

# Insurance & Reinsurance

## Law Briefing

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## Direct action against P&I clubs

**In spite of the Third Parties (Rights Against Insurers) Act 1930, direct action against marine P&I insurers is generally considered unavailable under a House of Lords judgment from 1990. A Law Commission report in 2001 expressed doubts about the validity of the rule and several conventions restricting its application have been ratified by the UK government. This possibly outdated rule, by-passed by developments and possibly counterproductive, certainly deserves a closer look, particularly in the delicately balanced and commercially crucial maritime sector.**

### Background

Under the Third Parties (Rights Against Insurers) Act 1930, the rights of an insolvent assured transfer to the injured third party, creating a right to claim directly against the insurer. The original intention behind the Act was to prevent the situation whereby insolvent assureds created insurance liabilities, whereupon the indemnity would be absorbed by *pari passu* creditors rather than be allocated as a whole to the injured third party. Its enactment was specifically designed to supplement the compulsory motor insurance provisions introduced by the Road

Traffic Act 1930 as a response to the advent of mass motorism. While the 1930 Act was soon superseded for that purpose by specific legislation (Road Traffic Act 1934, which remains more or less in that form in ss.151–152 of the Road Traffic Act 1988), the Act remains applicable to other types of insurance.

Shipowners commonly rely on mutual assurance societies, Protection and Indemnity Clubs (P&I Clubs) as their main source of cover for third party liabilities. Club Rules (deemed to be an insurance policy in *The Allobrogia* [1978] 3 All E.R. 423; [1979] 1 Lloyd's Rep. 190: although the judge was not seeking to make a general statement, it is now generally accepted to be the rule) usually contain a "pay first" or "pay-to-be-paid" clause (e.g. Rule 5A, UK P&I Club Rules 2003, and Rule 18 (i), Steamship Club Rules 2004/2005), to prevent that the P&I Club is placed in a position of paying for liabilities for which the member has not itself paid (application of the Contracts (Rights of Third Parties) Act 1999 is generally excluded by P&I Club Rules—by way of example see the London P&I Club Rules 2006–2007, para.23.3.3). The purpose of "pay first" clauses is clear in the context of the early mutual insurance societies relying on the individual finances of small shipowning companies, where each shipowner relied on the others to remain solvent and to honour its liabilities. Although today, P&I Clubs are incorporated just as any other insurer, "pay first" clauses are still perceived to be valuable in the context of an industry where a single accident may result in vast claims. Whether reliance on such

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terms as an indirect method of preserving solvency is an appropriate alternative to improved assessment of risks is a different question.

## The Fanti and The Padre Island—the reasoning

In the joined cases *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)* and *The Padre Island* [1991] 2 A.C. 1; [1990] 3 W.L.R. 78; [1990] 2 All E.R. 705; [1990] 2 Lloyd's Rep. 191 two cargo claimants had suffered loss or damage to cargo and attempted to sue the shipowners' liability insurers, the P&I Clubs, under the Third Parties (Rights Against Insurers) Act 1930. The P&I Club Rules contained a "pay first" clause. At first instance, the two leading shipping judges Saville J. (in *Socony Mobil Oil Co Inc v West of England Shipowners Mutual Insurance Association (London) Ltd (The Padre Island)* (No.2) [1987] 2 Lloyd's Rep. 529) and Staughton J. (in *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The Fanti)* [1987] 2 Lloyd's Rep. 299) gave judgment for the Clubs and the cargo interests respectively, whereupon the cases were joined. The Court of Appeal ([1989] 1 Lloyd's Rep. 239) agreed with cargo interests, but the House of Lords held that cargo interests had no right of direct action against P&I insurers (all Law Lords agreeing with the speech of Lord Brandon).

The House of Lords first held that the "pay first" clause constituted an explicit contractual agreement that there was nothing to transfer to a third party. Immediately before the insolvency, the entitlement of the shipowner under the contract of insurance did not include third-party liabilities that had accrued but which the shipowner had not discharged by paying the third party. There was thus no entitlement under the insurance capable of transfer, or at best a contingent entitlement predicated upon a condition precedent to "pay first". The Court of Appeal had come to the opposite conclusion on this point, saying that "the contrary conclusion would mean, subject to any argument under s.1(3) of the Act, that any liability insurer could drive a coach and horses through the Act by the simple device of incorporating a pay to be paid clause even if, in the case of a solvent insured, he did not always insist upon its performance" (as per the speech of Stuart-Smith L.J., at p.259).

A second argument, under s.1(3) of the Act was that a "pay first" clause had the effect of altering the rights of the assured in the case of insolvency and therefore fell under s.1(3) of the Third Parties Act, which provides that "insofar as any contract of insurance [...] purports, whether directly or indirectly, to avoid the contract or to alter the rights of the parties thereunder upon the happening to the assured of [an insolvency event], the contract shall be of no effect". None of the courts were particularly impressed with this argument, holding (with the exception of Staughton J., who (at p.307) said that "the combined effect of the Act and the rules is that the third party must pay himself before he can claim against the association, and that is something he cannot do") that the clause did not purport to alter the insurance contract in case of insolvency of the shipowner; the fact that the opportunity to exercise the rights was lost if the shipowner could not effect payment was a different matter (e.g. Lord Brandon at p.197). Since the clause applied throughout the life of the contract, the reference in s.1(3) to the insolvency event could not be fulfilled.

Thirdly, the House of Lords held that any rights that were to be transferred to a third party must be transferred together with the obligations coupled with those rights. In other words, in the case of insolvency of the assured shipowner, the pay first clause prevented a third party from recovering directly from the P&I Club, because the condition precedent to recovering any indemnity is that payment has first been made to the third party. The rights in this respect of the shipowner under the insurance were transferred to the third party, but they were transferred along with the condition precedent of "paying first". The opposite outcome would have meant that the rights transferred to the third party would be greater than those that the shipowner possessed at the time of the insolvency. The third party, having suffered the loss, would therefore technically have to indemnify himself (an impossibility) before he could recover. The Court of Appeal had considered that although the rights transferred were contingent on having fulfilled the condition of prior payment, the condition was impossible to perform (or "futile") and therefore should be disregarded. The first and third arguments are superficially similar but are fundamentally different in perspective. The key to the first argument is



the rights of the member, while the third focuses on the rights of the third party.

## The Fanti and The Padre Island and the shipping economy

While Lord Brandon provided the formal analysis of the arguments in a speech with which all other judges agreed, the speech of Lord Goff in a way sheds a great deal more light, although only Lord Ackner agreed with it (*The Fanti and The Padre Island* [1991] 2 A.C. 1; [1990] 2 Lloyd's Rep. 191; most of what is noted below refers to p.204). Lord Goff's speech was not so much designed to dissent as to provide further clarification.

Common to both speeches is an emphasis of the realities of the shipping sector. Lord Brandon commences with an overview of the background, modalities and importance of P&I insurance (at p.194, col.1). Lord Goff similarly notes several peculiarities of the shipping industry throughout his speech. The fact that P&I Club members are also the directors and financiers of the P&I insurers is mentioned at crucial junctures in the judgment. A first conclusion must therefore be that it is the shipping industry that is being discussed, rather than some universal rule.

The second point to take away from Lord Goff's speech relates to the type of loss concerned. The claims in both the joined cases had their origins in cargo claims. Lord Goff pointed out that such losses are more often than not covered by separate cargo insurance and that there was no particular reason why P&I insurance should provide alternative protection to cargo interests.

On the other hand, in relation to death or personal injury claims which are perhaps more likely to be uninsured, Lord Goff observed that the House had been informed that P&I Clubs as a rule made payment on such claims, irrespective of whether the member had complied with any "pay first" clause. He pointed out that it was in the interests of the shipping industry that this practice should continue.

Lord Goff also issued a stern warning to "other liability insurers" who might contemplate employing a "pay first" clause defence, cautioning that unless this practise continued to be observed, and if more widespread use of "pay first" clauses were observed, it would be desirable for the legislator to take action.

In sum, the defence of "pay first" clauses is understood not to be available to non-mutual (by which we must understand insurers with external shareholder interests other than member interests in the background) or non-marine insurers, and its continued availability is to be conditional upon faithful payment of death and personal injury damage.

## Charter Reinsurance v Fagan

The peculiarity of *The Fanti and The Padre Island* was underlined by another House of Lords case, *Charter Reinsurance v Fagan* [1997] A.C. 313; [1996] 2 Lloyd's Rep. 113. The reinsurer (Fagan) declined to indemnify the direct insurer, arguing that the reinsurance contract contained a "sums actually paid" clause which meant that the reinsured (Charter Re) could only recover from the reinsurer once all claims had been settled, so that it was fully known to what extent recovery through subrogation or other benefits off-set the claim made. Lord Mustill initially conceded that "sums actually paid" at first glance appeared to have an evident ordinary meaning, but then went on to interpret the real meaning of "actually", in the market context, as being "when finally ascertained" and of "paid" to be "exposed to liability as a result of loss insured".

The case concerns reinsurance and not liability insurance (whether reinsurance is to be regarded as a form of liability insurance remains a thorny question; see the judgment of Sedley L.J. in *WASA International Insurance Co Ltd v Lexington Insurance Co* [2008] EWCA Civ 150), and the Third Parties Act did not come into play—however the question of the interpretation of "pay first" clauses is common to both cases. It is striking that in *Charter Re v Fagan* as well as in *The Fanti and The Padre Island*, the House of Lords paid significant attention to practice in the respective markets.

On a theoretical level, the two cases contradict each other. Two insurers (albeit one Lloyd's reinsurance syndicate and one P&I Club) used clauses intended to have similar effects, whereby the insurer was protected from claims until such time as the insured had incurred a verifiable expense or liability to be indemnified. It appears however that the *sens moral* of *Charter Re v Fagan* is that courts will happily depart from the evident and ordinary meaning of words—any words—to ensure that "sums actually



paid” or “pay to be paid” or “pay first” clauses are made ineffective. In *The Fanti and The Padre Island*, the House of Lords created an exception from that rule—although the exception in the event arrived before the rule. That is the context in which the comment of Stuart Smith L.J. about the coach and horses must be seen.

## Later developments

A recent case, *Markel International Co Ltd v PMM Craft* [2006] EWHC 3150 (Comm); [2007] Lloyd's Rep. I.R. 403, appears to evidence just such a development as Lord Goff cautioned against. In *Markel*, the marine insurers declined to indemnify the family of Mr Craft, an oil rig worker, upon his death, and were consequently sued in Tunisia. Article 26 of the Tunisian Insurance Code is said to provide for direct action against insurers in such a case. The judgment deals with the insurers' request for an anti-suit injunction against the family, sought to protect the London arbitration commenced by insurers against the insured under the policy (the application was refused, Morison J. relying heavily on *Through Transport Mutual Insurance Association (Eurasia) Ltd v New India Assurance Co Ltd (The Hari Bhum)* (No.1) [2005] 1 Lloyd's Rep. 67) and is therefore not terribly informative about the arguments on the substantive case; nor indeed about the assured shipowner. It is not entirely clear from the judgment who the assured was, let alone if they were insolvent or what was otherwise their reason for not paying an indemnity to the Craft family. Importantly however, the judgment tantalisingly lists a “pay-to-be-paid” clause contained in the contract among the insurers' defences in the arbitration, at para.23.

However, whereas *The Hari Bhum* concerned a missing container, *Markel* was about a claim for liability in connection with the death of a person. In addition to the warranty and seaworthiness defences, the insurers apparently also made the point that the policy contained a “pay first” clause. Furthermore—and this may well be a matter of greater complexity than a superficial glance at the company's website can resolve—Markel International does not appear to be a mutual, in the sense of a member-owned and managed insurer, but a regular, incorporated one. Therefore, while Lord Brandon's statement of the law does cover the point, they do fall foul of the

playground rules laid down by Lord Goff in invoking the “pay first” clause.

Unfortunately, the arbitration award is not likely to come into the public domain—nor are we likely to learn much about the Tunisian court proceedings. The insurance policy contained an arbitration clause and the exact substance of Markel's argument or the reasoning of the arbitrator, if any, is therefore not a matter of public knowledge. According to the judgment in *Markel v Craft* award was made on October 12, 2006, discharging Markel from liability against the shipowners. It is not known which of the defences mentioned in the judgment was the successful one. There remains the intriguing thought that an incorporated marine insurer appears to have sought to rely on a “pay first” clause to reject a claim for personal injury or death.

They are of course entirely within their rights to do so—the judgment of Lord Goff was a minority judgment subscribed to by only one other Law Lord, whereas the judgment of Lord Brandon—which did not mention the two preconditions posited by Lord Goff but dwelt only on the technical arguments on the Third Parties (Rights Against Insurers) Act 1930—was subscribed to by all five Law Lords.

## Law Commission Report of 2001

Direct action is not one of the many issues considered in the current reform process of the Law Commission. However, in the 2001 report on the Third Parties Act, the Law Commission did propose reform in connection with claims for death and personal injury (LC 272). The Law Commission's deference to the peculiarities of the marine market was evident; however, doubt was expressed as to the validity of the approach of the House of Lords in *The Fanti and The Padre Island*, the Law Commission preferring the approach of the Court of Appeal (citing at para.5.35 the colourful observation of Stuart-Smith L.J. in the Court of Appeal, at FN 9 above). Nevertheless, apparently reluctantly but with reference to ongoing developments at the international level in the field of direct action against marine insurers, the Law Commission went no further than to propose a codification of what was understood to be the practice of P&I Clubs—payment on death and personal injury claims (see especially para.5.37).



Developments at international level were noted with apparent satisfaction:

"The IMO has already developed liability regimes for oil and other spills (see the 1969 Civil Liability Convention, the 1971 Fund Convention and the 1996 Hazardous Noxious Substances Convention). These are incorporated into UK law in the Merchant Shipping Act 1995 which contains its own regime for direct action by a third party against an insurer (see s 165, which excludes the operation of the 1930 Act)." (LC272, FN 54)

In spite of the report, so far the Act does not appear to occupy a central place in the mind of the legislator—none of the several proposals (marine or otherwise) of the Law Commission have been implemented.

## Direct action

Interestingly, Lord Goff in his speech also distinguished between compulsory insurance and non-mandatory liability insurance, saying that where the legislator requires compulsory liability insurance, it also provides for direct action in provisions specifically designed to override any "pay first" clauses and citing the Road Traffic Act 1988 and the Employers' Liability (Compulsory Insurance) General Regulations 1971, made pursuant to the Employers' Liability (Compulsory Insurance) Act 1969 (For further examples, see Merkin and Hjalmarsson, *Compendium of Insurance Law*, Chapter 6). He made the point that shipowners have not generally been required to possess compulsory insurance: "Parliament has not generally required (apart from special cases, such as the Merchant Shipping (Oil Pollution) Act 1971) that shipowners should be compulsorily insured against liability to third parties." The Merchant Shipping (Oil Pollution) Act 1971 was of course the vehicle transposing the International Convention on Civil Liability for Oil Pollution Damage 1969 (CLC 1969).

In the time since Lord Goff's statement, direct action has in fact been a strong trend in maritime conventions, especially with respect to pollution. Provisions to the effect of outlawing pay-to-be-paid clauses, combined with a compulsory insurance requirement, much like in the original CLC Convention, have recently featured in a number of conventions—the Protocol of 2002 to the Athens

Convention relating to Carriage of Passengers and their Luggage by Sea 1974 (inserting an art.4bis in the Athens Convention. Paragraph 10 of the article provides for direct action against insurers), the International Convention on Liability and Compensation for Damage in Connection with Hazardous and Noxious Substances by Sea 1996 (the HNS Convention will come into force pursuant to order by her Majesty in Council pursuant to s.182B of the Merchant Shipping Act 1995 as amended by the Merchant Shipping and Maritime Security Act 1997, or at the latest when the Convention does—it requires twelve ratifications and currently has ten as at March 27, 2008. In general, the Merchant Shipping Act 1995 foresees implementation of Convention provisions on compulsory insurance by regulations of Secretary of State, issued pursuant to Merchant Shipping Act 1995 s.192A, inserted by the Merchant Shipping and Maritime Security Act 1997), the International Convention on Civil Liability for Bunker Oil Pollution Damage 2001 (The Merchant Shipping (Oil Pollution) (Bunkers Convention) Regulations 2006 SI 2006/1244) and the International Convention on the Removal of Wrecks 2007 (adopted at a Diplomatic Conference in Nairobi in May, 2007).

None of these are currently in force, although the Bunkers Convention will enter into force on November 21, 2008. The HNS Convention and the Bunkers Convention have both been ratified by the United Kingdom. The Athens Convention is in force and has been ratified by the United Kingdom, unlike its 2002 Protocol which currently has a grand total of four ratifications (as at March 27, 2008). The feature appears to have become a rule in modern pollution conventions (See Røsæg, E., *Compulsory Maritime Insurance*, Scandinavian Institute of Maritime Law Yearbook 2000 (258) pp.179–205).

## Effect in practice

What is the relevance of these new conventions? One way to assess their importance is to look at the proportion of total P&I Club claims to which they relate (the author is grateful to Captain Richard Pille, Senior Visiting Research Fellow at the Institute of Maritime Law, University of Southampton for the figures provided in this segment. The figures given are a compiled average showing trends). The largest proportion, 39 per cent, of P&I Club claims



consists of claims for loss of or damage to cargo, with general average topping up the total to 41 per cent for cargo related losses. This large proportion is of course unaffected by any current conventions providing for direct action, and there is no indication of any movement to institute direct action for these—although of course P&I Clubs may feel the effects of the direct action provisions available in many other jurisdictions as demonstrated by cases like the *Hari Bhum* (above), where the cargo owner was ultimately able to recover pursuant to the Finnish Insurance Contracts Act s.67.

*The Fanti and The Padre Island* instruction to pay on personal injury claims ensures that these are the second largest group of claims at 31 per cent, which breaks down to 23 per cent for crew and 8 per cent for other persons, including passengers. Collisions represent 10 per cent of the total with damage to fixed and floating objects representing another 8 per cent. Pollution claims currently total 5 per cent of claims, but this may be set to increase with the entry into force of the agreed conventions. Wreck removal, currently a minor group of claims at 1 per cent, could gain an increased share of the total if the Wreck Removal Convention is implemented.

## UK implementation

Implementation of these Conventions in the United Kingdom will ordinarily take place through amendment of the Merchant Shipping Act 1995.

Section 165 of the Merchant Shipping Act provides for direct action against the insurer in the case of oil pollution liabilities arising under the CLC Convention. The provision was first enacted in near-identical form in the Merchant Shipping (Oil Pollution) Act 1971, the Act that provided for the enforcement of the CLC Convention. The defence of wilful misconduct on the part of the shipowner is retained for the insurers, and so is any limitation of liability from which the shipowner may benefit.

The final sub-section of the provision excludes the application of the Third Parties (Rights against Insurers) Act 1930. It appears that the purpose of the provision is to exclude the application of the Act as interpreted in *Post Office v Norwich Union Fire Insurance Society* [1967] 2 Q.B. 363; [1967] 2 W.L.R. 709; [1967] 1 All E.R. 577; [1967] 1 Lloyd's Rep.

216. That case requires the assured's liability to be established by judgment, award or agreement before the Act can be used against the insurer. Doubt has been expressed by Clarke, M. in the *Law of Insurance Contracts* at paras 5–8 at FN 286 and by Lord Mance in *Insolvency at Sea*, [1995] LMLCQ 34 at pp.39–40 as to whether this was in fact the intention of the legislator.

Whatever the purpose of the provision was in 1971, it is now largely without meaning, since the effect of the House of Lords ruling in *The Fanti and The Padre Island* was to confirm that the Act, if applicable, is not effective in the context of P&I insurance. If the intention behind the provision was to achieve added security for the assured, the effect appears to be the opposite—s.2 of the Third Parties Act provides further provisions of a procedural nature which may feasibly be of assistance. The third party notably has a right to obtain information from the insurer to help determine whether he has a right to an indemnity (it was determined in *Re OT Computers* [2004] EWCA Civ 653; [2004] Ch. 317; [2004] 3 W.L.R. 886; [2004] 2 All E.R. (Comm) 331; [2004] 2 B.C.L.C. 682; [2004] 2 C.L.C. 863; [2004] B.P.I.R. 932; [2004] Lloyd's Rep. I.R. 669 that the third party has such a right even before the liability has been established, overruling the earlier cases *Upchurch Associates v Aldridge Estates Investment Co Ltd* [1993] 1 Lloyd's Rep. 535 and *Woolwich Building Society v Taylor* [1995] 1 B.C.L.C. 132. The ruling is consistent with the recommendations of the Law Commissions in *Third Parties – Rights Against Insurers*, LC 272, esp. at para.4.23). This essential preliminary to a third party claim appears not to have been catered for in relation to direct action under s.165 of the Merchant Shipping Act 1995, neither for solvent nor for insolvent insurers. The same observation applies to legislation enacted later to implement other conventions.

The International Convention on Civil Liability for Bunker Oil Pollution Damage 2001, (the Bunker Oil Pollution Convention) (See further on the Bunker Oil Pollution Convention Tsimplis, M., *The Bunker Pollution Convention 2001: completing and harmonizing the liability regime for oil pollution from ships?* [2005] LMCLQ 83) is implemented for UK purposes by amendment and addition to the same provisions in the Merchant Shipping Act. A new



s.163A is added providing for compulsory insurance and s.165 is amended with the lightest touch possible to provide for direct action against insurers. These provisions are set to come into force on the day the Bunker Oil Pollution Convention comes into force for the United Kingdom. The United Kingdom ratified the Convention on June 29, 2006. It will enter into force on November 21, 2008.

## Conclusion

Compared to some jurisdictions, it is rare in England and Wales to see judgments based on public policy. It is rather amusing that when one should come along, it is one that serves to protect the shipping and insurance industries. However, in light of subsequent developments, perhaps the protection afforded through *The Fanti* and *The Padre Island* is no longer necessary.

While English law is being circumvented by service abroad, as in the cases *The Hari Bhum* and *Markel v Craft*, the freedom granted to P&I Clubs by the House of Lords in *The Fanti* and *The Padre Island* is looking increasingly circumscribed by the various conventions agreed, incorporating provisions on compulsory insurance and direct action against insurers. Rather than legislate piecemeal for each convention, the legislator may eventually find it preferable to stipulate by enacted law that direct action is generally available also against P&I Clubs, overriding *The Fanti* and *The Padre Island* for the purpose of particular types of liabilities, in order to guarantee the rights afforded to victims of accidents at sea by those conventions.

If the view is that the freedom provided by *The Fanti* and *The Padre Island* is being abused and that such abuse is now such that it should be curbed, the legislator is not to be envied. It must be almost impossible to arrive at legislation capable of making the fine distinctions asserted by Lord Goff in his speech. As a result, legislation must inevitably make the same rule for P&I Clubs as for non-marine non-mutuals.

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## Pratt v Aigaion Insurance Co, March 14, 2008, QBD (Admlty)

In judging for the defendant, the court found that the natural and literal meaning of a condition in a policy of marine insurance was that the owner or the owner's experienced skipper had to be on board and in charge at all times, subject to a qualification for emergencies rendering his departure necessary or temporary departures necessary for the purpose of performing crewing duties or other related activities.

## Dunlop Haywards (DHL) Ltd (formerly Dunlop Heywood Lorenz Ltd) v Erinaceous Insurance Services Ltd (formerly Hanover Park Commercial Ltd) April 01, 2008, QBD (Comm)

In refusing the application, it was held that the court had jurisdiction to order a person to be added as a new party under CPR r.19.2(2) notwithstanding that neither the applicant nor any other party to the proceedings was in a position to assert a claim against them.

## Walloon Government v Flemish Government (C-212/06) April 01, 2008, ECJ (Grand Chamber)

A care insurance scheme such as the one established by the Flemish Community fell within the scope *ratione materiae* of Regulation No 1408/71, and Community law precluded a system where access to benefits under the Flemish care insurance was unequivocally dependent on residence in the Dutch-speaking region or the bilingual region of Brussels-Capital, irrespective of the category of claimant.

## DG Competition Consultation Paper

A Commission of the European Communities consultation on the functioning of the Insurance Block Exemption Regulation (BER) examines how the BER is being used and its impact on the various insurance markets in the European Union. The BER applies art.81(3) of the EC Treaty which exempts from the Commission's ban on restrictive business practices certain co-operation agreements between insurance companies. The results of the consultation will be used to determine whether to renew the BER