

<b>Title:</b> Late payment of insurance claims  <b>IA No:</b> LAWCOM004X  <b>Lead department or agency:</b> HM Treasury  <b>Other departments or agencies:</b> Law Commission	<h2 style="margin: 0;">Impact Assessment (IA)</h2>
	<b>Date:</b> 02/09/2015
	<b>Stage:</b> Final
	<b>Source of intervention:</b> Domestic
	<b>Type of measure:</b> Primary legislation
	<b>Contact for enquiries:</b> Daniel Rusbridge HMT Daniel.rusbridge@hmtreasury.gsi.gov.uk

**SUMMARY: INTERVENTION AND**

**RPC Opinion:** GREEN

Cost of Preferred (or more likely) Option			
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2014 prices)	In scope of One-In, Two-Out?
£4.54m	£4.54m	-£0.37m	Yes
			OUT

**What is the problem under consideration? Why is government intervention necessary?**

Late payment is a major problem for businesses. Where a business has suffered a major loss such as a fire or flood, it is likely to rely heavily on insurance. Although Financial Conduct Authority rules require insurers to pay promptly (and consumers and micro-businesses can claim compensation from the Financial Ombudsman Service) indemnity insurers are under no legal obligation to pay valid claims within a reasonable time. This means that businesses with 10+ employees who suffer loss from an insurer's unreasonable delay cannot claim compensation. The law provides insufficient incentive for insurers to pay promptly.

**What are the policy objectives and the intended effects?**

Government is committed to combating late payment of sums due to businesses. The objectives of legal reform are to:

- ensure that the law incentivises insurers to pay within a reasonable time, and to promote payments within a reasonable time
- give policyholders a legal right to enforce prompt payment of insurance claims
- provide for limited compensation to be payable by an insurer where a policyholder suffers additional loss because of the insurer's unreasonable delay in payment.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

Option 0. Do nothing. This would leave the law out-dated and would leave policyholders who suffer additional losses because of an insurer's delay without a remedy.  
 Option 1. Introduce a legal obligation on insurers to pay valid insurance claims within a reasonable time. This would provide a legal basis for incentivising insurers to pay within a reasonable time, encouraging better claims handling practices and bringing the law into line with commercial expectations and normal commercial contract principles.

**Will the policy be reviewed?** It will not be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?	N/A				
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	Micro No	< 20 No	Small No	Medium No	Large No
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)	Traded:		Non-traded:		

**I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.**

Signed by the responsible Minister: \_\_\_\_\_  \_\_\_\_\_ Date: 02/09/2015

**Description:** Introduce a legal obligation on insurers to pay valid insurance claims within a reasonable time

### FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2016	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: £2.35m	High: £7.39m	Best Estimate: £4.54m

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.56	0.25	2.64
High	0.92	0.50	4.16
Best Estimate	0.65	0.38	3.77

#### Description and scale of key monetised costs by 'main affected groups'

**Transitional costs:** Familiarisation costs for insurers in Year 0 (best estimate - £202,250); Increased litigation costs in years 1-5 as measure is tested and precedent is developed (best estimate - £100,000 per year). **On-going costs:** Investigation cost of unmeritorious claims [Insurers] (best estimate - £0.375 million per year).

#### Other key non-monetised costs by 'main affected groups'

Maximum of 5 lines

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	0.60	4.99
High	0	1.50	12.47
Best Estimate	0	1.00	8.32

#### Description and scale of key monetised benefits by 'main affected groups'

No transitional benefits.

On-going benefits: Reduced losses arising from late payment of insurance claims (best estimate, £1 million per year).

#### Other key non-monetised benefits by 'main affected groups'

Reduced risk of business failure following catastrophic events such as fires and floods. Benefits to the wider economy resulting from faster recovery from insured events such as fire and floods.

Fewer cases where insurance fails leading to an increased level of confidence in the UK insurance market, including for overseas buyers, and more favourable perception of UK insurance contract law.

Key assumptions/sensitivities/risks

Discount rate (%)

3.5

Assumptions: Late payment litigation will be relatively infrequent, given requirement on policyholder to discharge burden of proof. Legal uncertainty will be resolved by precedents developed through courts.

Key benefit to be general improvement in claims handling.

Risks: more contracting out might remove some of the benefits of the reform.

### BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: 0.3	Benefits: 0.7	Net: 0.4	Yes	OUT

# EVIDENCE BASE

## TABLE OF CONTENTS

<b>Part 1: Introduction and background</b>	<b>2</b>
Problem under consideration	2
Scope and scale of the issue	4
Rationale for intervention	10
Policy objective	11
Consultation with stakeholders	11
Options considered	12
<b>Part 2: Costs and benefits</b>	<b>15</b>
Option 0	15
Option 1	16
Costs	17
Benefits	20
Table of monetised costs and benefits	23
<b>Part 3: General</b>	<b>24</b>
Risks and assumptions	24
One-in-two out	25
Sensitivity analysis and approach taken by this impact assessment	25
<b>Appendix A: Support for reform</b>	<b>27</b>
<b>Appendix B: Options considered but not taken forward</b>	<b>32</b>
<b>Appendix C: Calculation of costs</b>	<b>35</b>
<b>Appendix D: Specific impacts</b>	<b>38</b>
<b>Appendix E: Post implementation review plan</b>	<b>41</b>

# **PART 1**

## **INTRODUCTION AND BACKGROUND**

- 1.1 In 2006, the Law Commission and the Scottish Law Commission established a joint review of insurance contract law. This review has resulted in:
- (1) 10 issues papers;
  - (2) 3 consultation papers;
  - (3) 2 final reports with recommendations to Government; and
  - (4) 2 pieces of primary legislation: the Consumer Insurance (Disclosure and Representations) Act 2012 and the Insurance Act 2015.
- 1.2 The issue of late payment of insurance claims has been an important part of this review. Following complaints of late payment of claims by insurers, the Law Commissions recommended statutory reform to an anomalous common law<sup>1</sup> rule applying to England and Wales: namely that insurers are not legally obliged to pay valid claims within a reasonable time. As a result, policyholders who suffer loss as a result of the insurer's failure to pay on time may not seek compensation.
- 1.3 This impact assessment considers the costs and benefits of implementing the recommendation.

### **PROBLEM UNDER CONSIDERATION**

#### **The problem of late payment**

- 1.4 Late payment is a significant cost to business. As previous impact assessments have shown, late payment strains cash flow, adds financial costs, reduces potential for investment opportunities and fuels uncertainty. In some cases, it can lead to insolvency.<sup>2</sup> In response to the SME Business Barometer for February 2014, 37% of SME employers cited cash flow as an obstacle to their business success. Of these, two thirds (66%) said that late payment was a reason for this obstacle.<sup>3</sup> Similarly, research by Bacs in February 2015 found that 10% of businesses had experienced one or more of the following challenges as a result of late payment: difficulties paying staff, factoring invoices or difficulties paying regular bills.<sup>4</sup>
- 1.5 Businesses are especially vulnerable following a major loss, such a fire or flood. At such time they rely heavily on insurance payments to restore their businesses.

---

<sup>1</sup> Common law is law made through decisions of courts. Statutory law is law enacted by Parliament.

<sup>2</sup> See: See Impact Assessment on Directive on Combating Late Payment (4 December 2012) (IA No BIS0364).

<sup>3</sup> BIS: SME Business Barometer, March 2014.

<sup>4</sup> See Bacs News Release, 16 February 2015.

### **A special rule under English law: insurers not obliged to pay on time**

- 1.6 Under normal contract principles, where one party breaks a contract promise and the other party suffers loss as a result, the contract-breaker is liable to pay damages for the loss, provided the loss is foreseeable and the victim does all they reasonably can to mitigate it.
- 1.7 However, a rule developed through English case law treats contracts of insurance differently.<sup>5</sup> It is based on a “legal fiction” which states that the insurer’s obligation under a contract of indemnity insurance is not, in fact, to pay insurance claims in return for premiums. Rather, the insurer’s primary obligation is to “hold the indemnified person harmless against a specified loss or expense”.
- 1.8 The effect is that where an insurer refuses to pay a valid claim the policyholder may go to court to seek the insurance payment itself plus interest. But that is all they can ask for; the policyholder is not entitled to any additional losses caused by the failure to pay.
- 1.9 This rule is specific to England and Wales. In other jurisdictions (including Scotland) insurers are under a legal obligation to pay within a reasonable time.<sup>6</sup> It is also specific to payments under indemnity insurance. It does not apply to life insurance, or where an insurer undertakes to reinstate property.
- 1.10 Nor is the rule followed by the Financial Ombudsman Service (FOS), which receives complaints from consumers and micro-businesses, and has a jurisdiction to decide cases according to what is fair. The FOS is prepared to award damages to those able to prove actual loss. The Financial Conduct Authority rules also require insurers to handle claims promptly and fairly.<sup>7</sup>
- 1.11 However, insurers do not fall within the statutory framework for tackling late payment generally, which mandates payment terms and allows businesses to claim administrative fees and interest penalties.<sup>8</sup>

---

<sup>5</sup> *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)*; *Secony Mobil Oil Inc v West of England Shipowners Mutual Insurance Association (The Padre Island)* [1991] 2 AC 1 by Lord Goff at 35.

<sup>6</sup> The Law Commission considered the law on late payment of claims in seven other jurisdictions: all offered greater protection to policyholders than English law IP6, Part 7 and Appendix A.

<sup>7</sup> ICOBS Rule 8.1.1

<sup>8</sup> Late Payment of Commercial Debts (Interest) Act 1998, as amended in 2002 and 2013. Among other things, this legislation mandates a maximum, 60 day payment term, unless a longer term is agreed and the term is not grossly unfair. It also allows businesses to charge interest at 8% above the Bank of England base rate.

### **An example**

- 1.12 The case of *Sprung v Royal Insurance (UK) Ltd* illustrates the problem.<sup>9</sup> When Mr Sprung suffered damage to his factory, the insurers failed to pay his claim for four years, by which time he had been forced out of business. The judge at first instance found that, as a result of the insurer's delayed payment, Mr Sprung had suffered further losses of £75,000. The Court of Appeal held, with "undisguised reluctance", that the insurers were not liable for losses of this type. Instead, the Court of Appeal was bound by precedents which state that there could be no award of damages for late payment of a valid insurance claim. Mr Sprung was unable to recover the additional £75,000 loss.

## **SCOPE AND SCALE OF THE ISSUE**

### **Structure of the insurance market**

- 1.13 Insurance in the UK encompasses a very wide range of products. Different types of insurers underwrite different types of risks for different types of policyholders.
- 1.14 The Association of British Insurers (ABI) represents the UK's general insurance, protection and insurance-backed investment industry. It has over 250 members accounting for over 90% of premiums in the UK.<sup>10</sup> These members provide products like property insurance for consumers and SMEs as well as some very large policyholders and risks.
- 1.15 However, the general market is unlikely to write very large or unusual risks, or to deal much with international policyholders. This type of insurance cover is more usually provided by the specialist London Market, represented by the Lloyd's Market Association (LMA) and the International Underwriting Association (IUA). This market writes a huge variety of cover from, for example, shipping insurance to "parametric" products which, for example, might pay out to a national government on another continent in the event of a hurricane. These risks and the sums involved can therefore be far less predictable. However, this market accounts for less than 10% of the UK insurance market.
- 1.16 The proposed new measure discussed in this impact assessment is primarily aimed at the general insurance market, where insurance is often written on standard contract terms and when there is little opportunity for policyholders like consumers and SMEs to negotiate more favourable terms. In the specialist market, policyholders are often more sophisticated buyers of insurance and are more likely to agree bespoke contractual terms which are suitable for the particular policy which is being written.

### **Who is affected by late payment of insurance claims?**

- 1.17 The problem does not affect consumers who can complain to the FOS and obtain compensation of up to £150,000. The FOS is also available to micro-businesses, defined as those with less than 10 staff and an annual turnover of less than 2 million euros.

---

<sup>9</sup> *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111.

<sup>10</sup> <https://www.abi.org.uk/About> (last accessed 12 July 2015).

- 1.18 The main group affected is small and medium businesses in England and Wales, who employ between 10 and 250 staff. This group is especially vulnerable to late payment and lacks the market power to demand payment from insurers. Recent research published by BIS indicates that at the start of 2014 there were 238,435 businesses in this category.<sup>11</sup>
- 1.19 Generally, large businesses are less vulnerable to late payment, as they have more financial resources to cope with cash flow problems, and they have more power to negotiate with insurers on equal terms. On the other hand, research<sup>12</sup> suggests that large firms are not entirely immune to problems caused by late payment.
- 1.20 This section looks first at the number of insurance claims generally. In recent years, flood claims have had a major impact on this. This impact assessment therefore uses flooding as a case study, looking in more detail at the effect of prompt action in restoring businesses following flooding. It then summarises the available evidence on the scale and impact of late insurance payment more generally, both for SME and larger businesses.

#### **The number of business property insurance claims**

- 1.21 The problem of late insurance payment is most likely to occur with property claims, where premises or machinery have been damaged and must be restored before the business can continue to trade effectively.
- 1.22 In the UK the number of business property claims is weather dependent. It can vary between 7,500 in a “good weather year”, to 50,000 following major storms and floods. Over the last decade, the most serious damage occurred as a consequence of the floods in summer 2007, which resulted in 30,000 additional business claims.<sup>13</sup> The winter of 2013/14 also saw significant rain and storms. From 23 December 2013 to 28 February 2014, the ABI reported 3,100 business flood cases and 44,700 business storm damage claims. Of these, the flood claims were by far the most serious.

#### **Flood damage: the importance of prompt payment**

- 1.23 The importance of prompt payment can be illustrated by looking at the difficulties faced by small businesses following a major flood.

---

<sup>11</sup> BIS, *UK private sector enterprises: numbers of employees and turnover* (June 2015) Table 1. <https://www.gov.uk/government/publications/uk-private-sector-enterprises-numbers-of-employees-and-turnover>.

<sup>12</sup> For example. Mactavish summary of recent evidence provided to the Law Commission in January 2014, published in a different form in *Mactavish Evidence To Law Commission & HM Treasury Enquiries* (September 2014).

<sup>13</sup> Pitt Review ES55.

- 1.24 In 2005, David Crichton summarised research on this issue, looking in particular at the problems following the floods in 2000.<sup>14</sup> At that time, there had been many complaints of unreasonable delay. Crichton commented that loss adjusters had dealt with claims in an inconsistent way: “this lack of standardisation slows down claims handling enormously.”<sup>15</sup> Although a system had been developed to speed up the process, “claims managers could not see any direct benefits to them and the system was shelved”.<sup>16</sup>
- 1.25 The result had been that the business interruption costs had been much higher than anticipated. Crichton cited a 2002 survey by the Federation of Small Businesses of small businesses in the South East which had survived the 2000 floods. It found that losses had been significant: 42% had suffered losses of £50,000 or more taking into account business interruption costs. These firms were the lucky ones: a survey by AXA in 2003 found that the majority of small businesses affected by flooding either never re-open or cease trading within 18 months. The ABI reported a general loss of business as people avoided the disaster area and it was found that some communities “may be blighted permanently”.<sup>17</sup>
- 1.26 By contrast, following the floods in 2007, insurers co-ordinated a much quicker response. In 2008, the Pitt review looked in depth at the lessons learned. It found that by June 2008, 90% of flood claims had resulted in some payment, and that 70% of business claims had been paid in full.<sup>18</sup> The review commented:
- In general, the Review considers the insurance industry to have responded well to the summer 2007 floods, having being presented with one of its biggest ever challenges. As soon as the scale of the floods became apparent, insurers implemented their major event plans.<sup>19</sup>
- 1.27 On the other hand, the review noted some cases of poor claims handling, where the impact could be significant.<sup>20</sup>

### **The scale of delay**

- 1.28 The evidence suggests that late payment by insurers is relatively rare. However, it can occur. Generally the losses incurred by late payment are small, but can be substantial in some cases. In the most serious cases, the firm is put at risk.

---

<sup>14</sup> *Flood Risk and Insurance in England and Wales: Are there any lessons to be learned from Scotland?* Benfield Hazard Research Centre (March 2005).

<sup>15</sup> Above, p 62.

<sup>16</sup> Above, p 63.

<sup>17</sup> Above, p 36.

<sup>18</sup> See also ABI, *The Summer Floods 2007: one year on and beyond* (2008).

<sup>19</sup> Pitt review, para 9.59.

<sup>20</sup> Pitt review, para 9.58.



- 1.29 In 2011, the Law Commission carried out a survey to gauge the extent of late payment. They asked the independent research panel, Broking Now!<sup>21</sup> to survey a representative sample of 250 UK commercial insurance brokers. It was thought that, as insurance professionals, brokers would be better placed than policyholders to understand whether any delay was unreasonable. Out of the 250 brokers, 178 brokers (71%) had been involved in claims over the last two years.
- 1.30 All brokers who were involved in claims were asked how often they believed that the insurer had unreasonably delayed payment or settlement. In all, 60% of brokers said they had experience of unreasonable delay.<sup>22</sup> However, such cases were infrequent: two thirds of all brokers who had experienced delays stated that they occurred in less than 10% of cases, and almost half (47%) stated that they occurred in less than 5% of cases. This appears to be in line with the finding of the Pitt Review, which found that 10% of claims remained unpaid a year after the 2007 floods.

### **The effect of late payment**

#### **THE EFFECT OF LATE PAYMENT GENERALLY**

- 1.31 Although late payment of insurance claims can affect and negatively impact on any policyholder of whatever size, we have focussed on SMEs where there is already a growing literature on how small businesses deal with cash flow problems caused by late payments. SMEs are also more likely to operate on smaller margins and may therefore be less able or unable to cope with late payment after a major insured event.
- 1.32 Most businesses cope with late payments in the usual run of day to day business, but at some cost. They chase payments; they delay new expenditure; they delay payments to their own suppliers and they arrange loans.<sup>23</sup> All these have costs: for example, when faced with a serious cash flow problem, it often takes time to arrange a loan, and the business may face arrangement fees and high interest charges. A recent impact assessment on the effect of late payment summarised this point in the following terms:

Even when a company remains financially viable, late payment can drain resources, due to the need to chase late payments, manage the consequences of cashflow shortages (e.g. arranging an overdraft), and add uncertainty when taking decisions on their ability to invest and grow.<sup>24</sup>

- 1.33 However, some firms do not cope. As the same impact assessment put it:

---

<sup>21</sup> Broking Now!, Research on Damages for Late Payment (September 2011).

<sup>22</sup> By contrast, 36% said they had no experience of unreasonable delay or settlement, and 4% did not know.

<sup>23</sup> See bacs News Release, 16 February 2015; BIS: SME Business Barometer, March 2014.

<sup>24</sup> Impact Assessment: Requirement for large companies and listed companies to report on their payment practices and policies 03/10/2014.  
[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/380210/bis-14-1203-annex-e-duty-to-report-on-payment-practices-impact-assessment.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/380210/bis-14-1203-annex-e-duty-to-report-on-payment-practices-impact-assessment.pdf)

Late payments can have serious consequences, potentially leading to a firm declaring bankruptcy. One in four SMEs reported that if the amount owed to them rose to £50,000 it would be sufficient to put them at risk of bankruptcy. Research on Payment Culture in 2012 indicated that as a result of late payment 124,100 SME employers were almost put out of business. As many as 4,000 businesses could be forced into administration because of late payment.<sup>25</sup>

### ***The effect of late insurance payments***

- 1.34 Where insurance payments are delayed, the costs follow the same pattern. In a relatively small delayed storm damage claim, for example, the business may be able to restore the damage from its own resources, through a combination of chasing payments, delaying expenditure and borrowing money.
- 1.35 However, following a major incident, such as fire or flooding, any delay in repairing premises or equipment is likely to lead to lost business. At this stage, the risk of business failure is particularly acute. The Association of British Insurers reports research that in the absence of an insurance payment 80% of businesses which suffer such a major incident fail within 18 months.<sup>26</sup>
- 1.36 In the Law Commission's broker survey, brokers were asked to identify insurance claims where the insurers had acted with unreasonable delay. They were then asked to identify the costs of those delays to the business. Again, the survey showed that in most cases the costs were those of "coping". In 90% of cases brokers estimated the average financial loss as a result of an insurer's unreasonable delay was no more than £5,000, and in 71% of cases was no more than £2,000.<sup>27</sup> Although brokers were well placed to consider whether delay was unreasonable, they may have tended to under-estimate the extent of these losses. While they would have been aware of direct payments, they may not have been aware of the extent of staff time in dealing with cash flow problems, for example, or the opportunity costs of delaying expenditure on other items.
- 1.37 Substantial losses were rare, but they did occur. Three brokers mentioned cases with losses of more than £10,000. One broker reported a loss of over £100,000, where a company had been unable to resume trading for a substantial time.

---

<sup>25</sup> Impact Assessment: Requirement for large companies and listed companies to report on their payment practices and policies 03/10/2014.  
[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/380210/bis-14-1203-annex-e-duty-to-report-on-payment-practices-impact-assessment.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/380210/bis-14-1203-annex-e-duty-to-report-on-payment-practices-impact-assessment.pdf)

<sup>26</sup> Association of British Insurers, *Insurance for Small Businesses: A guide to protecting your business*.

<sup>27</sup> In all 65 brokers provided a figure.

### ***The scale of delay: larger businesses***

- 1.38 Mactavish is a research and advisory service specialising in insurance and risk. In 2012 and 2013 it interviewed around 400 UK businesses with an annual turnover of £50m or more. 40% reported making a significant insurance claim within the previous three or four years. Disputes had arisen in 45% of claims, and these disputes had taken an average of just under 3 years to resolve.<sup>28</sup> Mactavish commented that firms found delays more difficult to absorb. They were more materially dependent on insurance than before the financial crisis,<sup>29</sup> and would find it more difficult to obtain bridging loans from banks.
- 1.39 The risk managers' association, Airmic, represents insurance buyers and risk managers for about 75% of FTSE 100 companies and a substantial number from FTSE 250 and smaller firms. It speaks both for large and smaller businesses. When in 2013 Airmic asked its members to identify "the five aspects of the insurance market which are of most concern to you", two-fifths (42%) mentioned "delayed insurance claim payments". Airmic commented:
- Effective indemnity depends as much on the timing of payments as the adequacy of the final settlement if a business is to survive the post loss recovery period. In the event of unreasonable delays in the settlement process, there is currently inadequate opportunity for legal redress. This fact does nothing to encourage reasonable behaviour on the part of the insurer.
- 1.40 Although the available data concentrates on the effect of late payment to small businesses, it appears that the issue may also affect large businesses.

### ***The effect on the wider community***

- 1.41 The effect of late payment is not confined to the individual businesses. Many studies looking at late payment generally have found a "domino effect": that is, if a business is paid late, it is less likely to pay its own suppliers on time. For example, the Bacs research estimated that due to late payment 25% of companies were forced to pay their own suppliers late. In the survey undertaken by the FSB, 32% of SMEs had paid their suppliers late because of outstanding payment.<sup>30</sup>
- 1.42 Where a business is put at risk of failure following a fire or flood, the effect on the wider community can be more serious. It can have implications for suppliers, customers, employees and the local economy more generally.

---

<sup>28</sup> Mactavish summary of recent evidence provided to the Law Commission in January 2014, published in a different form in *Mactavish Evidence To Law Commission & HM Treasury Enquiries* (September 2014).

<sup>29</sup> That is, they could not now absorb a major loss of half or two-thirds of the insurance policy limit on a major class without severe financial and strategic consequences. Mactavish summary of recent evidence provided to the Law Commission in January 2014.

<sup>30</sup> See Impact Assessment: Requirement for large companies and listed companies to report on their payment practices and policies 03/10/2014. para 46.  
[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/380210/bis-14-1203-annex-e-duty-to-report-on-payment-practices-impact-assessment.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/380210/bis-14-1203-annex-e-duty-to-report-on-payment-practices-impact-assessment.pdf)

- 1.43 A study commissioned by DEFRA and Calderdale Council on the impact of flooding and flood risk on community economic resilience in the Upper Calder Valley identified the direct and consequential impact of floods which affected that area in June and July 2012.<sup>31</sup> It found that the negative impacts on the local community significantly outweighed the positive. Those positive impacts which did materialise were largely due to the impact of insurance payments, where these were spent at local businesses. The costs were those of business interruption, which had major knock-on consequences for local businesses.
- 1.44 The study found that the biggest loss suffered by the local economy was the decrease in trade among businesses and their supply chains in the months after the floods (£831,324 from 21 businesses), rather than from uninsured direct impacts (£199,449 from 12 businesses).
- 1.45 Clearly, if the insurance payment had been delayed, then the gain to local suppliers would be delayed or even lost, and trading would be likely to be reduced for a longer time, causing additional loss not only to the immediate business but also to its suppliers.

#### **Scale of the problem: conclusion**

- 1.46 Most insurers do pay claims fairly and within a reasonable time. Significant delays are rare. The Pitt review found that one year after the 2007 floods, no payment had been made in 10% of claims, but not all this delay is necessarily unreasonable. The 2011 brokers' survey indicated that unreasonable delays occurred in less than 5% of all claims.
- 1.47 In most cases, where the claims are relatively minor, businesses "cope" with the effect of late payment: they juggle income and expenditure, borrow money and restore premises. However, for major incidents such as floods, delay in insurance payments can put businesses at risk. Following a major incident such as a fire or flood, businesses are very likely to fail if they do not receive payment within 18 months.
- 1.48 This has repercussions for the community more generally. It is clear that the effects of delay in business restoration can be considerable, with repercussions for suppliers, customers, the local economy, employees and their families.

#### **RATIONALE FOR INTERVENTION**

- 1.49 SMEs are most affected by current arrangements because unlike individuals and micro businesses they are unable to complain to the Financial Ombudsman Service to claim compensation for late payment. There are economy-wide benefits from encouraging SMEs as they are significant contributors to employment, innovation and a competitive environment. Ensuring redress through damages reduces the risk perception associated with small business survival and directly impacts on finance arrangements.

---

<sup>31</sup> <http://www.nationalfloodforum.org.uk/wp-content/uploads/Calderdale-flooding-community-economic-resilience-final-Jan-2015.pdf>.

- 1.50 The current legal treatment of insurance claims risks bringing English law into disrepute and undermining a culture of prompt payment. It also does not do enough to encourage insurers to pay promptly, thereby increasing the risk of business failure. Insurers are insufficiently incentivised to make payments promptly.
- 1.51 The Government is committed to combating late payment through both legislative and non-legislative means. The current legal rule giving special treatment to indemnity contracts is well entrenched in common law. It can only be changed by legislation.

### **POLICY OBJECTIVE**

- 1.52 The policy objective is to incentivise insurers to pay insurance claims promptly and:
- (1) encourage better claims handling procedures and prompt payment generally;
  - (2) reduce cash flow bottlenecks due to late payment, which at their worst can result in failure of businesses;
  - (3) give policyholders an avenue to claim redress where an insurer fails to pay within a reasonable time;
  - (4) bring the law into line with the approach taken by the Financial Ombudsman Service which at present only consumers and micro businesses can benefit from;
  - (5) change a legal fiction in English law which appears unfair, unprincipled and which is out of step with commercial expectations, general contractual principles and most other comparable jurisdictions including Scotland; and
  - (6) enhance confidence in the UK insurance industry.

### **MAIN STAKEHOLDERS**

- 1.53 The main stakeholders for this reform are:
- (1) Insurers;
  - (2) Policyholders of all descriptions, but especially business policyholders which do not fall within the FOS' remit;
  - (3) Brokers; and
  - (4) Lawyers and judges.

### **CONSULTATION WITH STAKEHOLDERS**

#### **The Law Commission's review of insurance contract law**

- 1.54 The proposed measure has been developed by the Law Commission following considerable consultation with stakeholders over several years.

- 1.55 In March 2010, the Law Commission published an Issues Paper on Damages for Late Payment which proposed a solution centring on an obligation to act in good faith.
- 1.56 Following consultation, the Law Commission modified its views. It consulted on its modified views in December 2011, publishing both a consultation paper and an impact assessment.<sup>32</sup>
- 1.57 The Law Commission's proposals were well supported: 87% of respondents (33 of 38 who answered the question) agreed that insurers should be under a contractual obligation to pay claims within a reasonable time. Furthermore, 81% (30 out of 37) agreed that a failure to meet this obligation should trigger a liability to pay damages for any foreseeable loss which results.
- 1.58 In the insurance industry, the ABI accepted there was a need for reform, and there was majority support for reform among insurance companies themselves, particularly in the general insurance market. In her oral evidence to the Special Public Bill Committee on the Insurance Bill, the Head of Legal Affairs for the Association of British Insurers said:
- No member of the ABI came out against this clause, but there are members who are very supportive of it and who point out that for their SME customers, a claim being paid within a few months can be the difference between survival and failure.
- 1.59 Out of the 14 insurers and insurance organisations who responded to the Law Commission's consultation, 11 agreed that insurers should be under a contractual obligation to pay claims within a reasonable time:
- Insurers should be obliged to pay claims within a reasonable time, provided that this is adequately defined and allows for investigation of the claim. [Hannover Life Re]
- We agree that insurers should be obliged to pay a valid claim for foreseeable losses where the insurer has failed to pay a valid claim within a reasonable period. [RSA]
- 1.60 On the other hand, the specialist insurance market was less supportive: the Lloyd's Market Association expressed "grave misgivings". They were concerned that any legal change would generate litigation and open the floodgates to speculative claims. It is expected that, if the late payment provision is not suitable in this market or in particular types of contract, specialist insurers will seek to contract out or otherwise limit their liability in this area.
- 1.61 A fuller discussion of stakeholders' views is included in Appendix A.

### **OPTIONS CONSIDERED**

- 1.62 This impact assessment compares two options:

---

<sup>32</sup> Insurance Contract Law: Post Contract Duties and Other Issues (2011) Law Commission Consultation Paper No 201, Scottish Law Commission Consultation Paper No 152.

- Option 0: do nothing. This would leave policyholders without a remedy where an insurer unreasonably fails to pay a valid claim within a reasonable time.
- Option 1: introduce an implied contract term requiring insurers to pay insurance claims within a reasonable time, as set out below.

**Option 1: An implied contractual term that insurers should pay valid claims within a reasonable time**

- 1.63 The new measure creates an implied term in insurance contracts that insurers will pay sums due within a reasonable time. A policyholder who suffers loss as a result of breach of that term would then be able to recover contractual damages from the insurer.
- 1.64 What is a reasonable time for payment will depend on all the circumstances of the particular case, but some guidance is provided in the drafting. A reasonable time should always include time to investigate and assess the claim, bearing in mind:
- (1) the type of insurance;
  - (2) the size and complexity of the claim;
  - (3) compliance with any relevant statutory or regulatory rules or guidance; and
  - (4) factors outside the insurer's control.
- 1.65 During consultation, insurers expressed concern that allowing damages for late payment might inhibit the full investigation of fraudulent or dubious claims. The measure therefore gives insurers a defence to a claim for late payment where they incorrectly refuse to pay a claim but can show that they acted reasonably in doing so. This protects the ability of insurers to take a robust approach to decision-making where they suspect fraud or non-compliance with policy terms or where the precise circumstances of the loss are not clear.
- 1.66 The measure would apply to consumer insurance contracts as well as non-consumer (business) insurance, although the main focus is non-consumer policies. It is not thought that the measure would affect consumer policies, as consumers have the ability to complain to the FOS, which already awards compensation for late payments.
- 1.67 Consistent with other contract principles and with the more general reforms to insurance law introduced in the Insurance Act 2015, the implied term is a default rule for business insurance. The parties would be permitted to agree alternative arrangements in their contracts, provided that the insurer takes reasonable steps to ensure that the policyholder is aware of the contracting out provision and that the effect of the provision is reasonably clear. However, the measure prevents all contracting out of liability for an insurer's deliberate or reckless failure to pay within a reasonable time.

- 1.68 Contracting out is not expected to be a regular practice for the mainstream insurance market writing insurance policies for SMEs and for standard risks. However, the implied term may not be suited to some large or bespoke risks, which may be particularly difficult to investigate. In these cases, insurers may contract on the basis that the insurer would not be liable for any failure to pay or may limit the recoverable damages, provided that the term is reasonably clear and that the insurer takes reasonable steps to bring it to the attention of the policyholder.
- 1.69 The measure would not effect any substantial changes to the law in Scotland, where the Scots courts already award damages for late payment. Following a recommendation of the Scottish Law Commission, however, the new measure would apply throughout the UK. In Scotland it would act as a statutory codification of the position at common law, allowing the law to be clearer and better known.

#### **OPTIONS CONSIDERED BUT NOT TAKEN FORWARD**

- 1.70 Two other options were considered but were rejected as failing to adequately meet the policy objective or due to stakeholder concerns. For this reason, we have not assessed the monetised costs or benefits of these options. For completeness, these policy options and the arguments against them are outlined in Appendix B.



## **PART 2**

### **COSTS AND BENEFITS**

- 2.1 This impact assessment identifies both monetised and non-monetised impacts of intervention, with the aim of understanding the overall impact on society and the wider environment. The costs and benefits of each option are measured against the “do nothing” option (Option 0).
- 2.2 Impact assessments place a strong emphasis on valuing the costs and benefits in monetary terms. However, data in this area are extremely difficult to obtain. They were sought from stakeholders on several occasions, most notably as part of the Commissions’ consultation paper and impact assessment in 2011.
- 2.3 To complete this impact assessment, the Department has used publicly available information which largely relates to the effect of late payment on businesses generally (rather than in an insurance context) and studies on the effects of flooding on businesses and the local community. It has also relied on the results of a survey of brokers commissioned by the Law Commission in 2011. Furthermore, the Department has drawn on the impact assessment prepared in relation to the measures contained in the Insurance Bill, which was submitted to the RPC on 26 August 2014 and entitled *Insurance Contract Law: Updating the Marine Insurance Act 1906*. In particular, this has been used for the costs of familiarisation and the costs of insurance disputes.
- 2.4 It is thought that these data are adequate to monetise the costs and some of the benefits. However, many of the benefits have not been quantified. In the absence of other sources of data, this is considered to be a proportionate approach.
- 2.5 When calculating the New Present Values (NPVs) for the impact assessment, we have used a time frame of 10 years, with the year the legislation is passed (2016) being year 0. We have assumed that the transitional costs occur in year 0 and years 1-5, and ongoing costs and benefits accrue in years 1 to 10. A discount rate of 3.5% has been used in all cases in accordance with Treasury guidance. Unless stated, all figures are in 2015 prices, and have been up-rated using the GDP deflator.

#### **Option 0 – Do nothing**

- 2.6 Option 0 is the base case against which our other options are measured. Because the “do nothing” option is compared against itself, its costs and benefits are, of course, zero, as is its NPV. While there would not be any additional costs, current costs would continue to be incurred. These are discussed below to provide context for the assessment of the other options.

#### **Costs**

- 2.7 The “do nothing” option would leave the existing system unchanged. It is not a cost-free option. With insufficient incentive to pay promptly, insurers may continue to introduce unreasonable delays. This would be a particular problem for small and medium businesses, who will incur the costs of coping with late payment and face the risks of business failure.

## **Benefits**

- 2.8 Doing nothing would avoid the costs of reform.

### **OPTION 1**

- 2.9 This impact assessment is based on the additional costs and benefits which would be introduced by the measure. Below it considers the number of cases which would be affected. It then looks at the direct costs and benefits to businesses. The costs arise from the need for familiarisation, resolving legal uncertainty and from unmeritorious claims. The benefits arise insofar as the measure reduces the incidence of unreasonable delay.

#### **Additional costs only**

- 2.10 Under existing FCA rules, insurers are already required to handle claims promptly and fairly.<sup>33</sup> This means that the measure would not impose any substantial additional obligations on insurers who may face an FCA fine if they regularly fail to comply. It would, however, increase the sanctions on non-compliant insurers, by allowing policyholders to claim damages for the losses caused by unreasonable delay, provided that those losses were foreseeable and that the business took steps to mitigate the loss (in accordance with usual contract law principles).
- 2.11 Therefore in line with the Better Regulation guidance,<sup>34</sup> this impact assessment does not consider the costs to non-complying insurers of compliance. Nor does it consider standard interest payments: insurers are already required to pay interest on insurance payments as they make them.
- 2.12 In addition, the benefits to businesses of the compensation payments are not quantified. These are clearly a benefit to the policyholder but an equal cost to non-compliant insurers. Overall they are cost neutral. Nor do the figures include the costs on businesses of making successful claims against insurers. Under cost-shifting rules these costs will be borne by the non-compliant insurer.

#### **An estimate of the number of affected cases**

- 2.13 The measure would apply to all policyholders. However, consumers and micro-businesses can already claim compensation from the FOS. The FOS provides clear benefits over the court system: it is free to make complaints and operates more quickly. Therefore, it is not anticipated that consumers and micro-businesses will bring cases to the courts. The main effect, therefore, will be from businesses with more than 10 employees.
- 2.14 As we have seen, the number of business property claims is heavily affected by the incidence of severe weather conditions, ranging from 7,500 in good weather to 50,000 following major storms and floods.

---

<sup>33</sup> ICOBS 8.1.1.

<sup>34</sup> BIS, *Better Regulation Framework Manual: Practical Guidance for UK Government Officials* (March 2015), para 1.9.44.

- 2.15 Taking an estimate of around 20,000 business property claims, the insurer will have unreasonably delayed payment in only a small proportion. In a survey of brokers conducted on behalf of the Law Commission,<sup>35</sup> 40% of brokers reported no evidence of delay in any cases; out of the remaining 60%, almost half of brokers reported delay in less than 5% of cases. Based on that study, an estimate has been made that unreasonable delay occurs in 2% of cases, leading to a total pool of around 400 cases each year.
- 2.16 As the survey of brokers showed, most cases involve small losses of up to £5,000. Only a small proportion is likely to involve substantial losses of £100,000: probably less than 10%. However, in these cases the losses are likely to be substantial, with major business interruption and possible business failure, leading to impacts on employment and on the wider community generally.
- 2.17 There are methodological problems in estimating the number and value of these large potential claims. Studies of businesses fail to record the instances of business failure: once a business has failed it is no longer in the study. And studies of business failure tend to show multiple causes; it is difficult to relate failure to any one issue. Furthermore, instances of failure tend to be relatively rare, so it is difficult to extrapolate from one or two cases in any given study to the whole population. Below, some estimates are given of small losses where businesses used coping strategies to deal with late insurance claims, by obtaining money from other sources (often bridging finance at high interest rates) to repair premises and equipment.
- 2.18 It has not proved possible to estimate the larger losses where businesses fail to survive, although the effects may be substantial.

## **COSTS**

- 2.19 The main costs of this measure fall on insurers. Concerns were expressed by the Lloyd's Market Association on behalf of specialist insurers that the measure exposed them to new and uncertain claims. They would need to review their reserving guidelines, so that cases with potential large late payment claims were reserved for more than just the amount of the claim plus interest. They also feared that the measure would encourage speculative and unmeritorious claims, which would cost time to investigate and reject. These concerns are discussed further under risks and assumptions.
- 2.20 General insurers, who cover standardised risks for the SME market, did not raise these concerns. They felt that they already had systems in place to ensure prompt payment, and where these failed they were accustomed to paying small compensation payments to consumers and micro-businesses in response to FOS rulings. This was reinforced by their experience of dealing with insurance claims in Scotland where the courts already recognise claims for late payment. Insurers did not think that the Scottish approach to late payment had any effect on the cost of insurance, and none said they charged any additional premium for writing insurance under Scots law.

---

<sup>35</sup> Broking Now! In association with BIBA by FWD Research, *Research on Damages for Late Payment* (September 2011).

- 2.21 By contrast, specialist insurers do not write unusual or bespoke risks under Scots law and have no experience of the Scottish approach to damages for late payment. They would incur costs in familiarising themselves with the new measure.
- 2.22 Following consultation, the main costs identified are initial costs for specialist insurers: familiarisation; developing reserving guidelines; and litigation to resolve possible legal uncertainty. The on-going costs lie in investigating potentially speculative and unmeritorious claims.

## **TRANSITIONAL COSTS**

### ***Training***

- 2.23 It is not thought that the change would generate a need for additional training. Insurers are already required by FCA rules to pay promptly, and to have systems and training in place to ensure this. Claims handlers should already be trained on the need for prompt payment, and this change would simply reinforce the message that claims should be handled without delay, by pointing to the possibility of compensation claims if delay is unreasonable.

### ***Familiarisation: year 0***

- 2.24 This measure would be part of wider reforms to insurance law introduced by the Insurance Act 2015 and due to be introduced in August 2016. These were considered in detail in the Impact Assessment of 26 August 2014 on updating the Marine Insurance Act 1906.
- 2.25 The previous IA on updating the Marine Insurance Act identified 125 specialist insurers. It estimated that each of these 125 insurers would allocate 10 days of senior staff time to review the rules and consider their implications, at a cost of **£809 per day**. Senior managers would need to consider whether and when to contract out of the new rules and what training requirements may be needed. The basis of these calculations are set out in Appendix C.
- 2.26 We think this change on late payments would add an additional two days to this review process. In particular, senior managers would need to consider their policy on contracting out of the new provision and the implication for reserving. They would need to develop new guidelines for making reserves where files indicated losses caused by unreasonable delay.
- 2.27 On this basis, the costs would be 125 firms x 2 days x £809 per day = **£202,250, all in year 0.**

### ***Litigation caused by legal uncertainty: years 1 - 5***

- 2.28 Insurers were concerned that legal change would generate disputes and lead to litigation over the meaning of a “reasonable time” and acting reasonably to dispute a claim. Any change in the law is likely to generate some initial court rulings, to resolve uncertainty about how the rules apply in practice. However, it is not anticipated that this change would generate a great number of cases and the volume of litigation would fall back after an initial surge. In Scotland, where liability for late payment of insurance claims is already a feature of case law, there have been fewer than five cases on this issue in the past 25 years.

- 2.29 Furthermore, previous experience of litigation suggests that any disputes would be resolved by a few clear court rulings: that is two or three High Court judgments, together with one or two Court of Appeal judgments. These are likely to be spread out over the first five years.
- 2.30 It is highly likely that any late payment claim which was taken to court would be part of a more general dispute about the underlying insurance payment, rather than a discrete case. The initial costs to be calculated are therefore the additional costs of including a claim for damages for late payment in a dispute concerning payment of the substantive insurance claim. However, any appeal to the Court of Appeal on a point of law (such as the meaning of a “reasonable time”) is likely to be a stand alone appeal.
- 2.31 Again, the costs of High Court and Court of Appeal cases for major insurance disputes were considered in detail in the Impact Assessment of 26 August 2014 on updating the Marine Insurance Act 1906. They are repeated in Appendix C. Major insurance claims generate a high level of dispute, and those disputes can be expensive. For both sides, the total cost of a High Court judgment is estimated at £400,000 (see Appendix C for details).
- 2.32 It is not anticipated that late payment claims will result in major stand-alone disputes. In most cases they will simply be an ancillary claim added to the main dispute about whether the claim itself is valid. These ancillary claims will therefore add costs to other cases. The additional costs resulting from a late payment claim argued at the High Court are estimated at £100,000.
- 2.33 A Court of Appeal case is estimated at £200,000 (again, see Appendix C for details).
- 2.34 On this basis, a low estimate of two High Court judgments and one Court of Appeal judgment would be £400,000 over five years, amounting to £80,000 a year for the first five years. A high estimate of four High Court judgments and two Court of Appeal judgment would amount to £800,000, or £160,000 a year for the first five years. The best estimate (of three High Court and one Court of Appeal judgement) would be £500,000, amounting to **£100,000 a year for the first five years**.

**Present value over 5 years: £0.45 mn (best estimate)**

***Ongoing costs: insurers’ costs of investigating unmeritorious claims: years 1 - 10***

- 2.35 A major concern for insurers was that the change might provoke speculative and unmeritorious claims, which would take time and resources to investigate and dispute. Initially insurers were concerned that the change would encourage claims for “bad faith” similar to those received by the courts in the USA.
- 2.36 The policy was developed to meet this concern, so that the final provision requires policyholders to show six elements before damages will be awarded. To claim financial loss the policyholder must show that:
- (1) It has a valid claim.

- (2) The insurer is responsible for unreasonable delay. The insurer must have had sufficient time to carry out a full investigation, including time to seek information from third parties etc, and the insurer has a defence if it had a reasonable basis for disputing the claim.
  - (3) The policyholder has suffered actual loss. This would never be presumed and must be proved in each case.
  - (4) The loss was caused by the unreasonable delay.
  - (5) The loss was foreseeable, in that it was within the “reasonable contemplation” of both parties at the time the contract was made.
  - (6) The policyholder took all reasonable steps to mitigate its loss, for example, borrowing money for repairs where necessary.
- 2.37 Even where the policyholder succeeds in meeting the requirements set out above, the insurer has a defence if the insurer can show that it had a reasonable basis for disputing the claim.
- 2.38 Given these safeguards, it is not thought that there will be many speculative claims. A further curb on these claims is provided by the cost shifting provisions which mean that the losing party is responsible for the costs of both sides. Insurers will only incur substantial costs where policyholders make fraudulent claims which then require investigation. It is not thought that these will be numerous: based on consultation and the experience in Scotland, it is anticipated that these will be no more than 10 to 20 a year. Again, it is thought that there might be an initial surge in such attempts where policyholders “tried it on” but that this would die down in the medium term when the rule has bedded in and parameters have been set by case law.
- 2.39 Using the figures in Appendix C we have estimated the insurer’s pre-court cost of investigating and disputing a fraudulent claim at £25,000 per case.
- 2.40 A high estimate of 20 cases at £25,000 a case would be £500,000; a low estimate of 10 cases at £250,000. We have taken a best estimate at the mid-point of 15 cases, at a total of **£375,000 a year over 10 years**.

**Present value over 10 years: £3.77 mn (best estimate)**

#### **BENEFITS**

- 2.41 The direct beneficiaries of this measure would be policyholders. The primary benefit of the measure would be to encourage insurers to reduce the number of valid claims paid unreasonably late to business policyholders, and policyholders would therefore benefit from faster insurance payments. They would also benefit from the right to claim damages if an insurer delays unreasonably.

#### **Transitional benefits**

- 2.42 No transitional benefits identified.

### **Monetised on-going benefits**

- 2.43 As we have seen, many policyholders who are paid late use coping strategies to juggle cash flow and borrow money, suffering only small losses. These losses are relatively small, but can be quantified. Following the 2011 brokers' survey, coupled with other research on the cost of chasing debts, arranging loans and delaying further expenditure, the costs are estimated at between £2,000 to £5,000 per case.
- 2.44 The estimates given above are that unreasonable delay occurs in 2% of cases, leading to a total pool of around 400 cases each year, with average losses per case of between £2,000 and £5,000. The Impact Assessment Toolkit<sup>36</sup> states that 100% compliance with a regulation should be assumed unless there is evidence to the contrary. Given that insurers are already required to pay promptly under FCA rules yet some instances of late payment do arise, it seems likely that late payment may still be an occasional feature even after a legal obligation, and the threat of liability to pay compensation, are introduced. We do not think therefore think that we can assume 100% compliance, but we think it reasonable to assume that the prospect of legal liability for late payment would reduce the number of late payments from 400 to 100, a reduction of 300 cases where the policyholder would benefit by not suffering the relevant loss.
- 2.45 On this basis a high estimate of the benefits to business policyholders would be  $300 \times £5000 = £1.5$  million. A low estimate would be  $300 \times £2,000 = £600,000$ . We have taken a best estimate at the mid-point, amounting to **£1 million a year**.

### **Present value over 10 years: £8.32 mn (best estimate)**

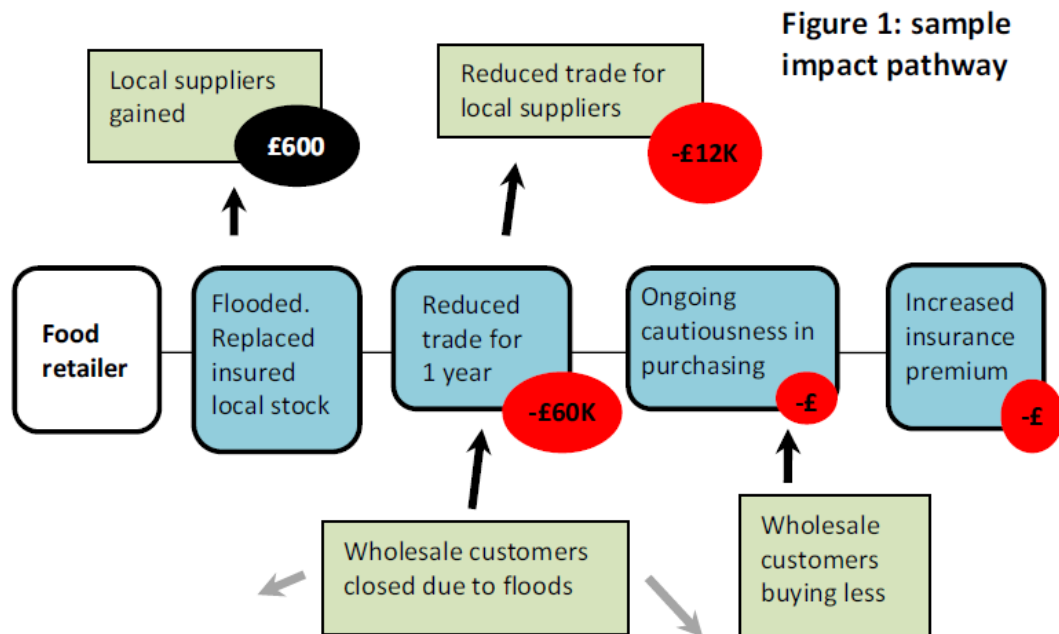
#### **Further benefits to policyholders**

- 2.46 More importantly, it would reduce the losses of those who as a result of late payment under the current law are unable to reinstate premises and equipment, suffering further business interruption costs and risking insolvency. We note the work done by the ABI and AXA which suggests that after delay of 18 months or more, most businesses will fail. Given the shortage of data in this field, we have not been able to quantify these losses. However, they could be considerable, both to the business itself and to the wider economy.
- 2.47 A study commissioned by DEFRA and Calderdale Council on the impact of flooding and flood risk on community economic resilience in the Upper Calder Valley set out a variety of case studies showing the losses and gains produced in specific instances.<sup>37</sup>

---

<sup>36</sup> HM Government, *IA Toolkit: How to do an Impact Assessment*, para 103.

<sup>37</sup> <http://www.nationalfloodforum.org.uk/wp-content/uploads/Calderdale-flooding-community-economic-resilience-final-Jan-2015.pdf>.



- 2.48 In the figure above, it appears that the insurance claim was paid quickly so that stock could be replaced, and yet there was still a £60,000 loss due to reduced trade in the first year, having an impact on suppliers. If this payment had not been received, the local suppliers would not have benefited by £600, the reduction in trade would be much more severe (or indeed the business may cease trading altogether) and the suppliers' trade would be further reduced.
- 2.49 Clearly, if the insurance payment had been delayed, then the gain to local suppliers would be delayed or even lost, and trading would be likely to be reduced for a longer time, causing additional loss not only to the immediate business but also to its suppliers.
- 2.50 If the business tries to mitigate its loss by borrowing money, it may be put in the position of having to take bridging finance which can come at high arrangement fees and high interest rates. However, they may find it difficult to obtain any finance when they are in a distressed state.
- 2.51 It is impossible to assess what these losses might be, or to extrapolate estimates for the effect of such situations on businesses more generally. However, it is clear that the benefits to businesses in some instances could be substantial.
- 2.52 If the business were to become insolvent then, as well as direct losses to the directors, many other people and entities are likely to suffer: employees who are made redundant, banks and other lenders who will not receive full satisfaction of their loans, local councils who will not receive business rates, HMRC which will not receive all outstanding taxes, and many others including trade creditors, suppliers, landlords and consumers.



### Benefits to the wider UK insurance market

2.53 The introduction of this reform could also have wider benefits for the UK insurance market if its legal protections are seen to be improving. The Government’s UK insurance growth action plan states:<sup>38</sup>

The Government wants to see an insurance sector that helps customers manage risk, puts its customers first...<sup>39</sup>

2.54 Insurance is a crucial UK export but on this matter the law does not put policyholders first or assist them in managing risk. The current law is out of step with other major insurance jurisdictions. The Law Commission considered the law on late payment of claims in seven other jurisdictions (Australia, the USA, Canada, Germany, Italy, Spain and China), all of which offered greater protection to policyholders than English law. In an international legal market, this perceived unfairness could affect the attractiveness of this jurisdiction. Covington and Burling LLP suggested that the current position:

acts as a disincentive to international policyholders from seeking cover under English-law-governed contracts and is therefore damaging to the UK insurance industry.

2.55 This reform, together with the reforms contained in the Insurance Act 2015, strengthen the position of UK law and may increase confidence in UK law in an international market place, leading to additional investment and increased use of UK law.

### TABLE OF MONETISED COSTS AND BENEFITS

	Relevant years	Low estimate	High estimate	Best estimate
<b>COSTS</b>				
<b>Transitional</b>				
Familiarisation	Year 0			<b>£0.2m</b>
Litigation	Years 1-5	£0.08m	£0.16m	<b>£0.1m</b>
<b>On-going</b>				
Investigating claims	Years 1-10	0.25m	£0.5m	<b>£0.375m</b>
<b>BENEFITS</b>				
<b>On-going</b>				
Reduced coping strategies	Years 1-10	£.6m	£1.5m	<b>£1m</b>

2.56 There will also be non-monetised benefits arising from fewer business failures.

<sup>38</sup> HM Treasury, *The UK insurance growth action plan* (December 2013), Foreword, p 3. [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/263148/the\\_UK\\_insurance\\_growth\\_action\\_plan.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263148/the_UK_insurance_growth_action_plan.pdf).

<sup>39</sup> Above, para 5.3.

# **PART 3 GENERAL**

## **RISKS AND ASSUMPTIONS**

### **Assumptions**

2.57 The key assumption made is that claims for damages for late payment will not be very common. The primary intended effect of the proposal is to encourage insurers to give due emphasis to prompt payment on a day to day basis as part of their claims handling procedures, rather than to encourage compensation claims after the event. Thus the level of unreasonable delay is expected to fall substantially. The main costs of the measure are related to litigation. It is assumed that litigation on this matter will be relatively infrequent because:

- (1) Late payment is already relatively infrequent and it is expected to decrease with this new measure. Insurers have pointed out that a combination of regulatory requirements and reputational pressures means that insurers do not routinely delay or refuse payments unless there is a good reason to do so.
- (2) The reforms will not affect consumers and very small businesses, where the FOS already has jurisdiction to provide compensation.
- (3) It will be relatively difficult to prove late payment against an insurer because of the six stage process outlined above. This is intended for exceptional cases rather than routine claims.
- (4) There is a specific defence for an insurer who shows it had reasonable grounds for challenging a claim.
- (5) Because of the expense of litigation and the fact that the unsuccessful party bears the costs, it will not be worth the risk of “tacking” a late payment claim on to an insurance claim which is being litigated unless the policyholder thinks they have a strong case.
- (6) Insurers will be entitled to contract out of liability unless their failure to pay is deliberate or reckless. It is anticipated that specialist insurers such as those in the London market, where large risks are unwritten and where the largest potential claims are likely to occur, will want to contract out.

### **Risks**

2.58 The risk which a small number of stakeholders have raised is the possibility that the reforms would open the door to speculative claims, and in particular to standalone bad faith actions which in the USA have resulted in substantive punitive damages being awarded against insurers. This would be undesirable, and would be counterproductive as it would lead to an increase in the cost of insurance generally.

- 2.59 However, in response to these concerns in 2008, the Law Commission changed its proposals and specifically moved away from its good faith proposals in direct response to these concerns. This is discussed further in Appendix B.
- 2.60 The proposed measure does not leave open this avenue. There is no general obligation to pay damages for failure to act in good faith. The measure introduces a standard contractual clause, breach of which would lead only to normal contractual damages. These are limited in three ways. To obtain damages, the claimant must show that the failure to pay causes the loss: in other words, that the loss would not have occurred if the claim had been paid on time. The loss must have been foreseeable (within the contemplation of both parties when they entered the contract). The policyholder must have taken reasonable steps to mitigate their loss.
- 2.61 The measure does not force insurers to pay out on more claims or pay without thorough consideration. It also provides a specific defence for reasonable disputes which will assist insurers. In Scotland, where claims for late payment are already possible, actual claims are rare and when they have been made the courts have applied the limits on contractual damages (for example foreseeability and mitigation) restrictively.

#### **ONE-IN-TWO OUT**

- 2.62 This measure is not deregulatory in the sense that it reduces the scope of Government regulation. Instead it removes an anomalous common law rule established in judge-made case law which no longer meets the needs of businesses. It therefore reformulates existing law to make it more suited to the needs of business, reducing the costs to them. It also brings the law into line with general contract law principles.
- 2.63 On this basis it is classified as a deregulatory measure with small monetised benefits and larger non-monetised benefits.

#### **SENSITIVITY ANALYSIS AND APPROACH TAKEN TO PREPARING THIS IMPACT ASSESSMENT**

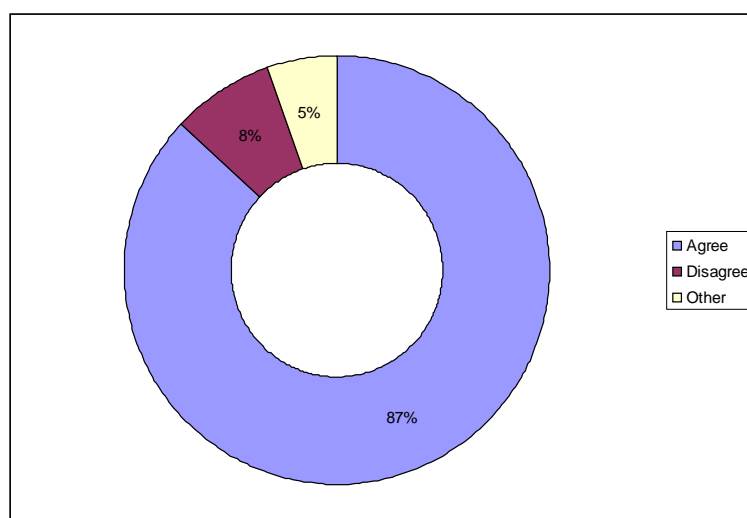
- 2.64 The main benefit of this measure is expected to be less delay in insurance payments. However, there are few robust data on the current level or cost of delay. Many insurance claims are dealt with by arbitration on a confidential basis, and therefore are not reported in judicial statistics. Some information has been provided by survey data, but there is always a risk that those answering the survey may not be fully representative.
- 2.65 There is considerable variation in court costs, making it difficult to extrapolate on the basis of small samples.

2.66 A further unknown is the extent of contracting out. As explained, commercial parties will remain free to agree alternative arrangements between themselves, including returning to the present system if this better suits their needs. Consultation suggests that widespread contracting out is unlikely, but if it were to happen it would reduce the intended benefits of the reforms. On the other hand, it would also reduce the risk of unanticipated costs. If insurers and businesses encounter unanticipated difficulties with the provisions, the issue can be dealt with through new standard terms.

## APPENDIX A

### SUPPORT FOR REFORM

- A.1 The Law Commissions published initial views on damages for late payment were set out in Issues Paper 6 (IP6), published in March 2010.<sup>40</sup> They received substantial feedback which led us to modify our views.<sup>41</sup> Their initial proposals are discussed in Appendix B.
- A.2 The Commissions published updated proposals on damages for late payment in our December 2011 Consultation Paper (CP2).<sup>42</sup> In December 2012 they published a summary of the responses.<sup>43</sup>
- A.3 The proposed clauses are intended to implement those 2011 proposals.
- A.4 In 2011, the Law Commissions asked whether insurers should be under a contractual obligation to pay claims within a reasonable time. Of 38 respondents to this question, 33 (87%) agreed with the proposal.



**Should insurers be under a contractual obligation to pay claims within a reasonable time?**

---

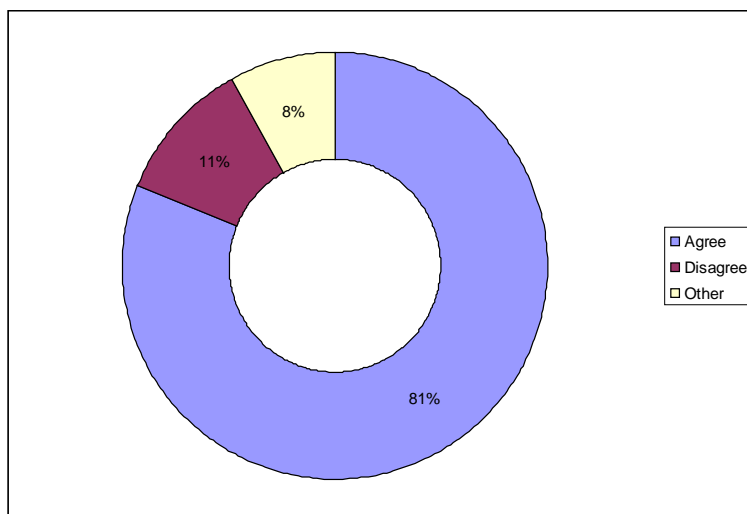
<sup>40</sup> Law Commission and Scottish Law Commission, Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith, March 2010. [http://lawcommission.justice.gov.uk/docs/ICL6\\_Damages\\_for\\_Late\\_Payment.pdf](http://lawcommission.justice.gov.uk/docs/ICL6_Damages_for_Late_Payment.pdf) and [http://www.scotlawcom.gov.uk/index.php/download\\_file/view/192/107/](http://www.scotlawcom.gov.uk/index.php/download_file/view/192/107/).

<sup>41</sup> See Summary of Responses to Issues Paper 6, November 2010. [http://lawcommission.justice.gov.uk/docs/ICL6\\_Damages\\_for\\_Late\\_Payment\\_responses.pdf](http://lawcommission.justice.gov.uk/docs/ICL6_Damages_for_Late_Payment_responses.pdf) and [http://www.scotlawcom.gov.uk/index.php/download\\_file/view/588/107/](http://www.scotlawcom.gov.uk/index.php/download_file/view/588/107/).

<sup>42</sup> Insurance Contract Law: Post Contract Duties and other Issues (December 2011) Law Commission Consultation Paper No 201; Scottish Law Commission Discussion Paper No 152. [http://lawcommission.justice.gov.uk/docs/cp201\\_ICL\\_post\\_contract\\_duties.pdf](http://lawcommission.justice.gov.uk/docs/cp201_ICL_post_contract_duties.pdf) and [http://www.scotlawcom.gov.uk/index.php/download\\_file/view/947/107/](http://www.scotlawcom.gov.uk/index.php/download_file/view/947/107/).

<sup>43</sup> Summary of responses to second consultation paper, chapter 1: Damages for late payment (December 2012). [http://lawcommission.justice.gov.uk/docs/damages-for-late-payment\\_responses.pdf](http://lawcommission.justice.gov.uk/docs/damages-for-late-payment_responses.pdf) and [http://www.scotlawcom.gov.uk/index.php/download\\_file/view/1089/107/](http://www.scotlawcom.gov.uk/index.php/download_file/view/1089/107/).

- A.5 Furthermore, 30 out of 37 (81%) agreed that a failure to meet this obligation should result in liability to pay damages for any foreseeable loss which results.



**Should an insurer who fails to meet this obligation be liable to pay damages for any foreseeable losses which result?**

#### **AGREEMENT**

- A.6 The Law Reform Committee of the Bar Council of England and Wales (the Bar Council) agreed “strongly” with the proposal. The City of London Law Society thought that a fundamental reappraisal of the insurer’s “essential obligation” was necessary, and that the current interpretation “makes the law look silly”. Covington & Burling LLP commented:

The current position of English insurance law is out of step with general English contractual law. This anomaly is not defensible either on grounds of logic or on grounds of policy. Furthermore, it acts as a disincentive to international policyholders from seeking cover under English-law-governed contracts and is therefore damaging to the UK insurance industry.

- A.7 K&L Gates LLP added:

Many insurance buyers (even sophisticated ones) are surprised that damages are not already available in circumstances where insurers have unreasonably denied and/or delayed payment of a claim and where the policyholder has suffered loss in consequence of this delay. Payment of the claim by insurers many months or even years after the incident which caused the policyholder loss is not uncommon and can cause severe hardship beyond that caused by the original insured loss. This is a particular problem for smaller companies as graphically demonstrated in the *Sprung* case.

- A.8 The Financial Ombudsman Service (FOS) supported reform:

We have already been applying a remedy of damages for late payment for some time and there is also broad acceptance within the industry about the approach we take. However, this approach is inconsistent with the current legal position in the case of *Sprung*.<sup>44</sup>

- A.9 There was also majority support for reform among insurance companies and insurance trade bodies. Out of the 14 insurers and insurance organisations who responded, 11 agreed that insurers should be under a contractual obligation to pay claims within a reasonable time:

Zurich agrees that the decision of the English court in the case of *Sprung-v-Royal Insurance* is no longer tenable and that the correct interpretation of an insurance contract is of “one to pay defined sums of money if particular losses occur”. [Zurich]

We agree that insurers should be obliged to pay a valid claim for foreseeable losses where the insurer has failed to pay a valid claim within a reasonable period. [RSA]

Insurers should be obliged to pay claims within a reasonable time, provided that this is adequately defined and allows for investigation of the claim. [Hannover Life Re]

We agree that insurers should pay valid claims within a reasonable time, a requirement that, it could be argued, is already set out in ICOBS 8.1.1 [ABI]

- A.10 Furthermore, eight insurers agreed that an insurer who fails to pay a valid claim within a reasonable time should be liable to pay damages for foreseeable losses. For example, Zurich agreed that where there has been an unjustifiable delay or a claim is wrongfully repudiated, the insurer may be liable under the contractual rules set out in the case of *Hadley v Baxendale*, but they added that “the test for foreseeable loss must be interpreted restrictively”.

- A.11 On behalf of commercial buyers, the risk managers’ association Airmic agreed in principle that damages for late payment should be available to an insured, but thought our proposal was the wrong way to achieve a fair result:

The phrase “pay valid claims within a reasonable time” is a vague obligation and does not give the insured sufficient claims certainty.

- A.12 Airmic referred us to the speed of settlement agreement they had reached with several large insurance companies in the London market in 2009 to provide a set of principles that would govern the speed of settlement of large claims.

- A.13 Finally, although our proposals were aimed at reforming English law rather than Scots law, the Judges of the Court of Session argued that the new statute should apply to both sides of the border:

---

<sup>44</sup> [1999] 1 Lloyd’s Rep IR 111.

Any legislation should apply to both England and Scotland, both to embed what is thought to be the Scottish position and to avoid the possible implication that the law as enacted for England and Wales may be subtly different from that in Scotland. There is also the need to deal with other matters, such as exclusion clauses and the inability to rely on them in consumer contracts or, in business contracts, unless the insurer can show he has acted in good faith.

## **DISAGREEMENT**

A.14 By contrast, the Lloyd's Market Association (LMA) said it had "grave misgivings about framing the contractual obligation as proposed". They pointed to the danger of opening the floodgates to speculative claims, leading to higher premiums. They thought that the concept of "reasonable time" would be difficult to define, and claims managers might be discouraged from investigating doubtful claims. The LMA also considered that the issue was better dealt with through Financial Services Authority (FSA) regulations, with compensation for the insured limited to interest and costs.

A.15 ACE also thought that the issue should be dealt with through regulation.

A.16 The International Underwriting Association (IUA) agreed with the idea of a contractual duty, but thought that an insured's remedy should be limited to a statutory rate of interest. Broader remedies would "drive up legal costs and the costs of insurance":

The propensity for a damages award that vastly exceeds the value of the contract, policy limits and premium received will require the insurer, as a matter of good practice, to reassess their coverage and pricing structures.

A.17 QBE also stated that "the remedy for breach should be limited to a claim for statutory interest". They accepted that this "does not align with general contractual principles" but thought it provided the necessary certainty.

A.18 Similarly, Munich Re thought that a statutory remedy was unnecessary, and that the courts had sufficient discretion over the period and rate of interest to deal with the problem. An alternative would be to tie any right of damages to a breach of "good faith" by the insurer. This would protect the consumer, but:

insurers would not be exposed to uncertain and potentially unlimited liabilities in circumstances where they have made a bona fide claims decision, perhaps based on uncertain evidence, but where the Court subsequently finds against the insurer.

A.19 Finally David Turner QC thought that the change would be "an unnecessary interference with the autonomy of parties to a commercial contract".

## **CONCERNS**

A.20 Although a majority of insurers agreed that they should be liable to pay damages for the late payment of claims, they raised two particular concerns about our proposals.



A.21 The first concern was that the concept of a “reasonable time” should be defined clearly. The ABI said:

“Reasonable time” and what would be considered an “unreasonable delay” needs to be clearly defined in order to ensure that it is not possible for claimant lawyers to simply put in a claim for late payment as a matter of routine.

A.22 The second concern was the concept of “foreseeable loss”. RSA commented that “the level of losses may be uncertain, surprising, and disproportionate, where loss of business is concerned”. The Law Commissions referred to the need for loss to be reasonably foreseeable in accordance with normal contractual principles.

A.23 The ABI was particularly concerned “to avoid a situation where insurers pay out claims without a proper investigation, simply to avoid having to pay damages if their decision not to pay a claim is repudiated”.

## APPENDIX B

# OPTIONS CONSIDERED BUT NOT TAKEN FORWARD

### Rejected option i: damages for breach of good faith

- B.1 When the Law Commissions first considered the issue of late payment of insurance claims in 2008,<sup>45</sup> they drew a distinction between insurers who fail to pay for a good reason, and those who delay payment or decline claims in bad faith. We provided an illustration of the difference:

At one end of the spectrum an insurer may refuse a claim because it genuinely believes that the loss falls outside the policy wording. It may receive legal advice to this effect, and may even win at first instance, only to be proved wrong by the Court of Appeal. Here the insurer had an honest and reasonable (though mistaken) view that the claim was not valid.

By contrast, a claims manager may know a claim to be valid, but deliberately delay payment beyond the end of the year simply to obtain a bonus. Here the delay is neither honest nor reasonable, but is made in bad faith.

- B.2 They considered whether the law should be reformed to provide policyholders with a claim for damages against an insurer who acted in bad faith. Such reforms would only have applied where the insurer acted dishonestly, or so unreasonably that no reputable insurer could act in that way. In the language of recent reforms, this would have focussed on “deliberate or reckless” failures to pay within a reasonable time.
- B.3 A significant number of respondents, however, argued against introducing damages for breach of the duty of good faith. They expressed concern about such a development opening the floodgates to speculative claims, and in particular to bad faith actions which in the USA have resulted in substantive punitive damages being awarded against insurers. Although the Commissions proposed that damages would be limited and controlled by normal contract rules as under the current measure, stakeholders feared that, however limited the right initially, it would soon develop along the lines of the doctrine of good faith in the United States, with substantial punitive damages being awarded in tort/delict claims against insurers.<sup>46</sup> Their preference was for the late payment issue to be dealt with discretely under normal contract principles: the insurer should have a duty to pay valid claims within a reasonable time, subject to the terms of the contract. The current measures reflect these arguments.

---

<sup>45</sup> IP6, from para 9.3.

<sup>46</sup> We discuss the position in the United States in IP6, paras A.41 to A.69 and 7.11 to 7.14. Also see *Whiten v Pilot Insurance Company* [2002] 1 SCR 595, in which the Supreme Court of Canada upheld an award of \$1 million in punitive damages.

### **Rejected option ii: damages for the insurer's breach of statutory duty**

B.4 The Financial Conduct Authority (FCA) provides detailed rules on claims handling by insurers, set out in the Insurance Conduct of Business Sourcebook (ICOBS). Rule 8.1.1 requires insurers to:

- (1) handle claims promptly and fairly;
- (2) provide reasonable guidance to help a policyholder make a claim and appropriate information on its progress;
- (3) not unreasonably reject a claim (including by terminating or avoiding a policy); and
- (4) settle claims promptly once settlement terms are agreed.

B.5 Breaches of the FCA Rules have two possible consequences. Firstly, the FCA may take disciplinary action against the insurer in its regulatory capacity, such as imposing a fine or publishing a statement of the insurer's misconduct.<sup>47</sup> This is unlikely to help an individual policyholder who has suffered loss.

B.6 Secondly, a policyholder may bring a claim for damages under section 138D of the Financial Services and Markets Act 2000 (FSMA). This states that:

A contravention by an authorised person of a rule made by the FCA is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.<sup>48</sup>

B.7 As part of its review, the Law Commissions considered whether the policy aim could be achieved through amendments to section 138D. This option was rejected, as discussed below.

#### ***The limits of section 138D***

B.8 A claim for damages under section 138D may be useful, but its predecessor section 150 was very rarely used in practice.<sup>49</sup> A claimant must establish that there has been a contravention of an FCA rule and that, as a result, a loss has been suffered.<sup>50</sup> Most problematically, redress under section 138D is only available to "a private person". This concept appears to envisage two broad categories of claimant:

---

<sup>47</sup> Financial Services and Markets Act 2000, s 66.

<sup>48</sup> Section 138D(2).

<sup>49</sup> IP6, para 5.18. It was considered in the recent case of *Bate v Aviva Insurance UK Ltd* [2013] EWHC 1687 (Comm) but the policyholder's case was rejected on other grounds.

<sup>50</sup> See, for example, *R (BBA) v Financial Services Authority and Financial Ombudsman Service* [2011] EWHC 999 (Admin), [2011] 18 LS Gaz R 20 by Ouseley J at [71].

- (1) An individual. This includes both a consumer who is not acting in the course of business, and a sole trader who is acting in the course of business.<sup>51</sup>
- (2) A legal person, such as a company or corporate body (including partnerships) which is not acting in the course of business.<sup>52</sup>

- B.9 It is not surprising that the right has been so little used. Most consumers and small businesses will find it easier to complain to the FOS than bring a complex, novel action before the courts for breach of statutory duty. Most other potential claimants are excluded because they are companies and suffer losses in the course of business. Many of the cases we are concerned with involve small companies which have lost profits following catastrophic events, such as fires. These policyholders are not entitled to rely on the provision.
- B.10 Some consultees suggested that the application of section 138D should be extended to more people, rather than a new cause of action being introduced. However, changing the scope of section 138D has implications far beyond insurance law. The Law Commission's recent consultation paper on *Fiduciary Duties of Investment Intermediaries* asked whether the rights to sue under section 138D should be extended, but this met with strong opposition.<sup>53</sup>
- B.11 As currently drafted, section 138D has limited potential to provide redress to claimants in the present context. Extending its application would be disproportionate to the policy need and would have implications far beyond the policy aim.
- B.12 The new implied term does not replace or displace the section 138D route. Recovery will be subject to the overriding principle that a claimant cannot recover twice for the same loss.

---

<sup>51</sup> Under this category, those losses cannot have been sustained in the course of carrying on any regulated activity under the FSA definition: Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001 No 2256), reg 3 (as amended).

<sup>52</sup> See CP2 from para 3.22 for more detail.

<sup>53</sup> Law Commission, LCCP 215, *Fiduciary Duties of Investment Intermediaries*, October 2013, paras 14.65 to 14.70. A summary of responses, along with a report, is due to be published shortly. See [http://lawcommission.justice.gov.uk/areas/fiduciary\\_duties.htm](http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm).

# APPENDIX C

## CALCULATION OF COSTS

### COSTS OF FAMILIARISATION (YEAR 0)

- C.1 Cost of the senior staff time is estimated at £809 per day. This is based on a senior underwriter's salary of £140,000.<sup>54</sup> A daily rate has been calculated by applying a 30% uplift and assuming 225 working days a year.<sup>55</sup>
- C.2 Based on the Department's and the Law Commission's understanding of the work involved, it is estimated that it will take two days of senior staff time per firm.

### COST OF LITIGATION (YEARS 1 – 5) AND INVESTIGATING DISPUTES (YEARS 1-10)

- C.3 As discussed in the 2014 impact assessment on changes to the Marine Insurance Act 1906, particularly in Appendix B, insurance litigation is expensive. This level of disputes generates substantial legal costs. This is illustrated by research carried out for Lord Justice Jackson's review of the costs of civil litigation.<sup>56</sup> The research collected data on the cost of 49 Commercial Court cases where the costs of one part to the dispute were determined by the court.<sup>57</sup> The Law Commission used these to estimate the cost of a High Court trial, by removing 6 cases which concerned minor pre-trial applications,<sup>58</sup> and 2 cases where insufficient data was presented.<sup>59</sup>
- C.4 Based on the remaining 41 cases, the mean cost was £402,389.41 and the median was £157,200. The high mean reflects a few very expensive cases, including one over £5 million. Clearly, any system in which a single case can add £5 million to total costs is variable and unpredictable. It is thought, however, that it is necessary to include such cases within the average (mean) cost figures as the few very expensive cases contribute so much to the total figures. The costs of an appeal were much less than the costs of a contested trial. In the study, the costs relating to the one appeal were estimated at around £35,000.

---

<sup>54</sup> Earnings figures for the insurance sector are provided in the ONS Annual Survey of Hourly Earnings, Table 16.1a. A higher degree of granularity is provided by <http://www.salarytrack.co.uk/average-underwriter-salary>, which shows that £140,000 is considered a "top end" salary for an underwriter. Only 1% of underwriters are paid more than £140,000.

<sup>55</sup>  $(140,000 + 30\%) / 225 = £808.89$ . The figure of 225 has been used to reflect the number of productive days the firm would normally be expected to receive from their employees, assuming a 5 day working week, less 25 days holiday and 10 days public holidays/sick leave. The 30% uplift reflects the reasonably generous pension provision in this sector: see also the use of 30% cited in the Green Book at p 59.

<sup>56</sup> Jackson LJ, *Review of Civil Litigation Costs: Preliminary Report* (2011).

<sup>57</sup> Jackson LJ, *Review of Civil Litigation Costs: Preliminary Report* (2011), Appendix 9.

<sup>58</sup> These cases all cost less than £20,000 and clearly did not involve trials.

<sup>59</sup> One case settled for a sum combining both damages and costs and another included the costs of the subsequent appeal which could not be disaggregated from the data.

- C.5 For illustrative purposes, disputes concerning non-disclosure have been used as an example. This is the sort of coverage dispute on to which a late payment claim might well be added. Based on the Jackson research and on the views of industry experts, the average costs in such cases have been estimated as follows:

Number of disputes	Average cost per case	Total costs in category (£M)
15 appeals	Additional £35,000	0.5
26 High Court judgments	£400,000	10.4
624 cases where proceedings were issued (but which did not proceed to trial)	£100,000	62.4
6,350 disputes where no proceedings were issued	£25,000	158.8
<b>OVERALL COSTS (one party)</b>		232.1
<b>OVERALL COSTS (both parties)</b>		464.2
<b>Average cost per case (both parties)</b>	£116,050	

#### **High court cases**

- C.6 Based on the Jackson research and on the views of industry experts, the average costs of a High Court case have been estimated at £400,000. This is for a major standalone dispute such as those concerning non-disclosure or breach of warranty. A late payment claim could be added these cases.

#### **Appeal court cases**

- C.7 Any new law involves new legal challenges, as new points of law are litigated before the appeal courts. There is a risk that the effect of legal reform will be that some disputes which would have been resolved at High Court level may now be taken to the Court of Appeal for a ruling on legal issues.
- C.8 Consultation feedback has indicated the likelihood of an increase in the number of appeals on points of law, at least in the first 5 years as precedent is developed.
- C.9 The limited evidence from Lord Jackson's review of costs put the additional costs generated by an appeal at £35,000, or £70,000 for both sides. However, given the Law Commissions' experience and knowledge of the legal sector, it is known that £70,000 is an extremely low estimate for a Court of Appeal case on an insurance law issue. This was confirmed by a number of contacts in the insurance legal world, who advised that £100,000 for each side, or £200,000 in total per appeal, is the better estimate.

### **COSTS OF INVESTIGATING CLAIMS**

- C.10 Some insurance bodies have expressed concern that policyholders will “try it on” and threaten late payment claims whenever there is any dispute surrounding an insurance claim. If this occurs, insurers will incur time and expense in investigating these claims and determining which may have a valid basis, potentially involving lawyers.
  
- C.11 Based on the Jackson review costs where the costs of disputes with no ultimate proceedings was £25,000, this has been taken as the best estimate of the cost of such investigations.

## **APPENDIX D**

### **SPECIFIC IMPACTS**

- D.1 This annex contains consideration of any specific impact on statutory equality duties, competition, small firms, human rights and the justice system.

#### **STATUTORY EQUALITY DUTIES**

- D.2 Having regard to the guidance on this specific impact test, it is considered that this proposal will have no equality impact in terms of the 9 protected characteristics. Completion of the screening questions indicated no need for a full equality impact assessment. There is unlikely to be any impact (adverse or otherwise) on any of the protected characteristics.

#### **COMPETITION**

- D.3 Having regard to the filter questions on this specific impact test, it is considered that this proposal will have no negative effect on competition and that a full impact assessment is not required. The filter questions were considered, with the following results.
- D.4 There will be no direct limit on the number or range of suppliers. The proposals concern only the terms on which insurance may be written. Access to the supply side of the insurance market in the UK is controlled by the Prudential Regulation Authority. Other EU insurance regulators also have a role where an insurance undertaking regulated in their jurisdiction exercises passporting rights to open a branch office in the UK. The proposals have no direct effect on these bodies.
- D.5 There will be no indirect restriction on the number or range of suppliers. The proposals represent a default regime which parties can choose to contract out of if they do not consider the proposals to be appropriate for their particular contracts. Indeed, there is no requirement on insurers in the UK to write business under English or Scottish law and an alternative regime may be chosen if more desirable.
- D.6 There is no restriction on the ability to compete. Since insurers will be able to contract out of the proposals, they will be able to offer higher or lower standards of protection to their clients as they see fit.



D.7 There will be no restriction on suppliers' incentives to compete vigorously. At present, it is difficult for policyholders to distinguish between insurers who will pay promptly, and those who may not. Policyholders therefore tend to buy on price, increasing the likelihood of under-pricing, and consequent market instability. Insurers offering a good quality product remain vulnerable to competitive pressure from others, as long as policyholders do not know how to identify them. Introducing a legal rule which gives a basic right to claim damages in the event of additional loss caused by unreasonable late payment supports insurers who have good claims handling practices and who pay as quickly as is reasonably possible taking into account the need to investigate and assess claims. Those who wish to compete on price alone will be able to contract out of this liability. Purchasers will be able to understand more easily the nature of the product they are buying, while insurers will be able to adopt a wider range of approaches to market positioning more easily than at present.

### **SMALL BUSINESSES**

- D.8 The policy impact on SMEs has been considered throughout the impact assessment. Having regard to the filter questions on this specific impact test, it is considered that this proposal will have no negative effect on small businesses and that a full impact assessment is not required. The filter questions were considered, with the following results.
- D.9 The proposed changes to insurance contracts law will affect small businesses as purchasers of insurance. However, the changes are protective of their interests, making it more likely that insurance claims will be paid within a reasonable time. The Law Commissions have made enquiries about the need for special protective measures to be taken for small businesses, and included a request for evidence of need in their third consultation paper. No evidence was forthcoming.
- D.10 Independently of the proposals, micro-businesses will still be able to complain to the Financial Ombudsman Service if they feel they have been treated unfairly by their insurer. The Financial Conduct Authority (the FCA) also has power to intervene if consumers (including small businesses) are being treated unfairly by insurers.
- D.11 The proposals will be a default regime for all insurance transactions. Accordingly, they will apply to all types of businesses, rather than any particular group.
- D.12 As the measures are not regulatory ones, there is no need to make alternative provision specifically for small businesses. Insurers are regulated by the FCA. The proposed changes are designed to improve the legal position in favour of small businesses. However, the proposals will function as a default position, all businesses who do not feel the reforms will benefit them will be able to make alternative arrangements.
- D.13 There is no evidence to suggest a greater impact on the operations and performance of small businesses than others as a result of the proposals other than in a positive way, as small businesses can be particularly vulnerable to the problems of late payment.

## **JUSTICE**

- D.14 The main impact on the court system is the possibility of some additional appellate disputes, estimated at no more than 1-3 over the next 10 years. Most insurance disputes are conducted by some form of alternative dispute resolution, such as arbitration.

## **HEALTH**

- D.15 The Pitt review has highlighted the significant effect of flooding on mental health. Faster insurance payments are likely to have a small health benefit in reducing stress and anxiety.

## **OTHER SPECIFIC IMPACTS**

- D.16 It is not considered that there will be any impacts on rural proofing, the environment or sustainable development.

## APPENDIX E

### POST IMPLEMENTATION REVIEW (PIR) PLAN

- E.1 HM Treasury is already committed to undertaking a review of the changes to insurance contract law introduced through the Insurance Act 2015. This review will take effect 5 years after implementation in August 2016. In other words, the review date will be August 2021. It is anticipated that this measure will be reviewed at the same time and along side the other changes to insurance contract law.

<b>Basis of the review:</b> Political commitment for HM Treasury to conduct post review in August 2016.
<b>Review objective:</b> Ensure that the new measure is operating as expected.
<b>Review approach and rationale:</b> The review will consist of: <ul style="list-style-type: none"> <li>- Discussions with insurers, buyers and brokers to understand the impact the new measure. In particular, are policyholders seeking to rely on this measure on a regular basis? Are insurers contracting out?</li> <li>- An analysis of the number of reported court cases, to establish whether the scheme has created legal uncertainty or large damages awards.</li> </ul>
<b>Baseline:</b> The existing regime; case law, FOS interpretation and FCA rules.
<b>Success criteria:</b> <p>Has the new measure:</p> <ul style="list-style-type: none"> <li>- gained to confidence of insurers and buyers?</li> <li>- encouraged better claims handling?</li> </ul>
<b>Monitoring information arrangements:</b> N/A
<b>Reasons for not planning a PIR:</b> N/A