INSURANCE

Stranger than fiction

Will the Supreme Court's ruling in *Teal* spell the end for the hold harmless fiction?

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In an appeal from *Teal Assurance v WE Berkeley Insurance [2012] Lloyd's Rep IR 315*, heard in mid-June 2013, the Supreme Court has the opportunity to consider and perhaps jettison the hold harmless fiction, which forms the current basis of liability of insurers in indemnity policies. Although the fiction has little to recommend it, the implications of its removal for the ability of assureds to obtain damages for late payment by their insurers merit consideration.

The 'hold harmless' principle is a legal fiction which characterises an insurer's obligation as a promise to protect the assured from loss from an insured peril. But this is an obligation the insurer cannot fulfil: in reality, the insurer cannot prevent the occurrence of an insured peril (for example the sinking of a ship or a factory fire). The fiction also contradicts ordinary perceptions of the function of insurance (ie to compensate the assured for loss resulting from an insured event).

One consequence of the fiction (although not one which arises on the facts of *Teal* itself) is that an assured cannot recover damages for loss suffered because the insurer is slow in paying out under the policy. The leading case is *Sprung v Royal Insurance (UK) Ltd [1999] Lloyd's Rep IR 111*. Mr Sprung's business premises were wrecked by vandals, following which his insurers rejected his claim for property damage. He could not afford to repair the premises himself and ultimately went out of business. The insurer later abandoned its defence, but Mr Sprung's claim for damages for the intervening loss of value in the business was rejected (with "undisguised reluctance") by the Court of Appeal. Under the hold harmless fiction, an insurer's primary liability sounds in damages (for failure to protect against the insured peril) and English law does not recognise a cause of action in damages for late payment of damages (see *The Lips [1988] AC 395*).

The hold harmless fiction has been widely criticised as technical and unrealistic (it is also out of line with other common law jurisdictions). If it is to be replaced, a number of alternative bases of liability could be adopted (each, potentially, with different implications for claims for damages for late payment). The Law Commission has recommended that the fiction be replaced by an obligation on the insurer to pay valid claims.

On that approach, it seems likely that *Sprung*-type damages could be recovered, provided that the primary cause of action no longer sounded in damages (so as to avoid the rule in *The Lips*) and subject to the possible obstacle of section 67 Marine Insurance Act 1906 (see *The Italia Express (No.2) [1992] 2 Lloyd's Rep 281*). There would remain, however, issues to be considered.

As observed in *The Italia Express (No.2)*, it is as artificial to assume that an insurer can, instantaneously on the occurrence of loss, pay a valid claim as it is to assume that the insurer can prevent the loss from occurring. There is a risk of replacing one artificial fiction with another. An answer to this point (favoured by the Law Commission) could be to allow the insurer a reasonable time to consider a claim before the obligation to pay is triggered. While this may have practical merit, it introduces uncertainty, both in considering when a right to additional (*Sprung*-type) damages might arise and in identifying the date on which a cause of action accrues for limitation purposes.

Also, it is not axiomatic that an insurer that rejects a claim on reasonable grounds but is found liable under the policy after lengthy (and reasonably-conducted) litigation should be liable for losses suffered by the assured in the interim as a result of being out of pocket by the insurance amount. This would impose a potentially significant additional liability on the insurer, which (at least as the law currently stands) would not have accounted for that liability in setting the premium. It might also be said that a corporate assured could have obtained business interruption insurance for just such a loss.

Considerations such as these might militate in favour of founding the insurer's additional liability on breach of good faith rather than breach of contract (so that an insurer which acts reasonably and in good faith would not be exposed). However, as the law currently stands, there is no remedy of damages for breach of the duty of utmost good faith.

If the law is to be changed, the most likely replacement for the hold harmless fiction is a contractual duty to pay valid claims. This would open the way to potential claims for *Sprung*-type damages, limited only by causation and remoteness principles. To the extent that such claims arise in any numbers, assureds can expect to see the consequences reflected in the premiums they are asked to pay.

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