Wrongful claims handling by insurers - A comparative overview of remedies available to the insured

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Introduction

[141] Insureds depend on the behaviour of their insurance companies for a swift resolution of the claims they submit. If an insurer wrongfully delays, denies or handles a claim, the consequences may be of great impact for an insured. Not only is the latter denied a much-needed payment, but the insurer's wrongful behaviour may also inflict additional damage to the insured. What is the legal position of the insured? Can he claim additional damages beyond the scope of the policy? Or do the insurance policy terms box him in and effectively shield the insurer from any additional liability for his wrongful claims handling?
Any act which constitutes unjustified denial of coverage, unnecessary delay in resolving claims or another violation of the rights of the insured under the policy, calls for an appropriate remedy. But what is appropriate? Given that most standard policies may be used to deflect any responsibilities beyond the primary cover, the question is whether and how legislatures and courts counter this out-balanced relationship between insurer and insured. Therefore, this contribution explores how legal systems deal with wrongful claims handling by an insurer. more specifically, we look into the approach taken in English law, German law and USA law. These major legal systems take distinct approaches to wrongful claims handling. By comparing these three, we aim to gain further insight in the various ways of shaping the remedies available to wronged insureds.[2] We proceed simply as follows: after reviewing the developments in **[142]** English law, German law and U.S.A. law, we briefly summarize and compare the stance taken in these three legal systems.

1. English law

English common law originally offered only damages for the actual loss in the form of interest but this position has recently been revisited. Changes in the law have now introduced a remedy against late payment as well in the form of a right to damages beyond the interest due.

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[2] Cf. Willem H van Boom, 'Do Insurers Have to Pay for Bad Behaviour in Settling Claims? Legal Aspects of Insurers' Wrongful Claims Handling', *Journal of European Tort Law* 2011/1, p. 82-88, for an overview consisting of and a comparison between the European Union, England and Wales, Germany, France and the Principles of European Insurance Contract Law.

Therefore, this paragraph first sketches the original position in the English common law and the problems that arose as a result, and then moves on to discuss the current position in English law.

1.1. Original position in English common law

The case of *Sprung v Royal Insurance (UK) Ltd* is often used to illustrate the problems that arise in indemnity insurance contract law in relation to the late payment of damages.[3] In this case, Mr. Sprung was the owner of a factory that he had insured against the risk of ''sudden and unforeseen damage.'' In 1986, he found that the dominant firm in the market was willing to buy his family business. In April of the same year, however, vandals trespassed and broke into his factory; they wrecked the machinery. The insurance company initially denied the insured his subsequent claim, only to pay out his claim three-and-a-half years later. As Mr. Sprung was unable to raise the money he needed to make repairs, he was unable to operate or sell the factory in the meantime. Although Mr. Sprung eventually did receive payment due under the policy plus simple interest, he was denied payment of further damages for the loss of the opportunity to sell his business.[4]

The original idea behind this restrictive approach of the common law is that the indemnity insurance contract is to 'hold the insured harmless', that is to protect the **[143]** insured from loss. Seen from this theoretical perspective, an insurer's primary obligation is to prevent loss from happening, and not to pay a claim. As soon as a loss occurs, the insurer is in breach of the insurance contract and an action for damages arises. Yet these damages were limited to the policy limit plus simple interest, because of the general principle that damages are not awarded for a failure in paying damages.[5]

What alternative remedy is available to an insured in such a case? Insurance contracts include a mutual duty of good faith for the insurer and the insured. If either is in breach of that duty, the remedy available to the other party was avoidance, which meant that the contract is thought to be void from the beginning. Such is expressed in, for example, the original wordings of section 17 of the Marine Insurance Act 1906:

> 17 Insurance is uberrimae fidei
> A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party.

Thus, if the late payment by an insurer due to wrongful delay and/or denial is viewed as a breach of the duty of good faith, the insured may avoid the insurance contract. Yet this remedy will not bring the insured much satisfaction: avoidance implies that the contract is not binding on either party and therefore, instead of paying any damages, the insurer will simply return the paid premium. Avoidance of the indemnity insurance contract is therefore called a one-sided remedy.[6]

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[3] [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70. See also Van Boom (fn. 1), p. 85; John Birds, *Birds' Modern Insurance Law*, London: Sweet & Maxwell 2016 (10th edition), p. 303; The Law Commission and The Scottish Law Commission, Insurance Contract Law. Issues Paper 6. Damages for Late Payment and the Insurers' Duty of Good Faith, March 2010 (referred to in this paper as ICL 6), p. 2-3, nrs. 1.6-1.13.
[4] [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70.
[5] Van Boom (fn. 1), p. 83; Birds (fn. 2), p. 301-302; see also ICL 6 (fn. 2), p. 10-13, nr. 2.28 ff.
[6] Van Boom (fn. 1), p. 85; ICL 6 (fn. 2), p. 34, nr. 4.22 ff. See also Birds (fn. 2), p. 166. Cf. Van Boom (fn. 1), p. 85-87 for other remedies at law which are not discussed here.

1.2. Current position in English common law

The restrictive stance of the English common law was long considered unsatisfactory. In March 2010, the Law Commission and the Scottish Law Commission published a joint paper titled 'Damages for Late Payment and the Insurers' Duty of Good Faith'.[7] **[144]** In this joint paper, the commissions revisited the then applicable law and concluded that statutory reform was needed to address the unsatisfactory situation. This call for change was repeated in their Consultation Paper of December 2011 and in their Report of 2014.[8] However, the Insurance Bill that later became the Insurance Act 2015 did not include the provisions on damages for late payment.[9] Possibly, the subject was considered too controversial at the time.[10] However, the Enterprise Act 2016, which came in effect 4 May 2017, fixed this omission, adding sections 13A and 16A to the Insurance Act 2015.[11]

Before discussing sections 13A and 16A, we must note section 14 of the Insurance Act 2015. In this section, the remedy of avoidance in case of breach of the duty of good faith is abolished, simultaneously adjusting the wordings of section 17 of the Marine Insurance Act 1906:

> 14 Good faith
> (1) Any rule of law permitting a party to a contract of insurance to avoid the contract on the ground that the utmost good faith has not been observed by the other party is abolished.
> [...]
> (3) Accordingly—
> (a) in section 17 of the Marine Insurance Act 1906 (marine insurance contracts are contracts of the utmost good faith), the words from ", and" to the end are omitted, and
> (b) the application of that section (as so amended) is subject to the provisions of this Act and the Consumer Insurance (Disclosure and Representations) Act 2012.
> [...]

Section 14 removes avoidance as a potential remedy, which was necessary to ensure that the other remedies introduced by the Insurance Act 2015 would not be undermined by the existence of this remedy and the reference to it in section 17 of the Marine Insurance Act 1906.[12] One of these other remedies is offered in section 13A, which introduces an implied term concerning the timely payment of claims: **[145]**

> 13A Implied term about payment of claims
> (1) It is an implied term of every contract of insurance that if the insured makes a claim under the contract, the insurer must pay any sums due in respect of the claim within a reasonable time.
> (2) A reasonable time includes a reasonable time to investigate and assess the claim.
> (3) What is reasonable will depend on all the relevant circumstances, but the following are examples of things which may need to be taken into account—
> (a) the type of insurance,

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[7] ICL 6 (fn. 2).
[8] Birds (fn. 2), p. 304.
[9] Andrew Tettenborn, 'Late payments of claims: better, but by no means perfect', in: Malcolm Clarke and Baris Soyer (eds.), *The Insurance Act 2015. A new regime for commercial and marine insurance law*, Abingdon/New York: Informa Law from Routledge 2017, p. 78-93, p. 81.
[10] Birds (fn. 2), p. 305.
[11] Tettenborn (fn. 8), p. 81.
[12] B. Soyer, 'The insurer's duty of good faith: is the path now clear for the introduction of new remedies?', in: Malcolm Clarke and Baris Soyer (eds.), *The Insurance Act 2015. A new regime for commercial and marine insurance law*, Abingdon/New York: Informa Law from Routledge 2017, p. 38-53, p. 39, who discusses this development in the light of new proportionate remedies available to the insurer.

(b) the size and complexity of the claim,
(c) compliance with any relevant statutory or regulatory rules or guidance,
(d) factors outside the insurer's control.
(4) If the insurer shows that there were reasonable grounds for disputing the claim (whether as to the amount of any sum payable, or as to whether anything at all is payable)—
(a) the insurer does not breach the term implied by subsection (1) merely by failing to pay the claim (or the affected part of it) while the dispute is continuing, but
(b) the conduct of the insurer in handling the claim may be a relevant factor in deciding whether that term was breached and, if so, when.
(5) Remedies (for example, damages) available for breach of the term implied by subsection (1) are in addition to and distinct from—
(a) any right to enforce payment of the sums due, and
(b) any right to interest on those sums (whether under the contract, under another enactment, at the court's discretion or otherwise).

Section 13A (1) introduces an implied term to insurance contracts, obliging the insurer to make payment within a reasonable time. Subsections (2) and (3) further explain which procedures and circumstances are included and used in determining whether the time used has been reasonable. Moreover, subsection (4) reveals that if an insurer shows that he had reasonable grounds to dispute the claim, he is not in breach of the implied term. In addition, however, his conduct whilst handling the disputed claim may be of relevance in determining if the implied term was breached. Finally, subsection (5) adds the possibility of claiming damages for late payment – thus if not paid within a reasonable time – as a remedy in addition to damages for the actual losses **[146]** and interest. Thus, damages for late payment may now be claimed separate from the original claim for payment and interest due.[13]
Some authors have raised the question whether the concept of a 'reasonable time' is concerned with the time taken to pay, or with the conduct of the insurer in taking that time.[14] In the first situation, the courts must take into account the time that has passed, and judge whether that time has been objectively reasonable, whereas in the second situation, the courts must look at the conduct of the insurer and assess whether he has been at fault for a late payment. Tettenborn notes that this may matter in cases where the time passed was objectively unreasonable but not at the fault of the insurer,[15] and he goes on to say that although a case may be made for both views, the objective approach is marginally preferable,[16] resulting in a strict liability of sorts, or rather it may be seen as a duty of care.

Section 16A of the Insurance Act 2015 adds the following:

16A Contracting out of the implied term about payment of claims: consumer and non-consumer insurance contracts
A term of a consumer insurance contract, or of any other contract, which would put the consumer in a worse position as respects any of the matters provided for in section 13A than the consumer would be in by virtue of the provisions of that section (so far as relating to consumer insurance contracts) is to that extent of no effect.
A term of a non-consumer insurance contract, or of any other contract, which would put the insured in a worse position as respects deliberate or reckless breaches of the term implied by section 13A than the insured would be in by virtue of that section is to that extent of no effect.
For the purposes of subsection (2) a breach is deliberate or reckless if the insurer—
knew that it was in breach, or
did not care whether or not it was in breach.

[13] John Birds, *Birds' Modern Insurance Law*, London: Sweet & Maxwell 2019 (11th edition), p. 311, nr. 15-03. See also Alison Padfield, Insurance Claims, London: Bloomsbury Professional 2021 (5th edition), p. 159.
[14] Tettenborn (fn. 8), p. 84.
[15] Tettenborn (fn. 8), p. 85.
[16] Tettenborn (fn. 8), p. 85.

A term of a non-consumer insurance contract, or of any other contract, which would put the insured in a worse position as respects any of the other matters provided for in section 13A than the insured would be in by virtue of the provisions of that section (so far as relating to non-consumer insurance contracts) is to that extent of no effect, unless the requirements of section 17 have been satisfied in relation to the term.
(5) In this section references to a contract include a variation.
(6) This section does not apply in relation to a contract for the settlement of a claim arising under an insurance contract.

[147] According to s. 16A (1), the implied term of s. 13A is mandatory in consumer insurance contracts. In other insurance contracts, however, parties may contract out of the implied term, to the extent allowed by the provisions in subsections (2), (3), and (4). If an insurer is in deliberate or reckless breach of the implied term any opt-out of the implied term is of no effect. What is understood as a deliberate or reckless breach, is explained in subsection (3).[17] Furthermore, if parties choose to contract out of the implied term, such must be done in accordance with section 17, which sets forth transparency requirements for insurance contract terms.[18] Therefore, it seems possible that parties in a commercial insurance context may include a term to limit the reasonable time to a certain period of time, such as, say, two years.

The additional damages are qualified as contractual in nature and therefore fall under the general law of contract,[19] which would suggest that the implied term of section 13A may be subject to liquidated damages. Indeed, Padfield notes that in a situation where parties are allowed to contract out of the implied term, they may opt to limit their liability rather than to insert a complete exclusion of the implied term.[20]
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2. Germany

In the German Insurance Contract Act, the *Versicherungsvertragsgesetz* (VVG), § 14 (1) states the main rule that payment of a claim is due once the investigation and assessment period of the claim has been closed.[21] In that sense, this subsection obligates the insurer to perform the mentioned investigation and assessment.[22] § 14 (2) adds that in case the investigation and assessment have not yet been closed one month after the submission of the claim, the insured is entitled to payment of the uncontested part of the claim.[23]

In case an insurer (wrongfully) delays a claim, it is generally accepted that an insured may claim additional damages for delay according to § 286 BGB.[24] Likewise, in case an insurer wrongfully denies a claim, it is also generally accepted that the insured may claim additional damages for delay according to § 280 (1) in junction with § 286 BGB.[25] For the application of § 286 BGB it is required that payment of the claim is due (*fällig*). Since in the two mentioned situations the

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[17] See also Tettenborn (fn. 8), p. 92-93, who raises two questions regarding section 16A.
[18] Birds (fn. 12), p. 311, nr. 15-03; Padfield (fn. 12), p. 159.
[19] Tettenborn (fn. 8), p. 88.
[20] Padfield (fn. 12), p. 161, fn. 21.
[21] Cf. Van Boom (fn. 1), p. 88-92; Manfred Wandt, *Versicherungsrecht*, Munich: Vahlen 2016 (6th edition), p. 374, nr. 975.
[22] Langheid/Wandt/Fausten, Münchener Kommentar zum VVG, Munich: C.H. Beck 2016 (2. Auflage), VVG § 14 Rn. 2.
[23] For some types of insurances, other rules apply, such as § 91 VVG for property insurance, § 187 VVG for accident insurance, and § 106 VVG for liability insurance, see Van Boom (fn. 1), p. 90-91.
[24] Langheid/Wandt/Fausten (fn. 21), VVG § 14 Rn. 68.
[25] Langheid/Wandt/Fausten (fn. 21), VVG § 14 Rn. 73-74.

claim cannot technically be due – in the first instance concerning a wrongful delay because the claim is still being investigated, and in the second instance concerning a wrongful denial because the claim is denied right away – a fictional due date is used.[26] This fictional due date is determined by applying the objective standard.[27] Upon the due date, the insured has to send the insurer a formal letter of notification of default (*Mahnung*), unless according to § 286 (2) sub 3 BGB the insurer seriously and definitively refuses to pay.[28]

[149] Exceptionally, there may be no claim for additional damages. This may be the case when an insurer refuses to pay because certain legal issues have not yet been settled. If a court later finds in favor of the insured, it may conclude that the refusal was excusable in these circumstances.[29] Furthermore, it must be noted that it is not possible for parties to contract out of the right to additional damages, although it is possible to alter the moment of § 14 (1) VVG after which payment is due.[30]

As aforementioned, if the insurer delays paying out the claimed insurance sum, he is liable for any damages ensuing from the delay. In addition, he is liable for the interest on the claimed sum (*Verzugszinsen*) in accordance with § 288 (1) BGB. It is, however, not possible to claim compound interest according to § 289 BGB. The simple interest accrues distinct from the actual loss suffered by the insured, yet if an insured claims damages that exceed the fixed interest, the latter will be considered and might even be subtracted from the actual loss.[31] Note that these rules apply irrespective of whether the insured is acting as consumer or in a commercial capacity.

Finally, it should be noted that in Germany liability insurers may be held liable in certain third-party liability cases through the tortious liability of its insured. In these instances, the compensation for non-pecuniary loss is topped up with a further liability of the insurer if the handling of the claim by the insurer is held to be wrongful. These instances can be found primarily in personal injury litigation.[32]

3. United States of America

A system that offers various remedies is the United States of America common law, which, broadly speaking, has seen a shift from awarding damages based on breach of contract to damages based on a tort of bad faith. Thus, there is a concurrence of remedies available to the insured. Yet, as the individual states of the United States each have their own jurisdiction, the law on the tort of bad faith resembles somewhat of a patchwork.[33] What we present here, is the common denominator of these jurisdictions.

[26] Langheid/Wandt/Fausten (fn. 21), VVG § 14 Rn. 68, 74.
[27] Van Boom (fn. 1), p. 89.
[28] Van Boom (fn. 1), p. 89, fn. 37.
[29] Van Boom (fn. 1), p. 89.
[30] Van Boom (fn. 1), p. 89.
[31] Van Boom (fn. 1), p. 89.
[32] Van Boom (fn. 1), p. 91-92.
[33] Recently, the developments concerning the tort of bad faith in the case of wrongful delay or denial by the insurer in the United States have been researched thoroughly by Midlige et al. Cf. Suzanne Midlige, Robert Re and William Hoffman, 6 Claims: an overview of the US tort of 'bad faith' – a common law approach to regulating insurer claims handling and settlements, in: Julian Burling and Kevin Lazarus (eds.), *Research handbook on international insurance law and regulation*, Cheltenham: Edward Elgar Publishing Ltd 2012, p. 120-145. See also Douglas R. Richmond, 'An Overview of Insurance Bad Faith Law and Litigation', *Seton Hall Law Review* 25/1 (1994), p. 74-140.

[150] In the United States, all contracts include an implied term of good faith and fair dealing. The implied term is recognized by the courts to be included in insurance policies as well.[34] This obligation of good faith and fair dealing opened the path for extracontractual damages,[35] and the breach of the implied term forms the basis for the tort of bad faith.[36] Furthermore, regarding third-party insurance, courts recognized that an insurer acts as an agent for the insured, becoming a fiduciary of its insured.[37] The idea behind a separate tort of bad faith apart from the breach of contract cause of action is to address the 'unequal bargaining power inherent in the relationship between an insured and its insurer,'[38] using tort liability to deter insurers from wrongful behavior.[39] Any contract remedy would be tied to the policy limits and offer little incentive for insurers to perform their obligations according to the duty of good faith and fair dealing.[40]

[151] Concerning third-party insurance, where a liability insurer takes on the duty to defend its insured, the tort of bad faith is recognized as a remedy in most states.[41] For first-party insurance, where an insurer is liable for its insured's own losses, the tort of bad faith is recognized in at least 31 states as an independent tort.[42] In addition, some states that view first-party insurer's bad faith as contractual in nature have broadened the range of damages, which may allow for punitive damages.[43]

The interpretation of bad faith varies per state as there is no universal definition of the legal concept.[44] It does appear, however, that most United States courts require 'intentional wrongdoing' by the insurer to assume bad faith, whereas only a minority of states simply require that the insurer did not apply ordinary care and prudence whilst handling a claim.[45] Bad faith claims in first-party insurance arise commonly in relation to 'inadequate claim investigation, deliberate misrepresentation of policy language to avoid coverage, unreasonable or coercive litigation conduct and unreasonable delay in resolving claims.'[46] In third-party insurance, bad faith claims arise often with regards to 'wrongful denial of defense or indemnity and the failure of an insurer to settle within policy limits.'[47]

[152] Midlige et al. do discern three general rules regarding the presence of bad faith, the first being that the question of whether an insurer acted in bad faith depends on the facts of the case.[48] Second, they note that the question of whether an insurer acted in bad faith must be considered within the circumstances which existed at the time.[49] Third, for punitive damages

[34] Midlige et al. (fn. 32), p. 124, 127.
[35] Midlige et al. (fn. 32), p. 125.
[36] Midlige et al. (fn. 32), p. 127.
[37] Midlige et al. (fn. 32), p. 125.
[38] Midlige et al. (fn. 32), p. 126.
[39] Midlige et al. (fn. 32), p. 131.
[40] Midlige et al. (fn. 32), p. 127.
[41] Midlige et al. (fn. 32), p. 129.
[42] Midlige et al. (fn. 32), p. 128.
[43] Ibid.
[44] Midlige et al. (fn. 32), p. 129.
[45] Midlige et al. (fn. 32), p. 130-131.
[46] Midlige et al. (fn. 32), p. 128.
[47] Midlige et al. (fn. 32), p. 129. See also in more detail Midlige et al. (fn. 32), p. 133-139.
[48] Midlige et al. (fn. 32), p. 131.
[49] Midlige et al. (fn. 32), p. 131.

to be awarded, the insured must prove malicious intent. This heightened standard also applies to those states that treat bad faith as negligence.[50]

Most United States courts maintain that there can be no bad faith if there is no coverage due under the policy. Midlige et al. view this as a logical stance, considering that the tort of bad faith is developed out of and based on the contractual implied term of good faith and fair dealing. However, they note that in exceptional cases some courts have accepted bad faith claims in cases where coverage was not owed under the policy.[51]

By means of an example of how states define bad faith, in the state of California eight factors have been created to determine whether an insurer breached his duty of good faith when refusing to settle a claim:

> 'the strength of the injured claimant's case on the issues of liability and damages; attempts by the insurer to induce the insured to contribute to a settlement; failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; the insurer's rejection of advice of its own attorney or agent; failure of the insurer to inform the insured of a compromise offer; the amount of financial risk to which each party is exposed in the event of a refusal to settle; the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and any other factors tending to establish or negate bad faith on the part of the insurer.'[52]

[153] The tort of bad faith allows an insured to recover damages beyond policy limits, for example in liability insurance when a judgment exceeds the original policy limits, or when punitive damages are awarded.[53] Extracontractual damages have been awarded as well by some courts for mental suffering, emotional distress, and economic loss. Although it is generally accepted that an insured may recover punitive damages, Midlige et al. note that there is no consensus between courts concerning the recovery of attorney's fees and interest.[54]

Final considerations

The three legal systems discussed in this paper represent various ways in which legislators or courts deal with insurers (wrongfully) delaying the payment of claims. Of these three systems, the English common law has recently been changed, and the current position holds that based on an implied term, an insured may claim damages in addition to and distinct from the underlying insurance claim. This means that the additional damages stand separate from any interest awarded as well.[55] However, unless it concerns a business-to-consumer contract, parties may contract out of this implied term or adjust the liability of the insurer as long as the contract adheres to the transparency requirements, and only to a certain extent. The additional damages follow the standard rules for contractual damages. It will be interesting to see how this implied term develops over time in the courts.

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[50] Midlige et al. (fn. 32), p. 132-133. Cf. Douglas R. Richmond, 'Truly ''Extracontractual'' Liability: Insurer Bad Faith in the Absence of Coverage', *Tort & Insurance Law Journal* 29/4 (1994), p. 740-760.
[51] Midlige et al. (fn. 32), p. 144-145.
[52] *Brown v Guarantee Ins. Co.*, 319 P.2d 69, 75 (Cal. Ct. App. 1957). Some courts have adopted these factors as well, see Midlige et al. (fn. 32), p. 130.
[53] Midlige et al. (fn. 32), p. 132.
[54] Midlige et al. (fn. 32), p. 132.
[55] Tettenborn (fn. 8), p. 91.

[154] Because of the English statutory reform, the English and German systems have become more alike, as the German civil code, too, generally allows for both interest and additional damages. However, the interest according to German law is simple and restricted by the provisions of the German civil code, whereas interest according to English common law may be awarded at the discretion of the court.[56]

Cut from a different cloth is the American common law approach, which offers not one but two remedies, both contractual and extra-contractual. In this paper, the extra-contractual tort of bad faith has been discussed. Since each state in the United States has its own jurisdiction, there is no uniformity to the tort of bad faith, as can be seen, for example, in the way United States courts define bad faith. Some developments are shared by the various states, nevertheless, such as that it is generally accepted that punitive damages are allowed, meaning that the damages awarded by a court may exceed the original policy limit.

All in all, that is exactly what these three large legal systems have in common, namely that legislators and courts have each in their own way enabled in principle an insured to claim additional damages beyond policy limits and interest.

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[56] Cf. Van Boom (fn. 1), p. 98. See also Tettenborn (fn. 8), p. 91.