.4 of this work.

³³⁶ See *Sempra Metals Ltd v. Inland Revenue Commissioners and another (IRC)* [2007] UKHL 34 (*Sempra*), at [74].

³³⁷ (1760) 2 Bur 1005.

and Macferlan which stated that Macferlan would not sue Moses, when Moses endorsed four promissory notes of Jacobs. However, Macferlan did sue Moses in the Court of Conscience and it was held that Moses was liable to pay Macferlan £6. Deciding not to sue for special breach in the High Court, Moses claimed for “money had and received”, which was supported by the court led by Lord Mansfield CJ, who delivered the famous and widely-cited judgment below:

“This kind of equitable action, to recover back money, which ought not in justice to be kept, is very beneficial, and therefore much encouraged. It lies for money which, *ex aequo et bono*, the defendant ought to refund; it lies for money paid by mistake; or upon a consideration which happens to fail; or for money got through imposition, (express or implied) or extortion; or oppression; or an undue advantage taken of the plaintiff’s situation, contrary to laws made for the protection of persons under those circumstances. In one word, the gist of this kind of action is that the defendant, upon the circumstances of the case, is obliged by the **ties of natural justice and equity**, to refund the money.”³³⁸

It can be seen that Lord Mansfield CJ made no special reference to interest. However, this issue was mentioned when His Lordship stated the advantage of the claim of “money had and received”. As to the benefit to the defendant, he stated that

“It is the most favourable way in which he can be sued: **he can be liable no further than the money he has received**; and against that,

³³⁸ *ibid*, at p.1012 emphasis added.

may go into every equitable defence, upon the general issue; he may claim every equitable allowance; he may prove a release without pleading it; in short, he may defend himself by everything which shews that the plaintiff, *ex aequo bono*, is not intitled to the whole of his demand, or to any part of it.”³³⁹

4.1.3 The meaning of the first part of the cited judgment of Lord Mansfield seems to be literal, that is to say, the award of the principal sum of the money had and received should be payable to the claimant. The legal effect of the second part, as to the benefit to the defendant, was explained by the Court of Common Pleas in *Walker v. Constable*.³⁴⁰ In that case the claimant claimed for the return of the money paid under an abandoned contract for the auction of land plus interest. Being unable to prove the specific contractual terms the claim could only be raised as a claim for money had and received. Even though Buller J was of the view that the claimant might perhaps be entitled to recover interest under the count for money had and received, the Court was of the opinion that it had been decided by Lord Mansfield in *Moses v. Macferlan* that in an action for money had and received nothing but the net sum could be recovered without interest.

It seemed, at that time, to be settled in common law that there would be no interest over the claim of money had and received. However, in *De Havilland v. Bowerbank*³⁴¹ Lord Ellenborough made a proviso to this rule. According to the Attorney General, Lord Ellenborough was of the view that

³³⁹ *Moses v. Macferlan* (1760) 2 Bur 1005, at p.1010 emphasis added.

³⁴⁰ (1798) 1 Bos & P 306.

³⁴¹ (1807) 1 Camp 50.

“If the party lost the use of his money, it was his own fault in not suing for it. He thought, that where money of the plaintiff had come to the hands of the defendant, to establish a right to interest upon it, there should either be a specific agreement to that effect, or something should appear from which a promise to pay interest might be inferred, or proof should be given of the money being used.”³⁴²

It has to be stressed that what was actually focused on in the judgment was the fact that it was not the party’s own fault in losing the use of the money, but it was the party’s own fault in not raising a claim for its return. Therefore, it might be inferred that Lord Ellenborough wished to stress the necessity of efficiency in litigation. However, it has to be noted that no matter how efficient the claimant in litigation is, there must be inevitable “gaps”, which could be the time loss in waiting for the trial and the time loss in waiting for the judgment, and based on such consideration, the discretionary power of the court is certainly required for achieving substantial and procedural justice.

It needs also to be pointed out that, if one of these preconditions is satisfied, namely a specific agreement is written down in the contract, or a promise of paying interest is inferred, or the gain of the money could be proved, the interest would be available to the claimant. It does not matter if the money is a debt or damages. Additionally, this case only answered the question about “should there be interest or not”, the issues about the type of the interest and the rate of the interest remain unresolved.

³⁴² *De Havilland v. Bowerbank* (1807) 1 Camp 50, at p.52.

(b) Lord Tenterden's Act

4.1.4 Subsequently, the position of Lord Ellenborough was narrowed into “debt” rather than all kinds of money possessed by the other party. This problem began in 1829 in *Page v. Newman*.³⁴³ In that case Mr. Page lent various sums of money to Mr. Newman in 1814 when they were prisoners of war at Verdun. Five years later Mr. Page claimed for the principal sum plus interest. According to the speech of Lord Ellenborough in *De Havilland v. Bowerbank* the claim for interest failed. It was held by the court that where there was an absence of special agreement, money lent as a debt did not carry any interest. Additionally, the court which was led by Lord Tenterden CJ raised another issue, namely the issue of “practical convenience”. It was believed by the court that should interest be allowed without special agreement in advance, difficulties might arise in determining whether a claimant had taken reasonable steps to mitigate his loss. It was pointed out by the court that

“... [i]t might frequently be made a question at *nisi prius* whether proper means had been used to obtain payment of the debt, as such as the party ought to have used...”³⁴⁴

This concern could be deemed as a confirmation of the importance of the statement made by Lord Ellenborough which stressed that the legal efficiency was required by law, however, it has to be pointed out again that the court at that time favoured legal efficiency so much that the issue of fair and just might have been ignored. Having recognized this disadvantage in the common law, Lord

³⁴³ (1829) 9 B&C 378.

³⁴⁴ *Page v. Newman* (1829) 9 B&C 378, at p.381.

Tenterden promoted the Civil Procedure Act 1833 which is now known as Lord Tenterden's Act. In this Act juries were empowered to award interest on "debt or sums certain" in limited circumstances. It was stated in the Act

"That upon all debts or sums certain, payable at a certain time or otherwise, the jury on the trial of any issue, or on any inquisition of damages, may, if they shall think fit, allow interest to the creditor at a rate not exceeding the current rate of interest from the time when such debts or sums certain were payable, if such debts or sums certain be payable by virtue of some written instrument at a certain time, or if payable otherwise, then from the time when demand of payment shall have been made in writing, so as such demand shall give notice to the debtor that interest will be claimed from the date of such demand until the term of payment; provided that interest shall be payable in all cases in which it is now payable by law."

4.1.5 *Prima facie* the scope of the 1833 Act was truly wide enough for awarding interest, as the only requirement for claiming interest was that notice should be given to the debtor that interest would be claimed, provided that the principal sum and the date of the repayment are certain or could be ascertained. In addition, it might be inferred that the juries were also empowered to award compound interest, provided that the rate did not exceed the current interest rate of the bank. Additionally, the principal sum was not limited by contractual debts and it could be extended to a principal payment of damages.

However, this was not quite the truth. After the Act was enacted, different interpretations were made by courts about the definition of “certain amount” and “certain date”.

In *Merchant Shipping Company v. Armitage*,³⁴⁵ it was stated in a contract of carriage that the money was payable after the correct delivery of the cargo. It was held by the Exchequer Chamber that even if the exact time could be ascertained and became settled by the contractual event, the money was not payable at a “certain time” within the definition of the Act and therefore the claim for interest failed. While by contrast, one year after that decision, in *Duncombe v. Brighton Club and Norfolk Hotel Company*³⁴⁶, the majority of the court held that if the written instrument contained provisions on the happening of which the time of payment or the sum payable was ascertained the requirement of Lord Tenterden’s Act should be deemed as satisfied.

(c) London, Chatham and Dover Railway Co v. South Eastern Railway Co

4.1.6 In the year of 1893 this dispute reached the House of Lords in *London, Chatham and Dover Railway Co v. South Eastern Railway Co*.³⁴⁷ In that case a joint traffic agreement was reached between two railway companies and they determined that accounts should be rendered by each company to the other. Specifically, it was stated in the contract that the amount of the payment was “not less than 75 percent on account of the balance appearing to be due on the face of the accounts so to be exchanged” and the date of the payment was “as soon

³⁴⁵ Law Rep. 9 Q. B.

³⁴⁶ Law Rep. 10 Q. B. 371.

³⁴⁷ [1893] AC 429.

after the 1st of June and no later than 15th of June”. At the first trial, the official referee felt that the amount of the sum and the date of the payment could be ascertained under the Lord Tenterden’s Act and therefore interest was awarded. In the appeal, the court reversed the trial judgment, feeling that they were bound by the *Armitage*³⁴⁸ case rather than the *Duncombe*³⁴⁹. In the appeal before the House of Lords the claimant, along with the issue of the application of the Lord Tenterden’s Act, raised another head of claim, namely, even if the claim was not within the Act, interest could also be awarded by way of damages or wrongful detention of debt.

In the leading speech Lord Herschell LC felt it would be unnecessary to decide whether *Armitage* and *Duncombe* were correct, even though His Lordship favoured the first.³⁵⁰ Alternatively, the learned judge put more weight on “debts or sums certain” rather than “payable at a certain time or otherwise”, and it was held that

“I think that the certain sum payable must be a certain sum which is due absolutely and in all events from the one party to the other...within the term ‘debt.’ **But here the payment of this 75 percent was really provisional only**... Nevertheless, if it had appeared that in reality, owing to errors in the accounts, 75 percent exceeded the amount due, that would have had to be adjusted by some kind of repayment or rectification in a subsequent account; and, therefore, this is not really a provision for the payment of a debt or a

³⁴⁸ *Merchant Shipping Company v. Armitage* Law Rep. 9 Q. B.

³⁴⁹ *Duncombe v. Brighton Club and Norfolk Hotel Company* Law Rep. 10 Q. B.

³⁵⁰ See *London, Chatham and Dover Railway Co v. South Eastern Railway Co* [1893] AC 429, at [437].

sum certain absolutely from one party to the other; it is at best a provisional payment which may have to be undone by a subsequent adjustment. My Lords, for these reasons I do not think it can be held in the present case that there is a sum certain payable at a certain time by virtue of a written instrument.”³⁵¹

Therefore, according to the very special facts of the case, the House of Lords refused to apply the Act.

4.1.7 However, by stating that the payment in that case was special and provisional, the House of Lords did not mean that the Act should be interpreted strictly. By contrast, Lord Herschell LC felt that the court should be granted more power to award interest even if the sum was “uncertain”. In a short comment, Lord Herschell LC expressed the view that

“...when [Lord Tenterden] dealt with the allowance of interest in this statute he certainly introduced language which kept such claims within very narrow limits; speaking for myself, they seem to be too narrow for the purposes of justice.”³⁵²

As to the other claim, namely the claim for damages or wrongful detention of the debt, Lord Herschell LC stated that

“...the party who is wrongfully withholding the money from the other ought not in justice to benefit by having that money in his possession

³⁵¹ *London, Chatham and Dover Railway Co v. South Eastern Railway Co* [1893] AC 429, at [437], [438] emphasis added.

³⁵² *ibid* at [440], [441].

and enjoying the use of it, when the money ought to be in the possession of the other party who is entitled to its use.”³⁵³

However, His Lordship refused to reopen the issue decided in *Page v. Newman* and therefore the alternative claim also failed. To that extent, the outcome of that case turned out to be curious, notwithstanding the hint that “the benefit of the money in possession” might be calculated by at least compound interest. Furthermore, the second quoted part of the speech made by Lord Herschell LC could be deemed as a very powerful, although *obiter*, statement that it might still be possible to award interest in common law once the former House of Lords or the current Supreme Court felt it fair and just to reopen the issue in *Page v. Newman*.

It has to be pointed out that from the cases given above, it could be found that the court had become more in favour of granting interest, whether simple or compound, in common law in debt, or certain/uncertain sums of money. However, due to the outcome, even with reluctance and the special facts of the case the issue of interest on debt or damage seemed to be settled after *London, Chatham and Dover Railway Co* but efforts were taken by some lower courts to distinguish that case.

4.1.8 The case of *Johnson v. The King*,³⁵⁴ as pointed out by Lord Mance,³⁵⁵ was a good example in the early 20th century. In that case Johnson fraudulently overcharged the Government by more than £8,000. A claim for repayment of the principal sum and a claim for interest were raised by the Government. In the

³⁵³ *ibid*, at p.437, and this would be referred to as “the latter statement” in this chapter.

³⁵⁴ [1904] AC 817.

³⁵⁵ See *Sempra* [2007] UKHL 34, at [173].

lower court interest was allowed, but the Privy Council reversed the judgment and it was held by Lord Macnaghten that

“...he (the trial judge) thought the law would ‘imply a promise from [the] defendant to pay back to the plaintiff the money paid in excess.’ He thought the allegation of **special damage** in the statement of claim sufficient, and gave ‘judgment for the plaintiff for £428.13s.3d **damages by way of interest** without costs.’ Having regard to the law as settled by the judgment of the House of Lords in the case of *London, Chatham and Dover Railway Co v. South Eastern Railway Co* it is impossible to support the decision...”³⁵⁶

In fact, this case could be regarded as one of a claim of restitution and it can be seen that the Privy Council extended the application of *London, Chatham and Dover Railway Co* rather than narrowing it, which, according to the very special facts of the case, should be the right approach. Therefore, it could be argued that the law in *Johnson v. The King* deviated again from what the law should be. In addition, the words “special damages” caused further disputes and uncertainties which lasted for more than a hundred years until it was settled by the House of Lords in the following cases, including the famous *Sempra* case.

4.2 The modern development

(a) The progress of Denning LJ

4.2.1 About 50 years after *Johnson v. The King*, the way to the right approach was pointed out by Denning LJ (as he then was) and with whom Romer LJ

³⁵⁶ [1904] AC 817, at p.821 emphasis added.

agreed, in a landmark case *Trans Trust SPRL v. Danubian Trading Co Ltd*³⁵⁷. In that case an agreement was entered into between the buyer and the seller and according to that agreement the buyer agreed to provide a confirmed letter of credit forthwith; however, no such letter was actually provided and no money was paid in accordance with a chain of sales contracts and the seller therefore suffered loss from the non-payment of the money. In the claim for damages the defendant argued that even though there was a failure to pay money the law, according to earlier cases which stated above, had never allowed any interest on that account. However, Denning LJ took another approach and stated

“...the only real ground on which damages can be refused for non-payment of money. It is because the consequences are as a rule too remote. But when the circumstances are such that there is a **special loss** foreseeable at the time of the contract as the consequence of non-payment, then I think such loss may well be recoverable.”³⁵⁸

Therefore, in that case the application of *London, Chatham and Dover Railway* was limited and the real effect of that case was understood as “interest was generally presumed not to be within the contemplation of the parties”.³⁵⁹ This approach which was taken by Denning LJ should be deemed as the right one. It was because, as mentioned above, the payment made in *London, Chatham and Dover Railway* was not only provisional, but also uncertain. This was especially true at that time; due to the rise and fall of the market, the money paid on a

³⁵⁷ [1952] 2 QB 297.

³⁵⁸ *Trans Trust SPRL v. Danubian Trading Co Ltd* [1952] 2 QB 297, at p.356.

³⁵⁹ *ibid.*

percentage basis might be difficult to reclaim as a certain amount. Therefore, it might be too difficult to argue that the exact interest loss was within the contemplation of the parties when the agreement was reached. However, the latter statement made by Lord Herschell LC might still be used as a good starting point both in claims of damages or restitution.

(b) The dawn of common law?

4.2.2 Even though the opinion of Denning and Romer LJJs was *obiter* in *Danubian*³⁶⁰ it was still followed and approved in *Wadsworth v. Lydall*³⁶¹ and became law.

In that case the claimant and the defendant entered into a partnership agreement with regard to the agriculture business in the farm owned by the defendant. At the dissolution it was agreed by the parties that the claimant would give up possession of the farm on or before an agreed date and once possession was given up the defendant would make a payment of £10,000. The claimant moved out of the farm on the agreed date and several days before he left, he had made another contract with a third party for new accommodation as he believed that the contractual payment by the defendant under the dissolution agreement would be enough. In fact, when the agreement between the claimant and the third party was entered into the claimant had no capital and the price under that new accommodation agreement was the same as the dissolution money, namely £10,000. However, no payment was made by the defendant and

³⁶⁰ It was because that case was mainly decided on the basis that there was a valid contract between parties but the damage was too remote.

³⁶¹ [1981] 1 WLR 598.

the solicitor for the third party served a notice to the claimant after two months. After another three months part of the dissolution money of £7,200 was paid by the defendant and in order to complete the agreement with the third party the claimant had to raise a mortgage from the third party and certainly there was loss for costs and interest.

Smith J in the first trial awarded damages of some £2,300 but refused the interest claim. It should be noted that in this case, the payment of money was a “certain sum” and the date of the payment could also be ascertained in accordance with the claimant’s behaviour and unlike *London, Chatham and Dover Railway*, the payment was final. Therefore, the Court of Appeal found a chance to clarify the legal position at that time with the guidance laid down by Denning LJ.

It has to be stressed that in *Wadsworth* the interest claimed did not arise from the unpaid sum by the defendant, but arose from the delay in completion of the contract between the claimant and the third party. In other words, the interest in dispute was not a sum from being deprived of the use of the money, but damages caused by non-performance of the contractual duty.³⁶² Therefore, technically, the facts in *Wadsworth* were different from *London, Chatham and Dover Railway*; additionally, it could be inferred with commercial sense that interest on money borrowed by the claimant from the third party should be calculated on a compound basis. Another fact which should be noted in *Wadsworth* was that at the time of the dissolution the defendant had already

³⁶² This is a very important difference between common law interest and statutory interest, which will be discussed further later on in this chapter.

noticed the fact that the claimant had no other capital and he needed to look for other accommodation, therefore, once the damages were allowed, it would fall under the second limb of *Hadley v. Baxendale*.

In the Court of Appeal, interest as special damages was allowed and Brightman LJ concurred with the *obiter* of Denning LJ. It was therefore held that

“In my view the court is not so constrained by the decision of the House of Lords. In *London, Chatham and Dover Railway Co. v. South Eastern Railway Co.* [1893] A.C. 429 the House of Lords was not concerned with a claim for special damages. The action was an action for an account. The House was concerned only with a claim for interest by way of general damages. If a plaintiff pleads and can prove that he has suffered special damage as a result of the defendant's failure to perform his obligation under a contract, and such damage is not too remote on the principle of *Hadley v. Baxendale* (1854) 9 Exch. 341, I can see no logical reason why such special damage should be irrecoverable merely because the obligation on which the defendant defaulted was an obligation to pay money and not some other type of obligation.”³⁶³

4.2.3 Accordingly, it could be concluded that after *Wadsworth* the interest loss was not as confusing as it used to be: it could be regarded as damages and if it was foreseeable it could be recovered under the general rules of damages. However, even *London, Chatham and Dover Railway* was carefully distinguished in *Wadsworth*; the Court of Appeal, perhaps due to the lack of

³⁶³ *Wadsworth v. Lydall* [1981] 1 WLR 598, at p.604.

authority, made no comment on that historical case. That is to say, the loss of the use of the money, without the intervention of another loan or a mortgage raised by the third party, was still unable to be calculated by common law. Therefore, *Wadsworth* did not recognize all of the statements of Denning LJ in *Danubian* because the loss of use of the money, generally speaking and once proved, could be deemed as special damages. However, the distinction made on the ground of general or special damages caused a further problem.

(c) The non-erasable common law blot

4.2.4 Not too long after *Wadsworth*, the House of Lords had another chance to make a further statement about the legal position on interest in common law, although, with respect, that attempt could now be regarded as a mistake.³⁶⁴

In *The La Pintada*³⁶⁵ the charterer delayed the payment of freight and demurrage in a charterparty. The charterparty incorporated an arbitration clause and according to that clause the arbitration umpire not only awarded interest, but also awarded it on a compound basis. The charterer appealed the interest award on a point of law, the appeal was rejected by the High Court and the dispute finally reached the House of Lords.

From the facts of the case it could be found that the type of interest loss in *The La Pintada* was different from that in *Wadsworth* because the interest loss in *The La Pintada* was not the loss suffered from a loan or mortgage between the claimant and the third party, but it was a claim based on the loss of the use of money by the innocent party itself and therefore, it was more likely that *London*,

³⁶⁴ See, for example, *Sempra* [2007] UKHL 34, at [84-88].

³⁶⁵ [1984] 2 Lloyd's Rep. 9.

Chatham and Dover Railway would bite. Therefore the House of Lords should have taken the chance to review the latter statement in *London, Chatham and Dover Railway* and, if possible, reopen other issues in *Page v. Newman* and other cases which were decided almost 100 years earlier. However, the House reversed the judgment and allowed the appeal and the decision was mainly based on *London, Chatham and Dover Railway* alone.

However, Lord Brandon, by whom the leading judgment was made, approved *Wadsworth* and the learned judge tried to reduce the application of *London, Chatham and Dover Railway* rather than overrule it. In order to achieve that Lord Brandon regarded the general damages as the same thing as what was stated in the first limb of *Hadley v. Baxendale*, which was the damages from the ordinary course of things, and the special damages as the second limb which was the damages specifically contemplated and agreed by the parties when the contract was concluded.³⁶⁶ Based on such understanding the legal effect of *Wadsworth* and *London, Chatham and Dover Railway* was decided by the House of Lords as follows:

“On the facts of the case before him Lord Justice Brightman found that, by reason of special matters known to both parties at the time of contracting, the two items of special damages claimed by the plaintiff came within the second part of that rule. Accordingly, treating the *London, Chatham and Dover Railway* case, [1893] A.C. 429 as applying only to damages falling within the first part of the rule in *Hadley v. Baxendale* (general damages), he saw no reason why the

³⁶⁶ *The La Pintada* [1984] 2 Lloyd's Rep. 9, at p.21.

plaintiff should not recover the two disputed items of special damages under the second part of that rule.

In my opinion the ratio decidendi of *Wadsworth v. Lydall*, [1981] 1 W.L.R. 598, that the *London, Chatham and Dover Railway* case, [1893] A.C. 429, applied only to claims for interest by way of general damages, and did not extend to claims for special damages, in the sense in which it is clear that Lord Justice Brightman was using those two expressions, was correct and should be approved by your lordships. On the assumption... the effect will be to reduce considerably the scope of the *London, Chatham and Dover Railway* case...³⁶⁷

4.2.5 It was true that the loss suffered by the claimant in *Wadsworth* was foreseeable and the words “special damages” were used in both *Wadsworth* and *Danubian*; however, from the starting point of Denning LJ it might be found that more weight was put on the word “special” because it referred to the rule of remoteness, which was the key point in both limbs of *Hadley v. Baxendale*; additionally in *Wadsworth*, Brightman LJ, by distinguishing *London, Chatham and Dover Railway*, focused more on the capability of the claimant to prove the actual loss: it might be appropriate to cite the stressed point stated by Lord Brightman again that:

“[i]f a plaintiff **pleads and can prove** that he has suffered special damage...”³⁶⁸

³⁶⁷ *The La Pintada* [1984] 2 Lloyd's Rep. 9 at p.21.

³⁶⁸ *Wadsworth v. Lydall* [1981] 1 WLR 598, at p.604, emphasis added.

Therefore, the interest loss in *The La Pintada* which was pleaded and proved before the arbitration tribunal and subsequently awarded by the umpire should have been regarded as “special damages” and the application of *London, Chatham and Dover Railway* should be restricted even further, if not overruled completely. In fact, it could be found that Lord Herschell LC, by whom *London, Chatham and Dover Railway* was decided, felt reluctant when the conclusion in common law was reached, and this was also noticed by Lord Roskill in *The La Pintada*. It was commented by Lord Roskill that

“I have arrived at this conclusion... with both regret and reluctance. It has long been recognized that *London, Chatham and Dover Railway Co. v. The South Eastern Railway Co.*, [1893] A.C. 429, left creditors with a legitimate sense of grievance and an obvious injustice without remedy. I think the House in 1893 recognized those consequences of the decision, but then felt compelled for historical reasons to leave that injustice uncorrected.”³⁶⁹

Therefore, it could be found that, based on historical reasons, there was a “blot” on common law from the very early stage and such a blot survived all reviews by the House of Lords from *London, Chatham and Dover Railway*. In *The La Pintada* both Lord Roskill and Lord Brandon noticed it, but in that case the House of Lords decided to keep it alive or at most merely erase it partly; this approach, with respect, could not be justified. Additionally, the right progress made by Denning and Brightman LJJs was wrongfully interpreted and it would lead to an absurd result: even if the claimant could plead and prove an actual

³⁶⁹ *The La Pintada* [1984] 2 Lloyd's Rep. 9, at p.11.

interest loss resulting from being deprived of the use of the money, he could not recover when that kind of interest is to be regarded as the ordinary course of things, namely, general damages as defined by Lord Brandon.

(d) The development of the statute

4.2.6 Before introducing the landmark case on interest in common law, *Sempra Metals*, it is appropriate to pause here and discuss the development of statute. About 40 years after *London, Chatham and Dover* Parliament enacted section 3 of the Law Reform (Miscellaneous Provisions) Act 1934 (the 1934 Act) which replaced the part related to interest in the Lord Tenterden's Act. The 1934 Act empowered courts to award **simple** interest where there was a claim for damages or debt. The amount of interest could be calculated during the period from when the cause of action arose to the date of judgment.

It should be noted that there are several differences between the 1934 Act and Lord Tenterden's Act:

Firstly, there was no requirement about the "certain date of payment" or "certain amount of money claimed" in the 1934 Act, therefore, the power of discretion of the court was extended; and should the 1934 Act be applied to *London, Chatham and Dover* there would be no need for the claimant to seek for a common law remedy as they could succeed on a statutory basis.

Secondly, even though the 1934 Act broadened the discretionary power of courts on awarding interest, the amount of the award of interest was narrowed and limited on the **simple** basis.

Thirdly, there was no provision for the payment of interest where a debt, or a sum for damages, was paid after the commencement of legal proceedings but before judgment; nor did the section apply where a debt or a sum for damages was paid late but before the inception of legal proceedings.

4.2.7 One year after *Wadsworth* the 1934 Act was superseded by section 35A of the Supreme Court Act 1981 (the 1981 Act) which is still in force. The relevant part of the new statutory provision reads as follows:

“(1) Subject to rules of court, in proceedings (whenever instituted) before the High Court for the recovery of a **debt or damages** there may be included in any sum for which judgment is given simple interest, at such rate as the court thinks fit or as rules of court may provide, on all or any part of the debt or damages in respect of which judgment is given, or payment is made before judgment, for all or any part of the period between the date when the cause of action arose and—

(a) in the case of any sum paid before judgment, the date of the payment; and

(b) in the case of the sum for which judgment is given, the date of the judgment.

...

(3) Subject to rules of court, where—

(a) there are proceedings (whenever instituted) before the High Court for the recovery of a debt; and

(b) the defendant pays the whole debt to the plaintiff (otherwise than in pursuance of a judgment in the proceedings),

the defendant shall be liable to pay the plaintiff simple interest at such rate as the court thinks fit or as rules of court may provide on all or any part of the debt for all or any part of the period between the date when the cause of action arose and the date of the payment.

(4) Interest in respect of a debt shall not be awarded under this section for a period during which, for whatever reason, interest on the debt already runs.

...

(6) Interest under this section may be calculated at different rates in respect of different periods."³⁷⁰

It can be seen from the 1981 Act that the discretionary power of the court increases to a large extent in deciding the rate and the period of interest, and from this point the 1981 Act provided a solution to the problem which common law could not solve from *London, Chatham and Dover* by providing statutory interest as a remedy for late payment of money. However, the statutory interest could only be awarded on a simple basis and it could not be awarded when the money is paid late, but before the beginning of legal proceedings; additionally, according to the 1981 Act, the statutory interest could only start to run when

³⁷⁰ Supreme Court Act 1981, s. 35A, emphasis added.

there is no other agreed interest rate but the owner is deprived of the use of the money owed.

4.2.8 After the discussion above, a pause is appropriate here to come to a conclusion on the position of interest in both common law and statute before *Sempra Metal*:

Firstly, it is certain that the late payment of money, damages or debt, could cause a loss of interest, and it is the obligation of the person who delays the payment to compensate the innocent party.

Secondly, there are, generally, two types of interest losses which might be caused by the late payment of money: one is damages suffered from the late payment of money, and this kind of loss could result from the intervention of a third party³⁷¹; it needs to be noted that only in this type of interest loss the two limbs in *Hadley v. Baxendale* will bite. The other is the interest loss resulting from being deprived of the use of the unpaid money;³⁷² in other words, in these circumstances the interest could better be deemed as the value carried by the money unpaid. Additionally, it could be inferred that, without extraordinary circumstances,³⁷³ most of the interest loss from the late payment of an insurance claim could be counted as the latter type.

As to the cases introduced above, it could be found that most of them, except *Wadsworth*, are claims for being deprived of the use of money, and due to the

³⁷¹ For example, see *Wadsworth* [1981] 1 WLR 598, it is a typical example for interest loss from a contract between the claimant and the third party.

³⁷² For example, see *London, Chatham and Dover* [1893] AC 429, *The La Pintada* [1984] 2 Lloyd's Rep. 9.

³⁷³ See *Sprung* [1999] Lloyd's Rep IR 111; however, it might be argued that the damages caused by the late payment in *Sprung* was special damages but, compared with *Wadsworth*, such damages were not the damages named as "interest".

differences between those cases and *Wadsworth* it could be argued that there is no common law remedy for being deprived of the use of money, that is to say, the common law remedy applies only where the loss of interest could be proved and pleaded.

However, the statutory remedy, according to the wording of all the statutes (Lord Tenterden's Act, the 1934 Act and the 1981 Act), is able to be used in both types of loss, even though the statutory remedy is not a full remedy as it could only be awarded on a simple basis. Therefore, there would be an overlap in common law and statutory remedy. This situation was pointed out by Lord Bridge in *The La Pintada* that

“...the alternative rule which must of necessity take its place could only be that in all cases of late payments general damages would be recoverable as of right calculated in accordance with the same common law principles that govern the award of general damages in the case of any other breach of contract. Such a sweeping provision would not merely be inconsistent with, but would, it seems to me, effectively override the ... statutory provisions for the discretionary award of interest in certain cases so as to render them a dead letter.”³⁷⁴

Even though the concern of Lord Bridge was true, however, the conflict had already occurred in *Wadsworth* and according to *Wadsworth* if the claimant could plead and prove the interest loss, common law would provide a full remedy rather than the statutory remedy. Therefore, even if the

³⁷⁴ *The La Pintada* [1984] 2 Lloyd's Rep. 9, at p.12

understanding of Lord Brandon about the definition of “general damages and special damages” were correct,³⁷⁵ the common law, by providing a remedy in *Wadsworth* or similar cases, superseded part of the statutory provision and it could be argued that the statutory provision would not apply or could only apply in a modified way when a common law remedy is awarded. It should be pointed out that this situation is not unpredictable, because at the very beginning the statutory remedy in Lord Tenterden’s Act was designed to fill the gap where a common law remedy was unavailable; again, in Lord Tenterden’s Act, even though the prerequisite was more difficult to be satisfied than in the 1934 Act and 1981 Act, the remedy provided by the Act could be a full remedy. During the development of the statute, Parliament should have considered the unsatisfactory effect of the common law as the disadvantage of cases such as *London, Chatham and Dover* has been pointed out by a number of judges; therefore what the statute should have done is to reduce the prerequisites in Lord Tenterden’s Act, retain the effect of its availability to grant a full interest remedy and even to empower judges with more discretion once a claim of interest is raised.

4.2.9 Notwithstanding the discussion above, in two subsequent Acts even though the original prerequisites were removed, it is hard to understand the reason why the power of a court to award full remedy was removed as well. Additionally, the effect of 1981 Act is to make compensation, in the name of statutory interest, in relation to the late payment of damages or debt;

³⁷⁵ In fact, the understanding was wrong as it was too narrow, see *Sempre* [2007] UKHL 34.

however, what is the exact legal definition of that compensation? *Prima facie*, it should be the damages. However, Lord Brandon also held in *The Lips* that there would be no cause of action where there was a claim for damages caused by late payment of damages. To read *The Lips* and the 1981 Act together, the effect would be that where a damage caused by late payment of damages occurs, the right of the claimant is protected by statute, but according to common law the claimant is not allowed to plead and prove it; in contrast, the court will use the discretionary power from the statute and such result sounds illogical and does not represent the intention based on Lord Tenterden's Act. Therefore, it would be hard to reconcile common law and statute in relation to interest with commercial sense and accordingly, there is a "blot" not only on common law, but also statute and this problem was further discussed by the House of Lords in the leading case: *Sempra Metals v. Inland Revenue Commissioners (IRC)*.³⁷⁶

4.3 Removing the blot: *Sempra Metals v. Inland Revenue Commissioners (IRC)*

(a) The fact and the judgment of the then European Court of Justice (ECJ)

4.3.1 In *Sempra Metals* the claimant company paid advance corporation tax (ACT) to the Inland Revenue Commissioners (IRC), as required by domestic law, and this payment could be set off against future tax when it became due. In fact, there was always a time gap of about eight months between the date when ACT was paid and when the actual payment of tax was due. It was held by the

³⁷⁶ [2008] 1 AC 561.

European Court of Justice (ECJ) that the domestic law which required companies to pay ACT was contrary to article 52 of the EU Treaty and it was then held that it was the duty of the national law to provide

“...an effective legal remedy in order to obtain reimbursement or reparation of the financial loss which they have sustained and from which the authorities of the member state concerned have benefited...”³⁷⁷

The ECJ also stressed the point of interest by stating that

“The mere fact that the sole object of such an action is the payment of interest equivalent to the financial loss suffered as a result of the loss of use of the sums paid prematurely does not constitute a ground for dismissing such an action... it is for the domestic legal system... to lay down the detailed procedural rules governing such actions, including ancillary questions such as the payment of interest, those rules must not render practically impossible or excessively difficult the exercise of rights conferred by Community law.”³⁷⁸

Therefore, it could also be noted that the traditional English common law would potentially contravene the judgment laid down by the ECJ, because it would not be able to provide an effective legal remedy, but it would render the right of the claimant, which was supported by the ECJ, practically impossible and excessively difficult to exercise. At this time the House of Lords, under the pressure of the ECJ, had to revisit issues related to interest in full.

³⁷⁷ *Metallgesellschaft Ltd v. Inland Revenue Comrs* [2001] Ch620, at [96].

³⁷⁸ *ibid.*

(b) The decision of the House of Lords

4.3.2 The claim raised by *Sempra Metals* contained three causes of actions: damages for late payment of money, tax paid pursuant to an unlawful demand and payments under a mistake of law.

As a final outcome, it was held by the majority of the members of the House of Lords that the claim would succeed on a restitutionary basis, and compound interest would be allowed. Additionally, the House of Lords also confirmed that the Court had a common law jurisdiction to award damages for late payment or non-payment of money, however, the money paid late was limited to the late payment of the debt.

Long before the judgment of *Sempra Metals* in Europe and in cases in some other common law countries such as Australia, New Zealand and the USA it had been well settled that claims for interest loss by way of damages due to the principal breach of a contract are available for the innocent party and it was also pointed out that that kind of decision should have been made over a century ago. It seems to be the case that *Sempra Metals* is a case in which the traditional blot on English law relating to interest loss claims is removed; however, that work is not finished completely and a detailed discussion of the outcomes in *Sempra Metals* shall be held below.

(c) Damages for late payment of money

4.3.3 As a starting point, Lord Nicholls introduced and summarized the common law position that

“...a claimant can recover damages for losses caused by a breach of contract or a tort which satisfy the usual remoteness tests. This broad common law principle is subject to an anomalous, that is, unprincipled, exception regarding... claims for interest losses by way of damages for breach of a contract to pay a debt...”³⁷⁹

It has to be pointed out that, the anomalous and unprincipled exception is not only limited to late payment or non-payment of debt, but, according to Lord Brandon’s unsupported *obiter* in *The Lips*, the exception also existed in relation to late payment or non-payment of damages.

Lord Nicholls continued

“The common law should sanction injustice no longer. The House should recognise the remnant of the restrictive common law exception for what it is: the unprincipled remnant of an unprincipled rule. The House should erase the remains of this blot on English common law jurisprudence.”³⁸⁰

By doing so, the House of Lords in *Sempra Metals* refused to accept the definition of general and special damages by Lord Brandon in *The La Pintada*. It was unanimously agreed that both general and special damages would be awarded by the court if they could be pleaded and proved.³⁸¹ Therefore, Lord Nicholls reached a conclusion that

³⁷⁹ See *Sempra Metals* [2007] UKHL 34, at [74].

³⁸⁰ *ibid*, at [92].

³⁸¹ *ibid*, at [16], [85] and [215].

“...in principle, it is always open to a claimant to plead and prove his actual interest losses caused by late payment of a **debt**. These losses will be recoverable, subject to the principles governing all claims for damages...”³⁸²

Regrettably, the House of Lords limited the right to damages for late payment of **debt** only; the judgment did not extend to late payment of damages without any interpretation. However, there might be room for an argument that it was not the intention of the House of Lords to limit the damages for late payment in debt: firstly, in the judgment the House intended to remove the anomalous and unprincipled exception, which, of course, contained damages for late payment of damages; secondly, the House of Lords stressed the point of “provability”, as it was stated by Lord Nicholls that

“The common law’s unwillingness to presume interest losses where **payment** is delayed is... unrealistic. ... If a party chooses not to prove his interest losses the remedy provided by the law is to be found in the statutory provisions.”³⁸³

It should be noted that in the paragraph quoted above, the word “payment” was used instead of “debt”, and it could be found in that statement that the only event in which common law would rest and statute would apply is the situation where the claimant could not prove the interest loss. This argument could also find support from Lord Hope:

³⁸² *ibid*, at [94], emphasis added.

³⁸³ *ibid*, at [97].

“The reality is that every creditor who is deprived of funds to which he is entitled and which he needs to run his business will have to incur an interest-bearing loan or employ other funds which could themselves have earned interest. It is a short step to say that interest losses will arise ‘in the ordinary course of things’ in such circumstances.”³⁸⁴

It seems that even though the foreseeability of interest loss as damages would be easy to presume, the actual proof such as an interest-bearing loan or employment of other funds are nevertheless required to be **actually proved** before the court. Once the claim for interest loss due to the late payment of damages is excluded the outcome would be anomalous.

4.3.4 Assuming that Mr. S insured his property against certain kinds of risks and, at the underwriting stage, he said to the insurer that once the payment of insurance money was not made in time, a high interest-bearing loan had to be raised in order to repair the property; sadly the property was destroyed the insurance payment was unduly delayed and the loan was raised. Mr. S claimed interest loss due to the late payment of insurance money. According to *Danubian* and *Wadsworth* the interest loss suffered by Mr. S would be awarded as special damages. However, once *Sempra Metals* is to be understood narrowly, there would be no common law remedy for Mr. S and the only reason for that is, according to current law, an insurance payment is not to be treated as debt even though all other requirements of *Sempra Metals* are satisfied.

It might be argued that even though there is no common law remedy for Mr. S, there is still a statutory remedy in accordance with the 1981 Act; however, the

³⁸⁴ *ibid*, at [16].

remedy provided by statute is not a full remedy, as discussed above, because as a statutory remedy only simple interest would be awarded; and simple interest, according to the opinion of Lord Hope, is an “artificial construct”³⁸⁵ which could not reflect the value of the payment delayed. His Lordship also quoted and agreed with the position of the Scottish Law Commission that

“...the case against the compounding of interest was essentially a case against interest itself.”³⁸⁶

It has been mentioned above that the ECJ required the national law to provide an efficient legal remedy to the claimant, therefore, simple interest would not apply in this case and the House continued in reaching a conclusion that compound interest should be the right approach in order to provide an efficient and full remedy but that compound interest was, again, limited by the late payment of debt.

(d) Compound interest

4.3.5 Even without the requirement of the ECJ, the House of Lords had already noted that compound interest was more practicable and businesslike. It was pointed out by Lord Nicholls that

“We live in a world where interest payments for the use of money are calculated on a compound basis. Money is not available commercially on simple interest terms. This is the daily experience of everyone... If

³⁸⁵ See *Sempra Metals* [2007] UKHL 34, at [33].

³⁸⁶ Discussion Paper on Interest on Debt and Damages (2005) (Discussion Paper No 127) at para. 8.18; quoted and agreed by Lord Hope in *Sempra Metals* [2007] UKHL 34, at para. 41.

the law is to achieve a fair and just outcome when assessing financial loss it must recognise and give effect to this reality.”³⁸⁷

Therefore, even though *Sempra Metals* was not necessarily decided on the issue of damages, it was approved by a majority of the members of the House of Lords that once the claimant could prove the interest loss as damages, he would be awarded a full remedy³⁸⁸ by way of compound interest.

(e) The position of s. 35A of the 1981 Act

4.3.6 It has already been mentioned that there is a potential conflict between common law and statute in relation to interest loss as damages, and this issue was also considered by the House of Lords in *Sempra Metals* and it was generally believed that there was no conflict.

The main reason given by the House of Lords was that, once the claimant refused to prove the interest or could not prove the amount of interest loss, the court would award a partial remedy according to statute.³⁸⁹ Additionally, two detailed reasons were given by Lord Nicholls.

Firstly, s.35A of the 1981 Act was not intended to replace the common law jurisdiction and the discretion which the courts possess to award interest; secondly, the statutory interest did not preclude a court from taking interest losses into account when awarding damages. With respect, both of these reasons require further clarification.

³⁸⁷ See *Sempra Metals Ltd v. Inland Revenue Commissioners and another (IRC)* [2007] UKHL 34, at [52].

³⁸⁸ *ibid*, at [17], [74], [95] and [100].

³⁸⁹ *ibid*, at [97].

As to the first reason, Lord Nicholls put things in the wrong order. According to the historical review provided in this chapter, it could be easily found that the intention of the statutory remedy is to fill the gap left by common law; therefore, once the common law is effective enough to provide the remedy, the application of the statute is unnecessary; it is for the common law jurisdiction and its discretion on interest to replace the application of the statute, rather than the statute to displace common law jurisdiction.

As to the second reason, Lord Nicholls pointed out that in cases relating to torts compound interest was awardable while the 1981 Act did not apply.³⁹⁰ This statement does nothing but stress the “second -in- line” nature of the statute, which means that where the common law remedy is available it is unnecessary for the court to apply s.35A of the 1981 Act.

Furthermore, by rejecting the definition provided by Lord Brandon in *The La Pintada* Lord Nicholls, with whom the other members of the House agreed, defined general damages as damages which needed to be pleaded and proved, but to be quantified in monetary terms by the courts; and special damages as damages which needed to be pleaded in quantified money terms.³⁹¹ Even though it was believed that there would be no common law remedy for general damages,³⁹² the suggestion made by Lord Hope³⁹³ would make the foreseeability of damages for interest loss almost “axiomatic” and could be easily quantified; for example, once the payment is delayed by one year, the claimant

³⁹⁰ *ibid*, at [99].

³⁹¹ *ibid*, at [85].

³⁹² *ibid*, at [96].

³⁹³ Namely, the interest loss would be regarded as the ordinary course of things.

could go to the court with the published interest rate provided by a bank and argue that the money should have been put into a saving account. Therefore, it could be concluded that the application of s.35A of the 1981 Act is very limited.

However, the claim for late payment of indemnity insurance money falls within the very limited application of the 1981 Act, the reason is purely technical, namely the claim is not a claim for late payment of debt but damages. It could therefore be predicted that it is only because of that technical reason that s.35A of 1981 Act is kept “alive”, even though the reason is a purely technical one and makes the law anomalous.

(f) The partly removed blot

4.3.7 What is confirmed by the House of Lords after *Sempra Metals* is that a full remedy could be awarded by common law in relation to the late payment of a debt, and the blot on common law has been partly removed. The blot is that there was no interest remedy for late payment of money; but after the decision made by the House of Lords interest is now awardable: a full interest remedy can be awarded in cases of late payment of debt or tort, while only partial interest (simple interest) is awardable in cases of late payment of damages. This is especially true when insurance claims are considered. It is settled that in the case of contingency insurance claims the damages for late payment could be recovered. However, it must be pointed out that once the damages for the late payment of damages is not reconsidered with full reasoning the blot will always exist in common law.

Additionally, in *Sempra Metals* the House of Lords had no chance to consider two other important questions: firstly, is it correct to regard an indemnity insurance claim as a claim for damages? Secondly, is the unreasoned *obiter* namely, there is no damage over damage provided by Lord Brandon in *The Lips*, correct?

As to the first issue, the ignorance could be justified as the case has no apparent relation with indemnity insurance; as to the second one, however, *The Lips* was mentioned by Lord Nicholls³⁹⁴ and Lord Mance³⁹⁵ but surprisingly the House refused to revisit that issue and it is certain that without doing so the blot could never be removed in full.³⁹⁶

It was critically discussed by academics after the decision in *Sempra Metals* was made. However, most of them focused only on interest in a restitution claim or debt³⁹⁷ and these articles shall be dealt with in the next chapter. As to indemnity insurance claims, it is generally accepted that *Sempra Metals* could not apply to indemnity insurance claims directly as such claims are claims for damages,³⁹⁸

³⁹⁴ See *Sempra Metals Ltd v. Inland Revenue Commissioners and another (IRC)* [2007] UKHL 34, at [88].

³⁹⁵ *ibid*, at [228].

³⁹⁶ This argument is supported by Malcolm Clarke in 'Compensation for failure to pay money due: a "blot on English common law jurisprudence" partly removed', J.B.L. 2008, 4, 291-303, at p.303.

³⁹⁷ For example, see Sarah Lee and Caroline Edwards, 'Sempra Metals- A simple solution to compound interest', Slaughter and May,

https://www.slaughterandmay.com/media/1428828/sempra_metals_a_simple_solution_to_compound_interest.pdf, accessed on 7th April 7, 2014; see also Man Yip, 'The use value of money in the law of unjust enrichment', L.S. 2010, 30(4), 586-609.

³⁹⁸ See Malcolm Clarke in 'Compensation for failure to pay money due: a "blot on English common law jurisprudence" partly removed', J.B.L. 2008, 4, 291-303 at p.295; see also Chris Nicoll, 'Compound interest for late payment of an insurance claim', L.Q.R. 2008, 124(Apr), 199-202 at pp.200-201.

while by contrast the compound interest in contingency insurance such as life insurance could find support from *Sempra Metals*³⁹⁹.

In Australia, the problem mentioned above has been solved. For example, in *Walker v. FAI Insurance (No.2)*⁴⁰⁰ the claimant assured suffered loss caused by the late payment of the insurer and in order to rebuild the damaged shop the assured raised a loan at the rate of 17% interest compounded monthly. According to the statutory remedy, in the first trial the interest was calculated at the rate of 11% only. The Supreme Court of Tasmania held that in this circumstance the interest should be awarded in full and accordingly remitted the case.

In Canada there is no such a problem either because it seems that under Canadian law a plaintiff is entitled to recover interest charges actually incurred on money borrowed on the defendant's default, or if the plaintiff owes money to anyone equal to the amount of the claim and is paying interest on it:⁴⁰¹ for example, in *Atlantic Salvage Ltd. v. City of Halifax*⁴⁰² the plaintiff's claimed for interest and succeeded on the ground that it had been indebted to its bank for a sum exceeding the amount of the claim throughout the period.

(g) The effect of the Enterprise Act 2016

4.3.8 According to the discussion above, it should be noted that the problem of interest in indemnity insurance could not be solved after *Sempra Metals* and

³⁹⁹ This point is mentioned by both Malcolm Clarke and Chris Nicoll in their articles quoted above.

⁴⁰⁰ [1992] TASSC 15.

⁴⁰¹ See Waddams, *The Law of Damages* (Canada Law Books, 1983), at s.833.

⁴⁰² (1978) 94 DLR (3d) 513.

what is worse, the answer to that problem remains uncertain even after the new Enterprise Act 2016 comes into force.

It is affirmed by the Act that

“Remedies (for example, damages) available for breach of the term implied by subsection (1) are in addition to and distinct from—

(a) any right to enforce payment of the sums due, and

(b) any right to interest on those sums (whether under the contract, under another enactment, at the court’s discretion or otherwise).”

Before moving on to the detail of the problem several points need to be pointed out here, as introduced by chapter 2 and 3 of this work, that:

Firstly, according to *The Lips* there is no causation of damages caused by the late payment of damages; and according to *The Fanti* that the payment made by the insurer is a payment of damages: both of them are cases ruled upon by the House of Lords.

Secondly, what is implied by the Enterprise Act 2016 is that the insurer is obliged to pay the indemnity within a reasonable time otherwise the assured is entitled to a remedy such as damages and interest.

Thirdly, according to this chapter, late payment of debt could carry compound interest while late payment of damages only carries simple interest.

The problem is that regardless of the original intention of the new legislation, either *The Lips* or *The Fanti* shall be overruled by the statutory implication: if *The Lips* is to be regarded as good law *The Fanti* shall be deemed as overruled and

the payment made by the insurer shall no longer be treated as damages because the statute allows damages over the payment of the indemnity; if *The Fanti* is to be regarded as good law then *The Lips* shall be deemed as overruled because the statute allows damages over the late payment of damages.

Notably, according to either assumption made above, the assured's new right to claim for damages granted by the Enterprise Act 2016 would not be affected, while as to the matter of interest it is another story, according to the third point above. Based on the current evidence it is uncertain which approach the court should adopt, but it is more businesslike for the court to overrule *The Fanti* in order to enable the assured to claim damages plus compound interest rather than simple interest. Compared with the uncertainty in a court trial arbitration has provided a clear answer in awarding interest.

4.4 A lesson from the Arbitration Act 1996

4.4.1 Unlike common law or the 1981 Act, the arbitrators are clearly empowered by s.49 of Arbitration Act 1996 to award compound interest in any kind of claim for late payment of money, debt or damages. The relevant section of the 1996 Act reads as

“49. Interest

(1) The parties are free to agree on the powers of the tribunal as regards the award of interest.

(2) Unless otherwise agreed by the parties the following provisions apply.

(3) The tribunal may award simple or compound interest from such dates, at such rates and with such rests as it considers meets the justice of the case—

- (a) on the whole or part of any amount awarded by the tribunal, in respect of any period up to the date of the award;
- (b) on the whole or part of any amount claimed in the arbitration and outstanding at the commencement of the arbitral proceedings but paid before the award was made, in respect of any period up to the date of payment.

(4) The tribunal may award simple or compound interest from the date of the award (or any later date) until payment, at such rates and with such rests as it considers meets the justice of the case, on the outstanding amount of any award (including any award of interest under subsection (3) and any award as to costs).

(5) References in this section to an amount awarded by the tribunal include an amount payable in consequence of a declaratory award by the tribunal.

(6) The above provisions do not affect any other power of the tribunal to award interest”

(a) The non-compulsory power to award interest

4.4.2 Subsections (1) and (2) of s.49 of the 1996 Act make it clear that this section is not compulsory and therefore the right of the arbitrators to award

interest could be removed or agreed otherwise by the arbitration agreement between the parties. Where there is no such an agreement, the default power granted by s. 49 would govern the jurisdiction of arbitrators in relation to interest, and it is certain that such power is greater than both s.35A of the 1981 Act and common law remedies; therefore, it is rightly pointed out by Professor Rob Merkin that

“The ability of the arbitrators to award compound interest is a particular innovation.”⁴⁰³

Practically, in marine cases or commercial cases such as marine insurance, it is widely believed that the power of awarding compound interest is necessary. For example, it is believed by the London Maritime Arbitrators Association (LMAA) that it is the general practice to award compound interest quite simply because it seems commercially just to do so. The Worshipful Company of Arbitrators commented that the power to award compound interest should be exercised unless there is good reason in the particular case not to do so.

According to the Departmental Advisory Committee on Arbitration Report on Arbitration Bill 1996 (The DAC report), it is believed that allowing arbitrators to award compound interest would not cause the problem of abusing the power to transfer the compound interest into a punitive one rather than a compensatory one, and it is also believed that once the arbitrator does make an award of punitive compound interest, then the award would be open to challenge.⁴⁰⁴

⁴⁰³ Merkin, *Arbitration Law* (loose leaf, Informa Law), at para.18.61.

⁴⁰⁴ See DAC Report, at para.237

<http://uk.practicallaw.com/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1247524753208&ssbinary=true>, accessed on 4th June 2014.

Even though it has not been clearly mentioned in the report on which basis the arbitrator could be challenged, it might be argued that once the arbitrator failed to understand the function of interest, as the DAC indicate, that arbitrator would be regarded as having a lack of competence and therefore s. 67 of the 1996 Act could be the proper regime.

(b) The procedural rule

4.4.3 If the default power of s.49 applies to an arbitration proceeding, the power of arbitrators to award interest will not be ousted by substantive law, even if under that substantive law no interest is legally allowed. This point was confirmed by the House of Lords in *Lesotho Highlands Development Authority v. Impregilo SpA*.⁴⁰⁵ In that case the contract was governed by the law of Lesotho while the arbitration agreement was governed by the 1996 Act. Under the law of Lesotho no interest was actually allowed in that specific circumstance. However, the arbitrators, relying on s.49 (3), awarded interest and that award for interest was challenged under s.68 (2) (b), namely the arbitrators had acted with serious irregularity by reason of an excess of powers.

At the first trial Morison J held that the award of interest was a matter of substance and therefore it should be governed by the law of Lesotho as he

“...could see no good reason why, if the issue of contract was a matter for the applicable law, it should cease to be so where the claim was for interest damages.”⁴⁰⁶

⁴⁰⁵ [2005] 2 Lloyd's Rep. 310.

⁴⁰⁶ *Lesotho Highlands Development Authority v. Impregilo SpA* , [2003] 2 Lloyd's Rep. 497, at [22].

Therefore, by awarding interest, the trial judge held that even though the seat was in London the arbitrators had no power to award interest.

The Court of Appeal confirmed that judgment and further held that if the applicable law to the contract had a specific provision on interest there would be no room for the tribunal to award interest by using the procedural power granted by s.49 of the 1996 Act; it was stated by Brooke LJ that

“The unpaid party to a contract is entitled as of substantive right to interest from the time when payment is contractually due. There was no need for the parties to agree the express exclusion of s. 49(3) of the 1996 Act, because of the saving provision in s. 49(6).”⁴⁰⁷

However, that outcome was firmly reversed by the House of Lords. It was held by Lord Steyn, with whom the majority of other members of the House agreed, that firstly the power of the arbitrators in relation to the award of interest was granted by the procedural law, and the mere fact that the substantive law provided otherwise did not preclude such power;⁴⁰⁸ secondly, the true effect of s.49 (6) did not oust the operation of s.49 (3); and even though it neither ousted any other power to award interest, it did not confer priority on such power.⁴⁰⁹ Therefore, the challenge under s.68 (2) (b) failed and it could be inferred that such a challenge was hardly likely to succeed in the future succeed in the future.

4.4.4 However, another problem arises: could the award of interest be challenged by s.69 (3) of the 1996 Act, on a point of law? More specifically,

⁴⁰⁷ *ibid*, at [48].

⁴⁰⁸ *ibid*, at [37].

⁴⁰⁹ *Lesotho Highlands Development Authority v. Impregilo SpA*, [2005] 2 Lloyd's Rep. 310 at [38].

currently there is no remedy for late payment in indemnity insurance or compound interest on late payment of damages, not even when the Enterprise Act 2016 comes into force; what if the parties agree to refer the claim to arbitration and the award of compound interest is made along with damages?

There is no reported case on this point; however, it could be inferred that such appeal, even technically available, could hardly succeed:

Firstly, it is required by s. 69 of the 1996 Act that an award is challengeable only if the award is “obviously wrong” and may “substantially affect the right of parties”.⁴¹⁰ According to the discussion about common law, even though the award could be arguably counted as “obviously wrong” in accordance with the unsupported *obiter* in *The Lips*, the award of compound interest would not substantially affect the rights of other parties as the right affected by such an award could not itself be justified.⁴¹¹

Secondly, even if compound interest is not allowed by s. 35A of the 1981 Act, on the one hand the intention of 1996 Act is to give a wider power to arbitrators than judges; on the other hand, it has been mentioned by courts at times that only compound interest could represent a “fair and just” outcome.

Thirdly, the wording of s.49 (3) is wide enough. Therefore, the position is summarized by Professor Rob Merkin that

“...it is hard to conceive of any situation in which the arbitrators’ decision could be second-guessed on this matter...the restrictive

⁴¹⁰ Arbitration Act 1996, s.69(3).

⁴¹¹ This right could be counted as a kind of unjust enrichment, for full discussion on this point, see below.

conditions which govern the grant of permission to appeal coupled with the right of the parties to exclude the right of appeal accordingly mean there is very little prospect of such a challenge even being mounted, let alone succeeding”⁴¹²

(c) The post-award interest

4.4.5 Before moving onto s.49 (4) an argument provided by Professor Eggers needs to be recalled. In short, it is argued by Professor Eggers that once the judgment is made, there will be no remedy if the damage is caused by the late performance of the judgment by the losing party. This, however, is not completely the case once an arbitration award is made. According to s.49 (4), the arbitrators can award compound interest from the date of the award until the date of the actual payment, and therefore it provides a strong incentive for the losing party to obey the award and pay the sum rapidly. Based on this point, it could be noted that the power of arbitrators is indeed wider than judges.

(d) The defect and the conclusion

4.4.6 It needs to be pointed out that interest on sums paid late, but before the arbitration proceeding, could not be awarded without special agreement, and this position leaves a gap in the same way as the 1981 Act.

However, it still needs to be admitted that in reaching a “fair and just” outcome, arbitrators could do better than judges, but the approach provided by the 1996 Act is not free from problems.

⁴¹² Merkin, *Arbitration Law* (loose leaf, Informa Law), at paras.18.61.2 and 18.65.

Practically, it might be argued that in order to reach a more “fair and just” outcome, assureds could have chosen to insert arbitration agreements in each and every policy, but in practice it rarely happens and this is especially true when consumer insurance is considered.

In s.91 of 1996 Act it states that a claim of a small amount is usually deemed as automatically unfair and could not be referred to arbitration and in the Unfair Arbitration Agreements (Specified Amount) Order 1999 the amount is fixed at £5,000; additionally, even if the amount is above £5,000, the arbitration agreement has to pass the test in the Unfair Terms in Consumer Contracts Regulations 1999.⁴¹³

Additionally, the 1996 Act has brought a new problem: under the 1996 Act the award of interest is a purely a matter for the arbitrator’s discretion and s.1(c) of the 1996 Act clearly states that the court cannot intervene unless provided by the Act; accordingly, a question has to be answered, namely, once the arbitrator fails to award interest, what should the court and the losing party do?

4.4.7 The first case in which this problem was considered was *Walker v. Rowe*.⁴¹⁴ In that reinsurance case the tribunal made two awards: the award on merit and the award on cost. There was no dispute between the parties about the award on merit which dismissed the reinsured’s claim; but as to the award on cost, which stated that the reinsured should pay a certain sum to the reinsurer, the problem appeared.

⁴¹³ See Merkin, *Arbitration Act 1996*, (5th edn, Informa Law), at the note for section 91.

⁴¹⁴ [2000] 1 Lloyd’s Rep. 116.

In the cost award, the reinsured was required to pay the cost on 9th November 1998 but the post-award interest was not mentioned. On 11th March 1999 part of the cost was still outstanding and the reinsurers applied to the court to enforce the award. On 7th May 1999 Mance J (as he then was) granted the order with interest to be calculated and the reinsurers subsequently applied for an order to set the rate of interest in accordance with s.35A of the 1981 Act, while the reinsured applied to set aside Mance J's order because the post-award interest should be a matter considered purely by the arbitrators rather than by the court.

The dispute was heard by Aikens J (as he then was). The judge firstly pointed out a significant difference between the 1996 Act and its predecessor, the Arbitration Act 1950. It was rightly pointed out by Aikens J that under the 1950 Act the post-award interest was not to be considered by the arbitrator because interest with the same rate of judgment debt attached automatically;⁴¹⁵ but this was not the case in the 1996 Act because

“Under s. 49(4) it is left solely to the arbitrators to decide whether (and if so what) "post-award" interest should be granted on an outstanding sum of an award, including "pre-award" interest. The sub-section states specifically that it applies to an award of costs. This provision means that a party seeking an award of "post-award" interest must ask for it and even if he does, the tribunal is not obliged to award it.”⁴¹⁶

Additionally, Aikens J felt that to set an interest rate in accordance with s.35A of the 1981 Act in this case was nothing more than unnecessarily intervening in the

⁴¹⁵ See *Walker v. Rowe* [2000] 1 Lloyd's Rep. 116 at p.121.

⁴¹⁶ *ibid.*

arbitration proceeding and altering the award and therefore he dismissed the claim.

Accordingly, it should be noted that Aikens J believed that the court should not intervene when the arbitrator did not award interest with or without pleading by either party.

This judgment, despite being regarded as a general principle, has to be read with caution because in this case Mance J was asked to give leave for enforcement and in that leave Mance J suggested that post-award interest should be added and his suggestion was criticized by Aikens J as such a suggestion would be a way by which the court would intervene without justified grounds.

However, once there is a justified ground the court could award interest even though the arbitrator intentionally refused to do so; as such interest awarded by the court is the interest on the judgment debt, rather than a part of the award.

This point was firstly raised by Aikens J himself in *Pirtek (UK) Ltd v Deanswood Ltd*⁴¹⁷, in which the learned judge held that once the award was enforced in accordance with s.66 of 1996 Act then the award had the same effect as a judgment and therefore a simple interest in the Judgments Act 1838 could attach⁴¹⁸ and this point has recently been confirmed by Flaux J in *Sonatrach v. Statoil*.⁴¹⁹

⁴¹⁷ [2005] 2 Lloyd's Rep. 728.

⁴¹⁸ See also *Gater Assets Ltd v Nak Naftogaz Ukrainiy (No.3)* [2008] 2 Lloyd's Rep. 295.

⁴¹⁹ [2014] EWHC 875 (Comm).

According to these judgments, it seems that the court can only award interest after an arbitration award is enforced as a judgment and the starting date of such interest could be no earlier than the date when that award is enforced.

However, the problem has not been answered in full: when the interest should have been awarded but nevertheless ignored by the arbitrator, will the court still stand aside? The short answer will be that: the court could not award interest itself, but it could remit the award and require the arbitrator to clarify this point. This is especially true when interest should have been awarded and there is no good reason for not awarding interest.⁴²⁰

Therefore, even though the 1996 Act makes great progress in awarding interest, the common law and statutory remedies are still of great importance and the blot needs to be removed by further legal reform, and it is also an important question which should be answered by the new Enterprise Act 2016.

4.5 Judgment debt and statutory interest

4.5.1 It has been mentioned above that an arbitrator could allow compound interest for the late payment of the award; the court also has such power in order to make sure that the judgment should be honoured and such power is granted by s.17 of Judgments Act 1838 (the 1838 Act) that “every judgment debt shall carry interest” and according to The Judgments Debts (Rate of Interest) Order 1993 the interest is fixed at 8 percent per year.⁴²¹

⁴²⁰ See *PJ Van der Zijden Wildhandel NV v. Tucker & Cross Ltd* [1976] 1 Lloyd's Rep 341.

⁴²¹ The Judgments Debts (Rate of Interest) Order 1993, s. 2.

Therefore, it could be found that unlike the statutory interest in s. 35A of the 1981 Act, the interest on judgment debt is not intended to compensate the loss by the claimant but a way to make sure that the judgment is honoured and therefore the rate of the interest, although on a simple basis, is comparatively greater than the value of the money owed; and it also seems that there is an element of punishment for the late performance of the judgment.

Additionally, it needs to be pointed out that the fixed interest rate could only be reduced but not increased, as in s.17 (2) of the 1838 Act it states that

“Rules of court may provide for the court to disallow all or part of any interest otherwise payable under subsection (1).”

Again, a difference could also be found here between the 1981 Act and the 1838 Act. In the 1981 Act the rate of the statutory interest could be decided on what is the commercial reality and therefore the interest rate is the one at which the claimant would be able to borrow the money while the interest rate in 1838 Act could only be reduced by the rules of the court.

4.5.2 In *Sycamore Bidco Ltd v Breslin*⁴²² Mann J noticed that there was a time when the commercial interest rates were generally higher than 8 percent and now the situation has been reversed, but he stressed that what was important in distinguishing interest under 1981 Act from the 1838 Act was the time when the judgment was delivered; therefore, it was summarized by Mann J in that case that

⁴²² [2013] EWHC 174 (Ch).

“It is desirable that the matter should remain clear — interest changes on the date of the judgment.”⁴²³

Accordingly, it should be noticed that the award of interest is by no means an easy issue to work through and becomes even harder in indemnity insurance cases and this issue shall be discussed in full in the next chapter of this work.

⁴²³ *ibid.*

Chapter 5 Interest in indemnity insurance claims

5.1 Interest in indemnity insurance claims

5.1.1 In the last chapter, the issues about interest were introduced and discussed generally, and it was found that only if compound interest is available within the court's jurisdiction could it be deemed as, and should be accepted judicially as, the right approach for commercial cases including indemnity insurance.

However, according to the judgment of *Sempra Metals* and academic discussions⁴²⁴ about that judgment, the conclusion reached is that currently there is only simple statutory interest for late payment of **indemnity** insurance money⁴²⁵ even though it has been admitted by the courts that the function of interest is to reimburse the loss suffered from being kept out of the money⁴²⁶; and according to decided cases there is a paradox between the current law and the purpose of the law itself.

Therefore, in this chapter, the focus will be put firstly on the statutory interest in indemnity insurance claims. It might also be argued that these unclear decisions on statutory interest are caused by the isolated recognition of the duty of the insurer in indemnity insurance and the date when the cause of action of the assured arises.

⁴²⁴ See Malcolm Clarke in 'Compensation for failure to pay money due: a "blot on English common law jurisprudence" partly removed', J.B.L. 2008, 4, 291-303 at p.295; see also Chris Nicoll, 'Compound interest for late payment of an insurance claim', L.Q.R. 2008, 124(Apr), 199-202 at pp.200-201.

⁴²⁵ It is crystal clear that after *Sempra Metals* compound interest **is** available for contingency insurance and since the contingency insurance claim is deemed to be a kind of contract debt, there would also be a valid claim for damages for delay in payment of that debt.

⁴²⁶ For example, see *Kuwait Airways v. Kuwait Insurance Co (No.3)* [2000] Lloyd's Rep IR 678, at p.688.

Additionally, it needs to be noted that after *Sempra Metals* the law on restitution has been well developed and even though it has not been firmly decided whether this might have an influence on indemnity insurance, it could be predicted that some approaches might be taken by the courts in the future.

(1) The defects of statutory interest

5.1.2 It has been stated in the last chapter that in an indemnity insurance claim the interest could be awarded by s.35A of the Supreme Court Act 1981 on a simple basis. The controlling principle of awarding interest, rightly summarized by Malcolm Clarke, is

“...that a successful plaintiff should be compensated for the loss involved in being kept out of his money”⁴²⁷

Meanwhile, Professor Clarke also points out the fatal defect of the statute: there would be no available statutory interest, not even on a simple basis, if the insurance money is paid late, but before the legal proceeding. Moreover, in that situation, the assured could not seek for common law remedies either, because the statutory interest is the only remedy available. This situation was found by the House of Lords in *The La Pintada*⁴²⁸ and it was pointed out by Lord Roskill that the current law

“...places the small creditor at grave disadvantage *vis-à-vis* his substantial and influential debtor. The former may fear to offend the latter by instituting legal proceedings either swiftly or at all and it is

⁴²⁷ See Malcolm Clarke, *Laws of Insurance Contract* (loose leaf, Informa Law), at para.30-8.

⁴²⁸ [1985] AC 104.

notorious that some substantial and influential debtors are not slow to take advantage of this tactical strength, especially in times of financial stringency.”⁴²⁹

In summary, the current statute has two defects: firstly, there is no authority for courts to award compound interest even though sometimes compound interest seems to be redundant and secondly, the law does not cover all types of late payment of money, and for the main purpose of this work it means the late payment of money in indemnity insurance claims. These two defects, according to *Sempra Metals*⁴³⁰, could be resolved by courts’ discretion if the claim is one of debt, but as to indemnity insurance law as long as the unsupported *obiters* in *The Lips*⁴³¹ and *The Fant*⁴³² stand, there is no room to remove that blot. Since the defective statute applied to indemnity insurance claims is the only available remedy currently, the courts have to find a way to interpret the statute and common law within a commercial setting. However, the approach taken by the courts is unsatisfactory, as it is pointed out that

“It is out of line not only with the reasonable expectations of commerce but also with other rules of insurance law.”⁴³³

(2) The position of the courts

5.1.3 The general legal position of interest can be found in a very important case: *Kuwait v. Kuwait (No.3)*⁴³⁴. In that case, a series of “substantial” issues were

⁴²⁹ *ibid*, at p.112.

⁴³⁰ [2007] UKHL 34

⁴³¹ [1987] 2 Lloyd's Rep

⁴³² [1990] 2 Lloyd's Rep. 191

⁴³³ Malcolm Clarke, *Laws of Insurance Contract* (loose leaf, Informa Law), at para.30-7A1.

decided in the first two judgments and in the third one Langley J made a detailed explanation of the application of the general principle of interest in an indemnity insurance claim.

In that case, aircrafts and spare parts owned by Kuwait Airways (KAC) were insured against war risks by Kuwait Insurance (KIC) and the latter subsequently reinsured the risk in London. The limit of the cover in respect of a single occurrence for aircrafts and spares was \$300m and \$150m.

On **2nd August 1990** Iraq invaded Kuwait and removed 15 aircrafts plus a large quantity of spares and equipment from Kuwait International Airport and after five days the loss suffered by KAC was notified to KIC but that claim was rejected on **5th December 1990**.

On 30th July 1991, KAC issued a writ and in October 1991, points of claim were served. On **14th May 1993**, the claim was raised by KAC's solicitors officially for the purposes of future legal proceedings.

KAC submitted that interest should be awarded from 2nd August 1990, the date on which the loss occurred and on which KIC failed to hold KAC harmless from loss, and the rate of interest should be calculated by the US Prime Rate plus 1 percent.

KIC argued that since the claim was officially raised by KAC on 14th May 1993 and the reasonable and honest investigation of that claim would take several weeks, the start date of interest would be postponed to 30th June 1993 (six weeks after the official claim by KAC), and the rate should be calculated by the

⁴³⁴ *Kuwait Airways v. Kuwait Insurance Co (No.3)* [2000] Lloyd's Rep IR 678.

London Interbank Offered Rate (LIBOR), which was 2.5 percent below the US Prime Rate.

During the trial, it was found by Langley J that in this particular case, no party acted unreasonably,⁴³⁵ notwithstanding the fact that both the insurer and reinsurers began investigating the loss after September 1990.⁴³⁶ As to the date on which the cause of action arose, Langley J provided a straightforward answer, according to *The Fanti*, even though counsel argued that *The Fanti* was somewhat anomalous, that **the cause of action arose on 2nd August 1990 when the loss occurred.**⁴³⁷ As to the function of the **statutory** interest, Langley J held that

“In principle interest is to be awarded to compensate the claimant for being kept out of the money from the date when it has been established that it was due to him; it is not based on fault or the wrongful withholding of payment by the defendant.”⁴³⁸

5.1.4 This legal position is widely accepted even though it has some disadvantages. Firstly the statutory interest, as the only remedy for late payment of an indemnity insurance claim, is not a fault-based remedy, and that is to say, even if the insurer wrongfully withholds the money due to his own fault the statutory interest is unable to reflect a punitive nature. This point is fine when late payment of debt is concerned because damage for late performance is punitive and interest could retain its compensatory nature, but when it comes to late

⁴³⁵ *Kuwait Airways v. Kuwait Insurance Co (No.3)* [2000] Lloyd's Rep IR 678, per Langley J at p.684.

⁴³⁶ *ibid.*

⁴³⁷ *ibid.*

⁴³⁸ *ibid.*, at p.688.

performance of damage the non-punitive interest could hardly protect the non-defaulting party. Secondly, even it has been admitted that the interest should have been awarded from the date when the assured is kept out of the money, the fact is that there are always two dates when interest is calculated: the date when the loss occurs and therefore the insurance payment is due, and the date when the interest begins to run; these two days rarely match in practice and there is no remedy at all during the gap between the two dates. Accordingly, it could be argued that the statutory interest, in fact, is an “artificial product” which could provide some protection but not enough.

Additionally, Langley J also interpreted the application of s.35A of the 1981 Act by saying that there was

“...discretion both as to the period and rate of interest save that the period cannot commence earlier than the cause of action arose and must end no later than the date of judgment”⁴³⁹

Therefore, once the judgment is made, but the payment of the amount according to the judgment remains outstanding, no statutory interest under s.35A of the Supreme Court Act 1981 would be granted as from that point the calculation of interest is taken over by s.17 of the Judgments Act 1838. It is generally believed that the post-judgment interest is also calculated on the simple basis and that interest is usually on a fixed rate of 8 percent.⁴⁴⁰ Even though to some extent the interest carried by a judgment could help with the fulfilment of judgment by

⁴³⁹ See *Kuwait v. Kuwait (No.3)* [2000] Lloyd's Rep IR 678 at p.684.

⁴⁴⁰ See Judgments Act 1838, s. 17; see also Hsu Mei O'Neill, 'A Tale of Interest', <<http://www.lawcareers.net/Information/BurningQuestion/Ince-Co-LLP-A-tale-of-interest>>, accessed on 15th April 2014.

the guilty party, it is less effective than the protection granted by the Arbitration Act 1996.

Moving back to *Kuwait v. Kuwait (No.3)*, Langley J had to decide firstly the starting date of interest based on the assumption that the insurance contract was breached when the loss occurred; and secondly on which rate the interest was to be calculated.

5.1.5 The first case which Langley J reviewed was *General Tire and Rubber Co v. Firestone*.⁴⁴¹ In that case the defendant began to infringe the patent (not granted) in March 1958 and the patent was actually granted in January 1963. It was held by the majority of the House of Lords that interest began to run from January 1963. In reaching that conclusion Lord Wilberforce held that

“In a commercial setting, it would be proper to take account of the manner in which and time at which persons acting honestly and reasonably would pay.”⁴⁴²

According to the specific nature of the patent claim, His Lordship continued

“...in normal commercial practice royalties in respect of use before grant are not expected to be paid until grant...”⁴⁴³

The opinion of Lord Wilberforce was accepted by the majority of the House⁴⁴⁴ and it was unanimously decided that

⁴⁴¹ [1975] 1 WLR 819.

⁴⁴² *General Tire Rubber Co v. Firestone* [1975] 1 WLR 819 at p.836.

⁴⁴³ *ibid.*

⁴⁴⁴ Lord Salmon dissenting and His Lordship believed that the interest should run from the date when infringement began; this was also the judgment in the first trial; see *General Tire Rubber Co v. Firestone* [1975] 1 WLR 819, at [841].

“Interest is not awarded as punishment against a wrongdoer for withholding payments which he should have made. It is awarded because it is only just that the person who has been deprived of the use of the money due to him should be paid interest on that money for the period during which he was deprived of its enjoyment.”⁴⁴⁵

Accordingly, it could be inferred that the aim for the statutory interest is to compensate the value of the money deprived from the claimant due to the late payment. However, the value of the money is better to be reflected by the available compound rate rather than a simple basis rate only.⁴⁴⁶ Therefore it could be argued that the statutory interest itself is a paradox. Therefore, and it would not be surprising if the court seeks to interpret the first statement provided by Lord Wilberforce widely in order to reach a more fair and just outcome; and in fact, it was also the approach which was taken by Langley J in *Kuwait v. Kuwait (No.3)*; by denying the interest-free investigation period, the judge stated that

“There is, however, no ‘independent evidence’ before me as to any normal commercial practice in relation to insurers’ settlements. The aircraft claim was paid without interest. As a matter of commercial and common sense it is, I think, also evident that insurers will usually and reasonably require some period to assess and consider a claim, **but it does not necessarily follow that interest is not payable or paid for that period.**”⁴⁴⁷

⁴⁴⁵ Per Lord Salmon, See *Firestone* [1975] 1 WLR 819 at [841].

⁴⁴⁶ See the judgment by Lord Nicholls in *Sempra Metals* [2007] UKHL 34.

⁴⁴⁷ *Kuwait v. Kuwait (No.3)* [2000] Lloyd's Rep IR 678 at [685], emphasis added.

5.1.6 Langley J went on to consider another case named *BP Exploration Co (Libya) v. Hunt (No.2)*⁴⁴⁸ in which the a restitution claim for unjust enrichment was raised following the frustration of the contract.⁴⁴⁹ In that case, the defendant who owned an oil concession in Libya, contracted with BP to exploit the oil and the costs incurred spent by BP shall were to be reimbursed by the defendant if the oil was found. A massive amount of oil was found, but in December 1971 the Libyan government took over BP's half share. In June 1974, BP notified the defendant that a claim against it would be made.

That case was heard before Robert Goff J (as he then was) and it was held that the contract was frustrated in December 1971 and that date was also the time when the cause of action arose. The judge further confirmed that

“The basic principle is...that interest will be awarded from the date of loss...**the mere fact that it is impossible for the defendant to quantify the sum due until judgment has been given will not generally preclude such an award**...There must have been many cases in the commercial court in which, although the quantum of damages was in doubt until the date of the judgment, interest was awarded from the date of loss.”⁴⁵⁰

5.1.7 However, notwithstanding the understanding on the nature of awarding interest, Robert Goff J refused to award interest from the date when the cause of action arose. It was found by the court that the intention of BP to make a

⁴⁴⁸ [1979] 1 WLR 783.

⁴⁴⁹ The differences in restitutionary claims between unjust enrichment and wrongdoing will be discussed below.

⁴⁵⁰ *BP v. Hunt (No.2)* [1979] 1 WLR 783 at [846], notably this judgment in fact deviates from *London, Chatham and Dover Railway* [1893] AC 429.

restitutionary claim was a “genuine surprise”⁴⁵¹ to the defendant: according to the special agreement between the parties in the case, it was agreed mutually by the claimant and the defendant that they were prepared to concentrate on the claim against the Libyan Government together. Therefore, considering the discretion to award interest was “unfettered”,⁴⁵² the judge emphasizes several exceptions in awarding interest:

The first group of exceptions concerns the position of the defendant and when the court believes that it is unjust to make the defendant pay when the cause of action arose, the start date of interest would be postponed until a claim is officially raised or when a reasonable investigation of the claim is finished. However, this group of exceptions has to be understood strictly and it has to be applied in very limited cases. A classic example could be found in *Firestone* where it was too uncertain for the defendant to predict that there would be a future claim as the grant of the patent was not a certainty. The second example is the case before Robert Goff J in which the learned judge stressed that the restitutionary claim raised by the claimant was a “surprise attack”; in other words, it could be understood as that by cooperating with the defendant rather than suing him, the claimant waived the right to interest, but only partly waived the right to interest during the period of co-operation: and once the co-operation ended interest started to run.

⁴⁵¹ *ibid*, at [848].

⁴⁵² *ibid*, at [846]; it might be argued that even though according to the statute the discretionary power of the court is large in considering the rate and the period of the statutory interest, the type of interest is strictly limited by statute and the discretionary power is therefore not absolutely “unfettered”.

However, it is obvious that these exceptions could hardly apply to indemnity insurance claims, because when a claim is notified to the insurer the latter must be aware that there will be a claim in the future and that claim could hardly surprise the insurer when a claim is subsequently made. Additionally, this legal position implies a requirement on the insurer during the claim handling stage: in order to reduce the interest loss the claim must be investigated with reasonable speed, no matter how complicated the facts are. This could be inferred from *The Berwickshire*.⁴⁵³ It was a collision case and the facts were complicated; the defendant argued that the interest accruing during the time spent on reasonable investigation should be excluded but that argument was finally rejected by the court.

The second group of cases concerns the behaviour of the claimant. In order to encourage claimants to prosecute claims properly, the culpable or unreasonable delay of prosecution may entitle the court to decline to award interest up to the full period.

More caution has to be taken with this explanation. It has been widely accepted that the statutory interest is not based on the fault of the wrongdoer, let alone the fault of the claimant. Therefore, a more precise interpretation has to be given to this group of exceptions bearing in mind that, as well as the first group, this group has to be interpreted strictly. It might be appropriate to make reference to the doctrine of waiver again. That is to say, once the claimant assured waived the entitlement to interest, the court would deduct the waived amount and that amount could be either part of or the full amount of the interest. A hint of support

⁴⁵³ [1950] P.204.

for this doctrine can be found in the judgment of Robert Goff J. When he tried to explain the second group of exceptions, he said that:

“...such conduct may lull a defendant into a false sense of security, leading him to think the claim will not be pursued against him”⁴⁵⁴

Therefore, if the assured decides not to raise the claim or to notify the insurer, knowing that he should have done so, the insurer may lose the chance to investigate the claim; in that situation, not only the award of interest but also the amount of the principal payment would be affected. In *Milton Keynes BC v Nulty and NIG*⁴⁵⁵ due to the intentional delay of the assured the principal sum of the claim was reduced by 15 percent. Accordingly, it is true that the award of interest would be deducted based on the “fault” of the assured, but it has to be noted that it would be better to view these very limited situations in the sense of “waiver”.

5.1.8 After reviewing those exceptional cases with *Firestone* and *BP v. Hunt (No.2)* Langley J held that the fundamental principle and the starting point of interest claims was that the interest should be awarded from the date of loss, and

“...doubts as to the amount of loss or damages and as to the merits of a claim are generally **immaterial**...”⁴⁵⁶

However, it is still true that those cases mentioned above are not indemnity insurance cases, and in order to consider the special nature of an indemnity insurance claim, a further reference is required.

⁴⁵⁴ *BP v. Hunt (No.2)* [1979] 1 WLR 783, at [846].

⁴⁵⁵ [2012] Lloyd's Rep. IR 453 (the appeal of the first trial was rejected by the Court of Appeal).

⁴⁵⁶ *Kuwait v. Kuwait (No.3)* [2000] Lloyd's Rep IR 678 at [686], emphasis added.

5.1.9 It could be inferred that a straightforward answer should have been found in most indemnity insurance cases, namely the interest should be calculated when the insured risk occurs, as it has been stated that generally the time used in calculating or investigating the loss would not postpone the starting date of interest and exceptions should only apply in very limited cases. However, legal practice goes the opposite way: courts are strongly in favour of granting insurers an “interest-free” period to make their investigations and adjustments. Additionally, by doing so, courts always refuse to admit that exceptions are in fact used as common cases.

In *Burts & Harvey Ltd v. Vulcan Boiler & General Insurance*⁴⁵⁷ a business interruption policy was issued. The factory owned by the assured was affected by insured risks twice, on 19th May 1961 and on 4th June 1961, and the claimant prosecuted in 1964. As to the merit of this case it was held by Lawton J that the assured should be indemnified from the period of 19th May 1961 to 6th August 1961.⁴⁵⁸ However, as to the starting date of interest the learned judge refused to award interest from that period, but instead held that the starting date of interest was 30th November 1962 when a letter was sent to the insurer and the insurance payment was requested accordingly. In reaching that conclusion, Lawton J held that

“It has taken over three years to get this dispute to Court, and the industrial undertaking could have made as good use of the money which is in issue as could the insurance company. In those

⁴⁵⁷ [1966] 1 Lloyd’s Rep 161.

⁴⁵⁸ *ibid.*

circumstances, I see no reason at all in this case why the insurance company should not pay interest on the amount which is due at a rate which bears some relation to the commercial rates of interest which have been in operation during the period between the end of 1962 and the present time.”⁴⁵⁹

It should be noted that the learned judge failed to give a sound explanation for the reason why the starting date of interest was delayed, but the “three years” were calculated from the date when the loss occurred; it should also be noted that, according to his judgment on the merit⁴⁶⁰ and on interest,⁴⁶¹ Lawton J believed that this case was neither unusual nor bizarre and therefore, it would be assumed that should this case happen after *Firestone* or *BP v. Hunt (No.2)* there would be no justifiable reason for the learned judge to depart from the general principle by delaying the starting date of interest and the interest should have been awarded on and from the date of loss.

5.1.10 However, the assumption above has never become reality; in contrast the general principle has been regularly disregarded and subsequent cases provide some examples.

In *McLean Enterprises Ltd v. Ecclesiastical Insurance Office Plc*⁴⁶² a fire policy was issued and the covered risk occurred on 24th June 1983. As to the issue of interest, Staughton LJ stated that

⁴⁵⁹ *Burts & Harvey Ltd v. Vulcan Boiler & General Insurance* [1966] 1 Lloyd’s Rep 354.

⁴⁶⁰ [1966] 1 Lloyd’s Rep 161.

⁴⁶¹ [1966] 1 Lloyd’s Rep 354.

⁴⁶² [1986] 2 Lloyd’s Rep 416.

“... I do so not because of ruing in any way that the insurers should not have investigated this claim nor the time taken to investigate it. But if upon investigation the material which they assemble is not sufficient to establish that it is not a proper claim under the policy, it seems to me that the interest on the money which they have retained meanwhile and which the insured has not had meanwhile should be transferred...”⁴⁶³

It should be noted that in that case Staughton LJ refused to state clearly in the judgment the reason why such an “interest-free” investigation should be supported; by contrast, the speech quoted above was rather a reflection on the general principle in *Firestone and BP v Hunt (No.2)*.

However, the starting date of interest conflicted with that speech, as it was held to be August 1st 1983, some five weeks after the risk even though it was clearly stated by Staughton LJ that the payment of indemnity was due as soon as the fire occurred. Therefore, it could be argued, with respect, that in that case, Staughton LJ deviated from the general principle without any sound reason and it might be argued further that in that case the court in fact “implied” exceptions into the indemnity insurance claim and exceptions are commonly used.

5.1.11 In 1984 the Court of Appeal should have grasped a good opportunity to give a clear answer to this question about interest in *The Popi M.*⁴⁶⁴ It is a case of significant importance in the history of marine insurance not only because of the issue of interest, but also the famous rule in applying the “Sherlock Holmes

⁴⁶³ *McLean Enterprises Ltd v. Ecclesiastical Insurance Office Plc* [1986] 2 Lloyd's Rep 416 at pp.427-428.

⁴⁶⁴ [1984] 2 Lloyd's Rep 555.

exception". However, more focus should be put on the issue about interest, as it was rightly stated by Langley J that

"I have been referred to a number of other authorities in the particular context of insurance but, apart from *The Popi M*, I do not derive great assistance from them."⁴⁶⁵

In that case, the vessel *Popi M* set sail in a good condition, but subsequently sank due to the entry of water in good weather and perfect sea on August 5th 1978 and the assured raised the claim in September 1980.

At the first trial, it was admitted by Bingham J that the facts of the case were "unusual and in many respects bizarre",⁴⁶⁶ and the case was decided on a change of claim by the claimant. Therefore, the judge refused to award interest from the time of the loss. Instead, the starting date of interest was postponed until January 1st 1983 when the changed claim was properly raised. In reaching that conclusion, it was held that

"...it does seem to me on the facts of this case to be wrong to treat the plaintiff as having been kept out of his money when he has put his claim on a basis substantially different from that which has proved successful... I think that the order for interest should be very much less favourable to the plaintiffs than would ordinarily follow in a case of this kind, and I think that justice is done."⁴⁶⁷

⁴⁶⁵ *Kuwait v. Kuwait (No.3)* [2000] Lloyd's Rep IR 678 at p.687.

⁴⁶⁶ *The Popi M* [1983] 2 Lloyd's Rep. 235, at p.251.

⁴⁶⁷ *ibid.*

It might be noted that although it was admitted that the facts of the case were unusual and bizarre, the award of interest was not decided or influenced on this point but on the claimant's change of case. It also seems that the award of interest, based on the view of Bingham J, was a more practice-based remedy rather than merely indemnifying the loss of the use of the money by the assured: because even though the case was changed by the assured it did not necessarily mean that the assured was at fault in any way or had any intention to waive the right of interest on changing the case and it could not be denied that the assured was deprived of the use of the money due to the late payment of the insurer.

Another fact to be noted is that even in this case the assured did not intend to claim interest from the time of loss; instead, the claimant asked for interest from January 1979 as the relevant material for the claim was given to the insurer in December 1978 and it was believed by the assured that the insurer could finish the reasonable investigation and adjustment in that period. In other words, it seems that the interest-free period was granted in the first place by the assured and the assured actually waived the entitlement to the interest during that time; but what was done by the court was to extend that period without any sound reason. Accordingly, it can be found that the general rule of awarding interest in *Firestone* was deviated from and in certain cases even the claimant did not follow the general principle. It is true that the assured could always do that because waiving the right is not forbidden by law, but it is at least open to serious doubt whether the court could extend the interest-free period.

The claimant in *The Popi M* appealed on the issue of interest and the claim was heard by the Court of Appeal before Sir John Donaldson MR, O'Connor and May LJJs. On the appeal, Sir John Donaldson MR, with whom May LJ agreed, held that the assured did not conceal information or mislead the assured, but the learned judge noticed the unusual nature of the case and agreed that

“...underwriters could not reasonably be expected to pay immediately that the claim was presented.”⁴⁶⁸

Nonetheless, the starting date of interest was in favour of the assured as Sir John Donaldson further held that

“The casualty occurred on Aug. 5, 1978. The writs were not issued until September, 1980, by which time underwriters must have made up their minds to reject the claim. They may well have undertaken further investigation..., **but from Oct. 1, 1980, and perhaps considerably earlier...the underwriters were in breach of their contract to indemnify the owners** and were thereafter enjoying the use of the owners' money.”⁴⁶⁹

Prima facie, the majority of the Court of Appeal believed that the starting date of interest had a strong connection with the issue of the writ by the court, because it could be inferred that after the writ was issued the insurer must have finished the reasonable investigation and adjustment; accordingly, the fact of the majority judgment was that the court tended to support the interest-free investigation period, even though the judgment was made in favour of the assured.

⁴⁶⁸ *The Popi M* [1984] 2 Lloyd's Rep. 555, at p.559.

⁴⁶⁹ *ibid*, emphasis added.

Additionally, it was not clearly stated by Sir John Donaldson MR whether the judgment would follow the general principle, because in the decision the issue of the cause of action was not clearly considered. What was mentioned by the Court of Appeal was that the defendant might have breached the contract from the time when the writ was issued or “perhaps earlier”, and it meant that it was not certain to Sir John Donaldson MR and O’Connor LJ at that time when the cause of action in an indemnity insurance claim would arise.

5.1.12 However, this issue was considered by May LJ and he prepared to award interest from an earlier date than October 1980. It was held that

“...a contract of insurance is a contract of indemnity. Where an insured suffers a loss due to a peril insured against he is prima facie entitled to have that loss made good to him by insurers directly it happens. A contract of insurance is different in this respect from... a contract for the sale of goods under which the buyer is by its terms of custom allowed credit for a period... **In the insurance situation, although reasonableness and commercial practice may on the authorities lead a Court to deny an insured interest on his indemnity monies for a period after the loss, in my opinion this should be limited.** Of course in most cases insurers will in practice need to investigate claims made upon them by their assured, but it should be remembered after a claim has been ultimately admitted or proved after litigation, that in law insurers had been liable to pay the

admitted or proved amount from the date of the loss and that *prima facie* at least interest should be awarded accordingly.”⁴⁷⁰

It is clear that the judgment made by May LJ reflected the current judicial understanding of both the primary obligation of the insurer and the principle which should be applied in indemnity insurance cases:

Firstly, the primary obligation of the insurer, under current law, is to hold the assured harmless, and therefore the cause of action for the breach of the insurance contract arises as soon as the loss occurs.

Secondly, unlike sales contracts, generally there should be no interest-free period; even a reasonable interest-free period for investigation is always required by the insurer and in practice it is always granted by the assured.

Thirdly, that interest-free period is not in line with the general legal principle, but courts always deviate from that principle to achieve fairness and commercial reality, despite saying that such a period granted is exceptional and could only be granted in limited situations.

Although May LJ did not give any examples of this exception, it could be inferred from the discussion about *BP v. Hunt (No.2)* above that generally the exceptions should be split into two groups: the first group is where the insurer does not or could not reasonably know that there is a loss and the second group is where the assured “waived” all or part of the right to interest.

However, the judgment made by May LJ was not clearly accepted by Langley J and no persuasive interpretation was given.⁴⁷¹ Nonetheless, it needs to be

⁴⁷⁰ *The Popi M* [1984] 2 Lloyd's Rep. 555 at p.562, emphasis added.

pointed out that should the approach taken by May LJ be accepted, a further question will arise: it is common practice that the insurer could not know or have any reasonable ground to know that the insured peril happens and causes damage unless the assured notifies the insurer; based on this fact, the exception in *BP v. Hunt (No.2)* will no longer be an “exception” in indemnity insurance claims, but a certain “routine” in almost every claim; therefore, it could be argued that the law is to some extent self-contradictory.

5.1.13 According to the discussion above, it might be inferred that it is better to regard the new implied obligation stated in s.28 of the Enterprise Act 2016 as intending to replace the original obligation of the insurer to hold the assured harmless by a new contractual obligation to make the payment of indemnity within reasonable time, and accordingly the decision of the House of Lords in *The Fanti* shall be overruled or limited in original indemnity contracts of liability insurance. Therefore, the assured has no cause of action against the insurer unless and until a reasonable time has passed, which could be decided by relevant circumstances, such as the nature or the size of the claim,⁴⁷² and the insurer is able to enjoy an interest-free period to investigate the claim reasonably.

5.1.14 After reviewing these cases, Langley J decided to follow the general principle stated in *Firestone* and *BP v. Hunt (No.2)*⁴⁷³ but the judge found the condition of “waiver” was satisfied by the assured’s intentional silence. Therefore, the judge expressed the view that

⁴⁷¹ See *Kuwait v. Kuwait (No.3)* [2000] Lloyd's Rep IR 678 at [688].

⁴⁷² See s.13A(2) (3) (4) of the Insurance Act 2015, which will be inserted by the Enterprise Act 2016, at s.28.

⁴⁷³ See *Kuwait v. Kuwait (No.3)* [2000] Lloyd's Rep IR 678 at [689].

“...it is wrong to view the claimant as kept out of or deprived of the use of money payment of which he has delayed in seeking. [Especially] in which a claimant consciously and for his own reasons chose not to pursue a claim immediately and notified the potential defendant...”⁴⁷⁴

As to the starting date, the judge continued that

“...once it was clear, as it was on 12 November 1990, that a claim in respect of the loss of spares was now being pursued and insurers had had a little time both to appreciate that fact and consider or re-consider it,...interest ...to be due should accrue. In fact KIC rejected the claim in its entirety on 5 December 1990 and it is on and from that date that I think it appropriate to award interest.”⁴⁷⁵

Accordingly, it could be found that even though the date of paying interest was due on 12 November 1990, the judge nonetheless granted an interest-free period for about a month for the insurer to hold a reasonable investigation or to properly consider the claim. It could also be inferred that should the assured decide not to delay the claim, which would not make him be blamed for waiver by the judge, but to claim as soon as the loss occurred, the same interest-free period would nevertheless be granted. In other words, no matter whether the assured elects to waive or postpone the starting date of the interest the courts will always grant an interest-free period from the date when the insurer is aware of the claim and the length of that period is the period for a reasonable insurer to finish the proper investigation and make the decision.

⁴⁷⁴ *ibid.*

⁴⁷⁵ *ibid.*

5.1.15 It needs to be remembered that in *The Popi M*, which has a significant influence on the present case, the claimant claimed the interest from the date of prosecution, rather than from the date of the loss, in the official claim form before the court; but in *Kuwait v. Kuwait (No.3)* it was clearly claimed by the claimant that the interest should be awarded from the date of loss; however, this difference had no actual effect because in both cases interest-free periods were eventually granted; and it would be more surprising to find out that in both cases the periods were about one month.

Additionally, in both cases, courts admitted that interest should have run when the cause of action arose and there were limited exceptions; however, in *Kuwait v. Kuwait (No.3)* Langley J in fact applied the exceptions twice: the first time was to postpone the starting date from the date of the loss to the date of the claim due to the “waiver” and the second time was to postpone the starting date from the date of claim to the date when the learned judge believed that the insurer had finished the investigation and had thereby rejected the claim.

Therefore, it might be predicted that in indemnity insurance claims, based on the current law, the starting date of interest has nothing to do with the general principle in *Firestone* or *BP v. Hunt (No.2)*,⁴⁷⁶ what is of relevance is the date of a proper claim raised by the assured and a period of reasonable investigation or consideration by the insurer and this position has been noted by Lord Mance that

⁴⁷⁶ Although this case is always cited with approval by courts, a deviation of that case will follow.

“...both parties to an insurance case would probably see the real obligation of an insurer as the paying of a valid claim after a reasonable period for investigation...”⁴⁷⁷

According to the discussion above, it should be noted that there is a difference between legal principle and commercial practice on the starting date of interest and this difference could be solved by understanding the new Enterprise Act 2016, which imposes an obligation on the insurer, and effectively replaces the traditional definition of the primary obligation of the insurer.

5.1.16 Notwithstanding the difficulty in understanding the starting date of interest in indemnity claims, it is well settled that once the interest begins to run, the only way to stop it is the fact that the dominant reason for the assured being kept out of the money is the fault of the assured, and this argument was accepted by Tomlinson J in *The Julia*⁴⁷⁸ that

“Where a claimant has been guilty of excessive delay in making the original claim or in pursuing it, the starting date may be adjusted adversely to him. The rationale for doing so is that it would be wrong to view the claimant as kept out of or deprived of the use of money, payment of which he has delayed in seeking.”⁴⁷⁹

Additionally, Tomlinson J noted that in order to stop the running of interest, the fault of the claimant must be substantial and culpable. Even though the learned

⁴⁷⁷ See Lord Mance, ‘The 1906 Act, Common Law and Contract Claims All in Harmony?’ [2011] L.M.C.L.Q. 346, at 352.

⁴⁷⁸ [2003] Lloyd's Rep IR 365.

⁴⁷⁹ This was an argument made by the counsel for the defendant and accepted by Tomlinson J in *The Julia* [2003] Lloyd's Rep IR 365, at [14].

judge might be wrong in the part dealing with the starting date of the interest, the judgment on this issue is correct. Therefore, the reconciliation of the legal principle and commercial practice on the starting date of interest is the only problem and this problem has never been answered directly.

5.1.17 In order to solve this problem, one must firstly remember that according to the general legal principle, interest should run as soon as the cause of action arises and in an indemnity insurance case the cause of action arises when the insurer's primary obligation is breached, but again, what is the primary obligation of the insurer?

It has been argued in this work that the primary obligation should be regarded as the one to pay a claim within a reasonable time rather than to hold the assured harmless by preventing the loss. Once the insurer's obligation is regarded as the one to hold the assured harmless a time gap will inevitably appear between the date when the cause of action arises and the date when interest starts to run in practice; however, once the insurer's obligation is regarded as one to pay a valid claim within a reasonable time, the reconciliation of general legal principle and commercial practice will be achieved. According to this understanding the starting point is that interest should not run until a reasonable time for the claim handling has been exhausted and that period should be decided by reference to market practice for different kinds of policies as well as by the special facts for each case. This argument could also be testified to and supported by the following cases and conclusions; and therefore this aspect of understanding should carry more weight when the Enterprise Act 2016 is to be interpreted⁴⁸⁰.

⁴⁸⁰ For example, see para 3.4 of this work.

5.1.18 In *Adcock v. Co-operative Insurance Society Ltd*⁴⁸¹ the assured's house which was insured against fire was burned down on January 13th 1990. After immediately notifying and claiming for the insured sum against the insurer the assured demolished the damaged house and rebuilt it. The insurer made two modest interim payments in August 1990 and January 1992. Due to the unsatisfactory negotiation, the assured commenced legal proceedings in December 1995 and the case was then heard in May 1999. At the first trial, HHJ Langan QC awarded the principal sum of £13,577 plus interest of £6,788 which was calculated from February 1993 until the date when the judgment was given. The insurer appealed the judgment on interest, alongside the principal sum.

The Court of Appeal upheld the decision but, unlike *Kuwait v. Kuwait (No.3)*, Waller LJ, who gave the judgment, did not explain the reason why the starting date of interest was delayed nor made any comment about the relation between the date when the cause of action arose and the date when the statutory interest should begin to run. Instead, Waller LJ made that judgment from another aspect. After analysing the Supreme Court Act 1981, the learned judge found that the statutory interest was a matter of discretion⁴⁸² and believed that the trial judge made no favourable judgment for the assured and even if there was misdirection Waller LJ expressed the opinion that he would not interfere.⁴⁸³

The assumption made above was followed by Thomas J in *Quorum AS v. Schramm (No.2)*⁴⁸⁴ by holding that

⁴⁸¹ [2000] Lloyd's Rep IR 657.

⁴⁸² *ibid* at p.661.

⁴⁸³ *ibid* at p.664.

⁴⁸⁴ [2002] 2 Lloyd's Rep 72.

“...the Court usually exercises its discretion on the basis it is proper to allow insurers some time to consider the claim. The time varies accordingly to the nature of the loss, the way in which the claim is presented and the circumstances that require investigation.”⁴⁸⁵

In *The Vergina (No.3)*⁴⁸⁶ Aikens J (as he then was) further clarified this position. In that case, the vessel sank off the West African coast and salvage work paid by the assured was done in February 1994. Aikens J firstly noticed that a contract of marine insurance was a contract of indemnity and the primary obligation of the insurer was to hold the assured harmless.⁴⁸⁷ However, the learned judge postponed the starting date until 17th May 1996 based on reasons below:

Firstly, Aikens J believed that the assured would not make a “formal” claim against the insurer until the salvage arbitrations or settlements had been completed even though the insurer had been notified by the assured.

Secondly, Aikens J noted that in fact the insurer began the investigation from February and March 1994.

Thirdly, on 17th May 1996 the insurer denied the claim and it was believed by Aikens J that by doing so the insurer must have finished the reasonable investigation.

Aikens J further expressed his opinion on the starting date of interest in indemnity insurance; he held that

⁴⁸⁵ *Quorum AS v. Schramm (No.2)* [2002] 2 Lloyd's Rep 72 at [8].

⁴⁸⁶ [2002] 1 Lloyd's Rep 238.

⁴⁸⁷ *ibid* at [16].

“...the correct approach in the case of a claim under an insurance policy where there is no obligation to submit a formal claim is that the initial starting date of interest is the date when the insurer is in breach of its obligation to hold the insured harmless. That date might well be moved forward to give insurers a reasonably short time to consider whether there is a valid claim under the policy...”⁴⁸⁸

Therefore, it could be found again that the starting date of interest and the date of the cause of action were isolated in *The Vergina (No.3)*. Additionally, even though a “formal” claim would not be the condition precedent to the starting date of interest, the insurer still needed to be informed about the loss.

Aikens J further held that the court was entitled to stop the running of the interest, but it could only be done so in very limited situations and after reviewing *The Athenian Harmony*⁴⁸⁹ he held that

“...the Court should not disallow interest unless it can be shown that the “predominant cause” of the claimant being kept out of money that the Court has held he is entitled to is the claimant’s own failure to prosecute the claim, as opposed to the defendant’s maintenance of its defense.”⁴⁹⁰

5.1.19 Accordingly, the way in which interest works in practice in indemnity insurance currently could be concluded as follows:

⁴⁸⁸ See *The Vergina (No.3)* [2002] 1 Lloyd’s Rep 238, at [29].

⁴⁸⁹ [1998] 2 Lloyd’s Rep.425.

⁴⁹⁰ See *The Vergina (No.3)* [2002] 1 Lloyd’s Rep 238, at [33].

Firstly, the time spent between the date when the cause of action arises and the date when the insurer is notified should not be counted as interest period, because the insurer could not be aware of a claim during that period and any delay in notifying the insurer is to be attributed to the assured. Additionally, since the assured has no right to interest during this period, the theory of waiver, which has been mentioned above, could not apply.

Secondly, once the notice, formal or informal, is given to the insurer an interest-free period will follow and the length of that period is a matter of discretion. It could be inferred that the argument that the insurer in fact does not investigate due to the lack of a formal claim would be rejected by the court because the decisive point is not about whether the notice is formal or informal, but whether a reasonable insurer, after receiving the notice, should begin the investigation.

Thirdly, once the interest-free period is exhausted the interest should run from that point on. However, if the assured, for his own reasons, is indolent in making a claim to the court it might be possible for the court to hold that the interest loss is predominantly caused by the assured.

5.1.20 Even though the analysis above seems to be correct according to current law, it reflects only the academic position and the general position of the court underlying the judgments. However the way the court uses its discretion remains unclear and unpredictable.

It is better to start this problem with *The Julia*.⁴⁹¹ In that case the vessel suffered an actual total loss by fire on 15th May 1994 and the assured sent the claim form to the insurer the next day but it did not reach the insurer's representatives until August 1994. After a reasonable investigation and consideration the insurer denied liability on 22 December 1994. The judgment delivered by Tomlinson J was surprising as the interest was awarded from 15th June 1994, and the reason was that

“I consider that a period of one month within which underwriters are entitled to investigate the loss and decide whether to accept or decline the claim is a modest allowance...”⁴⁹²

With respect, it could be hardly said that an underwriter could finish the investigation within one month without knowing that there is a claim against him. According to the facts, the learned judge in fact permitted the assured to “ambush” the underwriter, which was not allowed in either *Firestone* or *BP v. Hunt (No.2)*, and this case might be wrongly decided.

The position of the court seems to be clear in modern cases. In *AXL Resources Ltd v. Antares Underwriting Services Ltd*⁴⁹³ Gloster J held that

“... I exercise my discretion to award interest as from 1 April 2009. I choose this date to reflect the fact that the defendants are entitled to some time to consider the claim before interest should start to accrue. Although the claim was made on 27 January 2009, their loss

⁴⁹¹ [2003] Lloyd's Rep IR 365.

⁴⁹² *ibid*, at [13].

⁴⁹³ [2011] Lloyd's Rep. IR 598.

adjusters' report was not signed until 12 March 2009, and I have allowed them some time after that date to consider their position.”⁴⁹⁴

In *Synergy Health v. CGU Insurance Plc*⁴⁹⁵ Flaux J expressed the same opinion by holding that

“I consider that the insurers were entitled to a reasonable period in which to investigate the loss before interest should be payable, even if technically they were in breach of contract from the date of the fire.”⁴⁹⁶

5.1.21 In Australia there once was a debate on whether assureds should be allowed to claim interest when the payment by the insurer was delayed and ALRC, after a discussion about the nature of the insurance industry, provided an affirmative answer that:

“...[a] requirement to pay interest would diminish an existing incentive to delay. As the rate of return on investments would probably exceed the rate of interest payable, the insurer would not be under any pressure to settle quickly or to forgo proper investigation of claims. Thirdly, the proposal would have the effect of adding appreciably to the cost of insurance. This argument certainly has some merit. Costs would obviously increase. But the new cost would be the real cost of effective insurance, account being taken of the loss suffered by an insured if interest were not paid. If the payment of interest were required not from the date of loss, but only from the time after which

⁴⁹⁴ *AXL Resources Ltd v. Antares Underwriting Services Ltd* [2011] Lloyd's Rep. IR 598, at [28].

⁴⁹⁵ [2011] Lloyd's Rep. IR 500.

⁴⁹⁶ *Synergy v. CGU* [2011] Lloyd's Rep. IR 500, at [263].

further delay by an insurer would be unreasonable, there would be little, if any, increase in costs.”⁴⁹⁷

This issue was also developed by academics, especially on the type of interest.

It was suggested that

“If the plaintiff was expecting payment for a consignment of goods, but did not receive his money, the extent of his loss could be measured approximately by the amount of income that he could otherwise have generated simply by putting the proceeds into a deposit account at a bank. Such a move would attract compound interest, since the bank would automatically add to the account any interest generated. Equally, a plaintiff in a tort action can be thought of as incurring opportunity costs best measured by compound rather than simple rates. Had he received his award immediately upon the damage occurring, it may be assumed that he would have invested it at compound rates in just the same way as would the plaintiff who is suffering from a breach of contract.”⁴⁹⁸

5.1.22 Several years later, the issue of interest was developed further by *Hungerfords v. Walker*,⁴⁹⁹ which could be described as the “*Sempra Metals* in Australia” case. In that case Walker made an overpayment to the Tax

⁴⁹⁷ Australian Law Reform Commission Reports on Insurance Contracts (ALRC Report 20), [1982] ALRC 20, available on <http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/lawreform/ALRC/1982/20.html?stem=0&synonyms=0&query=law%20reform%20insurance%20contracts>, accessed on 11th Nov 2014, at para 324.

⁴⁹⁸ Bowles and Whelan, ‘Judgment Awards and Simple Interest Rates’, (1981) 1 International Review of Law and Economics 111, at p. 112.

⁴⁹⁹ [1989] HCA 8.

Department due to the miscalculation of Hungerfords Accounting Group (Hungerfords), and some of the amount overpaid could not be recovered from the Tax Department because of the statutory bar in Australia. Accordingly, Walker could only claim damages from Hungerfords and the key question of the case was “can interest be awarded for damages under common law?”

The answer provided by the High Court was simple: yes, and this judgment, to no-one’s surprise, brought a new era in general contract law as well as insurance law in Australia.

It has been proposed in this work that in England it was once described as a “blot” that no interest could be awarded for late payment of money and after *Sempra* the blot was partly removed, but in Australia the blot was removed in full.

In reaching that conclusion, it was noted by Mason CJ and Wilson J that the distinction made by the House of Lords in *The La Pintada* should not be followed⁵⁰⁰ and further held that

“...the plaintiff is entitled to full compensation for the loss which he sustains in consequence of the defendant’s wrong... Judged from a commercial viewpoint, the plaintiff sustains an economic loss if his damages are not paid promptly, just as he sustains such a loss when his debt is not paid on the due date.”⁵⁰¹

⁵⁰⁰ *Hungerfords v. Walker* [1989] HCA 8, at [23].

⁵⁰¹ *ibid*, at [25].

According to that speech, the first part of the blot in Australia was removed, that is to say, interest could now be awarded for late payment of damages and it was rightly pointed out that there should be no commercial difference between the remedy for late payment of debt and late payment of damage.

Unlike the House of Lords in *Sempre*, the High Court continued in dealing with the type of interest. It has to be mentioned that in Australia the statute only allows simple interest, but the High Court found that compound interest should nevertheless be allowed in common law by holding that

“The award of interest was of necessity compound interest. Simple interest would not reflect accurately the extent of the respondents’ loss. Simple interest almost always undercompensates the injured party’s true loss.”⁵⁰²

Therefore, it is now settled in Australian law that compound interest would be awarded in late payment of money, no matter whether it is debt or damage, and accordingly the common law “blot” no longer exists in Australia. However, it needs to be mentioned that, notwithstanding the great progress in the law of interest, according to the rule in *Hungerfords*, that case could only govern the pre-judgment interest and it means that in some states of Australia such as New South Wales compound interest is still prohibited.

Additionally, it is also clear in *Hungerfords* that the interest loss which could be awarded is not limited to the actual rate of the money borrowed by the claimant due to the wrongful act of the defendant, but also the chance to gain profit from

⁵⁰² *Hungerfords v. Walker* [1989] HCA 8, at [41].

the money and it is also clear that in Australia courts have a great discretion in awarding interest loss as additional damage.

5.1.23 However, this common law principle in the insurance field is problematic because it has been argued that *Hungerfords* would not necessarily apply to insurance cases⁵⁰³ since the statutory remedy for interest loss has been well established in s.57 of the Insurance Contract Act 1984 (the ICA 1984) and subsection (4) of the statute was designed to provide an “exhaustive interest remedy” for the assured, and in subsection (5) (b) it is clear that s.57 would replace any rule on interest in common law. Therefore, the statutory provision and the statement that “the statutory power is a complement to award interest in common law rather than a prohibition” conflict with each other and until now there has been no response from the High Court of Australia to provide a solution for this problem.⁵⁰⁴ It was also suggested that s.57 of the ICA 1984 should be changed when the Insurance Contracts Amendment Act 2013 was enacted but that section remains unchanged.

It has been suggested by the English Law Commission that, in certain cases, the assured should be entitled to interest under s.57 as well as *Hungerfords*⁵⁰⁵ and this argument is supported by *Sutton*.⁵⁰⁶

⁵⁰³ Mann, P, *Annotated Insurance Contracts Act*, (3rd Edition, Law Book Company 2001), at p. 219.

⁵⁰⁴ However, the lower court and academic seems to favour the view that the statutory interest and *Hungerfords* interest could be awarded concurrently in certain cases, see below.

⁵⁰⁵ See Law Commission Paper No. 201: Insurance Contract Law: Post Contract Duties and Other Issues (n.188), at para A.

⁵⁰⁶ See *Sutton* (4th edition, Thomson Reuters Australia, 2014) at para 16.73; see also *Moss v. Sun Alliance* 93 ALR 592, the facts of which case has been discussed in para 2.2.19 of this work.

Accordingly, it might be argued that the statutory interest remedy in s.57 should no longer be the exhaustive remedy and the common law approach should be used. It may also be argued that, once there is an accurate interest loss which can be proved and claimed, that loss should be named as “*Hungerfords* damage” rather than interest under s.57; this argument could be supported by the Australian *Sprung* case *Moss v. Sun Alliance Australia Ltd.*⁵⁰⁷ It has been shown in this work that in *Moss* the assured was awarded interest loss by way of damage and the amount of the payment was calculated on a common law basis in accordance with *Hungerfords* instead of s.57 of ICA even though s.57 is to provide an exhaustive interest remedy. It might be argued that once the accurate amount of the loss of the use of money could be properly proved, the “interest” should also be regarded as a part of the damage and that understanding it in that way might be the only way to reconcile s.57 of the ICA and *Hungerfords*.

While there is only a claim for the loss of the use of money without clear reference to the way in which the money should have been used, then the statutory interest would be the appropriate remedy;⁵⁰⁸ and as to the interest, the insurer could only argue on two grounds: one is, based on the wording of the policy and market practice, to convince the court to extend the period for investigation, and the other is to blame the assured for his own delay.⁵⁰⁹

⁵⁰⁷ 93 ALR 592.

⁵⁰⁸ This argument seems to be consistent with the *obiter* in *Elders Ltd v. Swinbank* (2001) 11 ANZ Ins Cas 61-496 at para 11; as to the availability of compound interest, see *Hannover Life Assurance v. Membrey* [2004] FCA 1095 and *Dumitrov v. S C Johnson & Son Superannuation (No.2)* (2007) 14 ANZ Ins Cas 61-722.

⁵⁰⁹ In the latter kind of argument, interest (statutory interest or “*Hungerfords* damage”) would be assessed on a causation basis.

5.1.24 Notably, based on the application of the ICA 1984, if the Act does not apply there will be no room for s.57. For example, the Act does not apply to a marine insurance claim which is regulated by the Australian Marine Insurance Act 1909 (the MIA 1909) and where it is a claim made by the assured against the broker for non-placement of the insurance s.57 does not apply, because it is not a claim under insurance contracts, even if the amount for payment is calculated on the “prospective insurance” basis.⁵¹⁰ Additionally, once the obligation of payment turns into an obligation to reinstate, the issue of interest will not arise, but if the insurer unreasonably delays the election the obligation under the duty of good faith will make the insurer liable to pay for damage caused thereby.⁵¹¹

5.1.25 Along with the common law and statutory regulation of interest, the calculation of the starting date of interest has also been reviewed by Australian courts several times in a few decades.

In *Bankstown Football Club v CIC Insurance Ltd*⁵¹² the High Court of Australia had a chance to review the standard of a reasonable period for an insurer to handle the claim and its connection with the duty of utmost good faith. The High Court restored the trial judgment delivered by Cole J and agreed unanimously that

“A reasonable period is to be given to the insurer to investigate and determine its position but if it adopts an incorrect position in relation to its obligation to pay under the policy, that, in my view, does not mean

⁵¹⁰ See *Sutton* (4th edition, Thomson Reuters Australia, 2014), at para 16.69; for English examples, see *Eurokey Recycling Ltd v Giles Insurance Brokers Ltd* [2014] EWHC 2989 (Comm) and *Arbory Group Ltd v West Craven Insurance Services* [2007] Lloyd's Rep IR 491.

⁵¹¹ For a recent example, see *K & M Prodanovski v. Calliden Insurance* [2012] NSWCA 117.

⁵¹² [1997] HCA 2.

that simply because that incorrect position is adopted on a *bona fide* basis, it becomes reasonable for the insurer to decline to pay the sums otherwise due.”⁵¹³

Accordingly, it is safe to conclude that in Australia once the insurer’s defence is rejected by the court, however reasonably reached at the time of denying liability under its policy, the reasonableness would be decided by the court rather than the insurer itself⁵¹⁴ and the insurer’s behaviour could not be used as a barrier to the obligation for the late payment.

This understanding is also correct in awarding interest: s.57 (2) of the ICA rules that the insurer’s liability to pay interest arises once a reasonable period has elapsed and that reasonable period is also to be decided by the court using the same principle.⁵¹⁵ Additionally, as to the liability to pay interest, the insurer is in a worse position: sometimes the insurer has no financial resources to perform the contractual obligation due to the late payment of the reinsurer, but this fact does not stop the counting of interest⁵¹⁶ and the insurer could not claim interest from the reinsurer as the ICA is inapplicable to reinsurance contracts.

5.1.26 In *Nguyen v. QBE Insurance Ltd*⁵¹⁷ the Australian court found a chance to illustrate how the interest could be awarded when a third party beneficiary was

⁵¹³ Judgment cited with approval by Brennan CJ, Dawson, Toohey and Gummow JJs.

⁵¹⁴ See also *Diosdado Sayseng v Kellogg Superannuation Pty Ltd* [2007] NSWSC 857, at [7].

⁵¹⁵ See *Mutual Community General Insurance Pty Ltd v. Khatchmanian* [2013] VSCA 144 and see also *CIC v. Bankstown Football Club* [1997] HCA 2.

⁵¹⁶ See *Sutton* (4th edition, Thomson Reuters Australia, 2014) at para 16.61, for a further discussion see ALRC Report No.20, available on

<http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/lawreform/ALRC/1982/20.html?stem=0&synonyms=0&query=law%20reform%20insurance%20contracts>, accessed on 11th Nov 2014, at para 324.

⁵¹⁷ [2007] SASC 454.

involved. In that case Nguyen, a 20-year-old boy was stabbed and became a paraplegic in a function where the security service was provided by H, and QBE was the liability insurer of H. In the claim against H, Nguyen was awarded \$2,823,700 (the principal sum) in a default judgment and then H became bankrupt; the QBE policy was subsequently assigned to Nguyen and in an earlier decision it was held that QBE was liable to indemnify the principal sum.⁵¹⁸ Nguyen then claimed in that case for the interest over the principal sum in accordance with s.57 of the ICA.

It was argued by QBE that firstly Nguyen was not a person who was entitled to payment under a contract of insurance and accordingly s.57 of the ICA was not applicable; should that argument be wrong, QBE insisted that the right to interest under s.57 could not be assigned in alternative.

Duggan J, who was in favour of Nguyen, refused both arguments. The judge held that in the present case, s.57 had to be explained widely and he found Nguyen was within the literal meaning of s.57 (1);⁵¹⁹ the judge also stated that one of the main purposes of s.57 was to provide interest so as to deter any unreasonable delay in performing the contractual obligation to indemnify and the present case clearly fell within such scope. Accordingly, Duggan J further expressed a view that Nguyen's right to claim interest came from the assignment of the right to be indemnified and the fact that the original assured was liable for the damage; in conclusion, the judge held that Nguyen was the right person to

⁵¹⁸ See *Nguyen v. QBE* (2007) 23 (2) ILB 31.

⁵¹⁹ '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'; emphasis added.

claim interest under s.57 of the ICA and His Honour continued to deal with the quantity of interest.

The default judgment between the original assured and Nguyen was entered on 30 July 2002; the same day Nguyen sent the judgment to QBE and QBE denied its liability under the policy. Accordingly, it was found by the judge that at that date QBE was aware of its liability and the principal sum and even though the policy was assigned to Nguyen later, the interest started to run from 31 July 2002. As to the type of interest, Duggan J confirmed that the court had discretion to make it compound interest, but in that case there was no basis for doing so.

The impact of this case is significant: it firstly confirmed that, according to a wide interpretation of s.57, the assignee of the policy has the right to claim for the interest.⁵²⁰ More importantly, it expresses a clear and robust attitude by the Australian court towards the insurer's obligation to make payment: that obligation is of primary force and could not be affected by a proper assignment and it could give rise to the statutory interest which could not be stopped or suspended by assignment either. Additionally, once the insurer denies liability under the policy it becomes the insurer's risk for the interest afterwards, because the law will regard the denial as a signal of the completion of the investigation.⁵²¹

Unlike Australian state legislations and the Supreme Court Act 1981 in England, interest under s.57 starts to run whenever the payment should have been made, no matter whether there is litigation or not, and the only way to stop or postpone

⁵²⁰ See also *Sutton* (4th edition, Thomson Reuters Australia, 2014) at para 16.61, it was also suggested silence could be caught by s.57 of the ICA, see *Moss v. Sun Alliance* 93 ALR 592.

⁵²¹ See *Legal & General Insurance Australia Ltd v. Eather* (1986) 6 NSWLR 390, see also *Sutton* (4th edition, Thomson Reuters Australia, 2014), at para 16.64.

the clock is to persuade the court that there is a reasonable ground for paying late⁵²² but the insurer's lack of funding is not a justifiable ground.

Before s.57 (4)⁵²³ was added into the statute, it was unclear about how to deal with the conflict between the ICA 1984 and the law from each state,⁵²⁴ but with such amendment, it is now clear that the rate of the statutory interest is to be decided in accordance with regulations and the ICA 1984 is the only applicable law on statutory interest.⁵²⁵

Therefore, the Australian understanding is clearer: the insurer's primary obligation under the contract is to make payment and once the insurer fails to do that within reasonable time interest will start to run and damages may be incurred.

(3) Academic views

5.1.27 After reviewing the comparative approach taken by Australian law, it is appropriate to discuss academic views in English law as they carry great value when the current legal position is uncertain. In the academic world, it is almost unanimously believed that the default position in an indemnity insurance claim is that the interest should not run until a reasonable period for investigation has been exhausted by the insurer, just as with the current legal position of Australia.

In *Halsbury's Law of England* it is suggested that

⁵²² For example, grounds such as the complexity of the case and the lack of co-operation of the assured: *CIC v. Bankstown* [1997] HCA 2.

⁵²³ This section applies to the exclusion of any other law that would otherwise apply; in s.57(5) the "law" is defined as statutes of the Commonwealth, State, Territory and rules from common law or equity.

⁵²⁴ See *Manchester Unity Total Care Building Society v. MGICA Ltd* (1991) 6 ANZ Ins Cas 61-062, where s.57 was denied because of the inconsistency with the state legislation.

⁵²⁵ See also *Sutton* (4th edition, Thomson Reuters Australia, 2014) at para 16.62.

“If the insurers have reasonably required an opportunity of deciding whether to meet a claim, it seems that interest will be awarded only from the date by which they have enjoyed such an opportunity.”⁵²⁶

It is also pointed out by Andrew Pincott of Elborne Mitchell that

“...a court would not award interest from the date of the assured’s loss itself, but rather would postpone the running of interest until the date at which the insurer had been given a reasonable opportunity to consider the claim.”⁵²⁷

The same conclusion is also reached in *MacGillivray on Insurance Law*⁵²⁸ that an interest-free period should be granted to the insurer for a reasonable investigation.

Professor Rob Merkin also makes a same conclusion by stating that

“Although the Court undoubtedly has power to award interest starting from the date of loss in insurance cases and is still likely to do so in straightforward cases, there are several instances in reported cases where interest has been awarded from a later date, so as to allow a reasonable time for investigation by the insurer after notification of the assured’s claim before interest starts running.”⁵²⁹

⁵²⁶ *Halsbury’s Law of England*, (4th ed, LexisNexis Butterworths), at vol 25, para.203.

⁵²⁷ Andrew Pincott of Elborne Mitchell, ‘Claims- Interest On Claims, Insurance Law Monthly’, (2000) 12 ILM 6 4.

⁵²⁸ Professor John Birds; Simon Milnes; Ben Lynch, *MacGillivray on Insurance Law*, (9th edn, Sweet & Maxwell), at para.19-62.

⁵²⁹ See *Arnould* (18th edn, Sweet & Maxwell), at para.12-05.

However, it might be argued that even though the learned professor stated that in “straightforward cases” the starting date of interest would match with the date of the cause of action in current law (the date when the insured risk happens), there is no reported case on that point; and it could also be argued that “straightforward cases” will not go to the court. This argument is supported by Professor Malcolm Clarke, who summarizes the exceptions in awarding interest with the approval of *Kuwait v. Kuwait (No.3)* and states that the starting date of interest will not run until a notice is given, because

“The defendant insurer neither knew, nor reasonably could have been expected to know, that the plaintiff was likely to make a claim.”⁵³⁰

5.1.28 It has been mentioned that in this work the focus is put on indemnity insurance, however, as to the award of interest it is nevertheless appropriate to make cross-reference from contingency insurance.

It is common ground now that the payment under a contingency insurance contract is a contractual debt, and therefore the claim could be made as a claim to recover the liquidated debt stated in the insurance policy. Additionally, once the contingency insurance claim is paid late, the assured will have a cause of action for the damages caused by the late payment of debt. Since it is clear that the word “damages” is used here the assured’s claim will not be limited by the insured sum: according to the principle of compensation the assured could not only recover the insured sum but also the damages caused by the late payment.

⁵³⁰ See M. Clarke, *The Laws of Insurance Contracts*, (4th Edition, Informa, 2002) at para.30-8B.

However, it needs to be noted that in a contingency insurance claim the interest would be awarded in two ways: one is the statutory interest which is to be used as a way to compensate the loss of the use of the money, which is the same as an indemnity insurance claim; the other is interest on borrowed money as damages⁵³¹ and this could be named as the common law interest which is in fact a payment of damage rather than “real interest”, and according to the powerful *obiter* in *Sempra Metals* that once there is a lack of a clear clause on interest between the assured and the third party, the common law interest should be awarded on a compound basis to reflect commercial reality. Additionally, it should be noted that there would be an overlap in the statutory interest and the common law interest and the common law interest should have the priority while the statutory interest, after the common law interest is awarded, will be adjusted by the court applying its discretion.⁵³² As to the statutory interest the contingency insurance claim shares the same principle with the indemnity insurance claim, and as to the common law interest it would be calculated by reference to the rule in *Hadley v. Baxendale*.

Accordingly, it seems that the rules on contingency insurance sound far more logical than indemnity insurance and therefore, one question has to be asked: is it appropriate to apply the rules of contingency insurance to indemnity insurance? *Prima facie* a negative answer is to be given because it has been emphasized in this work that, unlike contingency insurance, the payment in indemnity insurance is damages rather than debt, and there is

⁵³¹ See *Trans Trust SPRL v. Danubian Trading Co Ltd* [1952] 2 QB 297.

⁵³² See Supreme Court Act 1981, s.35A.

no room for common law interest because the common law interest is in fact damage; but what if the current understanding on indemnity insurance is changed, and once it is changed will there be a better understanding? According to the interpretation of the function of the implied obligation in the Enterprise Act 2016, which is to replace the insurer's obligation from holding the assured harmless by paying a contractual indemnity, it seems that a positive answer may be given after the Bill is actually enacted.

(4) A better understanding?

(a) The problem under current law

5.1.29 It has been pointed out that under current law, the starting date of interest seldom matches the date when the cause of action arises, and instead, the date is usually postponed twice: firstly the date will be postponed until the notice of the claim is sent to the insurer and this postponement seems to be justified by *Firestone and BP v. Hunt (No.2)*⁵³³.

However, it needs to be pointed out that the insurance contract is not the same as other types of contracts in English law, a bill of lading for example. In a bill of lading contract once a consignee asks for delivery without a bill of lading he is well aware or could be reasonably expected to be aware that there would be a claim against him; but in most, if not all, insurance cases insurers could not know about the claim unless the assured notifies the insurer. Therefore, the exception, *prima facie*, could apply to each and every insurance claim and that fact could make an insurance claim isolated from other contracts and also make the

⁵³³ [1979] 1 WLR 783.

exception become the normal situation and a practical routine. This is very much like the illusory definition of “hold harmless” which also makes the insurance contract isolated from other contracts and anomalous.

Secondly, in most cases the court would also grant an interest-free period for reasonable investigation and this postponement could be justified by the discretion granted by s.35A of the Supreme Court Act 1981. However, this discretion is somehow in conflict with the right approach provided by May LJ in *The Popi M* as the judge pointed out that

“... after a claim has been ultimately admitted or proved after litigation... in law insurers had been liable to pay the admitted or proved amount from the date for the loss and that *prima facie* at least interest should be awarded accordingly.”⁵³⁴

Additionally, the discretionary power granted by the statute could hardly be challenged,⁵³⁵ even if the deviation from common law in the first trial is unjustifiable.

(b) The proposed solution

5.1.30 It could be well noted that even though the current law on interest seems to be unfair and unclear, these problems have their legal basis, either from statute⁵³⁶ or from common law⁵³⁷. However, it needs to be remembered that all these cases mentioned above are decided under an unsupported and

⁵³⁴ See *The Popi M* [1984] 2 Lloyd's Rep. 555 at p.561.

⁵³⁵ For example, see *Adcock v. Co-operative Insurance Society Ltd* [2000] Lloyd's Rep IR 657.

⁵³⁶ Namely, the discretion power granted by s.35A of the Supreme Court Act 1981.

⁵³⁷ Namely, the exceptions approved in *Firestone* [1975] 1 WLR 819, *BP v. Hunt (No.2)* [1979] 1 WLR 783 and *Kuwait v. Kuwait (No.3)* [2000] Lloyd's Rep IR 678.

anomalous legal fiction: the primary obligation of the insurer is to prevent the loss suffered by the assured and therefore once the loss occurs the insurer breaches that obligation and therefore the cause of action arises at the same time.

In chapter 2 of this work, it has been discussed that this legal fiction should no longer stand and the primary obligation of the insurer should be replaced by a more realistic one, namely to pay a valid claim after the happening of the loss in a reasonable time. That approach could also provide assistance to the court when applying the discretion in awarding interest and it will make a new rule which is the same as the rule in contingency insurance claims and is more reasonable.

Firstly, each and every assured understands that the insurer will not pay a claim unless and until the insurer knows that there is a claim or potential claim; therefore, the assured must understand that, by delaying the notification, the loss of the use of the money is caused by the delay of the assured rather than the insurer; this understanding makes more commercial sense than the current law. Additionally, it could find support from the changed legal understanding: the period spent in giving the notice should not be counted as an exception in awarding interest because during that time the cause of action has not occurred when the insurer's primary obligation is regarded as one to pay a valid claim.

Secondly, once the assured makes a claim, without special terms⁵³⁸ in the contract or special requirements in regulations,⁵³⁹ it should be presumed as the

⁵³⁸ Once the primary obligation is regarded as one to pay a valid claim, the contractual clause in *Tonkin* might be presumed as an agreement of advance payment.

common knowledge of the assured that the payment will not come as soon as the claim is given to the insurer, and there will always be an interest-free period for the insurer to make reasonable investigation and adjustment. The discretion granted by the statute should be used in deciding whether the actual time spent in assessing the claim and in making an investigation is reasonable; once it is not, the court could fix the starting date of interest before the date of the actual payment, but after the date when the notice is made. Additionally, this approach does not mean to reduce the discretionary power as the court could also decide the fact that, if the claim was properly made, it could draw an inference as to the intention of a reasonable insurer. Therefore, it is important for the assured to know that even if there is an intention to reach a settlement with the insurer, it is better to give an official claim notice and the words such as “without prejudice” should be put into settlement claims.

Thirdly, it should be noted that those two points mentioned above also support the understanding of the effect of the Enterprise Act 2016 and once the payment under an indemnity insurance claim is deemed as a payment of contractual debt the court will then award compound interest in certain cases according to *Sempra Metals* and therefore the blot on English common law shall be removed in full.

Additionally, this understanding has another advantage: once the insurer’s obligation is accepted to be “paying a valid claim within reasonable time” by law the late payment, especially the unreasonable delay, could be clearly regarded

⁵³⁹ For example, see the Australian General Insurance Code of Practice, where advance payment is available when certain conditions are met.

as a “wrong-doing” and that understanding could open a very important door for the future: restitutionary interest and even though there is no clear authority which decides that the assured could not make a claim of restitution for interest it might be argued that even under current law the assured should be entitled to do so as a last resort.

5.2 The restitutionary interest

(1) An inspiration from the rate of statutory interest

5.2.1 It shall be remembered that the rate of the statutory interest is also a matter of discretion and the court is granted such power by s.35A (1) and (6) of the 1981 Act; and since it has been widely accepted that the award of statutory interest is not a matter of punishment but of compensation to the assured for the loss of the use of the money⁵⁴⁰ the court has to consider the appropriate interest rate with commercial rates offered by banks and therefore two types of widely used rates are often provided by parties in disputes: prime rate and interbank offered rate.⁵⁴¹ The position was summarized by Steyn J (as he then was) in *Banque Keyser Ullman SA v. Skandia (UK) Insurance Co Ltd*⁵⁴² that

“The selection of an appropriate interest rate is a matter of discretion.

But it is not an entirely open textured discretion”⁵⁴³

In *Tate & Lyle Food and Distribution Ltd v. Greater London Council*⁵⁴⁴ Forbes J held that

⁵⁴⁰ For example, see *The Popi M* and *Kuwait v. Kuwait (No.3)* [2000] Lloyd's Rep IR 678.

⁵⁴¹ The prime rate is preferred by the assured while the interbank rate is preferred by the insurer.

⁵⁴² The decision on interest was unreported, December 1987.

⁵⁴³ *ibid.*

“...interest is intended to reflect the rate at which the plaintiff would have had to borrow money... The correct thing to do is to take the rate at which plaintiffs in general could borrow money... If commercial rates are appropriate I would take 1 per cent over the minimum lending rate as the proper figure for interest...”⁵⁴⁵

This approach was also accepted by Steyn J in *Banque Keyser* and Langley J in *Kuwait v. Kuwait (No.3)*⁵⁴⁶ but it was held by Langley J that, based on the evidence of the case, the assured was able to raise a loan with the US Prime Rate and therefore there would be no need for the court to find the minimum commercial rate and add 1 percent and accordingly Langley J awarded the interest at the rate of the US Prime Rate directly.

5.2.2 It should be noted that the rate of interest is more economical than legal and therefore the general legal position could hardly be summarized since the rate of interest has to be decided in accordance with the general economic environment during a specific time, the economic position of the claimant and the special facts of each case; however, the leading guideline was provided by Steyn J (as he then was) in *Banque Keyser* case, in which he expressed the view that

“The purpose of an award of interest is to achieve *restitutio in integrum* (restitution to the original position).”⁵⁴⁷

⁵⁴⁴ [1982] 1 WLR 149.

⁵⁴⁵ *ibid*, at p.154.

⁵⁴⁶ [2000] Lloyd's Rep IR 678, at p.692.

⁵⁴⁷ unreported, December 1987.

However, even though the court could obtain guidance from commercial rates from banks, restitution could not be fulfilled by using the statutory interest, because even if the claimant borrows the money from the bank at the prime rate and that rate is also awarded by the court, there is still a gap: the money borrowed by the claimant from the bank is calculated by the **compound** prime rate whilst the interest awarded by the court is on the **simple** prime rate; and more importantly, before the changing of the primary obligation of an indemnity insurer that situation would not change.

Additionally, the definition of statutory interest also sounds like compensation for a restitutionary claim: it is not based on fault nor is it a form of punishment. However, the words in the statute are clear: no compound interest could be awarded by way of statutory interest and in order to achieve the purpose of restitution another proposed type of interest might be suitable for further consideration: interest-based restitutionary claims.

(2) An inspiration from *Sempra Metals*

5.2.3 It has been widely accepted that after *Sempra Metals* compound interest could be awarded for late payment of debt, while the indemnity insurance claim is a claim for damages and therefore *Sempra Metals* could not apply to insurance claims directly. However, it needs to be remembered that in *Sempra Metals* the claim was advanced in restitution as well and in fact the House of Lords decided the case on the ground of restitution and what was commented about debt could only be regarded as a powerful *obiter*.

In *Sempra Metals* it was decided that the advanced payment wrongfully withheld by the IRC was in fact a massive interest-free loan and it was held by Lord Hope that

“...there can be nothing unjust about requiring the Inland Revenue to pay compound interest...on the huge interest-free loan constituted by Sempra’s payment of ACT.”⁵⁴⁸

Therefore, in indemnity insurance claims, it could be argued that once a reasonable period of investigation is exhausted, the insurer is in fact holding the sum payable under the policy and no wonder that the sum withheld by the insurer is very much like the interest-free loan in *Sempra Metals* and, *prima facie*, there should be no reason to reject the restitutionary claim for compound interest by the assured based on the House of Lords decision in *Sempra Metals*.

Additionally, it has been widely accepted as well that restitutionary claims could be made in cases of multi-causality: they could be made for unjust enrichment as well as wrongdoings,⁵⁴⁹ and once the current unclear position towards the primary obligation of the insurer is changed it could be argued that the assured could make a claim based on the wrongdoing of the insurer once the payment is unreasonably delayed and a claim based on unjust enrichment if the insurer does nothing wrong.

It needs also to be pointed out that once the payment should have become due, even if it later turns out that no actual profit is made by the insurer, it could

⁵⁴⁸ See *Sempra* [2007] UKHL 34, at [118] per Lord Nicholls.

⁵⁴⁹ See James Edelman, ‘The measure of restitution and the future of restitutionary damages’, *Restitution Law Review*, v.18, 2010 Autumn, p.1-13.

nevertheless be argued that the free use of the sum owed to the assured is a kind of benefit and therefore the restitutionary claim should be supported because the possession of the money is itself a benefit.

5.2.4 Even under current law, there is no reported case to support the argument that the assured should have a chance to raise a restitutionary claim; there are, however, *obiters* from which this argument could find support: firstly, as it has been argued above, it was pointed out by Steyn J that interest itself was a restitutionary award; additionally support could also be found in the speech presented by Lord Walker, who observed that there were different types of claims of restitution, especially

“... (2) personal claims for an account of profits (that is, for a sum equal to the profits actually made by the defendant) and (3) personal claims for interest which represents (in a more or less conventional way) the benefit which the defendant is presumed to have derived from money in his hands...”⁵⁵⁰

It has been stressed at times in this chapter that even under the current law statutory interest is widely accepted to be the money used for compensating the loss of the use of the principal sum by the assured, and therefore, it could be found that there will be an overlap in restitutionary interest and statutory interest: both of them could be used as the compensation for the claimant but the statutory interest is calculated by the “loss suffered” by the claimant while the restitutionary interest is calculated by the “benefit enriched” by the defendant,

⁵⁵⁰ See *Sempra Metals* [2007] UKHL 34 at [180].

and there is no reason why statutory interest is widely accepted and restitutionary interest is refused.

Additionally, under current law, there is no contractual obligation for the insurer to pay the claim within a reasonable time, but once the payment is delayed no one could deny the fact that the money that should have been obtained by the assured is actually withheld by the insurer and therefore an equitable claim for restitution should be allowed.

It might also be noted that due to defects in s.35A of the 1981 Act, the restitutionary function could not be achieved in full by statutory interest, while the restitutionary interest has no such limitation: by rejecting the limitation in *Westdeutsche Landesbank Girozentrale v. Islington LBC*⁵⁵¹ the House of Lords in *Sempra Metals* held that the restitutionary interest could be awarded in the exercise of the court's common law restitutionary jurisdiction and the court's discretionary equitable jurisdiction in order to provide full compensation to the claimant.

Therefore, it might be suggested that once the restitutionary interest is awarded and the court is satisfied that the compensation made from the restitutionary interest is enough the court could, based on the discretion granted by s.35A of the 1981 Act, refuse to award further statutory interest.

However, this approach does not mean that discretionary interest is abolished. It was decided in *Sempra Metals* that in order to apply for the restitutionary interest the claimant had to plead and prove the loss. Therefore, the statutory interest

⁵⁵¹ [1996] AC 669.

could still remain as the bottom line as a constructive legal remedy once the claimant could not plead or prove the amount suffered by the loss of the use of the money.

(3) The measurement

5.2.5 It has been discussed above that under current law restitutionary interest might be awarded for the assured and once the law is changed, namely when the Enterprise Act 2016 comes into force, restitutionary interest should be awarded for the assured. Therefore, it is of importance to discuss the measurement of restitutionary interest. Before starting the discussion, one important distinction should be made in the first place: restitutionary interest is not the same as the interest awarded by Lord Denning MR in *Danubian*⁵⁵² because restitutionary interest has no element of damages.⁵⁵³

However, it is not easy to measure restitutionary interest as it might be measured either by restitution for unjust enrichment or restitution for wrongdoing⁵⁵⁴ and it is suggested that the award made for restitution for wrongdoing should be counted as “restitutionary damages”.⁵⁵⁵ It was pointed out by Lord Hope that

“...the remedy of restitution differs from that of damages. **It is the gain that needs to be measured**, not the loss to the claimant. The

⁵⁵² See para 4.2.1 of this work.

⁵⁵³ This argument is also supported by Lord Walker in *Sempra* [2007] UKHL 34.

⁵⁵⁴ Differences between these two options were talked and discussed in *Sempra Metals* by Lord Nicholls (at [116]), Lord Scott (at [132-146]) and Lord Mance (at [230-231]).

⁵⁵⁵ See James Edelman, ‘The measure of restitution and the future of restitutionary damages’, *Restitution Law Review*, v.18, 2010 Autumn, p.1-13.

gain needs to be reversed if the claimant is to make good his remedy.”⁵⁵⁶

Therefore, the difficulty in the measurement of restitutionary interest is in fact the measurement of the “gain” of the insurer.

According to *Sempra Metals* two ways of measurements are to be chosen: one is the actual profit made by the insurer and the other is the constructive profit that “should be made” by the insurer. Additionally, it is suggested that both of them belong to the idea of “the immediate gain”⁵⁵⁷ and once the assured makes the restitutionary claim due to the insurer’s wrongdoing the court would award the constructive profit rather than the actual profit.

In *Strand Electric and Engineering Co Ltd v. Brisford Entertainments Ltd*⁵⁵⁸ it was held by Denning LJ that the restitutionary award for wrongdoing focused upon the objective benefit to a person in the defendant’s position rather than the actual benefit received by the defendant or the loss suffered by the claimant. That decision was approved by Brightman J in *Wrotham Park Estate Co v. Parkside Homes Ltd*⁵⁵⁹ and *Sempra Metals*.

5.2.6 However, this is not the end of the discussion on restitutionary interest, as a restitutionary claim could also be made as a profit-stripping claim which will focus on the actual profit received by the insurer and this claim is described as

⁵⁵⁶ See *Sempra Metals* [2007] UKHL 34 at [28], emphasis added.

⁵⁵⁷ See James Edelman, ‘The measure of restitution and the future of restitutionary damages’, *Restitution Law Review*, v.18, 2010 Autumn, p.1-13.

⁵⁵⁸ [1952] 2 QB 246.

⁵⁵⁹ [1974] 1 WLR 798.

“disgorgement damages”.⁵⁶⁰ This argument is supported by an old *obiter* in *Livingstone v. Rawyards Coal Company*⁵⁶¹ by Lord Blackburn that the disgorgement damages could be decided

“...by the consideration whether the damage has been maliciously done, or whether it has been done with full knowledge that the person doing it was doing wrong. There could be no doubt that there you would say that everything would be taken into view that would go most against the wilful wrongdoer...”

In that case the respondent mined under the appellant’s land innocently but caused no damages and the court only awarded nominal damages. However, based on the *obiter* quoted above, the House of Lords suggested that once bad faith or sinister intention was found the full profits would be returned to the appellant as the disgorgement damages.

Caution is needed when considering the disgorgement damages as even though the word “damages” is used here, the disgorgement damages is not the same as the real damages in *Hadley v. Baxendale*.

This difference was noticed by Arden LJ in *Devenish Nutrition Ltd v. Sanofi-Aventis SA*⁵⁶² where Her Ladyship refused to award the disgorgement damages as *Hadley v. Baxendale* damages would be an adequate remedy in that case.

⁵⁶⁰ See James Edelman, ‘The measure of restitution and the future of restitutionary damages’, *Restitution Law Review*, v.18, 2010 Autumn, p.1-13.

⁵⁶¹ (1880) 5 App Cas 25.

⁵⁶² [2008] EWCA Civ 1086.

The disgorgement damages was also noted by Lord Nicholls in *Attorney General v. Blake*⁵⁶³ where his Lordship held that the disgorgement damages would not be available if other remedies such as damages, specific performance and injunction were adequate.

In *Greenwood v. Bennett*⁵⁶⁴ S promised to B that he would repair the car owned by B for £85 but fraudulently sold the car to H. H bought the car in good faith and spent a reasonable sum of £226 to repair the car. It was held by the court that once the car was recovered by B he was unjustly enriched by £226 and therefore Lord Denning MR awarded £226 as the restitutionary award for unjust enrichment.

Based on that case, a deviation should be made here in order to consider a situation in which the insurer withholds the money in good faith and therefore believes that the assured's claim is invalid but this belief is subsequently held by the court to be wrong. Generally speaking, in that case the court could refuse to award the restitutionary interest, but the statutory interest could nevertheless be awarded, because objectively speaking the assured is still deprived of the use of the money.

It is also suggested by James Edelman that the award of disgorgement damages is of great importance when normal remedies are inadequate to deter breach,⁵⁶⁵ but under current law in insurance this argument will fail as there will be no breach even if the insurer intentionally withholds the money. Therefore,

⁵⁶³ [2001] 1 AC 268, for recent examples, see *One Step (Support) Ltd v. Morris-Garner* [2014] EWHC 2213 (QB), *Stretchline Intellectual Properties Ltd v. H&M Hennes & Mauritz (UK) Ltd* [2016] EWHC 162 (Pat).

⁵⁶⁴ [1973] QB 195.

⁵⁶⁵ See James Edelman, 'The measure of restitution and the future of restitutionary damages', *Restitution Law Review*, v.18, 2010 Autumn, p.1-13.

under current law a better understanding would be that restitutionary interest would be allowed only in the name of wrongdoing or unjust enrichment and therefore the award would be quantified by the constructive amount rather than actual profit.

However, once the current law is changed into a better position, namely when there is a contractual obligation of the insurer to make the payment within a reasonable time, it could be appropriate for the assured to claim the disgorgement damages in order to deter the breach.

5.3 Conclusion

5.3.1 According to all the discussion above, it can be seen that the award of interest is not a simple issue due to the different understanding of the nature of statutory interest and restitutionary interest and it needs to be pointed out that these two kinds of interest should be awarded at the same time but once the restitutionary interest is awarded the court may reduce the amount of statutory interest.

As to the statutory interest, the starting date of the interest is seriously affected by the current unprincipled understanding of the primary obligation of the insurer and therefore the award of statutory interest in indemnity insurance cases has deviated from general principle and in order to reach a better understanding the current law should be changed according to the new Enterprise Act 2016 and therefore it could be assumed that the application of the statutory simple interest shall be limited while the common law compound interest according to *Sempra Metals* could be more suitable.

As to restitutionary interest, since there is no contractual obligation of the insurer under current law to make the payment in reasonable time, the fact that the insurer wrongfully withholds the money should constitute an equitable right of the assured to claim restitutionary interest but there is no reported case on this point and therefore the argument will remain academic.

5.3.2 In light of the enactment of the Enterprise Act 2016, the issue about the interest in indemnity insurance could be deemed as settled by the new legislation, however, it should also be remembered that not all indemnity insurance disputes will be referred to court: a great number of insurance disputes are subject to arbitration, settlement and other alternative disputes resolutions. The legal position of arbitration has been introduced and discussed in this work and it is clear that the discretionary power of an arbitrator is greater than a judge. In the next chapter, other alternative dispute resolutions will be discussed among which the Financial Ombudsman Services (FOS) in this country and the comparative Australian General Insurance Code of Practice (GI COP) are of great importance.

Chapter 6 FOS and other remedies

6.1 Financial Ombudsman Service (FOS)

6.1.1 It has been pointed out by the Law Commission that “contracts of insurance are ultimately contracts based on trust”.⁵⁶⁶ Unlike other contracts such as a sales contract, the assured pays the premium to the insurer not for goods, but for the promise that the agreed payment should be made when the insured risk occurs; the Law Commission recommends that in addition to changing the legal position about the primary obligation of the insurer, other remedies also play very important roles when damage to the assured is caused by the late payment of the insurer.

In chapter 4 and chapter 5 one of the most important remedies, interest, (common law, statutory or restitutionary) has been fully introduced and discussed and it needs to be noted that there are some other remedies which are still available to the assured other than interest and these remedies have been introduced by the Law Commission⁵⁶⁷ as well.

Therefore, in this chapter other remedies will be introduced and discussed with the guidance laid down from the Law Commission Paper.

Among all the other remedies, the FOS is the most important one for small businesses and the natural person. Technically, FOS is not a “remedy” but an “alternative dispute resolution (ADR)” and in the first part of this chapter, FOS and insurance disputes will be discussed.

⁵⁶⁶ Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (n.106), at para.4.81.

⁵⁶⁷ *ibid.*

(1) FOS: the historical development

6.1.2 In 1981 an organization named the Insurance Ombudsman Bureau (the IOB) was established voluntarily by some insurers from the market and subsequently more insurers joined the organization and became members of the IOB. The main purpose of this organization was to provide an alternative dispute resolution for the assured against the member in an independent, cheap, fair, and reasonable way. The dispute between the assured and the member could be dealt with by the board of the IOB and there was no charge to the assured, who was also known as the complainant in the IOB dispute resolution.

Among all ADRs such as arbitration, the IOB had the most significant feature: the claim was not necessarily to be solved on a legal basis; in other words the claim could be decided based only on the market practice and the special facts of the claim; additionally, in *R v. IOB, ex parte Aegon Life Assurance Ltd*⁵⁶⁸ it was even held by the court that the claim heard before the IOB could not only be solved on a non-legal basis, but was also not necessarily subject to the legal review, because of the power of the IOB came from the contract between members and the IOB.

Accordingly, the IOB was in fact a self-regulatory organization of insurers and since the IOB decisions were not bound by law the aim of flexibility could be easily reached; and since the IOB itself was an organization of insurers, which could be deemed as market specialists, the decisions could reflect the rules of the market better than judgments. It should also be noted that one of the most important aims of legal reform was to make the law more suitable for the market

⁵⁶⁸ [1994] CLC 88.

practice and, therefore, the IOB could be regarded as the “trailblazer” and the “prophet” of legal development at that time.

6.1.3 In 2000 the Financial Services Authority (FSA) was established and became the single regulator for financial activities and according to the requirement of the FSA the IOB, along with some other organizations, merged into a new scheme and that scheme was known as the Financial Ombudsman Service (FOS).

The FSA has the financial supervisory power over FOS even though the FSA and FOS are operationally independent, and according to that supervisory power the FSA has the right to approve the FOS budget and to decide the levy of the fee from FOS members.

The FOS keeps to its main aim in the same way as its predecessor, the IOB, to provide a more convenient ADR for the assured, but the jurisdiction of the FOS is considerably wider: all insurance companies are compulsorily regulated by the FOS; the complainant is no longer limited to the natural person and it could be include small businesses and charities. Additionally, in the days of the IOB, unless the beneficiary had the authorization of the assured, a to the IOB, but this situation has been changed in FOS: if the beneficiary is a person he can bring the claim without the permission of the assured complainant, as the beneficiary of the policy, while if the beneficiary is a company, the claim cannot be brought directly to FOS without the permission of the original assured.

Therefore, it can be seen that the government was satisfied with the function and activities of the IOB and has brought a wider jurisdiction to the successor of the

IOB and the role which is now played by the FOS in the insurance market becomes more and more important in insurance claims for small business and natural persons, especially consumers.

6.1.4 In December 2001 the Financial Services and Markets Act 2000 (FSMA) came into force and it became the procedural law for activities of FOS. The relevant parts of the activities of FOS are Dispute Resolution: Complaints (DISP) 2 and 3; in other words, DISP 2 and DISP 3 are the “Civil Procedure Rules (CPR)” for FOS activities. Even though the law is not binding on FOS decisions⁵⁶⁹, it does not mean that there are no general guidelines when the merit of a claim is under consideration and the most useful guideline is the Insurance Conduct of Business Rules (ICOB) which is now replaced by the Insurance: New Conduct of Business Sourcebook (ICOBS) and the general principle of ICOBS is the same as the aim of both the IOB and FOS: to reach a fair and reasonable outcome.

6.1.5 The importance of FOS and its role as the trailblazer and prophet can be found in the development of law on consumer insurance: in 1977 insurance contracts were excluded from the Unfair Contract Terms Act 1977 and the power of the arguments of by the consumer had become weaker since then. However, it was noticed by the IOB that this imbalance needed to be resolved in accordance with its leading principle that the outcome of an insurance dispute should be “fair and reasonable rather than legal” and it subsequently reflected that principle in its decisions and made recommendations to reform the law. This became a very important incentive for the Consumer Insurance Act 2012 and the

⁵⁶⁹ See *R (on the application of IFG) v. FOS* [2005] EWHC 1153.

accuracy of the IOB and FOS could be found in this well-balanced new statute. According to the new Financial Services Act 2012, which amends the FSMA 2000, the FSA has now been renamed as the Financial Conduct Authority (FCA). However, the relationship between FOS and the FCA seems to be the same as the relationship between FOS and the FSA, that is to say, FOS works independently from the FCA, but in order to carry out the function effectively, FOS needs also to cooperate with the FCA and the detail is clearly stated in the new Memorandum of Understanding.⁵⁷⁰ In other words, the general principle is that the FCA and FOS are to co-operate and communicate constructively to carry out independent roles and separate functions in order to benefit both consumers of financial services and the industry.

Even though the FCA is the regulator of the financial markets and its strategic objective is to ensure that the relevant markets function well⁵⁷¹ along with one of the operational objectives to secure an appropriate degree of protection for consumers,⁵⁷² it could not deal with individual complaints nor could it investigate such complaints, and therefore FOS has a very strong supportive role in assisting the FCA in order to make sure that the insurance market is developing a right approach. It needs also to be mentioned that, even though the FCA and FOS are independent, the FCA's supervisory power is significant, as both the directors and the chairman of FOS could be appointed or removed by the FCA,⁵⁷³ and additionally, the FCA sets rules for the compulsory jurisdiction on

⁵⁷⁰ <http://www.financial-ombudsman.org.uk/about/MOU_with_FCA-APRIL2013.pdf>, accessed on 2nd Jun 2014.

⁵⁷¹ See Financial Services Act 2012 (FSA 2012) s.1B (2).

⁵⁷² See FSA 2012 s.1B (3)(a).

⁵⁷³ The appointment or removal of the chairman must be approved by the Treasury.

complaint-handling by firms; activities covered; complainants eligible; time limits; limits on awards; and levies to cover the establishment and operation of that jurisdiction; and once the budget is approved by the FCA, it becomes the statutory responsibility for FOS to accept such budget.

Throughout the reforming and development, the function and the success of the FOS was noticed by Rix LJ who expressed a judicial view that

“For some years the insurance ombudsman (now within the FOS scheme) has been developing a new common law of insurance for consumer contracts, without which the courts would have been constrained to find, or alternatively to reject, solutions to problems from which they have been in the main shielded.”⁵⁷⁴

Additionally, the accuracy of FOS in relation to damages for late payment could also be found in the draft bill of the new Insurance Act 2015 in which the damages were originally recoverable. Even though, as was stated in the first chapter of this work, the relevant section on damages for late payment was intentionally omitted before the House of Lords, it has now been brought back in the Enterprise Act 2016.

(2) FOS and insurance claims

(a) Introduction

6.1.6 Any dispute which is brought to FOS is to be dealt with by adjudicators and ombudsmen and the way in which they deal with the claim must not only be fast,

⁵⁷⁴ *R (on the application of Heather Moor & Edgecomb) v. FOS* [2008] EWCA Civ 642, at [87].

but also fair and reasonable. These leading principles are now codified in ss.255 (1) and 228 (2) of the FSMA and DIPS 3.6.1R and 3.6.2G. It also needs to be noted that these principles are “pivotal”⁵⁷⁵ and “override the duty to decide matters in accordance with the law”.⁵⁷⁶

Accordingly, it could be found that even though the relevant law is a matter which has to be considered,⁵⁷⁷ the FOS award does not need to follow the law, and this fact also makes it clear that sometimes the current law is less helpful in reaching a fair and reasonable outcome and this is especially true when the damages for late payment is considered.⁵⁷⁸

After the establishment of FOS and completion of its regulations, FOS has become one of the most successful and busiest ombudsman services in the world and it is well ahead in its development.⁵⁷⁹ In 2012/2013 FOS took on a record 575,836 new cases in total in 2013, an increase of more than one-third of those in 2012⁵⁸⁰ and among which 49% were in favour of the complainant;⁵⁸¹ in 2014/2015 FOS answered 1,786,973 enquiries from consumers – around 5,000 each working day⁵⁸² and, excluding PPI cases, 53% of complaints were resolved within three months. In the first three quarters of 2013/2014 FOS has

⁵⁷⁵ See Dr. Judith P Summer, *Insurance Law and the Financial Ombudsman Service (Summer)*, (Informa Law from Routledge 1 Sep 2010), at para 1.8.

⁵⁷⁶ *ibid.*

⁵⁷⁷ Relevant issues which need to be considered by FOS in a dispute will be discussed later in this chapter.

⁵⁷⁸ This will be discussed in detail later in this chapter.

⁵⁷⁹ See *Summer*, (Informa Law from Routledge 1 Sep 2010) at para 2.15.

⁵⁸⁰ Stuart Collins, 'PPI compensation: Claims drive record number of complaints in 2013', Insurance Day, March 2014.

⁵⁸¹ For the sake of convenience, the assured or the relevant beneficiary from now on will be named as the complainant in this chapter.

⁵⁸² See <<http://www.financial-ombudsman.org.uk/publications/ar15/index.html#a1>>, accessed on 20th March 20, 2016.

dealt with 407,200 disputes, 58% of which were in favour of the complainant⁵⁸³ while in 2014/2015 this number was increased to 62%.⁵⁸⁴ According to this figure, it is clear that it is not that difficult for the complainant to argue that this is a “fair and reasonable” result from FOS. However, in order to present a claim before FOS several conditions have to be met and these conditions could also be seen as part of the disadvantages of FOS.

(b) The qualified claim

6.1.7 According to the rules of the Dispute resolution: Complaints (DISP)⁵⁸⁵
2.2.1G FOS will not consider a claim unless the following conditions are satisfied:

Firstly, the claimed event must have happened after 1 December 2001 because that is the date when FOS came into existence;

Secondly, the firm which the claim against must be within the jurisdiction of the FOS, as well as the claimed activity. As to the firm, the answer is straightforward because it has been mentioned above that all insurers, indemnity or contingency, in the UK are in the compulsory jurisdiction of FOS and that is the requirement made by law. It could also be presumed that, according to the general principle in company law, once the activity is done by a foreign branch of the UK insurer, the jurisdiction of FOS will bite; whereas the activity is considered to be outside the jurisdiction once it is done by a foreign subsidiary, rather than a branch.

⁵⁸³ See <http://www.financial-ombudsman.org.uk/publications/ombudsman-news/115/chart_issue115.pdf>, accessed on 6th May 2014.

⁵⁸⁴ See <<http://www.financial-ombudsman.org.uk/publications/ombudsman-news/131/issue131.pdf>>, accessed on 20th March 20, 2016

⁵⁸⁵ See <<https://www.handbook.fca.org.uk/handbook/DISP.pdf>>, accessed on 22nd Sep 2015

Additionally, if the majority of clients of a European insurance company are in the UK, that insurer could submit the jurisdiction to FOS voluntarily and therefore FOS could treat that insurer as if it were one in the UK. Additionally, according to the regulation of the FSA some activities of insurance brokers are within the jurisdiction of FOS unless

- (1) The broker is a travel agent and the policy is part of a package holiday;
- (2) The broker is handling an insurance claim on behalf of insurers under a delegated authority.

However, as to the targeted activity of the insurer the answer is less straightforward as

“...FOS will dismiss without consideration of merits a question that it considers involves a firm’s legitimate exercise of commercial judgment”⁵⁸⁶

Therefore, once the insurer increases the premium based on reasonable and legal grounds when the policy is to be renewed, that activity will not be considered on its merit by FOS; however, once the activity breaches some codes or self-regulation rules such as the ABI guideline, FOS will interfere.

Thirdly, the claim must be made by an eligible complainant and this requirement could be deemed one of the most significant disadvantages of FOS. The eligible complainant could be classified into two types: the basic complainant and the group complainant.

⁵⁸⁶ See *Sumner*, (Informa Law from Routledge 1 Sep 2010), at para 2.17.

The qualified basic complainant is developed and broadened from the IOB and according to DISP 2.7.3R it could be a person, a small business which has a turnover less than £1m and a charity. Subsequently, a small business is redefined by the Payment Services Directive⁵⁸⁷ as a business which has less than 10 staff and a turnover of less than 2m Euro.

The qualified group complainant is to some extent hard to define and according to a reported FOS award⁵⁸⁸ it was held that an employee could bring a claim against the insurer who provided a health policy for not only the complainant employee but also other employees, provided that the complainant employee could benefit from the group scheme. This issue is important as a group policy could not only cover the health of employees where the policy is a contingency one, but also properties of employees where the policy is an indemnity one and which is the main purpose of this work.

In order to decide whether the group policy is for the benefit of the employee rather than the company, FOS has to consider the operation of the policy and

“It is likely to be for the benefit of the employee if the benefits are paid or provided direct to him without the employer exercising any practical discretion over them, if the employee is involved in the claims process, and if the employer is only contractually obliged to pay benefits to the employee if the insurer accepts the claim”⁵⁸⁹

⁵⁸⁷ 2007/64/EC.

⁵⁸⁸ *Ombudsman News* Oct 2013.

⁵⁸⁹ See *Sumner*, (Informa Law from Routledge 1 Sep 2010), at para 2.14.

(c) The time bar

6.1.8 According to the requirement of DISP 2.8.1R, in order to bring a claim to FOS, the complainant has to exhaust the remedy from the insurer by its internal dispute resolution and if the argument of the complainant is rejected, the insurer is required to provide a final response to the complainant to explain the reason. According to DISP 1.6.2R a qualified final response should contain a summary of the complaint, the outcome and the investigation of the insurer as well as the insurer's acknowledgement of its own fault. If the insurer intends to make an offer of settlement, it should be recorded in the response as well. Additionally, the most important part of the final response is to remind the complainant that the dispute should be referred to FOS within six months and if the insurer fails to do so, the time bar will not apply and the assured could claim even after six months. If the insurer believes that the issue raised by the complaint is outside the jurisdiction of FOS, this issue should also be recorded in the response, but the insurer has to make it clear that the jurisdiction is to be decided by FOS rather than the insurer.

Once the complainant goes to FOS directly without exhausting the internal remedy, FOS would not reject the complaint but it would transfer the complainant along with the relevant materials to the insurer. Once the complaint is referred to the insurer, but there is no final response after eight weeks from the date of submission, the complainant can refer the dispute directly to FOS.

Therefore, it can be seen that FOS takes a strict view against the insurer's claim handling stage as the final response is in fact a requirement and a reminder that the insurer should deal with the claim in a reasonable way within a certain period

of time. Before November 2007, it was required by the FSA that an insurer needed to notify the assured that it was under the jurisdiction of the FOS, but now there is no such a requirement. This change is questionable as it in fact postpones the acknowledgment of the existence of FOS to the complaint stage; and because it is common ground that FOS is a very important remedy for an eligible complainant, without such knowledge some of the potential complainants, in fear of the strong power of the insurer, might not even raise a complaint against the insurer through its internal procedure, let alone through the FOS.

Therefore, it could be suggested that since the insurer has a better knowledge about the requirements of eligibility of a complainant to the FOS the insurer, in the underwriting stage, should have an obligation to disclose the jurisdiction of FOS if it believes that the assured is a potentially eligible complainant.

Unless there are certain special circumstances,⁵⁹⁰ the complaint to FOS will be time barred after six years after the disputed activity or three years after the date when the complainant knows or has reasonable ground to know that the complaint could be referred to FOS. Since FOS is a non-legal based service, the legal time bar will not be stopped by a complaint to FOS, even though it seems to be unwise to bring a claim to the court while the FOS is in operation.

Accordingly, once the insurer delays the payment or if the assured believes the speed for handling the claim is slow, it would be better if the assured begins the internal complaint resolution at an early stage, as it could force the insurer to speed up the process or to give a reasonable answer to the assured.

⁵⁹⁰ These circumstances are listed in DISP 2.8.5R and 2.8.6G.

(d) Dealing with the claim in FOS

6.1.9 In order to be friendlier to the eligible complainant, there is no official requirement in FOS about how a complaint should be made. A complainant could even start a complaint by telephone and the staff of FOS will send the telephone complaint form to the complainant and the latter will check the correctness and sign the form and then return it to FOS.

It has been mentioned that one of the most significant features of the FOS award is its efficiency, but in order to achieve that, FOS has to make some concessions and therefore most of the complaints are dealt with on a paper basis. It is commented by Dr. Judith P Summer that

“The FOS is a sophisticated body dealing primarily with paper claims.”⁵⁹¹

Therefore, it is understandable that FOS rarely holds oral hearings and one of the most important rationales for that approach can be found in *Heather Moor & Edgcomb Ltd v the United Kingdom*⁵⁹² a new case decided by the European Court of Human Rights where it was held that

“...the fact that proceedings are of considerable significance for an applicant ... is not decisive for the necessity of a hearing ... The court accepts that the relevant issues of fact and law could be adequately addressed in, and decided on the basis of, written submissions.”

⁵⁹¹ See *Summer*, (Informa Law from Routledge 1 Sep 2010), at para 2.34.

⁵⁹² [2011] Application no. 1550/09 ECHR.

There has been no published number of oral hearings recently, but in the FOS Annual Review 2009/10 there were less than 20 oral hearings among 166,321 resolved complaints.⁵⁹³ Recently, in *R (on the application of Calland) v. FOS*⁵⁹⁴ it was confirmed by Males J that an oral hearing had to be held only when that was necessary to determine the dispute in question.

Another concession in FOS is that it has no power for the cross-examination of witnesses, and therefore if either party believes that cross-examination is necessary the court is the better place to go.

6.1.10 Once a complaint reaches FOS it will be considered by the adjudicator and the ombudsman on its merit subject to two exceptions.

The first exception is set out in DISP 3.3.4R. Once a fair presentation is made by the complainant, orally or on paper, and the FOS believes that the case falls within one of the 18 circumstances in DISP 3.3.4R, the complaint will be dismissed without considering the merits. If the insurer wishes to avoid the FOS jurisdiction after the late payment, it will be better if a fair and reasonable settlement is provided to the complainant⁵⁹⁵ or if the insurer can prove that the late payment is still commercially reasonable.⁵⁹⁶

The other exception is that if the FOS believes that the court is the better place to go to rather than to FOS itself. This will happen when the complainant becomes a test case⁵⁹⁷ and this will be decided within the

⁵⁹³ See <<http://www.financial-ombudsman.org.uk/publications/ar10/ar10.pdf>>, at p.61, data accessed on May 13, 2014.

⁵⁹⁴ [2013] EWHC 1327 (Admin).

⁵⁹⁵ DISP 3.3.4R (4).

⁵⁹⁶ DISP 3.3.4R (5).

⁵⁹⁷ DISP 3.3.5R (2).

guidelines set out in DISP 3.3.6G⁵⁹⁸; or if the insurer promises that it will provide the legal costs to the complainant.⁵⁹⁹ However, this exception rarely happens.⁶⁰⁰

(e) The FOS award

6.1.11 In an award made by the FOS the facts and circumstances of the particular complainant will be considered on the civil law standard, the balance of probability, in order to reach a fair and reasonable outcome. It should be noted that the general principle of the IOB is maintained but with some changes because the ombudsman has to consider the relevant law and regulations and codes of practice and industry practice.⁶⁰¹ The requirement of considering relevant codes of practice and industry practice is axiomatic, as without such consideration the award could never be described as “fair and reasonable”; however, the consideration of the relevant law is a little difficult to understand because in the age of the IOB it was found that the law was unnecessary for a fair and reasonable outcome if good insurance practice was properly considered. Additionally, it needs to be noted that some ombudsmen have no legal training background and it would be difficult for them to consider the relevant law.

Therefore, Stanley Burnton J tried to solve the problem and it was held in *R (on the application of IFG) v. FOS*⁶⁰² that even though it was necessary for the ombudsman to consider the relevant law, he could deviate from the relevant

⁵⁹⁸ This is a non-exclusive list of factors.

⁵⁹⁹ DISP 3.3.5R (1).

⁶⁰⁰ See also *Summer*, (Informa Law from Routledge 1 Sep 2010), at para 2.46.

⁶⁰¹ DISP 3.6.4R, see also FSMA s.228.

⁶⁰² [2005] EWHC 1153.

legal principle, if he thought the deviation was helpful for a fair and reasonable outcome. According to this judgment, the effects of DISP 3.6.4R (1) and s.228 of FSMA are seriously diluted because the ombudsman could treat the consideration of the law as a formality; it could be stated in the FOS award that “I have considered the relevant legal principle” but in fact he has not; and since the requirement of DISP 3.6.4R (1) and s.228 of the FSMA remains in name only, there should be no problem abolishing them.

This suggestion was supported by *R (on the application of Heather Moor & Edgecomb) v. FOS*.⁶⁰³ Firstly, the Court of Appeal confirmed the *IFG* decision that a FOS award was not bound by law; secondly, it was found by the court that in the award the ombudsman stated that

“While I have taken into account the relevant law, I have determined this complaint based on what, in my opinion, is fair and reasonable bearing in mind all the circumstances of this case.”⁶⁰⁴

The Court of Appeal also found in the award that the issue on the “school of thought” was raised by the insurer before FOS and the ombudsman made some comments on that issue in the award; the Court of Appeal then satisfied itself that the ombudsman had considered the relevant law clearly.

Accordingly, it could be said that the court has a relaxed attitude towards the requirement of considering the relevant law and it could also be further argued that that requirement should be regarded as a formality. Since the FOS award is not required to be made by law, there is no reason to make the requirement of

⁶⁰³ [2008] EWCA Civ 642.

⁶⁰⁴ *ibid*, at [19].

considering the relevant law as a compulsory duty of the ombudsman. Alternatively, it would be better if the relevant law is a matter of the ombudsman's discretion and should be provided by the parties in the dispute.

6.1.12 Although currently the requirement of considering the relevant law has not caused many problems, once the jurisdiction of FOS has broadened so that more sophisticated cases can be involved then problems may appear. Therefore, it will be important to regard the requirement of considering the relevant law positively by the ombudsman as a matter of discretion, but once the relevant law is provided by the parties the ombudsman has to make a comment or explanation about whether the law is fair and reasonable for the complaint.

The *Heather Moor* case is also of great importance when damage for late payment is considered as, although apparently unfair, no damage for late payment is legally available at this moment. Even though the primary and secondary obligation of the insurer is a relevant issue which the ombudsman should consider, it is fortunate for the complainant that the ombudsman is not bound by *The Lips* or *The Fanti*, let alone the notorious *Sprung*.

6.1.13 Once either of the parties is unsatisfied with the award, a written response should be provided to the independent assessor of FOS within three months after the award. The independent assessor will not reopen the case, but he will investigate the service provided by FOS and report the proposed final award to the Chief Ombudsman. If the Chief Ombudsman does not accept the decision of the independent assessor, the award should then be made by the Board of FOS; however, it never happens in practice.

Unlike an IOB award, a FOS award could be judicially reviewed; however, a judicial review will generally focus on the way in which the award is reached rather than on the individual facts and merits of the complaint⁶⁰⁵ unless there is a serious error which deprives the award of its rationality. In *R (on the application of Garrison Investment Analysis) v. FOS* the court had a chance to reopen the case and interfere with the reasoning of the ombudsman because it was held that the award was entirely unconnected with the facts.

It is also unwise for the complainant to start a judicial review too abruptly, because, compared with FOS, the legal requirement for presenting a case is much stricter, and it is rightly pointed out by Summer that

“A common feature of these ‘failing’ cases is the judge’s criticism of the claimant’s argument, conduct, attitudes and evidence.”⁶⁰⁶

6.1.14 Recently in *R (on the application of Calland) v. FOS*⁶⁰⁷ Males J expressed some judicial comments on challenging the FOS awards. The learned judge pointed out the three most useful grounds for a successful challenge: failure to reach a determination of the case within a reasonable time, failure to hold an oral hearing when it was necessary and overall unfairness. It can be seen that the first two grounds for challenging an award are based on FOS procedure and the third ground is based on the merit of the outcome.

⁶⁰⁵ The full detail is provided by Simon Morris and Sarah Redlich from CMS Cameron McKenna, in ‘Challenging FOS decisions’, <<http://www.law-now.com/cmck/pdfs/nonsecured/challfos.pdf>> accessed on 14 May 2014; see also Dr. Judith P Summer, ‘Regulation: Financial Ombudsman Service’, Insurance Law Monthly 28 Mar 14.

⁶⁰⁶ Summer, (Informa Law from Routledge 1 Sep 2010), at para 2.56.

⁶⁰⁷ [2013] EWHC1327 (Admin).

As to the first ground, Males J pointed out that the complexity of the case, the conduct of both parties and the manner in which the matter was dealt with by FOS had to be considered.⁶⁰⁸ It needs to be pointed out that these issues could be mutually affected by each other. In that case, the ombudsman spent over six years dealing with the complaint even though it was found by both the judge and the ombudsman that, according to the facts of the case, it could hardly be counted as a complex one. However, it was pointed out by the judge that since the claimant complainant raised the jurisdictional and procedural points repeatedly, along with a threat of litigation which never happened before the final award was made by the ombudsman, the case became much more complicated than it should have been; and accordingly the judge also found that due to the conduct of the complainant the ombudsman had to spend more time considering unnecessary issues. Therefore, the judge reached the conclusion, without any hesitation that the substantial delay was principally caused by the claimant's own conduct even though the ombudsman delayed as well for some eight months.

As to the oral hearing, it has been pointed out above that an oral hearing is unnecessary for each case and that whether an oral hearing should be held is a matter for the ombudsman's decision with which the court would rarely interfere.

As to the matter of fairness, the judge found that the claimant was fully compensated and therefore there was no unfairness.

6.1.15 Additionally, once the complainant is unsatisfied with the speed of FOS, it is still unwise for him to present the case to the court directly while the procedure

⁶⁰⁸ *R (on the application of Calland) v. FOS* [2013] EWHC1327 (Admin), at [94].

of FOS is in operation. This can be illustrated by *Tonkin*.⁶⁰⁹ In that case, the complainant was aware that the loss adjustment stage by FOS would take some time and a claim was nevertheless brought to the court. Subsequently, the FOS dismissed the complainant due to the concurrent litigation and the court held that the time which had been spent waiting for the FOS adjustment did not carry any interest because the cause of the delay was the complainant's misconduct.

6.1.16 Before 1st January 2012 the limits of the FOS award was up to £100,000 and according to *Bunney v. Burns Anderson plc*⁶¹⁰ it was held that the amount which exceeded the limits was unenforceable, although it could nevertheless be regarded as a recommendation. Afterwards, the statutory cap of the FOS award increased to £150,000 and such award was binding on insurers but not assureds. It could be found from the increased limit that the weight of the role which FOS plays in the insurance market has become more and more important.

However, even the increased limit is not absolute: like the voluntary jurisdiction, the parties could mutually agree⁶¹¹ that FOS could have the jurisdiction to make an award over £150,000 and it will then bind both parties. In case 74/10⁶¹² the ombudsman notified both parties that the statutory limit (at that time) was £100,000 and in that case the award might exceed that amount; the insurer confirmed that the full amount would be paid and then the limit was breached but the award was still binding.

⁶⁰⁹ *Tonkin v. UK Insurance Ltd* [2007] Lloyd's Rep IR 283.

⁶¹⁰ [2007] EWHC 1240 (Ch).

⁶¹¹ Practically, obtaining the insurer's agreement will be enough.

⁶¹² *Ombudsman News* Dec 2008/Jan 2009, available on <http://www.financial-ombudsman.org.uk/publications/ombudsman.htm>, accessed on 22nd Sep 2015, at p.22.

It has been mentioned that the FOS deals with each complainant independently; therefore unlike case law the FOS awards are independent from each other, but it could be said nevertheless that the FOS awards are “practically binding”.

6.1.17 The effect of the FOS award is stated in s.228 (5) of FSMA that

“If the complainant notifies the ombudsman that he accepts the determination, it is binding on the respondent and the complainant and final.”

According to s.229 (8) of the FSMA, the award can be enforced by the courts. The FOS award is then binding on both parties unless there is a successful judicial review. If the insurer refuses to pay the award, the FOS will assist the complainant and the court will also make a judgment or issue an injunction.

In *Clark v. In Focus Asset Management*⁶¹³ it was held that a complainant to FOS who accepted the award could not get any additional compensation by means of litigation if the cause of action remained the same; and if the complainant insisted on the litigation the court was entitled to strike out the claim, and the complainant could not recover any more than the FOS award. It was further held that the reservation of the right to litigate subsequently when accepting the FOS award had no effect, no matter whether the statutory maximum was reached or not.

In that case the complainant was awarded £100,000 by the FOS plus a recommendation that the defendant to pay the full amount of the loss suffered by the complainant, the Clarks. The award was accepted, but a reservation of the

⁶¹³ [2014] EWCA Civ [118].

right to seek the balance through litigation was made by the Clarks and then the litigation for the rest of the loss began. At the first trial, it was held by Cranston J that the doctrine of merger did not apply to the FOS award as FOS itself was not a court, but a scheme to deal with complaints rather than with causes of actions,⁶¹⁴ and then judgment was given for the Clarks. In the Court of Appeal, the issue of merger was not argued, but the defendant relied upon the doctrine of *res judicata* and succeeded. Arden LJ, who gave the leading judgment, took two approaches to apply the doctrine of *res judicata*: to interpret the “cause of action” broadly and to interpret s.228 (5) of the FSMA strictly.

As to the cause of action, Arden LJ held that even though Rix LJ was right to say that the ombudsman was dealing with complaints rather than a “legal” cause of action, it was nevertheless sufficient that a complaint itself could be named as the cause of action for the purpose of *res judicata*.⁶¹⁵

As to the effect of s.228 (5) of the FSMA, Arden LJ accepted the argument that FOS was a scheme with a certain amount of limit which was well known by complainants and complainants were also free to reject the award; and therefore when Parliament was silent Arden LJ made a presumption that s.228 (5) of the FSMA must be strictly interpreted and Parliament did not intend complainants to be able to bring legal proceedings when they accepted FOS awards.⁶¹⁶

⁶¹⁴ *Heather Moor & Edgecomb Ltd v the United Kingdom* [2008] EWCA Civ 642, per Rix LJ at [80].

⁶¹⁵ See *Clark* [2014] EWCA Civ [118] at [77], [82].

⁶¹⁶ *ibid*, at [95], [118].

(3) FOS and late payment

6.1.18 FOS takes a strict approach on the claim handling stage of an insurer. It is pointed out that

“The FOS does not like insurers to cite different reasons for rejecting a claim at different times, rather than all together. The FOS may penalize non-compliance with [fairness and reasonableness]”⁶¹⁷

Therefore, it will not be surprising if FOS treats insurers strictly when damage is caused due to the insurer’s unreasonable late payment. In the response to the Law Commission FOS suggests that it will compensate the effects of late payment in three ways: interest, distress & inconvenience and damages.⁶¹⁸

(a) Interest in FOS awards

6.1.19 Since the main aim of the FOS award is to provide a fast and convenient solution to the complaint, when the complainant cannot prove the actual interest loss the FOS will generally award a simple interest of 8% from the date when the payment should have been paid to the date of the award.⁶¹⁹ As it has been argued in previous chapters of this work, in order to provide full compensation the interest should be calculated on a compound basis; it could be suggested that in order to reach a fair and reasonable outcome, the interest in FOS awards should be calculated on a compound basis as well. In fact, FOS is prepared to

⁶¹⁷ See *Summer*, (Informa Law from Routledge 1 Sep 2010), at para 2.28.

⁶¹⁸ See Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer’s Duty of Good Faith (n.106), at para 6.3.

⁶¹⁹ For recent indemnity insurance examples see FOS DRN1545885, DRN1545885, for a life insurance example, see FOS DRN2386314, available on <<http://www.ombudsman-decisions.org.uk/>>, accessed on 20th March 20, 2016.

award compound interest in investment claims.⁶²⁰ Therefore, it will be presumed that if the insurance policy is partly a kind of investment, or if the complainant could prove the actual interest loss, the interest rate and its basis could be modified by FOS.

(b) Distress and Inconvenience (d&i damages)

6.1.20 Once the insurer's late payment causes distress and inconvenience the FOS will, in appropriate circumstances, require the insurer to pay the d&i damages to the assured. The assured is not limited to persons, as the FOS treats sole traders and partnerships the same as personal customers. However, limited companies are excluded from d&i damages, because even though they may experience inconvenience due to the insurer's late payment, they could not "suffer" distress or pain.

There are three tiers of d&i damages: modest (less than £300),⁶²¹ significant (£300 to £999) and exceptional (£1,000 or more) and the aim is to compensate rather than penalize⁶²² and the detailed requirement of each tier can be easily found online.⁶²³

⁶²⁰ See *Ombudsman News* Issue 33, available on

<<http://www.financial-ombudsman.org.uk/publications/ombudsman.htm>>, accessed on 22nd Sep 2015.

⁶²¹ It needs to be noted that the modest damage is not necessarily a pecuniary one, it could be an order to send flowers or to apologise, but in a recent FOS decision, a £200 d&i damages was awarded, see FOS DRN1545885 (n. 604) DRN 4505323, where a £100 damages was awarded; in DRN 5100827 the complainant was awarded £150 d&i damages and £50 damages for poor claim handling methods in a building insurance dispute in which the complainant was unable to live in the damaged house as originally planned, a similar conclusion was also reached in DRN 6238474.

⁶²² See Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (n.106), at para 6.5.

⁶²³ <http://www.financial-ombudsman.org.uk/publications/technical_notes/distress-and-inconvenience.htm#19>, accessed on 20 May 2014.

(c) Damages

6.1.21 Unlike the court, FOS is not bound by court decisions such as *The Lips*, *The Fanti*, and *The Italia Express (No.2)*; therefore, the situation in *Sprung* will never happen in a FOS award. Not surprisingly, FOS regards the insurer's primary obligation as one to pay claims within a reasonable time rather than hold the assured harmless by preventing the loss, and therefore once the insurer breaches such obligation FOS will certainly award pecuniary damages as the secondary obligation subject, of course, to the limit of £150,000. Additionally, it is suggested by FOS that in exceptional circumstances the foreseeable rule will be breached; that is to say, when the loss is unforeseeable when the policy is entered into, but foreseeable when the claim is made,⁶²⁴ damages shall nevertheless be awarded by FOS. The rationale behind this approach is simple, namely, that that kind of loss is not absolutely "unforeseeable" but a loss caused by the insurer's behaviour and therefore the insurer will be liable.

(d) The balance

6.1.22 In the FOS case 33/3 an insurer had overpaid the assured on the first claim. When the second legitimate claim was sent before the insurer, it was insisted on by the insurer that no money should be paid unless the overpayment was returned. In that case, FOS was prepared to award the assured foreseeable damages caused by these strong-arm tactics.

⁶²⁴ See Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (n.106), at para 6.15.

(4) Summary

6.1.23 According to the discussion of the FOS above, it can be seen that the FOS could be regarded as a more appropriate scheme for achieving a reasonable and fair result, and approaches taken by the FOS should be regarded as significant guidelines for legal reform.

6.2 The Australian General Insurance Code of Practice

(1) Introduction to the Code

6.2.1 It was stated in the last chapter that in Australia the General Insurance Code of Practice has a significant position as a market regulator with more self-regulatory features than that of FOS in the UK and accordingly it is necessary to discuss the Code of Practice in this work to provide valuable cross references for the English insurance market.

At the beginning, it should be remembered that the General Insurance Code of Practice (the Code) has a limited application: it does not apply to reinsurance, marine insurance or other insurance which is governed by government statute or specific rules. The Code is a self-regulatory regulation for the insurance industry, which binds all general (non-life) insurers who sign it and the Australian Securities and Investments Commission (ASIC) have commented that the code plays

“...an important part in how financial products and services are regulated in Australia”⁶²⁵

⁶²⁵ ASIC, *Regulatory Guide 183: Approval of Financial Services Sector Codes of Conduct* (March 2013), available on

On 3rd May 2012 the Insurance Council of Australia (ICA) appointed Mr. Ian Enright to review the Code and after about 12 months an important document was released,⁶²⁶ which had a great influence on the 2014 Code.⁶²⁷ It is well known that, *prima facie*, the Code is a self-regulation of the insurance market; it is not legislation or normal market practice, but it is well believed that the Code should have the principal place in the general insurance market in Australia.

As to the general role of the Code, it is rightly pointed out that the function of the Code is to provide

“...a regime of co-regulation where statutory provisions provide the enforcement and broad principles for regulation, but the details are left to more flexible industry-based Codes and dispute resolution arrangements”⁶²⁸

The reason why such a self-regulation code is so important that it could be the principal rule in the general insurance market, is because the Code is regarded as a very important standard for the insurer’s behaviour even before the court, provided that the assured acts in a reasonable belief that the insurer is bound by

<<http://www.asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-183-approval-of-financial-services-sector-codes-of-conduct/>>, accessed on 13th Nov 2014, at para 183.1.

⁶²⁶ Ian Enright, ‘General Insurance Code of Practice Independent Review 2013’, available on <<http://www.insurancecouncil.com.au/assets/report/GI%20COP%20Independent%20Review%20Final%20Report%202012-13.pdf>>, accessed on 18th Nov 2014.

⁶²⁷ Available on <<http://codeofpractice.com.au/document>>, accessed on 18th Nov 2014.

⁶²⁸ Financial System Inquiry, *Discussion Paper* (Nov 1996), available on <<http://fsi.treasury.gov.au/content/DiscussionPaper.asp>>, accessed on 19th Nov 2014, at Overview page xix.

the Code⁶²⁹, and from this aspect, the Code could be regarded as a “benchmark”⁶³⁰ of the insurer’s conduct.

(2) Historical Development

6.2.2 The first version of the Code was developed by the Insurance Council of Australia (ICA) in 1994 in order to raise the standard of the general insurance service. In 2009 the Code was reviewed and was then amended in 2012: one of several major amendments⁶³¹ which was relevant to this work was to make sure that the signatories of the Code were liable to provide appropriate training and education for their employers so that they could understand the requirements of the Code⁶³² and comply with it in the insurance business. In the latest review of the code, Mr. Enright raises this issue again⁶³³ and clearly and rightly points out the importance:

“...even with the considerable work to date and continuing, the ICA, Code Participants and the Code Governance Body must redouble their resources and efforts in training and education. The terms of the Code are a clanging symbol only, if the performance of Code Participants, employees, agents and Service Suppliers who work with customers and the community do not understand and implement the spirit and the standards in the Code.”⁶³⁴

⁶²⁹ ASIC Act, s.12CC (1) (h).

⁶³⁰ General Insurance Code of Practice Independent Review, at para 6.22.

⁶³¹ For a detailed information of the changes, see General Insurance Code of Practice Independent Review (n. 613), at para 6.30-6.37.

⁶³² Especially s.3.6.7 of the 1994 Code.

⁶³³ General Insurance Code of Practice Independent Review, at para 2.6.

⁶³⁴ *ibid*, see also Insurance Law Service, *Joint Consumer Submission to the General Insurance Code of Practice Independent Review 2012 Issues Paper* (Nov 2012), available on

Another very important improvement from the 1994 Code to the 2012 Code is about the claim: even though both Codes require the insurer to act with good faith, in the 2012 Code it stresses the “honest, efficient, fair, transparent and timely manner”,⁶³⁵ and it adds a time limit for claim handling, which requires the insurer to make a decision within 4 months (in exceptional circumstances 12 months),⁶³⁶ even though both Codes require the insurer to give reasons when a claim is rejected. As a security of the Code, it is required by the 2012 Code that each signatory must have an internal complaints board for claims for breaching the Code; and, very similar to FOS in the UK, once the assured still feels unsatisfied, that claim will be heard by the Australian FOS. However, unlike the FOS in England, the Australian FOS does not make sanctions for Code breaches itself directly, but it only passes its interim decision to the CCC (Code Compliance Committee) and the final decision is to be made by the CCC.

(3) The Review

6.2.3 In the independent review of the 2012 Code, Mr. Ian Enright starts with the nature of the Code: a self-regulatory rule. It has been mentioned above that it is now accepted that a self-regulatory rule should play the **principal role** in the market, but how has that conclusion been reached?

It is well known that insurance is governed by several statutes and common law, and accordingly self-regulation may seem redundant; but ASIC does not agree and then provides that a self-regulatory code could

<http://www.humanservices.gov.au/spw/corporate/government-initiatives/centrepay-review/resources/ubmission-29-cclc.pdf>, accessed on 19th Nov 2014, at pp.13-14.

⁶³⁵ See the 2012 Code, ss.3.5 and 3.7.

⁶³⁶ These requirements are maintained in the 2014 Code, see below.

“...raise standards and to complement the legislative requirements that already set out.... We expect an effective code to do at least one of the following:

- Address specific industry issues and consumer problems not covered by legislation;
- Elaborate upon legislation to deliver additional benefits to consumers; and/or
- Clarify what needs to be done from the perspective of a particular industry or practice or product to comply with legislation.”⁶³⁷

No wonder ASIC’s statement is correct in saying that a self-regulatory code, especially in the insurance industry, could raise the legislative standards and put more weight on consumer protection; and from a broader point of view, the word “consumer” in the regulation could be rightly replaced, in insurance criteria, by “beneficiaries of the service supplier” so that both the original assured and the third party beneficiary could be protected by the Code.

6.2.4 As a matter of fact, the Code was not that promising in its development. The self-regulation in general insurance used to be described as hindsight of securities and investment and it had no principal place in the market and it was even described as

“...an orphan child of good intentions and political compromise.”⁶³⁸

⁶³⁷ See ASIC Regulatory Guide 183: Approval of financial services sector codes of conduct (ASIC RG 183), available on <http://www.asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-183-approval-of-financial-services-sector-codes-of-conduct/>, accessed on 19th Nov 2014, at RG 183.5, emphasis added.

Subsequently, in 2000, a taskforce published a final report on self-regulation according to the market practice at that time.⁶³⁹ In that report the importance of self-regulation (general insurance included) was well noted and the Taskforce stated that

“Industry self-regulation is increasingly being seen as an alternative means of promoting fair trading, ethical conduct and streamlining compliance with agreed product and service standards in an industry. While industry self-regulation can advance consumer confidence in products and individual companies, it also can promote good business practices.”⁶⁴⁰

It was also found by the Taskforce that customers of the industrial services should participate in making and reforming the self-regulation.⁶⁴¹ Along with the Taskforce, ASIC also noticed the importance of self-regulation and made some political and legislative amendments to self-regulation. It was once pointed out by Jillian Segal, deputy chair of ASIC then, that

“For self-regulation to be effective, it needs to be properly integrated into the overall regulatory framework ... It needs to dovetail with the law and the regulator’s policies — not repeating or confusing

⁶³⁸ General Insurance Code of Practice Independent Review (n. 613) at para 7.20.

⁶³⁹ Taskforce on Industry Self-regulation, ‘Industry Self-Regulation in Consumer Markets (August 2000)’, available on <http://archive.treasury.gov.au/documents/1131/PDF/final_report.pdf>, accessed on 20th Nov 2014.

⁶⁴⁰ *ibid*, at p.17.

⁶⁴¹ *ibid*, at pp.75,87,104.

requirements, but assisting and possibly extending them in some areas.”⁶⁴²

This statement also reveals the fact that good self-regulation could not only explain the law, but also improve the standard of a relevant industry. As to the insurance industry, it was found by ASIC that self-regulation was necessary for customers to deal with “hot issues”.⁶⁴³ After these endeavours, the importance of self-regulation has now been well recognized and it could certainly justify the existence of the Code, and the key advantages are:

1. The self-regulation is developed by the market (with some assistance from customers and government agency); it is more willing to be followed by the market.
2. The self-regulation, compared with relevant law, is more practical and effective.
3. It is axiomatic to say that a self-regulatory code provides a cheaper, faster and more accessible alternative dispute resolution.

6.2.5 In the independent review, submissions were asked for about whether the 2012 Code had provided adequate functions and in some of the submissions shortcomings of the Code were pointed out.

6.2.6 In almost all submissions, it was pointed out that even though the Code worked, there was nevertheless a possibility to stress the existence of the Code

⁶⁴² Jillian Segal, ‘Speech to the National Institute for Governance Twilight Seminar, Canberra’, 8 November 2001, cited by General Insurance Code of Practice Independent Review (n. 613), at para 7.25.

⁶⁴³ For example, natural disasters such as flood and earthquake make the Code known to assureds.

to customers⁶⁴⁴. It is very important to put this issue in first place because the awareness is the basis for wider application of the Code: without proper awareness the Code itself is nothing but a piece of paper and the latent power of the remedy⁶⁴⁵ rendered by it will also be ineffective. It was even suggested by some insurers that this aim could be achieved by improved measures taken by the Insurance Council of Australia (ICA) such as through a customer-friendly website, and with some help from insurers.⁶⁴⁶ It is therefore recommended that the Code should be promoted by the ICA as well as the Code participants, and there should be a body set up by the reformed Code to organize and coordinate the job.⁶⁴⁷

6.2.7 In order to facilitate the application and the promotion of the Code, it is axiomatic that the Code should be stated in a simple and clear structure, and plain English should be used and this suggestion was made during the review; and in the latest version of the Code that standard has been maintained.⁶⁴⁸

6.2.8 One of the fundamental characteristics of the Code is that it is voluntary for insurers to participate. During the consultation it was suggested the Code should apply compulsorily to all general insurance providers and the Australian Financial Services License (AFSL) holders.⁶⁴⁹ It needs to be noted that this suggestion may harm the reputation of the Code among insurers and will act against the spirit of self-regulation. However, even though this issue could not be

⁶⁴⁴ General Insurance Code of Practice Independent Review (n. 613), at para 9.1-9.6.

⁶⁴⁵ For example, the deterrent effect of sanctions made by FOS.

⁶⁴⁶ For example it is suggested by Suncorp that thanks to the Insurance Amendment Contracts Act 2013, insurers could deliver electronic versions of the Code to their customers easily with no extra cost.

⁶⁴⁷ General Insurance Code of Practice Independent Review (n. 613), at pp. 70-71.

⁶⁴⁸ *ibid*, at p.73.

⁶⁴⁹ *ibid*, at p.74.

lifted alone, it could be achieved by another way: that is to say, once the awareness of the Code is enhanced, assureds may become aware that there are so many advantages to the Code and they may prefer doing business with the Code participants and this commercial reality could invite more and more AFSL holders to join the Code “voluntarily”.

It needs to be pointed out here that in Australia insurance brokers are governed by the National Insurance Brokers Association Code (the NIBA Code) and the spirit of the NIBA Code is in line with principles in the General Insurance Code, although the coverage of the latter will not extend to brokers, but the Code does cover both retail insurance and wholesale insurance; additionally, since the Code is specially designed for general insurance and general insurance only, there is no intention to expand the Code coverage to marine insurance or reinsurance.

6.2.9 Among all the consultation issues this is probably the most debatable one. It was argued by insurers⁶⁵⁰ that should the Code become contractual terms, the flexibility of the Code would disappear and be replaced by “legalistic” interpretation, which was not in line with the spirit of self-regulation, and currently the sanctions provided by the Australian FOS are sufficient to protect customers, especially consumers. However, the Insurance Law Service (ILS) did not agree. It was advocated by the ILS that, without the compulsory application requirement by law and monetary sanctions for non-compliance⁶⁵¹, the Code was “weak and unenforceable”.

⁶⁵⁰ Insurance Australia Group (IAG) and Suncorp.

⁶⁵¹ Notably, the monetary sanction will not go to the assured but to the government agency.

As with the issue of coverage, this issue could also be analysed with market practice. The reputation of an insurer has become more important in the modern insurance market, and the latent power of the Code Compliance Committee (CCC) should not be undermined⁶⁵² and an example is appropriate to be added here to explain the effect of this power: a Code Participant agreed with the corrective action provided by the CCC and made an extra \$5.3m payment to the assured due to the Code breach⁶⁵³ and this outcome also supports the importance of the awareness of the Code. Additionally, this case also proves that the latent power of the CCC could achieve the aim of monetary sanctions: deterrence, but without the side effect⁶⁵⁴ of imposing monetary sanctions as a result of the Code breach. According to s.11F of the Insurance Amendment Contracts Act 2013 the deterrent effect could also be achieved by the power of ASIC over the insurer's Australian Financial Service License (AFSL) and this newly-developed sanction also makes monetary sanctions redundant.

Therefore, the compulsory incorporation and monetary sanction of the Code should not be recommended considering the fact that the Code is made up of principles, ethical principles and guidelines and the whole point of this kind of structure is flexibility, which will be ruined by compulsory incorporation.

6.2.10 This issue has been stressed at the beginning of this chapter; it is recommended that the training and education should be enhanced, not only as a requirement of market practice, but also of the Australian Corporation Act 2001,

⁶⁵² General Insurance Code of Practice Independent Review, at para 9.53.

⁶⁵³ CCC Annual Report 2011–2012, pp 9 and 53.

⁶⁵⁴ The side effects could be complexity, confusion and significant extra cost, see General Insurance Code of Practice Independent Review, at para 9.57.

and this aim should be achieved by the co-operation between participants and the Training and Education committee.

Claim handling

6.2.11 It is axiomatic to point out that the standard of the claim handling is the core of the Code, and it is not an exaggeration to admit that all the reviewed issues are to make sure that the Code can provide a satisfactory standard of claim handling and that standard shall be followed and improved in the new edition of the Code.

It was firstly suggested that the insurer could not refuse the claim unless a careful assessment is made. Naturally, this suggestion requires the insurer to provide sufficient reasons for a rejection of a claim⁶⁵⁵ and it also imposes obligations on participants to upgrade the level of their actual service suppliers, if any.⁶⁵⁶ This will inevitably increase the cost, but such increased cost should be regarded as the necessary and ordinary costs of a healthy insurance industry.⁶⁵⁷

It was then submitted by the Australian FOS that the time limit for communication with the assureds had caused difficulties for the Code participants to follow and this requirement could also incur extra cost,⁶⁵⁸ however, as mentioned above, those difficulties could be understood as reasons why the Code participants need to improve the standard of training and education; in fact some Code participants submitted that they could even do better than the requirement of the

⁶⁵⁵ It is therefore recommended that reasons for denials shall be disclosed to assureds, and the level of those disclosures is to be contained in the Code as good industry guidelines, see General Insurance Code of Practice Independent Review at p.97.

⁶⁵⁶ General Insurance Code of Practice Independent Review, at p.97.

⁶⁵⁷ The issue of increasing costs has also been addressed by ALRC.

⁶⁵⁸ General Insurance Code of Practice Independent Review, at pp 94-95.

Code.⁶⁵⁹ However, the time limit becomes more difficult when unexpected external factors occur: it was submitted by Suncorp that once the situation was beyond the control of insurers⁶⁶⁰

“...any arbitrary time limit could encourage poor repair practices to ensure it was met.”⁶⁶¹

Currently, the best solution is to disclose the situation and the reasons for the delay to the assured, plus information about internal dispute resolution (IDR) or external dispute resolution (EDR). Even though this “solution” is considered to be sufficient, it could also be regarded as a situation where it is time to show the flexibility of the Code: promoted training and education could certainly reduce the scope of factors which are beyond the control of insurers;⁶⁶² it may also be suitable for the Code to provide guidelines or recommendations (rather than principles) for dealing with those difficulties.

More importantly, there are reasonable grounds to believe that the Code, self-regulation in its nature and generally unenforceable in most of its contents, is enforceable with legal effect **only** as to the manner of claim handling⁶⁶³:

1. Once a sanction or corrective action is made due to the non-compliance with the Code, it is legally enforceable by the court.
2. As a benchmark of unconscionable conduct in the claim handling stage, the legal effect of the Code could be divided into two parts. Firstly, it could be

⁶⁵⁹ *ibid*, at p.95.

⁶⁶⁰ Natural catastrophes are typical examples.

⁶⁶¹ General Insurance Code of Practice Independent Review, at p.95.

⁶⁶² *ibid*, at p.97.

⁶⁶³ *ibid*, at para 9.121.

enforced directly by the ASIC Act 2001 s.12CC(1)(h) and (3); and secondly, it is also true that once the assured is aware of the Code and the insurer is bound by it, the manner of claim handling in the Code becomes legally binding. Once a claim is heard before the court, compliance with the Code would become a decisive matter for s.57 of the ICA 1984 in awarding the statutory interest; and more importantly, it is also a great reference for the court to consider whether the behaviour of the Code participant insurer is in line with the duty of good faith in s.13 of the ICA 1984. As to the latter part, it comes back to stressing the importance of promoting the Code, again; and in fact, that will be a sufficient remedy for the assured, even though it will be better to make this effect expressly stated in the Code.

6.2.12 It has been introduced above that as to the matter of claim handling the non-compliance of the Code will bring assureds a legal remedy; however, it needs to be remembered that the Code is not intended to facilitate claims before a court, but to reduce them; therefore, it is also important to discuss alternative dispute resolutions (ADR) provided by the Code.

It is a requirement of the Australian Corporations Act 2001 that AFSL holders have to provide IDR and EDR to their retail clients and it is also recommended that IDR should apply to retail clients only. However, it is further pointed out that the current IDR scheme is insufficiently designed: one example may be named as “the FOS circle”, which means that once the assured lodges a dispute in FOS, FOS will refer this matter back to the IDR process of the Code participants,

rather than deal with the dispute by the FOS EDR⁶⁶⁴ and in order to solve this problem it would be better to extend the jurisdiction of the FOS EDR. It is always to be remembered that the Code itself will not provide assureds monetary remedies **directly**, but after the discussion above, there are reasonable grounds to believe that, with further developments⁶⁶⁵ the **indirect** remedy provided by the Code will be sufficient.

(4) Important Changes in the General Insurance Code of Conduct 2014

6.2.13 After the detailed and helpful review, the 2014 Code has been published and with some significant improvements: some of them follow the recommendations of the review and some go even further. Before going into the detailed changes, it should be mentioned that most of the changed sections⁶⁶⁶ apply in retail insurance only.

(a) Improved customer experience

In order to promote the 2014 Code, a new website⁶⁶⁷ has been designed; it looks clear and easy and much useful information is contained within it and it has a special illustration for consumers about how the Code works.

(b) The legal effect

Unlike its predecessor,⁶⁶⁸ the 2014 Code makes it clear that, in appropriate circumstances, the Code could be used together with the law and provide a

⁶⁶⁴ See General Insurance Code of Practice Independent Review at para 9.136, and this is also a step taken by the FOS in the UK.

⁶⁶⁵ See discussion about the 2014 Code below.

⁶⁶⁶ They are ss.4,6,7,9,10.

⁶⁶⁷ See <<http://codeofpractice.com.au/>>, accessed on 10th March 2015.

wider cover than the law⁶⁶⁹, and it is reasonable to believe that the Code could work well with the ICA 1984.

(c) Governing body of the Code and sanctions

The enforcement and compliance of the Code are now governed by the new Code Governance Committee (CGC), which is made up of a representative from the insurance industry, a consumer representative and an independent chair. No wonder this structure is more suitable for interpreting the Code with commercial reality.

It has been mentioned above, that the CGC, like its predecessor the CCC, is not entitled to make direct monetary sanctions; however, this time the power of the CGC has been strengthened, since the non-monetary sanction made by it has a more binding⁶⁷⁰ and deterrent effect. The CGC does not only make corrective advice now,⁶⁷¹ it can also require rectification with a clear timeframe and compliance audit;⁶⁷² and the most deterrent feature is its publication: the CGC can now publish the Code participants' non-compliance of the Code and no wonder this could easily "ruin" the reputation of that participant and therefore, it is suggested that this sanction should only be used with extra caution and it is better for the CGC to consider both sides of the insurance contract.

⁶⁶⁸ Where the Code gives customers **no** right recognized by law.

⁶⁶⁹ The 2014 Code s.1.4.

⁶⁷⁰ The 2014 Code, at s.13.16: The CGC's decisions are binding on us (the Code participants).

⁶⁷¹ *ibid*, at s. 13.15 (c).

⁶⁷² *ibid*, at s. 13.15 (a), (b).

(d) Complaint information and process

In the 2014 Code the customer's right of complaint will be attached with the communication between the Code participant and the assured as well as on the insurer's website; further, detailed information about the complaint and its process will also be disclosed to the assured after any negative behaviour⁶⁷³ made by Code participants and the detailed regulations on complaints are stated in s.10 of the 2014 Code.

Generally speaking, there are two kinds of dispute resolutions, as introduced above: IDR and EDR. In the 2014 Code the IDR is divided into two stages which in total will not be more than 45 calendar days; the extension beyond that time limit or the customer's dissatisfaction could trigger the EDR process which is governed and administrated by FOS and decisions made by the IDR and EDR are binding on the Code participants.

(e) Claim handling

It is confirmed in the 2014 Code that participants under the Code dealing with general insurance should behave honestly, fairly, transparently and timely. These behaviours do not only appear in claim handling but also in the placement⁶⁷⁴ and complaint.⁶⁷⁵ As to the claim handling the time limit in the Code remains unchanged⁶⁷⁶ and the 2014 Code further makes it clear that:

⁶⁷³ They include denial of a claim or financial assistance, failure to comply with a timetable.

⁶⁷⁴ The 2014 Code, ss.4-5.

⁶⁷⁵ *ibid*, at s.10.

⁶⁷⁶ 10 days after investigation or 4 months after receiving the claim or 12 months if the claim is influenced by exceptional circumstances.

1. Only relevant information about the insurer's decision will be asked;⁶⁷⁷
2. A timetable will be provided if the claim is complex in nature and the detailed information about the complaint will be attached with the timetable;⁶⁷⁸
3. Assureds will be informed about the process of the claim;⁶⁷⁹
4. Reasons will be given for denial and complaint information will be provided.⁶⁸⁰

(f) Financial hardship

In s.7.7 of the 2014 Code it states that where the assured reasonably demonstrates an urgent financial need of the benefits from the policy caused by the event which leads to the claim, the insurer may fast-track the claim handling or makes advance payment within 5 business days. This section is intended to deal with immediate hardship, but in practice several points are worth noticing:

Firstly, it is always decided by the insurer about whether there is an urgent need, and if there is, whether it is appropriate to advance the payment (and what amount) or only fast-track the claim handling process, subject to the complaint to IDR or EDR; but once a complaint is initiated it means that the time is delayed and some loss may already be caused by that urgent hardship.

Secondly, it is for the assured to prove the causation; that is to say the urgent hardship has to be caused by the **claimed** event rather than one of the **insured** events and this may sometimes confuse the customer.

⁶⁷⁷ The 2014 Code, s.7.3.

⁶⁷⁸ *ibid*, s.7.5.

⁶⁷⁹ *ibid*, ss.7.11-7.15.

⁶⁸⁰ *ibid*, s.7.19.

Accordingly, in order to understand this section properly and avoid unnecessary disputes, it would be better if there were guidelines or examples interpreting the application of that section, and of course, the insurer's training and education are also important.

6.2.14 After the discussion about self-regulation in Australia, it may be concluded that the Code is well developed and the interests of both parties in general insurance are considered and reflected in the 2014 Code. It is predicted that the 2014 Code could develop in practice as well and it may become a good reference to other self-regulations such as marine insurance and reinsurance, and also a good reference for other countries, for example, England.

6.3 Principles of European Insurance Contract Law (PEICL)

6.3.1 It has been introduced at the beginning of this work that the current English legal position of indemnity insurance law is, generally speaking, not the same as in almost all the other EU countries regulated by the general principles of EU law, which is codified in PEICL. After comparing the Australian approach it is appropriate to introduce the EU principle.

The aim of the Principles of European Insurance Contract Law (PEICL) is to create a Common Frame of Reference (CFR) for European general contract law and to facilitate cross-border insurance business. Even though it is voluntary for parties to choose PEICL as the governing law of the insurance contract, once the PEICL are adopted by the contract they could exclude the national law(s) of the contractual parties and more importantly, no exclusion is allowed in applying PEICL. However, it needs to be remembered that the PEICL are in fact legal

principles and when they are interpreted derogations are allowed, provided that the interest of the policyholder is not harmed. Therefore, if PEICL is incorporated into an English policy, the assured could claim for the damages for late payment even before the Enterprise Act 2016 comes into force.

It is not necessary to go much further into PEICL but some key points have to be identified because PEICL could be regarded as a general understanding about some important matters in insurance contracts by the majority of countries of Europe.

6.3.2 There is no express term in PEICL which states the nature of the insurer's obligation, but clearly it is by no means the obligation to prevent the loss: in PEICL that obligation belongs to the assured to prevent further loss, which is similar to the English "sue and labour" provision in the MIA 1906; and from the expression in Art 4:103 (2)⁶⁸¹, it is reasonable to infer that the primary obligation of the insurer is to provide insurance money, in other words, to make the contractual payment stated on the policy.

6.3.3 It is clearly stated in PEICL that it is the insurer's obligation to "take all reasonable steps to settle a claim promptly" and unless information for the delay or denial is given in writing within 1 month, the insurer is presumed as accepting the claim. It is also stated in PEICL that once the claim is accepted, payment shall be made without undue delay in no more than 1 week after finishing the quantification. These principles could support the argument that under PEICL the obligation of the insurer is to make contractual indemnity and the cause of

⁶⁸¹ "(2) Subject to a clear clause providing for reduction of the insurance money according to the degree of fault, the policyholder or insured, as the case may be, shall be entitled to insurance money in respect of any loss caused by negligent non-compliance with a precautionary measure."

action will not arise until the reasonable quantification is finished and that is also the time when interest in PEICL should begin to run.

6.3.4 Once the payment is unduly delayed, the assured is allowed both interest and damage for late payment. In line with common practice in many countries, interest on late payment will run from the date when payment should be made at the rate applied by the European Central Bank in refinancing operations plus 7%.

However, the assured's co-operation is also expressly required by PEICL. If the lack of co-operation causes prejudice to the insurer, the insurer is allowed to reduce the amount of payment equal to the prejudice; once the duty of co-operation is breached either with intention or recklessness it may give insurers opportunity to discharge the whole liability.

Chapter 7 The Impact of Enterprise Act 2016

7.1 The sections in the new Enterprise Act 2016: Contracting out

7.1.1 As mentioned at the beginning of this work, the original section on the insurer's obligation to pay has been reintroduced in the new Enterprise Act 2016,⁶⁸² in addition, a new section on contracting out of the above-mentioned section has been added subsequently:

“(1) A term of a consumer insurance contract, or of any other contract, which would put the consumer in a worse position as respects any of the matters provided for in section 13A than the consumer would be in by virtue of the provisions of that section (so far as relating to consumer insurance contracts) is to that extent of no effect.

(2) A term of a non-consumer insurance contract, or of any other contract, which would put the insured in a worse position as respects deliberate or reckless breaches of the term implied by section 13A than the insured would be in by virtue of that section is to that extent of no effect.

(3) For the purposes of subsection (2) a breach is deliberate or reckless if the insurer—

(a) knew that it was in breach, or

(b) did not care whether or not it was in breach.

⁶⁸² See s.29 of the Enterprise Act 2016.

(4) A term of a non-consumer insurance contract, or of any other contract, which would put the insured in a worse position as respects any of the other matters provided for section 13A than the insured would be in by virtue of the provisions of that section (so far as relating to non-consumer insurance contracts) is to that extent of no effect, unless the requirements of section 17 have been satisfied in relation to the term...⁶⁸³

By virtue of this section, it is certain that as to the consumer insurance contract the insurer could not contract out of the duty to make timely payment nor could the insurer avoid the obligation to pay damages caused by the late payment.

However, parties to a non-consumer insurance contract could agree on less favourable terms and could contract out the implied term, provided that firstly, the deviation from the implied term does not avail the insurer of deliberate or reckless breach of the obligation to make payment and secondly, the alternative provision of the contract has to be clear and unambiguous and sufficient steps have to have been taken by the insurer to draw it to the attention of the assured.⁶⁸⁴

Accordingly, the position of the law is clear: as to the consumer insurance it would become the strict obligation of the insurer to make a timely payment, otherwise damage shall be paid if it is caused by the late payment; while as to non-consumer insurance or business insurance, the starting point of the law remains the same as consumer insurance but the law permits the market

⁶⁸³ See s.29 of the Enterprise Act 2016.

⁶⁸⁴ See s.17 of Insurance Act 2015.

practice to make an adjustment and it will then become a problem of business rather than a problem of law. However, unlike the Australian ICA 1984 the new Insurance Act 2015, which will be amended by the new Enterprise Act 2016 with the implied obligation on the insurer, applies universally to general indemnity insurance contracts, marine insurance contracts and even reinsurance contracts. However, its application on reinsurance contracts may cause unpredicted new problems.

7.2 The unexpected problems from the reinsurer

(1) The problems

7.2.1 It has been introduced at the beginning of this work that most insurers welcome the implied term approach of their obligation to make a timely payment because this approach could build up a comfortable environment for modern insurance business. However, some unexpected problems happen when reinsurance evolves, and the following questions have to be answered:

1. If the insurer delays the payment and actually pays the insured sum plus damage for the late payment, what is the legal position of the reinsurer?
2. If the insurer settles a claim with the assured, is the reinsurer obliged to pay the damage admitted during the settlement in case a "follow settlement" clause is incorporated in the reinsurance policy?
3. If the reinsurer takes over the claim handling process and the payment in the insurance policy is ultimately delayed, what will be the legal consequence?

(2) The general position of the reinsurer

7.2.2 Although it is always said that reinsurance shares most principles with insurance,⁶⁸⁵ under current English law the starting date of the insurer's obligation is different from the date of the reinsurer.

It has been discussed several times that under current law once the insured risk occurs the insurer is automatically in breach, however, that is not true for the reinsurer. There has been a heated debate on the exact subject matter of the reinsurance contract, which is caused by the vague language in s.9 (1) of the MIA 1906,⁶⁸⁶ and accordingly the subject matter of the reinsurance contract may either be understood as the liability of the insurer⁶⁸⁷ or the same risk in the original insurance policy⁶⁸⁸ (also known as the direct policy).

The continuous debate shall be discussed later in this part, but it is certain that, without an agreement to the contrary, unless and until two preconditions are met, the reinsurer's obligation will not arise: firstly, the insurer owes an established and quantified obligation to the assured and secondly, the insurer is able to

⁶⁸⁵ See *Arnould* (18th edn, Sweet & Maxwell) at para.33-01.

⁶⁸⁶ "The insurer under a contract of marine insurance has an insurable interest in his risk, and may re-insure in respect of it."

⁶⁸⁷ See *Arnould* at para 33-07; Ozlem Gurses, *Facultative Reinsurance and The Full Reinsurance Clause*, available on http://eprints.soton.ac.uk/210837/8.hasCoversheetVersion/soton.ac.uk_ude_PersonalFiles_Users_slb1_mydocuments_ozlemthesis_with_signed_declaration.pdf>, last accessed on 15th February 2016, at para 1.4; see also Lord Hope in *Agnew v Lansforsakringsbolagens AB* [2000] Lloyd's Rep. I.R. 637; *Feasey v. Sun Life Assurance Corporation of Canada* [2003] Lloyd's Rep IR 637; for an Australian approach see *Commonwealth of Australia v Vero Insurance Ltd* [2012] FCA 826.

⁶⁸⁸ See *Marine Insurance Legislation* (5th edn, Routledge, 2013), at notes 9, see also *Wasa International Insurance Co Ltd v. Lexington Insurance Co* [2009] UKHL 40, especially per Lord Collins.

prove that the reinsurance claim falls within the reinsurance contract.⁶⁸⁹ Accordingly, compared with a direct insurer the liability of the reinsurer would not arise unless the preconditions mentioned above are met; while the liability of the direct insurer, under current law, arises as soon as the insured peril occurs.

The nature of the reinsurance contract is not the main aim of this work, but it is rather difficult to discuss the influence of the implied obligation on the reinsurer without a clear definition of the nature of reinsurance, especially as to the reinsurer's legal position when the insurer is liable for the late payment. According to the effect of the implied obligation, it will become **contractual obligation** of the insurer to make payment within a reasonable time and accordingly, if a reinsurance contract is to insure against the insurer's contractual obligation the reinsurer could hardly deny its obligation to indemnify the insurer's damages paid to the assured, not even by inserting the Extra Contractual Loss (XCL) clause into the reinsurance contract. While if a reinsurance contract is to insure against the original risk the reinsurer would not be liable because the causation of the further damage is the insurer's behaviour rather than the insured risk. Therefore, the subject matter of the reinsurance contract shall be discussed in the first place and the relevant questions at the beginning of this part shall be discussed below.

⁶⁸⁹ See *Arnould* (18th edn, Sweet & Maxwell) at para 33-34, Ozlem Gurses and Rob Merkin, 'Facultative reinsurance and the full reinsurance clause', [2008] L.M.C.L.Q, at p.371, see also Malcolm Clarke, 'The Contractual nature of reinsurance', *The Cambridge Law Journal* (2010) 69 (1) 24-25 at p.25.

(3) The subject matter of reinsurance contracts

7.2.3 Notwithstanding the continuous debate on the subject matter of reinsurance, the House of Lords provided a straightforward answer in *Wasa International v. Lexington*,⁶⁹⁰ where Lord Phillips held that

“...under English law a contract of reinsurance in relation to property is a contract under which the reinsurers insure the property that is the subject of the primary insurance; it is not simply a contract under which the reinsurers agree to indemnify the insurers in relation to any liability that they may incur under the primary insurance...”⁶⁹¹

This understanding was also accepted by Lord Mance⁶⁹² and Lord Collins⁶⁹³ and accordingly under current English law, without special contractual provisions,⁶⁹⁴ the subject matter of the reinsurance contract is the original risk rather than the insurer’s liability and the reinsurance is described by Malcolm Clarke as if

“...the insurer of my house reinsured the risk: **my house would then be covered against fire by two insurers, insurer and reinsurer.** In the event of a fire my claim would only be against the insurer with

⁶⁹⁰ [2009] UKHL40.

⁶⁹¹ *Wasa International v. Lexington* [2009] UKHL40, at [2].

⁶⁹² *ibid*, at [32-33].

⁶⁹³ *ibid*, at [114].

⁶⁹⁴ For example, see *Feasey v. Sun Life Assurance* [2003] Lloyd’s Rep IR 640, where the principle of the “pervasive insurable interest” changed the subject matter of a reinsurance policy from the original risk to the liability of the insurer.

whom I had contracted. That insurer would later recover part of what it paid me from the reinsurer.”⁶⁹⁵

Accordingly, when an insurer reinsures the risk with a reinsurer, what the reinsurer insures against is the original risk rather than the insurer’s liability, no matter primary or secondary, and therefore, the problems at the beginning of this chapter could be answered below.

(4) The liability of the reinsurer in case of the insurer’s late payment

7.2.4 A brief answer to the first question is that generally the reinsurer is not liable when the insurer is held liable for damage for late payment according to the implied obligation. There are two sub questions to be answered in this part:

1. Could the implied obligation apply between the insurer and the reinsurer in case of the insurer’s late payment?
2. Could the reinsurer be held liable for the reason that the liability of the insurer to pay damages due to the late payment is within the scope of the reinsurance contract?

The answer to the first question is straightforward. In *Commercial Union Assurance Co v. NRG Victory Reinsurance Ltd*⁶⁹⁶ it was held that once a judgment was entered against the insurer, the liability of the reinsurer was then fixed and quantified. Accordingly, during the late claim handling stage the liability

⁶⁹⁵ Malcolm Clarke, ‘The Contractual nature of reinsurance’, *The Cambridge Law Journal* (2010) 69 (1) 24-25 at p.24.

⁶⁹⁶ [1998] 2 Lloyd’s Rep.600.

of the reinsurer does not arise and there is no reason why the reinsurer shall be liable for the period before its obligation arises.

The answer to the second question, according to the discussion on the nature of reinsurance, is that the reinsurer is not liable to indemnify the insurer on the damage. Even though there is no binding legal precedent on this point, it is worth noting that firstly, according to the discussion of the effect of the implied obligation in the Enterprise Act 2016, the primary obligation of the insurer will be a contractual one to indemnify the assured, and in a reinsurance context the original risk means the risk which could trigger the insurer's primary obligation; secondly, it should be remembered, based on the discussion in chapter 2 and chapter 3 of this work, that if a judgment on damage for late payment is entered it must be read as two parts: the first one is on the primary obligation of the insurer, which holds that the insurer shall be liable for the insured loss and this part is the liability caused by the original risk which could be recovered from the reinsurer; the second one is the secondary obligation, which holds that due to the delay of the performance of the primary obligation the insurer shall be liable for damage, and this part is not covered by the reinsurer. Other than the reason provided above, this answer could also find some support in s.55 of the MIA 1906, where it clearly states that the insurer is liable for any loss proximately caused by a peril insured against, but he is not liable for any loss which is not proximately caused by a peril insured against. Applying this section to the reinsurance context, it means that the reinsurer is only liable for the loss caused by the original risk, subject to the reinsurance policy limit,⁶⁹⁷ but that reinsurer is

⁶⁹⁷ See *Uzielli & Co v Boston Marine Insurance Co* (1884) 15 Q.B.D. 11.

not liable for damages caused by the insurer's poor behaviour. However, the best way to make sure that the reinsurer could get rid of the payment for damages is to express clearly on the reinsurance policy that it excludes damages and further interest caused by the insurer's late payment.

(5) The liability of the reinsurer in settlement

7.2.5 It is not uncommon for reinsurers to add a "follow the settlement" clause into the reinsurance contract and the typical wording of that clause reads as

"Being a Reinsurance of and warranted same . . . terms and conditions as and to follow the settlements of the Insurer..."

The leading case of this provision is *Insurance Co of Africa v. Scor*.⁶⁹⁸ In that case a reinsurance contract was entered into on the "follow the settlement" basis. A claim was raised by the assured and after consulting loss adjusters the insurer settled the claim and then sought an indemnity from the reinsurer who at that time obtained strong evidence that the assured of the direct policy was a fraud. It needs to be stressed here again that in order to make a reinsurer liable two conditions have to be met together: firstly, the insurer is liable according to the direct policy and secondly, the claim made by the insurer was within the scope of the reinsurance. While in *Scor* it was certain that should the assured destroy its property intentionally the insurer was not liable it would be redundant to consider whether the insurer's claim was within the scope of the reinsurance contract. However, Robert Goff LJ took another view on the effect of the "follow the settlement" provision:

⁶⁹⁸ [1985] 1 Lloyd's Rep. 312.

“In my judgment, the effect of a clause binding reinsurers to follow settlements of the insurers, is that the reinsurers agree to indemnify insurers in the event that they settle a claim by their assured... **provided that the claim so recognized by them falls within the risks covered by the policy of reinsurance as a matter of law**, and provided also that in settling the claim the insurers have acted honestly and have taken all proper and businesslike steps in making the settlement... **I do not read the clause as inhibiting reinsurers from contesting that the claim settled by insurers does not, as a matter of law, fall within the risks covered by the reinsurance policy**; but... I do consider that the clause presupposes that reinsurers are entitled to rely not merely on the honesty, but also on the professionalism of insurers, and so is susceptible of an implication that the insurers must have acted both honestly and in a proper and businesslike manner.”⁶⁹⁹

7.2.6 It is rightly suggested by *Arnould* that the effect of the “follow the settlement” clause is to relieve the insurer’s obligation of proving that the loss is within the direct policy while it is nevertheless necessary for the insurer to prove that the loss is covered by the reinsurance policy.⁷⁰⁰ It has been discussed above that because the subject matter of the reinsurance is the original risk rather than the liability of the insurer, the money paid according to the settlement is **not** covered by the reinsurance automatically and whether the insurer is entitled to recover from the reinsurer is subject to the following matters:

⁶⁹⁹ *Insurance Co of Africa v. Scor* [1985] 1 Lloyd’s Rep. 312 at p.330, emphasis added.

⁷⁰⁰ See *Arnould* (18th edn, Sweet & Maxwell), at para.33-38.

Firstly, the claim which is raised by the assured and triggers the settlement has to be covered by the reinsurance policy should it be raised by the insurer, but it is not necessarily within the scope of the direct policy,⁷⁰¹ and if the direct policy and the reinsurance policy are back to back, which means that the terms of both policies are identical, while the settlement is not covered by the direct policy, the insurer could not recover from the reinsurer at all.

Secondly, the settlement has to be made not only in good faith but also in a commercial way. This aspect has been reviewed by Field J in *Tokio Marine v. Novae Corporate Underwriting Ltd*⁷⁰² and it was held that as long as there was nothing additional to be gained by further investigation and negotiation, it would be sufficient for the insurer to argue that a businesslike settlement in good faith had been made and the reinsurer was liable to indemnify according to the “follow the settlement” clause.⁷⁰³

Thirdly, in *Tokio Marine v. Novae Corporate Underwriting Ltd* the reinsurance policy clearly stated on the “follow the settlement” provision that the liability of the reinsurer is subject always to the limits reinsured and in that case it was unnecessary to argue that the reinsurer was not liable for the amount over the limit of the reinsurance policy. However, it is arguably right that even if there is no such limit the “follow the settlement” clause would not make the reinsurer pay more than the policy limit. This argument could find some support from *Uzielli & Co v Boston Marine Insurance Co.*⁷⁰⁴ In that case the ship-owner insured the

⁷⁰¹ See also Lord Mance, Iain Goldrein QC, FRSA and Professor Robert Merkin, *Insurance Disputes*, (3rd edn, Informa, 2011) at para 28.46.

⁷⁰² [2014] Lloyd's Rep. IR 490.

⁷⁰³ See also *Assicurazioni Generali SpA v. CGU General Insurance Plc* [2004] Lloyd's Rep IR. 457.

⁷⁰⁴ (1884) 15 Q.B.D. 11.

vessel for 100% and the insurer subsequently reinsured the full value of the vessel and the reinsurer retroceded that risk. The vessel became a constructive total loss and the insurer settled the claim by paying 88% of the policy to the assured and subsequently paid 24% on its own to rescue the vessel which turned out to be fruitless. It was common ground that according to the 'sue and labour' principle the insurer was entitled to the full amount of 112%, but the dispute appeared when the reinsurer sued the retrocessionaire for 112%. In the first trial Mathew J gave the judgment for the reinsurer, but in the Court of Appeal the amount was firmly limited to 100% which was exactly the limit of the retrocession. It was held by Brett MR that the 'sue and labour' action was taken by the insurer rather than the reinsurer and even though the reinsurer was able to insure more than 100%, choosing not to do so would make the retrocession policy limit conclusive.⁷⁰⁵ Additionally, in *Scor* the insurer settled a claim and the amount of the final settlement was beyond the policy limit and it was held by the Court of Appeal that the obligation of the reinsurer was limited by the reinsurance policy, even though a "follow the settlement" clause was inserted in the reinsurance contract and it was not clearly stated whether the reinsurer's obligation in the settlement was subject to the reinsurance policy limit.

7.2.7 After considering the above issues, it is not the end of the story regarding settlements: it is common that the final amount of the settlement is a number combined with different considerations and among them the damage for late payment might be included. In other words, it has been argued by this work that the reinsurer is not liable for the damage for late payment paid by the insurer, as

⁷⁰⁵ *Uzielli & Co v Boston Marine Insurance Co* (1884) 15 Q.B.D. 11 at pp.16-17.

understood when applying the implied obligation under the new legislation; but what if the damage for late payment is admitted by the insurer in the settlement and in this situation, is the reinsurer liable according to the “follow the settlement” clause in the reinsurance contract? There is no reported case focusing directly on this point, however, it should be remembered that in *Scor* the court nevertheless permitted the reinsurer to refuse the settlement which was outside the reinsurance cover;⁷⁰⁶ accordingly if the reinsurer could prove that a part of the settlement amount reflects damage for late payment the reinsurer will not be held liable for that amount. However, what if the detail of the settlement amount is not known at all?

This happened in a liability insurance case, *Lumberman’s v. Bovis*;⁷⁰⁷ even though it was not a reinsurance case, the nature of the settlement was the same.⁷⁰⁸ In that case Bovis entered into a contract with Braehead and due to the conflict Bovis claimed its contractual payment of £37m while Braehead counterclaimed £103m or £75m based on different grounds. The claim was finally settled and Braehead paid £15m settlement to Bovis but the contents of the settlement were completely unknown. It was held by Colman J that the dispute in that case was in fact issues about the assured’s burden of proof and in order to claim against the insurer, the assured had to prove that

“Firstly, there has to have occurred an eventuality which has rendered the insured liable to a third party. Secondly, the eventuality and the consequent liability has to be within the scope of the cover provided

⁷⁰⁶ *Insurance Co of Africa v. Scor* [1985] 1 Lloyd’s Rep. 312 at p.330.

⁷⁰⁷ [2005] 1 Lloyd’s Rep. 494.

⁷⁰⁸ Ozlem Gurses, *Reinsuring Clauses*, (Informa, 2012) at para 6.69.

by the policy. Thirdly, it must be established that such liability has caused loss to the insured of an amount within the scope of the contractual indemnity. Each of these constituents of the obligation to indemnify the insured has to be established before it can be said that there is a cause of action.”⁷⁰⁹

Applying the above statement in a reinsurance context, it seems that it is the insurer’s obligation to prove the detailed information about the settlement, otherwise the cause of action against the reinsurer would not arise and therefore, if the detail of a settlement is completely unknown, the reinsurer would not be liable due to the lack of cause of action, in spite of the “follow the settlement” provision.

However, the outcome of *Lumberman’s* was not welcomed and in *Enterprise Oil v. Strand Insurance*,⁷¹⁰ another liability insurance case, it was not followed by Aikens J.

7.2.8 It is worth pausing here to stress the reinsurer’s obligation again. It has been discussed above that, it has been settled in law that in order to trigger the obligation of the reinsurer, the insurer has to firstly ascertain its obligation to the assured and secondly prove that a claim is within the scope of the reinsurance contract; this statement is undoubtedly correct, however, when a “follow the settlement” clause is inserted, this statement needs to be explained further: ascertaining the obligation to the assured could be named as the precondition issue while proving the cover could be named as the causation issue and in an

⁷⁰⁹ [2005] 1 Lloyd’s Rep. 494.

⁷¹⁰ [2007] Lloyd’s Rep IR 186.

insurance context those two issues are in fact one; when a “follow the settlement” provision is inserted it actually means that the precondition issue is waived by the reinsurer unless the settlement is made in an unreasonable or unbusinesslike manner but the causation issue nevertheless applies.

In light of this understanding *Lumberman’s* could be regarded as reaffirming what was decided in *Scor*: even though a settlement has been reached between the assured and the insurer, it is always open for the reinsurer to argue that the claim of the insurer according to the settlement is beyond the scope of the reinsurance contract.⁷¹¹

(6) Late payment caused by the reinsurer

7.2.9 It has been discussed above that if a “follow the settlement” clause is inserted into the reinsurance policy, the reinsurer is not entitled to deny liability if the insurer’s claim falls within the scope of the reinsurance policy. Therefore, for the sake of their own interest, reinsurers always wish to make sure that the insurance claims or settlements could be handled directly by the reinsurers rather than the insurers, or at least they could participate in the process and accordingly, claim control clauses and claim co-operation clauses are often found in reinsurance policies.

In *Gan Insurance Co. Ltd v. Tai Ping Insurance Co. Ltd (Nos 2 and 3)*⁷¹² the meaning of the claim co-operation clause was considered by the Court of Appeal; the wording of that clause was:

⁷¹¹ See also Butler and Merkin, *Reinsurance Law*, (Loose leaf, Sweet & Maxwell), at para. C-0009/2.

⁷¹² [2001] Lloyd’s Rep IR 667.

“...it is a condition precedent to any liability under this policy that

(a) the reinsured shall, upon knowledge of any circumstances which may give rise to a claim against them, advise the reinsurers immediately, and in any event not later than 30 days.

(b) The reinsured shall co-operate with reinsurers and/or their appointed representatives subscribing to this policy in the investigation and assessment of any loss and/or circumstances giving rise to a loss.

(c) No settlement and/or compromise shall be made and liability admitted without the prior approval of reinsurers.”

It was held both by Longmore J and members of the Court of Appeal that according to that provision the duty of the insurer’s co-operation, if properly drafted, could be regarded as the condition precedent of the reinsurer’s liability.⁷¹³ Two further questions about the implied obligation were also raised, namely, whether there were to be implied into the reinsurance policy that reinsurers could not withhold approval of a settlement unless there were reasonable grounds for withholding that approval; and that reinsurers would respond with reasonable promptness to a request for approval of a settlement. It is necessary to pause here to illustrate the importance of such implications in light of an important principle: “the privity of contract”.

⁷¹³ For a more recent example, see *Ted Baker plc and another v AXA Insurance UK plc and Others (No.2)* [2015] Lloyd’s Rep. IR 325.

(7) Privity of contract in reinsurance claims

7.2.10 It is common ground that a contract of insurance is between the assured and the insurer, while if the insurer signs a reinsurance contract it is a contract between the insurer and the reinsurer. It is settled that the contract of insurance and the contract of reinsurance are entirely separate undertakings, which means that the assured could not claim directly against the reinsurer, while the reinsurer could not avoid the reinsurance policy due to the assured's failure to comply with the duty of good faith. There is but one exception, according to which the assured could claim against the reinsurer: the insolvency of the insurer.⁷¹⁴

In *Grecoair v. Tilling*⁷¹⁵ the court was asked if there could be another exception to the privity of contract if the reinsurer assumed direct liability to the assured. In that case Grecoair was the assured which insured against certain kind of risks for aeroplanes with ENSA and the latter reinsured with Tilling; when the loss occurred, it was argued by Grecoair that according to special contractual arrangements and the settlement meeting it could claim directly against the reinsurer instead of the insurer. There were two grounds, according to which Grecoair made the claim: firstly, according to the reinsurance contract, the insurance claims had to be handled by the reinsurer and secondly at a settlement meeting on 11 March 1997 the representatives of the reinsurer made several points, which could constitute the assumption of direct liability.

⁷¹⁴ See *The Fantj* [1990] 2 Lloyd's Rep. 191.

⁷¹⁵ [2005] Lloyd's Rep IR 151.

However, Langley J was not persuaded by those arguments made by Grecoair; it was held that the principle of privity of contract had to be maintained in that case and, as to the first argument, it was stated by Langley J that

“In my judgment, there is nothing in either the contractual documents or context which justifies the case Grecoair seeks to make on the first issue. To the contrary, the documents and context are all consistent with the conventional status of assured, insurer and reinsurer. Grecoair’s claim on this basis therefore also fails.”⁷¹⁶

As to the second argument, it was unnecessary for Langley J to make further comment because a short meeting itself could not prove the assumption of liability and accordingly the assured failed on both issues.

Therefore, it is settled by law that although a claim could be handled by the reinsurer, the claim handling arrangement could not usually provide a direct cause of action for the assured to claim against the reinsurer directly. If *Gan v. Tai Ping* and *Grecoair* are read together, it is clear that the insurer is in a very awkward position: in order to be indemnified by its reinsurer, the insurer has to pass the direct claim under the insurance policy to the reinsurer, but the reinsurer is not contractually liable for its claim handling process due to privity of contract. Naturally the insurer wishes to add contractual obligations into the reinsurance contract about the claim handling manner of the reinsurer, expressly or impliedly.

⁷¹⁶ *ibid*, at [105].

(8) Implied terms about the reinsurer's claim handling manner

7.2.11 It has to be mentioned in the first place, that it is always open for the insurers and reinsurers to add express terms into the reinsurance contract about this issue, even though it rarely happens in commercial reality because most reinsurance contracts are written on a back-to-back basis and therefore, the discussion on the implied obligations is more important.

Moving back to *Gan v. Tai Ping* again, this issue was firstly discussed by Longmore J (as he then was). The learned judge, after reviewing the leading case⁷¹⁷ on implication and making cross reference to an authority on land law,⁷¹⁸ approved those implications and made it clear that

“... a right arbitrarily to refuse approval of a settlement would defeat the purpose of the reinsurance contract, which is to indemnify the reinsured in respect of his actual liability to his assured, not to give the reinsurer an option to indemnify the reinsured if he feels like it, but not if he does not feel like it. The implication that reinsurer's consent to a settlement is not to be unreasonably withheld is, in my opinion, necessary to give business efficacy to the contract as a whole. To force the reinsured to litigate his liability to the assured to the point of judgment is so uncommercial and so unbusinesslike that it cannot have been the parties' intention.”⁷¹⁹

⁷¹⁷ See *The Moorcock* (1889) 14 PD 64, this case has been discussed in chapter 2 of this work.

⁷¹⁸ See *Price v Bouch* (1986) 53 P & CR 257.

⁷¹⁹ *Gan Insurance Co. Ltd v. Tai Ping Insurance Co. Ltd* [2001] Lloyd's Rep IR 291, at p.308.

7.2.12 However, this judgment was overruled unanimously by the Court of Appeal. In the appeal, it was submitted by the reinsurer's counsel that the reinsurer's approval was not required to establish the liability of the insurer and therefore implying an obligation upon the reinsurer was not required to achieve the purpose of a reinsurance contract nor business efficiency.⁷²⁰

This submission was accepted by the court and it was firstly pointed out by Mance LJ (as he then was) that as to the purpose of the reinsurance contract, because the insurer could always settle a claim with the assured, with or without claim provision in the reinsurance contract, even though this settlement could deprive the insurer of recovery from the reinsurer and therefore, withholding a settlement, no matter rightly or wrongfully, could not defeat the purpose of the reinsurance contract.⁷²¹

As to the matter of business efficiency, after a detailed analysis, it was held by Mance LJ that there was indeed an implied requirement:

“I would therefore accept as a general qualification, that any withholding of approval by reinsurers should take place 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.”⁷²²

⁷²⁰ *Gan Insurance Co. Ltd v. Tai Ping Insurance Co. Ltd (Nos 2 and 3)* [2001] Lloyd's Rep IR 667, at [31].

⁷²¹ *ibid*, at [42].

⁷²² *Gan Insurance Co. Ltd v. Tai Ping Insurance Co. Ltd (Nos 2 and 3)* [2001] Lloyd's Rep IR 667, at [50].

No wonder the requirement of good faith is lower than the requirement of businesslike and reasonable steps even though there is no reported case on the exact difference between each other.

However, it could be assumed that the good faith standard only applies when the claim provision is the claim co-operation clause: it was accepted by Mance LJ, in light of *Scor* that if party A's behaviour could bind party B's financial obligation it was implied that party A had to act in a businesslike and reasonable manner⁷²³ while in *Gan v. Tai Ping* the settlement and the claim were actually dealt with by the insurer even though the reinsurer assisted the insurer's conduct;⁷²⁴ and, therefore, it could be argued that if the claim provision in the reinsurance contract is a claim control provision, it means that in case of a claim it is the reinsurer's right to take over, but at the same time it is also the obligation of the reinsurer to handle the claim in a businesslike and reasonable manner. However, in that situation, if the payment is delayed, it is also the obligation of the insurer to pay damage according to the new Enterprise Act 2016 and then recover from the reinsurer according to the implied obligation; this arrangement could also make the insurance and reinsurance contracts "back to back": it is the insurer's implied obligation to deal with a claim reasonably and failing to do so will lead to damages; when the reinsurer takes over that claim, it is also an implied obligation of the reinsurer to handle the claim with reasonable care and failing to do so will also lead to damage loss and this loss is to indemnify the damages paid by the insurer according to the privity of contract.

⁷²³ *ibid*, at [49].

⁷²⁴ *ibid*, at [77].

According to the discussion above, it seems that once the Enterprise Act 2016 comes into force, it is more appropriate for the insurer to insert claim control provision instead of the claim co-operation clause in order to make those contracts back to back.

7.2.13 In order to decide whether a claim has been handled properly, it is required by the new Enterprise Act 2016 that “factors outside the insurer’s control”⁷²⁵ have to be considered as an important reference. It has been discussed above that in case of a claim co-operation clause or a claim control clause the reinsurer’s conduct would not affect the obligation of the insurer and it was held by Mance LJ that

“...insurers’ rights could only ever arise under a reinsurance such as the present if and when insurers’ liability to their original insured had been ascertained as to its existence and amount, by virtue of a judgment, award or settlement/compromise; and that, if this was so, inability (under the Claims Co-operation Clause) to settle or compromise without approval would mean that reinsurers could oblige insurers to allow themselves to be sued to judgment, before reinsurers could become liable.”⁷²⁶

Accordingly, it seems that when the reinsurer’s delay in approving or co-operating a settlement threatens the insurer’s obligation to make timely payment to the assured, it would be wiser for the insurer to abandon the settlement and start a legal proceeding against the assured. However, this

⁷²⁵ See s.13A (3) (d) of Insurance Act 2015 (To be amended by s.28 of the Enterprise Act 2016).

⁷²⁶ *Gan Insurance Co. Ltd v. Tai Ping Insurance Co. Ltd (Nos 2 and 3)* [2001] Lloyd’s Rep IR 667 at [39].

approach seems to be anomalous: if the claim provision is a claim handling clause the insurer would never bother to do so, because it has been discussed above in this part that once a claim control provision is inserted the obligation of the insurer and the reinsurer is completely back to back; secondly, abandoning a settlement and starting a legal proceeding in order to claim against the reinsurer, this approach seems like a conspiracy between the assured and the insurer and the reinsurer would gain a potential defence, according to the claim co-operation clause.

To conclude, the insurer could not deny the liability of late payment simply because the claim is co-handled or actually handled by the reinsurer, but in order to make sure that the insurer could be indemnified it would be better to insert a claim handling clause instead of a claim co-operation clause.

7.2.14 According to the discussion on the law of reinsurance, it is clear that the implied obligation on the insurer could make a huge impact on the reinsurance industry and this impact is probably even more serious than that in insurance market.

If the reinsurance contract states nothing about the cover nor the claim handling, it is theoretically possible for the reinsurer to deny liability for the damage paid by the insurer; while if the reinsurance contract states specifically that it covers the liability of the insurer, in order to exclude further liability the damage caused by the late payment of the insurer has to be clearly and specifically stated and excluded, subject always to the “deliberate or reckless exception” in s.29 of the Enterprise Act 2016

If a “follow the settlement” clause is inserted into the reinsurance contract the reinsurer’s argument could proceed on two levels: firstly whether the settlement is made by taking reasonable steps and in a businesslike manner and secondly whether a claim according to the settlement is within the cover of the reinsurance contract.

If a reinsurer wishes to insert a claim provision it should be remembered that a claim control provision gives more power to the reinsurer but at the same time it also requires the reinsurer to handle a claim reasonably and this part is problematic: in order to achieve a real back-to-back result when the implied obligation is imposed on the insurer, it is very likely that a claim control provision will be widely used and it means that more and more reinsurers will be ahead of insurers, instead of lagging behind them.

7.3 The future of insurance law

7.3.1 Before this work is completed, the draft Enterprise Bill 2015 has become the Enterprise Act 2016 and it will come into force on 4th May 2017. Several changes have been made to the Bill during these stages but the implied duty of insurers remains unchanged.⁷²⁷ However, it does not mean that this clause is uncontroversial and perhaps that is also the reason why the implied obligation could not exist in the Law Commission Bill.

⁷²⁷ Although there is an added section on time bar for the damages claim.

It is suggested by Hill Dickinson LLP⁷²⁸ that the “reasonable time” is too vague to be practical and therefore the insurance community, including insurers, brokers and policyholders, should work together to clarify which elements should be considered to constitute “a reasonable time”.⁷²⁹ It is also of concern to the law firm that the implied obligation of the insurer could bring uncertainty and unfairness to the reinsurance and subscription market; even though these problems could be solved by inserting policy wordings, the lead-in time is insufficient.

Unlike Hill Dickinson LLP, Lord Patten believed that the insurance industry should carry the implied obligation even before the Bill starts having its legislative power and the insurance industry has the power to do so; and it is rightly pointed out that the long-standing bad behaviour of the insurers could

“...hinder, or at worst torpedo, the efforts of small businesses to get back on their feet after, for example, the catastrophic floods...”⁷³⁰

This view is shared by Kit Malthouse from the House of Commons, who believes that it is necessary to impose such an implied obligation upon the insurers, and

⁷²⁸ Written evidence submitted by Hill Dickinson LLP (ENT 69), available on <http://www.publications.parliament.uk/pa/cm201516/cmpublic/enterprise/memo/ent69.htm>, accessed on 14th March 2016.

⁷²⁹ *ibid*, at para 19.

⁷³⁰ Lords Hansard 12th October 2015, available on <http://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151012-0001.htm#15101212000385>, accessed on 14th March 2016.

he also gives some examples where the insurer's failure to make a timely payment caused huge further losses to the assured.⁷³¹

Sajid Javid, who is also in favour of the implied obligation, addresses the problem from another aspect: it is stressed by Mr. Javid that the skill base plays a very important role in order to unlock the increasing productivity⁷³² and therefore the new implied obligation could "force" the insurance market to improve its skills to grow in prosperity.

7.3.2 Considering the practical difficulty of the implied obligation, an amendment was moved by Baroness Neville-Rolfe to insert a time bar for the damages claim for late payment, which requires a policy-holder to raise a claim within one year after the insurer pays all sums due under the insurance claim⁷³³ and this suggestion was successfully inserted in section 30 of the Enterprise Act 2016. It is believed by Baroness Neville-Rolfe that this amendment

"...does not prejudice them unduly. It also has the potential to protect the vast majority of policyholders, who will never need to bring a late payment claim, from any premium increases that may result as a consequence of insurers' increased costs..."⁷³⁴

⁷³¹ House of Commons Hansard 2nd Feb 2016, available on <http://www.publications.parliament.uk/pa/cm201516/cmhansrd/cm160202/debtext/160202-0004.htm#16020280000007>, accessed on 14th March 2016.

⁷³² House of Commons Hansard 2nd Feb 2016, available on <http://www.publications.parliament.uk/pa/cm201516/cmhansrd/cm160202/debtext/160202-0002.htm#16020263000002>, accessed on 14th March 2016.

⁷³³ Lords Hansard 15th December 2015, available on <http://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151215-0001.htm#15121538000331>, accessed on 14th March 2016.

⁷³⁴ *ibid.*

According to the new section, any **damages claim** has to be made within one year after the insurer made the payment under the policy. This short limitation does not affect the ordinary six years' time limit for **policy claims**, and the payment under the policy, according to subsection 2, could be widely interpreted as a payment according to the policy, a settlement payment or a payment forced by a judgment or an arbitration award. This section, *prima facie*, is a section to limit the right of the assured through using a short time limit; however, the true aim of that section is to balance the interests of both sides of the policy: it is of concern to the insurers that the implied obligation and the new cause of action could inevitably force them to keep their claim records and hold reserves in respect of possible late payment claims for an uncertain length of time; no unsurprisingly it would increase the cost of maintenance for insurers and therefore potentially increase premiums, while inserting this new limitation clause could reduce that concern and more importantly, it reflects the government's ambition that the late payment provision shall not be substantially changed.

It seems probable that the implied obligation may bring more cost for the insurance industry in the future, however, according to the Impact Assessment⁷³⁵ of the implied obligation there is a different answer:

Firstly, it is believed that there would be little training cost for the insurer because it has already been required by the FCA rules that all insurers should pay

⁷³⁵ Late payment of insurance claims- Impact Assessment, available on <<http://www.parliament.uk/documents/impact-assessments/IA15-009E.pdf>>, accessed on 14th March 2016.

promptly and be trained to do so, implying that an obligation on insurers does nothing more than stress that requirement.⁷³⁶

Secondly, even though it is predicted that a cost about £202,250 is to be spent to enable senior insurance managers to become familiar with the new law, that cost is for the new Insurance Act 2015 as a whole, not only for the implied obligation.

Thirdly, it is believed by the Assessment that the vague definition of “reasonable time”, which insurers worry about most, could only cause a few disputes in future litigation and those disputes are able to be clarified by several High Court’s rulings.⁷³⁷

It is also considered by the Assessment whether there could be speculative claims in the future and a negative answer is given, because even though the assured is able to prove all the required elements to raise a damages claim⁷³⁸ it is nevertheless open to the insurer to use the “reasonable basis” defence,⁷³⁹ additionally, the insurers are protected by the new limitation section,⁷⁴⁰ which would also increase the difficulty of raising a speculative claim.

Therefore, it could be argued that the actual main “cost” is not from the monetary aspect but the confidence in the law and in the insurance industry itself: if the insurance industry could provide a general guideline to define “reasonable time” and “reasonable basis”, it could then be predicted that after one or two leading cases decided by the court, the new law would be less uncertain.

⁷³⁶ *ibid*, at para 2.23.

⁷³⁷ *ibid*, at para 2.29.

⁷³⁸ These elements, for example, are a valid claim, causation, and the limbs in *Hadley v. Baxendale* which is fully discussed in chapter 3 of this work.

⁷³⁹ Insurance Act 2015, s. 13A (4), (to be amended by the Enterprise Act 2016).

⁷⁴⁰ See The Enterprise Act 2016, at s. 30.

Alternatively, the implied obligation could bring great benefits not only to assureds, but also the insurance industry and even to the economic environment of this country:

Firstly, it is axiomatic to mention that assureds could have direct monetary benefits from the new law and according to the Assessment that amount could be £1 million a year at the mid-point.⁷⁴¹

Secondly, it has been mentioned in this work that the current legal position of the insurer in the UK (except Scotland) is both isolated and anomalous; the new legislation could enhance the international reputation of English law and therefore attract more international assureds.

As to the economic environment, it is believed by the Assessment that the improved claim handling method could facilitate the recovery of the trading line between the supplier and business after the loss, and it could even provide safeguards when an assured company becomes insolvent.

Through all the stages of the Enterprise Act 2016, the implied obligation on the insurer has not been substantially changed: as a part of the Government Bill, the late payment provision has gone through the full scrutiny by House of Lords and House of Commons, and it is indeed a change “overdue”⁷⁴² in English law.

7.3.3 The development of indemnity insurance in this country has been discussed and it is very good to see that the reform focuses more on the

⁷⁴¹ Late payment of insurance claims- Impact Assessment, at para 2.45.

⁷⁴² Baroness Neville-Rolfe in Lords Hansard 15th December 2015, available on <http://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151215-0001.htm#15121538000331>, accessed on 14th March 2016.

commercial reality and re-balancing the interests between the insurer and the assured (and, of course, the insurer and the reinsurer).

When the Enterprise Act 2016 comes into force, there will be some inevitable problems. For example, it has been argued in this work that the implied obligation in the new Enterprise Act 2016 may have changed the primary obligation of the indemnity insurer: if it has, the indemnity insurance could be regarded as an ordinary contract (although the position of liability insurance remains due to the “hold harmless” principle), then the interest could be calculated on a compound basis and damages would certainly be recoverable; while if it has not, the implied obligation does nothing more than introduce a brand new cause of action in insurance law only, it does not deal with the unsolved problem as to the nature of the indemnity insurance or the common law blot in interest. However, although the debate on those problems could last, no one can deny the fact that those new rules on insurance law accelerate the prosperity of the insurance industry.

Chapter 8 Conclusion

8.1 After the discussion of the whole work, it is safe to conclude that: firstly, it should have been clarified that the primary obligation of the insurer is to indemnify the assured by payment or reinstatement and once such an obligation is breached a secondary obligation of paying damage will incur, in that scenario, the general rule of damages shall apply. Notably, damage is still payable even if the insurer refuses a claim with good faith but the refusal is turned out to be wrong objectively.

Secondly, interest carried by the primary payment of indemnity shall not start to run until the insurer finishes a reasonable investigation; even though interest does not mean punishment it should be calculated in compound basis to reflect the value of the money and the commercial reality.

Thirdly, it has been noticed that the non-legal ADR, the FOS has worked well in this country and it does help non-commercial assureds to a large extent since the law used to be silent. When the new Enterprise Act comes into force, it does not mean that the effect of the FOS will be diluted, in the contrary, it means that the importance and correctness of the FOS has been supported and proven by law. Moreover, the insurers, especially those general insurers in the UK shall learn from their colleagues in Australia as the Australian General Insurance Codes of Practice could be regarded as a good standard for their future performance.

Most importantly, it should be remembered that the Enterprise Act 2016 will come into effect in May 2017 and damages will be available for the assured and a brand new era for insurance has come.

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