Principle of Indemnity

A review of the principle of indemnity in relation to property claims and consideration arising as a result of the judgement in Sartex Quilts & Textiles Ltd ("Sartex") v Endurance Corporation Capital Ltd ("Endurance") (2019).

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For those involved in the measurement of compensation, the concept of a fair and equitable settlement is one that will seek an outcome which provides a financial result ensuring that any entity suffering damage will be reimbursed, in whole and in equal measure, to the value of what has been lost.

This is the *principle of indemnity*, the bona fides of which are not in dispute as a doctrine and one that has been well established over the years in determining the level of payment due to an injured party following damage. In its purest form, the test of the principle is to place that party in the same financial position after the damage to that which had existed immediately prior to the event. No better or no worse.

The principle can be applied equally in relation to compensation payable under contract or statute as well as actions taken against wrongdoers in matters of tort and is certainly well established in cover provided under property insurance policies.

Lowry LCJ confirmed[1] that the cardinal legal principle to be applied in relation to compensation *"… Is that of "restitutio in integrum" which, loosely translated, means that the claimant is to be completely restored, so far as money can do it, to his former situation".*

In the context of insurance, the principle had been set out in ***Castellain v Preston***[2] establishing that *"the insurance policy Is a contract of indemnity and of indemnity only in which the insured shall be fully indemnified, but shall never be more than fully indemnified and if ever a proposition is put forward which is at variance with it then, such a proposition, must certainly be wrong.*

However, those practitioners involved in property claims appreciate that whilst in theory well principled, the calculation of an indemnity is not an exact science, a position recognised by Lord Wright in ***Maurice v Goldsborough***[3] and Lowry LCJ the latter indicating that *"The qualifying words "so far as money can do it," provide the key to the obvious fact that in practically all cases there is no such thing as perfect compensation".*

In the insurance contract, this commitment of providing an indemnity is set out within the **Insuring Clause** which will confirm an undertaking that the insurer will **"***indemnify the insured against loss or destruction or damage to the property".*

Typically, such a property loss will be measured as the cost of identical reinstatement less consideration for any betterment that might occur. This measure is acknowledged as the primary standard by which compensation is to be given to achieve a proper indemnity. When an indemnity has been agreed, the analogy of common law is applied that when compensation is paid, the use of the settlement monies becomes solely a matter for the recipient.

[1] ***O'Hanlon v Armagh C C [1973] NI***
[2] ***Castellain v Preston [1883]***
[3] ***Maurice v Goldsborough, Mort & Co Ltd [1939]***

Whilst within the insurance contract there is no specific or express direction around the concept of betterment, it has been accepted by the courts that such a financial contribution by an insured is a well-established and justified practice in measuring compensation in insurance claims.

However, this position is less likely to be accepted in an action in tort were there could be resistance to the notion that a wrongdoer should expect an injured party to be bound at all to any financial contribution.

To alleviate any potential financial loss following reinstatement caused by betterment, it is now common for insurance policies to provide by express terms an option enabling an insured to reinstate the property without any such reduction.

This *reinstatement option* is offered to the policyholder, subject to an undertaking that

1. *reinstatement commences and proceeds without unreasonable delay; and that*
2. *the cost of reinstatement has actually been incurred.*

Under such cover it is accepted that, if a property is restored to a condition similar to that which existed prior to the damage, then the actual cost of reinstatement in full is the appropriate indemnity without any further deduction. Otherwise, the policy will revert to a payment which reflects the standard measurement; the indemnity payable had the *reinstatement option* not applied.

It is also accepted[4] that a settlement on a reinstatement indemnity leaves it open for an insured to take advantage of the consequences of the damage to the property in making significant changes to what was already there, albeit within the financial parameters of the agreed settlement.

The courts have recognised that on some occasions, there will be circumstances when reinstatement may not be an appropriate measure of indemnity but, rather an alternative loss measurement, such

[4] ***Tonkin v UK Insurance Ltd [2006]***

as that based on an assessment of the overall value of the asset before and after damage. This is known as the diminution in market value (DMV).

However, it is important to recognise that such a method of assessment has to fully embrace the concept of value in regard to identifying the specific worth of the entire asset to the insured at that time. Particularly in relation to business properties, such valuations should not be a mere question of the "bricks and mortar" value but include an additional factor within the assessment for the future profit which would have been achieved from the loss of the activities carried out in the building. The valuation of such a property therefore, as a going concern, can often produce a measurement up to or indeed in excess of the total cost of the property replacement

This position was specifically addressed by O'Connor LJ[5] indicating that *"Inasmuch , as we are to put the owner of the thing destroyed, as far as money can, in a position as good as, and not better than, his position before its destruction, we have to ask ourselves what was the value of the thing, not merely its value in the abstract, but its value to its owner; and then we must try to put a money equivalent on such value***."**

In ***Leppard v Excess***[6] an unoccupied cottage, that had been purchased from a family member for £1,500 with a view to a later sale, was destroyed by fire. As a result, it was determined that the actual financial loss would not be based on the cost of the reinstatement of the cottage established at £8,694, but the loss of the actual market value at the time of damage. That value was established at £3,000 which was based on the anticipated likely sale value of the "bricks and mortar" without the need for any further special interest to be recognised.

This was due to the fact that the court considered that the loss value should reflect the facts pertaining at the time of the fire which included certain future events foreseeable at that date, namely that the owner's declared intent was to sell rather than reinstate and occupy.

[5] ***Heppenstall v Wicklow C C [1921]***
[6] ***Leppard v Excess Insurance Co Ltd [1979]***

Alternatively, in ***Reynolds v Phoenix***[7] the insured had purchased an old commercial building complex for £16,000 for use in the manufacture of animal feedstuffs. The buildings and machinery were insured for a total sum of £628,000. The buildings were subsequently seriously damaged, but the insurer only offered a market value settlement until reinstatement was carried out. The insured contended that as there was a genuine intention to reinstate, in such circumstance, the indemnity must be based on the cost of reinstatement irrespective as to the work being undertaken.

The court found in the insureds favour commenting on the general principles of indemnity that *"these are broad principles, i.e. not to enrich or impoverish. The difficulty lies in deciding whether the award of a particular sum amounts to enrichment or impoverishment. This question cannot depend, in my view, on an automatic or inevitable assumption that market value is the appropriate measure of the loss. Indeed, in many, perhaps most cases, market value seems singularly inept as its choice subsumes the proposition that the insured can be forced to go into the market (if there is one) and buy a replacement. To force an owner who is not a property dealer to accept market value if he has no desire to go to market seems a conclusion to which one should not easily arrive. The question of the proper measure of indemnity thus becomes a matter of fact and degree to be decided on the circumstances of each case."*

Furthermore, in Reynolds, the insurer argued that even if there was a genuine intention to reinstate with the insurance monies (but not the owners' money) such an intention would be unreasonable. This contention was rejected, the court indicating satisfaction *"that the plaintiffs do have the genuine intention to reinstate if given the insurance monies; that this is not a mere eccentricity but arises from the fact, as I find, that they will not be properly indemnified unless they are given the means to reinstate the building substantially as it was before the fire."*

[7] ***Reynolds & Anderson v Phoenix Ass Co & Others (1978)***

Therefore, the direction which evolved from the already decided cases was that an insureds prevailing interest and defined intentions in relation to the property at the time of the damage were important factors in determining the value of the loss.

Certainly, if there was at the time of damage an intention to sell a property which had never been in beneficial occupation then DMV could be regarded as an appropriate basis to determine the loss. However, this would be less likely to be appropriate when the property was in, or was intended for, beneficial occupation when damaged and that there was every reasonable expectation that the insured would continue to have the option to enjoy such a beneficial use.

Such a beneficial occupation would apply in connection with residential premises which are owner occupied. Insurers accept that an owner occupier of residential property is not indemnified by the payment of a market value set lower than the cost of reinstatement. Whilst an established position in connection with occupied residences, in ***Newcastle v Broxtone***,[8] the reinstatement cost was also held to be the measure of indemnity for the destruction of an uninhabited castle, once more reflecting its unique value to the owner.

Similar considerations can be applied to commercial property in use for the operation of a functional business. In such circumstances, there is clearly a specific beneficial interest on the part of the business as a going concern which could well be such as to warrant compensation based on a reinstatement indemnity.

The Sartex action related to a commercial fire which occurred in May 2011 at the plaintiffs Crossfield Works in Rochdale. The fire caused serious damage to the factory premises severely damaging the building and destroying all machinery and plant.

[8] ***Duke of Newcastle v Broxtowe (1832)***

The Sartex business had initially been formed in 1979 by a partnership manufacturing home textiles. In 1984, the partnership purchased the Crossfield Works to where production was transferred. In 1992 the business was incorporated and Sartex was established as a corporate trading entity.

By way of a subsequent agreement, the original partners arranged that Sartex could use the Crossfield factory rent-free but taking responsibility for the insurance of the property and an obligation to maintain the property at all times in a good state of repair.

As the business developed, larger premises were purchased to which production was moved leaving the Crossfield Works mainly as a storage facility. However, the business then explored the feasibility of a new production line which indeed was established at Crossfield in 2010. At this time insurance cover was placed with Endurance in relation to the buildings, machinery and plant. Business interruption cover was also provided by Endurance for any profit lost resulting from damage over a 12-month period.

It was this production facility which was destroyed in the fire which took place in May 2011, resulting in a complete cessation of production activities from the site.

In the years following the fire, Sartex had explored various options in relation to their fire recovery plans for the Crosssfield Works within their business. These included like-for-like replacement as well as other alternative development opportunities on site and also the possibility of reinstating by way of the acquisition of a textile manufacturing business in Pakistan.

The evidence provided by Sartex to the court was that none of these options had been developed into a feasible business proposition and that the intention was now to belatedly reinstate the Crossfield factory and resume production.

Endurance had initially indicated a willingness to settle the claim under the policy on a reinstatement basis, reflecting the terms of the *reinstatement option* applicable to the policy. However, within the express terms of the policy this option had subsequently been lost to Sartex.

The insurer therefore indicated in late 2012 that, as Sartex had not demonstrated a genuine, fixed and settled intention to reinstate, the policy indemnity available would be limited to a measurement based on DMV. Endurance duly made such a payment under the policy in the sum of **£2,141,527** which fell short of the full reinstatement indemnity value measured at **£3,492,041.** Details were not provided within the judgement as to the basis by which the DMV was assessed.

It should be noted that this proposed reinstatement value did not represent the total cost of reinstating the property, due to a significant level of under insurance established after the damage, but only the reduced sum which would be payable under the insurance policy as a consequence of the underinsurance. Indeed, this fact lead to a separate action by Sartex against their insurance intermediary which was only settled in September 2016 in the overall sum of £1,000,000.

Sartex did not accept the measurement of indemnity offered by Endurance. Whilst acknowledging that the opportunity of an indemnity within the terms of the *reinstatement option* had been lost, reverting back to a standard indemnity measurement, they maintained that such an indemnity should still be based on the cost of reinstatement, leaving them free to consider all available options including reinstatement.

Sartex submitted that the question of what was intended after the loss was only relevant in rare instances such as, at the time of damage, there was a clear intention to sell the property or to cease trading when an alternative basis, such as DMV might be appropriate. However, this was not in the opinion of Sartex, one such exceptional case.

For their part, Endurance sought to rely on the Court of Appeal decision in **Great Lakes Reinsurance**[9] arguing to the contrary that in that judgement there was a requirement for a genuine intention on the part of the insured to reinstate, in the absence of which, a market value settlement was appropriate.

In the Great Lakes case, the insured owned former commercial premises which had been granted planning permission to convert to residential flats. However, the size of the development was restricted by the listed status of the property and, as a consequence, it had not been economic to continue with the development. Subsequently, a fire took place destroying the building as a result of which the listed status was revoked. The market value of the building before the fire was £75,000 and afterwards (following delisting) £500,000. To reinstate would cost £2,121,800.

However, the court disagreed with Endurance on this issue indicating that it did not read the Great Lakes judgement as indicating that an indemnity on a reinstatement basis could not be given if the reinstatement works were not carried out. Rather, the court noted that the Great Lakes judgement confirmed that "*where the insured is the owner of the property the indemnity is to be assessed by reference to the value of the property to the insured at the time of the peril. In many, perhaps most, cases of damage or destruction the insured's loss is the cost of reinstatement although that may not be the case if, for instance, the insured was trying to sell the property at the time of the loss.*"

The relevant question for the court to ask, in consideration of all the facts was, what is the loss which has been suffered by the insured as a result of the fire and what measure of indemnity fairly and fully indemnifies it for that loss. Subsequent events may support that a reinstatement measure might be seen to overcompensate the insured, but any final determination will depend on the circumstances of each case.

[9] ***Great Lakes Reinsurance (UK) v Western Trading Ltd (2016)***

It was noted by the court that Sartex had not immediately taken up the reinstatement option available under their policy. Endurance had argued that, as reinstatement had not taken place, Sartex had failed that test of commitment. The court disagreed and accepted the evidence of Sartex that whilst some considerable time had passed since the date of the fire without reinstatement taking place, this was entirely due to the fact that the business had spent that time exploring alternative options none of which, in the round, had been identified as a viable option against reinstatement in similar form.

In hearing the evidence, the court concluded that it was appropriate to award Sartex an indemnity on the reinstatement basis. This recognised the circumstances, including all of the events before and after the fire and up to and including the trial. It will be noted that this was a similar outcome on the part of the court in relation to the Reynolds case.

Furthermore, whilst accepting that betterment would normally be an inherent element of the indemnity principle, the court considered that the onus was on Endurance to identify and justify any particular reduction they considered should be made. In the view of the court, Endurance had not done so and consequently, no reduction for betterment was allowed.

So, what can be taken from the Sartex case? It is clear that in arriving at the decision, the court has followed the conventions already set out in regard to indemnity compensation for property claims in line with the previously decided cases.

That will be fundamentally a recognition that whilst each and every case will be judged on the prevailing facts, the likelihood is that compensation will be measured on the standard measurement of reinstatement less betterment. Any reliance on an alternative measurement will only be supported if it displays a proposition which is deemed to better reflect the actual financial loss incurred given the extent of any beneficial interest enjoyed by the injured party at the time of the loss. The most likely alternative measurement is DMV and again, it is probable that any such basis of indemnity will only be considered appropriate in exceptional cases.

Certainly, it did seem that Sartex enjoyed a beneficial interest as a going concern operating from the damaged premises at the time of the fire, with no intent in the foreseeable future for that position to change.

Indeed, it is noted that in 2013, Endurance agreed a settlement with Sartex in relation to the business interruption cover which extended to provide an indemnity for the gross profit lost by the business during the period insured i.e. 12 months immediately following the fire. It would have been expected that such a payment would have been resisted if the insurer was not satisfied that production would not have continued from this factory throughout that period, but for the fire. In addition, the fact that a separate payment for loss of profit was made by Endurance might infer that the insurers DMV assessment did not fully provide for the beneficial value of the building.

Also, although not specifically raised in the judgement, as recognised in the Reynolds case it does seem a reasonable position that Sartex would not have desired to immediately commit their own funds to the total cost of reinstatement, particularly bearing in mind the significant level of under insurance which existed, until the full level of compensation available for the reinstatement had been established, including the secondary action against the broker.

In such circumstances, Sartex could further have justified the time spent by them exploring every possible option available to the business until compensation had been established thereby, at that time, giving them the means to reinstate.

In general, the danger for compensators is that, in considering indemnity, a view is taken that DMV is the automatic default measurement in circumstances were reinstatement has not taken place or where they opine that there is no clear genuine, fixed and settled intention so to do.

That is not the position and indeed there is a strong case for adopting a stance that DMV should only be recognised as appropriate when there has been a clear and unequivocal declaration of intent on the part of the owners that reinstatement will not be carried out.

The outcome of the action appears therefore, to have placed Sartex in a position where their beneficial interest in the property has been properly indemnified, particularly given the possibility of an ongoing financial impact from the loss of the production facility.

To that extent, the Sartex decision reaffirms the position of indemnity based on reinstatement to be awarded in circumstances were reinstatement has been carried out or an intention to reinstate is reasonably justified and is not a mere eccentricity on the part of the owners.

Whilst the strength of that evidence of intent might well be subject to the facts around each particular case, DMV should not be seen as an automatic alternative, given that it is very likely that those with a beneficial interest, at the time of the damage in relation to the subject property, will be in a favoured position to succeed in establishing a reinstatement indemnity.

The question of the proper measurement of indemnity will always remain a matter of fact and degree based on the particular circumstances arising. Inevitably, the principles of indemnity will continue to be tested by the vagaries of a negotiating path taken between the parties in the interpretation of the facts and towards seeking a particular settlement outcome.

However, there is every reason to take comfort that, for their part, the courts will continue to maintain a consistent view in relation to those key principles in achieving a fair and reasonable indemnity. That is to ensure that there is a proper recognition as to the absolute value of the damaged property and that the injured party is restored to the same beneficial position as that which had existed at the time of damage. No better or no worse.

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